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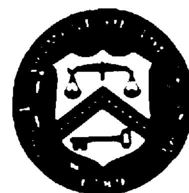
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 3, 1982

RESULTS OF AUCTION OF 10-YEAR NOTES

The Department of the Treasury has accepted $ 2,500 million of $ 6,344 million of tenders received from the public for the 10-year notes, Series A-1992, auctioned today. The notes will be issued February 16, 1982, and mature February 15, 1992.

The interest coupon rate on the notes will be 14-5/8%. The range of accepted competitive bids, and the corresponding prices at the 14-5/8% coupon rate are as follows:

	Bids	Prices
Lowest yield	14.60% 1/	100.129
Highest yield	14.72%	99.511
Average yield	14.68%	99.716

Tenders at the high yield were allotted 32%.

TENDERS RECEIVED AND ACCEPTED (In thousands)

Location	Received	Accepted
Boston	$ 28,347	$ 13,667
New York	5,266,184	2,060,404
Philadelphia	16,900	12,900
Cleveland	29,974	14,574
Richmond	27,338	12,978
Atlanta	15,565	13,829
Chicago	508,339	177,999
St. Louis	46,186	37,326
Minneapolis	16,548	16,548
Kansas City	22,980	22,310
Dallas	18,613	16,613
San Francisco	345,348	99,628
Treasury	1,523	1,513
Totals	$6,343,845	$2,500,289

The $2,500 million of accepted tenders includes $417 million of noncompetitive tenders and $2,083 million of competitive tenders from private investors.

In addition to the $2,500 million of tenders accepted in the auction process, $100 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities, and $200 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

1/ Excepting 1 tender of $10,000.

R-601

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
February 4, 1982

CONTACT: George G. Ross
(202) 566-2041

TREASURY ANNOUNCES SECOND PUBLIC MEETING ON
MODEL INCOME TAX TREATY

The Treasury Department today announced that a second public meeting will be held on March 9, 1982 in Room 4121 of Main Treasury at 1:30 p.m. to discuss the provisions of Article 16 (Limitation on Benefits) of the draft U.S. Model Income Tax Treaty, released on June 16, 1981. The second public meeting is occasioned by the weather and transportation difficulties in the Washington, D.C. area on January 14, 1982 the date the first public meeting was held, which prevented a number of interested persons from attending that meeting.

As discussed in the original announcement (attached), the purpose of the public meeting is to discuss specific provisions which might be used in Article 16 to assure that source basis tax benefits provided by a U.S. income tax treaty are not obtained improperly by residents of third countries, as well as the administration of such a provision. It is not the purpose of the public meeting to discuss Treasury's policy of including a limitation of benefits article in all tax treaties, but Treasury welcomes written comments on this policy.

In the Discussion Draft released with the original announcement, the word "or" should be inserted between clause (i) and clause (ii) of subparagraph e) of paragraph 2.

Those intending to attend the March 9, 1982 meeting are requested to so advise A. W. Granwell, International Tax Counsel, Main Treasury Building, Washington, D.C. 20220 by March 2, 1982. Written comments should also be addressed to Mr. Granwell.

R-602

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
December 23, 1981

CONTACT: George G. Ross
202/566-2041

TREASURY ANNOUNCES PUBLIC MEETING ON MODEL INCOME TAX TREATY

The Treasury Department today announced that a public meeting will be held on January 14, 1982 in Room 4121 of Main Treasury at 1:30 p.m. to discuss the provisions of Article 16 (Limitation on Benefits) of the draft U.S. Model Income Tax Treaty. The draft Model was released for public comment on June 16, 1981.

The Treasury has considered the comments submitted to it concerning Article 16 and the other provisions of the June 1981 draft Model and intends to publish a new Model in the near future. The Treasury has concluded that the new U.S. Model Income Tax Treaty and future U.S. income tax treaties will contain a provision such as Article 16 of the draft Model to assure that source basis tax benefits provided by a U.S. income tax treaty are not obtained improperly by residents of third countries.

The purpose of the January 14, 1982 meeting is to discuss specific provisions which might be used in Article 16 to achieve this objective. Examples of such provisions may be found in: Article 16 of the June 16, 1981 draft Model; Article 17 of the proposed Protocol to the proposed Income Tax Treaty between the United States and Jamaica; the proposed anti-abuse reservation to the proposed Income Tax Treaty between the United States and Argentina (attached); a discussion draft of Article 16 (attached). The Treasury invites interested parties to submit comments and/or further drafts of Article 16 for discussion at the January 14 meeting.

In practice U.S. tax treaties generally deviate to some extent from the U.S. Model due to the bilateral nature of a treaty. Any Article 16 adopted in the new U.S. Model would be modified in negotiations with a treaty partner to the extent necessary to take into account the nature of the treaty partner's system of taxation and the other provisions of the proposed income tax treaty with that country.

Consequently, one of the purposes of the meeting is not only to develop a Model provision but, also to consider appropriate variations for use in differing situations.

Treasury announced that the January meeting will cover possible methods for withholding agents and taxpayers to comply with the provisions of Article 16. In this context Treasury also invites comments on whether any reduction of U.S. tax available to foreign persons under U.S. tax treaties should in the future be provided solely by requiring eligible taxpayers to request a refund from the Internal Revenue Service, or by allowing U.S. withholding agents to reduce or eliminate withholding on the basis of a certification of foreign residence, IRS rulings, or forms and information supplied by a foreign taxpayer in support of his eligibility for the reduced rate.

Those intending to attend the January 14, 1982 meeting are requested to so advise A. W. Granwell, International Tax Counsel, Main Treasury Building, Washington, D.C. 20220 by January 8, 1982.

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Proposed Senate Reservation to Proposed Income Tax Treaty between the United States and Argentina

Reservation that, a person (other than an individual) which is a resident of a Contracting State and which derives income from sources within the other Contracting State shall not be entitled to the benefits under this Convention accorded by that other Contracting State if: 25 percent or more of the beneficial interest in such person is owned, directly or indirectly, by individuals who are not residents of the first-mentioned Contracting State. For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by residents of that Contracting State. This paragraph shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

Discussion Draft

Article 16

Investment or Holding Companies

1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:

a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which of any class is so listed; or

b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or

c) it was not a principal purpose of the corporation or of the conduct of its business or of the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived to obtain any of such benefits.

2. For the purposes of this Article:

a) an approved stock exchange in ________ means ________________________________;

b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;

c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting

State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;

d) notwithstanding subparagraph c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph b) of paragraph 1 of this Article if the corporation establishes that individuals who are:

i) citizens of the United States;

ii) residents of a Contracting State; or

iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention;

own directly more than 75 percent of the total combined voting power of all classes of

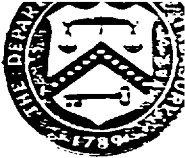
the corporation's stock entitled to vote and more than 75 percent of the number of shares of each other class of the corporation's stock;

e) a corporation is presumed to meet the requirements of subparagraph c) of paragraph 1 of this Article, in particular, where:

i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident;

ii) the corporation is engaged in business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-20

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FOR RELEASE UPON DELIVERY
Expected at 9:30 A.M.
February 4, 1982

Testimony of the Honorable Donald T. Regan
Secretary of the Treasury
Before the
Subcommittee on Securities
of the
Senate Committee on Banking, Housing and Urban Affairs
February 4, 1982

Mr. Chairman and members of this distinguished Subcommittee:

I appreciate this opportunity to present the Administration's proposals to deregulate the securities activities of commercial bank holding companies.

The Administration believes that its approach to expanding the securities activities of commercial banks is better than that currently contained in S. 1720, and recommends that its proposal, "The Bank Holding Company Deregulation Act of 1982", be substituted for the present Title III when S. 1720 is marked up. I hope, Mr. Chairman, that our proposal will have your support and the support of this Subcommittee.

Introduction

Broadly speaking, the Administration favors removing the anti-competitive legal barriers that restrict different types of financial institutions to specific activities. Not only have these restrictions weakened depository institutions, they have served the consumer poorly.

Due to the many limitations on their lending and investment powers, thrift institutions have had tremendous difficulties coping with the inflation and high interest rates of the last couple of years. At the same time Federal deposit interest rate ceilings and Glass-Steagall prohibitions have made it difficult for all depository institutions to compete with money market funds, with traditional securities organizations, and with new entrants into the financial services industry.

R-603

S. 1720, by eliminating most of the remaining statutory restrictions that prevent thrift institutions from performing the same activities as commercial banks, would remove the major barrier to competition between the two. Title III, however, would be much less effective in promoting equitable competition between depository institutions and other financial intermediaries. We believe this is an important shortcoming of the proposed legislation.

A major symptom of the malady afflicting depository institutions is the fact that their business is growing more slowly than that of other unregulated financial intermediaries. The malady is caused in part by statutory restrictions that keep depository institutions from competing fully. If we do not act soon to remove these restrictions, we may find that the problems of the thrift industry are only a precursor of the problems of commercial banks. All of them have a declining share of financial assets and are struggling to acquire deposits.

We cannot remove all the anti-competitive barriers at once. But we can begin to approach our objective by putting the proper legal structure in place and by initiating the process of removing as many restrictions as possible. Once the structure is established, the remaining barriers to competition in specific industries and activities can be eliminated at the most propitious time.

Expansion of Bank Holding Company Powers

Our alternative to Title III would provide that framework for progressive deregulation by authorizing registered commercial bank holding companies to establish subsidiaries that would compete fully with all non-depository financial institutions. Bank holding companies would be authorized to engage in those activities of a financial nature listed in our legislation or later authorized by the Federal Reserve Board as long as they were to do so through a subsidiary of the holding company. Case-by-case regulatory approvals would not be required, but only those approvals customary to the particular trade or business.

After thrift institutions have had an opportunity to adjust to the new lending powers proposed for them in S. 1720, we would extend to multi-savings and loan holding companies the same statutory authority we are proposing for bank holding companies. At this time, however, it seems appropriate for thrift institutions to have only those increased lending and investment powers that will supplement their existing business. It is doubtful they could undertake other new activities at the same time.

Our proposal also envisions all subsidiaries of bank holding companies operating under those regulatory and business practices that are customary in a particular line of business. For example,

finance companies, real estate companies, and so forth would continue to be primarily regulated by state agencies. This approach to deregulation of the financial services industry has two principal advantages. It permits a wide variety of financial organizations to be included under the holding company umbrella in a manner that maximizes competitive equality with independent firms. Secondly, it permits the inclusion of subsidiaries with very different regulatory regimes--from highly regulated depository institutions to the least regulated financial services organizations. Particularly important is our proposal's treatment of commercial banks. They, like other depository institutions, are accorded, as a matter of public policy, a special status among financial organizations. A large portion of their depositors' funds is insured by Federal government agencies to prevent any loss of confidence in the banking system during economic crises. The Federal government regulates bank activities to limit the risks to depositors and to its insurance funds, and to guarantee the effective and continued operation of banks as the principal supplier of funds to commerce and industry. In addition, the Federal Reserve System relies on banks as the principal vehicle for implementing monetary policy.

Bank subsidiaries of deregulated bank holding companies could maintain these important characteristics. Other subsidiaries of the holding company could not impose a higher order of risk on the holding companies' affiliated banks and could not benefit from the special status accorded to those affiliated banks. A bank's financial relationship with other affiliates or the holding company would virtually be the same as with independent firms. The bank affiliate's value to the holding company would be only as a profit generating business, the same as all its other subsidiaries.

Bank Securities Activities

We are proposing that bank holding companies be authorized to conduct two new activities: first, to underwrite and deal in municipal revenue bonds and second, to sponsor and underwrite the shares of open-end investment companies (mutual funds). The new securities activities would have to be conducted through a securities subsidiary or subsidiaries, as would all securities, brokerage, underwriting and dealing activities already carried on by the bank. Only if a bank holding company did not engage in the new securities business could it continue to have brokerage, underwriting or dealing activities within a commercial bank subsidiary.

However, commercial banks having assets of less than $100 million and unaffiliated with a holding company would be authorized to conduct new and existing securities activities through a subsidiary of the bank in lieu of forming a holding company. This is intended to hold down the costs of smaller banks' entering into the new activities. Larger banks unaffiliated with a holding company would have to form a bank holding company. Upon engaging in the new securities activities all banks would have one year within

which to reorganize their corporate structure. However, some 5,400 of our nation's 14,000 banks already operate as subsidiaries of bank holding companies and these 5,400 banks accounted for about 80 percent of total bank assets as of September 30, 1981.

We propose to remove some of the barriers to competition between the banking and securities industries for several reasons. The distinctions between these two industries have become increasingly blurred in recent years. The securities industry has generated new products and services, such as money market funds and cash management accounts. Banks, on the other hand, have increased their participation in the private placement market, sponsored closed end investment companies, and announced plans to underwrite commercial paper. These developments have had an enormous impact on competition and on expectations of future competition between banks and securities firms.

Consumers have realized higher interest on their funds and more convenient services because of this competition, but it has also caused some serious dislocations in the financial markets. Many consumers have placed their savings in money market funds instead of deposit accounts, more to avoid the restrictions on interest rates and services of depository institutions than to benefit from the different products and services of money market funds and securities firms. This uneconomic allocation of resources to circumvent government restrictions is weakening depository institutions by concentrating their sources of funds, and inconveniencing consumers by fragmenting their access to financial services.

For this reason alone, it is important that we begin removing some of the barriers to competition between these two industries. There is, however, an important additional reason. The structure of the securities industry is changing rapidly. Very large organizations, financial and nonfinancial, have entered the securities business by acquiring leading firms. In the process the firms acquired have gained access to much greater amounts of capital with which to pursue the attractive opportunities in their business. The emergence of stronger intermediaries in the financial markets is a healthy development. It should expand the breadth and depth of the markets, stimulate efforts to find more new products and services, and increase competition, all to the benefit of consumers.

It is not beneficial, however, for the structure of the securities industry to be changing so significantly without some role for commercial banks. Today, the securities industry is financially strong. Several securities firms are connected with organizations as large as any in the financial services industry. The growing strength of securities firms and the increasing scale of the industry will accelerate competition with banks in markets that overlap. The longer we wait to remove the anti-competitive barriers, the more the market will be distorted and the more politically and economically difficult it will be to remove those barriers at a later date.

Revenue Bond Financing

For several reasons, the municipal revenue bond business is a logical candidate for further bank holding company participation in the securities business. Commercial banks were excluded from underwriting and dealing in revenue bonds while being authorized to underwrite and deal in municipal general obligation bonds. The reasons were as accidental as they were analytical. This differentation occurred some 50 years ago when the securities activities of banks were being questioned for reasons that had little to do with municipal revenue bond financing. In fact, this form of financing was almost unknown; general obligation bonds were the primary municipal long-term financial vehicle.

The Administration feels strongly, however, that to enter the municipal revenue bond business, commercial banks should place all their securities underwriting and dealing activities in a separate subsidiary. We believe that the present bank practice of underwriting U.S. Government securities and state and local obligations within the corporate structure of the bank affords significant competitive advantages to banks vis-a-vis securities firms. While we are not proposing that this practice be altered in and of itself, we do oppose proposals to expand bank securities activities that would perpetuate and compound the competitive inequalities in bank underwriting and dealing activities. Our holding company and small bank subsidiary approach is designed to remove these inequalities.

Our proposal would make securities subsidiaries subject to the same tax treatment as any other nonbank underwriter/dealer. This treatment assumes particular importance in the carrying of municipal debt in dealer inventories. The interest on funds borrowed to finance such inventory is not deductible by securities firms for income tax purposes as provided in Section 265(2) of the Internal Revenue Code. This provision, from which bank dealers are exempt, was enacted to prevent the double benefit that would otherwise ensue from such borrowing and investing in tax free municipal securities. In the competitive financial markets we envision for the 1980's, this bank dealer exemption would provide too great an advantage over nonbank dealers in competing for new revenue bond business. Moreover, it is difficult to justify expanding the use of such an exemption at a time when the Administration and Congress are attempting to reduce budget deficits.

The securities subsidiary would have to pay market rates for funds obtained to carry its securities inventory. By contrast, dealer operations within a bank have direct access to a bank's own funds in whatever amount the bank's management chooses, and at a cost lower than that available to an independent firm. Banks raise funds more economically than nondeposit organizations because many of their deposits are payable on demand with little or no explicit interest cost, and because certain deposits are under

Federal rate ceilings and are Federally insured against depositor losses. In addition, banks have the Federal Reserve System as a lender of last resort in periods of economic adversity. These advantages must be offset if a nondeposit financial organization of any kind is to compete on equal terms with a bank. A separate subsidiary, not enjoying these legislated advantages, is proposed as the solution to this disparity.

Our proposal would mean that the National Association of Securities Dealers (or the Securities and Exchange Commission should the subsidiary not elect NASD membership) would be the appropriate regulatory agency for the securities subsidiary. This would place a comparable regulatory standard on both bank holding company securities subsidiaries and on independent firms, and would assure investors and firms the protection afforded by a uniform application of the securities laws. In past years legislation has been introduced in this Subcommittee, and supported by the SEC, which would have upgraded bank procedures involving various securities activities to the standards of broker-dealers performing similar activities. As banks and bank holding companies increase their securities business, investors' interests must be afforded the same quality of attention as those of depositors.

Mutual Fund Activities

We have recommended that bank holding companies be authorized to sponsor and underwrite the shares of mutual funds. In 1981 alone, money fund assets grew 144 percent to $182 billion. As economic conditions improve in the next few years and individual savings and investment increase, other types of funds should gain in popularity, particularly common stock funds. For many years banks have managed other peoples' money in their trust departments in an agency and fiduciary capacity. Extending this expertise to a potentially larger market of small investors should help to expand the availability of mutual funds, thus promoting increased savings and investment.

Mutual funds, were they the only new securities activity authorized for banks and bank holding companies, should still be offered through a securities subsidiary. While bank involvement with mutual funds does not generally raise those issues of competitive equality associated with municipal revenue bond financing, it does raise all the traditional Glass-Steagall concerns and questions of equal regulation-- those that arise from the SEC's supervision of investment advisers and investment company activities under the Investment Company Act of 1940. The solicitation and distribution of these open-end investment company shares is an underwriting function and therefore merits rigid separation from the insured depository business of a bank.

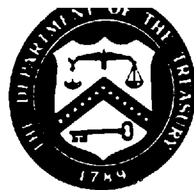
A key concern that led to the prohibition of most bank securities activities in the 1930's was the potential for self dealing and other abusive practices. We believe that our proposed legislation, in company with existing banking and securities laws, provides adequate safeguards against self dealing transactions between banks and bank holding companies and their securities subsidiaries. Neither the bank's depositors nor their fiduciary customers should be adversely affected by the new revenue bond or mutual fund business or by any existing securities activities transferred to subsidiaries. The subsidiary will have its own customers, records, and suppliers of funds. Mutual fund shares will be sold to bank depositors or fiduciary customers on the same terms as those sold by an independent investment company. Moreover, if the subsidiary encounters financial difficulties, credit assistance, asset purchases or other efforts to rescue it would have the same limits as those governing the bank's relations with non-affiliated funds. In structuring the relationship of our securities subsidiaries with affiliated banks, we have made every effort to deal specifically with the problem that inspired Glass-Steagall in the 1920's and 1930's.

In concluding, I should like to emphasize that, although I have dealt at some length with our securities affiliate proposal in this testimony, the Administration regards securities as only one of a number of financial activities in which bank holding companies should be permitted to engage through subsidiaries. I again urge this Subcommittee to endorse this principle so that our financial system will not be subject in the future to needless regulation which only hurts the interests of consumers of financial services.

* * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Subcommittee may have.

TREASURY NEWS



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FOR IMMEDIATE RELEASE
February , 1982

CONTACT: Mary Boswell Watkins
(202)566-2041

GOLD COMMISSION TO MEET

The Gold Commission will hold its sixth meeting on February 12, 1982.

Treasury Secretary Donald T. Regan will chair the meeting which will be open to the public. The meeting will begin at 9:30 a.m. in the Cash Room of the Main Treasury Department Building in Washington, D.C. The public is advised to use the Pennsylvania Avenue entrance to the Treasury Department.

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R-604

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 9:00 a.m. EST
February 5, 1982

STATEMENT OF WILLIAM S. McKEE
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
AND THE SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS
OF THE SENATE BANKING COMMITTEE

To the Chairmen and Members of the Subcommittees:

I am pleased to have this opportunity to present the views of the Treasury Department on S. 1828, entitled the "Thrift Partnership Tax Act of 1981." This bill would make a number of changes in the Internal Revenue Code to permit thrift institutions to market the unrealized losses in their mortgage loan portfolios as tax shelters for private investors.

For the reasons set forth in this statement, Treasury opposes S. 1828.

Description of S. 1828

S. 1828 is designed to enable thrift insitutions to form partnerships with private investors in order to obtain financial benefits from the unrealized losses in their mortgage loan portfolios. As contemplated by the bill, a thrift institution could contribute low-yield mortgages in its existing portfolio and private investors could contribute cash to a "qualified thrift partnership." Because the partnership would take carryover bases in the mortgages that are significantly above the fair market values of those

assets, the mortgages would have "built in" unrealized losses for income tax purposes. The partnership would then sell the mortgages to realize the losses, allocate the losses to the investors for income tax purposes, and invest the cash realized from the mortgage sales and the cash received from the investors in other mortgage loans. Through this mechanism the thrift institution could effectively market its unrealized losses as tax shelter investments for private investors.

The bill would make a number of changes in the Internal Revenue Code to enable these partnership arrangements to work. First, a new section 703(c) would be added to the Code to provide that the losses realized by the partnership on the mortgage sales would be treated as ordinary losses rather than as capital losses. This change is needed to insure that the investors receive the maximum tax benefit from the use of the losses to offset their income from other sources. Second, the bill would add a new paragraph to section 704 of the Code to provide that the tax loss allocations in the partnership agreement will control without regard to the general rules of sections 704(b)(2) and (c)(1), which provide that tax loss allocations in partnership agreements will be respected only if they have substantial economic effect. This special rule is needed to permit the artificial loss allocations to the investors that are contemplated in the partnership agreements.

Third, the bill would add a new paragraph to section 721 of the Code to provide that a thrift institution's transfer of mortgages to a qualified thrift partnership followed by the sale of the mortgages by the partnership will be treated as a contribution of the mortgages (and not their sales proceeds) to the partnership in exchange for a partnership interest. This prevents the application of general tax rules that otherwise could attribute the sales of the mortgages (and, hence, the tax losses) to the thrift institution rather than the partnership. Finally, the bill would amend section 7701(a)(19)(C) of the Code to take mortgages held by the partnership into account in determining whether the thrift institution has sufficient mortgage investments to qualify for preferential tax treatment as a domestic building and loan association after formation of the partnership.

Treasury Position

Before discussing S. 1828 from the standpoint of Federal tax policy, I would like to make it clear that the Treasury Department is quite aware that many of our nation's thrift institutions are in difficult financial circumstances. We

also know that thrift institutions have served a vital role in helping several generations to fulfill the American dream of owning their own homes. Since other Administration spokesmen have outlined on other occasions the Administration's position on the financial problems in the thrift industry, I will limit my remarks to the Treasury Department's concerns about the tax policy implications of S. 1828.

S. 1828 purports to clarify the application of existing law to qualified thrift partnerships. Nevertheless, the description of the bill set out above makes it clear that the bill would override numerous existing rules of general applicability in the tax law. The general rules that would be overridden -- the limitations on deductions for capital losses, the prohibition of artificial loss allocations by partnerships, and the rules that attribute losses to the taxpayer who actually incurs them -- are all designed to prevent distortions of a taxpayer's taxable income. The bill would negate these fundamental rules in an attempt to use the Federal income tax system as a means of reimbursing thrift institutions for losses resulting from past loan transactions.

Indeed, S. 1828 would make it more advantageous for a thrift institution, whether or not it is currently profitable, to transfer the low-yield mortgages in its portfolio to a qualified thrift partnership for sale. Losses realized on a direct sale of the mortgages by a profitable institution would provide a maximum tax benefit equal to approximately 28% of the loss, since 28% approximates the maximum income tax rate applicable to thrift institutions after taking into account the special deduction provided by section 593 of the Code. By using the partnership device to sell its unrealized losses to individual investors in the 50% income tax bracket, the institution could increase the tax benefits to 50 cents (rather than 28 cents) per dollar of loss. The ability to engage in this sort of tax rate arbitrage would cause even the most profitable thrifts to use these partnerships to obtain unwarranted tax advantages. Moreover, it could motivate thrift institutions to structure mortgage loans with large front-end payments and below market nominal interest rates, since the initial payments would be taxable at the maximum 28% rate and the devalued mortgage loans would produce potential tax losses for sale to investors in the 50% bracket.

We are also concerned about the impact that the marketing of these tax shelter schemes would have on the general public's perceptions as to the fairness of our tax system. Authorization of these partnerships would launch an

unprecedented marketing program for the sale of "government certified" tax shelters to individuals in the highest income tax brackets. The tax benefits being marketed would not be attributable to any new capital investments and would provide no new incentives for economic growth. Rather, they would simply reimburse thrifts for economic losses incurred in loan transactions consummated many years in the past.

Viewed as it should be -- as an attempt to use the tax system to grant Federal subsidies to distressed thrift institutions -- S. 1828 has other defects. Since a qualified thrift partnership could be formed by any thrift institution, the bill would not limit its extraordinary tax benefits to distressed institutions. Moreover, the benefits to the thrifts would be reduced by transaction costs and by the fact that the large volume of losses being marketed at one time would drive down their value. Because of these and other factors, the revenue loss to the Treasury would exceed by far the benefits flowing to thrift institutions. Our preliminary analysis indicates that the revenue loss from the bill could be as much as 50 billion dollars, assuming that the bill is revised to deal only with losses on mortgage loans now in existence. This would be vastly more expensive to the Federal government than any program of direct subsidies or supports for thrift institutions in financial distress.

Even if S. 1828 could be revised to meet the objections noted above, we would still oppose the bill on tax policy grounds because it seeks to use the tax system to grant Federal subsidies to a particular industry group. Any additional subsidies to these institutions should be granted directly, so that normal budgetary and appropriations procedures can be followed and the Federal benefits can be allocated in the most efficient manner.

Conclusion

The Treasury Department opposes S. 1828 for many reasons of tax policy. The bill would provide special exceptions to established tax rules that are designed to prevent distortions of a taxpayer's taxable income. The bill would open the way to tax rate arbitrage by thrift institutions and would present a significant potential for abuse. The marketing of interests in qualified thrift partnerships as tax shelters for high bracket investors would damage the public's perceptions concerning the fairness of our tax system. As a subsidy mechanism, the bill would be inefficient and ineffective and its cost would be prohibitive. Finally, the bill is contrary to sound tax policy because it would circumvent the normal budgetary and appropriations procedures.

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STATEMENT OF
THE HONORABLE R.T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 4, 1982

Mr. Chairman and Members of the Committee:

With me from the Treasury Department is our General Counsel, Peter J. Wallison.

We are pleased to appear before the Committee to present the views of the Treasury on the Administration's bill. This bill would deny the benefits of tax exempt status to organizations maintaining private schools that follow racially discriminatory practices.

Indeed, in light of the controversy that has developed in this area in recent weeks, we are especially pleased to have an opportunity to dispel some of the confusion and misconceptions regarding the policy of this Administration both with respect to racially discriminatory schools and the appropriate role of the Internal Revenue Service.

At the outset, we wish to emphasize the following points:

The Reagan Administration is unalterably opposed to racial discrimination in any form. Further, the Administration endorses, in the strongest fashion, the principles of Brown v. Board of Education, that racial discrimination in education has no place in a free society and should not in any way be tolerated or encouraged by the Government.

Thus, the Administration believes that racially discriminatory schools, and the organizations that maintain them, should not be recipients of tax deductible contributions. However, we recognize that protection must be accorded to the legitimate exercise of religious beliefs.

While the Administration believes that the benefits of tax exemption should be denied to racially discriminatory schools, it also believes that such a position must be based on statute. However popular it would have been to come out the other way, we and the Justice Department are unable to find that Congress has yet authorized such action in the Internal Revenue Code.

It is not satisfactory to say that the tax laws permit the Internal Revenue Service to require that tax exempt organizations must comply with certain fundamental public policies. If we follow this approach, at any time the Service may go beyond

racial discrimination and decide that some other policy -- such as discrimination based on sex -- requires the revocation of tax exemptions for schools which admit only women. Instead, we believe that Congress should authorize the denial of tax exemption based only on racial discrimination by passing a law to this effect. That is why the Administration has submitted the bill that is before this Committee today.

Against this background, I would like to discuss in some detail three specific areas that are of appropriate interest to the Congress and the American public. They are:

1. The chronology of events in reaching the joint Treasury and Justice decision not to file a brief in support of the position of the Internal Revenue Service before the Supreme Court.

2. The rationale for this decision.

3. A discussion of the Administration's legislation.

CHRONOLOGY OF EVENTS

Although it is unusual for any agency to recount in detail the events which led to a particular legal or policy decision, Congress has indicated a desire to inquire into this matter and there have been allegations that the decision was the result of a political choice. On the contrary, as the chronology of events will show, the decision was the result of a careful, thorough legal analysis, and was made despite a recognition of the politically unpopular nature of that decision. In fact, the events show that the Treasury and Justice Departments hoped to be persuaded that the Service's policy of administratively denying tax exemptions to schools that racially discriminate was supportable.

The decision announced on January 8 was not an easy one and in my view presented an issue that should have been confronted in 1970 when the Service, at the request of the Nixon White House, adopted a position which was then being advanced by the plaintiffs in the first Green case. In that case, plaintiffs argued that the Service was authorized to deny tax exemptions to racially discriminatory schools because all tax exempt entities had to be "charitable" in the common law sense amd as such had to pursue certain fundamental public policies. One of these fundamental public policies was non-discrimination on the grounds of race.

In adopting the position of the plaintiffs in Green v. Connally, the Service achieved a satisfactory outcome in that particular case; it could deny tax exemptions to racially

discriminatory schools. But there was a broader issue involved, which was not adequately considered at the time. If the Service could require tax exempt schools to follow a policy of racial non-discrimination, could it also impose other policies on the ground that they too were Federal public policies? In other words, did this legal principle establish a basis for IRS actions which went well beyond the laudable objective of prohibiting racial discrimination?

After eleven years, when it came time for a subsequent Administration to file a brief in the Supreme Court endorsing the legal theory adopted by the Service in 1970, that issue had to be faced squarely. In December 1981, as the time for filing a Supreme Court brief approached, the question could no longer be avoided, and after extensive review of the law the Treasury and Justice Departments were compelled to conclude the theory adopted by the Service in 1970 could not be rationalized under existing statutes on either a legal or a policy basis, because it would confer on the Service a breadth of discretion that no administrative agency should have.

The decision to grant Bob Jones University its tax exemption was made as a matter of policy and law, and involved politics only in its broadest and best sense -- the mandate of the Reagan Administration to assure that the Government of the United States acts responsibly and in accordance with the laws enacted by Congress. Let me summarize what the Chronology of Events shows and include all my contacts with the White House.

I first became aware that there was a concern over our legal position in the Bob Jones case when Deputy Attorney General Ed Schmults called me on the evening of December 8 and asked if I were aware of the Bob Jones case. I indicated I knew of its existence and that it involved tax exempt status for religious schools that practiced racial discrimination. He indicated that the Justice Department was reviewing the legal papers it was preparing for the Supreme Court on December 31. He asked that I look into the matter because it involved important policy issues and get back to him.

I subsequently informed Secretary Regan about the Justice Department's concerns in the Bob Jones case sometime during the week of December 14, at one of the frequent meetings we have during any given week. He did not suggest that I come to any particular conclusion. Rather, he indicated he wanted to be kept apprised over the Christmas vacation.

As we reviewed the legal basis for our position, the Treasury began to have concerns about the policy issues which were then under review in the Justice Department. However, in an effort to continue supporting the Service's position, we agreed to postpone any decision until we all had a chance to read the brief being prepared by the Solicitor General's office. About this time, I informed Fred Fielding, White House Counsel, of our growing concern about the case and the government's position. I later met with him in his office, on December 22, to explore the legal problems of the case, and indicated we were awaiting the Solicitor's brief supporting the Service.

Subsequently, on Monday, December 28, Secretary Regan informed me that Ed Meese wished to be apprised of the case. That afternoon I phoned Meese and told him that I was concerned about our position, that we had informed Fielding and that we all recognized the political sensitivity of taking a legal position that might be construed as contrary to the Administration's policy against racial discrimination. He pressed me to be sure that the Justice and Treasury Departments were absolutely comfortable with their position on the law before taking any action. I indicated that we were waiting for the final Justice Department draft brief supporting the IRS position before we made any decision.

On the evening of December 23, I read the initial Justice Department draft of the brief for the Supreme Court. The brief supported the IRS position that it had authority to deny the tax exemptions. I was unpersuaded by the logic or the legal citations. I then asked for a second draft brief narrowed to the issue of racial discrimination. However, the second draft, which I received on December 29, was still based on the theory that the Service could determine that certain Federal public policies could be used as a precondition for obtaining and retaining tax exempt status. Given two tries, there was apparently no legal theory that would permit the Service to deny tax exemptions on the basis of racial discrimination without also giving the authority to deny or revoke exemptions on other grounds.

I, therefore, concluded that the Treasury could no longer support the IRS on this matter, because the Government would be required to take a position in the Supreme Court that we simply did not regard as being either supported by statutory authority or adequately determined by the relevant case law and appropriate policy.

On December 30 the Deputy Attorney General, the Assistant Attorney General for Civil Rights and I met with Fred Fielding and others to tell Fielding of Treasury's preliminary decision. I talked to Secretary Regan in person on December 28 and by telephone on December 30. At no time during this process did either Fielding or Regan attempt to influence my judgment of the legal issues in the case or order me to reach any particular conclusion. I also had no contact with any Congressmen or Senators in making this decision.

In an effort to be certain that the Departments of Justice and Treasury were legally correct on a matter of such important national policy, we requested a one-week extension from the Supreme Court and reviewed the matter several times with the Commissioner and the Chief Counsel of IRS, the Treasury Department's Office of Tax Policy and with the Justice Department.

During this period, a number of the initial thoughts in our discussions were reduced to a draft memorandum by the Department of Justice -- the unsigned, undated copy of which has been furnished to this Committee -- and the final decision was made on January 8. This additional time permitted a thorough review of my decision by all the relevant senior officials in the Justice and Treasury Departments who might have a perspective on the case. By January 8 we were ready to announce our decision. Since we could not support the Service's position before the Supreme Court, there was no choice but to grant the tax exemptions which were the subject of the suit. I was out of Washington and by phone I directed the Commissioner of Internal Revenue to take the actions necessary to grant these exemptions. Since the case before the Supreme Court was now moot, the Justice Department filed a memorandum with the Supreme Court seeking to have the court vacate its jurisdiction.

RATIONALE FOR TREASURY DECISION

The decision announced on January 8, 1982, had its origins in a policy determination by the Nixon White House in 1970. That decision directed the Service to accede to the position of the plaintiffs in the first Green case in the Federal District Court. This reversed the long-standing IRS opposition to involving the administration of the tax laws in the controversy surrounding racial discrimination. Although this decision advanced a laudable goal, the 1970 decision was not soundly based on statutory law and the consequences of this expedient approach were finally recognized in late 1981 when the Treasury Department was required to approve the Justice Department brief which articulated the legal rationale adopted in 1970.

The Justice Department has prepared and delivered to the Treasury Department a memorandum of law which describes the legal deficiencies in the Service's position. As the Justice Department memorandum concludes, there is no adequate basis in law for the Service's position that it has the authority to select certain Federal public policies and impose these policies on tax exempt organizations. Nor is there a legal basis for concluding that the IRS has the statutory authority to invoke Section 501(c)(3) and the attendant denial of deductions under Section 170 to any school or university that violates the civil rights laws. The Justice Department memo makes clear that there is no statutory language or Congressional direction, no legislative history, and no definitive Supreme Court opinion, that authorizes or requires the IRS to revoke the tax exemptions of schools that do not comply with Federal public policy or otherwise violate the civil rights laws.

The Committee should note that there is no question that the Internal Revenue Service was under tremendous pressure to adopt the view it took in 1970, and has acted professionally and responsibly. However, the "public policies" rationale the Service adopted was a post hoc legal justification for a prior policy action.

In making the Treasury's policy decision we were faced with a classic moral dilemma. "Does the end justify the means?" That is, does the attainment of a good end or objective (eliminating discrimination) justify the endorsement of a theory that we regarded as unauthorized by law? This ethical dilemma has been long settled in all civilized societies. The answer is "no."

In addition, in the United States we have consistently adhered to the trite-sounding but immutable principle that we will have "a government of laws and not of men," and that is what this matter is all about. Should administrators and executives of the law be free to define "public policy" in the absence of legislative authority duly enacted by Congress? Again, the answer is "no."

The implications of continuing the policy of allowing the IRS to determine on its own those public policies denying tax exemptions was well stated by the district court in the Bob Jones case. There, the judge pointed out that Section 501(c)(3) does not endow the IRS with authority to discipline wrongdoers or to promote social change by denying exemptions to organizations that offend federal public policy. Voicing apprehension over such broad power, the district court observed: "Federal public policy is constantly changing. When can something be said to become federal public policy? Who decides? With a change of federal public policy, the law would change without congressional action -- a dilemma of constitutional proportions. Citizens could no longer rely on the law of Section 501(c)(3) as it is written, but would then rely on the IRS to tell them what it had decided the law to be for that particular day. Our laws would change at the whim of some nonelected IRS personnel, producing bureaucratic tyranny."

For example, if we were to endorse the theory on which the Service was proceeding before the Supreme Court, what would prevent the Service from revoking the tax exempt status of Smith College, a school open only to women? Does sex discrimination violate a clearly ennunciated public policy? Apparently someone in the state of Massachusetts thinks so, because litigation on this issue is currently going forward in the state courts of Massachusetts.

What about religious organizations that refuse to ordain priests of both sexes? And could the Commissioner decide that if Black Muslim organizations refuse to admit whites they should be denied a tax exempt status because they discriminate?

Further, should the IRS Commissioner be permitted -- in the absence of legislation -- to determine what is national policy on abortion? Should hospitals that refuse to perform abortions be denied their tax exempt status? Or, reading Federal policy another way, should hospitals that do perform abortions be denied their tax exempt status?

These extremely difficult but real issues illustrate the need for Congressional action on the question of tax exempt schools which discriminate on the basis of race. Here perhaps we have a national consensus which should be embodied in statute so that the Internal Revenue Service has appropriate guidance. To leave the judgment solely to the Service is not the responsible course.

It is simply because these issues are so difficult and fundamental to our society that they should not be left to an administrative determination by employees of the Federal Government, but rather should be determined by the elected representatives of the American people. It is for this reason that the Administration has developed and proposed the Administration's bill which is designed to give a clear Congressional mandate on these matters.

Thus the Administration urges the Congress to exercise its authority and responsibility to provide guidance on these matters so that there will be a basis in law to deny tax exempt status to educational institutions that discriminate on the basis of race.

DISCUSSION OF LEGISLATION

Finally, I turn to a description of the Administration's bill, which is before the Committee this morning. Section one of that bill directly addresses the issue before us. Specifically, a new Section 501(j) would be added to the Internal Revenue Code to deny 501(c)(3) treatment and 501(a) treatment if the school practices racial discrimination.

Failure to be described in Section 501(c)(3) also means that the organization is not within the exemptions from Federal social security and employment taxes provided in the Code. Correlative changes are made to the income, estate and gift tax deduction sections to provide that no deduction will be allowed for contributions to such organization.

The organizations covered are defined in new section 501(j)(1) to include those that maintain a regular faculty and curriculum and normally have a regularly enrolled body of students in attendance at the place where its educational

activities are regularly carried on. Generally, this is the same definition as appears in Code Section 170(b)(1)(A)(ii), and parallels the class of schools covered by the IRS's prior published procedures. Further, consistent with Rev. Rul. 75-231, the definition covers all organizations maintaining these schools.

New Code Section 501(j)(2) defines "racially discriminatory policy." Generally, under the bill, a school has such a policy if it refuses to admit students of all races (defined to include also color and national origin) to the rights, privileges, programs, and activities usually accorded or made available to students by that organization, or if the organization refuses to administer its educational policies, admissions policies, scholarship and loan programs, or other programs in a manner that does not discriminate on the basis of race. This definition generally conforms to that first established by the court in the Green litigation and carried forward by the IRS in Rev. Rul. 71-447 and subsequent pronouncements.

Additionally, Section 501(j)(2) contains an explicit provision in recognition of the legitimate interests of religious-based schools. Thus, under the bill, an admissions policy or a program of religious training or worship that is limited to, or grants preference or priority to, members of a particular religious organization or belief would not be considered a racially discriminatory policy. Thus, schools may confine admission and training to persons of a particular religion. The protection, however, will not apply if the policy, program, preference or priority is based upon race or upon a belief that requires discrimination on the basis of race. Pursuant to this rule, we expect that Bob Jones and Goldsboro would be denied their tax exempt status if they continue their past racial practices.

To ensure that the express congressional sanction does not grant a windfall to discriminatory schools and their contributors, previously denied the benefits of exemption, the legislation applies retroactively to July 10, 1970, the date the IRS first announced it would not grant exemption to private schools with discriminatory policies. We believe that a retroactive effective date is essential to preserve the national policy of denying tax exempt status to schools that racially discriminate, and that the retroactivity is constitutional.

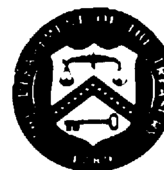
Finally, the bill contemplates that present procedures regarding grant or denial of tax exemption will remain in place. Thus, a nonexempt organization must generally submit to the IRS an application requesting recognition of exemption, together with supporting material enabling the IRS to rule on all relevant issues, including racial discrimination. Organizations whose exemptions have been recognized will be subject to periodic examination to ensure continuing compliance with all applicable requirements.

If discrimination is found to exist, revocation will be proposed and advance assurance of deductibility of contributions will be suspended. Thereafter, the organization will be accorded substantial administrative appeal, including review by the National Office. If the finding of discrimination is sustained, exemption will be revoked and the organization, of course, has the opportunity to seek judicial review.

We have proposed this legislation to deal with the immediate need to empower the Internal Revenue Service with unmistakable authority to deny tax exemption to racially discriminatory schools. We recognize that it will not resolve the difficult definitional problems faced by the Internal Revenue Service in giving meaning to such general terms as "charitable" and "educational," and we invite further Congressional action to define better standards in those areas as well. We will, pending such action, continue to support the Internal Revenue Service in applying the 1959 regulations in the charitable area and in its efforts to deny exemption to those organizations engaged in illegal activities.

This concludes my testimony. I will be pleased to answer any questions you may have.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 4, 1982

RESULTS OF AUCTION OF 29-3/4-YEAR TREASURY BONDS
AND SUMMARY RESULTS OF FEBRUARY FINANCING

The Department of the Treasury has accepted $2,500 million of $5,050 million of tenders received from the public for the 14% 29-3/4-year Bonds of 2006-2011, auctioned today. The bonds will be issued February 16, 1982, and mature November 15, 2011.

The range of accepted competitive bids was as follows:

	Prices	Approximate Yield To First Callable Date	Approximate Yield To Maturity
High	96.68	14.48%	14.47%
Low	95.75	14.62%	14.61%
Average	96.08	14.57%	14.56%

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 8,209	$ 4,209
New York	4,276,798	2,122,628
Philadelphia	5,129	5,129
Cleveland	14,730	8,610
Richmond	16,260	11,260
Atlanta	18,737	17,225
Chicago	361,950	130,950
St. Louis	50,105	47,700
Minneapolis	5,887	2,315
Kansas City	6,696	6,696
Dallas	7,126	6,126
San Francisco	277,949	137,329
Treasury	143	133
Totals	$5,049,719	$2,500,310

The $2,500 million of accepted tenders includes $ 394 million of noncompetitive tenders and $2,106 million of competitive tenders (including 1 9 % of the amount of bonds bid for at the low price) from private investors.

In addition to the $2,500 million of tenders accepted in the auction process, $75 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

SUMMARY RESULTS OF FEBRUARY FINANCING

Through the sale of the three issues offered in the February financing, the Treasury raised approximately $6.4 billion of new money and refunded $5.4 billion of securities maturing February 15, 1982. The following table summarizes the results:

	New Issues 14-5/8% Notes 2/15/85	14-5/8% Notes 2/15/92	14% Bonds 11/15/06-2011	Nonmarketable Special Issues	Total	Maturing Securities Held	Net New Money Raised
Public.............	$5.0	$2.5	$2.5	$--	$10.0	$4.3	$5.7
Government Accounts and Federal Reserve Banks..	0.3	0.1	0.1	0.6	1.1	1.1	--
Foreign Accounts for Cash...........	0.5	0.2	--	--	0.7	--	0.7
TOTAL..........	$5.8	$2.8	$2.6	$0.6	$11.8	$5.4	$6.4

Details may not add to total due to rounding.

R-602

2-5-82
Poland

The President has decided that maximum pressure can be put on Poland by insisting on repayment rather than declaring a default now. A declaration of default might be used by the Polish Government as an excuse to relieve itself of its obligations to make repayments. The U.S. Government has fulfilled its legal obligations to U.S. banks. The U.S. Government, through the Commodity Credit Corporation, guaranteed loans made by U.S. banks for the sale of agricultural commodities to Poland. In 1981, when the Poles did not pay the banks the amount due on these loans, the U.S. Government fulfilled its obligation by making payments to the banks. We are, of course, doing the same in 1982. These payments in no way relieve Poland of any of its obligations. The only difference now is that Poland owes the money to the U.S. Government instead of U.S. banks.

The following questions have been raised:

1. Are payments to the banks on the Commodity Credit Corporation loans a bail out of the banks? No. The U.S. Government guaranteed these loans and it is obligated to honor the obligations.

2. Is this payment to the banks letting the Poles off the hook? No. The obligation is now owed to the U.S. Government instead of to the banks, and we will do everything possible to collect it.

3. Did these payments to the banks prevent them from declaring Poland in default? No. The banks are owed amounts on non-guaranteed loans for which they have not declared default but can declare default at any time.

4. Would a formal declaration of default force the Soviets to pay the amount due by the Poles? No. This is an obligation incurred by Poland and not guaranteed by the Soviet Union.

5. Wouldn't a declaration of default keep further credits from going to Poland? No. Private banks are not lending to Poland. The Polish debt situation prevents further credits from going to Poland. Some funds are coming from Poland to the West toward satisfying previous Polish obligations while no new credits are going to Poland.

6. Would a declaration of default stop credit from going to the Soviet Union? No. Unguaranteed private bank credit unrelated to short-term trade transactions has not been going to the Soviet Union. This is because of the debt

situation of Poland and other countries in Eastern Europe, as well as the other economic and financial difficulties faced by the Soviet Union itself.

7. Can we declare a default on the Soviet Union? No. They are current on all their obligations to the U.S.

8. Will the USG ever declare Poland in default? Default always remains an option, to be used at which time as we see fit.

FEB 05 1982

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

May 17, 1982

DR. BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS

Dr. Beryl W. Sprinkel, 58, was confirmed March 30, 1981 by the United States Sénate as Under Secretary of the Treasury for Monetary Affairs. This followed his nomination by President Ronald Reagan on January 29, 1981.

As Under Secretary for Monetary Affairs, Dr. Sprinkel is responsible for formulating and implementing U.S. international financial policies; developing U.S. policy toward the international financial institutions, such as the World Bank and the International Monetary Fund; financing and managing the federal debt; establishing Treasury financial policies; and coordinating between Administration economic policies and the monetary policies of the Federal Reserve System.

Previously, Dr. Sprinkel was Executive Vice President and Economist at the Harris Trust and Savings Bank in Chicago, Illinois, where he worked for 28 years. He was director of "Harris Economics," an economic and financial forecasting service published by the bank; a member of Time Magazine's Board of Economists; chairman of the Economic Advisory Committee of the American Bankers Association; and member of the Board of Directors of the U.S. Chamber of Commerce. He also served as a consultant to various government agencies and Congressional committees.

Before joining Harris Trust and Savings, he taught economics and finance at the University of Chicago (1949 to 1952), and at the University of Missouri School of Business and Public Administration (1948 to 1949). He is the author of two books, and co-author of a third, on the effects of monetary policy on financial markets and the economy and has written numerous articles.

Dr. Sprinkel received his B.S. degree in Public Administration from the University of Missouri in 1947, M.B.A. degree from the University of Chicago in 1948, and Ph.D. in economics and finance from the University of Chicago in 1952. He was a founding member of the Shadow Open Market Committee. He holds a Chartered Financial Analyst degree from the Institute of Chartered Financial Analysts; an honorary Doctor of Humane Letters degree from DePaul University; and an honorary Doctor of Laws degree from St. Michael's College.

He was born November 20, 1923 on a farm near Richmond, Missouri, and is married to the former Barbara Angus. They have four children.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

January 20, 1982

DR. BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS

Dr. Beryl W. Sprinkel, 58, was confirmed March 30, 1981 by the United States Senate as Under Secretary of the Treasury for Monetary Affairs. This followed his nomination by President Ronald Reagan on January 29, 1981.

As Under Secretary for Monetary Affairs, Dr. Sprinkel is responsible for the formulation and implementation of U.S. international monetary policy; overseeing Treasury involvement in the development of U.S. policy across the range of international financial institutions such as the World Bank and the International Monetary Fund. In addition, he is responsible for financing and managing the federal debt and domestic financial policies and coordinating between Administration economic policies and the monetary policies of the Federal Reserve System.

Prior to his nomination, Dr. Sprinkel worked for the Harris Trust and Savings Bank in Chicago, Illinois, for 28 years. Following a series of promotions, he was named Executive Vice President and Economist in 1974. In that position, he headed the bank's economic research office, and was a member of its management, investment guidance, trust investment and asset/liability committees.

He was director of "Harris Economics," an economic and financial forecasting service published by the bank; a member of Time Magazine's Board of Economists; and formerly Chairman of the Economic Advisory Committee of the American Bankers Association. Between 1955 and 1975, Dr. Sprinkel also served as a consultant to various government agencies and Congressional committees. For the past 16 years Dr. Sprinkel travelled extensively abroad calling on customers, central banks and Treasuries, and participated in numerous international conferences dealing with international monetary policy issues.

Before joining Harris Trust and Savings, he taught economics and finance at the University of Chicago (1949 to 1952), and at the University of Missouri School of Business and Public Administration (1948 to 1949). He is the author of two books, and co-author of

a third, on the effects of monetary policy upon financial markets and the economy, and has contributed numerous articles concerning economics and finance to professional and business journals.

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TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:30 A.M.
February 3, 1982

STATEMENT OF THE HONORABLE R. T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TREASURY, POSTAL SERVICES
AND GENERAL GOVERNMENT
U.S. HOUSE OF REPRESENTATIVES
February 3, 1982

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to meet with the Subcommittee to discuss the effects of the 1982 budget on Treasury operations.

Treasury, like many other agencies, has been operating under unusual and difficult circumstances this past year. Over one-third of the current fiscal year is already completed, and we still do not know what the total availability of funds will be for the entire year. We strongly urge the Congress to complete final action on our funding for Fiscal Year 1982 so that we can take the steps needed to streamline the Department and accomplish the goal of lean and more efficient management.

This Administration has from the beginning had the goal of slowing the growth of the Federal budget as one part of its overall program to restore the Nation's economy. It is important that the Congress adopt a spending level for Treasury in Fiscal Year 1982 that meets the Administration's overall goal.

In providing you with the requested information about the effects of the Fiscal Year 1982 budget reductions, I would like to emphasize that there are two major problems for Treasury with the levels provided in the 3rd Continuing Resolution, Public Law 97-92. These problems are:

(1) the funding level for the Bureau of Government Financial Operations and

(2) the funding level and the overall reorganization plan for the Bureau of Alcohol, Tobacco and Firearms.

R-609

For the Bureau of Government Financial Operations, the Continuing Resolution provides $147.7 million. Under that level, we will have to suspend Bureau operations by June. At that time, we will be forced to halt the processing and mailing of social security checks as well as all other government checks. To remedy this problem, the President's budget, which you will receive next week, includes supplemental funding for Fiscal Year 1982 totaling $81.6 million for the Bureau of Government Financial Operations. An alternative to adding additional funds is to enact appropriations language, which we proposed last September, to have the Social Security Trust Fund reimburse Treasury directly for the cost of processing and mailing social security checks. It is important that the Congress take swift action to remedy this problem.

For the Bureau of Alcohol, Tobacco and Firearms, our original plan was to reorganize and transfer basic law enforcement and revenue-raising functions to the Secret Service and the Customs Service, respectively. A total of $138 million is necessary to carry out that plan. The Continuing Resolution, however, provides $115.7 million for the Bureau. At that level, we would have to abandon reorganization plans and eliminate approximately 1,100 Special Agent positions.

To carry out our planned reorganization of the Bureau of Alcohol, Tobacco and Firearms, the President's budget, which you will receive next week, includes a supplemental request of $22.3 million for Fiscal Year 1982. In addition, we urge the Congress to remove the requirement in the Continuing Resolution that $15 million be spent in Fiscal Year 1982 to administer the Federal Alcohol Act. If this requirement is continued, we will have to increase our planned staffing from 100 to 400 positions for that activity.

I would also like to outline briefly the effects of the Continuing Resolution concerning other Treasury operations.

For the Bureau of the Public Debt, we will reduce the fees paid to financial institutions for the redemption of savings bonds. These fees will be reduced by almost 50 percent between March through June.

For the Bureau of the Mint, we are taking a number of actions to accomplish the 16 percent reduction. These actions include the closing of the New York Assay Office, temporarily postponing the production of strip metal in Philadelphia, reducing training, travel, equipment services, and supplies, and furloughing administrative and support personnel.

The New York Assay Office is presently responsible for refining the Nation's gold. Only 4 percent of the Nation's gold bullion remains in an unrefined state. There is no present or foreseeable necessity to refine this gold. If in the future a need occurs to refine gold, it can be accomplished by the private sector. With respect to the Philadelphia strip production, 70 percent of this production has been accomplished by the private sector and will be continued in this fashion. However, strip and coin inventories allow us to postpone in-house production through the end of this fiscal year and transfer the staff to penny production, thereby accomplishing two basic goals of the Bureau--the continued adequate supply of coin production to the public and lean and efficient management of the Bureau.

In the Office of the Secretary, although we have not finalized our plans, we expect to reduce approximately 100 positions, postpone building repairs and improvements and equipment purchases, and transfer certain functions to other Treasury organizations.

For the Federal Law Enforcement Training Center, we expect to reduce training unless participating agencies are able to reimburse Treasury for such training.

For three Treasury bureaus--the Internal Revenue Service, the U.S. Customs Service, and the U.S. Secret Service--the Continuing Resolution levels are higher than the President's September budget. Where reductions are required in these organizations due to inflation and increased costs above Fiscal Year 1981 levels, we believe that we can take necessary administrative actions to prevent reductions in essential services and functions.

In closing, I have additional information concerning the reorganization of the Bureau of Alcohol, Tobacco and Firearms that I would like to insert into the record as an appendix to this statement.

I will be happy to answer any questions that the Subcommittee may have.

# # #

APPENDIX A

DISCUSSION OF
THE BUREAU OF ALCOHOL, TOBACCO AND FIREARMS REORGANIZATION

Mr. Chairman and Members of the Subcommittee:

This statement is being submitted for the record. It explains the reasons why and the benefits which will be attained from the reassignment of the Bureau of Alcohol, Tobacco and Firearms (ATF) to other Treasury bureaus. It also supplies the basic plan developed by the Department to carry out the reassignment and budgetary and personnel considerations connected with this plan.

On November 12, 1981 the Treasury Department announced the intention of the Administration to reorganize ATF by transferring functions and personnel relating to firearms and explosives to the Secret Service and those relating to alcohol and tobacco to the U.S. Customs Service This reorganization is based on sound management decisions which will cut costs, lead to greater efficiencies and produce solid law enforcement benefits.

In July 1981, the Office of Enforcement and Operations within the Department undertook a management review of the enforcement functions of the Bureau. The most significant conclusions and recommendations of this review are as follows:

* * *

"Whatever motivation there may have been in the past for placing the function of enforcement of firearms and explosives laws in the same bureau responsible for alcohol and tobacco revenue collection and regulation, it can no longer be rationalized today."

* * *

"The firearms and explosives criminal enforcement and regulatory functions should be severed from ATF and those functions and personnel needed to perform them should be transferred to another Treasury enforcement bureau such as the Secret Service. A study should be conducted to determine where the remaining functions of ATF criminal and regulatory enforcement could best be located."

* * *

Some of the other findings of the Management Review Study Group are listed as follows:

-- There exists within the Bureau an inefficient regional management structure that was created because of the diverse functions and does not operate well because of the lack of commonality of purpose and interest between these functions. This regional management structure has led to unhealthy competition for resources between criminal enforcement and regulatory enforcement.

-- There are too many criminal enforcement offices within ATF and many of them are non-productive with respect to firearms, explosives and arson cases. Approximately 40 to 50 of these offices should be closed with personnel reassigned to areas of the country where there is a high incidence of firearms and explosives cases and where the number of enforcement agents to do the job is insufficient.

-- The study found that there was generally low morale among criminal enforcement personnel brought on by budget cutbacks, media attacks and frequent program changes. Personnel did not have a sense of job security.

-- ATF is viewed by state and local law enforcement as the most cooperative of all the Federal enforcement agencies and its criminal enforcement activities are held in high regard by these agencies.

The Reorganization Plan

A plan was developed within the Department to reassign the functions of ATF and the people who perform them to the Secret Service and the Customs Service in a manner that would ensure both efficiencies in the form of reduced personnel and costs and also effectiveness in carrying out statutorily mandated enforcement, revenue protection, and regulatory functions.

The plan developed calls for the reassignment of approximately 1731 Special Agent and administrative personnel to the Secret Service and either 719 or 1019 personnel to the U.S. Customs Service depending on the level of compliance required under the F.A.A. Act.

Of the 1731 personnel reassigned to the Secret Service approximately 1200 will be criminal enforcement Special Agents while the remaining 531 will provide administrative, technical and clerical support. The personnel transferred will carry out the enforcement and regulatory functions of the firearms, explosives and arson statutes. Present planning calls for the reassigned personnel to operate as a separate division of the Secret Service until such time as a full merger can be effectively accomplished. The full merger will depend upon the resolution of such matters as cross-training of personnel, transfer of property and equipment, shared space arrangements, development of a new organizational structure, etc.

The transfer of ATF functions related to alcohol and tobacco to the U.S. Customs Service will be accomplished by the reassignment of 719 personnel if there is to be compliance only with the mandatory provisions of the F.A.A. Act. In the event that full compliance with the non-mandatory features of the F.A.A. Act is mandated by the Congress it will become necessary to transfer 1019 people to the Customs Service. It is envisioned that the personnel transferred

will operate as a separate division until such time as they can be assimilated into the Customs Service. Full assimilation will depend on the resolution of problems such as cross-training of personnel, transfer of property and equipment, shared space, development of a new organizational structure, etc.

The plan also calls for the outplacement of approximately 250 ATF personnel to other bureaus. These outplacements will occur as a result of budget reductions wholly apart from any reorganization or transfer of functions. Plans are underway to outplace 100 regulatory inspectors in the 1854 series to the Internal Revenue Service. Approximately 150 criminal enforcement Special Agents in the 1811 series will be outplaced to the U.S. Customs Service and U.S. Secret Service. ATF agents outplaced to the Customs Service will be utilized in Customs' expanded enforcement role in control of the export of critical technology, export investigations and investigations of the financial dealings of major drug traffickers and their money launderers under the Bank Secrecy Act.

Benefits Resulting From Reorganization

The ATF reorganization and reassignment of functions to the Secret Service and U.S. Customs Service within the Treasury Department represents a sound management decision. When combined with needed office closings and other structural changes, it will achieve economies, result in a

better allocation of law enforcement resources, maintain revenue protection and provide for the desired level of alcohol regulation. It is the logical result of Treasury's management review of ATF that revealed deficiencies, largely of an institutional nature, for which corrective action was required as well as the more general need for a more economic management of government resources.

The anomalous and at time counterproductive combination of resources devoted to disparate missions, alcohol and tobacco revenue protection and regulation on the one hand, and criminal investigations of firearms and explosives violations on the other, will be terminated. These resources and functions will now be allocated to agencies with goals that are fully compatible with the received functions.

When ATF personnel who are reassigned to the Secret Service for the firearms and explosives functions are fully merged into the Secret Service, the average field office will have a combined strength and capability well beyond what either agency has today. This strength will enable field offices of the new organization to devote more personnel not on full-time protective duty to priority investigations whether they are counterfeiting. and check forging - the regular investigative duties of the Secret Service - or firearms, protective intelligence, explosives or arson-type matters. Absent protective

needs, most of these personnel will be available for investigative work. Conversely, when there is a peak protective period or an urgent protective need occasioned by the visit of the President, Vice President of visiting head of state to a particular city, there will be greater personnel resources available in that city to satisfy that need.

Upon examination, the benefits to the reorganization both for the firearms/explosives function and the protective function are evident.

A. Benefits to Law Enforcement

It is submitted that the reassignment of the firearms and explosives functions to the Secret Service will result in a more efficient enforcement of the firearms, explosives and arson statutes with fewer people and less cost by the following measures:

1. By putting these functions into a strictly law enforcement organization as opposed to an organization that placed great emphasis on regulation and revenue protection of two commodities in areas totally unrelated to the enforcement of the firearms and explosives laws. The Secret Service is strictly a law enforcement organization. The 1100 field agents of the Secret Service made 6600 arrests in FY 1981 despite the fact that 45 percent of their

time was devoted to protective activities. 1700 of these arrests were made in counterfeiting cases. These accomplishments indicate a field organization strongly oriented toward the working of criminal enforcement cases and and a high level of productivity.

2. The transfer to the Secret Service should bring about a much-needed improvement in the morale and self image of ATF personnel who are reassigned by placing them in an organization with a high level of morale and an excellent public image. These factors taken by themselves contribute to greater productivity.

3. The transfer to the Secret Service will facilitate the closing of non-productive Posts of Duty and the reassignment of some of the personnel from these offices to areas where firearms, explosives and arson violations are concentrated. In addition, these reassignments will permit a greater concentration on the firearms, explosives and arson activities of major traffickers, criminal figures, hate groups and terrorists.

4. This transfer will give the Secret Service the ability to draw on additional resources badly needed for

its protective mission. The management review conducted by the Treasury Department in connection with the assassination attempt on President Reagan on March 30, 1981, stated that the protective responsibilities of the Secret Service have been expanding in recent years while budgetary restraints reduced the number of special agents available for protective duties. It recommended that if the Secret Service is to continue to provide the level of protection equivalent to that which it has historically achieved, the manpower and financial resources available to the Secret Service for the performance of this function must be significantly increased. This review also found that there has been approximately a 15 percent overall decline in the Special Agent and Uniformed Division categories of the Secret Service since 1977. The utilization of ATF agents to support the Secret Service in the protective area is not new. ATF routinely supports the Secret Service during campaign years. During the 1980 Presidential Campaign 600 ATF agents were used at various times in support of Secret Service protective activities.

5. The merger of ATF functions to the Secret Service will enhance intelligence gathering capabilities of the Service. Individuals and groups who threaten and attack Secret Service protectees need and acquire guns and explosives. ATF's criminal investigative work in these areas frequently uncovers individuals and groups of possible interest to the Secret Service. ATF's gun tracing abilities as demonstrated in the Hinckley case will greatly enhance Secret Service needs. ATF has a great deal of information on various hate groups and terrorist groups who have violated the firearms and explosives statutues. This information will be of great benefit to the Secret Service in its protective mission.
6. In order to be most effective in its protective mission, the Secret Service needs to maintain excellent working relations with state and local law enforcement throughout the country. ATF personnel have developed strong working relationships with state and local law enforcement which will benefit the Secret Service.

B. Regulatory and Revenue Protection Benefits

The Customs Service receipt of the excise tax and regulatory functions of ATF pertaining to alcohol and tobacco is a

sound management decision. Both agencies collect substantial revenues, maintain laboratories for testing commodities, utilize all-in-bond procedures and have significant regulatory responsibilities. In combining the collection of import duties with excise tax collection, Customs will follow the practice of most European countries. Apart from combining activities of common expertise, this reassignment of functions will also result in efficiencies by reducing administrative and management overhead and combining laboratory resources.

C. Cost Benefits

The cost benefits derived from the reorganization result from administrative and management overhead savings, closing of unproductive field offices and outplacement of enforcement personnel, and from a planned reduction in the level of F.A.A. Act enforcement. Following a budget level of $138 million for FY 1982, the reassigned functions will be operated in FY 1983 at a level of $121 million. This will represent a savings of approximately $29 million from the FY 1981 level of $150 million. Specifically, these savings will be achieved from the more efficient use of the following resources:

Space and Equipment

Administrative and Management Overhead

Criminal Enforcement Personnel

Regulatory Enforcement Personnel

Conclusion

The reassignment of functions outlined above is based on sound management principles and cost-effective planning. The firearms and explosives laws can be enforced more efficiently with fewer people in the right locations with existing Secret Service personnel available for priority firearms, explosives and arson cases. The Secret Service will have a larger manpower base to call on for unusual protective requirements and the flow of intelligence will be facilitated. The collection of excise taxes on alcohol and tobacco and the regulation of the alcohol industry to the degree mandated by Congress will not be impaired by the merger of these functions into the Customs Service while significant savings will be achieved.

We would appreciate the support of this Committee for the funding level which we need and by approving our plan to reassign functions and personnel.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

February 8, 1982

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 5,000 million of 13-week bills and for $5,000 million of 26-week bills, both to be issued on February 11, 1982, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing May 13, 1982			26-week bills maturing August 12, 1982		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	96.481	13.921%	14.63%	92.979 a/	13.888%	15.14%
Low	96.428	14.131%	14.86%	92.939	13.967%	15.24%
Average	96.436	14.099%	14.82%	92.956	13.933% 2/	15.20%

a/ Excepting 1 tender of $10,000

Tenders at the low price for the 13-week bills were allotted 45%.
Tenders at the low price for the 26-week bills were allotted 84%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 71,840	$ 71,840	$ 79,600	$ 74,600
New York	9,322,900	3,993,400	8,058,900	3,919,060
Philadelphia	47,930	46,410	33,460	33,460
Cleveland	86,095	63,095	168,675	132,675
Richmond	54,000	54,000	169,850	73,850
Atlanta	76,610	75,335	89,355	76,855
Chicago	663,235	193,985	486,120	118,020
St. Louis	41,860	31,860	38,645	25,645
Minneapolis	13,965	11,965	15,920	15,840
Kansas City	81,055	81,055	72,000	61,500
Dallas	36,270	31,270	28,265	18,265
San Francisco	682,900	117,150	821,300	213,280
Treasury	228,680	228,680	237,295	237,295
TOTALS	$11,407,340	$5,000,045	$10,299,385	$5,000,345
Type				
Competitive	$ 9,222,405	$2,815,110	$ 7,964,775	$2,665,735
Noncompetitive	1,239,710	1,239,710	1,028,110	1,028,110
Subtotal, Public	$10,462,115	$4,054,820	$ 8,992,885	$3,693,845
Federal Reserve	879,225	879,225	825,000	825,000
Foreign Official Institutions	66,000	66,000	481,500	481,500
TOTALS	$11,407,340	$5,000,045	$10,299,385	$5,000,345

1/ Equivalent coupon-issue yield.
2/ The four-week average for calculating the maximum interest rate payable on money market certificates is 13.602%.

R-610

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Statement by
Secretary of the Treasury Donald T. Regan
at a
Press Briefing on the Budget
State Department Auditorium
Saturday, February 6, 1982, 10:00 a.m.
Washington, D.C.

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing federal spending and the tax burden.

It's a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakenly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together. There have been at least two occasions in my life when I had a relatively firm idea of my personal income. The first was in the Marines; the second as Secretary of the Treasury. Both times I had salaries set by Uncle Sam with small expectations for a bonus. Budgeting under those circumstances is fairly easy.

Uncle Sam himself, however, has the added luxury of being able to raise taxes as the mood strikes. Assuming, of course, that the Congress goes along. Thus we have the good fortune of being able to decide how much money we want to spend, for what purposes, and how we'll raise the money.

Today we present a budget for Fiscal 1983 that brings in tax revenues totalling $666.1 billion, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excise or other

kinds of taxes.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend. In a minute I will discuss a chart showing the rapid rise in government revenues that will occur over the next several years, in spite of the tax reduction program. Even adjusted for inflation, there is a rise in revenues over the period.

However, the revenue picture has two important flaws in terms of this year's budget: the recession and the drop in inflation. One bitter pill and one piece of candy which together have significantly decreased revenues to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we have chosen to close tax loopholes, upgrade our tax collection program and renew our efforts at controlling spending.

It is preferable to close the transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

The budget deficit can and must be narrowed from the spending side. Some progress was made last year in reducing the runaway rate of growth in federal non-defense spending. Even greater efforts will be required this year and into the future.

Today's budget also demonstrates that economic variables can sometimes produce a misleading bottom line. Certainly they produce a fluid set of circumstances. For example:

A 2 percent rise in interest rates raises outlays on debt service by $4 billion in 1982, $11.2 billion in 1983, and $16.2 billion in 1984, rising to $25 billion in 1987. If interest rates average 2 percent lower than we forecast over the period,

that is how much we would take off the deficit.

We have been very conservative in our real growth estimate. we are forecasting an average of 4.7 percent real growth from 1982 through 1987. This is better than the 1947 through 1982 average of 3.5 percent. However, it is lower than the 1961-1966 average of 5.4 percent, and considerably lower than the typical period of rebound following past recessions. In light of the tax incentives we have enacted, and historical evidence, there is ample reason to expect a period of better than average growth. This is in fact the main goal of the President's Economic Recovery Program.

If we were to have real growth at 1.2 percent faster than projected, and inflation less by an equal amount, the budget picture would be significantly improved. Higher revenues from having more people working, lower outlays on unemployment and welfare programs, and lower cost-of-living adjustments on indexed programs would produce a major reduction in the deficit. The deficit would be $32 billion less than forecast by 1984, $48 billion by 1985, $65 billion by 1986 and $82 billion less - in fact, a substantial surplus - by 1987.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficits. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next 5 years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the 5 years. After allowing for regular outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congress planned to balance the budget. Not this time. We intend to balance the budget through lower taxes and higher real growth, not through inflation. In the short run there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation. Normal year-to-year increases in saving run $40 to $50 billion each year. Adding in the personal savings and additional business retained earnings induced by the tax cuts

brings the increase in saving over 1981 levels to an estimated $60 billion in 1982 and $250 billion in 1984.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until they are certain it is safe to proceed. But I am confident that new investment is coming.

What the economy needs is a respite from the burden of excessive spending growth. If given time to grow out from under the spending burden, the economy can perform wonders.

I want to conclude with a few comments about the nature of this program. When the President said in his State of the Union Message that we will not balance the budget on the backs of taxpayers, it was a reminder to everyone of just what this program stands for. The budget is another reminder. Our program is designed to let people keep more of their own money, to increase private sector economic growth, to create jobs and reduce inflation.

As this budget makes abundantly clear, we are paring Federal spending and making government more accountable to local citizens -- and more responsive to local needs.

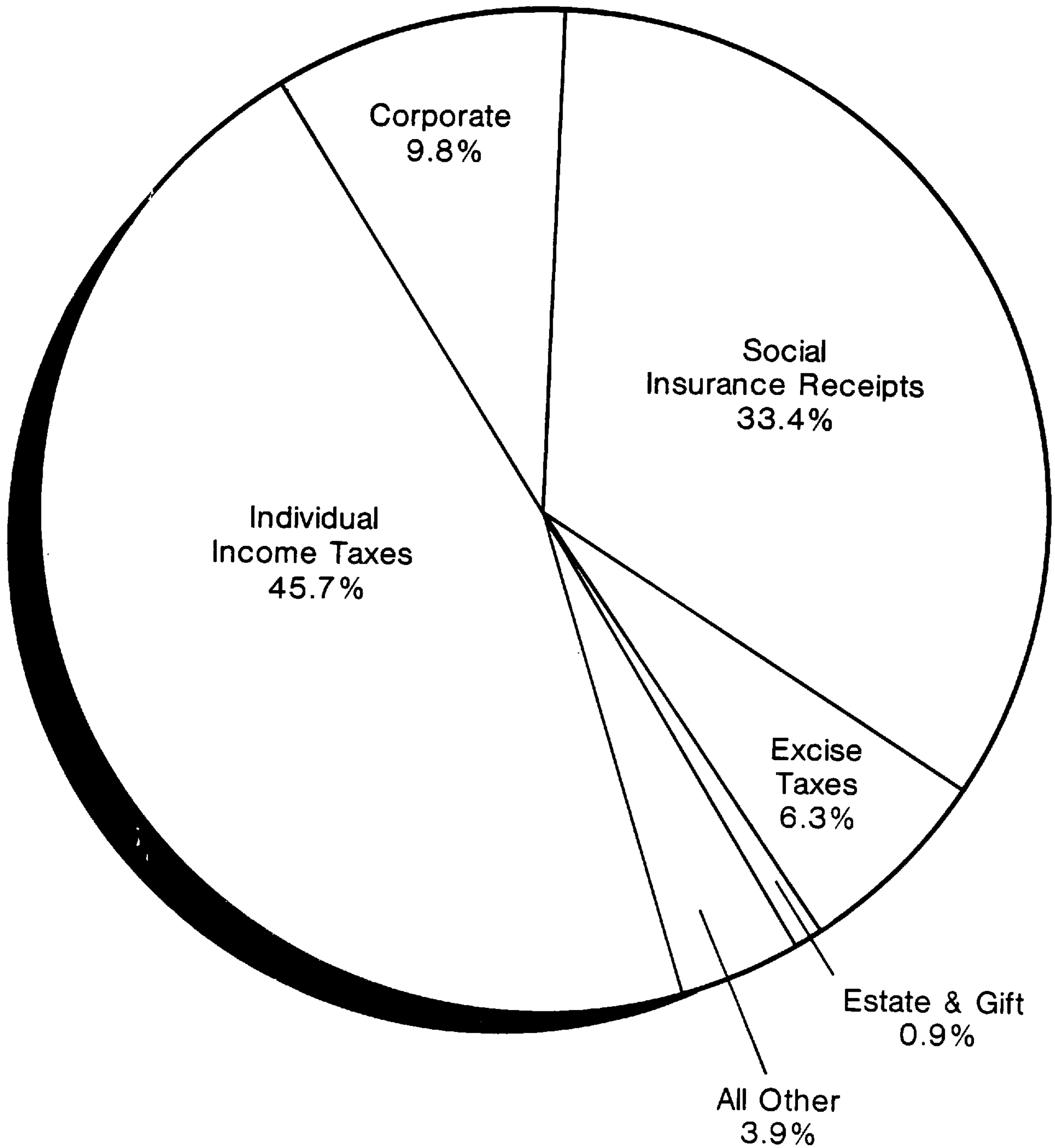
Earlier this week I spoke at the National Press Club about a return to prosperity and my conviction that we will see a strong economic recovery in the months ahead. I continue to believe that. The current recession, which follows hard upon the downturn of 1980 and the weak economy of this spring, began in earnest in July, before the President's program was implemented. That program is now in place and it is on the verge of leading us out of this recession.

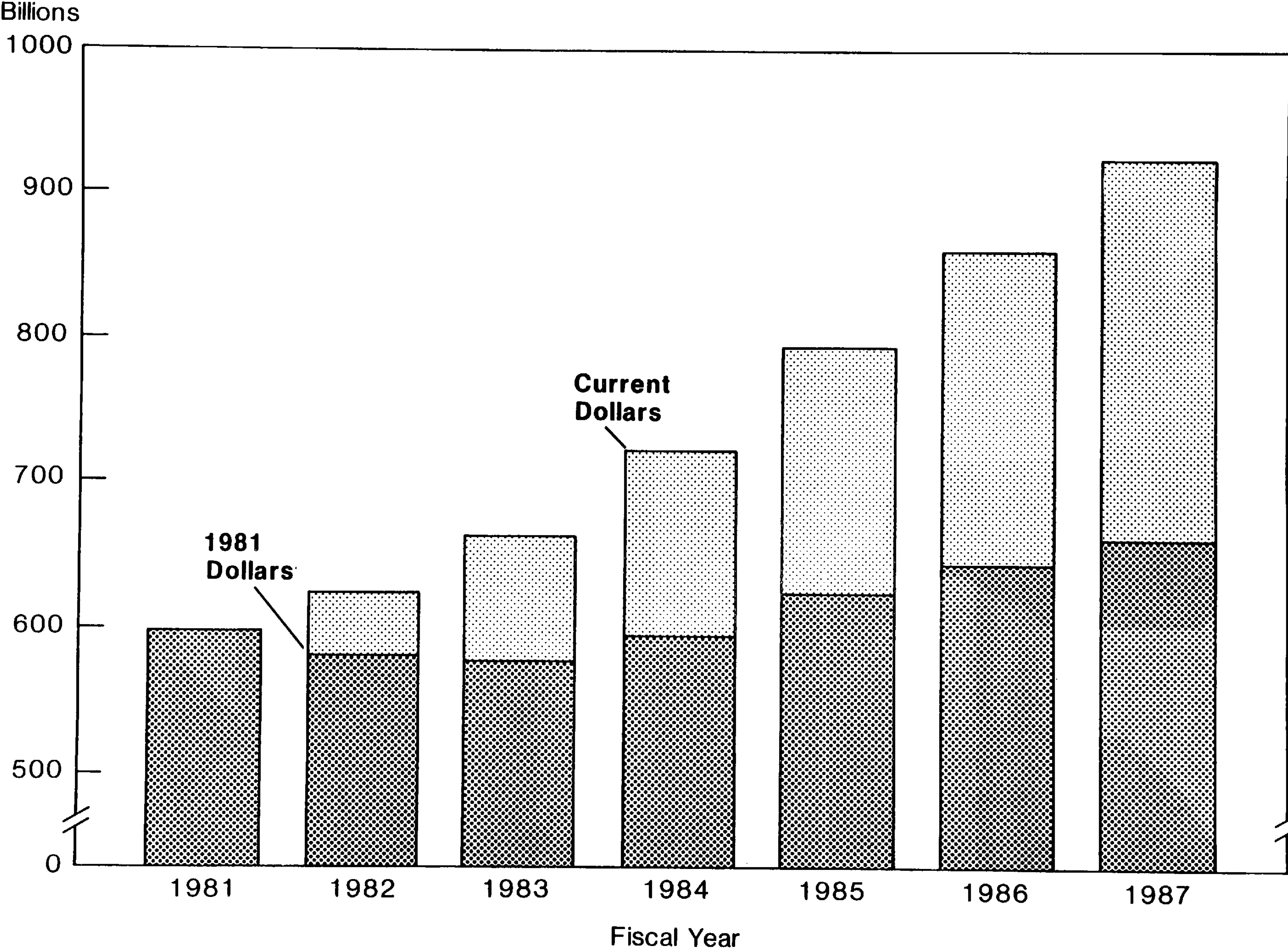
It's time to look forward, not backward. And I urge the Congress to consider this budget with that in mind.

Thank you.

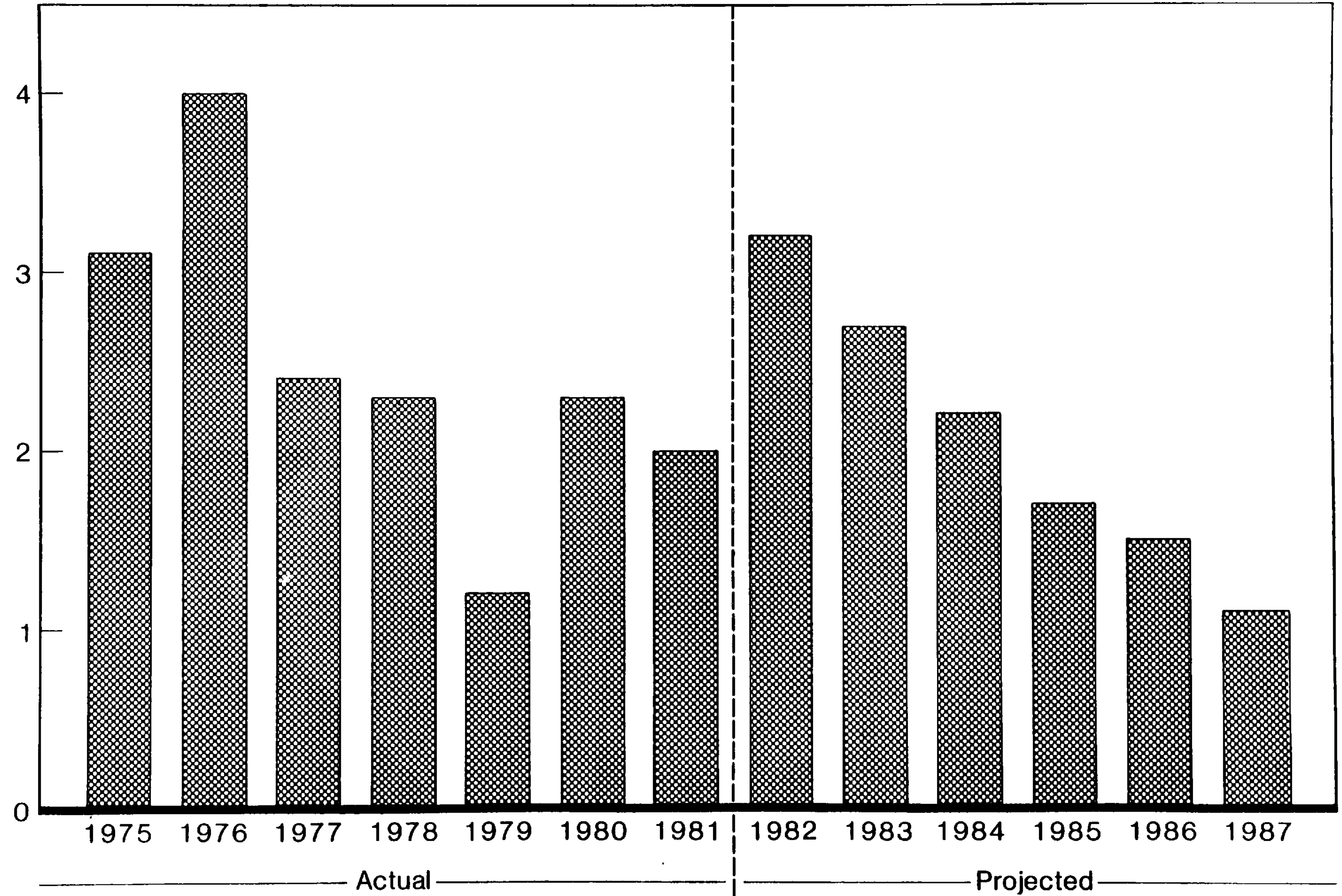
# # #

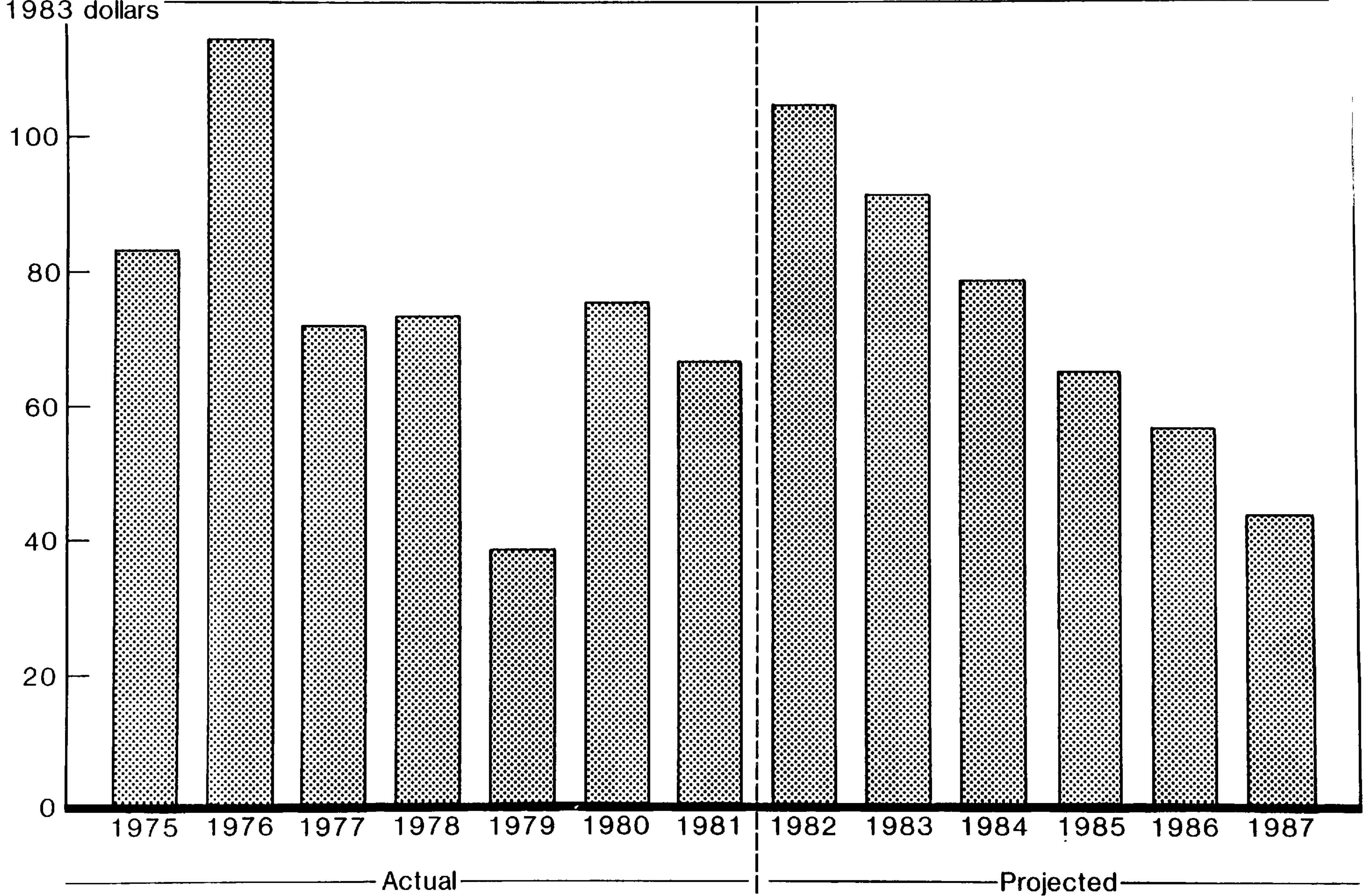
Unified Budget Receipts by Source
Fiscal Year 1983



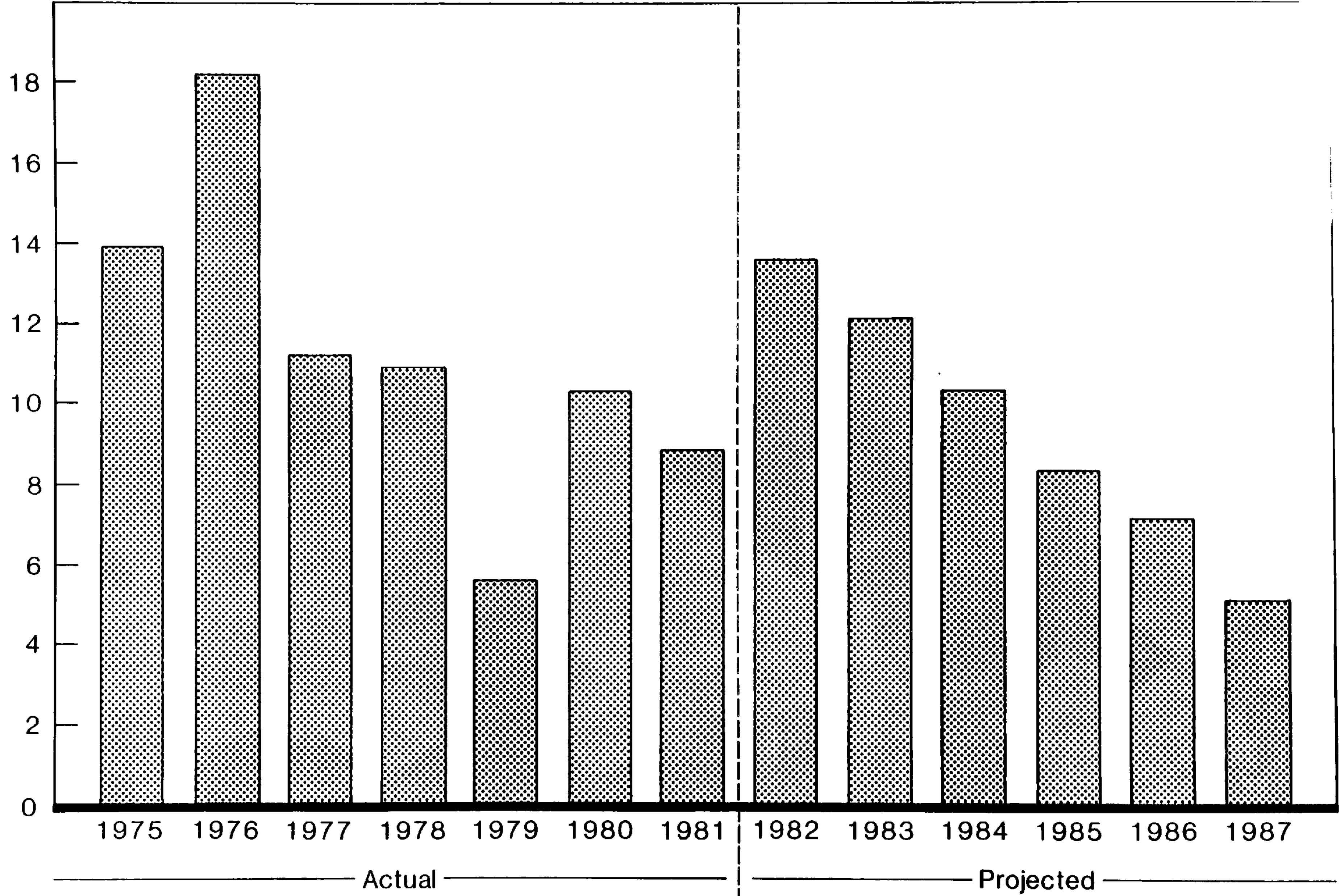


Budget Receipts in Current and Constant Dollars
Billions
1000
900
800
700
600
500
0
Current Dollars
1981 Dollars
1981
1982
1983
1984
1985
1986
1987
Fiscal Year

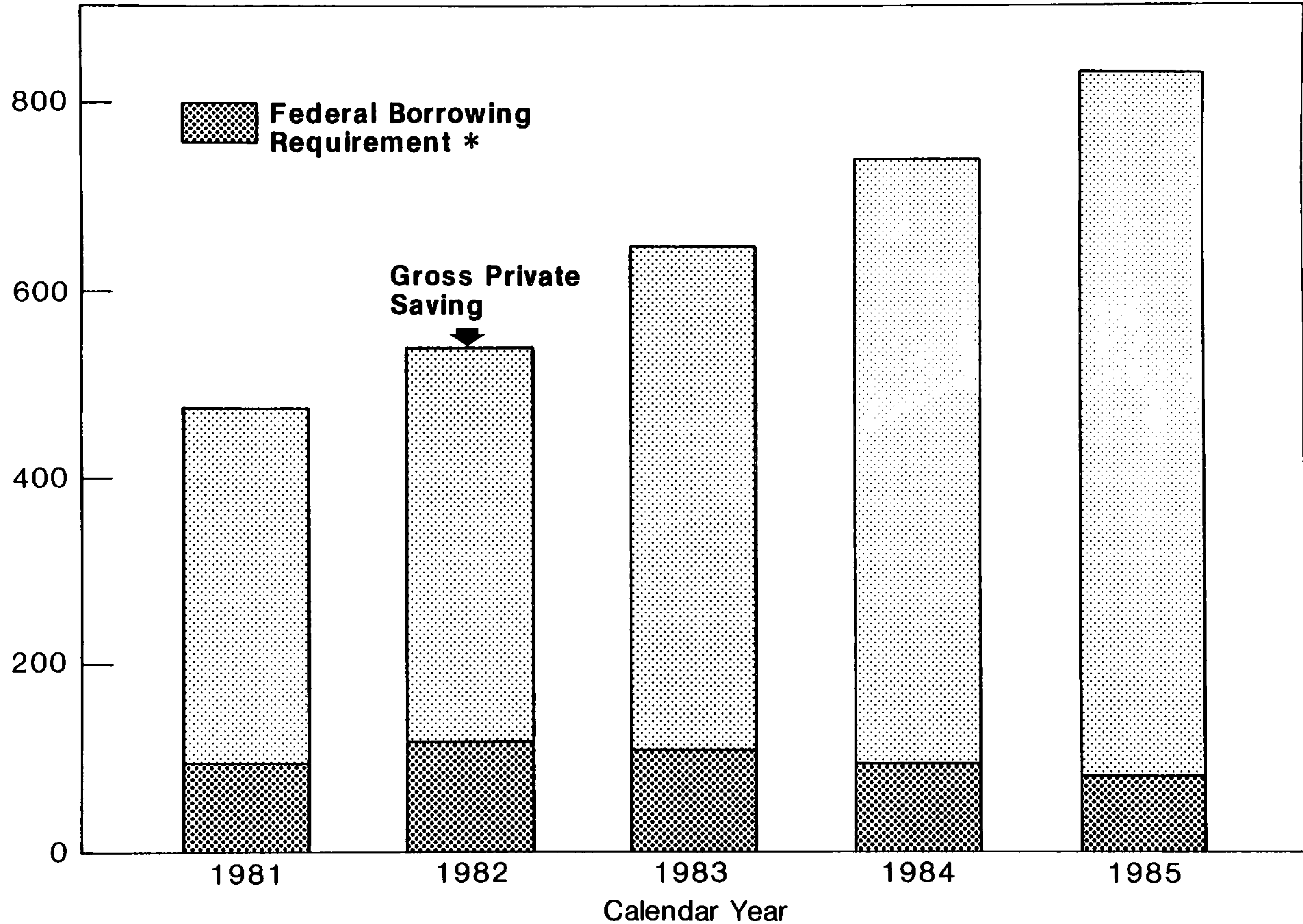

Budget Deficits in Relation to GNP*
Percent
4
3
2
1
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected
* Unified budget deficit as percent of fiscal year GNP


Constant Dollar Budget Deficits
Billions of
1983 dollars
100
80
60
40
20
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected

Budget Deficits as a Percent of Outlays

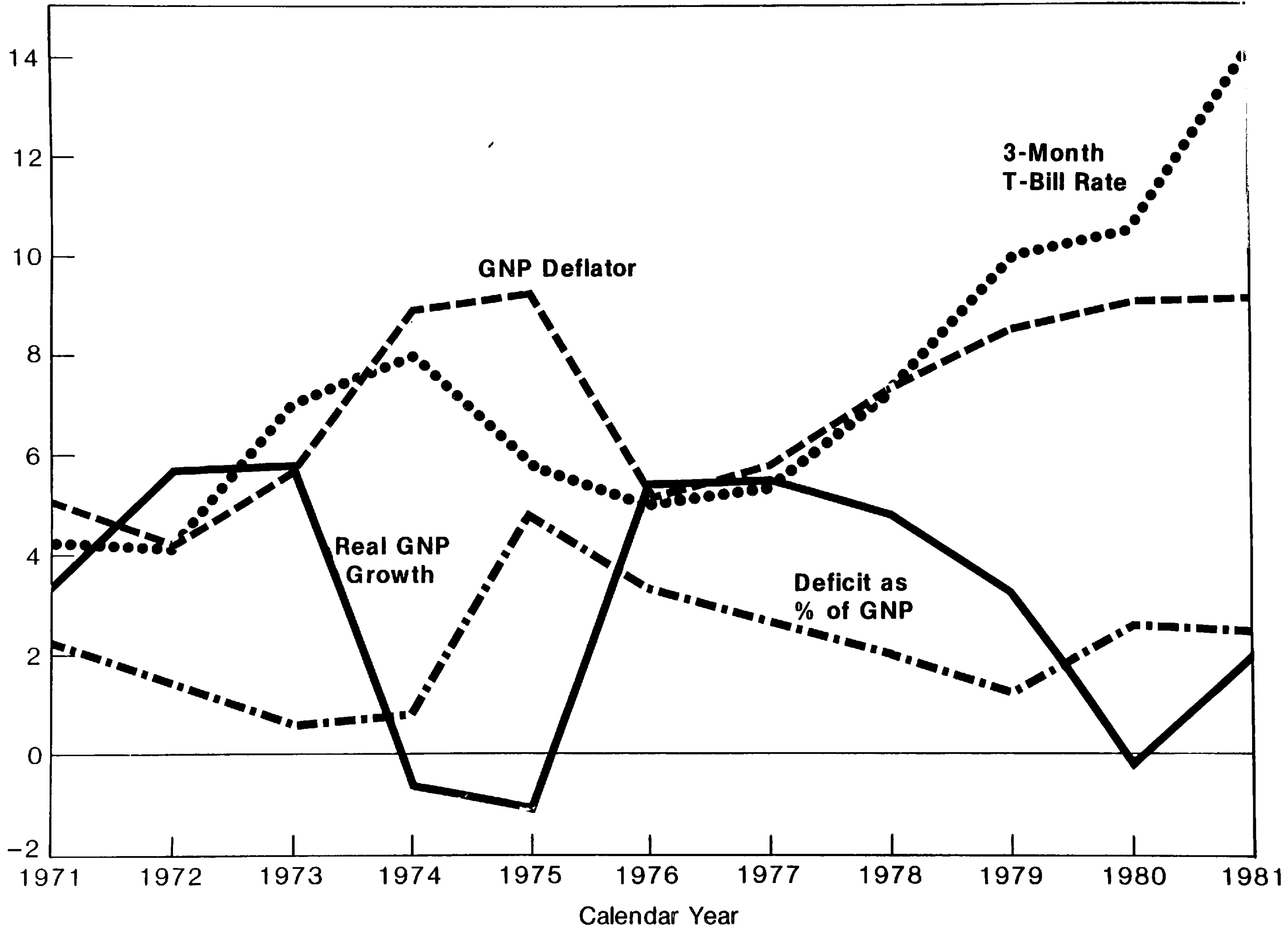


Projected Borrowing Requirement in Relation to Private Saving

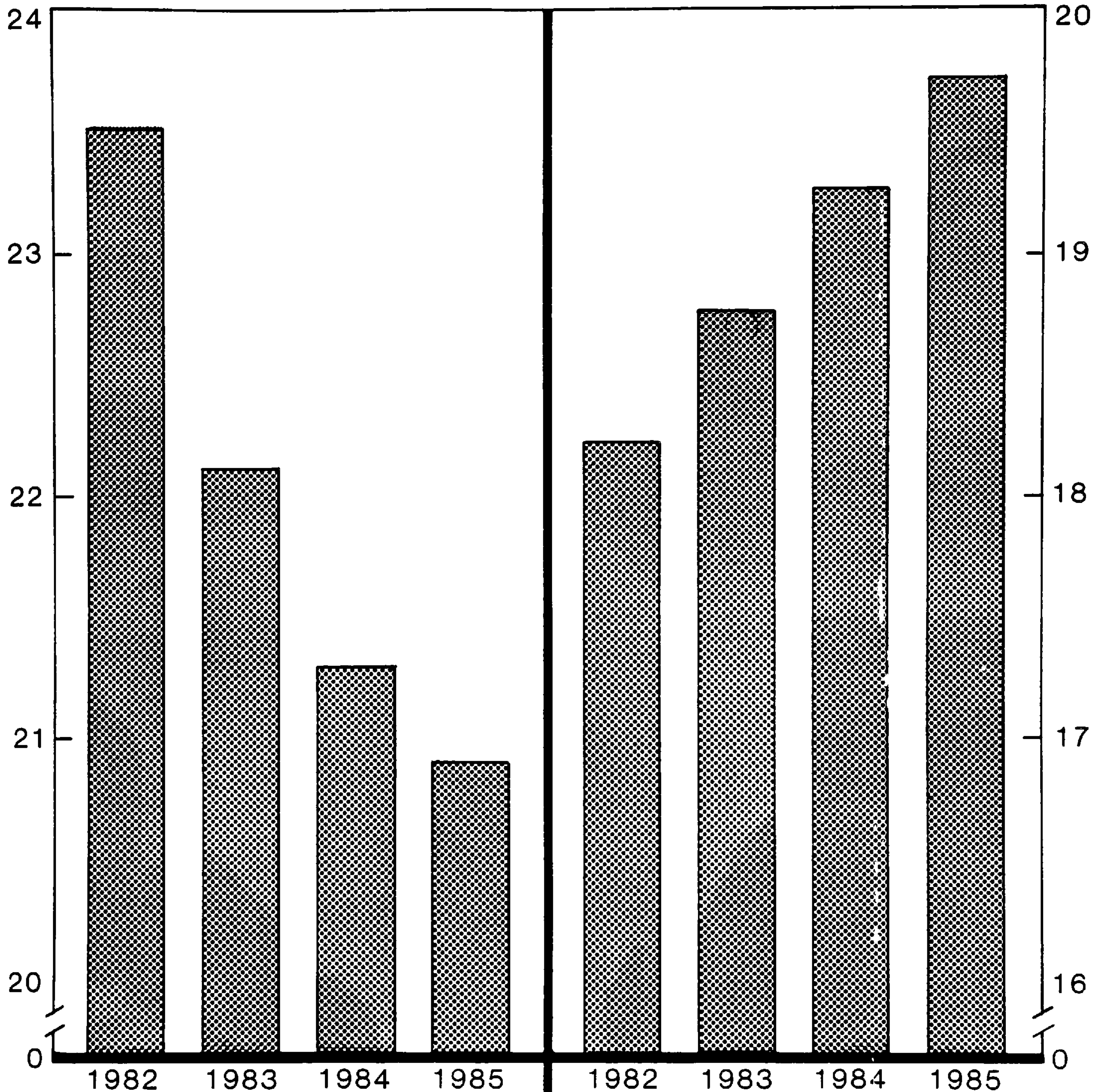


* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.



Deficit, Inflation, Real Growth, and Interest Rates
Percent
14
12
10
8
6
4
2
0
−2
3-Month
T-Bill Rate
GNP Deflator
Real GNP
Growth
Deficit as
% of GNP
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
Calendar Year


Government Budget
Family Budget
Percent
Thousands of
1982 dollars
24
23
22
21
20
0
20
19
18
17
16
0
1982
1983
1984
1985
1982
1983
1984
1985
Federal Outlays as a percent of GNP
After-tax real income for family of four with $20,000 wage income in 1982 growing with productivity

TREASURY NEWS

)epartment of the Treasury • Washington, D.C. • Telephone 566-2041

EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED FOR DELIVERY AT 9:30 A.M., EST
TUESDAY, FEBRUARY 9, 1982

TESTIMONY OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE APPROPRIATIONS COMMITTEE
Tuesday, February 9, 1982
Washington, D.C.

Mr. Chairman and Members of the Committee, it is a pleasure to be with you to discuss the 1983 budget.

President Reagan's new budget is a blueprint for growth and prosperity. It is a plan for reducing Federal spending and tax rates. It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government. And that is what this debate is all about: limiting government spending versus raising people's taxes. Those who believe that the Federal government is too small, or that the American people do not pay enough taxes, will be disappointed in our budget.

This budget contains dramatic reductions in government spending, yet it is important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

<u>Receipts by Source Chart</u>

Today we present a budget for Fiscal 1983 that raises tax revenues totalling $666.1 billion. As the first chart shows, 45.7 percent or $304.5 billion comes from individual income taxes, 9.8 percent or $65.3 billion from corporations, 33.4 percent or $222.5 billion from payroll taxes and the remainder from excise or other kinds of taxes.

R-612

Revenue Growth Chart

We have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend. The second chart shows the rapid rise in government revenues that will occur over the 1981-1987 period. Receipts are shown in nominal terms and in real terms (1981 dollars) adjusted for inflation.

Even with the tax cuts, the recession, and the sharp drop in the inflation rate, Federal tax receipts are rising -- from $627 billion in 1982 and $666 billion in 1983, all the way to $797 billion in 1985 and $926 billion in 1987.

In real terms, revenues fall by about $20 billion between 1981 and 1983, but they rise again strongly from 1983 to 1987, ending up some $60 to $70 billion higher (in 1981 dollars) than they were in 1981. If it were not for the recession, revenues would have risen in real terms each year in spite of the tax reductions and the fall in the inflation rate. What the tax reductions have done is prevent even larger tax increases. They have not slashed revenues from current levels.

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have significantly decreased revenues to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It

would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are presenting today take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a non-disruptive fashion. Let me put the deficit into perspective.

Deficit as Percent of GNP Chart

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The third chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. Due to the high growth policy now in place, the recession will be ending shortly, and deficits will be declining as a percent of GNP.

Savings Chart

The deficits will be manageable because of the growth of private sector saving, as shown in the next chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earnings induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

Deficits, Inflation, Real Growth and Interest Rate Chart (Historical)

Some have questioned whether there will be enough saving to permit economic recovery in the face of these deficits, or whether deficits will force interest rates higher and choke off the recovery. I think we can turn to recent history and the next chart to allay these fears.

The 1974-1975 recession started with high interest rates, sharply reduced output, and rising prices; it sent the deficits soaring. Following that recession, the 1976-1977 period was one of much lower inflation rates, lower interest rates, and sharply accelerating growth. All this occurred in spite of the high recession-induced deficits of 1975 and 1976. Though high, they were due primarily to the recession, and they were falling.

Deficits, Inflation, Real Growth and Interest Rate Chart (Projected)

This is exactly the situation we face today, as the next chart shows. We expect to do even better on all fronts than in the 1975-1980 recovery, bringing down the recession-induced deficits, lowering inflation and interest rates and increasing real growth over the next four years.

We already have in place a four-part program to restore economic growth and full employment while reducing inflation.

- With the help of the Congress, we achieved significant reduction in the growth of Federal spending for Fiscal Years 1982 and beyond, freeing up real and financial resources -- manpower, goods and services, and money -- needed by the private sector to modernize and grow.

- The Economic Recovery Tax Act is in place, with its major incentive provisions taking effect over five calendar years.

  Under the full three-year incentive tax rate reduction, followed by indexing in 1985, bracket creep that has been poisoning labor negotiations and pricing U.S. labor out of world markets is at an end. The rising marginal tax rates that, with inflation, cut personal savings rates by almost 40 percent between 1975 and 1981, will be reduced.

  The accelerated cost recovery system will restore a reasonable rate of return on investment in plant and equipment. For the first time in years, firms will be allowed a tax write-off large enough to let them fully replace their plant and equipment, the costs of which have been rising sharply with inflation.

- Regulatory reform is under way to reduce the enormous compliance costs that are holding back production and raising prices.

- Monetary policy has shifted toward reducing inflation. We have encouraged the Federal Reserve to keep money growth steady at levels consistent with a gradual return to stable prices and low interest rates.

> The key to lower interest rates is lower inflation and stable policies. Excessive money growth raises fears of inflation and sends interest rates higher. Erratic money growth, even for a few months, creates confusion and risk and sends interest rates higher. Finally, inadequate money growth interferes with economic recovery. We have consistently urged the Federal Reserve to stick to a steady, moderate rate of money growth, neither too high nor too low. This is its announced policy as well, and it is struggling to put it into practice.

The successful completion of these policy changes is essential for faster economic growth, lower inflation, lower interest rates, and an improved budget picture. The new budget demonstrates how sensitive the budget figures are to economic variables.

For example, a 2 percent rise in interest rates raises outlays on debt service by $4 billion in 1982, $11.2 billion in 1983, and $16.2 billion in 1984, rising to $25 billion in 1987. If interest rates average 2 percent lower than we forecast over the period, that is how much we would take off the deficit.

We have been very conservative in our real growth estimates. We are forecasting an average of 4.7 percent real growth from 1982 through 1987. This is better than the 1947 through 1982 average of 3.5 percent. However, it is lower than the 1961-1966 average of 5.4 percent, and considerably lower than the typical period of rebound following past recessions. In light of the tax incentives we have enacted, and historical evidence, there is ample reason to expect a period of better than average growth. This is in fact the main goal of the President's Economic Recovery Program.

If we were to have real growth 1.2 percent faster per year than projected, and inflation less by an equal amount, the budget picture would be significantly improved. Higher revenues from having more people working, lower outlays on unemployment and welfare programs, and lower cost-of-living adjustments on indexed spending programs would produce a

major reduction in the deficit. The deficit would be $32 billion less than forecast by 1984, $48 billion by 1985, $65 billion by 1986 and $82 billion less -- in fact a substantial surplus -- by 1987.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficits. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until they are certain it is safe to proceed. Some of them are waiting for lower interest rates. Some of them are

waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

What the economy needs is a respite from the burden of excessive spending growth and a period of stability and predictability in monetary and fiscal policy. If given a stable monetary and fiscal climate and time to grow out from under the spending burden, the economy can perform wonders. The best thing Congress can do to help is to get behind the President's program and stick with it.

I want to conclude with a few comments about the nature of this program. When the President said in his State of the Union Message that we will not balance the budget on the backs of taxpayers, it was a reminder to everyone of just what this program stands for. The budget is another reminder. Our program is designed to let people keep more of their own money, to increase private sector economic growth, to create jobs and reduce inflation.

Outlays/GNP and After-Tax Family Income Chart

The last chart shows what we mean. And this is the real bottom line of the budget and the Economic Recovery Program -- the restoration of prosperity to the American family.

We propose to reduce Federal spending as a percent of GNP from 23.5 percent in 1982 to 20.9 percent in 1985. We intend to restore incentives and return resources to the private sector through both tax and spending reduction. It is our goal to reverse our productivity slump, increase real wages, and increase the disposable incomes available to families.

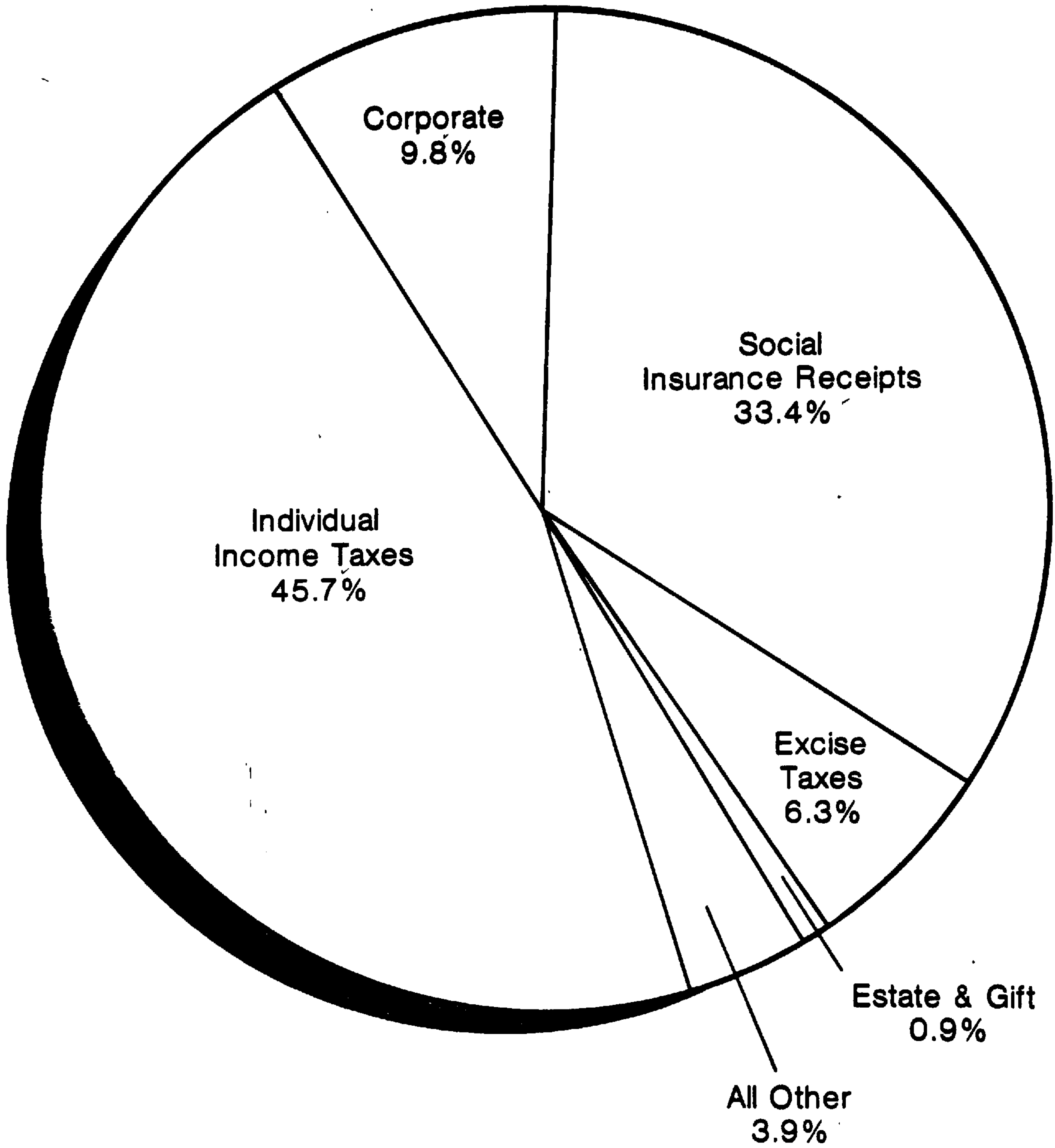
If we are successful, a family earning $20,000 in 1982 will experience a substantial rise in its real after-tax income -- an increase of more than $1,400 -- by 1985.

This is our major goal. It is the purpose behind our economic program and the budget suggestions we are making here today. We are determined to restore prosperity to American families at all income levels, so they may live more productive and rewarding lives. They, and we, will settle for nothing less.

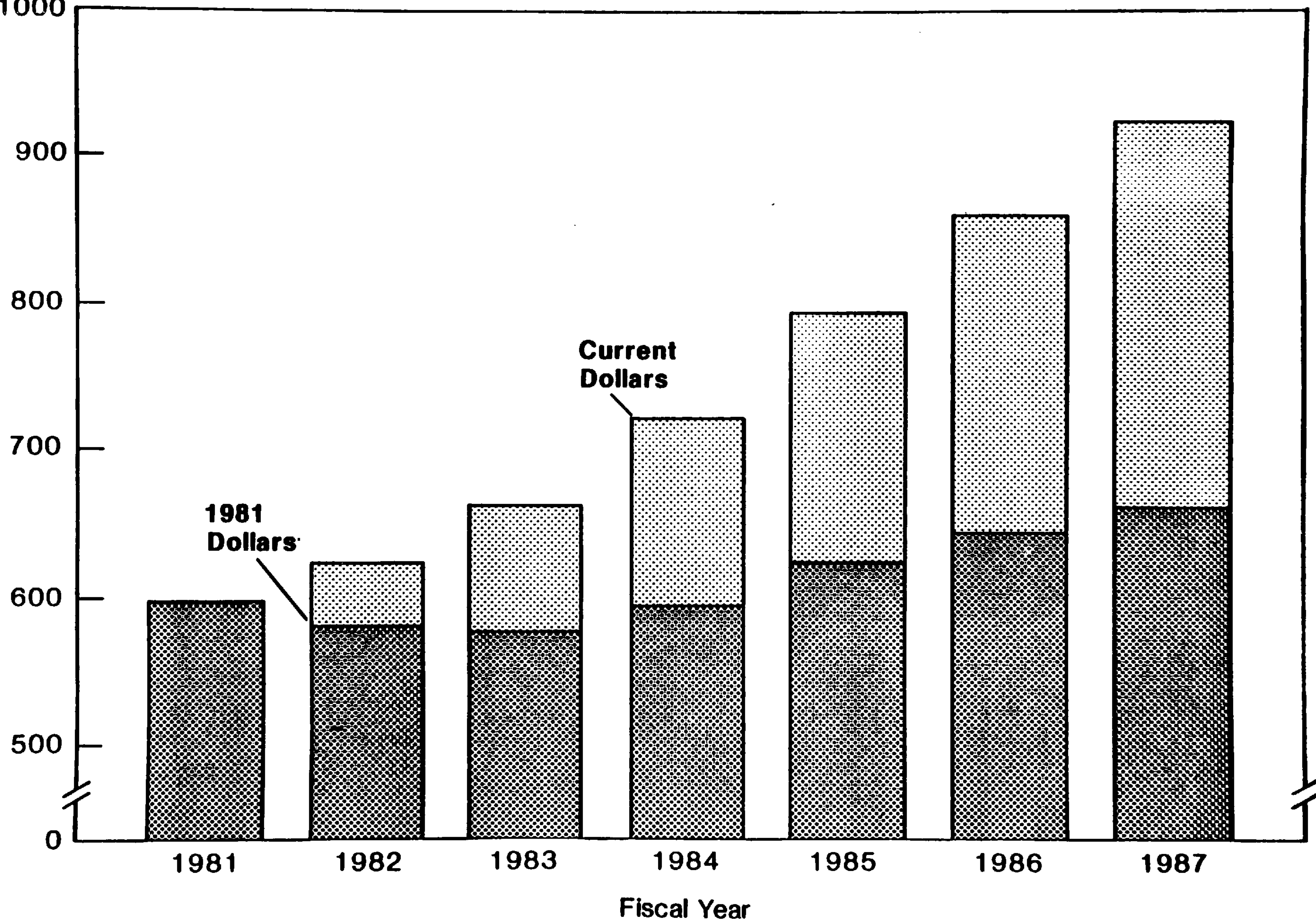
As the President said in his Budget Message, this is not the time to retreat. It is our conviction that we will see a strong economic recovery in the months ahead. The current recession, which follows hard upon the downturn of 1980 and the weak economy of this spring, began in earnest in July, before the President's program was implemented. That program is now in place and it is on the verge of leading us out of this recession. Signs of recovery are already visible.

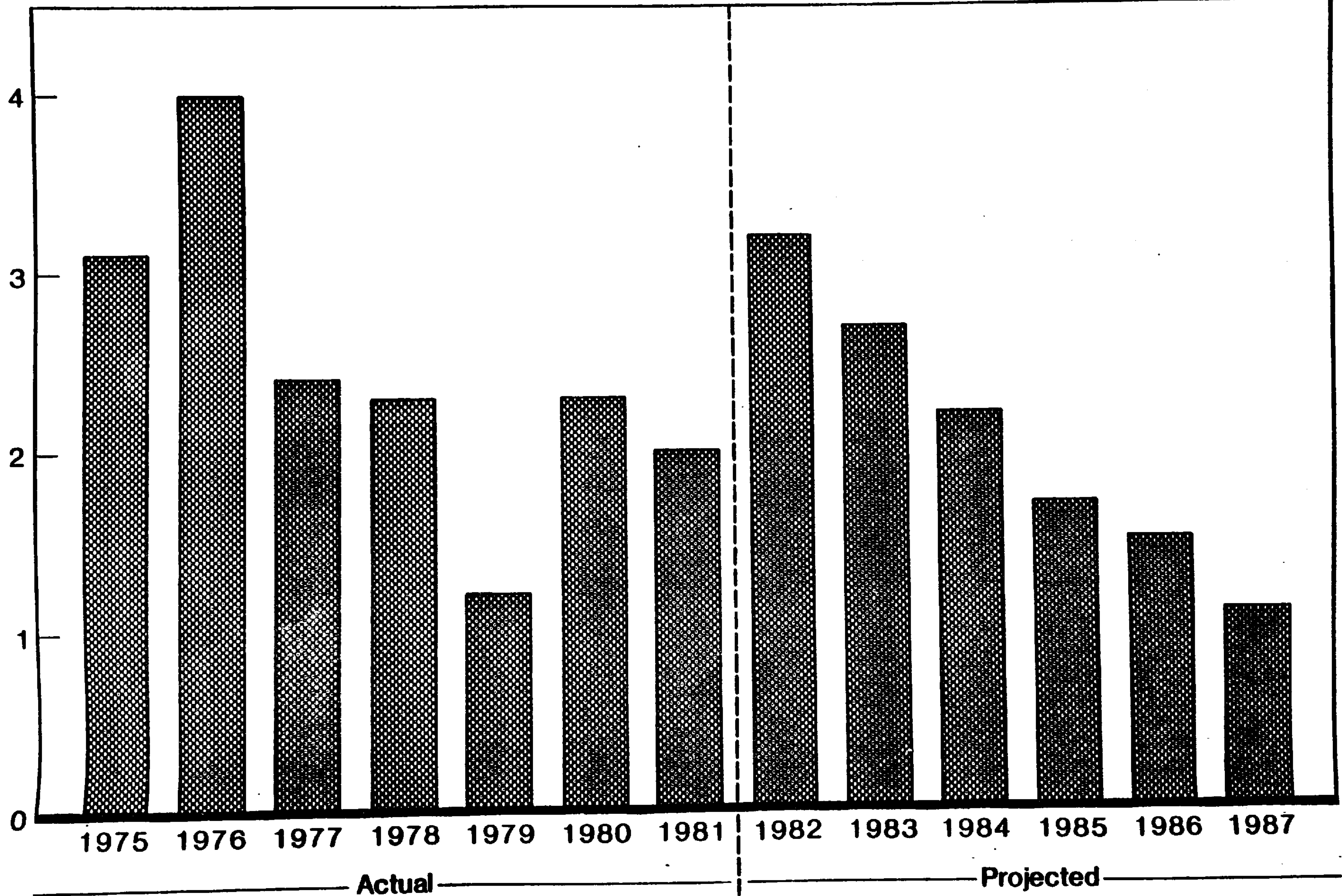
It is time to look forward, not backward. And I urge the Congress to consider this budget with that in mind.

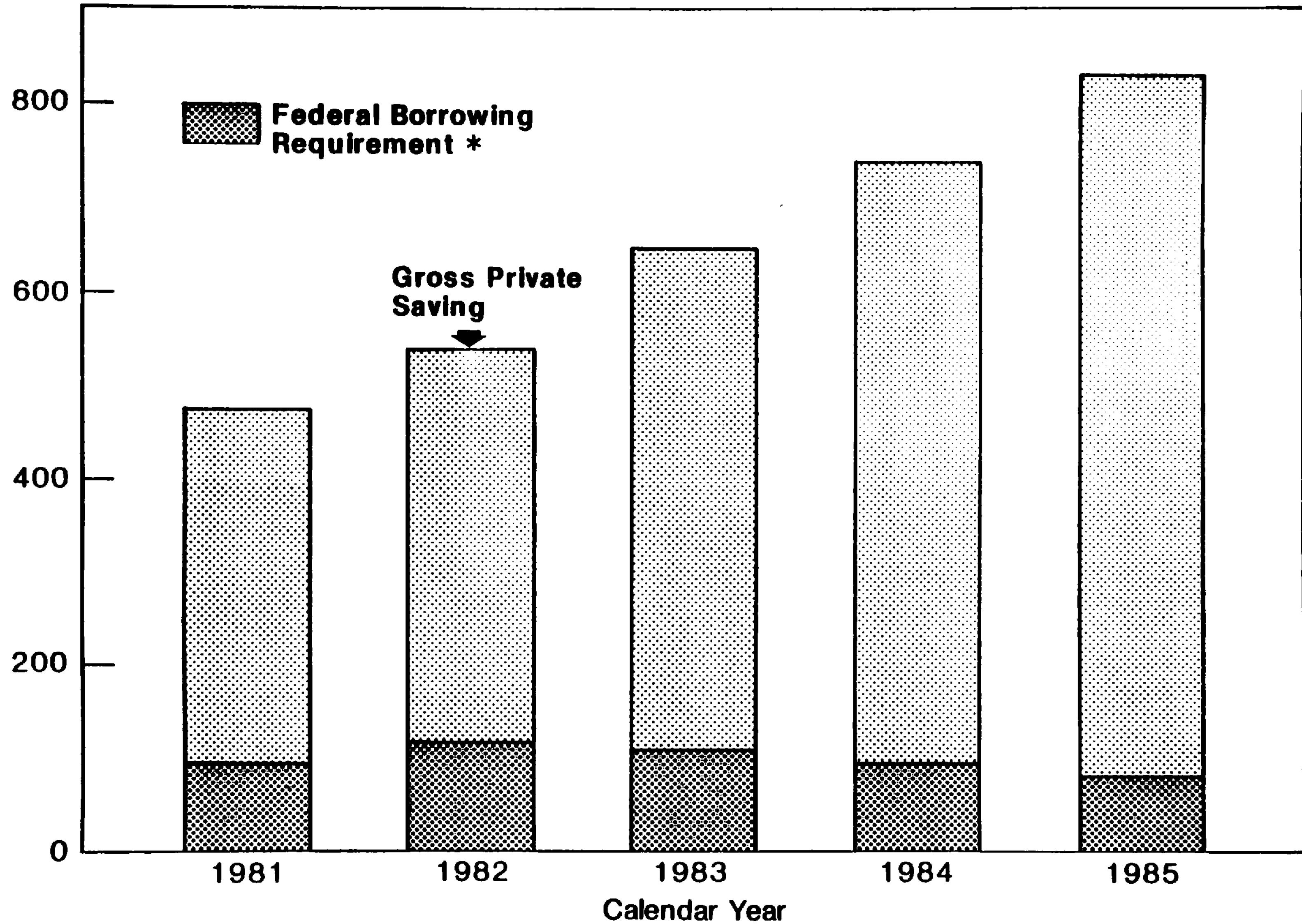
Unified Budget Receipts by Source
Fiscal Year 1983



Budget Receipts in Current and Constant Dollars

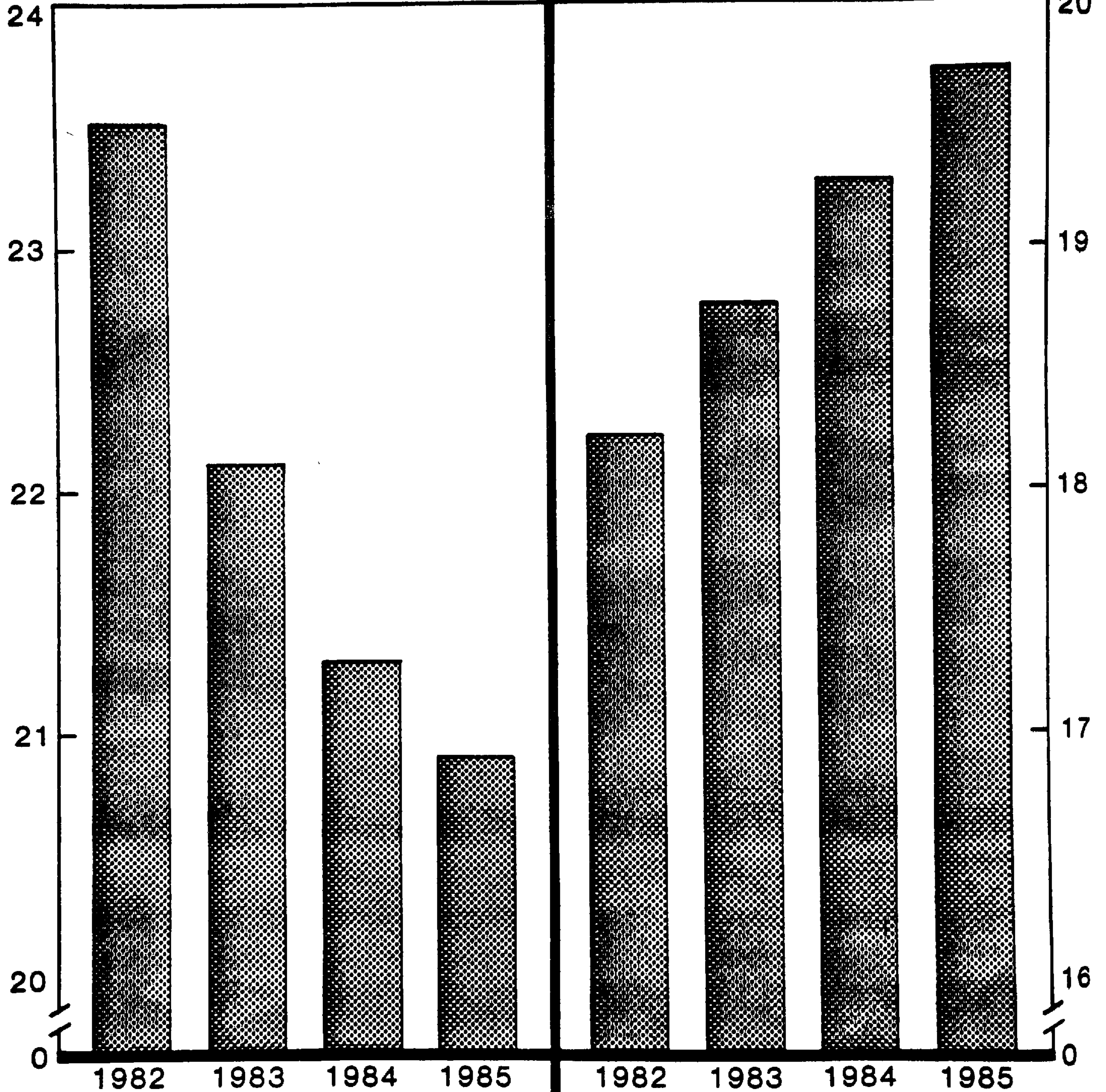



Budget Deficits in Relation to GNP*
Percent
4
3
2
1
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected
* Unified budget deficit as percent of fiscal year GNP



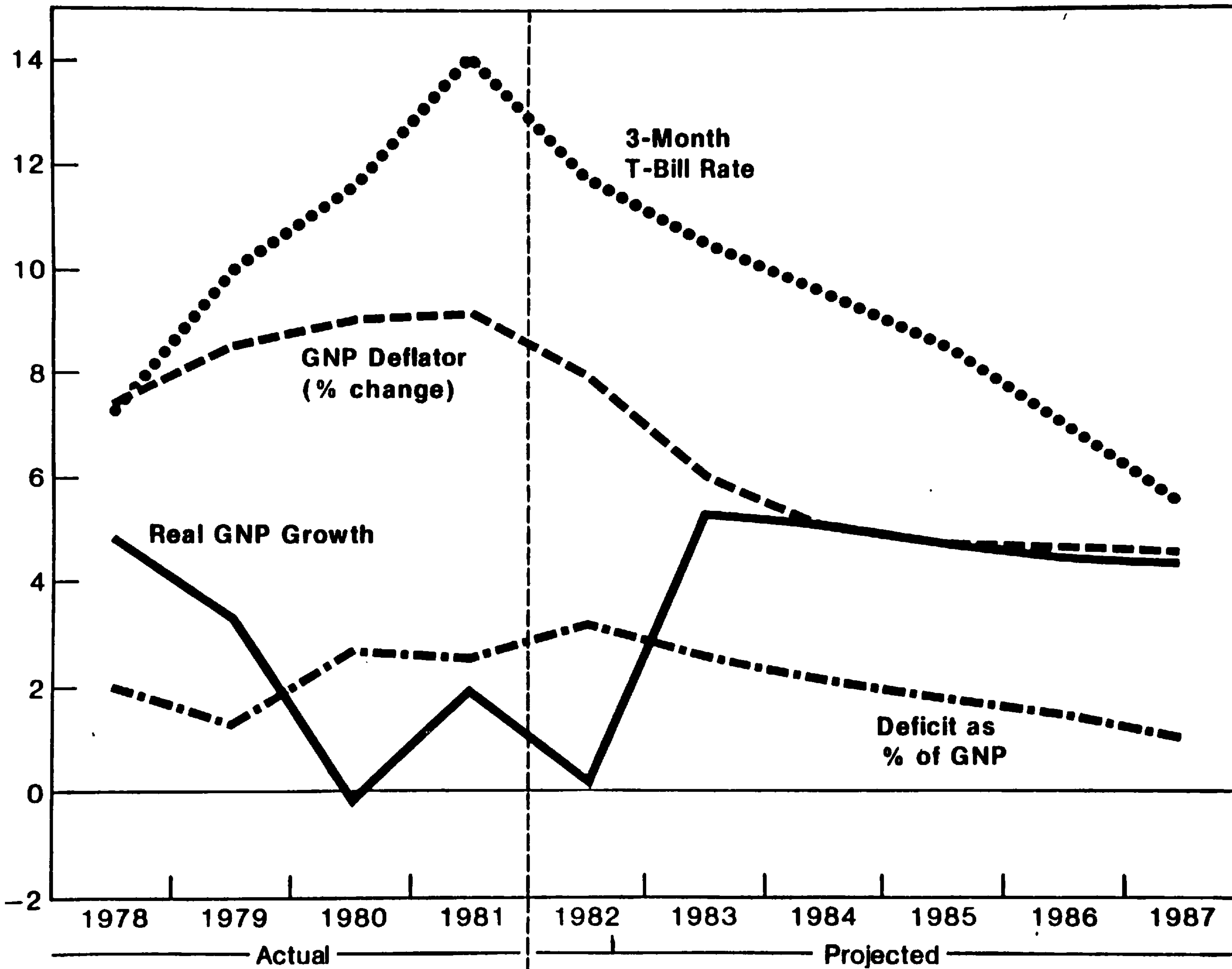
* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

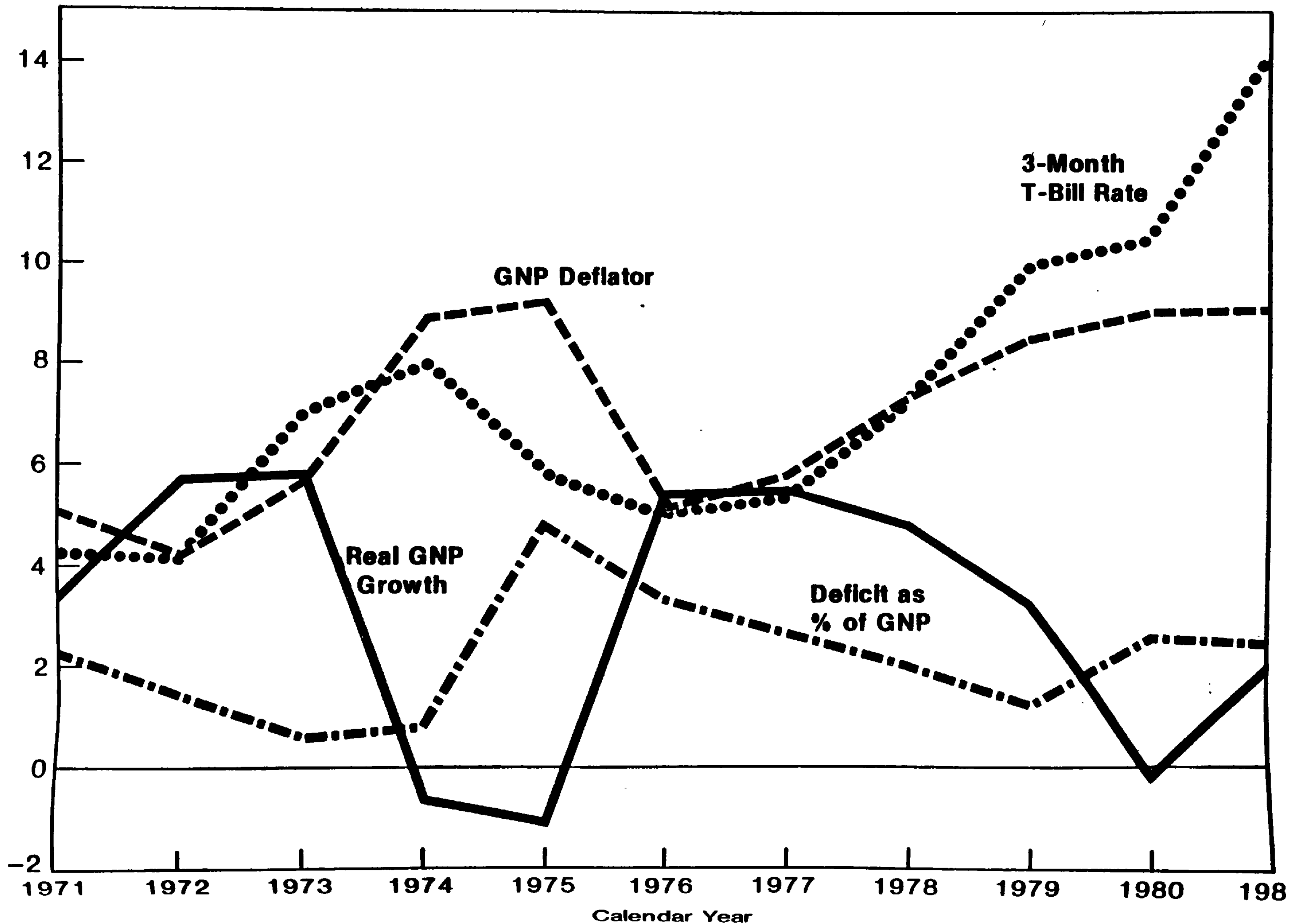


Federal Outlays as a percent of GNP

After-tax real income for family of four with $20,000 wage income in 1982 growing with productivity



Deficits, Inflation, Real Growth, and Interest Rates
Calendar Year
Percent
14
12
10
8
6
4
2
0
−2
3-Month
T-Bill Rate
GNP Deflator
(% change)
Real GNP Growth
Deficit as
% of GNP
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected


Deficit, Inflation, Real Growth, and Interest Rates
Percent
14
12
10
8
6
4
2
0
−2
3-Month
T-Bill Rate
GNP Deflator
Real GNP
Growth
Deficit as
% of GNP
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
198
Calendar Year

TREASURY NEWS

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FOR RELEASE UPON DELIVERY
At 3:30 P.M., EST, February 10, 1982

REMARKS PREPARED FOR DELIVERY BY
THE HONORABLE R. T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
TO THE CALIFORNIA TRUCKING ASSOCIATION
SAN DIEGO, CALIFORNIA
WEDNESDAY, FEBRUARY 10, 1982

Good afternoon. It's a pleasure to be here.

And it's an auspicious time to be here. It's been just over a year since President Reagan's inauguration and a lot has happened in that year. So much has happened, in fact, that it's hard to believe that the economic report and budget released this week are the first submitted by this Administration.

That's right, I said the first. After a year of budget battles, tax cuts, economic swings, and in another first, an actual shut-down of the Federal government for a day, I know that doesn't seem right. Nonetheless, it's true. All of that effort was devoted to undoing the excesses and bloated spending of the last ten years, and to reversing a lot of adverse trends that were a long time in the making.

The pace has been so frantic at times, that it's difficult to keep in mind the broader perspective of where we came from, why we're in office, and just where it is that we're going.

As I know you have heard it said before, "when you're up to your ass in alligators, it's hard to remember that your original objective was to drain the swamp!" Nowhere is that more true than in swampy Washington.

Today, then I would like to step back and regain some of that perspective -- talk about the problems we were elected to solve, what we've done about them, and where we go from here.

R-613

The Problem

Specifically, let's examine the legacy of rapid and inconsistent monetary growth, stop-and-go fiscal policies, spending commitment piled upon spending commitment, and the constant growth in federal revenue caused by inflation and a counterproductive corporate and personal tax system.

The inflation rate as measured by the CPI almost tripled in four years to over 12 percent on a quarterly basis in 1980. Federal spending rose from $270 billion in 1974 to $660 billion in FY 81 and now claims 23 percent of GNP -- almost one dollar in every four generated by our massive economy.

Unfortunately, during this period not all the trends were rising. Productivity, for example, has long been in a major decline. The rate of productivity growth decreased from an annual average of 3.1 percent during the first 20-years after World War II to 0.7 percent in the 1973-80 period. And American jobs and investment went overseas as a result. (Many of you in the trucking and transportation industry are well aware of this.)

Real GNP growth, after averaging 4.2 percent in the 1960's, dropped to 3.2 percent in the 1970's, and plunged to minus 0.2 percent in 1980.

What we've been witnessing was a sort of slow, strangulating death of economic activity and productivity in this country -- continuing through both Democratic and Republican Administrations. Against this backdrop, the roller coaster events of the past two years take on a new perspective.

Academic economists define a recession as two successive quarters of real GNP decline. With this definition in hand they will record a sharp recession -- almost a collapse -- in 1980, followed by a brief recovery in late 1980 and early 1981, followed by the recession that we are in today.

From a longer-term perspective, though, I believe that the graphs of this period will look like one long, unbroken, unprosperous time -- the trough at the bottom of all those adverse trends.

My message is this: on taking office, the Reagan Administration inherited an economic situation that could be described as dismal.

Frankly, this is a mess that was so long in the making that it will be more than days, or weeks, or months, in the mending. But what we are trying to do is to re-define the relationship between the public and the private sectors and -- for a change -- redefine it in favor of private initiative and private enterprise.

And we want to redefine the roles of Federal, State and local governments -- for a change in favor of State and local governments. In short, we want to establish a long-term framework for the future of our economy and of our political system.

The President's Program for Economic Recovery

Let me briefly summarize the program at this point, then give you some idea of its current status and of the outlook for the future.

The program is composed of four carefully integrated parts which, if consistently implemented by Congress will ameliorate inflation, reduce the size of the federal government and restore the kind of real economic growth that will benefit everyone -- investor and industrialist, consumer and corporation, hard hat and housewife.

The first element of the program is a non-inflationary monetary policy. There has been a lot of talk in the press about our seemingly inconsistent pressure on the Fed -- first to speed up money growth, then to slow it down.

We haven't been inconsistent, and there really is no disagreement on objectives. When the Fed has been below their own announced targets, as they have been for considerable periods of time, we've suggested that they could speed up. And by the same token, during those periods when the money supply has grown faster than the Fed's own targets, we've suggested a slowing down.

In short what we want and what the Fed wants, is a slow steady growth in the money supply. That will allow real GNP to grow without rekindling inflation. At the same time, this steady growth will allow our jittery financial markets to calm themselves and interest rates to come down steadily.

Second, there's the tax program. Let's look at some of its highlights.

For individuals, it offsets inflationary tax increases and the disincentives of rising marginal tax rates with a cumulative tax cut of 25 percent across the board. The act immediately reduces the top marginal rate for investment income from 70 percent to 50 percent. Both are precisely the right tax policies both for the long-term and for the recession we are now passing through.

These tax provisions are important changes for individuals, but at least as dramatic are the new provisions for business. Specifically, the Act establishes an accelerated capital recovery system that virtually eliminates the erosion through inflation of the value of the old depreciation allowances.

In 1982 alone, business tax reductions will total more than $10 billion. That amounts to a $10 billion increase in business cash flow -- $10 billion that should be invested in productive ventures.

We've also greatly expanded the opportunities for leasing plant and equipment by making it possible to transfer some tax benefits, thus helping companies -- particularly new ones -- with little or no earnings to take advantage of the program's incentives.

On the subject of leasing, most of the public comments have been focused on the benefits from leasing to a few large, established companies experiencing losses in depressed industries. By contrast, we view these provisions as credit indifferent. In fact, we think that -- as the leasing market develops -- these provisions will become increasingly important to a broad range of industries, including your own. The leasing provisions should be of particular interest to the trucking industry, especially new companies, during this period of continued rapid adjustment to deregulation.

Third, let's talk about federal regulations. For decades the business community has been insisting that excessive regulation stifles capital investment, protects the inefficient, and exacts unwarranted costs for minimal benefits.

Early in his Administration, the President appointed Vice President Bush to head a task force on regulatory reform. By mid-summer, over seven hundred regulations had been reviewed, and that review continues unabated.

The Federal Register was 25 percent smaller in 1981 than in 1980. The result is an initial saving to the economy of $16 billion, plus a recurring, annual saving estimated at $6 billion. Again that's cash that corporate borrowers won't be coming to market to seek.

Fourth, and finally, we want to slow the growth of the federal spending and actually reduce government's size as a proportion of the Gross National Product. In this way we can free real resources for the private sector -- capital that can be used to modernize and expand the productive elements of our society.

What's more, curbing the growth of federal spending now and in the future reduces competition for credit and alleviates pressure on the Federal Reserve to monetize the deficit and therefore contribute to inflation.

We have succeeded in initiating this period of budgetary discipline. Last summer Congress agreed to cuts in the fiscal 1982 budget amounting to $35 billion. From 1982 to 1984 the cumulative cuts already enacted will amount to $130 billion. More recently, an additional $4 billion has been shaved from 1982 outlays. Additional cuts totalling $56 billion in FY83, and $239 billion over the next three years (FY83-85), have been proposed in the budget just released.

Nonetheless, even with all this restraint, Federal government spending will continue to grow in real terms.

Still, that's sound progress. It's an indication that the Administration and the Congress are moving in the right direction.

The budget we've just submitted will reduce the percent growth in federal outlays from 17.4 in Fiscal 1982 and 14.0 in 1981 to 10.4 in 1982. For the just released budget, the increase for 1983 is 4.5 percent. Still more cuts are needed.

Nor should anyone question our resolve to go back to the Hill again and again for more cuts in Federal spending, for more cuts in entitlement programs, and for a workable, bipartisan reform of the Social Security program. That's a sine qua non to long-term success.

In 1981 we've redefined and shifted the terms of debate and policy deliberation. The road to fiscal responsibility will be long and arduous, but the objective is clear. We'll pick our times, we'll lose some battles, but eventually the economic war will be won.

Current State of the Economy

In fact, we now have some rather dramatic evidence that major battles in the war are being won even as we pass through this recession.

Dramatic progress has been made on the inflation front, for example. Consumer price increases -- measured December over December -- fell from 12.4 percent in 1980 to 8.9 percent last year. By the final quarter of 1981, this inflation measure had further slowed to a 5.3 percent annual rate.

Producer price increases peaked early in 1980, and have fallen dramatically since early this year. For example, producer prices on intermediate goods rose at a 12.6 percent rate for all of 1980, but slowed to only a 2.5 percent annual rate in the last quarter of 1981.

Equally important, we have recently witnessed the first decline in the rate of wage inflation in a number of years. From a high of 9.3 percent in 1980, the hourly earnings index for production work hours slowed to an 8.9 percent rate in the first half of 1981. A further drop to 7.5 percent in the second half of last year culminated in an increase of only 0.1 percent last month.

While inflation and interest rates have been declining, there can be no doubt that the economy is performing poorly. Although, unemployment fell to 8.5 percent in January, it may yet go to 10 percent before we get things turned around.

The current downturn, in fact, will be far worse than envisioned in our earlier scenarios. You can attribute that to two things. First, interest rates did stay high longer than expected. Second, the first round of personal tax cuts was delayed until October 1 and reduced from 10 percent to only 5 percent. That amounts to only 1.25 percent for all of 1981. In fact, bracket creep and social security tax increases actually produced a $15 billion tax increase in 1981 despite the 5 percent cut. We have prevented even larger inflation-induced tax increases. Yet with all the Washington rhetoric we have not yet had major tax cuts.

None of this constitutes sufficient reason to change the program materially. It only adds to the case for trimming the budget even further, and for giving the economy time to respond to the changes we've already made.

Admittedly this new budget will try the American political will during a recession this winter and during an election year. As Henry Kissinger said of the American lack of patience: "Americans seem to have a proclivity to pull up the trees every few weeks to see if the roots are really growing."

Deficits

Probably the greatest single stimulus for pulling up the trees to check the roots is a concern in many quarters about the projected deficits. There's no question in anyone's mind that the outlook for the anticipated Federal deficits has deteriorated sharply from the projections that we made last spring.

This is not primarily due to the tax cuts, however. The basic cause of the projected deficit is the sluggish economic performance of 1980-81, and the continued growth in government spending in real terms. As a rough rule of thumb, whenever real growth falls off enough to produce an additional percentage point of unemployment, the deficit widens by about $25 billion as revenues fall and outlays rise on income maintenance programs.

Ironically, the second major reason the deficits will be temporarily higher than expected is because of the progress that has been made in fighting inflation.

Think about it. Due to the way in which most entitlement programs are indexed, Federal spending or outlays are linked to the previous year's inflation rate, but revenues based on taxable income are basically linked to the current year's inflation rate. So, the faster inflation comes down, the worse the budget deficit is for awhile.

The circular equation is fairly simple. Inflation-indexed programs increase federal outlays -- the Treasury borrows to meet the entitlement obligation -- the Fed buys the Treasury's debt -- the money supply increases too rapidly causing inflation -- the inflation causes indexed programs to increase federal outlays and so on. This vicious circle must be broken, because inflation is the largest, most regressive tax of all.

And the circle must be broken by attacking its fundamental cause, the overall level and rate of growth in government spending -- a growth rate of over 16 percent in recent years.

That is what we are determined to do. We are not going to engage in more futile rounds of trying to raise taxes faster than Congress can raise spending. Congress has shown that it can win that race every time, and that, as President Reagan said, we can never balance the budget on the backs of the taxpayers. We are going to cut spending.

Deficits are a part of the transformation process and they can be financed out of the real growth and increased savings that will result from our program. In fact, the deficits that we project, while large in nominal dollars, are actually much smaller in relation to our total economy, that is, to GNP, than the deficits that occurred after the 1974-75 recession. But they are not something this Administration takes lightly, and they are not something we intend to live with permanently.

The Policy Agenda for 1982

Just as these economic issues -- spending, taxes, and deficits -- shaped the policy agenda for 1981, they will continue to shape the Administration's agenda -- the policy debate -- for 1982.

Many of those special interests that both fostered the growth of and derived ever-greater benefit from the Federal government, have been declaring the President's economic program a failure since before it was unveiled. And though they suffered defeat in every major battle last year, they have reemerged as born again budget balancers and will undoubtedly try to unravel that program this year. Hence, much of the policy agenda will be aimed toward preserving last year's gains, as well as launching this year's initiatives.

Most important, we must be prepared to meet attacks on the program's key incentive-oriented tax provisions. Those attacks will not be aimed directly at the core provisions that take effect this year or perhaps next. Rather the attacks will be aimed at what some critics perceive to be the weak periphery.

Some will seek to delay, reduce or eliminate the third personal tax reduction -- a 10 percent reduction that becomes effective July 1, 1983. Others may seek to eliminate the indexing provision. Still others will seek to repeal the safe-harbor leasing provisions of last year's tax act. All these attempts will be shrouded in specious arguments of "sound fiscal policy," reduced "corporate welfare," and "lower interest rates."

Contrary to the claims that will be made, these tax provisions are not peripheral. In fact, they are central to our efforts to restore long-term incentives to save, invest, and work. And they will be preserved.

There will also be some new initiatives for 1982. The Administration has proposed a package of tax changes, not contradictory to our basic tax program, but designed to remove a number of provisions of the tax code that are no longer warranted or that were made obsolete by the passage of the Economic Recovery Tax Act last year.

Perhaps most unjustified are provisions of the tax code that allow profitable corporations to pay little or no regular income tax. No company should be exempt from shouldering a fair share.

Similarly, we will propose to repeal business energy tax credits, restrict tax exempt bonds, and close several other loopholes in the tax code.

Bear in mind: these changes in the tax laws are consistent with the tax incentives enacted last year; they will not undermine them.

Another proposal, Enterprise Zones, provides tax incentives and relaxes government regulatory barriers to encourage economic growth in designated Zones. The purpose of the incentives is to help overcome the extraordinary conditions and costs (e.g., crime and insurance costs, lack of skilled labor, inadequate infrastructure and government services) that discourage the location of economic activity in distressed areas; encourage the creation of jobs for economically disadvantaged workers; and encourage other workers to seek employment in these Zones.

States and localities will be encouraged to add to the Federal tax and regulatory relief efforts with incentives of their own.

In sum, this proposal is another effort to get government out of the way, and let the private sector do the job of creating jobs and real economic growth.

Finally, the President's New Federalism proposal is the concrete implementation of a theme he has advanced throughout his public career. This long term proposal, as well as every other domestic measure that the President proposed in his State of the Union Message, is molded by the same philosophical consistency that guided the economic program. Its unifying principle is the belief that government should assume only those responsibilities that individuals in the private sector cannot assume, and that each level of government should assume only those responsibilities that cannot be carried out at a lower level.

The Federal government has usurped a lot of power and responsibilities in recent years. Our economic program returns a lot of it to the individual and the private sector, and the New Federalism returns a lot more, along with the financial resources to pay for it, to State and local governments.

Both are a part of a long-term framework for the future.

The Management Agenda for 1982

Our policy agenda, we hope, will also help shape your management agenda this year.

The key to the nation's economic recovery is not what we in the Government do; it's what you in business do in response to the restored economic incentives that were enacted last year.

How well, for example, you learn about and take full advantage of the investment incentives provided in the tax reduction act and the Enterprise Zone proposal -- will determine whether or not our country will again enjoy high real growth and rapid rates of improvement in productivity.

Similarly, how well management and labor respond to an improved outlook for inflation will determine whether we lock in lower rates of inflation for the long term or not.

In recent years, wage settlements have been ever larger as both blue and white collar workers attempted to catch-up with a constantly rising inflation rate.

Inflation is no longer rising. It is falling -- and falling rapidly. It is important that wage settlements at all levels -- senior management, union, non-union, white collar -- begin to reflect these lowered inflationary expectations. Fortunately there are signs that this kind of adjustment is beginning in a number of industries, including autos, rubber, meatpackers, and trucking. While I would not want to comment specifically on the Teamsters agreement that, according to press reports, is currently being circulated for ratification, I am encouraged by what appears to be a broad reexamination of underlying inflationary assumptions that is taking place in our economy.

This type of adjustment in wage inflation is essential to improving the outlook for long-term productivity increases and renewed real growth.

The Outlook

How realistic is that outlook?

As I noted earlier, interest rates have fallen since early September. Unfortunately, in recent weeks we have witnessed renewed growth in the money supply in excess of 12 percent -- a rate that would threaten to rekindle inflation if it continued. Interest rates have temporarily risen in response to that danger. However, I think we can look forward to the basic downward trend in interest rates continuing -- albeit with unfortunate short-term fluctuations, as at present -- as the Fed continues to focus its policy toward achieving slower steady growth in the money supply.

Contributing to declining interest rates is an economic slowdown that is worse than we had anticipated and that has reduced loan demand. In fact, we are experiencing a recession that will bottom out probably in the spring of 1982. But I'm confident that we'll emerge from it briskly at that time.

In addition to lower interest rates that should begin to help such sensitive areas as autos and housing, a 5 percent tax cut became effective October first. Another 10 percent cut in personal rates will occur on July 1, and the business tax provisions should be worth over $10 billion in fiscal 1982, as well.

These tax reductions will do more than spur consumption demand. They'll increase cash flow or capital, adding to both individual and corporate ability and incentive to save. Remember, investment spending is spending too, and the wages paid in the investment goods industries will contribute to further saving and consumption spending.

Together these policies will result in an upturn beginning in the spring. Already the somewhat improved leading indicators may be foretelling that development. By the last half of the year, a very strong period of economic growth should be underway.

We've made some good progress toward draining that swamp, and some sturdy trees are beginning to take root in its place.

The real question is: What will happen as the recession ends? Will we face another round in the cycle of "stagflation" or will we emerge into a new era of noninflationary growth?

The answer to that question depends on how resolute we and the Congress are; and it depends on the response of management and labor to the incentives in the economic program. As I suggested earlier, we -- the Reagan Administration -- fully intend to stay the course.

We intend to succeed and I believe that you have a stake in that success. And I'm asking you to join us by making sure that Congress knows the views of you and your employees. If you don't participate you'll be ignored.

If together we can once again place limits on the growth of government, we will emerge into a decade when confidence in the long-term will supplant expedience for the short-term. In short, we will emerge into an era of prosperity.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 9:00 a.m.
Wednesday, February 10, 1982

Address
by
The Honorable Beryl W. Sprinkel
Under Secretary for Monetary Affairs
before the
American Banker Association's
1982 National Trust Conference
New Orleans, Louisiana
February 10, 1982

Good morning.

I am honored to have been invited to speak before such an august group of banking professionals.

Having spent 28 years in the banking business myself, I think I can understand your interests, your problems and your goals.

I would like to discuss two themes with you this morning. First, the Administration's efforts in the area of financial deregulation: why we feel that it is so important, and what is in store in the near future. Secondly, I would like to offer a few observations on the economy; where we are now and, much more importantly, what we foresee for the remainder of this year.

Financial Services Deregulation

As I know you are aware, the elimination of unneeded and cumbersome regulations is one of the cornerstones of the President's Economic Recovery Program. The real effects of deregulation are sometimes hard to measure. But let me give you just one indication of what we are up to in Washington. Last year, the Federal Register -- the publication that contains new regulations -- contained 23,000 _fewer_ pages than in 1980. And that is just the beginning. All of this is born out of a philosophy that economic systems work efficiently to the degree that they are free and open.

And what of the financial services industry?

The environment in which the financial life of this nation goes on has evolved over the last half-century and the institutional inhabitants of that environment need -- more than ever -- to respond to new demands. Those demands are insistent.

They will be met -- and this Administration prefers that they be met in the most efficient manner -- by financial institutions that are free to compete for the consumer's business.

We've already begun to usher some segments of the financial service industry back to the marketplace. As most of you know, the Depository Institutions Deregulation Committee is freeing depository institutions from interest rate ceilings. Their assets are also in the process of becoming more responsive to market forces.

Those market forces -- given high yield alternatives to depository institutions and an extremely sophisticated public -- were in the process of moving deposits into money market funds. I suppose some would have resolved that situation with rate ceilings for money market funds, on the theory that the federal government should play fiscal gumshoe, and track fugitive funds from one savings instrument to another, regulating as it goes.

The explosive growth of money market funds, however, is ample testimony to the futility of trying to control consumer behavior. As many of you already know, the first money market fund was offered in 1971 -- November fifth to be precise. It was The Reserve Fund, Inc.

During the next two years, three more funds were offered. And three years later -- in 1974 -- nineteen money market funds were offered to the public -- a public that was more than willing to risk an uninsured investment in return for much higher interest rates in the face of increasing inflation.

Today there are one hundred forty-five funds available to the public with assets of $186 billion. There are slighty more than nine million accounts. Eighty percent of them are held by individuals.

Our preference is to rely on the efficiency and creativity of a free marketplace. That preference arises as much from pragmatism as from philosophy: regulations that are not in the best interests of the consumer -- the one who ultimately makes any market -- are doomed in the long run to fail. The market -- the consumer -- is simply too creative to conform for very long to artificial conditions that are not in his best interests.

Demonstrably not in the interest of the consumer are interest rate ceilings. One study of the period between 1968 and 1979 put consumer losses attributable to interest rate ceilings at $42 billion.

The financial regulatory system -- as it exists today -- is like a baseball manager who won't let a fast ball pitcher use a slider, or a change of pace, even though he's competing with a lot of heavy hitters who can swing from both sides of the plate. The manager may be right, but we think the player should be free to use all of his pitches.

With this principle in mind, the Administration believes that all depository institutions -- commercial banks, savings and loan associations, mutual savings banks, credit unions -- all -- should be free to compete for the financial consumer's dollar. The primary arbiter of the institutions activities should be competitive skills.

Rather than dealing with several institutions, the consumer -- in a single stop -- should be able to satisfy his financial needs -- be they for checking or savings accounts, or for mortgage loans or other types of consumer credit. Nowhere else in the American retail marketplace is the consumer forced to go from door to door.

And maintaining that separation of services among financial institutions would be like requiring that meat and dairy products be sold in different stores rather than in a supermarket. I am not predicting or urging the end of specialized institutions. I am saying that those which do specialize should do so by choice, not because they are required by government regulation.

Just as the market for financial services has transcended institutional distinctions, so too it has rendered absurd geographical barriers to banking. Geographic restraints on the expansion of banks today actually prevent the entry of competition in some markets. The fact that those restraints were originally intended to prevent undue economic concentration makes the relationship between intent and effect ironic in the classical sense of that term.

Consider some of the changes that have occurred in the financial marketplace. Commercial banks now legally reach beyond geographic limitations through various corporate devices to conduct "bank-like" activities. The largest banks compete nationally -- and legally -- for "wholesale" and retail business. They do so through surrogates for full service branch facilities.

For example, there are at least 350 loan production offices operating in about 20 states. The latest data indicate that 35 of the 100 largest "non-captive" finance companies are subsidiaries of bank holding companies -- for example Finance America and B of A. Likewise, banks and bank holding companies control 47 of the 100 largest mortgage bank firms. In fact, one bank holding company operates thirteen subsidiaries, including a finance company with 370 offices scattered through 39 states.

Foreign banks have achieved a unique presence in the American market. Thirty foreign banking organizations -- "grandfathered" under the International Banking Act of 1978 -- conduct operations in more than one state. As was recently pointed out by Citibank, six of the ten largest banks in California have their home offices in foreign countries.

Today, a foreign bank can cross the Atlantic or the Pacific far more readily than a Texas bank can cross into Louisiana. If it is not already doing business here, that foreign bank can simply acquire an existing bank in Louisiana -- something a bank based in Texas cannot do. I suggest that this is ludicrous.

These are just a few examples of the market's having outstripped the regulations. But perhaps the most dramatic market changes are attributable to technological innovation.

When the SEC was established, the fastest means of communication between banks or between banks and their customers was by telegraph wire. Today billions of dollars can be transferred globally -- and instantaneously -- through sophisticated electronic networks. Deposits can be made directly by payroll departments using electronic tapes. Home computers may eventually eliminate the need for people physically to appear at the bank.

It may not be too long before "bricks and mortar" bank branches are supplanted by a combination of card, computer, telephone and mail systems.

Recently, Sears announced that it was establishing a money market fund. And its President announced that it was Sear's intention to become (quote) "... The largest consumer oriented financial service entity."

And -- while dealing in superlatives -- need I remind you that the largest merger in the history of the savings and loan industry took place just recently. Two eastern savings and loans were absorbed by Citizens Savings and Loan -- a subsidiary of United Financial Corporation which, in turn is owned by -- believe it or not -- National Steel. Not only could a steel company do what many of our domestic financial institutions couldn't, but it was assisted by the Federal Savings and Loan Insurance Corporation.

Technology will also widen the gap between the services the public demands and those that many commercial banks can offer. That gap will be filled by financial institutions that are free of geographic restraints. For example, American Express recently

announced that its gold card holders can have access to $500 a day from automatic teller machines in 100 locations -- nationwide.

Finally, technological advances reduce costs and increase efficiency in ways that directly benefit the consumer. The potential is enormous, but it will never be fully realized in today's regulatory climate.

Markets are essentially people. And -- like people -- they change and grow. The parents among us are painfully aware of the problems of trying to fit this year's high school sophomore into last year's freshman slacks. Likewise, the fabric of regulation -- woven so long ago -- no longer fits the market for which it was designed.

To put it simply, regulation of the financial services industry must be modernized. And in many respects, that means liberalized.

That liberalization must go beyond deregulating the liabilities and assets of depository institutions. It must include a diversification of servies, and a gradual lowering of the geographical barriers erected by the McFadden Act.

The time has also come to examine the segregation of commercial from investment banking under the Glass Steagall Act. Many of those who have studied, worked with, or tried to operate under Glass-Steagall -- or the Banking Act of 1933, if you will -- question whether events have transformed the law from the keystone of the bank regulatory structure to the chief stumbling block preventing the efficient operation of the capital markets.

Several major concerns were reflected in the Banking Act. First, it was believed that the soundness of the commerical banking industry, and the public's confidence in it necessitated the separation of commercial and investment banking.

Congress bought the argument which held that commercial banks' efforts to promote or rescue their security affiliates had threatened the bank themselves. The Senate Banking Committee back then went so far as to observe that a major cause of bank failures was the extensive investment of bank assets in worthless, illiquid securities -- many acquired from the security affiliates of correspondent banks.

But it's worth noting -- despite these widely held beliefs -- that the great majority of the thousands of banks that failed during the Depression were not engaged in the securities business.

The conflict of interest issue is also at the heart of Glass-Steagall. The legislative soil, once it had been thoroughly cultivated, brought to fruition the "real bills" doctrine which separated banking and investment activities on the model of the British banking system.

I might add that West Germany -- one of our most aggressive and successful competitors -- does not separate these two functions. But be that as it may, in 1933, legislative sentiment -- which had been inclined toward regulation and inspection of bank securities affiliates -- turned in favor of Senator Glass' position, and separated investment and commercial banking by statute.

But after fifty years, these two activities -- though separated *de jure* -- have been converging *de facto*.

Although we can not remove all the anti-competitive barriers at once, we can begin to approach our objective by putting the proper legal structure in place. The Administration has proposed legislation that would provide that framework for progressive deregulation by authorizing registered commercial bank holding companies to establish subsidiaries that would compete fully with all non-depository financial institutions.

The Administration proposal would authorize bank holding companies to conduct two new activities immediately: first, to underwrite and deal in municipal revenue bonds and second, to sponsor and underwrite the shares of open-end investment companies. (Mutual funds.)

After this initial step is taken, bank holding companies will gradually move into other areas.

Historically, it has been the commercial banks which have accentuated the convergence of banking and securities activities. The recent acquisition of leading Wall Street firms by major participants in the credit, insurance, and commodities industries have only dramatized radical market changes. All the innovations of the last decade -- from money market funds and cash management accounts to bank-assisted private placements and the pooling of investment funds -- have changed the financial face of this country.

That marketplace, like everything else about this country, has changed drastically.

In 1933 the average daily volume on the stock market was 2.3 million shares -- and in 1933 the exchanges were open on Saturdays. Last year, the average daily volume approached 47 million shares.

In 1933, Lindbergh's flight was a five-year old memory; our aeronautical memories are of the Appolo Mission that put a man on the moon and those memories are twelve years old.

Lindbergh flew the Spirit of St. Louis over the Atlantic; now we're flying a space shuttle in orbit.

We have plastic money, electronic tellers and computers that do everything but breed.

Today's financial markets are to those of Senator Glass' day what the movie Star Wars is to D. W. Griffiths' Birth of a Nation.

Yet we're still governing the financial system with a law that was passed almost fifty years ago.

That is why the Administration's commitment to deregulation embraces the financial services industry. And, as that commitment finds its gradual expression in legislation, we will be guided by one major principle: the best interest of the consumer of financial services.

Increased freedom in the financial services industry is, to speak bluntly, the freedom to make a buck. But in a real sense it is also the freedom to adapt and to survive, to create and to contribute to the vigor of this society.

Now, all of this -- the whole move toward financial deregulation -- is a part of the Administration's overall program of deregulation. And that, in turn, is one of the four major elements of our Economic Recovery Program. As I am sure you are aware, the other three are: tax rate reductions, reductions in government spending and a stable, moderate-growth monetary policy.

The Economy

And speaking of our economic recovery program, let's shift gears for a moment -- move away from deregulation -- and take a look at the economy. Where have we come from, where are we now, and where are we headed?

First, we have come from a decade of explosive growth in government spending, steadily rising inflation, deteriorating rates of productivity growth and massive stimulation of the money supply.

The second quarter of 1980 was one of sharp collapse, at a 9.9 percent annual rate. It was followed by two quarters of very slow recovery, with 2.4 and 3.8 percent growth, respectively. Not until the 8.6 percent growth of the first quarter of 1981 did real GNP exceed that of the first quarter of 1980. Unfortunately, the 1981 recovery was soon choked off in what might best be described as a continuation of the 1980 situation. There is no school of economic thought -- Keynesian, monetarist, or supply-side -- which provides even the hint of a suggestion that any of the policies called for by this Administration could have <u>retroactively</u> brought on this downturn.

<u>The Recovery</u>

Fortunately, we think we are near the bottom of this recession. And with decreasing inflation, in-place tax cuts and slower money growth, we have the foundations for a vigorous recovery.

If you take a look at the previous 7 post-World War II recessions, the average -- not best -- <u>average</u> growth in real GNP coming out of the recession has been 6.9 percent over the first four quarters.

We have strong reason to believe that this recovery will also be strong. But the primary reason is that we are in the position -- perhaps serendipitously -- of having a significant tax cut in place early in the recession.

Due at least in part to the tax cuts, the rate of savings in this country is -- finally -- on the upswing. In 1975 personal savings was 8.6 percent of disposable income. By 1980, it had fallen to 5.6 percent, and it finally bottomed out at 4.3 percent, in the first quarter of last year. The figure for the 1981 4th quarter was an encouraging 6.0 percent.

<u>Encouraging Signs</u>

Trying to find the end -- or even the beginning of the end -- of a recession is still like trying to read the tea leaves. And I am reminded of George Bernard Shaw's remark that if all the economists were laid end to end, they would not reach a conclusion.

There are, nevertheless, some encouraging signs:

> The leading indicators rose 0.6 percent in December after a very small revised dip of 0.2 percent in November.

Manufacturers' durable good orders an important leading indicator, have shown broad-based increases in the last two months.

Housing starts are up modestly.

Unemployment has dipped from 8.8 percent in December to 8.5 percent last month. I frankly do not place a great deal of significance on this. But the figure is encouraging.

Consumer confidence - The Sindlinger Index of consumer confidence -- a sensitive if somewhat erratic measure -- fell from late summer to an early December low and had risen substantially by mid-January. The University of Michigan index of consumer sentiment rose in December. The Conference Board index of consumer confidence was off some in December but typically lags behind the Sindlinger index in detecting shifts in consumer attitudes.

I don't want to place too much importance on these signals. The important point is not whether the economy is giving signs that it will move up next week or next month.

What _is_ important is that it is going to move up -- and soon. And when it does, I am confident that it will do so in a vigorous way.

What else can we say about the future?

Interest Rates

They have moved up in recent weeks; but I am confident that they will return to their previous downward trend.

It is baffling that many economic analysts do not even agree on the _direction_ that interest rates will head. Now why is this? I think there are a number of reasons. First, there is a difference of opinion over the relative power of market forces.

The bearish fellows believe, I _think_, that the level of interest rates will be forced up by a forthcoming expansion of the demand for credit colliding with an alleged restriction of supply by the Federal Reserve. Big borrowing by the Government puts upward pressure on interest rates. Economic growth produces corporate demand for loans for business expansion -- which also puts upward pressure on interest rates. If you have big government deficits _and_ economic expansion -- as we will have

this year -- then you will supposedly get a double whammy effect on credit demand. If you add to this the popular notion that the Fed is keeping credit tight, you can see why some believe that interest rates will go through the roof.

All that sounds very compelling doesn't it? And it sounds as if it came right out of Adam Smith's Wealth of Nations. Let me say that there is some truth to this view. The law of supply and demand is alive and well in the market place and increased demand for credit does exert pressures on interest rates.

But our case, it turns out, is also based on Adam Smith -- that part in his book where he says people would rather make money than lose money.

You, as bankers, know that a key factor in projecting the future profit margin from a loan is future inflation. Even if your borrower is the most credit-worthy sort, you are going to charge him higher interest rates if you think he will be paying you back in inflated -- and therefore less valuable -- dollars.

If you think the rate of inflation will be low in the future, you can reduce your rates and still expect to make a profit.

In a nutshell, then, we have one view that says an increase in demand for credit puts upward pressure on interest rates. The other view says that declining inflation -- due to responsible monetary policy -- puts downward pressure on interest rates. In fact, there is pressure pushing rates both ways. But the downward pressure is much stronger than the upward pressure.

Now if the argument in the abstract leaves you cold, let's forget theory for a moment and look at history. In the fall of 1975, as post-recession real economic growth was gaining speed, interest rates moved up for a few weeks. However, the Fed maintained a steady hand on the tiller. And what happened? As the economy continued to grow that Fall and into the following year, inflation continued to go down.

This was a period, please remember, of massive Federal deficits: 66 billion in Fiscal year '76, a deficit which as a percentage of GNP, was larger than the deficit projected for this year. And yet there was solid economic growth. And as inflation was declining to under 5%, interest rates continued their downward trend. Not until late 1977 did rates move up. Because not until late 1976 did money growth increase sharply.

There is a rather subtle shift taking place in America. And failure to perceive this shift is, perhaps, a second reason for the differing views. In periods of accelerating inflation -- which is what we had until last year -- real assets tend to have a greater real rate of return than financial assets. As a result, over the last several years, savvy investors have tended to move out of such things as stocks and bonds and into such things as houses, land and antiques.

Conversely, in periods of decelerating inflation, there is a tendency for investors -- institutions and individual households -- to shift their portfolios somewhat from real assets to financial assets. The reason for the shift, of course, is that investors see a shift in the rate of return of one category of assets relative to the other category. I am not saying that everyone is selling rugs and condominiums and buying stocks and bonds. But there is some of that going on.

And in a 4 trillion dollar economy -- which we are on the verge of having -- a shift of 1 or 2 or 3 percentage points puts tens of billions of dollars into the system in the form of expanded potential credit. Thanks to declining inflation that phenomenon is already happening, and additional credit needed for economic expansion is forming rapidly.

Finally, there is a third explanation of the differing "upstairs, downstairs" ideas on interest rates.

Some who say interest rates are going higher actually are saying: "The Fed is going to blow it ... again." When economic recovery really picks up steam later this year, there may be some temporary upward movement of interest rates. And there is fear that, if this happens, the Fed could over-react and send a gusher of new money out. Now, if that were to happen, I heartily agree, we would be in for high interest rates. Fortunately, I am hopeful that that will not happen.

The Money Supply

Finally let me make a few comments about the money supply.

The past three months have provided a good example of the disruptive effects of volatile money growth. And I hope that those who still believe that high interest rates are caused by "tight money" have been paying attention.

When the market sees a money growth pattern, it increases interest rates to cover for future inflation. When the market sees the money supply shoot up and doesn't know if it is seeing a pattern or not, it raises interest rates even further to cover for the unknown.

Traditionally, you know, things worked like this: The Fed would pump out a lot of new money. And for a period, there would be heightened economic activity with no perceptible change in inflation. Then later on, gradually, inflation would start to move up. And also, gradually, interest rates would start up.

Then, money supply growth would be curtailed to dampen inflation. But these "cooling off" periods were typically short-lived and when new money was cranked out again, inflation rose to new highs. Each subsequent inflation and interest rate peak was higher than previous peaks. And subsequent troughs were likewise higher than earlier troughs.

Today, the market place has become very astute. It sees very clearly the cause and effect relationship among money supply, inflation and interest rates. What you might call the "eternal infernal triangle." One leads to the other which leads the other. Now, the market doesn't even bother to wait for the middle step: visible inflation. Instead, as soon as weekly reports of high money growth come out, interest rates -- immediately -- move up. That is exactly what began to happen 3 months ago. From October to January, the money supply grew at an annual compound rate of over 15%! And interest rates rose accordingly.

We are hopeful that the fed is working hard, not only to slow the rate of growth in money but to reduce that disruptive volatility in the system.

Conclusion

This Administration is a low interest rate Administration because we are reducing inflation. But please remember, we inherited a pretty tough situation. You know, when Don Regan and I first went down to Washington we felt like the two teenage boys who were on a tour of an art gallery, and found themselves alone in a room of modern sculpture. Staring at the twisted pipes, broken glass, and tangled shapes, one of them said, "Let's get out of here before they accuse us of wrecking this place." We were tempted to leave; but we stayed. In the last twelve months we have had to spend a great deal of time repairing the wreckage from the last Administration.

Getting interest rates down is critical to the success of our overall program. In one sense, governments cannot force interest rates to come down. But governments can set up the proper conditions in the economy so that they fall naturally of their own weight. And that is precisely what we are doing.

We have a tight money-easy credit program. We may not be perfect, but -- contrary to some of our critics -- we are smart enough to study and learn from history. We are pragmatists, not ideologues. And history has shown very clearly what reduces interest rates and inflation. We are taking those steps. And I think a year from now you will be able to look back on 1982, as history, and see a period of real growth, continued progress on the inflation front and declining interest rates.

In summary, then, we have taken a look at two very broad areas of interest: what lies ahead for a deregulated financial services industry and, secondly, what lies ahead for the American economy.

As I was talking I suspect you my have had some questions but didn't want to interrupt me. If you do, I will be happy to answer them.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. February 9, 1982

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $10,000 million, to be issued February 18, 1982. This offering will provide $ 700 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $9,293 million, including $ 970 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities and $ 1,719 million currently held by Federal Reserve Banks for their own account. The two series offered are as follows:

91-day bills (to maturity date) for approximately $5,000 million, representing an additional amount of bills dated May 21, 1981, and to mature May 20, 1982 (CUSIP No. 912793 7H 3), currently outstanding in the amount of $8,744 million, the additional and original bills to be freely interchangeable.

182 -day bills for approximately $5,000 million, to be dated February 18, 1982, and to mature August 19, 1982 (CUSIP No. 912794 BH 6).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing February 18, 1982. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average prices of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. 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.

R-615

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, February 16, 1982. 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. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. 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, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on February 18, 1982, in cash or other immediately-available funds or in Treasury bills maturing February 18, 1982. 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 Section 454(b) of the Internal Revenue Code, the amount of discount at which these bills are sold is considered to accrue when the bills are sold, redeemed, or otherwise disposed of. Section 1232(a)(4) provides that any gain on the sale or redemption of these bills that does not exceed the ratable share of the acquisition discount must be included in the Federal income tax return of the owner as ordinary income. The acquisition discount is the excess of the stated redemption price over the taxpayer's basis (cost) for the bill. The ratable share of this discount is determined by multiplying such discount by a fraction, the numerator of which is the number of days the taxpayer held the bill and the denominator of which is the number of days from the day following the taxpayer's date of purchase to the maturity of the bill. If the gain on the sale of a bill exceeds the taxpayer's ratable portion of the acquisition discount, the excess gain is treated as short-term capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
Thursday, February 11, 1982

Contact: Willy Carney
Marlin Fitzwater
566-5252

TREASURY ISSUES REPORT ON BATF REASSIGNMENTS

The Treasury Department today issued a report outlining the strengthened law enforcement and tax collection capabilities to result from a proposed reassignment of functions and personnel of the Bureau of Alcohol, Tobacco and Firearms (BATF).

The report concludes that merging the functions and personnel of the BATF with the Secret Service and U.S. Customs Service would achieve a better allocation of law enforcement resources, maintain the desired level of alcohol regulation and produce major administrative economies.

Among the conclusions of the report are:

° The reassignment of the firearms and explosives functions to the Secret Service will result in a more efficient enforcement of the firearms, explosives and arson statutes with fewer people and less cost.

° The transfer to the Secret Service will facilitate the closing of non-productive posts of Duty and the reassignment of some of the personnel from these offices to areas where firearms, explosives and arson violations are concentrated.

° The transfer will give the Secret Service the ability to draw on additional resources badly needed for its protective mission.

° The merger of ATF functions to the Secret Service will enhance intelligence gathering capabilities of the Service.

° Assuming a budget level of $138 million for FY 1982, the reassigned functions will be operated in FY 1983 at a level of $121 million. This will represent a savings of approximately $29 million from the FY 1981 level of $150 million. Specifically, these savings will be achieved from the more efficient use of the following resources: space and equipment, administrative and management overhead, criminal enforcement personnel and regulatory enforcement personnel.

Treasury announced on November 12, 1981 that it planned to reassign the statutory firearms and explosives functions and personnel from BATF to the Secret Service. The alcohol and tobacco regulatory functions and personnel would be assigned to the U.S. Customs Service. Both the Secret Service and U.S. Customs Service are part of the Treasury Department.

Attached is a copy of the report.

February 4, 1982

REPORT ON
THE BUREAU OF ALCOHOL, TOBACCO AND FIREARMS REORGANIZATION

This paper explains the reasons why and the benefits which will be attained from the reassignment of the Bureau of Alcohol, Tobacco and Firearms (ATF) to other Treasury bureaus. It also supplies the basic plan developed by the Department to carry out the reassignment and budgetary and personnel considerations connected with this plan.

On November 12, 1981, the Treasury Department announced the intention of the Administration to reorganize ATF by transferring functions and personnel relating to firearms and explosives to the Secret Service and those relating to alcohol and tobacco to the U.S. Customs Service. This reorganization is based on sound management decisions which will cut costs, lead to greater efficiencies and produce solid law enforcement benefits.

In July 1981, the Office of Enforcement and Operations within the Department undertook a management review of the enforcement functions of the Bureau. The most significant conclusions and recommendations of this review are as follows:

* * *

"Whatever motivation there may have been in the past for placing the function of enforcement of firearms and explosives laws in the same bureau responsible for alcohol and tobacco revenue collection and regulation, it can no longer be rationalized today."

* * *

"The firearms and explosives criminal enforcement and regulatory functions should be severed from ATF and those functions and personnel needed to perform them should be transferred to another Treasury enforcement bureau such as the Secret Service. A study should be conducted to determine where the remaining functions of ATF criminal and regulatory enforcement could best be located."

* * *

Some of the other findings of the Management Review Study Group are listed as follows:

-- There exists within the Bureau an inefficient regional management structure that was created because of the diverse functions and does not operate well because of the lack of commonality of purpose and interest between these functions. This regional management structure has led to unhealthy competition for resources between criminal enforcement and regulatory enforcement.

-- There are too many criminal enforcement offices within ATF and many of them are non-productive with respect to firearms, explosives and arson cases. Approximately 40 to 50 of these offices should be closed with personnel reassigned to areas of the country where there is a high incidence of firearms and explosives cases and where the number of enforcement agents to do the job is insufficient.

-- The study found that there was generally low morale among criminal enforcement personnel brought on by budget cutbacks, media attacks and frequent program changes. Personnel did not have a sense of job security.

-- ATF is viewed by state and local law enforcement as the most cooperative of all the Federal enforcement agencies and its criminal enforcement activities are held in high regard by these agencies.

The Reorganization Plan

A plan was developed within the Department to reassign the functions of ATF and the people who perform them to the Secret Service and the Customs Service in a manner that would ensure both efficiencies in the form of reduced personnel and costs and also effectiveness in carrying out statutorily mandated enforcement, revenue protection, and regulatory functions.

The plan developed calls for the reassignment of approximately 1731 Special Agent and administrative personnel to the Secret Service and either 719 or 1019 personnel to the U.S. Customs Service depending on the level of compliance required under the F.A.A. Act.

Of the 1731 personnel reassigned to the Secret Service approximately 1200 will be criminal enforcement Special Agents while the remaining 531 will provide administrative, technical and clerical support. The personnel transferred will carry out the enforcement and regulatory functions of the firearms, explosives and arson statutes. Present planning calls for the reassigned personnel to operate as a separate division of the Secret Service until such time as a full merger can be effectively accomplished. The full merger will depend upon the resolution of such matters as cross-training of personnel, transfer of property and equipment, shared space arrangements, development of a new organizational structure, etc.

The transfer of ATF functions related to alcohol and tobacco to the U.S. Customs Service will be accomplished by the reassignment of 719 personnel if there is to be compliance only with the mandatory provisions of the F.A.A. Act. In the event that full compliance with the non-mandatory features of the F.A.A. Act is mandated by the Congress it will become necessary to transfer 1019 people to the Customs Service. It is envisioned that the personnel transferred

will operate as a separate division until such time as they can be assimilated into the Customs Service. Full assimilation will depend on the resolution of problems such as cross-training of personnel, transfer of property and equipment, shared space, development of a new organizational structure, etc.

The plan also calls for the outplacement of approximately 250 ATF personnel to other bureaus. These outplacements will occur as a result of budget reductions wholly apart from any reorganization or transfer of functions. Plans are underway to outplace 100 regulatory inspectors in the 1854 series to the Internal Revenue Service. Approximately 150 criminal enforcement Special Agents in the 1811 series will be outplaced to the U.S. Customs Service and U.S. Secret Service. ATF agents outplaced to the Customs Service will be utilized in Customs' expanded enforcement role in control of the export of critical technology, export investigations and investigations of the financial dealings of major drug traffickers and their money launderers under the Bank Secrecy Act.

Benefits Resulting From Reorganization

The ATF reorganization and reassignment of functions to the Secret Service and U.S. Customs Service within the Treasury Department represents a sound management decision. When combined with needed office closings and other structural changes, it will achieve economies, result in a

better allocation of law enforcement resources, maintain revenue protection and provide for the desired level of alcohol regulation. It is the logical result of Treasury's management review of ATF that revealed deficiencies, largely of an institutional nature, for which corrective action was required as well as the more general need for a more economic management of government resources.

The anomalous and at time counterproductive combination of resources devoted to disparate missions, alcohol and tobacco revenue protection and regulation on the one hand, and criminal investigations of firearms and explosives violations on the other, will be terminated. These resources and functions will now be allocated to agencies with goals that are fully compatible with the received functions.

When ATF personnel who are reassigned to the Secret Service for the firearms and explosives functions are fully merged into the Secret Service, the average field office will have a combined strength and capability well beyond what either agency has today. This strength will enable field offices of the new organization to devote more personnel not on full-time protective duty to priority investigations whether they are counterfeiting, and check forging - the regular investigative duties of the Secret Service - or firearms, protective intelligence. explosives or arson-type matters. Absent protective

needs, most of these personnel will be available for investigative work. Conversely, when there is a peak protective period or an urgent protective need occasioned by the visit of the President, Vice President of visiting head of state to a particular city, there will be greater personnel resources available in that city to satisfy that need.

Upon examination, the benefits to the reorganization both for the firearms/explosives function and the protective function are evident.

A. Benefits to Law Enforcement

It is submitted that the reassignment of the firearms and explosives functions to the Secret Service will result in a more efficient enforcement of the firearms, explosives and arson statutes with fewer people and less cost by the following measures:

1. By putting these functions into a strictly law enforcement organization as opposed to an organization that placed great emphasis on regulation and revenue protection of two commodities in areas totally unrelated to the enforcement of the firearms and explosives laws. The Secret Service is strictly a law enforcement organization. The 1100 field agents of the Secret Service made 6600 arrests in FY 1981 despite the fact that 45 percent of their

time was devoted to protective activities. 1700 of these arrests were made in counterfeiting cases. These accomplishments indicate a field organization strongly oriented toward the working of criminal enforcement cases and and a high level of productivity.

2. The transfer to the Secret Service should bring about a much-needed improvement in the morale and self image of ATF personnel who are reassigned by placing them in an organization with a high level of morale and an excellent public image. These factors taken by themselves contribute to greater productivity.
3. The transfer to the Secret Service will facilitate the closing of non-productive Posts of Duty and the reassignment of some of the personnel from these offices to areas where firearms, explosives and arson violations are concentrated. In addition, these reassignments will permit a greater concentration on the firearms, explosives and arson activities of major traffickers, criminal figures, hate groups and terrorists.
4. This transfer will give the Secret Service the ability to draw on additional resources badly needed for

its protective mission. The management review conducted by the Treasury Department in connection with the assassination attempt on President Reagan on March 30, 1981, stated that the protective responsibilities of the Secret Service have been expanding in recent years while budgetary restraints reduced the number of special agents available for protective duties. It recommended that if the Secret Service is to continue to provide the level of protection equivalent to that which it has historically achieved, the manpower and financial resources available to the Secret Service for the performance of this function must be significantly increased. This review also found that there has been approximately a 15 percent overall decline in the Special Agent and Uniformed Division categories of the Secret Service since 1977. The utilization of ATF agents to support the Secret Service in the protective area is not new. ATF routinely supports the Secret Service during campaign years. During the 1980 Presidential Campaign 600 ATF agents were used at various times in support of Secret Service protective activities.

5. The merger of ATF functions to the Secret Service will enhance intelligence gathering capabilities of the Service. Individuals and groups who threaten and attack Secret Service protectees need and acquire guns and explosives. ATF's criminal investigative work in these areas frequently uncovers individuals and groups of possible interest to the Secret Service. ATF's gun tracing abilities as demonstrated in the Hinckley case will greatly enhance Secret Service needs. ATF has a great deal of information on various hate groups and terrorist groups who have violated the firearms and explosives statutues. This information will be of great benefit to the Secret Service in its protective mission.
6. In order to be most effective in its protective mission, the Secret Service needs to maintain excellent working relations with state and local law enforcement throughout the country. ATF personnel have developed strong working relationships with state and local law enforcement which will benefit the Secret Service.

B. Regulatory and Revenue Protection Benefits

The Customs Service receipt of the excise tax and regulatory functions of ATF pertaining to alcohol and tobacco is a

sound management decision. Both agencies collect substantial revenues, maintain laboratories for testing commodities, utilize all-in-bond procedures and have significant regulatory responsibilities. In combining the collection of import duties with excise tax collection, Customs will follow the practice of most European countries. Apart from combining activities of common expertise, this reassignment of functions will also result in efficiencies by reducing administrative and management overhead and combining laboratory resources.

C. Cost Benefits

The cost benefits derived from the reorganization result from administrative and management overhead savings, closing of unproductive field offices and outplacement of enforcement personnel, and from a planned reduction in the level of F.A.A. Act enforcement. Following a budget level of $138 million for FY 1982, the reassigned functions will be operated in FY 1983 at a level of $121 million. This will represent a savings of approximately $29 million from the FY 1981 level of $150 million. Specifically, these savings will be achieved from the more efficient use of the following resources:

Space and Equipment

Administrative and Management Overhead

Criminal Enforcement Personnel

Regulatory Enforcement Personnel

Conclusion

The reassignment of functions outlined above is based on sound management principles and cost-effective planning. The firearms and explosives laws can be enforced more efficiently with fewer people in the right locations with existing Secret Service personnel available for priority firearms, explosives and arson cases. The Secret Service will have a larger manpower base to call on for unusual protective requirements and the flow of intelligence will be facilitated. The collection of excise taxes on alcohol and tobacco and the regulation of the alcohol industry to the degree mandated by Congress will not be impaired by the merger of these functions into the Customs Service while significant savings will be achieved.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
February 10, 1982

CONTACT: George G. Ross
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TREASURY DEPARTMENT RELEASES TEXT OF JOINT STATEMENT WITH NETHERLANDS ANTILLES

The Treasury Department today released the text of a joint statement signed by the Minister of Finance of the Netherlands Antilles, Mr. Marco J. de Castro, and the Assistant Secretary (Tax Policy) of the Treasury Department, Mr. John E. Chapoton. The statement relates to the recently concluded round of negotiations with respect to a new income tax treaty between the United States and the Netherlands Antilles.

The text of the joint statement is attached.

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R-617

February 4, 1982

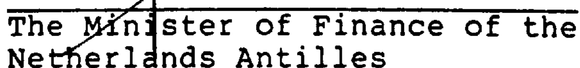
JOINT STATEMENT

The Minister of Finance of the Netherlands Antilles, Mr. Marco J. de Castro, and the Assistant Secretary (Tax Policy) of the United States Treasury Department, Mr. John E. Chapoton, announced today that further negotiations between the Government of the Netherlands Antilles and the Government of the United States, for the purpose of agreeing on a new income tax convention, were held in Washington, D.C. from February 1 through 4, 1982. The chief negotiator for the United States was A. W. Granwell, International Tax Counsel, and the chief negotiator for the Netherlands Antilles was Harold Henriquez, Minister Plenipotentiary.

During these negotiations, there was a review of the main issues. There was a detailed discussion of the possible solutions to reconcile the respective tax, enforcement and economic policy goals of the two governments in light of the historical relationship between the two countries.

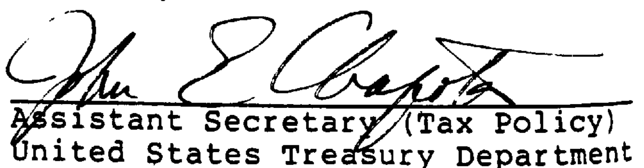
The two delegations will resume the negotiations shortly. The next meetings have been scheduled for the spring of 1982.

In the meantime, the present treaty relationship between the United States and the Netherlands Antilles will remain in effect and will be administered in accordance with its terms.



The Minister of Finance of the Netherlands Antilles

Mr. Marco J. de Castro



Assistant Secretary (Tax Policy)
United States Treasury Department

Mr. John E. Chapoton

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF MARC E. LELAND

ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS

APPROPRIATIONS COMMITTEE

U.S. SENATE

FEBRUARY 9, 1982

Mr. Chairman: Thank you for giving me the opportunity to discuss the Polish debt situation with you and members of this Committee. I understand that the Committee is concerned about whether Poland should be declared in default as a means to exert pressure on the Polish regime and is also concerned that the Government is paying the Commodity Credit Corporation's (CCC) guarantees of commercial bank loans to Poland.

The President has decided that maximum pressure can be put on Poland by insisting on repayment of their debt -- both that portion which we did not reschedule last year and that which falls due this year -- and <u>not</u> by declaring the Poles in default at this time. I want to emphasize this point strongly because there has been much confusion and misinformation on the issue.

Private banks are not now lending any money to the Polish government. Poland, however, is making some payments though by no means all that is due both to official creditors and commercial banks in the west. Thus, we have a situation of money flowing from the East to the West as opposed to the opposite situation which existed just a year ago, when banks and governments were putting money into Poland. By adhering to this policy of pressuring the Poles for repayment, while not putting any new money into Poland, we will perpetuate this situation. This hurts the Polish regime because this net outflow means that they are giving up more than they are getting and, as I noted above, they are getting no new credit now.

Would declaring a default bring more pressure on the Poles than that which now exists? I don't think so. In fact, declaring a default now would make things easier for the Polish regime. This sounds like an anomaly but in fact it is not. If the United States Government were to declare a default against the Polish government, as some have argued, Poland could use that as an excuse to keep from paying even the small amounts which it is presently paying. Thus, they would be free to use their scarce foreign exchange either to pay other creditors -- who might not declare default -- or make new purchase. In this situation, the USG would, of course, be free to seek to attach Polish assets, of which there are virtually none. Even if there were any, they would be difficult to attach for reasons of sovereign immunity.

Thus, analysing the situation in this way, the Government, like private banks, has determined that there is more chance of getting paid if we do not declare Poland in default but insist that that they pay their indebtedness.

It has also been suggested that a declaration of default against the Poles could force the Soviets to pay the Polish obligations. I don't believe this is the case. It would in fact, reduce the pressure that currently exists for the Soviet Union to help Poland in whatever way it can so that the Poles can continue to make some payments.

It has been alleged that any payments by the Commodity Credit Corporation to the commercial banks would in effect be "bailing out" the banks and letting the Poles "off the hook". This simply is not the case. The United States Government has a legal obligation to honor its guarantees on the loans which commercial banks made to Poland. This we are doing. When that process is complete, the guaranteed portion of Poland's debt will be owed to the United States Government, rather than the commercial banks. I can assure you that we will do everything possible to collect that debt. I can also assure you that this transfer will not, in any way, undermine or weaken the ability of the commercial banks to call a default on their many unguaranteed private bank loans to Poland which are not being paid on time. That they have not done so and show no intention of doing so

denotes as I have said that they have come to the same conclusion as we -- by an independent process -- that it is better to collect some money than none. By insisting that this be done we preserve to the maximum extent possible our separate, but similar, interests in being repaid. At the same time, the USG is maintaining its objective of placing the maximum possible pressure on the Polish regime. We firmly believe that this policy is the most effective one.

I will be happy to answer any questions which you or other members of the Committee may have.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. February 10, 1982

TREASURY TO AUCTION $5,250 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $5,250 million of 2-year notes to refund $3,907 million of notes maturing February 28, 1982, and to raise $1,343 million new cash. The $3,907 million of maturing notes are those held by the public, including $421 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $591 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders. Additional amounts of the new security may also be issued at the average price to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing securities held by them.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

R-619

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED MARCH 1, 1982

February 10, 1982

<u>Amount Offered:</u>

To the public	$5,250 million

<u>Description of Security:</u>

Term and type of security	2-year notes
Series and CUSIP designation	Series P-1984 (CUSIP No. 912827 MX 7)
Maturity date	February 29, 1984
Call date	No provision
Interest coupon rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	August 31, 1982; February 28, 1983; August 31, 1983; and February 29, 1984
Minimum denomination available	$5,000

<u>Terms of Sale:</u>

Method of sale	Yield auction
Accrued interest payable by investor	None
Preferred allotment	Noncompetitive bid for $1,000,000 or less
Payment by non-institutional investors	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable

<u>Key Dates:</u>

Deadline for receipt of tenders	Wednesday, February 17, 1982, by 1:30 p.m., EST
Settlement date (final payment due from institutions)	
a) cash or Federal funds	Monday, March 1, 1982
b) readily collectible check	Thursday, February 25, 1982
Delivery date for coupon securities	Wednesday, March 10, 1982

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

February 11, 1982

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $ 5,250 million, of 364-day Treasury bills to be dated February 25, 1982, and to mature February 24, 1983 (CUSIP No. 912794 BZ 6). This issue will not provide new cash for the Treasury, as the maturing 52-week bill was originally issued in the amount of $5,265 million.

The bills will be issued for cash and in exchange for Treasury bills maturing February 25, 1982. In addition to the maturing 52-week bills, there are $9,278 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks as agents for foreign and international monetary authorities currently hold $2,176 million, and Federal Reserve Banks for their own account hold $2,988 million of the maturing bills. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average price of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $964 million of the original 52-week issue.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Thursday, February 18, 1982. Form PD 4632-1 should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders, the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions. 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, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for $500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on February 25, 1982, in cash or other immediately-available funds or in Treasury bills maturing February 25, 1982. 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 Section 454(b) of the Internal Revenue Code, the amount of discount at which these bills are sold is considered to accrue when the bills are sold, redeemed, or otherwise disposed of. Section 1232(a)(4) provides that any gain on the sale or redemption of these bills that does not exceed the ratable share of the acquisition discount must be included in the Federal income tax return of the owner as ordinary income. The acquisition discount is the excess of the stated redemption price over the taxpayer's basis (cost) for the bill. The ratable share of this discount is determined by multiplying such discount by a fraction, the numerator of which is the number of days the taxpayer held the bill and the denominator of which is the number of days from the day following the taxpayer's date of purchase to the maturity of the bill. If the gain on the sale of a bill exceeds the taxpayer's ratable portion of the acquisition discount, the excess gain is treated as short-term capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
Tuesday, February 16, 1982

Contact: Marlin Fitzwater
(202)566-5252

TREASURY ESTABLISHES FINANCIAL LAW ENFORCEMENT CENTER

Secretary of the Treasury Donald T. Regan today announced the establishment of a Financial Law Enforcement Center to analyze currency transactions related to criminal activity.

"Analysis of financial reports required under the Bank Secrecy Act can be very useful in fighting crime, especially drug trafficking," Secretary Regan said. "These reports can disclose large currency transactions, the international movement of currency and the control of foreign bank accounts."

The Bank Secrecy Act requires reports on (a) deposits with financial institutions of $10,000 or more in currency or monetary instruments, (b) the transportation in and out of the country of $5,000 or more in currency or monetary instrument, and (c) the existence of foreign bank accounts.

The new center will be part of the U.S. Customs Service in Washington. It will be permanently staffed by 38 personnel, of which 30 will be intelligence analysts. The analysts will primarily concentrate on currency flows associated with nationwide drug trafficking. In coordination with the President's task force on south Florida crime, 20 additional Customs officers will be detailed to the Center to provide financial analytical support to the task force.

The creation of the Center will greatly increase utilization of financial information among Federal law enforcement investigative agencies, including the U.S. Customs Service, the Internal Revenue Service, the Federal Bureau of Investigation and the Drug Enforcement Administration by upgrading analytical capability and promoting greater coordination.

Previously, this activity was conducted within the Customs Service's Reports Analysis Unit, which was manned by 18 personnel.

The policy direction and interagency coordination for the Treasury Financial Law Enforcement Center will be provided by the Office of the Assistant Secretary of Treasury for Enforcement and Operations.

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R-621

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. February 16, 1982

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $9,800 million, to be issued February 25, 1982. This offering will provide $525 million of new cash for the Treasury, as the maturing bills were originally issued in the amount of $ 9,278 million. The two series offered are as follows:

91 -day bills (to maturity date) for approximately $4,900 million, representing an additional amount of bills dated November 27, 1981, and to mature May 27, 1982 (CUSIP No. 912794 AR 5), currently outstanding in the amount of $ 4,718 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 4,900 million, to be dated February 25, 1982, and to mature August 26, 1982 (CUSIP No. 912794 BJ 2).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing February 25, 1982. In addition to the maturing 13-week and 26-week bills, there are $ 5,265 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Federal Reserve Banks, as agents for foreign and international monetary authorities, currently hold $ 2,104 million, and Federal Reserve Banks for their own account hold $2,988 million of the maturing bills. These amounts represent the combined holdings of such accounts for the three issues of maturing bills.

Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average prices of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,140 million of the original 13-week and 26-week issues.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

R-62

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, February 22, 1982. 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. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. 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, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on February 25, 1982, in cash or other immediately-available funds or in Treasury bills maturing February 25, 1982. 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 Section 454(b) of the Internal Revenue Code, the amount of discount at which these bills are sold is considered to accrue when the bills are sold, redeemed, or otherwise disposed of. Section 1232(a)(4) provides that any gain on the sale or redemption of these bills that does not exceed the ratable share of the acquisition discount must be included in the Federal income tax return of the owner as ordinary income. The acquisition discount is the excess of the stated redemption price over the taxpayer's basis (cost) for the bill. The ratable share of this discount is determined by multiplying such discount by a fraction, the numerator of which is the number of days the taxpayer held the bill and the denominator of which is the number of days from the day following the taxpayer's date of purchase to the maturity of the bill. If the gain on the sale of a bill exceeds the taxpayer's ratable portion of the acquisition discount, the excess gain is treated as short-term capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

STATEMENT FOR RELEASE UPON REQUEST
ON RECOMMENDATION OF THE GOLD COMMISSION
FRIDAY, FEBRUARY 12, 1982

The Gold Commission today rejected a recommendation to restore the gold standard with a fixed price of gold by a vote of 15 to 2.

The Commission adopted a related recommendation by a 9 to 8 vote which said, "The Commission recommends that Congress and the Federal Reserve study the merits of establishing a rule specifying that the growth of the nation's money supply be maintained at a steady rate which insures long-run price stability. In addition, the Commission concludes that under present circumstances, restoring a gold standard does not appear to be a fruitful method for dealing with the continuing problem of inflation. The Congress and the Federal Reserve should study ways to improve the conduct of monetary policy, including such alternatives as adopting a monetary rule.

The Commission also voted 12 to 3 to issue gold bullion coins of specified weights and without dollar denomination or legal tender status, to be manufactured from its existing stock of gold and to be sold at a small mark-up over the market value of the gold content. The coin shall be exempt from capital gains tax and sales tax.

The Commission will meet again before approving it's final report to the Congress due March 31, 1982.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Request

STATEMENT BY DEPUTY SECRETARY R. T. MCNAMAR
FRIDAY, FEBRUARY 12, 1982

The American Bankers Association's Consensus Statement on the powers banks need to be competitive in the 1980's is a productive first step in support of legislative and regulatory actions to deregulate depository institutions. It should further the dialogue among industry leaders, trade associations and legislators toward Congressional action on S. 1720 this year.

However, it is evident that significant differences still remain among the affected industry groups. We hope that considerable progress can be made to resolve these differences in the next few weeks. The competitive and economic situation confronting depository institutions requires prompt action to strengthen our financial system.

Future progress can only be attained if each industry group presents a constructive response to the initiatives already before Congress. As they continue to meet, we hope that over the next several weeks substantive progress will replace the kinds of public bargaining positions contained in the ABA's Consensus Statement. The secure future of all depository institutions depends on their reaching an understanding.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. February 16, 1982

TREASURY TO AUCTION $3,250 MILLION
OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury will auction $3,250 million of 5-year 2-month notes to raise new cash. Additional amounts of the notes may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

Attachment

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R-623

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 5-YEAR 2-MONTH NOTES
TO BE ISSUED MARCH 3, 1982

February 16, 1982

Amount Offered:

To the public........................ $3,250 million

Description of Security:

Term and type of security............ 5-year 2-month notes

Series and CUSIP designation......... Series E-1987 (CUSIP No. 912827 MY 5)

Maturity date........................ May 15, 1987

Call date............................ No provision

Interest coupon rate................. To be determined based on the average of accepted bids

Investment yield..................... To be determined at auction

Premium or discount.................. To be determined after auction

Interest payment dates............... November 15 and May 15 (first payment on November 15, 1982)

Minimum denomination available....... $1,000

Terms of Sale:

Method of sale....................... Yield auction

Accrued interest payable by investor............................ None

Preferred allotment.................. Noncompetitive bid for $1,000,000 or less

Payment by non-institutional investors........................... Full payment to be submitted with tender

Deposit guarantee by designated institutions.............. Acceptable

Key Dates:

Deadline for receipt of tenders...... Wednesday, February 24, 1982, by 1:30 p.m., EST

Settlement date (final payment due from institutions)

a) cash or Federal funds.......... Wednesday, March 3, 1982

b) readily collectible check...... Monday, March 1, 1982

Delivery date for coupon securities.. Wednesday, March 17, 1982

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 16, 1982

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 5,003 million of 13-week bills and for $5,004 million of 26-week bills, both to be issued on February 18, 1982, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing May 20, 1982			:	26-week bills maturing August 19, 1982		
	Price	Discount Rate	Investment Rate 1/	:	Price	Discount Rate	Investment Rate 1/
High	96.297	14.649%	15.42%	:	92.770	14.301%	15.63%
Low	96.271	14.752%	15.54%	:	92.730	14.380%	15.72%
Average	96.274	14.740%	15.52%	:	92.740	14.360% 2/	15.70%

Tenders at the low price for the 13-week bills were allotted 27%.
Tenders at the low price for the 26-week bills were allotted 100%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 58,650	$ 55,595	:	$ 60,490	$ 60,490
New York	8,591,510	4,027,060	:	7,261,710	4,063,710
Philadelphia	87,425	37,425	:	24,135	24,135
Cleveland	89,055	48,055	:	80,690	44,190
Richmond	79,915	54,375	:	83,075	58,575
Atlanta	70,475	69,475	:	73,780	63,780
Chicago	863,490	201,125	:	700,900	121,900
St. Louis	43,875	34,550	:	39,855	31,855
Minneapolis	24,515	15,015	:	37,155	20,155
Kansas City	62,200	60,560	:	69,110	61,110
Dallas	38,900	28,990	:	30,370	21,370
San Francisco	544,165	120,640	:	875,605	205,605
Treasury	250,140	250,140	:	227,050	227,050
TOTALS	$10,804,315	$5,003,005	:	$9,563,925	$5,003,925
Type					
Competitive	$ 8,598,325	$2,797,015	:	$7,247,295	$2,687,295
Noncompetitive	1,266,875	1,266,875	:	968,930	968,930
Subtotal, Public	$ 9,865,200	$4,063,890	:	$8,216,225	$3,656,225
Federal Reserve	893,515	893,515	:	825,000	825,000
Foreign Official Institutions	45,600	45,600	:	522,700	522,700
TOTALS	$10,804,315	$5,003,005	:	$9,563,925	$5,003,925

1/ Equivalent coupon-issue yield.
2/ The four-week average for calculating the maximum interest rate payable on money market certificates is 13.917%.

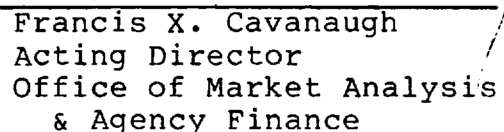
R-624

FOR IMMEDIATE RELEASE FEBRUARY 16, 1982

The Treasury announced today that the 2-1/2 year Treasury yield curve rate for the five business days ending February 16, 1982, averaged 15.05 % rounded to the nearest five basis points. Ceiling rates based on this rate will be in effect from Wednesday, February 17, 1982 through Monday, March 1, 1982.

Detailed rules as to the use of this rate in establishing the ceiling rates for small saver certificates were published in the Federal Register on July 17, 1981.

Small saver ceiling rates and related information is available from the DIDC on a recorded telephone message. The phone number is (202)566-3734.

Approved 

Francis X. Cavanaugh
Acting Director
Office of Market Analysis
& Agency Finance

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Immediate Release
Thursday, February 18, 1982

Contact: Stephen Hayes
566-2041

Secretary Regan Urges Improved Effectiveness in the Multilateral Development Banks

Secretary of the Treasury Donald T. Regan today reaffirmed continued United States support for the Multilateral Development Banks (MDBs) and said that the MDBs should continue to serve as important catalysts for market-oriented economic growth.

In releasing a new report on U.S. participation in MDBs, Secretary Regan said, "In the broadest sense, this report embodies our philosophy of how economic development can be most efficiently promoted and highlights the importance of the private sector in the development process. More specifically, it concludes that future U.S. support for the MDBs should be designed to encourage the banks' promotion of the following set of principles: adherence to free and open markets; emphasis on the private sector as a vehicle for growth; minimal government involvement; and assistance to the needy countries who demonstrate an ability to make good use of available resources by adopting appropriate domestic economic policies.

"United States participation in the multilateral development banks has, overall, served to advance important U.S. economic, political, and humanitarian interests," Secretary Regan said. "However, improvement in the effectiveness of the MDBs can be achieved in the performance of their roles as financial catalysts in developing countries and as providers of sound economic policy advice. U.S. influence in the banks should aim to improve MDB effectiveness over the remainder of the decade."

"This is the most thorough U.S. examination of the multilateral development banks since they were established," he said.

"The assessment was undertaken to establish the necessary framework for future U.S. participation in the MDBs and to outline policy goals to be pursued."

"We have a new Administration," he added "and this is a new, and comprehensive look at the banks by the Administration."

The following proposals are among the key elements in a U.S. strategy designed to improve MDB effectiveness:

Market Forces - The U.S. will seek to have lending policies and programs increasingly stress the importance of correct pricing and allocative incentives, with particular emphasis on the private sector orientation being followed by the International Finance Corporation (IFC). In addition, greater resort to private sector financing through expanded co-financing activities is advocated.

Country and Sector Allocation - Annual country and sector lending levels should be more flexible and less determined by arbitrary aggregate lending targets. The amounts and types of lending should be geared to a borrower's willingness to implement policy reforms through stricter adherence to loan conditionality.

Maturation/Graduation - The United States will seek better utilization of scarce MDB concessional funds through the adoption of a systematic "maturation" policy designed to move countries from total reliance on "soft funds" to "hard-and-soft blends" and then into the "hard loan windows" exclusively. Recipient countries should be moved through this maturation process as rapidly as their debt-servicing capacities and credit-worthiness permit. Such a policy will enable the banks' scarce concessional funds to be reserved for the poorest of the LDCs willing to help themselves. Concurrently, improved implementation of graduation policies for the hard loan windows is necessary to phase-out lending to the most advanced borrowers consistent with their financial and developmental prospects. Co-financing should play an increasing role during the phase-out period.

U.S. Budget Priorities - It is expected that the MDBs will eventually phase-out reliance on new paid-in capital for the hard loan windows, consistent with maintaining the financial integrity of the institutions. The United States should begin to reduce its participation in the soft loan windows in real terms. In terms of overall U.S. interest in the MDBs, callable capital allocations to the banks should have priority over concessional window replenishments.

In discussing the future of the MDBs, Secretary Regan stressed that "they are multilateral institutions. Therefore, the U.S. strategy described in the assessment will require a skillful effort to build an international consensus supporting our policy objectives. Our deliberations with other donors and MDB managements will stress the positive evolutionary aspects of our recommendations."

A summary of the report is attached. Copies of "United States Participation in the Multilateral Development Banks in the 1980's" can be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, D. C. 20402 (Tel: 202-783-3238). The report's GPO stock number is 048-000-00352-4.

Attachment

United States Participation in The Multilateral Development Banks in the 1980's

EXECUTIVE SUMMARY

This assessment is intended to provide a comprehensive and dispassionate evaluation of the policies and operations of the multilateral development banks (MDBs) and, by applying the Administration's basic policy preferences and priorities to the findings, to establish a policy and budgetary framework for U.S. participation in these institutions in the 1980s. The study focuses on four institutions -- the World Bank Group, the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), and the African Development Bank (AFDB).

The first part of the assessment discusses the role of the MDBs in the international economic system (Chapter I), criticisms which have been raised regarding the MDBs (Chapter II), the extent to which MDB operations contribute to U.S. interests (Chapter III), and the ability of the United States to exercise effective leadership within the institutions (Chapter IV). Attention is then directed to the development rationale which underlies our approach to improving MDB effectiveness (Chapter V). The second part of the assessment provides policy recommendations for future U.S. participation in the MDBs (Chapter VI), and illustrates the relationship between the budgetary implications of this policy direction and the lending operations of the institutions (Chapter VII).

The appendices, which are an important and integral component of the assessment, describe the structure and operations of the MDBs (Appendix I); assess the economic/financial situation of the developing countries over the next several years (Appendix II); and survey and evaluate in detail the criticisms, identified in Chapter II, which have been levelled against the MDBs (Appendix III).

Role of the MDBs in the International Economic System

In addition to providing project finance and technical assistance, the MDBs also act as financial catalyst, institution builder (including human capital formation), and policy advisor.

MDB flows account for a relatively small proportion (6-7 percent) of total flows to developing countries, but low income countries tend to be significantly more dependent on them. The catalytic role the MDBs can play in promoting the prudent economic policies necessary to facilitate private financial flows is expected to remain highly important for developing countries in the 1980s -- as will actual MDB financial support for the poorer countries.

The economic justification for the MDBs rests upon their capabilities to play an effective role in situations which require government intervention to provide economic benefits that private investors would not or could not generate. The most important aspects of MDB lending relate to correcting internal or external "market imperfections" hindering LDC development, and facilitating projects which yield positive externalities or benefits to the community at large. A look at the distribution of MDB lending by sector suggests that an overwhelming proportion of MDB lending has been directed into those sectors which tend to be in this desirable framework. The extent to which MDB activity is competitive with the private sector appears minimal.

While data are incomplete, an analysis of World Bank and ADB projects indicates that the economic rates of return on these projects are relatively high, 15-20 percent on average. This suggests that the institutions are making positive contributions to economic development. However, the effective implementation of a fairly high percentage of recent loans has been hindered by difficulties in a number of countries which could have been avoided had there been stronger efforts by the lending institutions to encourage appropriate economic policies in recipient countries. In their ability to influence economic policies in developing countries, the MDBs' record is mixed, with influence more easily exerted at the micro-level of policy and in countries willing to cooperate with the MDBs in identifying and implementing policy changes. This would suggest that the country allocation of lending should favor borowers willing to work constructively with the MDBs to insure projects are carried out in an efficient and rational economic framework.

Criticisms of the MDBs

A number of recent criticisms of the banks imply that policy and/or operational deficiencies have detracted from their institutional effectiveness. A total of nineteen criticisms were evaluated.

In some cases, such as independent audits and staff salaries, the situations which generated criticism have already been remedied or improved. While a significant number of other criticisms appear to have little validity, others focus on areas (such as evaluation systems, and the issue of absorptive capacity) where the evidence is not conclusive or the extent of the problem has not been quantified. These particular areas warrant additional follow-up. In addition, there are two specific criticisms which appear sufficiently serious so as to require the United States to seek corrective policy initiatives in the banks. These are: (1) the indication that in some instances there has been an overemphasis on loan quantity rather than loan quality, which

has served to erode MDB policy influence, and (2) the strong indication that a more effective maturation/graduation policy is required to make MDB lending more reflective of country need and the availability of alternative financing.

U.S. Objectives and MDB Performance

The United States has pursued three broad policy objectives through its participation in the MDBs. The first of these, political/ strategic, is based on the U.S. foreign policy role as leader of the non-Communist world. Fulfillment of this role has several specific dimensions as it relates to our participation in the MDBs. The long term dimension calls for the development of a more secure and stable world through the promotion of steady economic growth. The medium term dimension calls for effective development assistance programs in those countries which are of ongoing political/strategic importance. The short term dimension calls for rapid economic support for key countries which are in need of immediate assistance.

The second, and closely related, broad policy objective has to do with the preservation and growth of a free, open, and stable economic and financial system through the promotion of economic and social development. The MDBs work to achieve this objective by strengthening the ability of the LDCs to participate more fully in an international system based on liberalized trade and capital flows. The MDBs do this by acting as a catalyst for private investment and other private capital flows, as well as trade and technology flows; mobilizing and transfering government backed capital directly to developing countries; and encouraging rational LDC economic policies under free market concepts and global economic efficiency.

The third broad policy objective has to do with our humanitarian concern with alleviating poverty and improving the material well-being of the poor in developing countries. The MDBs are able to assist in the achievement of this objective by promoting overall economic growth and productivity in developing countries and by pursuing programs targeted directly on the poor. The banks can also provide emergency relief and/or reconstruction assistance.

The United States has also pursued three operational or cost-effective objectives in the MDBs. The first relates to advancing U.S. commercial interests, and the benefits which accrue to such interests from MDB efforts to promote economic and social development. MDB projects can lead to increased supplies of raw materials and other products needed by the U.S. economy, as well as expanded U.S. earnings, both through MDB financed purchases of U.S. goods and services as well as by the expansion of developing country markets for U.S. exports. A second operational objective is budgetary, with the goal of minimizing direct U.S. budget outlays

for foreign assistance. This can be done in the MDBs through cost sharing arrangements with other donors and by leveraging U.S. paid-in contributions to the hard loan windows of the MDBs through MDB market borrowings backed by callable capital which does not require budget outlays. The third operational objective, institutional efficiency, has to do with the operational and administrative efficiency of the MDBs in carrying out their development programs. This involves having the MDBs design and implement high quality development loans so as to maximize the impact of scarce development resources.

Taking into account specific criticisms which have been directed at the MDBs with regard to each of these six objectives, the MDBs as a group were assessed in terms of their performance in promoting each objective. The conclusions are as follows:

-- the MDBs, by and large, have been most effective in contributing to the achievement of our global economic and financial objectives and thereby also helping us in our long term political/ strategic interests. However, there is room for improvement in terms of encouraging more effective economic policy reform in individual LDCs and implementing graduation policies more consistently;

-- the soft loan windows of the MDBs are particularly effective in advancing U.S. humanitarian interests;

-- the MDBs, particularly the hard loan windows, contribute significantly to the achievement of U.S. long and medium term political/strategic interests but are less effective with regard to the achievement of short term objectives, where identification of the assistance with the United States is important.

With regard to the operational objectives:

-- the MDBs have served U.S. commercial interests well;

-- the MDBs, particularly the hard loan windows, are particularly effective in serving the budgetary objective because of cost-sharing with other donors and the financial leverage derived from MDB borrowing against callable capital guarantees;

-- The MDBs have served the U.S. institutional efficiency objective reasonably well through operational and administrative efficiency and the generation of generally high quality loans.

U.S. Influence in the MDBs

A total of fourteen significant issues were identified for a detailed review of how effectively the United States was able to influence the MDBs over the last ten years. Of these fourteen -- which were generally representative of the success/failure composition of a much larger list -- the results were judged fully successful, in terms of the extent to which the eventual outcome matched the original objective, in nine instances. We were partially successful in three instances and failed in two of cases studied.

Analysis of the fourteen case studies reveals that U.S. leadership involved in each case the expenditure of political capital, with the United States drawing on its prestige as a world leader, its position as a major MDB shareholder, its capabilities as a primary actor in the banks, and on the confluence of interest among other bank members. The effort frequently required high level political involvement, up to and sometimes including the President.

The successful exercise of U.S. influence depended to a large degree on the United States Administration being fully and clearly committed to a well defined objective. Also important was the position and roles of other relevant actors such as bank management, other donors, the developing countries, and the U.S. Congress. Conversely, instances where the exercise of U.S. influence was not fully successful were characterized by inconsistency among objectives pursued, poorly defined objectives, and significant opposition from other parties.

In terms of the ability of the United States to exercise leadership in the future, certain key conditions will need to be met. The United States must be strongly and clearly committed at high levels to a well-defined policy objective which is not inconsistent with other objectives we are pursuing. The United States must also be prepared to expend political capital to succeed. Finally, one or more of the other significant actors -- MDB management, other major donors, or borrowers -- must support, or at least not oppose, the United States.

The extent of U.S. financial support for the MDBs and our willingness to play a positive, active role in the MDB decision making process are also relevant. If other significant actors perceive the United States is no longer willing or able to continue to play a major financial and leadership role in the MDBs, they may be less likely to be supportive of U.S. policy initiatives in the banks.

Improving MDB Effectiveness

Effective use of MDB resources requires a clear focus on increasing the quality rather than quantity of MDB lending, with country allocations of MDB lending directed on the basis of both policy performance and relative economic need.

MDB effectiveness in promoting LDC development in the 1980s will depend to a large extent on the banks' success in encouraging appropriate policies in recipient countries. The elimination of "targetry" (aggregate lending volume objectives) would permit more selectivity in the loan process and strengthen the relationship between loan programs and effective micro and/or macro policies. MDB efforts to catalyze domestic, particularly private, resources and to encourage individual incentives in a free market environment will also be very important.

The desirability of focusing scarce MDB resources on the most needy countries requires that renewed attention be focused on the adoption and equitable implementation of MDB maturation and graduation policies. Guidelines for the implementation of existing policy in the IBRD are somewhat vague and have resulted in the inconsistent application of the policy. A more sophisticated approach which incorporates a range of factors including debt servicing capacity, access to private capital, and others, appears warranted.

It is important to recognize that a more systematic implementation of maturation/graduation policies will over time change the country composition of MDB loan portfolios. Thus, in order to maintain the MDBs' international credit standing, particular care will have to be taken to ensure that the allocation of MDB resources continues to reward good economic management and performance and contributes to maintenance of a sound MDB loan portfolio.

Conclusions and Recommendations

Drawing on our analysis of MDB operations, we conclude that the value of the MDBs lies primarily in their cost effective contribution to LDC economic growth and stability. Continued U.S. participation in the MDBs is justified by a fundamental national interest in a more stable and secure world, which we believe can be best achieved in an open, market oriented international system. To the extent that the MDBs encourage the participation of developing countries in that international system on a permanent and self-sustaining basis, they are one of the major vehicles available for pursuing these U.S. economic and political/strategic interests.

U.S. support for the MDBs should be designed to encourage adherence to free and open markets, emphasis on the private sector as a vehicle for growth, minimal government involvement, and assistance to the needy who are willing to help themselves. Within this framework, the following specific policy recommendations are set out:

1. Market Forces. Lending policies and programs should increasingly emphasize attention to market signals and incentives, to private sector development and to greater financial participation by banks, private investors, and other sources of private financing (with particular emphasis on the IFC's approach and type of program).

2. Promoting Policy Reform. Annual country and sector lending levels should be more flexible and less target oriented. The banks should be encouraged to introduce more selectivity and policy conditionality within projects and sector programs they support. The banks should concentrate their lending in those sectors where they have the most expertise and where they will have the most policy leverage. The IBRD structural adjustment lending program and the IDB sectoral lending program should be closely monitored to assess the potential for achieving policy reform.

3. Sector Allocation. The MDB sector allocation process should be based upon the economic or social priorities of the borrower government -- but only to the extent that their priorities are consistent with the basic economic principles of the MDBs. Increased emphasis should be given to the economic rate of return and policy improvements that can be obtained in the project selection process, and lending should increasingly be linked to specific policy reforms. Due consideration should also be given to the relation of the project to the overall development strategy, and to its overall economic impact.

4. Graduation. Existing IBRD graduation policy should be implemented more effectively and emulated in the regional banks. Countries above the agreed income threshold should be phased out over a reasonable period, with the Bank assisting the graduation candidate to remove the remaining constraints to self-sustaining growth during the phase-out period.

5. Maturation. The United States should encourage better allocation of soft lending funds through a more systematic "maturation" policy. This would require obtaining agreement to move countries into the hard loan windows as rapidly as their debt servicing capacity permits, also giving due consideration to the impact on the loan portfolios of the banks' hard-loan windows.

6. Paid-in Capital. The United States should develop and implement a plan to phase down and eventually phase out new paid-in capital for the hard loan windows on a schedule consistent with maintaining the financial integrity of the MDBs.

7. Soft Loan Window. The United States should begin to reduce its participation in real terms in the soft loan windows, especially IDA because of its large share of the budget, but at a pace consistent with U.S. economic and political objectives. This is consistent with our desire to realign the concessional windows more closely to assisting the poorest developing countries, and saves budgetary resources. We should also place increased emphasis on the adoption of effective policies by the remaining soft loan recipients.

8. U.S. Budget Priorities. The following factors should be carefully considered in determining U.S. allocations to the institutions:

-- to the extent needed, callable capital allocations to hard loan windows are preferable to concessional window replenishments;

-- the World Bank Group has been more successful than the regional banks in promoting appropriate economic policies; and

-- among the regional banks, the Inter-American Bank ranks particularly high in terms of our political/strategic interests. The Asian Bank ranks highest in institutional efficiency. The African Bank ranks high in terms of humanitarian concerns.

U.S. Budget Implications

The Administration remains committed to financing those MDB cost-sharing arrangements which have already been agreed to internationally. Based on the preceding conclusions and recommendations, the following points will also have a direct impact on future U.S. budgetary appropriations for the MDBs:

-- the United States should participate in upcoming MDB capital increases but seek agreement that no paid-in capital is required;

-- U.S. subscriptions to callable capital should continue to be made on the basis of program limitations rather than appropriations;

-- the United States should begin to reduce its participation, in real terms, in the soft loan windows, especially IDA; and

-- the United States should work to implement a more consistent "graduation" policy in the hard loan windows and a more systematic "maturation" program in the soft loan windows.

The principal U.S. budgetary issue relates to whether the United States should participate in future soft loan window replenishments and, if we do participate, at what levels. Given the importance attached to cost sharing traditions, any significant U.S. funding reductions probably would also reduce the overall availability of MDB resources and thereby to a large extent determine the speed with which our recommendations regarding graduation and maturation will need to be implemented. In general, the greater the U.S. contribution in future replenishments of the soft windows, the longer and more gradual could be the maturation of countries from the soft window to the hard windows. In effect, there is a trade-off between our desire to reduce budgetary outlays and mitigating the political costs and economic repercussions of accelerated graduation/maturation. The extent of China's access to IDA and/or IBRD financing will also have an impact on IDA/IBRD net funding availabilities for other borrowers and have important consequences for the speed and scope of maturation and graduation.

Therefore, deliberations on the level of future U.S. MDB contributions must carefully weigh their impact on MDB operations, on political relations with other developed country donors, and on the resulting consequences for individual developing countries. Such consequences include the debt service impact on borrowing countries and/or their access to alternative financing, the implications for the pace of growth and development, and the probable effect on U.S. bilateral relations with, and economic and strategic interests in, the "maturing" and "graduating" countries.

We have reviewed the implications of the following three illustrative ranges of U.S. MDB financing for the FY 1983-87 planning period.

(a) <u>No U.S. Participation in Soft Loan Replenishments</u>

This implies an annual U.S. appropriation for budget authority of $125 million after FY 1984. Given the importance attached to equitable cost-sharing, particularly with regard to IDA, most other key donors would either sharply reduce or cease contributions to soft window funds. Available soft window funds would be dependent on reflows, plus whatever small contributions were provided by other donors, and would only constitute a small fraction of current lending in nominal terms to "IDA only" recipients. There would be an increased demand by soft window recipients for hard window resources, hardening their debt profile and contributing

to debt service problems for some. In order to accommodate former soft window recipients, the IBRD would have to think seriously about speeding up the graduation of countries from hard window lending. To the extent that individual developing countries considered the soft windows important, relations with the United States could be affected adversely.

(b) A Major Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.0 to $1.25 billion in the mid 1980s and focuses soft window lending almost entirely on the very poorest countries. It would represent a reduction from levels of current replenishments as originally negotiated of roughly 30 to 45 percent in real terms in U.S. contributions to the soft loan windows. While U.S. funding would be below international expectations, the United States would retain the flexibility to participate in either most (lower end of range) or all (upper end of range) soft window replenishments, but at reduced levels. There would also be moderate funds for encouraging the development of the private sector in recipient countries. Concessional lending to IDA only countries could grow at 9 percent per year in nominal terms from 1978-80 levels.

(c) A Modest Real Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.5 to $1.75 billion in the mid 1980s, and is geared to a more gradual maturation/graduation process. It would represent some nominal increase from levels of current replenishments as originally negotiated, but a reduction of roughly 12 to 16 percent in real terms in U.S. contributions to the soft loan windows. The United States could participate in replenishments of all concessional windows and a private sector initiative. Soft window lending would focus not just on the very poorest countries (growth at 9 percent per year in nominal terms), but also on selective lending to blend countries linked to policy reform. These levels would imply a slower pace of maturation/graduation and slower movement toward increased reliance on market forces.

With regard to the hard loan windows, there is an economic rationale for reducing the budgetary impact of MDB capital increases arising from the paid-in element. While the key financial indicators of each MDB vary significantly, it appears that -- with the exception of the AFDB -- appropriate financial ratios during the 1980s could be achieved without further paid-in amounts.

The actual amount the Administration will request from Congress to fund U.S. participation in new replenishments in the

future will be dependent on the results of Congressional consultations, international negotiations, and on how successful the United States is in pursuing our new policy recommendations in each of the MDBs. With this caveat, however, the Administration has made some judgments for planning purposes on a range of appropriations requests for the MDBs through the mid 1980s. The Administration believes the middle budget range described above best meets international, institutional, and domestic requirements.

Although this middle budgetary range would represent a substantial real reduction in the appropriations for U.S. MDB funding of the soft loan windows, it is fully consistent with the conclusions we have reached and with the Administration's view of how development can be most efficiently promoted. This budgetary range would encourage a substantially greater degree of discipline in both the MDBs themselves and in borrowing countries. A reduced flow of financial resources in real terms would still provide adequate financing for the poorest countries who are willing to take appropriate measures to help themselves but are unable to obtain external resources from other sources. It would also necessitate more effective maturation/graduation, reinforce selectivity in lending linked to economic policy reform, and require the MDBs to step up their efforts as financial catalysts. Greater private sector involvement, including expanded co-financing, would now be seen as essential steps, not just potential improvements. The middle budgetary range is thus in keeping with the Administration's overall economic philosophy and our desire to improve the operational effectiveness of the MDBs.

In contrast, the budgetary numbers implied by the lower range would be unrealistic in terms of U.S. long term international economic and political interests, particularly in the developing world. On the other hand, the numbers implied by the upper range are inappropriate at home in the light of the Administration's basic economic philosophy and program of reduced government intervention, greater reliance on market forces and the need for stringent budgetary restraint over the next several years.

In sum, the Administration's policy preferences reflect an attempt to improve MDB operations, and thereby maximize their effective contribution to a more stable international environment, while at the same time take into account the real budgetary constraints upon the United States Government.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 9:00 a.m.
Friday, February 19, 1982

Remarks by The Honorable Beryl W. Sprinkel
Under Secretary of the Treasury
for Monetary Affairs
before the
Board of Directors
of the
Health Insurance Association of America
Palm Beach, Florida
February 19, 1982

Good Morning.

I am delighted to be with you this morning. I would like to take the next few minutes to talk -- not so much about the Administration's economic program -- but about the popular impression of that program, and about how that impression often differs from reality.

Those of you in the insurance industry I am sure have heard the story of the life insurance agent who said to a prospect: "Don't let me frighten you into a decision. Sleep on it tonight and if you wake up in the morning let me know what you think."

In a similar vein, there are some who are predicting dire consequences this year and next. And there are those who are so skeptical that they refuse to see the truth if it is put right in front of them. They are like the obituary editor of a Boston newspaper who was not one to admit his mistakes easily. One day he got a phone call from an irate subscriber who said his name had been printed in the obituary column. "Really." said the editor. "Where are you calling from?"

Let me turn, on a more serious note, to economics.

Paul Volcker testified last week before the House Banking Committee. It was an open hearing, with written copies of the testimony available to anyone who wanted them. The following morning the Washington Post account of the hearings was headlined (front page) "Fed Plans to Ease Monetary Policy."

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Simultaneously, the New York Times headline, based on the same hearings was, "Volker Says Fed Plans to Continue Tight Money Stand." Is it any wonder the average layman is sometimes confused about what is going on along the shores of the Potomac?

This leads me to the real subject of my remarks this morning: the public's understanding of what is going on in the economy and the policy actions being pursued in Washington.

There has always been an important psychological dimension to the marketplace. What happens in the stock market, for example, is not so much a reflection of what is happening in the economy. Nor is it a reflection of what people think is going to happen.

Increasingly, it is a function of what people think other people think will happen in the future.

The news media obviously play a key role in shaping public perceptions and public expectations. Let me add here that journalists - certainly the ones with whom I have had contact -- are hard working and dedicated professional men and women. And they tend to be very bright people. By and large the flow of their writing proceeds from a set of assumptions in a very logical sequence to a conclusion. But logic has been defined as the art of going wrong with confidence.

The difficulty is that their starting assumptions are often incorrect. Therefore we often find an editorial argument ending up wrong because it starts out wrong.

Let me give you some examples. These are popularly held beliefs which I think many -- certainly not all -- but many journalists subscribe to. They are thought to be truisms and many assume their veracity and start from that point. And, of course, the more these so-called "truisms" are repeated, the more the public and the press assume the assumptions are true.

I am going to read eight statements that are assumed to be true. Think how often you hear them.

First statement: there is a basic inconsistency between supply side economics and monetarism.

Second, the main purpose of the tax cuts is to get people to spend more.

Third, if you have big government deficits you are going to have high inflation.

Fourth, the Federal Reserve Board is controlling the availability of credit.

Fifth, tight money means high interest rates.

Sixth, Ronald Reagan has reduced the size of the Federal budget.

Seventh, you can balance the budget by raising taxes.

Last, Reaganomics is some new and untested approach to economics.

Now, don't worry. You are not going to be tested on this. In case you hadn't guessed, all eight of those statements are false. Unfortunately, they are usually put in the category of "Everyone knows that ...." or "Based on the fact that ...." and analysis of the current situation proceeds from there. Any analysis of the economic situation which starts with one or more of these assumptions is headed for trouble.

Now let me give you the right answers. In the interest of time, I will give you the answers in a popular, journalistic style. These are a bit oversimplified but true nevertheless:

First, not only are supply-side and monetarist economics compatible, it is essential that they go together. To make the incompatibility argument is like saying a guard and a fullback on the same team are working at cross purposes.

Controlling the money supply is the only lasting way to get nominal income growth and hence inflation under control. The supply-side tax cuts are designed to increase real output.

Second, the main objective of the tax cuts is to encourage savings, investment and productivity.

The traditional Keynesian approach has been to cut taxes for a very different reason: to increase consumer spending.

Third, although deficits are undesirable for many reasons, it is nevertheless possible to have low inflation and low interest rates with big government deficits. Japan and Germany have been doing it for years. How? They have controlled their money supply and have high rates of savings.

Fourth, the Federal Reserve Board controls money not credit. Money and credit are not the same thing. The Fed could not control total credit even if it wanted to.

Fifth, tight money means low interest rates. The correlation between money growth and interest rates is, in the current environment, exactly the opposite of what most people believe.

Sixth, the Reagan budget is the largest budget in the history of the United States. What the president has done is to slow the rate of increase in federal spending.

Seventh, we have been raising taxes in this country for over thirteen years and the budget is yet to be balanced. You balance a budget by controlling spending and getting real economic growth up.

Eighth, the Reagan program is fundamentally based on classic market-oriented principles which have been successfully demonstrated through history. We have been under the influence of Keynesian Economics so long, it just seems like what we now call "Reaganomics" has never been tried.

Those are the right answers. And for anyone -- whether he is in government, the media or private sector -- to understand clearly the President's program, he must separate the wheat from the chaff.

The President's Economic Recovery Program is really not complicated; it is not esoteric. It is based on sound economic fundamentals. The four parts, as I am sure you know, are: one, to reduce government spending; two, to cut tax rates; three, to have a moderate, stable growth in the money supply; and, four, to reduce government regulation. Does that sound like the voodoo fringe? I submit to you, rather, that it is the ultimate in common sense.

We have been in office only a little more than twelve months. And in that short twelve months, the legislative and executive branches, together, have fashioned the most dramatic tax reduction program in the history of the country. Inflation has moved under 9% and is declining. Interest rates have declined significantly from their history high, in the case of the prime, of 21 1/2 in December a year ago. The rate of personal savings in America is on the rise for the first time in years.

Is everything rosy with no problems? Of course not. We are coming out of a recession. Unemployment is much too high. Interest rates, after dropping dramatically last fall, have moved up recently because of -- what I trust will be temporary -- a rapid increase in the money supply. Federal spending is still much too high.

But after decades of over taxing, over spending and over regulating, are we making some good progress? You bet we are.

And are we going to have in this country -- finally -- sustained, non-inflationary economic growth? I say the answer is yes.

Now a few minutes ago I ran through a list of popular assumptions that are not true. My purpose was not to poke my finger in the eye of an editor or to say smugly "we are right and you are wrong."

My purpose rather is to ask for a sincere and honest dialog. It is irresponsible for us in public service to throw technical economic jargon at you. And it is irresponsible for opposition voices continually to repeat assumptions that are not supported by the facts. The stakes are too high this time around. And we all care too much about our country to indulge in that sort of counter-productive bickering. Whoever he is, beware of the man who knows the answer before he understands the question.

William James once wrote, "A great many people think they are thinking, when they are merely rearranging their prejudices."

Those of you who are in positions of leadership in industry can play a very valuable role by speaking out and by helping to keep attention focused both on the facts and on the fundamental issues.

We need your interest and your support.

We now have -- at long last -- a president courageous enough to do the right thing for the country and for the long run -- even if it means a short term sacrifice.

There are some tough roads ahead of us and, at times, the going will not be easy. But we in this Administration are terribly excited about the future.

Thank you.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

February 17, 1982

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $5,252 million of $8,651 million of tenders received from the public for the 2-year notes, Series P-1984, auctioned today. The notes will be issued March 1, 1982, and mature February 29, 1984.

The interest coupon rate on the notes will be 15-1/8%. The range of accepted competitive bids, and the corresponding prices at the 15-1/8% coupon rate are as follows:

	Bids	Prices
Lowest yield	15.12% 1/	100.008
Highest yield	15.26%	99.775
Average yield	15.21%	99.858

Tenders at the high yield were allotted 58%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 75,525	$ 74,525
New York	6,711,925	3,829,525
Philadelphia	64,800	49,800
Cleveland	127,940	127,100
Richmond	161,280	146,440
Atlanta	94,710	94,105
Chicago	597,545	396,605
St. Louis	102,175	101,755
Minneapolis	49,260	49,260
Kansas City	99,310	97,885
Dallas	40,085	40,085
San Francisco	519,695	238,595
Treasury	6,345	6,345
Totals	$8,650,595	$5,252,025

The $5,252 million of accepted tenders includes $1,085 million of noncompetitive tenders and $3,847 million of competitive tenders from private investors. It also includes $320 million of tenders at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities in exchange for maturing securities.

In addition to the $5,252 million of tenders accepted in the auction process, $591 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

1/ Excepting 1 tender of $25,000.

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TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 18, 1982

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $ 5,250 million of 52-week bills to be issued February 25, 1982, and to mature February 24, 1983, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon-issue Yield) 1/
High -	86.724 a/	13.130%	14.80%
Low -	86.648	13.205%	14.90%
Average -	86.674	13.180%	14.87%

a/ Excepting 2 tenders totaling $2,220,000.
Tenders at the low price were allotted 43%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 71,450	$ 32,600
New York	8,332,145	4,320,045
Philadelphia	33,185	18,185
Cleveland	91,515	72,515
Richmond	131,840	41,340
Atlanta	50,070	36,570
Chicago	817,350	167,850
St. Louis	33,850	31,850
Minneapolis	9,750	9,750
Kansas City	43,885	31,785
Dallas	11,075	11,075
San Francisco	819,355	415,355
Treasury	61,250	61,250
TOTALS	$10,506,720	$5,250,170
Type		
Competitive	$ 8,636,110	$3,379,560
Noncompetitive	450,610	450,610
Subtotal, Public	$ 9,086,720	$3,830,170
Federal Reserve	1,100,000	1,100,000
Foreign Official Institutions	320,000	320,000
TOTALS	$10,506,720	$5,250,170

1/ The average annual investment yield is 15.42%. This requires an annual investment yield on All-Savers Certificates of 10.79%.

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TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
February 19, 1982

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STATEMENT BY
SECRETARY OF THE TREASURY DONALD T. REGAN
ON LEASING
Friday, February 19, 1982

I believe it would be extremely unwise to repeal, in the middle of a recession, the leasing provision of the new tax law which is aimed at increasing investment, business expansion, and the creation of jobs. The leasing provision was designed specifically to ensure that as many companies as possible could use the Accelerated Cost Recovery System. Repeal now could have a serious impact on such basic and distressed industries as steel and autos.

The Administration does not support, in any way, the proposal to repeal the leasing provision. Senator Dole, who is a valued ally of the Administration and who played a very prominent role in last year's tax bill, has made his proposal without consultation with this Administration.

President Reagan said, as recently as yesterday, that he would not support changes in the business and individual tax program passed by the Congress last year. These are important tax laws designed to stimulate savings and investments in this country. The leasing provision is a key element of the effort to increase growth and productivity in the economy and to provide more jobs. Both the business and personal tax rate cuts are essential to our economic recovery program.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT BY
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
MONDAY, FEBRUARY 22, 1982

Good afternoon.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It's plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected

by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow between one-third and one-half as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher

inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Admnistration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair

to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Within a day or two we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income

from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed

tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political

jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In

addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes rates are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate the unintended tax benefits resulting from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all

reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation,
- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience,

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

- o Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,
- o Deductions for interest on debt to carry tax-exempt securities,
- o Deferred DISC income,
- o Shipping income deposited in capital construction funds or construction reserve funds,
- o Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,
- o Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and
- o Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an opportunity to increase tax revenues substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for

interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from

past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an

increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

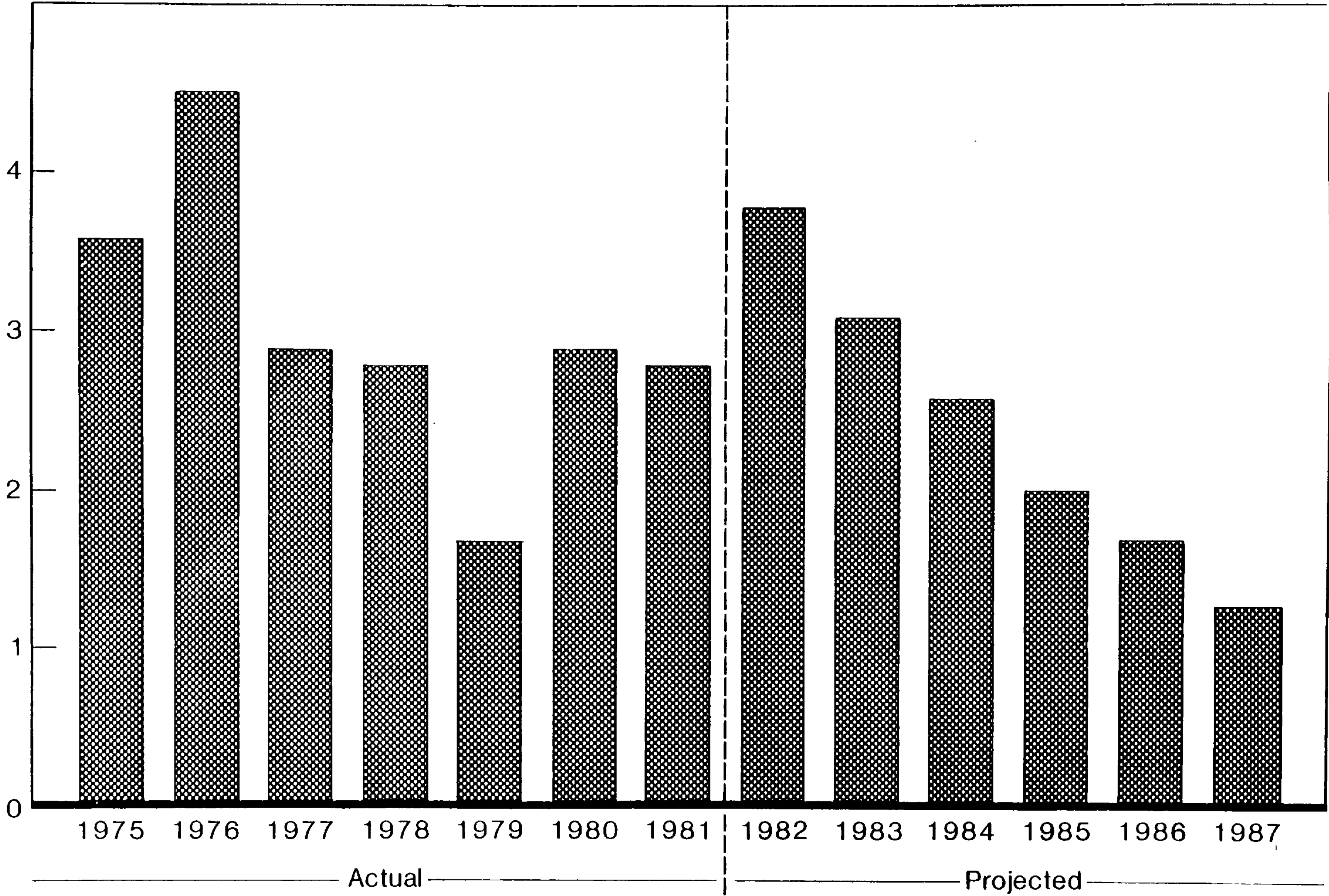
The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

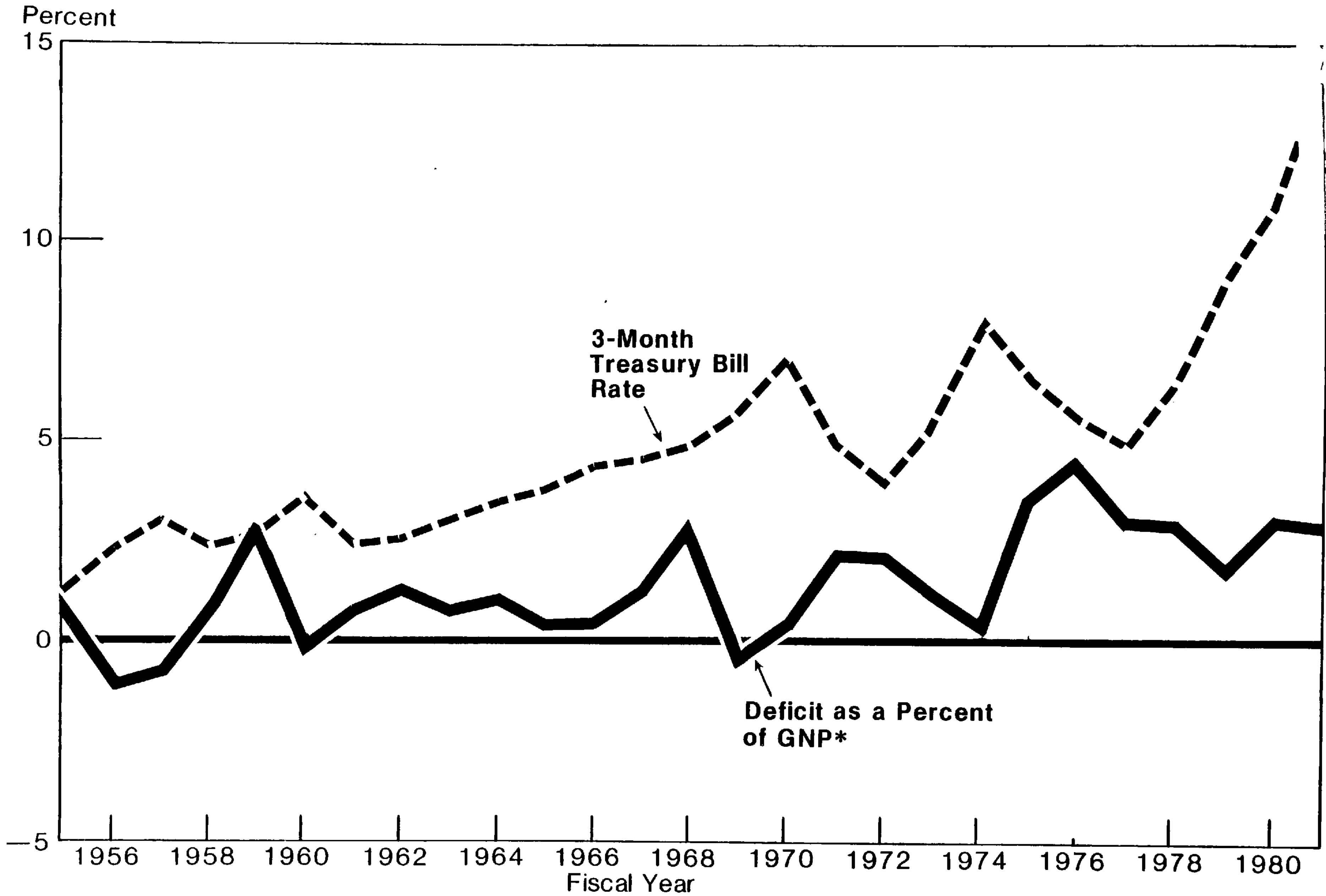
While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

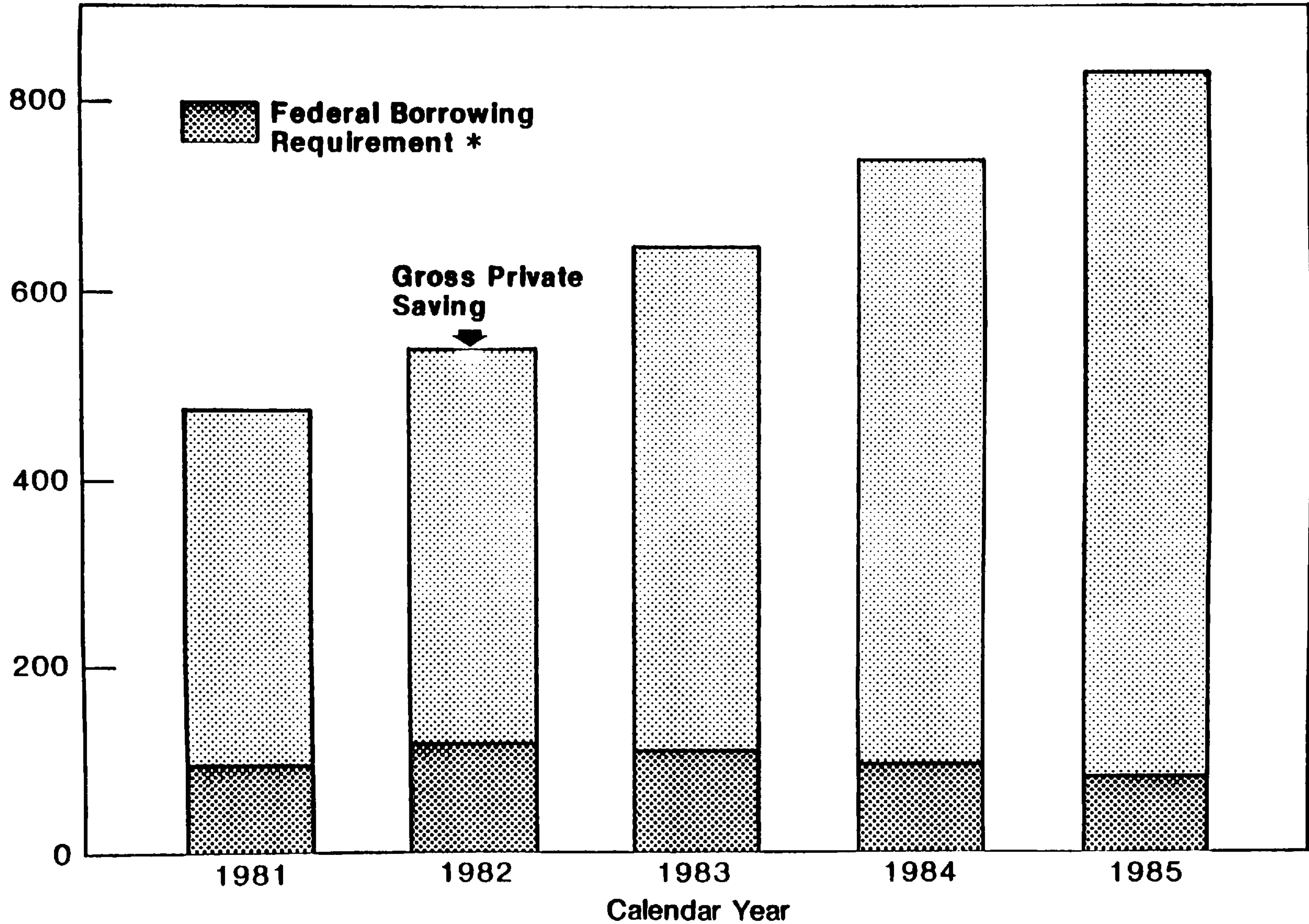
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.



Budget Deficits in Relation to GNP*
Percent
4
3
2
1
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected
* On and off budget as percent of fiscal year GNP.



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
Friday, February 19, 1982

Responding to the temporary restraining order issued yesterday by the United States Court of Appeals for the District of Columbia Circuit, R.T. McNamar, Acting Secretary of the Treasury, noted that "the Court's Order is currently being reviewed by the Justice Department and neither the Secretary of the Treasury nor the Commissioner of Internal Revenue will have any response until this review is completed."

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
February 22, 1982

Contact: Marlin Fitzwater
566-5252

TREASURY ANNOUNCES APPOINTMENT
OF
GEORGE ASETENGO AS DEPUTY ASSISTANT SECRETARY FOR ADMINISTRATION

George Astengo was appointed Deputy Assistant Secretary for Administration in October, 1981, following service in Presidential Personnel at the White House.

Before that, Mr. Astengo was Vice President of Employee Relations and Administrative Services with Beneficial Standard Corporation of Los Angeles.

From 1975 to 1979 he was with the Ameron Corporation of Monterey Park, California, where he was Corporate Manager of Personnel Administration for four years.

He has also been Director of Personnel for Brotman Medical Center, a major facility of General Health Services, Inc., Culver City, California, and has worked for ITT General Controls, Glendale and ITT Gilfillan, a high-technology firm in Van Nuys.

Mr. Astengo holds a bachelor's degree in Psychology from California State University, Los Angeles (1963) and did master's work in industrial relations at the University of California at Los Angeles.

He is a member of the American Society of Personnel Administration and of the National Association of Corporate and Professional Recruiters, Inc.

Before coming to Washington, Mr. Astengo resided in Glendale, California with his wife Minerva and their two children.

R-631

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 22, 1982

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 4,912 million of 13-week bills and for $ 4,902 million of 26-week bills, both to be issued on February 25, 1982, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing May 27, 1982			:	26-week bills maturing August 26, 1982		
	Price	Discount Rate	Investment Rate 1/	:	Price	Discount Rate	Investment Rate 1/
High	96.860	12.422%	13.00%	:	93.609	12.642%	13.69%
Low	96.858	12.430%	13.01%	:	93.562	12.735%	13.80%
Average	96.858	12.430%	13.01%	:	93.582	12.695% 2/	13.75%

Tenders at the low price for the 13-week bills were allotted 76%.
Tenders at the low price for the 26-week bills were allotted 42%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 95,635	$ 53,460	:	$ 72,150	$ 58,150
New York	10,059,740	4,131,515	:	7,744,560	3,918,560
Philadelphia	92,405	40,365	:	25,380	25,380
Cleveland	76,170	49,515	:	102,065	77,065
Richmond	48,530	45,125	:	66,875	49,375
Atlanta	68,495	67,380	:	61,955	57,955
Chicago	710,225	66,645	:	567,115	128,140
St. Louis	25,215	24,215	:	26,935	23,935
Minneapolis	20,125	11,125	:	24,805	18,805
Kansas City	57,125	48,250	:	69,565	69,065
Dallas	33,685	31,685	:	19,700	17,625
San Francisco	439,085	109,700	:	802,495	212,495
Treasury	232,700	232,700	:	244,960	244,960
TOTALS	$11,959,135	$4,911,680	:	$9,828,560	$4,901,510
Type					
Competitive	$ 9,590,045	$2,542,590	:	$7,228,605	$2,301,555
Noncompetitive	1,204,900	1,204,900	:	1,005,655	1,005,655
Subtotal, Public	$10,794,945	$3,747,490	:	$8,234,260	$3,307,210
Federal Reserve	1,113,390	1,113,390	:	1,050,000	1,050,000
Foreign Official Institutions	50,800	50,800	:	544,300	544,300
TOTALS	$11,959,135	$4,911,680	:	$9,828,560	$4,901,510

1/ Equivalent coupon-issue yield.
2/ The four-week average for calculating the maximum interest rate payable on money market certificates is 13.708%.

R-632

TREASURY NEWS

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STATEMENT BY
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE
TUESDAY, FEBRUARY 23, 1982

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher

inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair

to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Shortly we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income

from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed

tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political

jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In

addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate the unintended tax benefits resulting from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all

reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,

- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,

- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation, and

- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience.

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,

- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

- o Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,
- o Deductions for interest on debt to carry tax-exempt securities,
- o Deferred DISC income,
- o Shipping income deposited in capital construction funds or construction reserve funds,
- o Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,
- o Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and
- o Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an opportunity to increase tax revenues substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for

interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an

increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

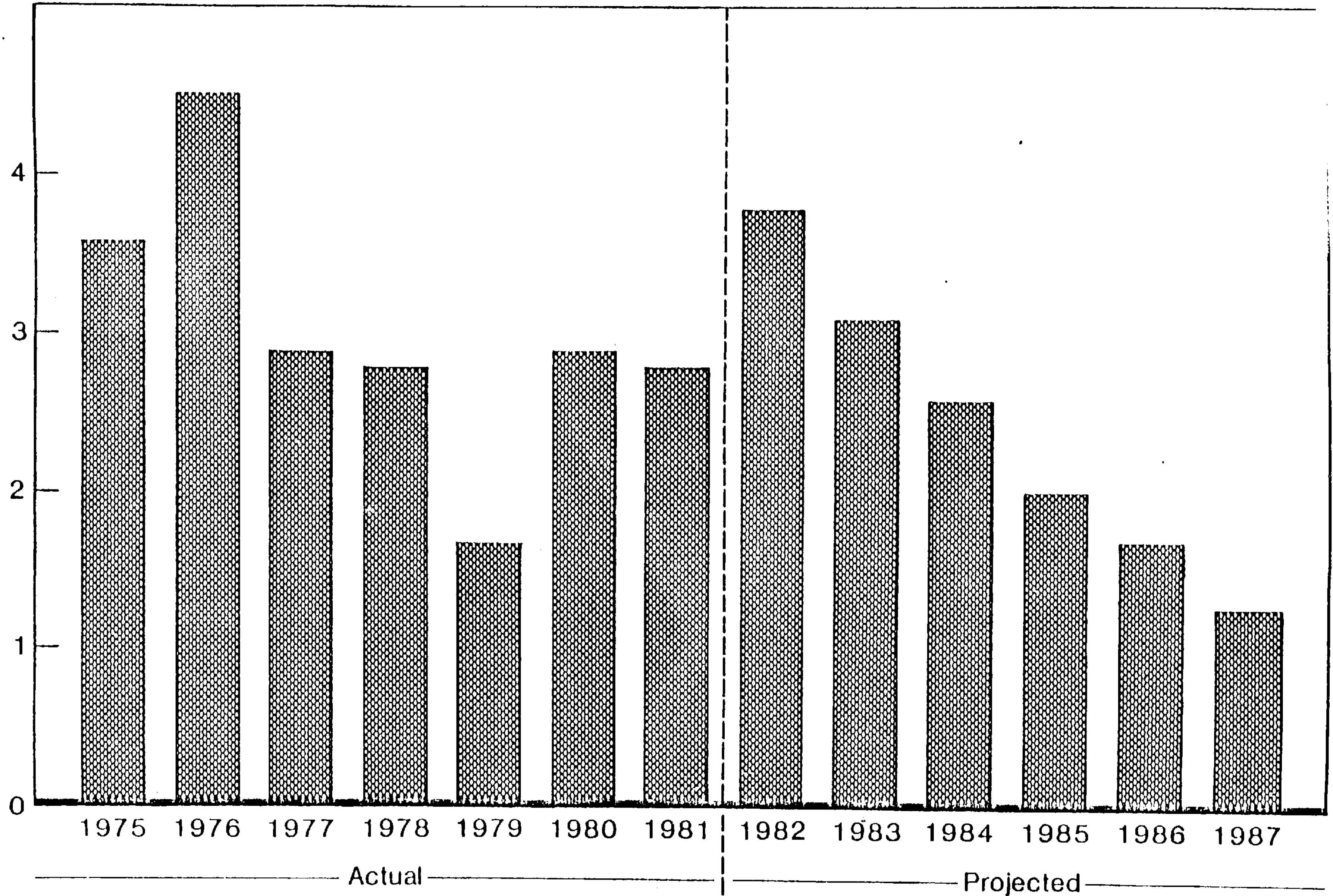
Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

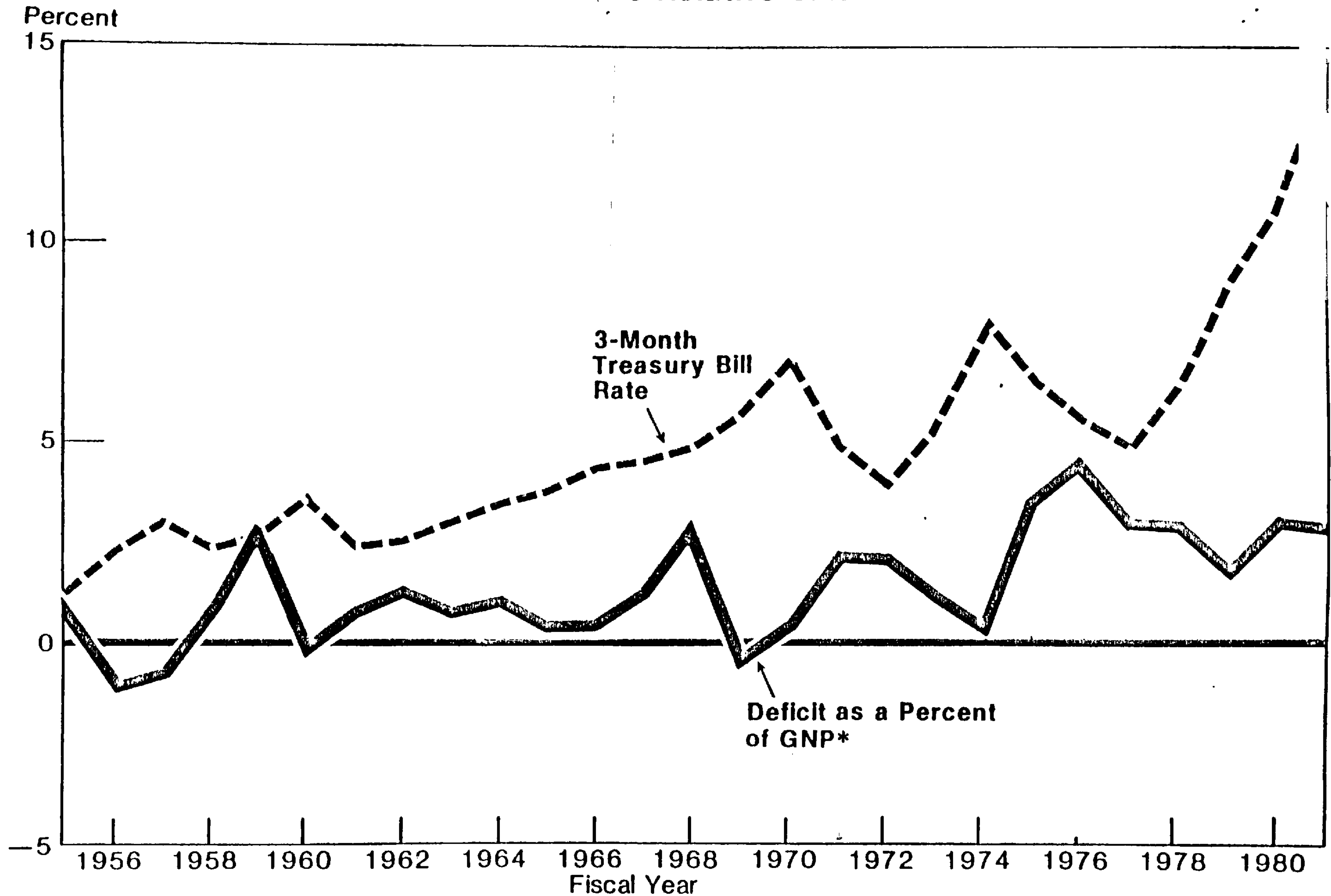
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

Budget Deficits in Relation to GNP*



* On and off budget as percent of fiscal year GNP.

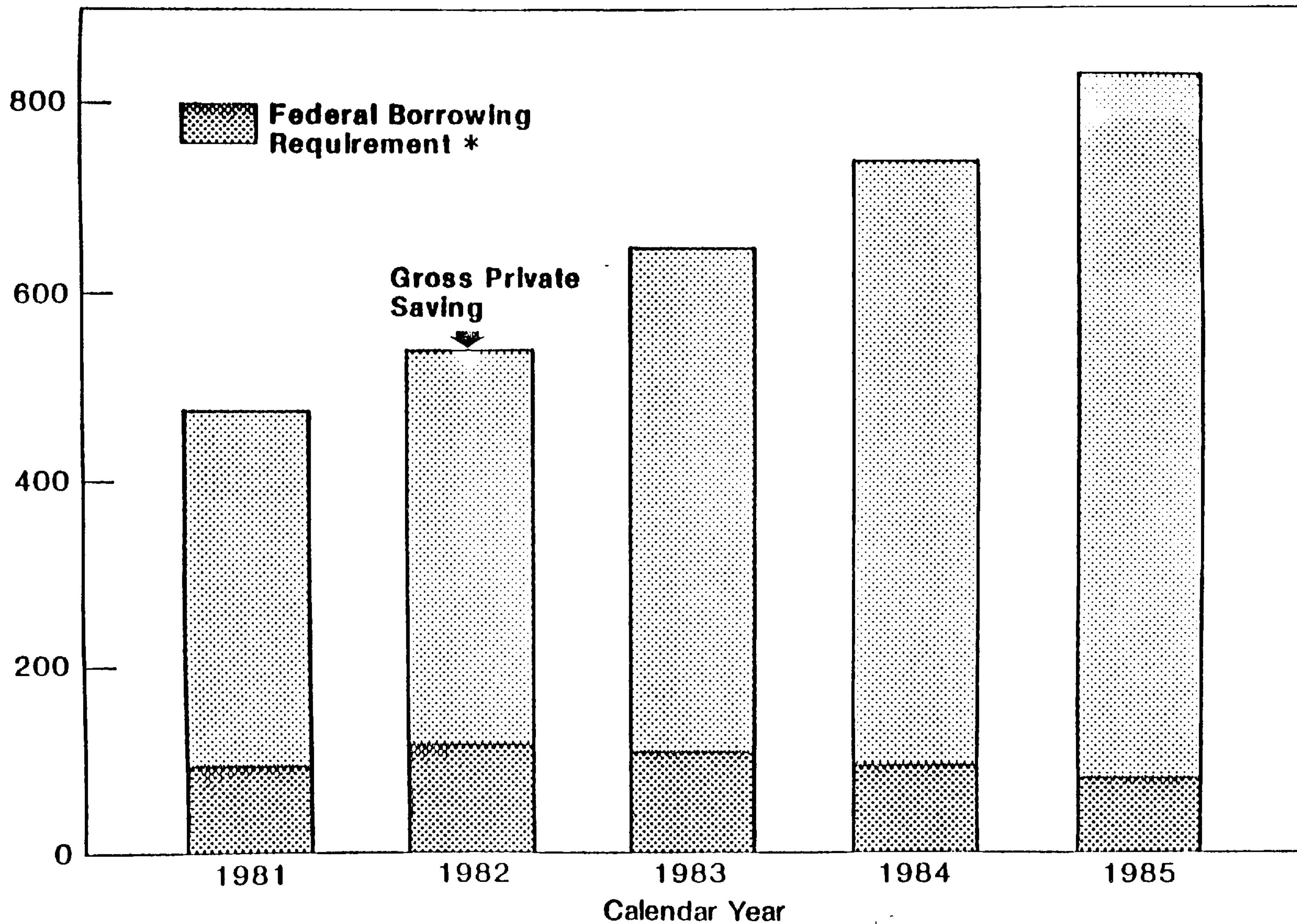
Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving

Billions of Dollars



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

// TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TESTIMONY OF THE HONORABLE BERYL W. SPRINKEL

UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

FEBRUARY 23, 1982

Mr. Chairman: I welcome this opportunity to discuss the Polish economic and financial situation with you and other members of the Committee. In my prepared statement, I will review how the situation has deteriorated to the position in which Poland finds itself today, the debt rescheduling exercise with offical creditors for dealing with Poland's 1981 maturities, the parallel exercise with the commercial banks which appears to be in its concluding phases, and most importantly, the economic and financial pressures we have brought to bear on Poland and the Soviet Union in the light of the repressive actions of December 13, 1981. In particular, I will set forth the Administration's view as to why we have not declared Poland in default on its official debts, because we see this as a means to bring greater pressure to bear on the Polish regime. There has been considerable misunderstanding and confusion on this subject, and I think it would be helpful to understand the position we have taken and why.

Poland's Economic Strategies

In the early 1970's, Poland embarked upon an ambitious economic development program to modernize its economy and to increase substantially its standard of living. The strategy envisaged a simultaneous expansion in investment and consumption. Massive increases in investment were needed to re-orient the economy away from inefficient import substitution and toward the development of an export oriented industrial base. This would enable Poland to sell its products in Western markets. Concurrently, it was felt that increases in consumption, particularly of food, would be required to provide Polish workers with an incentive to stimulate the growth of output.

In this strategy, it was recognized that substantial foreign borrowing, primarily from the West, would be necessary to finance massive capital imports from the West. The Poles thought that the trade deficit which this would elicit would ultimately shift into a trade surplus as a result of Polish sales in Western markets; the surplus was envisioned to become large enough to enable Poland to eventually reduce its external debt.

The Polish Failure and Build-up of Debt

This strategy failed, and failed badly. The main problem arose because the Polish authorities made a number of policy errors. For example, when the Western recession began in 1974, Poland, like a number of developing and industrial countries, maintained its ambitious development plan rather than cutting back on imports which were used to build its industrial capacity. As a result,

its trade deficit with the West widened, and for 1975, it exceeded $2 billion compared to $1.5 billion in 1973. Incorrect income and pricing policies also played their role as Poland tried to insulate its economy from the inflationary pressures of the mid-1970's through use of subsidies and price controls. These measures increased the degree of distortion already existing in this centrally planned economy and exacerbated the financial problems of Polish enterprises. The emphasis on expansion of heavy industry resulted in a neglect of the agriculture sector. The combination of six consecutive years of bad weather and the lack of appropriate agricultural policies gave rise to rapidly increasing rates of food imports -- more than doubling between 1972-1975, and increasing by one-third again between 1975-1979. These imports necessarily had to be covered by Polish exports. But when Poland found it was unable to generate the level of export sales it envisaged, these imports had to be covered by additional borrowing.

As a result of these and other developments the Polish external debt situation deteriorated significantly. For example, in 1972, Poland's gross hard currency debt totaled only $1.6 billion. Its debt service, consisting of $200 million of principal and $74 million of interest, amounted to only 15% of its foreign exchange earnings from the West. As Poland's hard currency imports continued to exceed its hard currency exports, total debt and debt service continued to rise. By 1974, Poland's external debt was $4.6 billion and its debt service was 23% of export earnings; by 1976, total debt more than doubled to $11.5 billion and debt service was 42%; by 1979, total debt virtually doubled again to $21.1 billion and debt service

was 92% (see attached table). Poland was now truly caught in a vicious circle wherein a rising standard of living that its people had come to expect and demand depended on ever-growing borrowing from the West.

By mid-year 1981, Poland's hard currency debt stood at approximately $26 billion. It owed roughly $20 billion of this amount to sixteen Western countries, $11 billion to official creditors or guaranteed by them, including $1.9 billion to the U.S. Government; and $9 billion of unguaranteed debt to private banks including $1.3 billion to U.S. banks. At the beginning of 1981 it was estimated that Poland would require some $11 billion to cover its projected trade deficit and service its debt. Poland was clearly not in a position to raise these amounts and on March 26, 1981, the Polish authorities notified their creditors that they would no longer be able to guarantee payment of their external debt.

Public and Private Debt Rescheduling

The governments and private banks responded to the Polish notification by agreeing to enter into debt rescheduling negotiations. Separate debt rescheduling exercises were organized by the official and private creditors. Fifteen official creditor nations (later increased to sixteen with the addition of Spain) concluded negotiations with the Government of Poland and a multilateral debt rescheduling agreement was signed in Paris on April 27, 1981. This agreement serves as an umbrella agreement for subsequent Government to Government agreements to reschedule 90 percent of Poland's debt service obligations to these creditors, including both the principal and interest falling due during the last

three-quarters of 1981. These obligations, totaling $2.4 billion, are to be repaid during a four year period beginning in 1985. Interest on the rescheduled debt, both interest and principal, is to be charged during the 1981-1985 grace period and on the outstanding debt during the repayment period. The U.S./ Poland Government to Government agreement was signed on August 27, 1981.

Western banks, moving on a parallel track, established a consortium to negotiate a debt rescheduling agreement with the Polish Government. By September, the consortium reached an ad referendum agreement with the Poles for rescheduling 95 percent of the principal ($2.3 billion) falling due during April-December 1981, over eight years, including a four year grace period.

The consortium of Western banks set a precondition for signing the document, namely that Poland pay all of the 1981 interest -- an estimated $700 million -- which fell due in the last 9 months of 1981. The Government of Poland could not completely fulfill this condition at year's end, and as a result, the Western banks did not sign the rescheduling agreement. At the present time, we understand the Poles have almost brought their interest payments to the banks current through December 1981. Final payment of 1981 interest -- and signature of the rescheduling agreement with the banks for 1981 -- is expected in March.

Internal Deficits: Their Causes and Impact

The problems created by the massive buildup of Poland's external debt were exacerbated by the growth of large scale budget deficits which rose from 26 billion zlotys in 1980 to over 200 billion zlotys

in 1981 (34 zlotys=$1), an amount equal to about 6 percent of their GNP. These deficits came about primarily from three sources: (1) increased government expenditures for social benefits, (2) higher wages in administration, education and other units financed by state funds, and (3) losses of socialized enterprises because of rapidly rising wage increases, declining output and stagnant prices.

The Polish response to these developments was to finance the overall budget deficit by monetizing the debt. Rather than take corrective measures to eliminate the budget deficits, the Polish authorities printed money. The Polish Government has estimated that nearly 22 percent of their expenditures in 1981 were financed by newly issued money. With official prices suppressed, a thriving black market developed. As a result, the Polish currency became worthless, both as a medium of exchange and a store of value. It was no surprise to economic observers that in these circumstances Polish workers would not produce when they were to be paid in a currency which was virtually worthless; and it was no surprise that the Polish farmers would not bring their products to market in the state distribution systems when they too would be paid in a worthless currency.

Bringing Pressure to Bear on Poland and Default

Subsequent to the imposition of martial law in Poland on December 13, 1981, the United States and other official creditors took financial measures to bring financial pressure to bear on Poland. First, government credits and export guarantees to Poland

have been limited to those of a humanitarian nature, e.g., food and medical supplies. In this regard the United States Government has terminated all discussions regarding CCC loan guarantees for agricultural exports, while permitting food assistance which was in the pipeline and was being distributed by Catholic relief services and CARE was allowed to continue to go forward. Second, the official creditors suspended indefinitely any talks with the Poles on rescheduling their 1982 debt maturities and are insisting that the Poles service all their 1982 debt obligations as they fall due. They are also insisting that the 1981 obligations which were not rescheduled and are in arrears, be paid.

By these actions, we are creating a situation whereby funds are flowing from Poland to the West rather than from the West to Poland as was the case just a year ago. By adhering to a policy of pressuring the Poles for repayment while not providing any new credits, we can perpetuate a situation that hurts the Polish regime. The net outflow of funds means that the Poles are giving up more than they are getting, and as I pointed out above, they are getting no new funds.

In these circumstances, would declaring a default now bring more pressure on the Poles than that which now exists? I don't think so. In fact, declaring a default now could make things easier for the Polish regime. This sounds like an anomaly but in fact it is not. If the United States Government were to declare a default now, as some have argued we should, the Polish Government could use that as an excuse to keep from paying even the small amounts which it is presently paying. Thus, they would be free to use their scarce

foreign exchange either to pay other creditors -- who might not declare default -- or make new purchases. We do not wish to bring about this type of situation as it would ease the pressure with which the Poles are now confronted.

Thus, the Administration has determined that we can maximize pressure on Poland by insisting that they pay their indebtedness. We firmly believe that this policy is the most effective for advancing our political and financial interests.

I will be happy to answer any questions which you or other members of the Committee may have.

Poland

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
					(billions of U.S. $)					(estimate)
Non-Communist										
a)Exports	1.8	2.5	3.9	4.1	4.4	4.9	5.5	6.3	7.4	5.6
b)Imports	2.0	4.0	6.0	7.4	7.5	7.1	7.5	8.8	8.8	6.5
c)Trade balance	-0.2	-1.5	-2.1	-3.3	-3.1	-2.2	-2.0	-2.5	-1.4	-0.9
Gross Debt	1.6	2.8	4.6	8.0	11.5	14.0	17.8	21.1	25.0	26.0
Principal Repayment	0.2	0.3	0.5	0.7	1.2	2.0	2.9	3.6	5.6	6.4
Interest	0.1	0.2	0.4	0.5	0.7	0.9	1.5	2.2	2.4	3.3
Debt Service (as % of exports)	15	19	23	30	42	59	79	92	108	173

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. February 23, 1982

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 9,600 million, to be issued March 4, 1982. This offering will provide $ 300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 9,288 million, including $ 977 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities and $ 2,077 million currently held by Federal Reserve Banks for their own account. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 4,800 million, representing an additional amount of bills dated December 3, 1981, and to mature June 3, 1982 (CUSIP No. 912794 AS 3), currently outstanding in the amount of $ 4,723 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 4,800 million, to be dated March 4, 1982, and to mature September 2, 1982 (CUSIP No. 912794 BK 9).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing March 4, 1982. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average prices of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. 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.

R-635

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, March 1, 1982. 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 three decimals, e.g., 97.920. 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. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. 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, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on March 4, 1982, in cash or other immediately-available funds or in Treasury bills maturing March 4, 1982. 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 Section 454(b) of the Internal Revenue Code, the amount of discount at which these bills are sold is considered to accrue when the bills are sold, redeemed, or otherwise disposed of. Section 1232(a)(4) provides that any gain on the sale or redemption of these bills that does not exceed the ratable share of the acquisition discount must be included in the Federal income tax return of the owner as ordinary income. The acquisition discount is the excess of the stated redemption price over the taxpayer's basis (cost) for the bill. The ratable share of this discount is determined by multiplying such discount by a fraction, the numerator of which is the number of days the taxpayer held the bill and the denominator of which is the number of days from the day following the taxpayer's date of purchase to the maturity of the bill. If the gain on the sale of a bill exceeds the taxpayer's ratable portion of the acquisition discount, the excess gain is treated as short-term capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
February 23, 1982

STATEMENT OF
THE HONORABLE JOHN M. WALKER, JR.
ASSISTANT SECRETARY (ENFORCEMENT & OPERATIONS)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
SENATE COMMITTEE ON APPROPRIATIONS

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to appear before you to explain the reasons why and the benefits which will be attained from the reassignment of the Bureau of Alcohol, Tobacco and Firearms (ATF) to other Treasury bureaus. I would also like to discuss the basic plan developed by the Department to carry out the reassignment and budgetary and personnel considerations connected with this plan.

On November 12, 1981, the Treasury Department announced the intention of the Administration to reorganize ATF by transferring functions and personnel relating to firearms and explosives to the Secret Service and those relating to alcohol and tobacco to the U.S. Customs Service. This reorganization is based on sound management decisions which will cut costs, lead to greater efficiencies and produce solid law enforcement benefits.

In July 1981, the Office of Enforcement and Operations within the Department undertook a management review of the enforcement functions of the Bureau. The most significant conclusions and recommendations of this review are as follows:

* * *

"Whatever motivation there may have been in the past for placing the function of enforcement of firearms and explosives laws in the same bureau responsible for alcohol and tobacco revenue collection and regulation, it can no longer be rationalized today."

* * *

"The firearms and explosives criminal enforcement and regulatory functions should be severed from ATF and those functions and personnel needed to perform them should be transferred to another Treasury enforcement bureau such as the Secret Service. A study should be conducted to determine where the remaining functions of ATF criminal and regulatory enforcement could best be located."

* * *

Some of the other findings of the Management Review Study Group are listed as follows:

-- There exists within the Bureau an inefficient regional management structure that was created because of the diverse functions and does not operate well because of the lack of commonality of purpose and interest between these functions. This regional management structure has led to unhealthy competition for resources between criminal enforcement and regulatory enforcement.

-- There are too many criminal enforcement offices within ATF and many of them are non-productive with respect to firearms, explosives and arson cases. Approximately 40 to 50 of these offices should be closed with personnel reassigned to areas of the country where there is a high incidence of firearms and explosives cases and where the number of enforcement agents to do the job is insufficient.

-- The study found that there was generally low morale among criminal enforcement personnel brought on by budget cutbacks, media attacks and frequent program changes. Personnel did not have a sense of job security.

-- ATF is viewed by state and local law enforcement as the most cooperative of all the Federal enforcement agencies and its criminal enforcement activities are held in high regard by these agencies.

The Reorganization Plan

A plan was developed within the Department to reassign the functions of ATF and the people who perform them to the Secret Service and the Customs Service in a manner that would ensure both efficiencies in the form of reduced personnel and costs and also effectiveness in carrying out statutorily mandated enforcement, revenue protection, and regulatory functions.

The plan developed calls for the reassignment of approximately 1731 Special Agent and administrative personnel to the Secret Service and either 719 or 1019 personnel to the U.S. Customs Service depending on the level of compliance required under the F.A.A. Act.

Of the 1731 personnel reassigned to the Secret Service approximately 1200 will be criminal enforcement Special Agents while the remaining 531 will provide administrative, technical and clerical support. The personnel transferred will carry out the enforcement and regulatory functions of the firearms, explosives and arson statutes. Present planning calls for the reassigned personnel to operate as a separate division of the Secret Service until such time as a full merger can be effectively accomplished. The full merger will depend upon the resolution of such matters as cross-training of personnel, transfer of property and equipment, shared space arrangements, development of a new organizational structure, etc.

The transfer of ATF functions related to alcohol and tobacco to the U.S. Customs Service will be accomplished by the reassignment of 719 personnel if there is to be compliance only with the mandatory provisions of the F.A.A. Act. In the event that full compliance with the non-mandatory features of the F.A.A. Act is mandated by the Congress it will become necessary to transfer 1019 people to the Customs Service. It is envisioned that the personnel transferred will operate as a separate division until such time as they can be assimilated into the Customs Service. Full assimilation will depend on the resolution of problems such as cross-training of personnel, transfer of property and equipment, shared space, development of a new organizational structure, etc.

The plan also calls for the outplacement of approximately 250 ATF personnel to other bureaus. These outplacements will occur as a result of budget reductions wholly apart from any reorganization or transfer of functions. Plans are underway to outplace 100 regulatory inspectors in the 1854 series to the Internal Revenue Service. Approximately 150 criminal enforcement Special Agents in the 1811 series will be outplaced to the U.S. Customs Service and U.S. Secret Service. ATF agents outplaced to the Customs Service will be utilized in Customs' expanded enforcement role in control of the export of critical technology, export investigations and investigations of the financial dealings of major drug traffickers and their money launderers under the Bank Secrecy Act.

Benefits Resulting From Reorganization

The ATF reorganization and reassignment of functions to the Secret Service and U.S. Customs Service within the Treasury Department represents a sound management decision. When combined with needed office closings and other structural changes, it will achieve economies, result in a better allocation of law enforcement resources, maintain revenue protection and provide for the desired level of alcohol regulation. It is the logical result of Treasury's management review of ATF that revealed deficiencies, largely of an institutional nature, for which corrective action was required as well as the more general need for a more economic management of government resources.

The anomalous and at time counterproductive combination of resources devoted to disparate missions, alcohol and tobacco revenue protection and regulation on the one hand, and criminal investigations of firearms and explosives violations on the other, will be terminated. These resources and functions will now be allocated to agencies with goals that are fully compatible with the received functions.

When ATF personnel who are reassigned to the Secret Service for the firearms and explosives functions are fully merged into the Secret Service, the average field office will have a combined strength and capability well beyond what either agency has today. This strength will enable field offices of the new organization to devote more personnel not on full-time protective duty to priority investigations whether they are counterfeiting, and check forging - the regular investigative duties

of the Secret Service - or firearms, protective intelligence, explosives or arson-type matters. Absent protective needs, most of these personnel will be available for investigative work. Conversely, when there is a peak protective period or an urgent protective need occasioned by the visit of the President, Vice President of visiting head of state to a particular city, there will be greater personnel resources available in that city to satisfy that need.

Upon examination, the benefits to the reorganization both for the firearms/explosives function and the protective function are evident.

A. Benefits to Law Enforcement

It is submitted that the reassignment of the firearms and explosives functions to the Secret Service will result in a more efficient enforcement of the firearms, explosives and arson statutes with fewer people and less cost by the following measures:

1. By putting these functions into a strictly law enforcement organization as opposed to an organization that placed great emphasis on regulation and revenue protection of two commodities in areas totally unrelated to the enforcement of the firearms and explosives laws. The Secret Service is strictly a law enforcement organization. The 1100 field agents of the Secret Service made 6600 arrests in FY 1981 despite the fact that 45 percent of their time was devoted to protective activities. 1700 of these arrests were made in counterfeiting cases. These accomplishments indicate a field organization strongly oriented toward the working of criminal enforcement cases and and a high level of productivity.

2. The transfer to the Secret Service should bring about a much-needed improvement in the morale and self image of ATF personnel who are reassigned by placing them in an organization with a high level of morale and an excellent public image. These factors taken by themselves contribute to greater productivity.

3. The transfer to the Secret Service will facilitate the closing of non-productive Posts of Duty and the reassignment of some of the personnel from these

offices to areas where firearms, explosives and arson violations are concentrated. In addition, these reassignments will permit a greater concentration on the firearms, explosives and arson activities of major traffickers, criminal figures, hate groups and terrorists.

4. This transfer will give the Secret Service the ability to draw on additional resources badly needed for its protective mission. The management review conducted by the Treasury Department in connection with the assassination attempt on President Reagan on March 30, 1981, stated that the protective responsibilities of the Secret Service have been expanding in recent years while budgetary restraints reduced the number of special agents available for protective duties. It recommended that if the Secret Service is to continue to provide the level of protection equivalent to that which it has historically achieved, the manpower and financial resources available to the Secret Service for the performance of this function must be significantly increased. This review also found that there has been approximately a 15 percent overall decline in the Special Agent and Uniformed Division categories of the Secret Service since 1977. The utilization of ATF agents to support the Secret Service in the protective area is not new. ATF routinely supports the Secret Service during campaign years. During the 1980 Presidential Campaign 600 ATF agents were used at various times in support of Secret Service protective activities.

5. The merger of ATF functions to the Secret Service will enhance intelligence gathering capabilities of the Service. Individuals and groups who threaten and attack Secret Service protectees need and acquire guns and explosives. ATF's criminal investigative work in these areas frequently uncovers individuals and groups of possible interest to the Secret Service. ATF's gun tracing abilities as demonstrated in the Hinckley case will greatly enhance Secret Service needs. ATF has a great deal of information on various hate groups and terrorist groups who have violated the firearms and explosives statutues. This information will be of great benefit to the Secret Service in its protective mission.

6. In order to be most effective in its protective mission, the Secret Service needs to maintain excellent working relations with state and local law enforcement throughout the country. ATF personnel have developed strong working relationships with state and local law enforcement which will benefit the Secret Service.

B. Regulatory and Revenue Protection Benefits

The Customs Service receipt of the excise tax and regulatory functions of ATF pertaining to alcohol and tobacco is a sound management decision. Both agencies collect substantial revenues, maintain laboratories for testing commodities, utilize all-in-bond procedures and have significant regulatory responsibilities. In combining the collection of import duties with excise tax collection, Customs will follow the practice of most European countries. Apart from combining activities of common expertise, this reassignment of functions will also result in efficiencies by reducing administrative and management overhead and combining laboratory resources.

Some of the significant similarities and reasons which support the alcohol and tobacco functions going to Customs are listed as follows:

1. The taxes on alcoholic beverages are, in effect, commodity taxes which do not differ in any substantive way from specific rate duties assessed on imported commodities. The resource expertise and management disciplines necessary to collect Customs duties on importation are substantially similar to the expertise and disciplines required to collect taxes on alcoholic beverages.

2. Imported merchandise is retained in Customs custody and controlled by a system of bonds, seals, warehouses, and physical supervision at all times from importation to release into consumption. Alcoholic beverages are controlled by a similar system of physical and bond security until released into the commerce of the United States or exported with benefit to drawback.

3. BATF supervises manufacturing operations to control the use of taxable alcohol in nontaxable products with benefit of drawback or tax exemption. Customs

likewise supervises manufacturing operations to control the use of imported materials in products to be exported with benefit of drawback. Both agencies employ similar audit and inspection disciplines for this purpose.

4. Customs already possesses significant expertise in the assessment of taxes on alcoholic beverages gained through its responsibilities for calculating these taxes on imported wines and liquors and enforcement of labeling and other restrictions.

5. Customs has 8 field and 1 Headquarters laboratories geographically dispersed which are already engaged in alcohol analysis.

6. Most cigars and cigarettes manufactured in the United States are produced in whole or in part from imported tobacco, which is stored in Customs bonded warehouses on the manufacturer's premises. Customs personnel are stationed in these warehouses and already have some familiarity with the manufacture of tobacco products.

7. The tax on cigarettes is relatively simple to control and administer, and elaborate production controls are not necessary for tax assessment and determination purposes.

C. <u>Cost Benefits</u>

The cost benefits derived from the reorganization result from administrative and management overhead savings, closing of unproductive field offices and outplacement of enforcement personnel, and from a planned reduction in the level of F.A.A. Act enforcement. Following a budget level of $138 million for FY 1982, the reassigned functions will be operated in FY 1983 at a level of $121 million. This will represent a savings of approximately $29 million from the FY 1981 level of $150 million. Specifically, these savings will be achieved from the more efficient use of the following resources:

Space and Equipment

Administrative and Management Overhead

Criminal Enforcement Personnel

Regulatory Enforcement Personnel

Illicit Alcohol and Cigarette Smuggling Enforcement

In connection with the reassignment of alcohol and tobacco functions of ATF to the Customs Service, 50 ATF personnel (40 criminal enforcement special agents and 10 support) will be transferred to the Customs Service to carry out the law enforcement efforts against illicit alcohol and cigarette smuggling. These personnel will be distributed in strategic locations where the incidence of these violations is the highest. There will be a small supervisory cadre at Customs Headquarters to oversee and coordinate these functions. Additional enforcement personnel will be located in New York because of the cigarette smuggling problem in that state. The remainder of these personnel will be based strategically at several locations in the Southeast. In these locations the enforcement personnel will be able to take advantage of the fact that this area is both the source for contraband cigarettes to the Northeast and the center of illicit alcohol production.

The Department's position with respect to the enforcement of the Contraband Cigarette Law (P.L. 95-575), is hereby stated as follows:

> "The law explicitly states its intention that primary responsibility for cigarette tax enforcement rests at the state level with the Federal effort to be concentrated in those cases which are beyond the jurisdiction and resource capability of state agencies."

Consistent with the intention of the Congress, the Department is retaining the capability to investigate cigarette smuggling in the event it becomes necessary to assist the states. Such assistance will be furnished to the states in cases involving significant organized crime affiliated interstate smuggling operations which are beyond the state's jurisdiction and resource capabilities. The personnel referred to above who will be transferred to Customs will handle these investigations. Planning is underway to ensure that agents are experienced in the enforcement of the contraband cigarette law so as to ensure the continuance of strong Federal collaboration to the states in this area. Personnel reassigned will also be in a position to act in an advisory capacity to the cigarette enforcement community.

A brief history of ATF's involvement in the enforcement of the Contraband Cigarette Law will furnish some important background on this problem. ATF began enforcing the law in December 1978 with a goal of assisting state enforcement and revenue agents in efforts to collect all cigarette taxes as set forth by statute. ATF's efforts in 1979 and 1980 together with state enforcement agencies drastically reduced the over-the-road smuggling of cigarettes into New York from locations such as Virginia, Kentucky and North Carolina. ATF's program included a detailed analysis of the cigarette distribution system. This analysis revealed that the constant threat to cigarette tax evasion was not as a result of over-the-road smuggling but rather at the level of the cigarette stamping agent. To cope with this problem ATF and the National Tobacco Tax Association (NTTA) initiated a program to encourage all states to use a Schedule C Reporting procedure to verify interstate shipments of cigarettes by interstate stamping agents.

Consistent with the recognition by Congress that cigarette tax diversion is primarily a state responsibility, ATF actively trained state and local officials in cigarette smuggling investigation techniques. 190 state and local officers received such training in 1980. Additional officers were trained in 1981 with a concentration on audit capabilities, since some of the states were not exercising adequate controls to ensure that proper taxes are paid on all cigarettes received by stamping agents within the state. These programs have had notable success. Several states, including New York, have reflected increases in cigarette tax revenues. If the alcohol and tobacco functions are reassigned to the Customs Service, Customs will continue to respond to requests for assistance in those cases where the enforcement problem is of such diverse nature that they are beyond state control.

Conclusion

The reassignment of functions outlined above is based on sound management principles and cost-effective planning. The firearms and explosives laws can be enforced more efficiently with fewer people in the right locations with existing Secret Service personnel available for priority firearms, explosives and arson cases. The Secret Service will have a larger manpower base to call on for unusual protective requirements and the flow of intelligence will be facilitated. The collection of

excise taxes on alcohol and tobacco and the regulation of the alcohol industry to the degree mandated by Congress will not be impaired by the merger of these functions into the Customs Service while significant savings will be achieved.

We would appreciate the support of this Committee for the funding level which we need and by approving our plan to reassign functions and personnel. I now welcome the opportunity to answer questions you may have.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
February 23, 1982

STATEMENT OF
THE HONORABLE R.T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to meet with the Subcommittee and to discuss the plans which the Administration has to reassign the functions of the Bureau of Alcohol, Tobacco and Firearms (BATF) to the U.S. Secret Service and to the Customs Service and to discuss the budgetary requirements to carry out this reassignment. With me today are Assistant Secretary for Enforcement and Operations, John M. Walker, Jr.; his Deputy for Enforcement, Robert E. Powis,; and Assistant Secretary for Administration, Cora P. Beebe.

It is the Administration's proposal to reassign the functions of alcohol and tobacco regulation, revenue protection and enforcement to the U.S. Customs Service and the functions of firearms and explosives enforcement and regulation to the U.S. Secret Service. We seek your support on this transfer.

This proposal for reassignment of functions is based on sound management decisions which will cut costs, lead to greater efficiency and produce solid law enforcement benefits. It is our intention by this reorganization to strengthen the criminal law enforcement functions now being performed by

ATF. I firmly believe that the reassignment of duties to the Secret Service will result in the more efficient enforcement of the firearms, explosives and arson statutes. It is our intention to fully carry out these important law enforcement duties. The firearms and explosives work at ATF will be performed by approximately 1200 experienced Special Agents who will be transferred from ATF to the Secret Service. The criminal investigation personnel of the Secret Service will also be available for this important work. I wish to assure the Committee that the arson program, which is an outgrowth of the explosives statutes, will be maintained and carried out in an effective manner. ATF's four arson National Response Teams, which have been widely acclaimed for their expertise in determining the cause and origin of fires, will be reassigned to the Secret Service intact.

The targeting and investigation of hate groups, terrorists, outlaw motorcycle gangs, and narcotics traffickers who illegally deal in firearms and explosives will continue.

The merger with the Secret Service will be accompanied by a number of administrative actions which will result in greater productivity and a greater concentration on the criminal misuse of firearms and explosives. Among these are the following:

1. The closure of a number of non-productive Posts of Duty offices;

2. The phasing out of the regional management structure in criminal enforcement;

3. Placing the tracing function under the supervision of criminal enforcement;

4. Transferring the regulatory compliance functions to criminal enforcement.

In addition to the enhancement of firearms enforcement, there are also significant law enforcement benefits which will accrue to the Secret Service. The most important of these is the fact that the Service will have more resources available for its protective mission. This need was recognized in the Management Review performed by the Treasury Department following the assassination attempt on President Reagan on March 30, 1981.

There will be significant cost reductions realized by the reassignment of ATF functions. By cutting administrative and management overhead and comingling resources in these areas presently in ATF with those in the receiving bureaus. There will also be significant cost reductions realized from shared space, equipment and laboratory facilities.

Another significant part of the proposal is the transfer to the Customs Service of the excise tax and the regulatory functions of ATF which pertain to alcohol and tobacco. Both agencies now collect substantial revenues, maintain laboratories for testing commodities, utilize all-in-bond procedures and have significant regulatory responsibilities. Customs already possesses significant expertise in the assessment of taxes on alcoholic beverages gained through its responsibilities and have calculated these taxes on imported wines and liquors and enforcement of labeling and other restrictions. In combining the collection of import duties with excise tax collection Customs will follow the practice of many Western nations. The addition of these duties will not adversely affect Customs border management activities.

The reassignment which has been described requires a minimum of $138 million for FY 1982. The Continuing Resolution, however, provides $115.7 million for the Bureau. If that figure is not raised we would have to abandon reorganization plans and may have to RIF up to 1100 special agents. The actual number RIFed, of course, will depend on the months left for savings in the fiscal year as well as the magnitude of separation costs. Extensive furloughs may be necessary instead of some RIFs if separation costs are too high. The present budget for FY 1982 includes a supplemental request of $22.3 million. In addition, we requested the Congress to remove the requirement in the Continuing Resolution that $15 million be earmarked in FY 1982 exclusively to administer the Federal Alcohol Act. If this requirement is continued we will have to increase our planned staffing from 100 to 400 positions for that activity.

The proposal to reassign ATF functions to other bureaus was based on the fact that the functions of alcohol and tobacco have no commonality of interest or purpose with the criminal enforcement functions of firearms, explosives and arson. There are no identifiable reasons for these diverse functions to be performed in a single agency. This fact has been previously recognized within the Department. The diversity of functions has led to an inefficient organizational structure and to an unhealthy competition for resources between criminal enforcement activities and revenue protection and regulation in a declining budget picture.

Now is the time to make the break and to place the functions into bureaus more compatible with these responsibilities. Cost savings will be realized and law enforcement activity will be strengthened. The Administration urges the support of this Committee for the funding level which we need and the approval of our plan to reassign functions and personnel.

At this time, I would like to introduce John M. Walker, Jr., who will present his prepared statement.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TESTIMONY OF

Marc E. Leland

Assistant Secretary for International Affairs
Department of the Treasury

Before the

Subcommittee on International Economic Policy and Trade
Of the Committee on Foreign Affairs

February 23, 1982

I welcome this opportunity to discuss United States policies toward international investment, particularly in regard to foreign investment in the United States. I will comment on the subjects raised by the Subcommittee, most of which concern the activities of the Committee on Foreign Investment in the United States (CFIUS) and other issues relating to inward investment. I would like to begin, however, by outlining our basic policy.

U.S. Investment Policy

The long-standing position of the United States Government is to maintain and encourage open capital markets for the free flow of foreign investment. We welcome foreign investment into this country, and generally extend national treatment to foreign investors to put them on an equal footing with domestic investors in our markets. The rationale underlying this approach is that foreign investment, like all investment, makes its optimum contribution when it responds to market forces. Foreign investment provides substantial benefits to the United States through increased employment, the introduction of new technology, the reduction in the cost of capital to U.S. firms, and the strengthening of capital markets. Also, while foreign investment in the United States has increased rapidly in recent years, the United States is

still investing far more in the rest of the world in the form of private direct investment than is being invested here. U.S. direct investment outflows in 1980 were around $18.5 billion, compared to foreign direct investment inflows of approximately $10.9 billion. Moreover, U.S. direct investment abroad was approximately $213 billion at the end of 1980, compared to $65 billion of foreign investment in the United States. Thus, the United States has a strong interest in maintaining an open investment policy both here and abroad. Restrictive actions on the part of the United States could generate negative actions against U.S. investment abroad which, on balance, could be substantially more harmful to U.S. interests than to the interests of other countries.

This does not mean, however, that we are unconcerned about foreign investment in the United States, or about the increasing use of restrictive investment practices of other countries. We are examining both of these issues in the CFIUS and the Cabinet Council on Economic Affairs (CCEA). I will briefly review the activities of these two groups.

Committee on Foreign Investment in the United States

The CFIUS was established by Executive Order in 1975. Its formal membership includes, in addition to Treasury, representatives from the Departments of State, Commerce, and Defense, and the Office of the United States Trade Representative and the Council of Economic Advisors. Representatives from other agencies participate, particularly the Departments of Justice, Energy, and Interior, and the Securities and Exchange Commission. The Committee has responsibility for monitoring the impact of foreign investment in the United States and for coordinating the implementation of U.S. policy on such investment. To carry this out, the Committee reviews specific foreign investments here which may have major implications for U.S. national interests. In these reviews, the CFIUS examines the potential implications of a given investment in several areas and the application of pertinent U.S. laws. The CFIUS reports its findings to the CCEA. In this context, it is important to emphasize that the CFIUS is a monitoring body. It does not have authority to approve or disapprove foreign investments in the United States.

In theory, the CFIUS could review any foreign investment in the United States. In practice, however, the Committee has limited its reviews to government-controlled investments. It is possible that specific private foreign investments may pose problems to the United States, and if a particular private investment were thought to have implications for national interests, the CFIUS could initiate a review. We believe, however, that this is much less likely in cases of private investment than in cases of foreign governmental investment.

The key areas that may be examined in a CFIUS review include: competition; national security, defense, and related areas; national energy policy and impact; tax implications; and sensitivity of technology and technology transfer questions.

The CFIUS reviewed five cases during 1981. Reviews of two of these cases are completed, and the remaining three are close to completion. The completed reviews include a joint venture of the Kuwait Petroleum Corporation (KPC) with Pacific Resources Inc. (PRI), and a merger between KPC and Santa Fe International Corporation. In both cases, the CFIUS determined that the proposed transactions would not have major negative implications for U.S. national interests. The three reviews still in progress include a proposed joint venture between KPC and AZL Resources, Elf-Aquitaine's takeover of Texasgulf, and a planned acquisition of Pathfinder, a subsidiary of G.E., by COGEMA, a French firm. I will briefly review each of these cases.

The planned joint venture between PRI, a Hawaiian oil refiner, and KPC, a state-owned oil company, calls for the transfer of the Hawaiian company's subsidiary, Hawaiian Independent Refinery, Inc., to the new venture, with joint ownership by both Pacific Resources and KPC.

The full CFIUS, along with the Department of Energy, participated in the review of the still pending KPC investment in Pacific Resources. The key issues involved the national security implications of foreign government control of refining capacity in the United States and the security of supplies of fuel oil to the U.S. Navy. The Committee determined that the proposed arrangement would not pose serious problems to U.S. interests. The refining capacity of the plant is small relative to total U.S. refining capacity and, in the remote case of a disruption of supply to the Navy, the small amount easily could be made up through other sources.

The KPC-Santa Fe merger was reviewed in detail by the CFIUS. The full CFIUS was joined in this review by the Departments of Energy, Justice, and Interior and the Federal Trade Commission.

Hearings were held on this merger by the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Commiteee on Government Operations and extensive testimony and information relating to the merger and the operations of both firms were provided. The issues of greatest concern were the transfer of technology and access to classified and sensitive information in the nuclear area that would occur with the merger. These primarily involved a subsidiary of Santa Fe, C. F. Braun and Co., which has contracts with the U.S. Department of Energy.

In its review, the CFIUS noted that existing DOE controls prevent the transfer of classified information and that DOE had authority to isolate Braun and the Government of Kuwait to protect sensitive information and technology. The Executive

Branch also has sufficient authority under the Export Administration Act to restrict technology exports that might threaten U.S. interests. The CFIUS concluded, therefore, that the proposed merger did not have major negative implications for U.S. interests.

The third CFIUS review concerns a planned joint venture between KPC and AZL Resources Inc., an agribusiness and natural resources company, to explore for oil, natural gas, and minerals in the United States.

The fourth case under review by the CFIUS involves Societe Nationale Elf-Aquitaine's acquisition of Texasgulf, Inc. and the related sale of Texasgulf's Canadian business to Canada Development Corporaton. Elf-Aquitaine is 67 percent owned and controlled by the French government. Canada Development Corporation is 50 percent owned by the Canadian government.

The final CFIUS investigation involves the proposed acquisition of Pathfinder Mines Corporation, a wholly-owned subsidiary of General Electric Company, by Compagnie Generale des Matieres Nucleares, or COGEMA. Pathfinder is a major U.S. uranium mining company. COGEMA is wholly owned by the French government. It is the largest uranium mining company in France and is responsible for most non-military activities involving nuclear power.

Mid-East Portfolio Investment

The Subcommittee also requested that I respond to the question of whether the CFIUS has had a role in the Executive Branch's decision not to provide country-by-country data on aggregate portfolio investment in the United States by various Middle East countries, and to contest in court efforts by the American Jewish Congress (AJC) to obtain the information. The CFIUS has not been involved in these matters in any way.

I welcome the opportunity to review again for the Congress Treasury's position of not disclosing portfolio investment data it compiles for individual Mid-East and African oil-exporting countries. Treasury is defending this position in court in response to a suit brought by the AJC, which seeks selected data for particular Mid-East countries. Treasury's position has rested on the confidentiality provisions of the laws under which the data are collected. Both the Bretton Woods Agreements Act and the International Investment Survey Act, in Treasury's view, require that the affairs of individual investors not be disclosed.

For certain oil exporting countries, the U.S. holdings of their official institutions increased substantially in 1974 and have remained such a high proportion of total country holdings in the United States as to be effectively disclosed in the country total. With the 1974 increase in U.S. holdings, some oil-exporting countries requested that the confidentiality of their official accounts in the United States be maintained. Treasury continued

to afford confidentiality to the oil exporters by grouping these countries in the published figures.

In Treasury's view, disclosure of country data for oil-exporting countries would reveal official institutions' holdings in the United States, and could be expected to cause identifiable damage to the foreign relations of the United States. Since 1974 the country data for Mid-East and African oil exporters have been classified CONFIDENTIAL; their disclosure is thus prohibited by the Executive Order governing national security information.

You asked whether the Executive Branch is concerned about Mid-East portfolio investment in the United States. In general, investment by the oil exporters has been concentrated in U.S. Government securities and has constituted a small percentage of our domestic market for portfolio instruments. Our preliminary figures for the end of 1981 indicate that $39 billion, or 59 percent of Mid-East oil exporters' portfolio investment in the United States, was held in U.S. Government securities, principally in U.S. Treasury bonds and notes and U.S. Treasury bills. While large in amount, such investment has represented a very small percentage of U.S. Government securities outstanding -- just over two percent at the end of 1980.

CCEA Working Group

To ensure that our investment policies are adequate, the Administration has decided to undertake a comprehensive, high-level review of U.S. investment policy. The CCEA is conducting this review, which is currently concentrated on three areas: the broad implications of government-controlled investment for U.S. interests, the adequacy of the CFIUS for dealing with such investments, and the implications for U.S. interests of the foreign government investments which arise from the French nationalization program.

One of the major questions the CCEA review is considering, particularly in regard to its examination of the CFIUS, is whether additional legislative authority to review or restrict foreign investment in the United States is necessary at this time. The Administration's approach in this area will be based on the conclusions of the CCEA review. I realize that there is concern about our policy toward investments in the United States, particularly at a time when a number of countries are erecting barriers to U.S. investment overseas. While I understand your frustration with the situation, I must caution against the urge to retaliate in ways that are potentially more harmful to ourselves, and probably would not result in any modifications in these discriminatory policies.

For instance, Secretary Watt recently determined that Canada is reciprocal under the Mineral Lands Leasing Act of 1920 (MLLA). This act mandates the U.S.G. to retaliate against citizens of a nation whose policies in one particular area are found to discriminate

against U.S. citizens. In making his decision, Secretary Watt found that Canadian laws do not deny Americans the privilege of owning stock in Canadian oil and gas companies and, therefore, Canada could be found reciprocal under the provision. This determination was made within the narrow, technical confine of the provision. Nonetheless, it is consistent with overall U.S. investment policy and objectives. A finding of non-reciprocity would have resulted in the imposition of restrictions on Canadian investment in U.S. oil and gas concerns, a step which runs directly counter to efforts to develop our energy resources. In addition, Canadian investment subject to the MLLA is extremely small relative to the amount of U.S. investment in Canada. Thus, invoking the MLLA could invite retaliation potentially more harmful to U.S. than Canadian interests. Finally, it is doubtful whether invoking the MLLA would have resulted in the modification of Canadian investment policies.

Granting Canada reciprocal status should not in any way be interpreted as U.S. Government acquiescence of Canadian investment policies. The Administration continues to be seriously disturbed by Canada's discriminatory investment policies, embodied in the National Energy Program (NEP) and in the operations of the Foreign Investment Review Agency (FIRA). The U.S. Government is pursuing these issues bilaterally, in the Organization for Economic Development (OECD), and in the General Agreement on Tariffs and Trade (GATT). We have undertaken consultations under the GATT with respect to Canadian trade-related performance requirements associated with the FIRA. The U.S. Government continues to press for changes in the NEP and in the FIRA, and is considering further actions under domestic law, including a possible action under Section 301 of the Trade Act and possible modifications to U.S. law to deal with discriminatory and restrictive foreign investment practices.

Reciprocity

A more broad-based reaction in the U.S. to the restrictive practices of other countries is to advocate a more general, far reaching policy of reciprocity. Such a policy attempts to compare the degree of openness of the U.S. market with that of other countries On this basis, most people would agree that strict reciprocity does not exist between the United States and Canada on the one hand, and the United States and Japan on the other. The creation of the FIRA, and the implementation of the NEP, have created a discriminatory investment climate in Canada, with negative effects on its economy and on individual investors. In addition, while the Japanese have taken steps recently to open their markets to investment, they have a long way to go before they approach the openness of the U.S. market.

While reciprocity may not exist between the U.S. and individual foreign countries, we must be careful not to adopt measures which may be more injurious to U.S. interests than to foreign interests. In addition, we must consider whether such measures will in fact be successful in inducing changes in the policies

of those countries which we believe have restrictive policies that disadvantage U.S. investors.

This does not mean that we will not retaliate against certain restrictive foreign investment practices and policies. A number of countries currently employ discriminatory and restrictive investment practices -- which may call for retaliation by the United States to protect our national interests. Where appropriate, we will take selective actions against these countries while ensuring that any actions we take do not harm the United States more than these countries, and are in our national interests.

Concurrent Resolution 49

The Administration, in previous testimony, supported House Concurrent Resolution 49, which requests Commerce and the SEC to prepare a report on the impact of foreign private investment in the United States. Concern with the inequitable investment policies among countries prompted the request. It is my understanding that key Congressional members decided that the report should be prepared by the Congressional Research Service, rather than by the Executive Branch agencies.

I should also point out that in addition to the CCEA review, the Administration is taking a number of steps to reduce inequities, as called for in the resolution. A principal aim of the Bilateral Investment Treaties we are seeking to negotiate with a number of countries is to provide for national treatment of investment. The Administration has also raised the discriminatory investment policies of Canada and France in numerous bilateral meetings and in the OECD and GATT. As part of the CCEA review, we are considering a number of measures to induce changes in these policies. We must be sure, however, that any measures we agree upon are effective and not harmful to overall U.S. interests.

Conclusion

I'd like to conclude by emphasizing that the United States welcomes foreign investment because of the benefits it provides. The CFIUS was set up to review such investments. Nonetheless, while we generally welcome foreign investment, we do have concerns regarding certain kinds of foreign investments, and are likewise concerned about the increasing use of restrictive investment policies by other countries. These concerns have prompted us to undertake a major, high-level review of our investment policy to determine whether additional legislation in these areas is warranted. Until the results of the review are available, however, I caution against the imposition of legislative remedies in this area that may be ineffective and contrary to overall U.S. interests.

TREASURY NEWS

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TESTIMONY OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE BUDGET COMMITTEE

Since the Administration's 1983 budget proposal is well known to all of you by now, I thought I would submit my prepared statement for the record and take this time to make some additional remarks.

I realize that this is a difficult time for the economy. No one relishes the thought of Americans out of work. However, in seeking a solution, it is imperative that I point out that the short-run improvisations of past administrations to deal with economic crises have left a legacy of stagflation, failed policies high interest rates, and inflation.

The previous decade and one-half has seen a series of quick fixes to deal with short-run difficulties. An income tax surcharge was applied at mid-1968. But after the passage of the surtax, fears of "fiscal overkill" floated to the surface and the Federal Reserve lowered the discount rate and pumped up bank credit, only to reverse itself later in the year as inflationary pressures gained in strength.

The recession of 1969-70 ensued and was followed soon thereafter by the ill-fated Nixon price controls of 1971-74. The consequence was an uncertain economic situation. In late 1974 the Ford Administration was still fighting inflation with its WIN program while the recession of 1973-75 was well underway. After the recession had largely run its course, fiscal policy was eased in early 1975 and monetary policy shifted to an easier stance. This ushered in the Carter years of high taxes and monetary expansion with their legacy of severe inflationary pressure.

When this Administration took office, it inherited a very difficult economic and financial situation. The economy was stagnant and inflationary pressures were strong. Real Gross National Product had fallen by 0.2% in 1980 and the GNP deflator had risen by 9.0%. This only marked the culmination of a process in which real growth had fallen in every year of the Carter Administration and the inflation rate had risen.

The government was locked into a policy of deficit spending, looking to the Federal Reserve for its monetization. The money supply increased at an average 7-1/2% annual rate throughout the Carter years compared to an annual average rate of increase of only some 5% over the previous four year period. By 1980, both real growth and inflation objectives had largely been

abandoned in the face of economic stagflation. In a very real sense, economic policy was on automatic pilot, trying to deal with erratic short-term swings but with no clear sense of long-run direction.

Continued policy failures over a 10 to 15 year period has finally led to the incredibly high interest rates and economic disruptions we face today.

The Reagan Administration resolved to chart a new course. Rather than try to drive the economy with government spending and money creation, our goal is to restore noninflationary economic growth which produces private sector jobs and income.

Unfortunately, the recession hit before all of our program could be put in place. The National Bureau of Economic Research dates the beginning of the recession at July 1981. The economy had gone nowhere after early 1979, with real growth stunted, inflation unchecked, and interest rates at very high levels.

The Reagan budget and tax program was signed into law in August and became effective October 1, 1981. Monetary policy was the only part of the Reagan program which did not require legislative action or unavoidable administrative delay. Working with us, the Federal Reserve did not monetize the Carter deficit

that it inherited, and slower monetary growth brought down the rate of inflation dramatically.

- The CPI has risen at a 5.3 percent annual rate in the last 3 months compared to 8.9 percent for all of 1981 and 12.4 percent in 1980.

- The PPI also has risen at about a 5.3 percent annual rate in the last 3 months compared to 7.2 percent in all of 1981 and 12.4 percent in 1980.

- The GNP deflator has reacted more sluggishly but there are signs of improvement there as well.

The current economic environment poses real policy challenges. In the past, the policy response to a recession has typically taken the form of a series of quick fixes with little concern for their ultimate consequences. It is certainly possible to put together spending programs to help particularly distressed sectors, and a variety of tax measures - touted as "temporary" -- could be formulated as well. But none of these will work to overcome the fundamental economic problems which have produced the current recession and which will produce other recessions in the future if not corrected. Our program does deal with those problems.

Our program deals with fundamentals and it will require time to take full effect. The economic difficulties that our program seeks to overcome have required years to develop. There is no overnight solution. If we tinker with the basic thrust of the program, it will never get a chance to work, and we will lapse back into the depressing cycle of low growth and high inflation, that has brought us where we are today.

The deficits which we are facing are certainly troublesome. Deficits do matter and they do concern this Administration. It is important to realize, however, that the major factor in these deficits is the revenue loss from lower real growth. The fall in receipts of $31 billion in 1982, compared with our 1981 forecast, is entirely related to economic assumptions.

Raising taxes to deal with the deficit would only make the recession worse. Rather than helping the economy and the budget, the higher marginal tax rates that would result from some quick-fix like a surtax or repeal of the individual tax cuts would reduce work, savings, and investment, lower real economic growth, and worsen the budget picture.

Look what happened with the Johnson surtax. Johnson imposed a surtax of 7.5% in 1968, 10% in 1969, and 2.5% in 1970. From

late 1969 to late 1970, real GNP declined by one percent. Unemployment rose from 3.4% in 1969 to 6.1% in 1971. A $25 billion deficit in 1968 went to a $3.2 billion surplus in 1969, but by 1971 and 1972 the deficit had jumped back to $23 billion in each year.

For years, we have attempted and failed to balance the budget with higher taxes. We have only succeeded in wrecking the economy.

The only real way to balance the budget is through increased economic growth, and increased growth would not be possible with higher marginal tax rates.

Tying tax cuts mechanically to economic performance is equally self-defeating. Tax cuts are needed most when the economy is sick. To raise taxes when the economy is healthy would cause a return to lower growth. The last fifteen years, of endless experimentation with finetuning of tax and economic policy has clearly shown that the only result is slower growth, higher inflation and higher interest rates. The time has come to break that dismal sequence. The long-run policies that are now in place will work if they are only left alone.

The recession -- itself a legacy from the past -has thrown the budget numbers into heavy deficit. Without the recession,

progress toward early budget balance would be clearly apparent. What we face are transitional budget deficits -large in absolute size but not in relation to typical recession experience, such as 1974-75.

This is a critical point for the determination of economic policy. We must not be thrown back into a series of "stop-go" measures. Our long-run course is clearly charted. We must have the good judgment and resolve to stick with current policies.

To do otherwise is to insure this Committee will be back again this year and next year and every year following...still reacting, still looking for a quick fix to the problems caused by the previous quick fix.

Last year when I appeared before this Committee, the challenge before us was inflation. The urgency for action then was no less than today. That threat has abated.

But we must not solve this year's challenge with a policy that will result in next year's crisis.

This type of patch-quilt economic policy must stop.

(Conclusion)

Mr. Chairman, I look forward to working with you and with the members of this Committee -- from both sides of the aisle.

This Administration achieved last year's success through the help and cooperation of those on the Hill. This year will be no different.

I welcome the input of new ideas and suggestions on how we can improve our budget proposals and achieve long-term economic stability.

QUESTIONS AND ANSWERS REGARDING THE CARIBBEAN BASIN INITIATIVE

February 24, 1982

QUESTIONS AND ANSWERS ON THE
CARIBBEAN BASIN INITIATIVE

Q. Why is the US doing the lion's share of the job? There are lots of countries who can afford to help - Europe, Japan, the richer LDC's; they should do more.

A. Given the close proximity of the Caribbean Basin to the US, we, the Mexicans, Venezuelans and Canadians understandably have a greater interest in the area's economic well-being than Japan or Western Europe. Nevertheless, other donors and international financial institutions provide considerably more assistance to the region than the US does bilaterally. We hope and expect that these other donors will join us in doing more for the region (see details in the Fact Sheet on Caribbean Basin Policy).

Q. Ninety percent of imports from the Basin already enter duty free. Why is this FTA such a big deal?

A. Well let me answer you this way. If these countries only exported coffee,we could say 100% of their exports entered the U.S. duty free. The idea is to stimulate new and more diversified production. Many items on which the U.S. has high tariffs are the kinds of products these countries could produce. Moreover, the present duty free treatment is under the Generalized System of Preferences which is complex, requires products to qualify one by one, and eliminates duty free treatment altogether if exports of a product in any given year exceed a certain quantitative limit. By contrast, we are proposing duty free treatment for all products except textiles and apparel for a period of 12 years with no quantitative limits except in the case of sugar.

Q. Why were textiles excluded from the Free Trade Area?

A. Textile trade is a special case, being regulated by the provisions of the GATT Multi-Fiber Arrangement. As such, it was judged inappropriate for inclusion in the Free Trade Area.

Q. How are Caribbean countries supposed to develop their textile industries if textiles are not included in the FTA?

A. We believe that Caribbean textile products are price-competitive in the US market even at present duty rates. Caribean suppliers have a natural advantage over Asian and European suppliers because of their proximity to the US. Since most Caribbean textile exports to the US are assembled from U.S components, they already enjoy a duty advantage over wholly foreign products under tariff provision 807. This provision requires that duty be paid only on the value-added content, not on the components that are imported from the U.S.

Q. How can more liberal quota treatment for the Caribbean be reconciled with the Administration's pledge to relate textile import growth to growth in the domestic market?

A. The Administration remains committed to preventing disruption of the US textile market by imports. Textile imports from the Caribbean, however, amount to only about 3% percent of total US textile and apparel imports (6% of apparel imports). The Administration has made known its intention to seek lower growth in imports of sensitive products from the major Asian suppliers; this will permit more liberal treatment of Caribbean Basin suppliers without risking disruption of the US market.

Q. You say you are going to get these countries to reform their internal policy measures. Isn't that interference in domestic affairs?

A. We will not impose the CBI. We are creating new opportunities. If countries are to benefit fully from CBI trade and investment measures, it is in their best interest to make necessary adjustments, particularly to orient themselves more toward export in products

where they have a comparative advantage. Regarding short-term balance-of-payment assistance, we would want to ensure that the countries have developed sound economic programs in cooperation with international financial institutions. Otherwise, the assistance will do more good elsewhere.

Q. These countries don't deserve all this help. They have a much better economic base than most other LDCs.

A. We are concerned, not because they are the poorest, although some of them are among the world's poorest. They are our neighbors. What troubles them troubles us, whether it is the security threat to the sea lanes, or the pathetic plight of refugees perishing at sea to escape poverty.

Q. This program will make the Basin countries even more dependent on the US. Is it really in the long-term political interest of the US to have weak client states in this area?

A. The entire thrust of the CBI is designed to make Basin countries less dependent on a few basic commodity exports and external assistance. We greatly welcome assistance and tariff preferences that other countries may give to encourage investment in the region, as well as domestic investment.

Q. If you can exclude textiles, how do you justify not excluding other domestic industries which have been having a difficult time recently? (leather, electronics, agriculture, especially in view of the Florida freeze, footwear,...)

A. Our policies in textiles will continue to be based on our MFA agreements. The economies of the Basin are not large. In the case of electronics, for example manufacturers of US components may have the components assembled in Basin countries, allowing us to be more competitive with Far Eastern suppliers.

Q. The safeguard mechanism -- doesn't that mean that as soon as trade begins to flow from the Basin, restraints will be imposed to protect economically weak and/or politically powerful US interests? Why would any sensible investor put his money into the Basin which such a threat hanging over his investment?

A. The criteria for a safeguard action require that the affected industry show that it is, or is threatened with, serious injury substantially caused by increased imports. This is a standard that has been commonly used in existing trade legislation, and we are confident that it meets the legislation concerns of US industry and foreign exporters.

Q. This safeguards mechanism is worthless. It's so hard to prove we're being hurt by imports. By the time we get relief, we're already bankrupt. Why don't you have a real safeguard mechanism?

A. The language and standard we have adopted is almost identical to the standard legislated by Congress to protect industry from undue competion from international trade. We believe it is perfectly suited to meet similar concerns regarding imports from the Caribbean.

Q. Since World War II, the US has been the champion of non-discrimination and of de-politicization of trade. The US has been criticizing the rest of the world for its preferential arrangements, for letting "short-term political expediency" overwhelm "long-term rationality and effeciency." Now the shoe is on the other foot. How can the US justify its position?

A. The US recognizes the inconsistency of the preferential trade aspects of the CBI with our well established position on non-discrimination. We also, however, believe that the serious economic deterioration in the Caribbean Basin justifies this temporary departure from our trade policy, and will in the long run allow the countries of the Basin to develop to the point where the preferences will no longer be necessary. We have no plans to extend preferential arrangements to other areas of the world.

Q. The U.S. economy is reeling - recession, near-record unemployment, massive trade deficits. And this is the time you pick for another trade give-away?

A. Yes, it is a bad time. But the Caribbean Basin crisis is so serious to overall U.S. interests we have to deal with it.

Q. The Administration fought against all kinds of things in the Farm Bill but was neutral on sugar. If the U.S. is sincere in helping provide better trade opportunities to these countries, then why did it not fight against a program severely restricting their opportunities in sugar, which is one of the region's major exporets? What is the U.S. going to do to offset the effects of this restrictive program?

A. The CBI legislation will propose duty-free treatment for Caribbean Basin sugar. This will offset some of the negative effects of the US sugar program on the demand for Caribbean sugar. In order to protect our domestic price support program, The larger Caribban sugar producers (Dominican Republic, Panama, Guatemala) will also have an absoloute quota, which will be based on their past shipment levels. The smaller ones will retain the benefits they now enjoy under the Generalized System of Preferences.

Q. Now that the U.S. has given up the fight for a non-discriminatory international economic system, we face a real danger of the world degenerating into a set of regional economic blocs. Can you make sure that we can stop with FTA and go no further?

A. The U.S. has in no way abandoned our overall opposition to non-discrimination. GATT, the institution that supervises the multilateral trading system, allows for the type of one-way free trade arrangement we are proposing. And we will apply to GATT for the appropriate waiver.

Q. Isn't this proposal a violation of GATT? Won't it have an effect on the trade disputes we are trying to resolve in GATT with our other trading partners (e.g., the EC).

A. We will have to seek a GATT waiver. But there are precedents, e.g., the Lome arrangement or the European Community. We expect no problems in obtaining waiver.

Q. Will the CBI proposal to eliminate duties on rum imported from Caribbean Basin countries reduce the level of assistance that Puerto Rico and the Virgin Islands currently receive through the transfer of US excise taxes collected on rum entering the United States from these islands?

A. No. The Administration has included as part of the CBI package a proposal to transfer to Puerto Rico and the US Virgin Islands excise taxes collected on all rum imports. Any loss of revenue from a reduction in their market share for rum will be more than compensated for under this proposal.

Q. The problem in Central America is essentially one of security and politics. Doesn't experience teach us that this is not a one-shot deal, and that the financial demands will mushroom in the years ahead?

A. In some of the countries of the region where insurrection and adjustment problems are particularly severe, future-year special financing may be necessary. But the goal of the entire program is to lessen these demands as countries become increasingly capable of self-help.

Q. Why is the Caribbean Basin being singled out for special attention?

A. Because many Caribbean and Central American countries, which together make up our third border, face a massive economic crisis that is contributing to instability and creating fresh openings for our adversaries.

The Caribbean is too close and too important for us to stand by while misery and conflict grow and spill over. This is our neighborhood. We cannot move out. These are our neighbors. We cannot turn our back on them.

Q. Will Cuba be eligible to participate in the CBI?

A. The U.S. will not extend any benefits of our Caribbean Basin program to Cuba unless there should be great changes in Cuba.

The Castro government has excluded itself from participation in the U.S. program with its imposition of a Communist system on Cuba and elimination of the private sector; through an aggressive policy of active support for violent extremists in Latin America; and by its failure to compensate U.S. firms expropriated after Castro came to power.

Other nations participating in the Caribbean Basin Initiative are, of course, free to determine which countries in the region they will assist.

Q. How will the CBI Support U.S. Political and Security Objectives in the Region?

A. Our objective is a Caribbean Basin whose nations are free from any threat to their security and able to devote their energies to peaceful economic progress and the development of stable democratic institutions. Peace, economic development and democracy are clearly linked. Our support for economic development in the Basin enhances both our political and security interests by helping moderate governments deal with the problems they are facing and convincing the peoples of the region that economic progress is possible without having to surrender their freedom or undergo a period of violent revolution.

Q. How do the Europeans and Japan regard the CBI?

A. The United States has consulted closely with our European allies and Japan in developing the Caribbean Basin Initiative and these countries have expressed an interest in cooperating with the CBI. A number of European countries and the European community already have extensive trade benefits and aid programs with Caribbean and to a lesser extent Central American countries. We look forward to consulting further on how our trade, investment, and assistance program

might be best integrated with what our European and Japanese allies plan to do.

Q. Is the Caribbean Basin Initiative just a cover for increased military assistance to El Salvador?

A. Most assuredly not. From its earliest days, the Administration has been discussing with Mexico, Canada, and Venezuela and then with other countries in the Caribbean and Central America how we might best address the economic crisis in the region. It was in consultation with other donors and with recipient countries that we drew up the Caribbean Basin Initiative.

There is, of course, concurrently a security threat to the region stemming from Cuban and Nicaraguan efforts to subvert governments in the region. Security problems have aggravated the economic crises in Central America. The United States must and will respond to this security threat as well. But, we will not follow Cuba's lead in seeking to resolve human problems by brute force. Our economic assistance is more than five times our security assistance to the area.

Q. Why are Nicaragua and Grenada included?

A. As President Reagan said, we seek to exclude

no one. Those who accept and practice the traditions and common values of this hemisphere are welcome. The choice is theirs.

The benefits of the free trade and investment provisions can only be realized in practice by those countries which accept the role of a strong private sector. In the case of both Nicaragua and Grenada, extensive discussions will be needed to determine if their policies are consistent with our program.

Q. How will the President's Caribbean Basin Program affect Cuba?

A. The proposed program is a serious effort to address the economic crisis affecting our closest neighbors which will lay the basis for self-sustained economic development in the region. The program's focus is economic and developmental -- it is not fundamentally an anti-Cuban initiative.

At the same time, we must recognize that Cuba has adopted an aggressive policy toward its neighbors, supporting violent extremists with military training, material and advice. Left unaddressed, the economic crisis in the Caribbean Basin would provide new opportunities

for Cuba to exploit these small countries' vulnerabilities. By carrying out a comprehensive program which addresses both emergency problems and long-range development, we will strengthen our neighbors and limit opportunities for Cuban adventurism. We will show our adversaries and our friends worldwide that the United States will help friendly nations on our border when they face desperate circumstances.

Q. In view of well-known differences between the U.S. and Mexico over Cuba and Central America, how is it that Mexico is participating in the Caribbean Basin Initiative?

A. While we and Mexico each have our own position, we share concerns over the economic crisis and major development needs of Central America and the Caribbean. Mexico, incidentally, is contributing significantly to reducing the foreign exchange costs to these countries through an oil facility it has established with Venezuela. The CBI was developed in consultation with Mexico which is a founding member of the Nassau Four, which also included Canada, Venezuela and the United States.

PANAMA

Q: Will the CBI proposals help Panama?

A: The investment and trade measures of the President's proposal will be of great benefit to Panama which is actively encouraging foreign investment. Thus these proposals should further strengthen our relationship with this key country.

Q: What has been our experience to date in operating the Panama Canal under the new Treaties? What is the outlook for the future?

A: The first two-plus years under the Treaties have proceeded without serious problems. We are gradually institutionalizing the new relationship between our two countries, and the Canal itself continues to operate safely and efficiently, with record tonnages being transitted. Our intention is to protect American interests by remaining fair, firm and businesslike as we proceed to implement the Treaties.

GUATEMALA

Q: Will Guatemala with its bad human rights record benefit from the CBI?

A: Guatemala may benefit from the trade and investment aspects of the CBI if our discussions with the Government of Guatemala indicate that its economic policies will support free enterprise. While we have not yet established a final division of the $350 million supplemental, it would not appear that Guatemala's economic situation requires such emergency assistance.

Q. Given Guatemala's deplorable human rights record, why has the Administration requested $250,000 in military assistance training for that country in the 1983 budget?

A. $250,000 in IMET training for Guatemala has been included in the budget to provide the necessary legislative and financial authority if a decision is made to proceed with a program. That decision has not been made. There will be extensive testimony by Administration witnesses in the FY'83 budget, and ample opportunity in that context to discuss the proposed program for Guatemala. We will consult with Congress before actually proceeding with either training or military sales to Guatemala.

El Salvador: The Economy

Q: Why does El Salvador need our economic assistance?

A: The Salvadoran economy, traditionally one of the most dynamic in the region, now needs external assistance very badly. Earnings from the major exports -- coffee, cotton, and sugar -- are down 40 percent since 1979. Investor confidence remains low. There has been a chronic shortage of hard currency since 1979, when ~~there~~ a large-scale flight of capital occurred. The hard currency shortage has paralyzed the business sector and forced the Central Bank into expensive short-term borrowing to maintain imports. In addition, Marxist-Leninist terrorists and guerrillas are waging a major campaign to destroy the economy by sabotaging the electrical system, the telephone system, railroads, and bridges, and by bombing small businesses. As a result of all these factors, the Salvadoran economy shows a 20-25 percent decline in real GDP since 1978, and overall unemployment is around 30 percent. The Salvadoran Ministry of Planning projects economic stabilization (at zero growth) for 1982, but this will require substantial outside assistance.

MILITARY AID

Q. Is a large part of the Caribbean Basin Initiative going for military aid?

A. No. The CBI itself is a trade, economic aid, and investment program and does not have a military element. However, as the President pointed out, the United States has very important security interests in the Caribbean Basin, and the threat to these interests is real. The President is asking Congress for a separate supplemental appropriation for security assistance. Up to $60 million of this appropriation would go to the Caribbean Basin, only one-sixth as much as the $350 million the President is asking for economic aid.

MILITARY AID

Q: Will all the countries of the Caribbean receive military aid?

A: With the exception of Nicaragua, all the Basin countries who received US economic aid this year will also receive military assistance. However, several of the countries have only small training programs. Of the $172 million in military aid planned for the Caribbean Basin this year, including the supplemental request, 83 percent will go to El Salvador and Honduras. Of the $106 million being requested for FY 83, 72 percent will go to those two countries.

MILITARY AID: HONDURAS

Q: Why was Honduras singled out, along with El Salvador, to benefit from the military assistance supplemental?

A: Honduras never had a large security assistance program. Prior to 1981, it never received more than $3 million a year. Through no fault of its own, just as it returned to elected, civilian government, it became a major conduit for external support of the Salvadoran insurgency. The more it has tried to prevent this abuse of its territory, the more it has been threatened with terrorism and violence from leftist elements. Assistance to El Salvador would be of little avail if we did not also act to protect the integrity and freedom of its neighbor, Honduras.

In addition, Honduras is particulary concerned by the major military buildup by its other neighbor, Nicaragua. The creation in Nicaragua of the largest, heaviest-armed military force in Central American history obviously causes Honduras to look to its own security. We cannot remain indifferent to that concern.

MILITARY AID: EL SALVADOR

Q: The Administration was already providing $81 million in military assistance to El Salvador this year, including the $55 million in emergency aid given just three weeks ago. Why are more guns being given to El Salvador now?

A: I don't think anyone ever argued that the military assistance planned for FY 1982 fully met El Salvador's need for equipment and training to turn back the Marxist insurgency. Much of the assistance provided under the emergency Presidential determination earlier this month will simply replace the aircraft lost in the insurgent raid on the Salvadoran airbase. More than just replacing equipment is needed. The additional funding for El Salvador that will be requested in the FY 82 supplemental will enable an expansion of the El Salvadoran Army, improving the army-to-insurgents ratio, with new US-trained and equipped battalions.

MILITARY AID TO EL SALVADOR

Q: How can you justify giving more aid to El Salvador in light of the serious human rights violations there?

A: Our military training increases the discipline and professionalism of the Salvadoran armed forces. The equipment we provide improves the high command's communications and control of its own forces. We believe this assistance, combined with the strong determination of the Duarte government to improve the performance of its armed forces, will in fact continue and accelerate the improvement in El Salvador's human rights record that has occurred.

MILITARY AID VS. ECONOMIC AID

Q: Aren't the real problems of the Caribbean Basin economic? How does the Administration's request for military aid compare with what it is providing to meet the economic needs of the region?

A: Neither economic problems nor security threats can be dealt with in isolation. Military assistance is no help to a country if its economy collapses. All the economic help in the world will not produce a free and prosperous society if power is seized by a Marxist minority.

Our regular economic assistance to the Caribbean Basin countries in FY 82 was programmed at $473.9 million, and the military aid at $112.1 million. Adding in the two supplemental requests now being proposed, our total aid to the region this year will come to $996 million. Of that, only 17.3 percent, or $172 million, will be military aid.

In 1983, the Administration is asking for $664 million in economic aid and $106 million, or less than 14 percent, in military aid.

MILITARY AID: WHAT ABOUT HUMAN RIGHTS?

Q: Doesn't our military aid simply build up military dictatorships and encourage human rights violations?

A: That's a cliche that doesn't stand examination. Of the 16 countries in the Caribbean Basin that will receive US military aid this year and next, 10 have democratically elected, civilian governments with excellent human rights records. Three Caribbean governments that will not receive US assistance -- Cuba, Grenada, and Nicaragua -- were never elected and have human rights records that range from poor to appalling. The whole purpose of both our security and our economic assistance is to enable the survival of free societies in which human rights can be guaranteed and protected.

TREASURY NEWS

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STATEMENT OF
THE HONORABLE MARC E. LELAND
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
OF THE HOUSE OF REPRESENTATIVES
FEBRUARY 25, 1982

Mr. Chairman, Members of the Committee, I appreciate this opportunity to present to you the Administration's fiscal year 1983 budget proposals for the multilateral development banks (MDBs).

The Administration proposes $1,537 million in budget authority and $2,361 million under program limitations for subscriptions and contributions in fiscal year 1983. Except for the $50 million requested for the African Development Fund, these proposals represent amounts negotiated in agreements concluded from 1976 to 1980. The President has emphasized the importance of fulfilling these previously negotiated international agreements.

For the International Bank for Reconstruction and Development (IBRD), we propose $109,720,549 in budget authority and $1,353,220,096 under program limitations for the second of six installments toward the U.S. share of the 1981 General Capital Increase (GCI).

To subscribe to the U.S. share of the 1981 "companion" increase, we propose $30,158,750 under program limitations. This increase is designed to prevent dilution of member voting power by providing each member with 250 additional votes. The increase has no paid-in component and requires no budget authority.

Finally, to complete the U.S. subscription to the 1977 Selective Capital Increase, we propose $16,321,004 in budget authority and $146,897,067 under program limitations.

The total request for the IBRD is $126,041,553 in budget authority and $1,530,275,913 under program limitations.

For the International Development Association (IDA), the Administration is proposing a third installment of our contribution to the sixth replenishment in the amount of $945,000,000. This level of funding is consistent with the ceiling placed on fiscal year 1983 appropriations for IDA in the Omnibus Budget Reconciliation Act of 1981. The proposed level is also a reduction of $945 million from the amount originally envisioned by the Administration in March 1981 and entails a significant reduction in the IDA lending program.

For the Inter-American Development Bank (IDB), we propose $62,423,437 in budget authority for paid-in capital and $828,137,742 under program limitations for callable capital to complete our subscription to the fifth replenishment.

For the Fund for Special Operations (FSO), we propose $175,000,000 for the fourth installment to the current

replenishment and $46,677,000 for the unfunded portion of the previous replenishment -- a total of $221,677,000.

For the Asian Development Bank (ADB), we propose $248,097 in budget authority and $2,243,811 under program limitations to complete the U.S. subscription to the most recent capital increase.

For the Asian Development Fund (ADF), we propose $111,250,000 for the fourth installment to the current replenishment and $20,384,478 for the unfunded portion of the previous replenishment, summing to $131,634,478.

For the African Development Fund (AFDF), we propose $50,000,000 for the first of three installments for the new replenishment. The Administration will propose legislation in the coming weeks to authorize a U.S. contribution of $150,000,000 over the three years of this replenishment, which is expected to total a little more than $1 billion. While the proposed U.S. contribution over three years is 20 percent higher than the $125 million negotiated in 1978 for the previous three year replenishment, it is likely to represent a decline in real terms.

The total request represents an increase of $275.3 million in budget authority and $20.7 million under program limitations over the fiscal year 1982 appropriation.

I realize, Mr. Chairman that in light of the importance of government-wide budget restraint, any proposal to increase spending must be carefully scrutinized. I want to assure you that we have,

in fact, done just that. As with last year's budget submission, this budget request reflects the President's intention to fulfill previously negotiated international agreements. The sole exception is $50 million proposed for a new replenishment for the African Development Fund.

Almost the entire increase over last year's appropriations -- $245 million -- can be traced to the request for the IDA and stems from the Administration's decision last March to reduce contributions in the early years and to make up the amounts in later years.

This budget request should be seen against the backdrop of this Administration's firm intent to halt and, in some cases, to reverse the trend toward ever-increasing replenishments. For example, we estimate for planning purposes that in fiscal year 1985 the request for budget authority will be less than $1.2 billion. In this light, the budget request for fiscal year 1983 is consistent with a reordering of budgetary priorities and represents the minimum requirement for meeting our national interest through continued support for the MDBs.

Mr Chairman, I want to state for the record this Administration's appreciation for your efforts and those of Mr. Kemp and the other members on this Subcommittee whose hard work culminated in the enactment of the foreign assistance appropriations bill last year -- the first in three years. While not an easy or popular subject, foreign assistance appropriations are, nonetheless, a critical element of our foreign policy.

As you know, the Administration last week released its policy assessment on U.S. participation in the MDBs in the 1980s. This report represents the completion of a comprehensive review designed to provide a policy and budgetary framework for our future role within the MDBs and for a new effort to strengthen the institutions' ability to promote market-oriented economic growth. Members of this Committee and their staffs provided helpful and insightful contributions to this process. I sincerely hope that this new policy framework can serve as a basis for strengthened bipartisan support for future U.S. participation in the MDBs.

It is this spirit of working together which must continue if we are serious about protecting and preserving the national interest of the United States. Continued U.S. participation in the MDBs is justified by a fundamental national interest in a more stable and secure world, which we believe can be best achieved in an open, market-oriented international system. To the extent that the MDBs encourage the participation of developing countries in that international system on a permanent and self-sustaining basis, the MDBs serve to advance important U.S. economic and political/strategic interests. This is the major conclusion of our evaluation.

While concluding that U.S. interests can be well served by continued U.S. participation in these institutions, we are equally convinced that their programs can be more effective in promoting

market-oriented economic growth. There has been too much concern in the banks over the quantity of lending, and not enough over the quality.

In specific terms, we have identified four areas where the programs can become more effective: (1) greater selectivity and policy conditionality within projects and sector programs to encourage, growth-oriented economic policies (2) more emphasis on catalyzing private sector flows and promoting LDC private sector development, (3) firm implementation of graduation from hard windows and maturation from soft windows to distribute resources to those countries with the greatest need, and (4) the reduction of MDB program rates of growth, particularly for soft-loan windows, in light of budget realities.

If the MDBs are to use scarce budgetary resources to best effect, lending should go to countries which pursue sound economic policies. Thus, the United States has been reviewing project loans and policies more critically and insisting that borrowers take steps to help themselves.

-- In September, the United States opposed an FSO agricultural loan to a country where excessive governmental interference had undercut incentives to farmers. In response to objections by the United States and other IDB members, the borrower raised farmgate prices and reduced subsidies. In addition, a thorough sector study was accelerated which should provide for further liberalization.

-- The United States supported a recent IDB water supply loan which provided for home water flow meters to permit appropriate user fees and which will extend service to 47,000 people in 55 small towns and villages.

-- The United States supported an IFC loan which provided financial support to expand a plant to convert low value molasses into ethanol for blending with imported gasoline. The expanded plant will provide 12-14 percent of current gasoline consumption in this small African country.

-- The MDBs have a good record of supporting power and transport projects which provide important economic benefits to developing countries. However, the projects are not generally as financially sound as would be desirable because in some cases user charges are kept low. The Administration is working actively in the banks to remedy these policies and to mitigate the resulting distortions in consumption.

A second step to strengthen effectiveness reflects the President's stress on the private sector as the main impetus for development. The private sector should have a more prominent role in MDB lending programs.

-- The International Finance Corporation knows the private sector and understands how to attract outside investors. We will be working closely with the IFC and other governments to determine additional ways to strengthen the private sector role in programs of the World Bank Group and the regional MDBs.

-- The U.S. Executive Director in the IDB, Jose Manuel Casanova, has been working with his counterparts from Venezuela and other countries of Latin America to fashion a program targeted on the private sector. We expect to consult soon with interested Members of Congress on this subject.

-- The Administration has encouraged the MDBs to extend project cofinancing with private financial institutions. U.S. financial corporations should consider opportunities in the cofinancing field. We are currently examining whether some U.S. regulations may unreasonably limit possibilities in this area.

A third area for improved effectiveness consists of policies to "mature" countries from the soft lending programs as they achieve the requisite level of creditworthiness and to "graduate" countries when their level of development permits full reliance on private capital markets.

-- In December, the Congress mandated that the Administration undertake negotiations to reduce the share of IDA credits provided to any given country. The World Bank has firmly indicated to India the need to shift its borrowing from the IDA to the IBRD. We expect that in the World Bank fiscal year 1982, India's traditional 40 percent share of IDA will decline to about 34 percent and forsee a continuing decline in subsequent years.

-- In the Asian Development Bank we have proposed -- and other donors have supported our position -- that relatively creditworthy countries, such as Thailand, Philippines, Indonesia and Papua-New

Guinea, cease to borrow from the soft window, the Asian Development Fund. This position has generally been adopted, and the last ADF loans for these countries are being processed this year.

-- In January, the World Bank Executive Directors reviewed the IBRD graduation policy and accepted new, more specific procedures for limiting and eventually phasing out lending to higher income countries. While we welcomed these steps, we would prefer a lower trigger point than the proposed $2650 per capita income level and are continuing to explore this issue with other Executive Directors and Bank management.

A fourth area we think important is that, consistent with domestic budget reductions, budgetary realities require a change in direction in future replenishments, particularly for soft loan windows.

-- The replenishment negotiations for the African Development Fund were completed earlier this month. Our proposed contribution of $150 million over three years provides for a continuing lending program for this needy region.

-- The negotiations for an FSO replenishment have recently begun. However, we are currently exploring with other IDB members and IDB management the possibility of a special private sector program. Patterned after the IFC, the program would encourage the growth of productive private enterprise in Latin America. At the same time, we would expect to phase down the FSO, in light of relatively high income levels in Latin America.

-- In replenishment negotiations for the Asian Development Bank and for the Inter-American Development Bank, we are suggesting the elimination of paid-in capital. The reaction to total elimination from other donors has generally been negative. I understand that some members of Congress also have reservations. We believe elimination of paid-in capital is reasonable and consistent with maintaining the financial integrity of the MDBs, given that the institutions have strong positions in capital markets and ample reserves. We also believe the requirement for program limitations in appropriations acts fully protects Congressional influence over these programs, but we are prepared to listen to the views of others on this issue.

We now have a broad budgetary and policy framework for U.S. participation in the MDBs. Sharing a common desire to strengthen their effectiveness, we will want to stay in close touch with you and other concerned Members of Congress.

The fundamental decision in our assessment is to continue U.S. leadership in these programs and is based on our conclusion that U.S. foreign policy interests can be well-served by the MDBs. Cost sharing and financial leveraging mean that the MDBs can provide significant resources at a relatively small direct budgetary cost to the U.S. Government.

In the Caribbean Basin, the MDBs provided $234.3 million to Costa Rica, El Salvador and Jamaica in 1981, while U.S. bilateral economic and military assistance was $165.9 million.

The region adjacent to the Persian Gulf is of critical importance to U.S. interests. In 1981, seven key countries -- Kenya, Pakistan, Mauritius, Seychelles, Somalia, Sudan and Oman -- received $345.4 million from U.S bilateral programs. The MDBs more than matched that amount with $700.5 million.

The United States maintains basing arrangements in Kenya, Oman, Somalia, Thailand and the Philippines. These five countries accounted for a total of $1,456.6 million in MDB lending in 1981. Our bilateral program provided $396 million to these same countries.

In seven countries of strategic importance to the United States in Africa -- Botswana, Djibouti, Liberia, Sudan, Tunisia, Zambia and Zimbabwe -- U.S. bilateral economic and military assistance programs provided $247 million in 1981, while the MDBS provided $426.1 million in the same year.

For all 27 countries in the table I have attached to my statement, all U.S. bilateral economic and military assistance programs provided $5.6 billion in 1981. If MDB graduates, Israel, Oman and Spain, are omitted, the bilateral total is $3.3 billion. The MDBs provided $3.8 billion to these countries.

The point that these statistics establish is that the MDBs -- where the United Stated provides a fraction of the resources -- are important complements to our bilateral assistance program.

The MDBs are an important aspect of cooperation with our allies. They share with us a belief that steady, rational economic development can provide a sound basis for political stability in developing countries and have demonstrated that belief through steady support for the MDBs.

Beyond political and strategic considerations, U.S. support for the MDBs is an expression of a long-standing and deep American commitment to extend the help we can to the poorest and most disadvantaged peoples. The Administration expresses this view in its report on the banks, and the Congress has repeatedly emphasized this point in legislation -- most recently, in the "Targeting the Needy" provision enacted in August.

In terms of future U.S. participation in MDB replenishments, we would propose to provide for 9 percent nominal growth in concessional lending programs to the poorest nations during future replenishments provided maturation policies are implemented. Our effort to strengthen support for good economic policies reflects a belief that better growth performance will lead to higher productivity, improved employment opportunities and higher incomes for those people on the bottom rung. Countries, which demonstrate a willingness to adopt policies which strengthen their economies, should experience relatively favorable access to concessional windows.

In its domestic economic policies, the Administration is guided by a philosophy of reduced government interference in the economy, monetary stability and strengthened incentives for private sector growth. The recently completed report on the MDBs reflects this philosophy and advances its principles forward into multilateral economic assistance programs.

In examining our alternatives, I see the choice before the United States in relatively stark terms. We can become absorbed in our domestic economic problems and put aside the leadership the United States has provided to these institutions. We can then address development needs on a selective bilateral basis, according greater political advantage to ourselves, but leaving countless others to look elsewhere for help.

Or we can turn these institutions, which we had a strong hand in creating, into catalysts for market-oriented growth. This task will require patient, but persistent coalition building with our allies, the borrowers and MDB management.

This Administration has selected the latter course as the best way to serve the interests of this country. To succeed in our effort to transform these institutions, we will need the firm support of the Congress.

Comparison of Bilateral and MDB Assistance to countries of Importance to the United States 1/
($ million)

	1981 MDB Lending 2/			FY 1981 U.S. Economic Military Assistance 3/
	Hard	Soft	Total	
Africa				
Botswana	17.0	15.8	32.8	16.5
Djibouti	--	--	--	5.2
Kenya	83.0	58.0	141.0	55.3
Liberia	5.0	4.0	9.0	33.0
Mauritius	30.0	--	30.0	4.9
Seychelles	--	8.6	8.6	1.2
Somalia	--	18.8	18.8	67.5
Sudan	--	90.1	90.1	137.2
Tunisia	152.6	--	152.6	--
Zambia	26.0	8.6	34.6	30.1
Zimbabwe	92.0	15.0	107.0	25.0
Asia				
Pakistan	55.0	357.0	412.0	53.0
Philippines	733.5	15.0	748.5	167.2
Thailand	533.3	15.0	548.3	79.7
Latin America				
Costa Rica	40.0	18.2	58.2	8.8
El Salvador	1.0	42.4	43.4	94.9
Jamaica	132.7	--	132.7	62.2
Near East				
Cyprus	14.0	--	14.0	24.0
Jordan	46.0	--	46.0	72.1
Lebanon	--	--	--	24.4
Oman	--	--	--	26.3
Turkey	722.0	--	722.0	451.6
Egypt	89.0	197.6	286.6	739.6
Israel	--	--	--	2185.0
Europe				
Poland	--	--	--	--
Portugal	120.0	--	120.0	88.8
Spain	--	--	--	132.2
Total	2892.1	864.1	3756.2	5586.7

1/ The countries are those which received an allocation of Economic Support Funds in fiscal year 1982.

2/ The lending levels include commitments of the International Bank for Reconstruction and Development and the International Development Association in World Bank fiscal year 1981, and commitments from the Inter-American Development Bank (and its Fund for Special Operations), the Asian Development Bank and Fund and the African Development Fund during calendar year 1981.

3/ USAID 1982 Congressonal Presentation.

U.S. Treasury
February 24, 1982

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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STATEMENT OF DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL
AND BUSINESS OPPORTUNITIES

Mr. Chairman and Members of this Subcommittee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). As you know, Assistant Secretary John Chapoton appeared before the Senate Finance Committee and the House Ways and Means Subcommittee on Oversight last December and discussed in great detail the purpose and design of the leasing rules. I have brought with me a copy of that testimony and I request that it be entered in the record of this proceeding.

I will not repeat everything that Mr. Chapoton said, but I would like to reemphasize certain fundamental points about leasing in general, and as it may apply to small business in particular. At the outset, I would like to make it absolutely clear that we stand firm in our conviction that leasing is a necessary part of the President's tax program. We recognize that we have an uphill battle in educating the public on the merits of leasing, and we certainly welcome this opportunity to appear before you today to explain the purpose for the rules and to answer any questions you may have.

Background

As I indicated, the leasing rules are an integral part of the President's tax program to restore economic growth. Every lease is associated with spending for new equipment and much of this spending would not have otherwise occurred. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

"Safe harbor" leasing allows all companies, large and small, full access to the incentives in the recent tax bill for making new investments. Without these rules, there will be unequal competition for funds, new companies will face additional financial barriers, and there will be increased pressure for tax-motivated mergers and takeovers. Moreover, as I will discuss hereafter, we expect any additional financial burdens that would arise in the absence of leasing to fall heavily on small business.

The Investment Incentives of ERTA

To see the need for leasing, the operation of the investment incentives of ERTA must be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. The acceleration of deductions effectively lowers the cost of buying new equipment and thereby raises the after-tax rate of return on that investment.

This increase in the after-tax return is the primary investment incentive of the President's tax program. A problem arises, however, when these accelerated deductions become available at a time when the new equipment is producing little income. In that case, the deductions will serve their purpose only if they can be used to offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to a firm that is able to use them, the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans; and firms with temporary losses, but profitable investment

opportunities. Additionally, the more rapid write-offs for cost recovery under ACRS will moderately increase the number of currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

How Leasing Works

As an illustration of how a company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco, making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed to claim deductions under ACRS of $37,000 and an investment credit of $10,000. To use all of these tax benefits, Newco would need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from other assets, Newco would have to postpone using some or all of the ACRS benefit, which, in turn, may make Newco's after-tax return on the new investment less than that of its competitors. Stated otherwise, Newco's return from that investment would be lower than that of corporations which, for various reasons unrelated to the investment, may be able to use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms like Newco to invest in new equipment even though their investments have not yet produced large profits. With leasing, Newco has the option of retaining the ACRS deductions and credits, or it may sell the tax benefits associated with the equipment to another corporation. This allows Newco to use the equipment in its business and, at the same time, permits it to enjoy the benefits of the investment credit and accelerated deductions.

There are three important aspects of leasing which should be borne in mind. First, leasing creates no extra deductions or credits. The total deductions and credits taken by both parties to a lease transaction are the same as would have been taken if Newco had taxable income from other investments. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative (but much less desirable) way to accomplish the same result would be by an actual merger of Newco with a mature company wishing to reduce its tax liability.

Second, virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, in our case, Newco. This is because the purchasing company, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for the tax benefits is becoming very competitive. From our preliminary analysis of a small sample of sale and leaseback transactions closed in 1981, we have found that about 88 percent of the tax benefits from leased property are being passed through to lessees. This percentage should increase as safe harbor leases become routine market transactions.

This is an important point because it means that the investment incentive inherent in ACRS remains where it should be, namely, in the hands of the firm that will undertake the new investment and employ the new equipment. Although the purchasing company claims the credits and ACRS deductions on its tax return, it pays for those credits and deductions. With this payment, and the tax saving from the excess of its rental payments over its interest receipts from the purchasing company, Newco can ultimately receive virtually all the benefits of ACRS.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not foster uneconomical or tax-motivated investments. Even with the lease agreement, Newco makes a substantial investment in the asset, and the income that asset generates will be taxed. Unless the asset produces sufficient income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as is provided to firms with taxable income. With those incentives equally available, firms are able to select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Leasing and Small Business

We are well aware of the various bills that have been introduced to repeal the leasing provisions. We are also mindful of the size of the projected budget deficits and the thought that a repeal of leasing would help to alleviate that deficit. While the repeal of leasing would reduce the revenue loss in the short run, we believe that in the longer

term, its repeal would do much to undercut the investment incentives adopted by the Congress last year as part of ERTA. As a result, investment in new plant and equipment would decline with a concommitant reduction in economic activity. If leasing is repealed, we expect much of the impact would fall on small business.

As I mentioned earlier, leasing is intended to help those firms which cannot fully utilize the tax benefits associated with new investments in plant and equipment. A typical firm in this category would include a new firm or a firm which does not have sufficient income from other assets to absorb the tax benefits. Firms in these categories are usually smaller companies. The ability of these firms to sell their tax benefits is an important source of financing, particularly in these times of tight money and high interest rates. This is especially important for small businesses because they typically finance their operations from current earnings or from borrowings, and tend to rely less on equity financing.

Thus, in relative terms, the retention and utilization of safe harbor leasing is at least as important to small companies as it is to larger ones. In this connection, while most of the attention on leasing has been on the reported transactions that have thus far been closed between large companies, we do not think that this is indicative of the entire class of companies that have or will benefit from leasing.

We understand from informal discussions with investment bankers and lawyers that because of the November 13, 1981 deadline for closing initial transactions, and because of the newness of the legislation, many brokers refused to consider small leases. The complexities of the legislation and the transactions made closing costs high and small leases uneconomical. However, we now understand that as the leasing industry becomes more familiar with the rules and the lease documents become standardized, lease brokers are turning their attention to smaller leases. This should make leasing available to all companies on an equal basis.

In addition, the information we have gleaned from the lease information returns indicates that many smaller companies have been able to use the leasing rules effectively even without the aid or assistance of large professional brokers and investment bankers. Of the nearly 16,500 information returns that were filed with the IRS through the end of last week, only 1,217 represent lease deals involving more than $10 million in leased property, and

only 859 represent deals involving between $1 million and $10 million in property. Virtually all of the remaining 14,500 leases, or over 85 percent of all safe harbor leases, involve property worth less than $100,000, with some as small as a few hundred dollars.

As I noted earlier, our preliminary analysis of a small number of sale and leaseback transactions indicates that about 88 percent of the tax benefits of leased property are being passed through to the users of the equipment. Although this sample is too small to generalize, it does indicate that the percentage of benefits passed through are about the same regardless of the size of the lease. Further, the benefits appear to pass through fairly uniformly over industries.

We have not yet analyzed the data we received on leveraged or straight lease transactions, but we anticipate that the same positive benefits would flow to a user of equipment in those types of transactions that we are finding under a sale and leaseback arrangement. Small companies traditionally are big lessees of typewriters, copying machines, office furniture, automobiles, etc. Before safe harbor leasing, the savings realized by these companies through leasing versus buying the equipment depended in large part on the uncertain value of the property at the end of the lease term. By eliminating the need to take the value of the residual into account, the safe harbor rules have made leasing more efficient. As a result, less of the benefits of leasing should be siphoned off by lessors and more should pass through to the users of the equipment.

We are currently analyzing the remaining lease information returns and should be able to provide the Subcommittee with additional data on the effect of leasing on small business within the next few weeks.

Before concluding my remarks, I would like to comment on one aspect of the leasing regulations that has drawn criticism from some small business groups, namely, the application of the "at risk" rules to leasing transactions.

Leasing and the "At Risk" Rules

Code section 465 limits the amount of losses that certain closely held companies may deduct with respect to an activity to the extent of the amount they have at risk in that activity. The concept of at risk was introduced in the Tax Reform Act of 1976. It was basically a measure to restrict tax shelters by altering the timing of deductions,

so that a taxpayer could not claim deductions in excess of the amount of cash and recourse debt that he had invested in an activity at the end of any year. At risk has nothing to do with the calculation of deductions; it affects the timing of deductions by matching them dollar for dollar with the taxpayer's investment. As his investment increases, a taxpayer is allowed to claim excess deductions that have been suspended from earlier years when his investment was small.

Individuals, subchapter S corporations, and closely held businesses (in which five or fewer individuals own at least 50 percent of the stock) are subject to at risk. At risk now applies to all activities, including leasing of depreciable property. Leasing companies that meet certain requirements as to the volume of their business are exempt from at risk. In general, companies that enter into safe harbor leases will not qualify for this special exception.

The Economic Recovery Tax Act of 1981 extended the at risk rules to the investment tax credit. Although the at risk amount for the investment tax credit is separate from the at risk amount for ACRS and other deductions, it is similarly measured by the cash and recourse debt with which the property has been financed.

A taxpayer's amount at risk includes cash investments and recourse debt, as long as these amounts are not guaranteed against loss or borrowed from a related person or a person who has an interest in the activity other than as a creditor. Nonrecourse debt is counted in the at risk amount only as it is paid off.

Except in the case of a subchapter S corporation or a personal holding company, the new leasing rules do not expressly prevent closely held companies from engaging in leasing transactions. However, the regulations do provide that the at risk rules apply in determining the amount of deductions and credits a purchaser of tax benefits, <u>i.e.</u>, a lessor, may claim. Because of these rules, any safe harbor lessee or lessor that is subject to the at risk rules will have restrictions placed on the timing of both the ACRS deductions and the investment credit that are generated by the lease. This means that some closely held companies may be effectively excluded from safe-harbor leasing by operation of the at risk rules.

In a speech delivered last October, Mr. Chapoton indicated that the at risk rules may not apply to closely held lessors in safe harbor leasing transactions. In developing the regulations, however, the Office of Tax Policy

concluded that the leasing regulations could not add an exception to the at risk statute without express statutory authority.

Various people representing the small business community have suggested that the leasing provisions should be amended to relax the at risk restrictions as they apply to safe harbor leasing transactions. With respect to the application of the at risk rules to the activity of the user of equipment, i.e., the lessee, we would strongly oppose any amendment which would exempt a lessee from at risk if it would otherwise be subject to those rules. Closely held businesses that are lessees should not be able to pass through the fully accelerated effect of ACRS deductions on the leased property or the full credit in the first year of the lease if the lessee would have been otherwise precluded from claiming the deductions and credit on its own return by virtue of the at risk rules. The effect of such an amendment would be to emasculate the at risk rules altogether.

A relaxation of the at risk rules as they apply to lessors in leasing transactions, however, involves different considerations. Initially, we question the need for such an amendment.

The cash flow generated by the accelerated write-offs and credits allowed under ACRS are intended to stimulate investment by reducing a firm's effective cost of capital. The incentive is lost, however, where a firm has no positive tax base against which it may use the tax benefits. Leasing is intended to restore that incentive in those cases by allowing a company to sell the tax benefits with respect to a new investment in equipment. While it is true that a lessor will presumably earn a positive return from investing in a leasing transaction, that return should be no more than that available elsewhere. The real beneficiaries of the new leasing rules are (and should be) the lessees, that is, the users of equipment which are selling the tax benefits. To that end, closely held companies are not disadvantaged by the regulations. Under the statute, anyone may be a lessee, including individuals. Although the at risk rules are applicable to lessees as well, this should not be a significant problem since we would expect most lessees which are small businesses will be at risk in their investments anyway.

Moreover, any profit earned by a lessor on a leasing transaction is payment to the lessor for advancing the money to the lessee for the ACRS deductions and credits to which the lessee was otherwise entitled. The effective exclusion

of closely held companies as lessors discriminates in favor of large companies only to the extent that large companies have an additional investment option available to them. It certainly does not mean that closely held companies are denied the benefits of leasing.

It has been suggested that an amendment to ease the at risk rules is needed because small companies will only deal with other small companies. Thus, if small companies are prevented from entering leasing transactions as purchasers of tax benefits, many small companies as sellers of tax benefits will be unable to take advantage of the leasing provisions.

We question whether there is any natural hesitancy on the part of small companies to deal with large companies in a leasing transaction. Moreover, as I have indicated, we fully expect that lease brokers will be able to package the leasing of equipment to make the leasing of small amounts of equipment attractive to large companies.

On the other hand, we would agree that since the leasing provisions are market-oriented, there is no reason to curtail the universe of potential lessors by discriminating among corporations that are allowed to be lessors. Also, we are satisfied that there are sufficient safeguards within the leasing rules that a change in the at risk rules as they apply to lessors would not open any abuse the at risk rules were intended to prevent. At risk was intended principally to prevent individuals, partnerships, and closely held companies from artificially overstating the depreciable basis of their assets through the use of nonrecourse debt. It would not be possible to circumvent this purpose through a leasing transaction as long as the lessee continues to remain subject to at risk. This is because the timing and amount of the lessor's deductions may not exceed the deductions and credits that would be available to the lessee had the lessee not entered the lease in the first place.

Although we have doubts that an amendment to relax the at risk rules as they apply to lessors would have any appreciable affect on the benefits of leasing flowing to small companies, we would not oppose carefully developed legislation along those lines. However, before giving our approval to any such amendment, we would want to take a close look at the proposal as there may be special circumstances where we would not want the at risk rules modified.

Summary

It is not surprising that the celebrated leasing transactions have been those involving large, well-known corporations. These make news. But the safe harbor provision is especially important to the growth and continued independence of small businesses. Small businesses are already using the provision and many more will benefit from it, if the Congress does not overreact to publicity from a few unusual cases.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE February 24, 1982

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $3,251 million of $6,481 million of tenders received from the public for the 5-year 2-month notes, Series E-1987, auctioned today. The notes will be issued March 3, 1982, and mature May 15, 1987.

The interest coupon rate on the notes will be 14%. The range of accepted competitive bids, and the corresponding prices at the 14% coupon rate are as follows:

	Bids	Prices
Lowest yield	13.96%	99.965
Highest yield	14.05%	99.639
Average yield	14.01%	99.784

Tenders at the high yield were allotted 16%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 20,496	$ 14,656
New York	5,164,173	2,603,523
Philadelphia	14,160	14,160
Cleveland	57,469	57,469
Richmond	41,382	29,942
Atlanta	19,740	18,917
Chicago	512,873	196,388
St. Louis	42,899	41,889
Minneapolis	23,640	22,472
Kansas City	27,015	27,015
Dallas	18,121	18,121
San Francisco	537,847	205,077
Treasury	1,559	1,554
Totals	$6,481,374	$3,251,183

The $3,251 million of accepted tenders includes $482 million of noncompetitive tenders and $2,769 million of competitive tenders from private investors.

In addition to the $3,251 million of tenders accepted in the auction process, $ 255 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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STATEMENT BY
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE APPROPRIATIONS COMMITTEE
THURSDAY, FEBRUARY 25, 1982

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

R-643

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher

inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair

to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Shortly we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income

from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, ~~tax incentives for specific investments fail~~ to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed

tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political

jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In

addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

<u>Modified Coinsurance</u>

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to ~~eliminate the unintended tax benefits resulting~~ from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all

reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation, and
- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience.

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

- o Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,
- o Deductions for interest on debt to carry tax-exempt securities,
- o Deferred DISC income,
- o Shipping income deposited in capital construction funds or construction reserve funds,
- o Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,
- o Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and
- o Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

<u>Withholding on Interest and Dividends</u>

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an ~~opportunity to increase tax revenues~~ substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for

interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an

increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

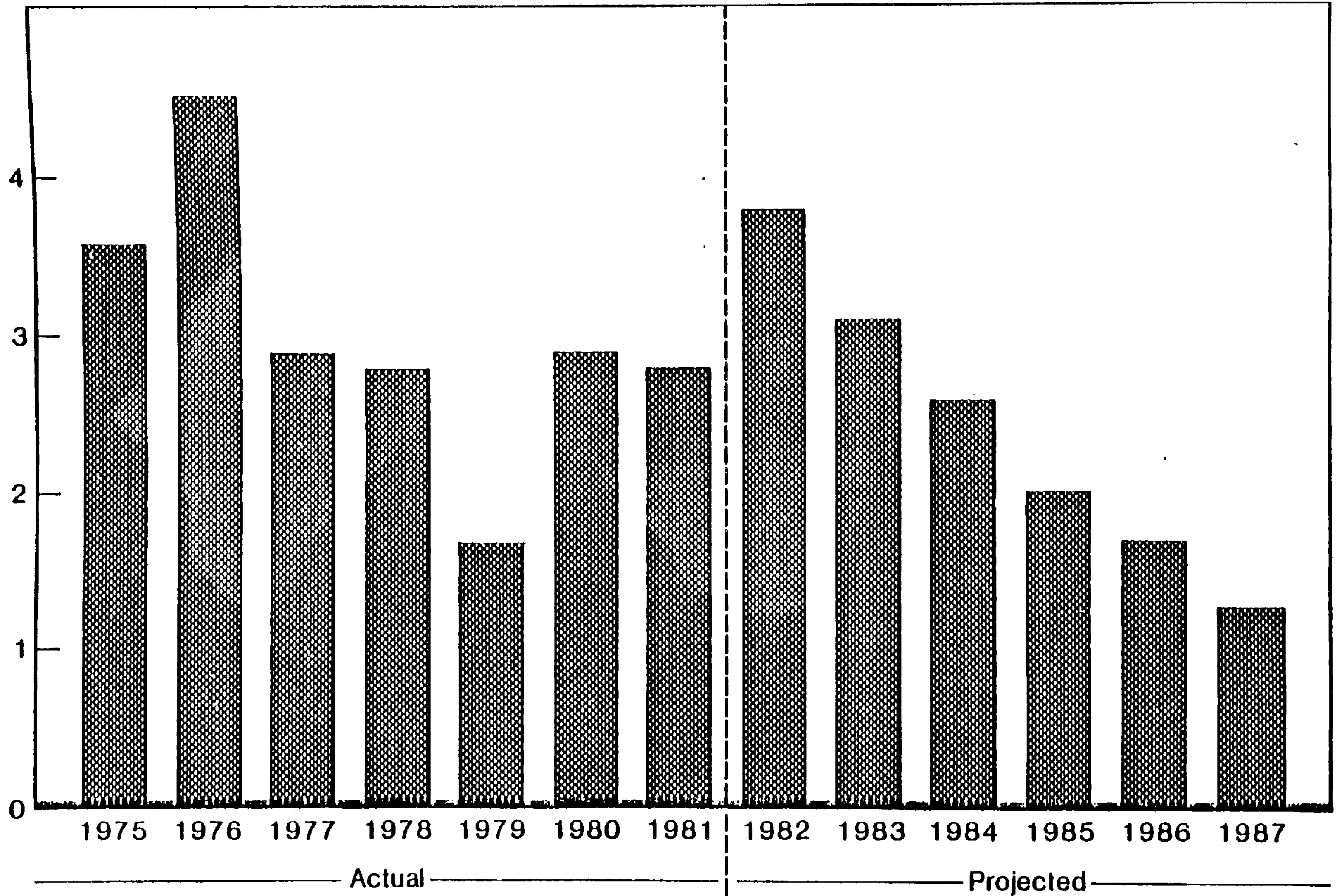
The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

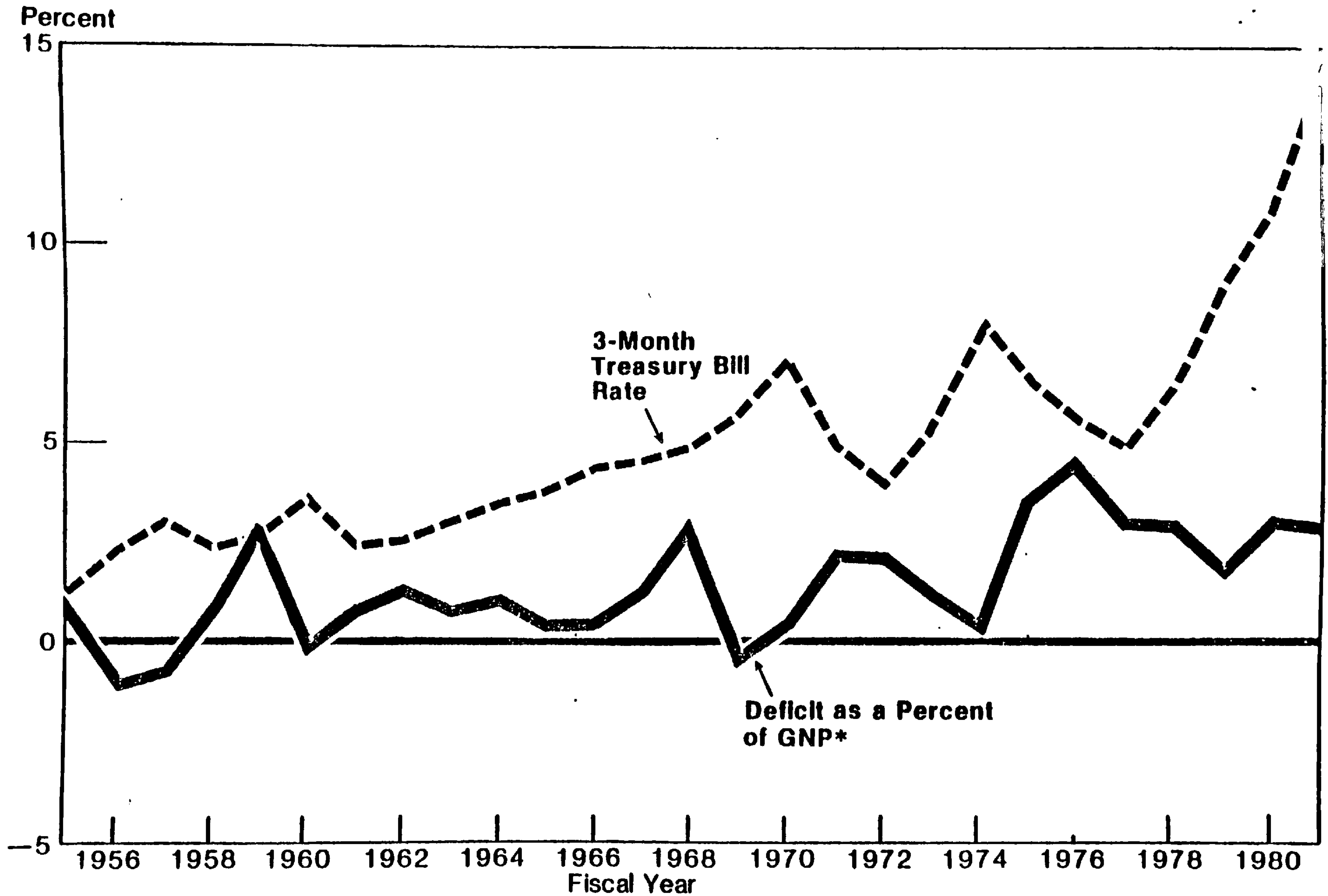
While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

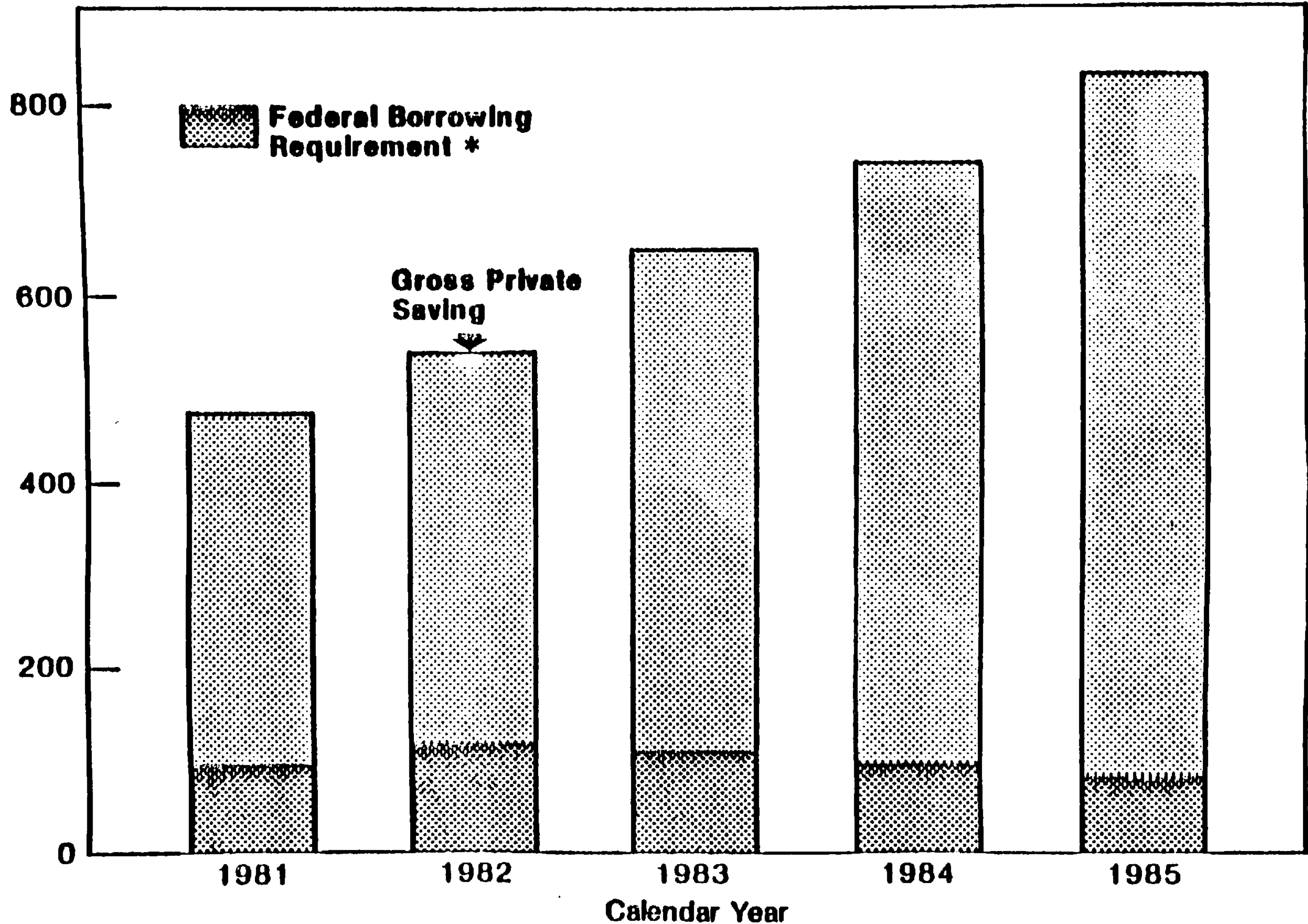

Budget Deficits in Relation to GNP*
Percent
4
3
2
1
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
Actual
Projected
* On and off budget as percent of fiscal year GNP.

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 9:30 a.m.
February 25, 1982

STATEMENT OF BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D.C.

Thursday, February 25, 1982

It is a distinct pleasure to be here this morning to offer you the views of the Administration on monetary policy. While the Federal Reserve is an independent institution which is accountable to the Congress, the Administration considers monetary policy to be a crucial element in the economic recovery program. Without actions to ensure a steady moderate pace of monetary growth, inflation would continue to plague the economy, severely blunting efforts to restore growth of production and employment. As President Reagan stated last week, "I have confidence in the announced policies of the Federal Reserve Board." Their stated policy is gradual reduction in money growth.

While the various schools of economic thought often differ on the particular causes of inflation, I believe that all serious analysts would agree that inflation can persist only when it is accommodated by monetary expansion. The policy implication is that the elimination of inflation requires that the rate of money growth must ultimately be reduced from the rapid pace of recent years to a level in line with the expansion of real economic activity. This is the foundation of the Administration's anti-inflation program and is the basis of the current policy of the Federal Reserve.

I reemphasize the point -- a permanent reduction in the rate of monetary expansion is a necessary requirement for reducing inflation. The Administration also believes that a steady, moderate pace of money growth is sufficient to ensure long-run price stability. With a moderate pace of monetary expansion, the effect of factors--such as oil price shocks--that can cause temporary price changes, would not be translated into an ongoing general inflation. But even those who would rely less on monetary policy to fight inflation or, who argue that the current effort is too intense, recognize that <u>any</u> effort to control inflation ultimately requires, at a minimum, slower money growth.

R-644

We must keep this long-term requirement in mind as we consider the more immediate problems in the economy. The implementation of an effective anti-inflation program has been delayed for many years by continually focusing on immediate conditions and futile attempts to provide quick and painless solutions to stagflation. Ironically, the perceived costs of fighting inflation were not avoided, but instead only postponed, to grow larger each year. At last, we have an opportunity to make significant progress in permanently reducing inflation; and the key is to continue the effort to restrain the rate of monetary expansion.

The task of monetary policy is to reverse the rising trend of money growth that has produced similar trends of accelerating inflation and rising interest rates. This goal focuses, by necessity, on relatively long-term relationships, which unfortunately often appear to clash with concern for the immediate economic situation. The attention of the monetary authorities cannot be diverted, however, to providing short-term expedients. The focus must remain on reducing the trend of money growth.

Every journey must begin with the first step and the Federal Reserve took that step in 1981, holding the rate of money growth to 5%. If that step had not been taken last year, inflation would have become more deeply entrenched in the economy. In addition, the problems of unemployment and financial stress associated with moving to a noninflationary monetary policy would have grown larger. These are problems that must ultimately be faced -- the longer we procrastinate, the longer inflation continues, the larger these problems become.

The Administration's support for the policy of reducing the trend of money growth is complete. It is of critical importance that the growth of money -- M1 -- be held within the announced target range this year. In particular, concerns for the budget deficit should not interfere with actions to control money growth. The Administration does not expect the Federal Reserve to make any concessions on its monetary targets for the purpose of monetizing the deficit.

Deficits are not a monetary problem. Instead, the prospective government borrowing bears on the competition for savings in the economy. Budget deficits over the next several years would indicate excessive growth of government spending, which would be financed in competition with private investment. While we expect the supply of savings to increase sharply, allowing expansion of private investment, large deficits would, nevertheless, represent a substantial absorption of credit by the government. Thus it is important that the Administration and the Congress work together to restrain the growth of government spending, with the clear intention of balancing the budget.

We should recognize that the immediate or short-run effects of slower money growth are quite different from the ultimate impact. In the long run, slower money growth would result in less inflation, thereby reducing the growth of nominal income and the level of nominal interest rates. The transition to slower money growth -- as we move from the excessive 8 percent growth of recent years to a noninflationary pace -- can have temporary but substantial effects on real economic activity.

In a sense, the restriction of output and employment that we now feel is the inevitable payment for past monetary excesses. At the same time, however, it is possible to reduce these transitional costs and it is desirable to do so, since they involve the real burdens of unemployment and loss of income. Thus, a policy of achieving a noninflationary rate of money growth addresses half of the problem. Equally important is the way in which that policy is implemented.

The problem is that economic policymakers are not starting with a clean slate. We all wish that someone could wave a magic wand, wipe out the effects of past failures and allow the economy to start from scratch with the assurance that inflation is finished. Unfortunately, the effects of past policy failures are deeply imbedded in all aspects of economic activity and that legacy has a dramatic effect on the public's reaction to current and future policy actions. In terms of monetary policy, the Federal Reserve faces the task of establishing the credibility of the policy to reduce the rate of monetary expansion.

Policy failures of the past are now a major factor determining the economic impact of current efforts to reduce money growth. Prior attempts to slow money growth over the past 15 years resulted in several short-lived periods of monetary restraint, but in each case money growth was subsequently reaccelerated to a higher, more inflationary pace. As a result, the immediate impact of monetary restraint on real economic activity -- in terms of lost output and employment --has been intensified. In addition, the financial markets have become extremely sensitive to short-term variations in money growth as potential indicators of yet another monetary explosion. This sensitivity is reflected in high and volatile interest rates.

Trends and Fluctuations of Money Growth

The implications of current monetary policy and Federal Reserve policy actions are influenced greatly by the economic trends that have developed over the past several decades. As shown in the table below, the average rate of monetary expansion has accelerated steadily from the mid-1960's. This rising trend of money growth was associated with a similar acceleration in the average rate of inflation.

	Annual Rates of Change			
	M1	GNP Deflator	Real GNP	Average Unemployment Rate
1950-65	2.7%	2.2%	3.8%	4.9%
1965-70	5.0	4.2	3.2	3.9
1970-75	6.1	6.5	2.6	6.1
1975-80	7.1	7.2	3.7	6.8
1965-80	6.1	6.0	3.2	5.6

Source: Council of Economic Advisers, Federal Reserve Bank of St. Louis.

Note, however, that persistent monetary stimulus did not result in lasting gains in output. Comparing the 15 years before and after 1965 reveals that average money growth and inflation more than doubled, while the average growth of output declined slightly. The average rate of unemployment was almost one point higher in the second period.

The relationship between money growth and economic activity has remained fairly constant, as indicated by the accompanying chart (Chart I). Growth of nominal income continues to be related closely to the pattern of growth of M1. Despite widespread financial innovations, which offer a variety of alternative types of deposits, the basic underlying demand for money in the economy continues to be satisfied by the narrow class of currency and deposits which comprise M1. We are confident that efforts to control the growth of M1 will be reflected in lower inflation and less variation in nominal income.

The reduction of money growth to a 5 percent rate in 1981 was just the first step; persistent action is required to reverse the trend of money growth and inflation over the next several years. The target for M1 growth which the Federal Reserve has adopted for 1982 is another step in that direction. Holding money growth to 5% again this year would consolidate the gains which have already been made and would ease the immediate costs of transition to a noninflationary path.

This moderate pace of money growth would provide the appropriate monetary environment for renewed economic expansion. It is not the cure-all for economic problems, but instead is the prudent next step in establishing a permanent, noninflationary rate of money growth, while contributing to an environment which encourages real economic growth.

As shown clearly in the table above, a secular acceleration of money growth did not give us more real economic growth. We should keep this in mind in considering the current economic recession. An effective anti-inflationary monetary policy will not require sustained or unrelenting restriction of output and employment. Reducing inflation and stimulating economic growth are mutually consistent goals.

The notion that relying on monetary policy to fight inflation necessarily involves an ongoing restriction of production and employment is based on a very short-sighted and incomplete view of economic relationships. Frequent references to the current situation are a case in point, but this situation is far from unique.

Monetary restriction in 1981 was a major factor contributing to the current economic recession. The slowing in money growth was abrupt and substantial, exceeding both the expectations of the Administration and the targets of the Federal Reserve. Given the prevailing trends, it was inevitable that such a sudden shift in money growth would have a significant depressive effect on real economic activity. While this effect involves real hardship for many sectors of the economy, it is, nevertheless, temporary and we would expect these depressive effects to wear off quite soon. This is part of the basis of our expectation that the economic expansion will begin this spring.

While some temporary restriction of production and employment is inevitable, given the persistence of inflationary trends of the past 15 years, the severity and duration of the restriction can be reduced substantially through prudent monetary actions. In formulating the economic recovery program, for example, the Administration opted for a gradual slowing of money growth over several years. We saw this approach as offering the economy time to adjust to a noninflationary environment. The inflationary experience had become deeply embedded in all aspects of economic activity -- including wage negotiations and contracts, investment programs, financial contracts and international currency markets. We thought that moving abruptly to end inflation would probably result in severe short-term disruptions, as economic activity would have to be reordered quickly.

In addition to reducing money growth gradually, the costs of transition to less inflation can be reduced if money growth is slowed steadily and smoothly. Following years of volatile but ever-accelerating money growth, the financial markets are now very cautious of large changes in money, even on a weekly basis. While it is certainly true that such short-term fluctuations *should* have no economic meaning or effect, they do now have economic consequences because the financial markets react to them.

Sudden swings in money growth, which persist for several months, have therefore proven to be extremely disruptive to financial markets and the effect has spilled over into real economic activity. The most visible symptom of the disruptive effects of volatile money growth is high and volatile interest rates. While long-run monetary trends are ultimately the important consideration, short-term monetary fluctuations can be a potent force during the transition from an inflationary to a noninflationary trend of monetary expansion.

The problem is not that these very short term variations *per se* have fundamental effects on economic activity. Instead, their importance stems from the environment in which they occur. As shown by the experience in several foreign economies, variations in money growth can be absorbed with little disruption, once a basic noninflationary trend of monetary expansion is firmly established. Low inflation countries, such as Germany, Japan and Switzerland, have had smoothly declining monetary trends in recent years, even as they have experienced substantial short-term monetary variability.

The history of monetary actions in the United States since the mid-1960's is very different. As I have mentioned, prior efforts to control money growth were soon abandoned and rapid money growth was reestablished. The table below presents the major episodes of monetary restriction over the post-war period. Notice that each of the severe economic recessions was preceded by an abrupt slowing of money growth (column 2) and that this restraint was maintained into the recession (column 3). Typically, however, money growth was then increased sharply (column 4).

Periods of Recession		Annual Rates of Change of M1			
		(1) Prevailing Prior to Recession *	(2) 2 Quarters Before Peak	(3) 2 Quarters After Peak	(4) 4 Quarters After Trou
Peaks	Trough				
1948IV	1949IV	0.4%	-0.5%	-0.7%	4.4%
1953III	1954II	3.3	1.6	0.8	3.8
1957III	1958II	1.0	0.1	-1.3	4.5
1960II	1961I	2.1	-1.0	2.1	3.2
1969IV	1970IV	6.9	2.1	4.2	6.7
1973IV	1975I	7.9	4.9	5.3	5.7
1980I	1980II	8.2	5.8	5.4	9.9

*Rate of money growth during year-ended two quarters prior to peak in economic activity.

Prior to the mid-1960's, these cyclical variations in money growth had little effect on underlying monetary trends. Despite frequent and large variations, the money stock increased at an average rate of less than 3% from 1950 to 1965. Since 1965, however, the cycles of money growth have been around an increasing trend -- the rate of monetary expansion following a period of restraint was typically faster than it had been prior to the restraint. Money grew 5% per year from 1965 to 1970, at more than 6% over the next 5 years, and accelerated to over 7% per year from 1975 to 1980.

The only exception to this cyclical pattern came after the 1973-75 recession. While money growth was increased somewhat following the recession, the pace was in line with the prevailing trend. As a result, the economic expansion was accompanied by general decreases in interest rates and an easing of inflationary pressure. In addition, this occurred despite a substantial increase in the Federal deficit. It was not until late in 1976 that the Federal Reserve began to inject money at a rapid pace, resulting in an 8% annual rate of money growth over the next four years.

This experience of a rising trend of money growth, punctuated by several periods of restraint, has had a profound effect on financial markets. The influence is evident in the markets' reaction to recent monetary variability. The cycles of money growth since the mid-1960's have been accompanied by similar cycles in long-term interest rates. Each period of monetary restraint led, after a short lag, to decreases in long-term interest rates. The evidence indicates that these decreases reflected easing of inflationary expectations. The subsequent monetary explosions, however, proved these expectations to be premature and long-term interest rates rose accordingly. The result was a series of cycles in long-term rates, with each low point at a level above the preceding low and each expansion leading to a new high in rates.

From this experience, the long-term credit markets have become very skeptical about the prospects for inflation, and thus interest rates, in the future. Each time that market conditions have generated downward pressure on long-term interest rates, a sharp acceleration of money growth aggravated concern about the impending monetary trends, leading to a rise in rates. While financial markets are well aware that trends in money growth are the dominant factor in inflation, experience has led them to doubt that several months of monetary restraint is a clear signal that the trend of money growth is downward.

This fear is evident in the markets' reaction to the surge in money growth that has occurred since October. On the one hand, the surge led to the expectation that the Federal Reserve would tighten money market conditions in an effort to restrain money

growth. This concern causes short-term interest rates to rise. On the other hand, however, the persistence of the bulge in money growth has lent credence to the view that the restriction of money growth last year might be just another temporary downturn, to be followed by accelerated money growth, as in the past. This view has led to significant increases in long-term interest rates.

It is obvious that projections of the Federal deficit also play a role in this process. During periods of heavy government borrowing in the past, monetary actions designed to offset the resulting short-term pressures on interest rates contributed to rapid money growth. While both the Administration and the Federal Reserve are firm in their commitment to avoid monetization of the debt and to reduce the trend of money growth, the combination of history and the recent erratic swings in money growth have been sufficient to raise serious doubts in credit markets. These doubts are reflected in the level of interest rates.

These fears aggravate problems for specific sectors of the economy, which were already in considerable trouble. The continued problems of the housing and the automobile industries are a drag on the entire economy, and the persistence of high interest rates would seriously endanger the prospects for economic expansion.

The Federal Reserve can make a significant contribution to easing this problem through efforts to dampen the systematic variations in money growth, such as have occurred over the past two years. Random variations in money growth are to be expected and there is no reason to attempt to offset such changes. However, monetary actions can ensure that these random changes do not persist and lead to several months of either very rapid or very slow money growth. The accompanying chart (Chart II) shows the short-term growth of the money supply, as well as the monetary base, which is a summary measure of the actions of the Federal Reserve. As this chart illustrates, current control procedures have produced swings in growth of the monetary base which have caused and exaggerated variation in the money growth.

I believe that the variability of money growth would be reduced if the Federal Reserve targeted and controlled the monetary base, rather than the money supply. While control of the base would certainly not remove the temporary and random changes in the money supply, it would take the Federal Reserve out of the difficult business of distinguishing between changes in money that are random and self-correcting and those that are not temporary and should trigger a policy response. Since growth of the monetary base is closely correlated with money growth in the long run, a moderate and steady rate of growth in the monetary base would be expected to produce a similar growth pattern for money. While the short-run fluctuations in money growth would still occur with steady growth of the base, these changes would tend to be self-correcting and would be cancelled out quickly.

With a policy that provided for steady growth of the base, short-run fluctuations in money would not be answered with explicit policy actions. This would remove pressures on interest rates that now result from speculation in financial markets about how the Federal Reserve may react to a particular wiggle in the money data. An announced policy of steady growth in the base would reduce the uncertainty that now surrounds monetary policy and contributes to instability in the financial markets and volatile interest rates.

To complement a policy of controlling the base, I believe the Federal Reserve should eliminate lagged reserve requirements and tie the discount rate to a market interest rate so that it would be changed with market conditions. These administrative changes would improve the precision of the Federal Reserve's policy actions.

The ability of the economy to adjust to lower inflation would be enhanced by dampening the systematic swings in money growth. The transition to less inflation would be smoother and the costs--in terms of output and employment--would be less.

The Administration supports completely the stated policy of slowing the average rate of money growth and we believe that the announced target of 2.5-5.5% for 1982 is appropriate. However, in view of the severity of the current recession, we recommend monetary expansion in the upper one-third of the range. We hope that the actions by which this policy is implemented would produce a more even pattern of money growth, thus reducing the temporary, but very real, costs of the transition to less inflation.

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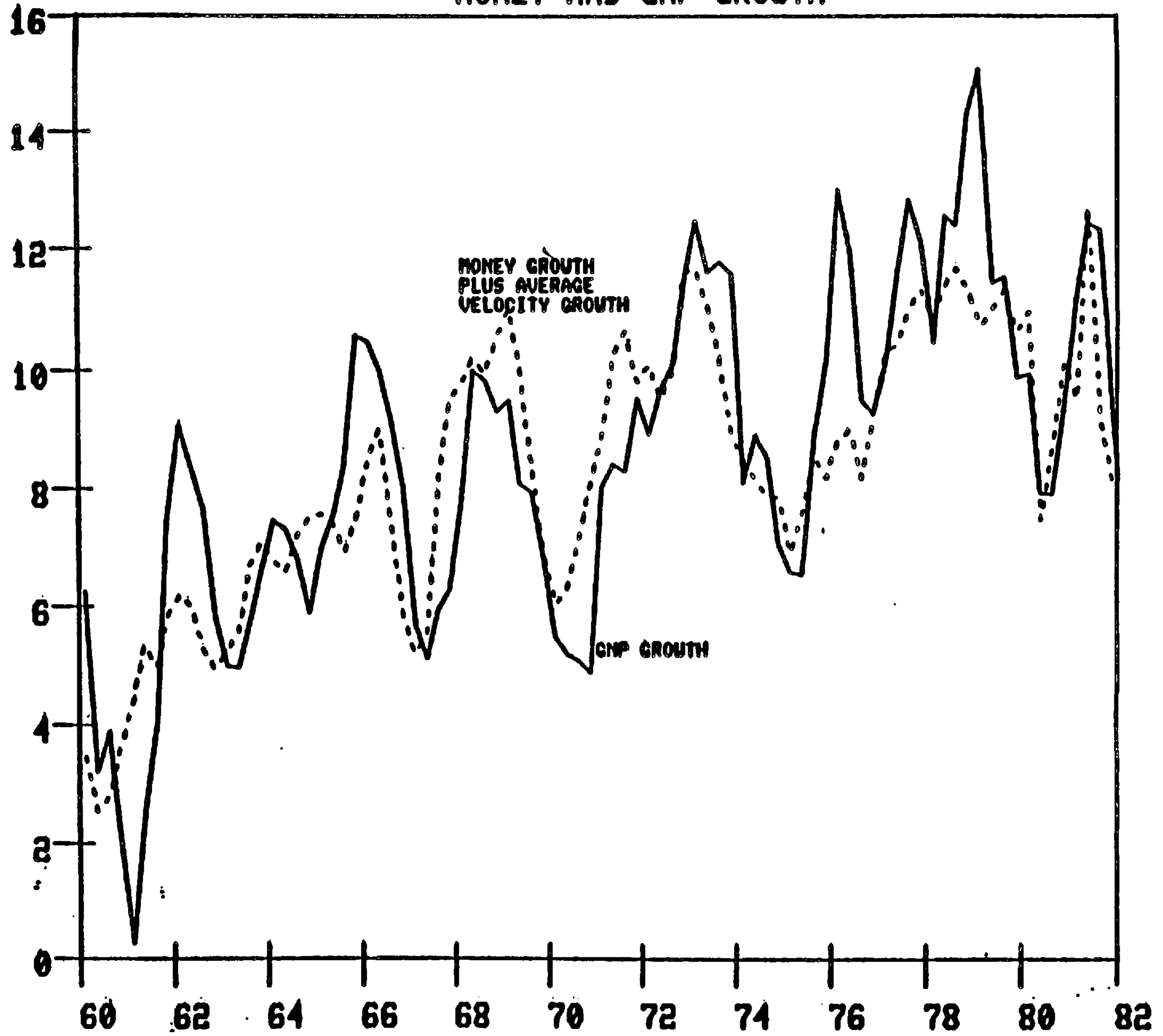
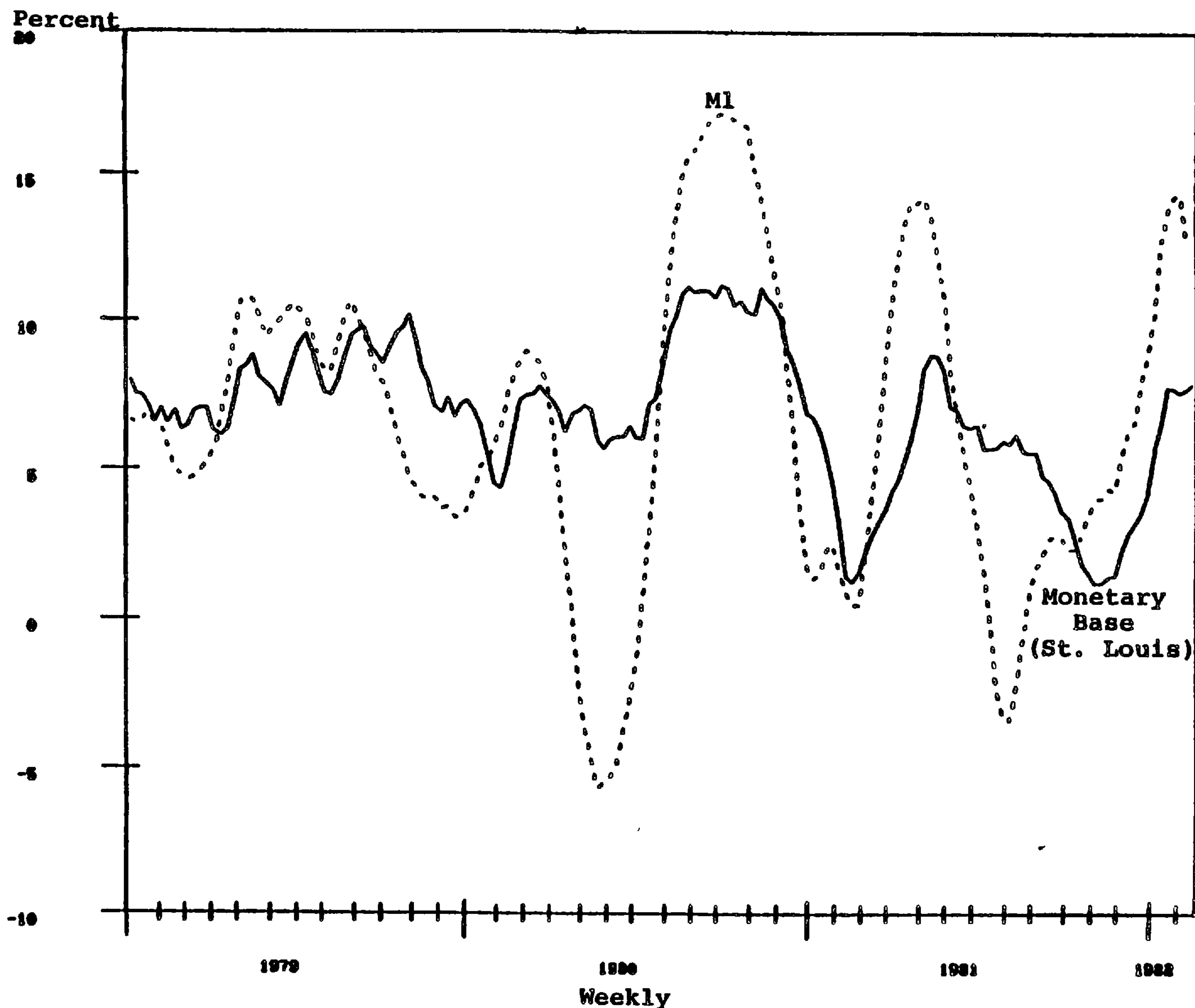
CHART 1



CHART

Quarterly Rates of Growth of Monetary Base and the Money Supply (M1)*



*Quarterly growth rates based on four-week averages compared with four-week averages thirteen weeks earlier, at annual rates. Latest week plotted: Feb. 10 for M1 and Feb. 17 for monetary base.

Note: The M1 data series is being revised, but all historical data are not yet available. Therefore, 1981 and 1982 data are not strictly comparable to earlier years.

TREASURY NEWS

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For Release Upon Delivery
Expected at 1:00 p.m.
Friday, February 26, 1982

Address
by
The Honorable Beryl W. Sprinkel
Under Secretary for Monetary Affairs
before the
Business Week/Securities Week
Conference on the Financial Revolution
New York, New York
February 26, 1982

Good afternoon.

I appreciate the kind invitation of Securities Week and Business Week to join you today.

I would like to take the next few minutes to touch on three themes: first, the underlying philosophy of the Reagan Administration's general approach to deregulation. Second, what has been happening to the financial services industry over the past half century. And last, what are our specific recommendations for what is being popularly described as "bank deregulation."

Administration Economic Program

First, I am sure you are aware that the President's overall economic program consists of four broad themes which are, simply stated, pursuance of moderate, steady growth in the money supply; reduction in tax rates and controlling government spending. The fourth area is, of course, reduction of costly, cumbersome and unnecessary government regulations.

We believe that economic systems work efficiently to the degree that they are free and open. I don't think, for example, that it is coincidental that the significant slowdown in American productivity occured during the greatest period of regulatory growth this country has ever known.

Vice President Bush heads the Administration's Task Force on Regulatory Relief and that task force is making real progress. Putting deregulation into dollar-and-cents terms is not an exact science. But we estimate that we saved American business about two billion dollars last year in annually recurring operating costs.

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Over 100 government regulatory programs are now under review. A quick look at the Federal Register -- the publication that contains new regulations -- will show you the direction we are heading. In 1970, the watershed year of the regulatory boom, the Federal Register had 54,000 pages. Ten years later it had almost doubled, to 93,000. The Register, I am pleased to report, had 25,000 fewer pages last year than in 1980. So, in a way, what we're trying to do is get the Register down from the size of War and Peace to the size of, say, a few issues of the Atlantic Monthly.

Bank Regulation

In a similar way, the regulations for the financial sector just grew and grew. After the Federal Reserve Act of 1913, came the McFadden Act of 1927, the Glass-Steagall Act of 1933, the Federal Deposit Insurance Act of 1935 and, later, the Bank Holding Company Act and a group of now famous guidelines such as Regulation Q.

All of this legislation wove an elaborate matrix of guidelines for the financial services industry. Banks were forbidden to take deposits across state lines. Investment banks were separated from commercial banks and forbidden to take deposits at all. Special sources of funds, for example savings deposits, were reserved to special uses, such as housing.

These restrictions arose from a number of motivations, most, if not all, worthy. And, by and large, they arose in an era where a strategy of borrowing short from small savers and lending long to home buyers was a sure formula for success. In recent years, of course, that approach has been a blueprint for disaster.

Changes Over The Years

But that is only one of the changes that has come upon us since the rush to regulate in the 1930's. Two other changes -- one economic, the other technological -- have swept through the financial services industry.

Water seeks its own level. And it does not stay behind a dam if there is any other place where the force of gravity will allow it to flow.

In a similar sense, the financial services industry has simply outgrown -- or gone around -- the regulatory boundaries of a half-century ago. I am not suggesting sleight of hand on the part of bankers. I am suggesting that the marketplace is inherently very creative.

Commercial banks now legally reach beyond geographic limitations through various corporate devices to conduct "bank-like" activities. The largest banks compete nationally -- and legally -- for "wholesale" and retail business. They do so through surrogates for full service branch facilities.

The whole picture becomes even more interesting when you add thirty foreign banks, "grandfathered" under the International Banking Act of 1978, which conduct operations in more than one state. You now have a situation where 6 of the 10 largest banks in California have their home offices in foreign countries.

So that what is happening is that distinctions that were created de jure several decades ago are become blurred in a de facto sense today.

People often say, "what's in a name?" There is often quite a lot in a name. Names like American Express hyphen Shearson hyphen Boston Safe Deposit and Trust. Names like Prudential hyphen Bache. Names like Sears hyphen Dean Witter Reynolds. Names like these are the signs of the real revolution that is taking place today in the financial services industry.

That is the economic change.

What about the technological change?

Those of us who are now out of our youth remember space adventurers like Buck Rogers and Flash Gordon and all those fancy space age things they were supposed to be able to do. Those who are a bit younger probably identify more with Star Wars. In case any of you still think that stuff is all science fiction hocus-pocus, I'll let you in on a little secret. Much of that space age technological magic is right here, right now.

Literally billions of dollars can be transferred globally -- and instantaneously -- through sophisticated electronic networks. Deposits can be made directly by payroll departments using electronic tapes. And home computers may soon eliminate the need for people to physically appear at the bank.

It may not be too long before "bricks and mortar" bank branches are supplanted by a combination of card, computer, telephone and mail systems.

Administration View

What has been our response to all this? The regulatory apparatus of the Federal government is trying to catch up and, at the same time, get out of the way of progress. Indeed, in the case of this Administration, we are trying to catch up by getting out of the way.

For example, there are two ways to build a sidewalk. One: you can lay out a sidewalk, build it, and then try to "force" people to walk on it. Or: you can watch where most of the people walk already, and then lay out your sidewalk along that path. That, in essence, is what we are setting out to do. I am not suggesting, of course, that we are to be completely laissez faire. I am suggesting that the government's approach to financial services deregulation must be shaped to match the current reality in the industry.

Just as the President's Economic program contains four parts, it is useful to think of the Administration's approach to financial deregulation in terms of four broad themes.

The first theme deals with interest rates. As most of you know, the Depository Institutions Deregulatory Committee -- DIDC -- chaired by Secretary Regan, is working hard to free depository institutions from interest rate ceilings. This would allow these institutions to compete for deposits that unregulated financial institutions (i.e. government and money market funds) have been able to attract by offering market rates of interest. But if thrift institutions are to invest higher cost, ceilingless, deposits at a profit, their asset powers must be made more flexible.

So the second broad theme of our approach has to do with equalizing the powers of the respective financial institutions.

The thrift industry, which has been most heavily affected by interest rate controls, has proven to be remarkably resiliant in the face of record high interest rates. The thrifts actually managed to exhibit a modest degree of asset and deposit growth in 1981 (up 5.2% and 2.5%, respectively). Earnings and net worth, however, declined as a result of a continued imbalance between the industry's cost of funds and an inadequate stream of revenues.

The problems being experienced by the thrift industry highlight the difficulty of structuring an industry by government statute. But the Administration strongly supports legislation currently before Congress that would give savings and loans and mutual savings banks bank-like powers. That is, the ability to accept deposits and make commercial loans.

The barrier between commercial banking and investment banking, erected by Glass-Steagall, is another of what I would call the "powers problem."

Recent developments outside of, what used to be, the financial services industry have underscored the need to permit bank holding companies, to compete with what are now, in essence, a less regulated part of the financial services industry. Let me give you a few examples. Prudential and Sears Roebuck plan to market mutual fund shares through their nationwide network of insurance agents and retail outlets. General Electric Credit Corporation, with $9 billion in assets and 300 branches already makes secured loans and is involved in leveraged leasing and mortgage insurance.

Our proposal would allow commercial banks to establish separate subsidiaries, to engage in certain securities activities; specifically dealing with municipal revenue bonds and mutual funds. Our hope here is that such action will pave the way for further deregulation.

The third broad area of concern deals with current geographic restrictions.

Today, a foreign bank can cross the Atlantic or Pacific Oceans more easily than a New York bank can cross the Hudson River. I suggest that this is ludicrous.. It is another example of the market's having out stripped the regulations.

Next year -- 1983 -- we will have a comprehensive set of recommendations on the geographic boundaries question.

For the immediate future, we have already proposed legislation which would permit the emergency acquisition of ailing deposition institutions by healthy ones -- across state lines.

The fourth and final element in the picture has to do with the way the Federal government has organized itself to regulate.

The existing regulations and legislation have, in essence, compartmentalized the financial services industry; separating brokerage operations from banks, commercial banks from investment banks, thrifts from banks and so on.

The government, of course, has organized itself along these same lines. The Federal Home Loan Bank Board regulates the thrifts. The SEC regulates the investment houses. The Comptroller of the Currency, the FDIC, and the Federal Reserve regulate the banks, and so on.

Now, please don't misunderstand me. I am not making any proposals here. I am not even hinting at an Administration direction on this. All I am suggesting is that if we have a financial services industry which is rapidly becoming integrated in a real world, operational sense, the Administration and Congress, together, need to start thinking seriously about the organization of regulatory agencies in light of the revolution now going on in the industry.

Conclusion

In a nutshell, then, that is my message. There is a real revolution going on in the financial services industry. Our deregulatory approach is designed to catch up with reality, provide the industry with the flexibility it needs to remain sound in any economic environment while -- at the same time -- working to the advantage of the consumer.

The Reagan Economic Program has four elements and the bank deregulation part of the overall program, in turn, has the four parts that I described a moment ago.

If you would like me to expand on any of those themes, I would be happy to answer your questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

REMARKS BY THE HONORABLE BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
FOREIGN EXCHANGE COMMITTEE
NEW YORK, NEW YORK
February 26, 1982

First, I would like to express my pleasure at being able to speak to your group. I regret that I haven't had a chance to make it sooner. I welcome all the opportunities I get to stay in touch with the banking community.

Foreign exchange markets and foreign exchange trading have a special intellectual appeal for me, because they exemplify so much of what is best about the market mechanism. Here is a huge but totally intangible international marketplace and communications network, guiding and facilitating transactions with tens of billions of dollars every day. Who could consciously design a planning and coordinating mechanism to handle such a job?

Certainly no government agency could do it. And yet, the task is getting done continuously and efficiently, through the interactions of foreign exchange market participants.

Well, I've been in government for a year now, but despite that I am still a firm believer in free markets. On second thought, maybe I am now an even <u>firmer</u> believer in free markets, precisely <u>because</u> I've been in Washington.

A Free-Market Economic Policy

That is the essence of this Administration's economic policies: they are free-market policies. The premise of President Reagan's economic recovery program is the the inherent superiority of private market activity as a guide to economic decisions and as an engine of growth. He has acted decisively to end needless government interference with private markets, to reduce the burden of government on the economy, and to provide a stable, non-inflationary policy environment.

As difficult as the job the Administration set out for ourselves is, some parts of it have been more difficult than we expected. One profound disappointment has been the persistence of high and volatile interest rates. There is no need for me to catalogue for this group the problems interest rates have been causing, domestically and internationally. But I will come back to this topic later.

On some fronts we've been more successful than we had expected. Among these I would include the passage of the President's incentive-oriented tax reductions; the regulatory reform movement; and our rapid progress in winding down inflation. At the end of last year, consumer prices were only 8.9 percent higher than a year earlier -- compared with rises of 12.4 and 13.3 percent during the two previous years. In December, the inflation rate was only about 5 percent. And the pattern of inflation rates during last year, while distorted by volatile factors like food prices and mortgage rates, showed a marked downward trend. With monetary discipline, we expect continued steady improvement on the inflation front.

International Economic Policy

This Administration's approach to international economic issues is also a direct reflection of our basic free-market orientation. We take this approach, not as ideologues, but as pragmatists. Our reading of history is that the market works, while attempts to circumvent or constrain it do not.

Free trade and investment have been major contributors to the successful economic recovery from World War II, and to the subsequent outstanding growth performance of both developed and developing nations. Over most of the postwar era, the U.S. was at the forefront of trade liberalization, and provided the major, comparatively unrestricted international capital market. Our large free capital market, the unrestrained use of our currency, and our low inflation rate during the first postwar decades, helped make the U.S. dollar the central currency of the international monetary system. As such, it was a source of stability in a rebuilding world.

This Administration's approach to international economic issues is straightforward and consistent. We believe private market activity -- free-flowing international trade and investment, and unrestricted private trade and investment within national economies -- is still the key to non-inflationary growth. We want continued forward movement on liberalizing international trade and investment. We want to avoid a trade war, but we would like other countries to do their part -- we are not planning on just a unilateral disarmament, but a general straightening up of the rules of the game and more uniform adherence to them. Within the framework of a liberal trading system, countries -- both developed and developing -- mold their own fate by choosing

whether or not to adopt economic policies which stimulate private savings and investment and foster non-inflationary growth. Domestically, our greatest contribution will be to make the U.S. economy and the U.S. dollar sources of strength and stability for the international economy once again. We are confident that we are taking the only route which can get this economy back on a sustained noninflationary growth path.

But many of our economic partners seem to be asking for something different.

The list of foreign complaints lengthened quite a bit during the last few weeks. The basic complaints are twofold. First, there is the complaint that our policy mix -- restrictive monetary policy combined with expansionary fiscal policy -- has driven up U.S. interest rates unnecessarily high. Other countries claim they are then caught in a dilemma: they must either jack up their interest rates to match ours, thereby postponing their economic recoveries and worsening already-record unemployment levels; or they must resign themselves to sharp currency depreciation. Their second complaint is that, having put them in this dilemma, we are making it worse by not intervening in foreign exchange markets. If only we would join them in concerted exchange market intervention, the argument goes, they would somehow be spared this difficult choice.

Because of our determination to pursue a steady policy course, I and others may sometimes appear deaf to this outcry from abroad. But we <u>do</u> listen, and we understand the frustrations of our European allies. We share their deep concern over the unemployment situation. But all the hand-wringing in the world would not make it possible to insulate Europe from economic reality. Nor is a panoply of govermental programs to cure this

or that problem the answer. We believe governments should get out of the way and let markets work. Other U.S. administrations, and governments in other countries, have often taken the opposite approach to each passing event: "Don't just stand there, do something!" Actions are prepared -- sometimes substantive, sometimes empty gestures -- to prevent market forces from operating. Ours is not a program of dramatic governmental activism based on wishful thinking, but one of consistently minimizing governmental interference in the interest of greater economic efficiency. We also are determined to provide a stable, predictable policy environment, rather than stop-go policies that make long-term business planning impossible. Stability is also desirable internationally. However, this cannot be achieved through artificial props or gimmicks, despite some claims to the contrary. It can only be achieved through better coordination of policies; that is, if all countries provide a better and more predictable policy environment.

Foreign Exchange Market Policy

Perhaps nowhere is this more obvious than in our approach to foreign exchange markets. Our policy is clear: we minimize intervention in foreign exchange markets, by restricting it to cases of serious disorder which disrupt the normal functioning of these markets.

We have two basic reasons for our policy. The first is that we do not believe any individual or government is capable of identifying what the correct level of an exchange rate should be. The second is that, historically, intervention to fix or manage exchange rates has been a failure.

Economists and exchange market analysts have plausible theories

about the main factors determining exchange rates in the long run. My own belief is that purchasing power parity should hold over sufficiently long periods. But in the short run, many different factors influence exchange rates, not all of which are measurable or obvious.

Exchange markets are large and breathtakingly efficient. With their tremendous worldwide volume -- sometimes estimated with ballpark figures like $40 to $50 billion in total turnover per day -- and the rapidity with which pertinent information becomes available to all market participants, it is difficult for any one market participant to gain any advantage over others. We can all read the ticker and call our friends. How can you outguess a market like that? Most of us would admit that nobody can do so consistently. Experience has demonstrated repeatedly that governments can't.

So in the short run, with everybody constantly digesting the most up-to-date information possible, what often ends up driving exchange rate movements is changing market expectations. While these are expectations about the future behavior of market fundamentals -- like interest rate differentials, inflation rates, or balance of payments developments -- they often bear no obvious relationship to what those fundamentals are doing right now. They may not even bear any relation to what the fundamentals *will* do in the future. After all, expectations can be wrong.

Thus it is that in recent years we have seen exchange rate movements apparently correlated with, and thus *seemingly* caused by, widely differing economic variables at differing points in time. In 1980, when the biggest economic news in town was the wild gyrations in U.S. money growth and interest rates, these

seemed to drive exchange rate movements.

But since then exchange rate movements have been all over the map with regard to particular economic variables. During most of 1981 the U.S. dollar was appreciating, in spite of contrary movements of international interest rate differentials. We sometimes inferred that pessimism over European economic performance was dominating -- concern over European resolve to fight inflation, concern over some persistently large current account deficits, and concern over overly rapid money growth and budget deficits in many countries -- but even this will always remain a conjecture. The Polish situation undoubtedly had a depressing impact on European currencies. And at times there seemed to be a kind of "Reagan euphoria" at work in favor of the dollar.

More recently, it would appear that the rebound in U.S. interest rates has driven up the dollar. But why has this factor only now begun to dominate again? Why not all those times last year when the interest rate differentials were moving against the United States?

Under these circumstances, perhaps it's fortunate that intervention in exchange markets has been so spectacularly unsuccessful. The major Western governments intervened frequently and massively during the late 1970s, but this did not prevent large and rapid exchange rate movements in the directions they were trying to avoid. Intervention in an effort to fix rates, or ranges for rates, does not prevent exchange rates from reaching the levels to which market forces were driving them. Even intervention to slow rate movements, by "leaning against the wind," presupposes much more knowledge of equilibrium rates (or, if you will, about the constancy of the wind's direction and strength)

than governments ever really have at their disposal.

The U.S. current account surplus of the past few years is now being held down by the dollar's appreciation over the last two years. As the U.S. begins recovering from the current recession, that surplus will disappear. Nevertheless, we expect that our strong non-inflationary economy will continue to be reflected in a strong dollar.

So that aspect of foreign complaints is not going to go away. Disciplined U.S. economies policies will always tend to produce a relatively strong dollar. If policies abroad appear weak and inflationary to market participants, market forces will cause currency depreciation.

But what about the other complaints, the ones about our unreasonably high interest rates? Doesn't the recent rebound in U.S. interest rates validate these complaints?

I think the impact of U.S. interest rates on foreign economies has been grossly exaggerated -- especially in cases where poor inflation performance abroad would have been forcing up foreign interest rates anyway.

That does not mean that we are indifferent to this rebound in U.S. interest rates. Quite the contrary! We are watching interest rate and money supply developments closely. Were the rebound to continue, it would be a serious threat to economic recovery.

But we are confident that interest rates will soon resume their downward course in line with the continuing reduction in the inflation rate, provided money growth remains under control. In recent months, you have all had to react to confusing signals from Washington. There has been a lot of controversy over the

budget. And I doubt that financial market participants have been certain how to interpret the recent acceleration of money growth. Extended periods of overly rapid money growth do run a substantial risk of reheating inflation and inflation expectations. But we think the Fed is already acting to bring money growth back in line with its targets, and we expect any concerns of this type will not last long.

Markets should become less skittish as they see that the Administration intends to stick to its strong anti-inflation policies, and that we will not change our basic policy approach to meet each hour's changing circumstances. A steady course, and continued improvement in our inflation performance, will bring declining interest rates.

Conclusion

This Administration arrived in Washington with high hopes and a strong commitment to free-market principles. Those hopes and commitments were regarded as idealistic and unrealistic by many observers. Sometimes it seemed as if nobody believed we would stick to our principles, and get our economic program enacted. Those doubts were misplaced.

And now, with our domestic program in place, and forward movement on our free-market-oriented agenda for dealing with international economic issues, some critics are predicting that our policies will never succeed. Given their track record, I consider that a strong endorsement for our approach. For most of us, experience during the Reagan Administration's first year should be telling us that the President's long-term program for economic recovery is here to stay.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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REMARKS OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE NATIONAL ASSOCIATION OF BOND LAWYERS
SEMINAR ON FEDERAL ARBITRAGE LAW
ATLANTA, GEORGIA

I appreciate this opportunity to discuss the Administration's concerns with recent developments in the tax-exempt bond market and our legislative proposal to place additional limits on tax-exempt financing for private purposes. I believe it is particularly appropriate and timely to address these matters before a gathering of bond lawyers for two reasons. First, you have the primary duty, acting as bond counsel for a prospective tax-exempt bond issue, to insure that the bond issue meets the requirements for income tax exemption. Second, your experience in practice makes you uniquely qualified to comment on the practical and other aspects of our legislative proposal.

I urge you also to consider, as objectively as you can, the policy ramifications of our proposal, and the effect of doing nothing to retard the growth of private purpose tax-exempt obligations. While the Treasury Department does not expect you to embrace all aspects of the proposal, we do expect your meaningful review; and we are most receptive to your comments and practical suggestions.

I would like to review some of the factors which have caused the Treasury Department to conclude that additional restrictions on tax-exempt bonds for private activities are needed. There has been a virtual explosion in the last five or six years in the issuance of private purpose tax-exempt bonds. This includes bonds issued for single family housing,

student loans, and private nonprofit hospitals and colleges as well as industrial development bonds. More than $25 billion were issued in 1981, up from $8.5 billion in 1976. Private purpose bonds accounted for 24 percent of the long term tax-exempt bond market in 1976, but rose to 48 percent in 1981. We estimate that 55 percent of the long term tax-exempt bonds sold in 1982 will be for private activities.

The largest growth has occurred in small issue IDB's, which allow virtually any business to obtain tax-exempt financing for land or depreciable property. Small issue IDB's marketed in 1981 were an estimated $10.5 billion of the total $25 billion of private purpose bonds. Small issues represented 20 percent of the entire long term tax-exempt market in 1981, as compared with only 4 percent in 1976. The estimated revenue loss to the Federal Treasury from small issue IDB's alone will be $1.65 billion in fiscal 1982 and will exceed $2.1 billion in fiscal 1983 unless additional restrictions are imposed. Moreover, we estimate that less than 15 percent of the new investments made in 1981 that were eligible for small issue IDB financing were in fact financed by that method. This means that the potential for future growth in the volume of small issue IDB's remains enormous.

The proliferation of private purpose tax-exempt obligations -- along with reduced demand by institutional investors and the tax rate reductions and other structural tax changes enacted in the Economic Recovery Tax Act -- has contributed to the significant narrowing of the difference in interest rates between tax-exempt and taxable bonds. While the tax-exempt rate has historically been about 65 to 75 percent of the taxable rate, tax-exempt bonds are now generally yielding approximately 80 to 85 percent of the taxable rate. In short, the relative advantage of tax-exempt financing has eroded significantly; and the projected future growth in private purpose bonds is expected to cause further damage.

It is argued that tax-exempt financing is a valuable tool that can be used by state and local governments to encourage the location of job-producing businesses in their communities. This argument may have had some merit in the past, when IDB financing was available in a limited number of localities. Now, however, IDB financing is available in virtually every locality and offers no <u>relative</u> incentive to induce new business location in a particular community.

Federal law presently requires no effort to demonstrate that a local public purpose is to be served as a prerequisite to tax-exempt financing for a private activity. In fact,

some issuing authorities reportedly have authorized tax-exempt bonds for facilities located outside of their own boundaries. State and local governments and bond authorities in many cases have acted as mere conduits to provide entry into the tax-exempt market for activities that would not merit direct governmental assistance at either the Federal or local level.

There has been a great deal of publicity about other alleged "abuses" of small issue IDB's. Much has been said about the unwarranted use of IDB financing for office buildings, fast food restaurants, recreational facilities, and massage parlors. While a person's definition of an "abuse" depends largely on the particular interests that the person wishes to protect, it is clear that exempt small issues have been used in ways that were not contemplated when Congress enacted the small issue exemption in 1968. The legislative history indicates that the small issue exemption was designed to allow tax-exempt financing for small businesses. However, small issue IDB's have been used extensively by the largest corporations in the country -- firms that are able to raise funds readily in capital markets without an interest subsidy from the Federal government. For example, one of the largest retailing chains in the country has used small issue IDB's to finance $240 million of facilities since 1976.

The expansion of private purpose tax-exempt bonds now threatens the financial well-being of the state and local governments that gave them birth. IDB's and other private purpose obligations compete for funds in the same market as bonds issued for essential public projects such as schools, roads and prisons. Thus, the erosion of the interest savings from the income tax exemption has increased significantly the interest costs incurred by state and local governments in financing essential public services. However, no single local government has any reason to limit its issuance of private purpose revenue bonds. All costs are borne directly or indirectly by the Federal government; and the jurisdiction's activities, viewed in isolation, will have little impact on the overall tax-exempt market.

The increasing volume of private purpose tax-exempt bonds has also caused mounting Federal revenue losses. We estimate that the total Federal revenue loss from private purpose tax-exempt bonds outstanding in fiscal year 1981 was $3.22 billion and will be $4.19 billion for fiscal 1982. The proliferation of tax-exempt bonds also has made them less efficient as subsidy mechanisms for private activities. Tax-exempt financing has often been criticized as an inefficient

subsidy. The revenue loss to the Federal Treasury from the income tax exemption exceeds the interest cost savings to users of the bond proceeds. For example, if we assume that an investor in the 40 percent bracket purchases a bond bearing interest at 70 percent of the taxable rate, the Treasury loses $1.33 for every $1.00 of interest savings to the bond user. This problem is exacerbated as tax-exempt rates grow closer to taxable rates and more of the benefit is siphoned off for investors.

It is also appropriate to reevaluate the current law relating to IDB's in view of the additional tax incentives for new capital investment provided by the Economic Recovery Tax Act. The Accelerated Cost Recovery System and the investment tax credit produce tax savings that are generally sufficient to offset the income tax liability attributable to investments in new equipment. When IDB financing is added to ACRS and the investment tax credit, however, the combined benefits not only offset the future income tax attributable to the equipment, but also reduce the tax on income from other investments. The resulting tax shelter or "negative tax" may cause a firm to make investments that would be economically unprofitable if the firm were subject to no income tax on its other assets. This duplication of tax benefits disrupts normal market forces and artificially diverts capital into investments that qualify for IDB financing.

Our legislative proposal, which generally applies to bonds issued in 1983 and thereafter, responds directly to the considerations I have outlined. First, we believe that tax-exempt financing should be limited to activities which merit the support of local communities, as evidenced by the local government's meaningful review of the project to be financed. We propose, therefore, to limit the tax exemption to bonds that are publicly approved by appropriate elected officials. In addition, for bonds issued in 1986 and thereafter, the state or local government would have to make a contribution or commitment on behalf of the bond-financed activity, such as a direct grant, provision of services, tax abatement, or guarantee. We think that it is reasonable and appropriate for the Federal government to require state and local governments to make political and financial commitments of this sort on behalf of the projects that receive the Federal interest subsidy.

Our proposal also requires businesses to choose between the use of accelerated cost recovery and IDB financing for depreciable property. Assets financed with IDB's would have to be depreciated under the straight-line method over the

extended recovery periods used for computing corporate earnings and profits, rather than by using the more advantageous ACRS rules. This will prevent an unwarranted duplication or "double dipping" of tax benefits and will prevent the distortions in capital resource allocation that otherwise could result. This will not cause all firms to elect against IDB's, particularly in the case of new or rapidly growing firms. It will only require firms to evaluate the competing tax benefits for each qualifying investment.

Small issue IDB's will be available only for businesses that have capital expenditures of less than $20 million over the 6-year period from 3 years before to 3 years after the issuance of the bonds. In addition, no single firm will be able to have over $10 million of IDB-financed facilities at any one time. These limitations will prevent the use of small issue IDB's by large corporations that have ready access to capital markets through other means. However, subject to the additional restrictions, small issue IDB's could be marketed as a part of a composite or umbrella bond issue.

We also are asking Congress to require bond issuers to report to the Treasury information concerning bonds that are issued, and to issue bonds only in registered form. The information reporting requirements are necessary to provide the Treasury Department with data concerning the volume and developing uses of tax-exempt financing for private activities. The registration requirement is essential to determine the ownership of private purpose bonds and to deter their use for "off the books" investments within the underground economy.

Finally, we are proposing to eliminate, in the case of private purpose bonds, the exceptions in the arbitrage rules that allow unlimited arbitrage profits to be earned on funds held during temporary construction periods and on reserve funds. The legislation also will provide that bond issuance costs may not be taken into account in determining yields for purposes of the arbitrage limitations. These changes are needed to insure that arbitrage profits are not used to provide additional, hidden benefits to bond issuers and users, and to make it clear that the costs of obtaining the Federal interest subsidy may not themselves be be recouped at the expense of the Treasury.

There are several other proposals now before the Congress to restrict small issue IDB's to particular types of business activities. Our proposal deals with all private

purpose bonds, not just small issues. While the recent growth in small issue IDB's has been the most dramatic, the growth in other private purpose tax-exempts has also been significant and will likely accelerate in the absence of additional restrictions. In addition, our proposal does not select particular types of business activities for preferred treatment. We believe that local communities, not the Federal government, should determine the kind of development activities that should be encouraged within their boundaries through the use of tax-exempt financing.

To reiterate, recent developments have convinced us that additional restrictions on private purpose tax-exempt bonds are needed. There is no truth, however, to reports or rumors to the effect that Treasury regards the current legislative proposal as a step toward the total elimination of industrial development bonds or other forms of tax-exempt finance. Nor do we relish the thought of disrupting the legitimate business activities of bond lawyers or underwriters, who have merely worked to obtain for their clients the full benefits provided by existing statutes. If the total elimination of tax-exempt financing were the Treasury's long-range objective, the best course of action at this time might be to do nothing until conditions in the tax-exempt market grow bad enough and the Federal revenue losses become large enough to make Congress and the state and local governments demand such a remedy.

To the contrary, our proposal accepts the fact that Congress generally has regarded tax-exempt financing as a desirable means of providing Federal assistance to certain activities. There is a growing consensus, however, that statutory changes are necessary if tax-exempt financing is to be retained as a subsidy mechanism. The additional limits that we propose should promote more prudent use of the Federal interest subsidy and help preserve the benefits of the program for those activities that are deemed to be the most deserving.

Thank you again for your attention. I would be happy to answer your questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
Friday, February 26, 1982

Contact: Marlin Fitzwater
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TREASURY ISSUES TAX EXPLANATIONS FOR PUBLIC COMMENT

The Treasury Department today issued general and technical explanations of the tax revisions and improved collection and enforcement proposals announced in the President's State of the Union Message.

The explanations cover: completed contract accounting, business energy credits, tax-exempt revenue bonds, modified coinsurance, construction period interest and taxes, corporate minimum tax, withholding on dividends and interest, corporate tax payment acceleration, and IRS enforcement staffing.

The Treasury Department invites comment by the public, business and Congress regarding the impact of the proposals, particularly the impact of the corporate minimum tax on business investment decisions, and the cost of implementing withholding on dividends and interest. Formal legislation on each of the tax proposals will be submitted to Congress in the near future.

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TESTIMONY OF

Marc E. Leland
Assistant Secretary, International Affairs
Department of The Treasury

Before The
Subcommittee for International Trade
Senate Finance Committee

March 1, 1982

Mr. Chairman, I appreciate the opportunity to present the Department of the Treasury's views before your subcommittee on the subject of the GATT Ministerial. Treasury has taken a strong interest in this initiative, and supports the work program outlined in Trade Representative Brock's testimony.

The Treasury Department considers the GATT Ministerial particularly important at this time when national and international economic problems threaten to bury the concept of free trade once and for all. Unless we move forward and liberalize markets, governments will slip back into protectionism. That is especially true today.

The world's leaders will be meeting in several different fora this year to discuss the vital international economic

issues of importance to the international community. In April the Interim and Development Committees of the IMF will meet. In May the OECD will hold its annual Ministerial meeting. In June President Reagan and other national leaders will hold an economic summit in Versailles.

At all of those meetings, trade issues will be a major item of discussion. The GATT Ministerial, coming in November after these other high-level economic gatherings, offers an excellent opportunity to synthesize the earlier discussions and reach agreement multilaterally on how trade problems should be addressed.

The Economic Landscape

We are faced today with serious economic and social problems. Record high rates of unemployemnt and weak economic growth worldwide are encouraging protectionist pressures which threaten the stability of the international economic system, and may weaken or destroy the trade-liberalizing achievements of the Tokyo Round of Multilateral Trade Negotiations. Increasingly, the voices in support of free trade have been drowned out by calls for new or increased barriers to trade. These include the traditional imposition of barriers at the border, such as tariffs and quotas, as well as barriers such as export performance requirements, voluntary export restraints and subsidized export credits. In the U.S., the principle of "reciprocity" has received increasing attention. Strict application of this concept, especially on a sectoral level, has the danger of resulting

in higher U.S. barriers to trade, and retaliation against U.S. exports, to the detriment of all.

The U.S. Perspective

Retaining as open a market as possible, both here and abroad, is critical for the U.S. economy. Trade benefits national welfare by promoting the efficient allocation of resources, lowering costs, increasing competitive pressures, providing consumers with a wider choice of goods and services, and, in the export sector, increasing U.S. production and employment. A turn toward protectionism, here or abroad, would weaken the U.S. economy. In particular, it would dangerously threaten the President's Recovery Program, which aims to reduce the level of government involvement in the economy, encourage market allocation of the factors of production, increase investment and reduce the level of inflation.

As Ambassador Brock has outlined, the United States is asking the Ministers to adopt an ambitious work program for trade liberalization which includes negotiations in certain areas (such as safeguards) and preparatory work, possibly leading to negotiations, in other areas. This program has apparently worried many of our trading partners, who would prefer to digest the results of the Tokyo Round before advancing new initiatives in the GATT. We should not allow the reticence of other countries to stand in the way of the U.S. pursuing this work program. There is a danger that, without a positive program, protectionist forces will claim the field.

Another concern is that for certain trade-related international activities the present rules, including the new agreements made in the Tokyo Round, do not apply, or apply only in certain cases. Treasury has a keen interest in reducing current barriers to international financial services, especially with regard to banking and securities. A particular concern of the Treasury Department has been the lack of a comprehensive framework of rules and agreements in the investment area.

Investment

While international institutions and laws have been developed for virtually every other area -- trade, monetary policy -- there are none in the investment area. The U.S. Government believes that there is a serious need to correct this deficiency.

There are a number of reasons for this omission:

-- During the post-war period, when international institutions such as the IMF and the GATT were created, international investment was not an important issue. In fact, capital controls were viewed as preferable to trade restrictions and were applied by most countries.

-- The types of international investment have changed from passive portfolio investments to active direct investments. For example, the proliferation of multinational corporations (MNCs) is a phenomenon of the 1960's.

-- It is also difficult to determine what role international investment plays both with regard to the international system and individual countries.

These conditions have certainly changed. The level of foreign investment and the number of countries participating, both as sources of and hosts to foreign investment, has increased dramatically. For example, U.S. direct investment abroad increased by 1600 percent from 1950 to 1980, and at year end 1980, the stock of U.S direct investment abroad was equal to $213 billion. Global direct investment at the end of 1980 is estimated to have reached between $450 billion and $530 billion.

A recent OECD study is also indicative of the increased activity of countries in this area. While the U.S. is still the major source country for foreign direct investment, data prepared by the OECD reveals that its share of total direct investment flows of the 13 largest OECD countries decreased from 60 percent in the mid-1960's to about 35 percent in the late 1970's.

Foreign direct investment also has significant effects on our balance of payments. In 1980, income earned on U.S. direct investment abroad was equal to roughly $38 billion.

Most governments would also now agree that foreign investment is an extremely important issue. For example, a review of investment measures such as performance requirements is a high priority on the OECD's agenda for the 1980's.

Government Intervention

The importance governments attach to foreign investment has also been displayed in a much more disturbing manner -- that is through a proliferation of sophisticated national measures

which are designed to manipulate foreign direct investment flows. Governments have become exceedingly active players in attempting to maximize the flow of foreign direct investment to their economies and to control or influence that investment so that it supports their national economic or social goals

These national measures may take various forms ranging from incentives for attracting prospective foreign investors to the imposition of preconditions, often onerous, for approval of foreign investments. These conditions may cover such diverse areas as ownership, technology transfer, market prohibitions and a host of performance requirements relating to areas such as job creation, local content, and exports. Both the incentives offered to and conditions placed on foreign investors may be applied universally or on a selective sector or industry basis. Often incentives offered to and conditions imposed on foreign investors are linked in a "carrot and stick" fashion so that foreign investors are given some inducement to comply with conditions that would be too onerous in isolation. Most of these measures discriminate as between foreign and domestic investment and most result in a distortion of capital, often trade flows, and lead to mis-allocations of domestic resources.

These discriminatory and restrictive national investment measures are applied by developed and developing countries alike; and the rationale for their use varies between countries. Some countries are motivated by a need to develop their economy

generally or to support certain sectors or regions. Others are motivated by nationalism, balance of payment, or employment concerns. Visible country examples include: Canada, France, Australia. Mexico. and Brazil; but there are others.

Past and Current Approaches

The basic objective of the U.S. Government with regard to these practices has been to work in various fora to develop some discipline on the use of these measures. We have taken every opportunity to express our concerns regarding these practices bilaterally and in multilateral institutions such as the OECD, the GATT, the UN, and the World Bank. The U.S. Government recently entered into Article XXII consultations in the GATT with the Government of Canada regarding their Foreign Investment Review Agency (FIRA) screening practices, and the conditions they apply to foreign investment in Canada.

Through the U.S.-Mexico Joint Commission on Trade and Commerce, the U.S. Government plans to discuss with the GOM conditions they apply to foreign investment in autos, pharmaceuticals, and proposed conditions on foreign investment in the computer sector.

We also initiated in September of 1981 consultations with the Government of France regarding the national measures they apply to foreign investment. Those consultations are continuing.

The U.S. Government has also pursued this basic objective vigorously in multilateral institutions. In the OECD we

succeeded along with other member countries in negotiating an investment package covering national treatment, incentives and disincentives, and the behavior of MNCs. This effort led to an OECD Declaration in 1976 that signatory countries would provide national treatment to foriegn investments of member countries. This Declaration was reaffirmed in 1979, and the U.S. and other governments are pressing for an extension of this principle. Work is also proceeding in several OECD Committees on the implications for trade and investment flows of national investment incentives and performance requirements.

In the GATT, at the March and September 1981 meetings of the CG-18 the U.S. Government proposed that the GATT undertake a systematic study of trade-related investment performance requirements and incentives, starting with development of an exhaustive listing of these measures comparable to the NTB inventory developed for the Tokyo Round negotiations. We plan, as Ambassador Brock noted in his testimony, to request at the GATT Ministerial that this be included in a GATT work program on investment.

In the World Bank/IMF the U.S. and other developed and developing countries joined in a 1979-80 Joint Development Committee task force to analyze investment incentives and performance requirements. Subsequent to that effort, the U.S. and other countries requested that the Bank initiate a detailed study of these measures to determine their impact on trade and investment flows. The IFC has begun such a study and expects to complete it by February of next year.

U.S. Government Proposals for Future Work

While the U.S. Government is pleased that the OECD and the Bank are working on these issues, we also beleive that more can and should be done regarding investment. Present efforts in the OECD, the World Bank and other fora should continue. There is, however, a strong need for this issue to be taken up by the GATT and perhaps other institutions. Our ultimate objective in pressing for such work is to develop in a multilateral setting or settings "rules of the road" for foreign direct investment. The current OECD Declaration on national treatment and the Code of Capital Movements represent important commitments of OECD governments to open investment principles, but the Declaration is not binding and neither includes developing countries.

We are working internally to develop proposals on investment to present to the GATT Ministerial and perhaps elsewhere. At a minimum, we want to arrive at a concensus to begin to address these issues internationally in a serious, analytical manner and to determine whether existing rules apply. We may also wish to develop either within existing or potentially new mechanisms, how rules relating to discriminatory national investment practices could be established. In addition to trade-related performance requirements, other items we may wish to include are issues relating to:

-- right of establishment and national treatment, including screening mechanisms and equity participation requirements;

-- investor protection, nationalization, compensation, and dispute settlement; and

-- transfer of capital, and information disclosure.

We are serious about this effort and hope to conclude our internal work soon.

In the absence of some generally agreed upon rules relating to investment, the increased use of discriminatory and restrictive investment measures by governments will seriously threaten the international economic system. It's clear that the use of these measures is increasing and will become even more important as the reductions in tariff and non-tariff barriers negotiated in the Tokyo Round are implemented.

I should underscore that the basic concept of developing rules for foreign investment is not new. Other countries are aware of our concerns in this area. The U.S. has been discussing this general concept and our concerns with specific issues relating to investment for a number of years. Past work in the OECD and the Bank/Fund reflect those concerns.

We can, however, expect opposition to any U.S. investment initiative. For many countries these measures are considered an integral component of their overall development plans or their industrial policies. As such an attack on these investment practices may may be viewed as an attack on these general economic policies.

This should, however, not deter us in this effort. The U.S. Government should be prepared at the same time to take appropriate action against selective national measures which

discrminate against U.S. investment and distort U.S. trade and investment flows.

In taking such selective actions we must be careful, however, that those actions:

-- don't do significant and potentially more damage to U.S. interests;

-- that they will help promote removal of egregious practices by other countries; and

-- that hey don't lead to a recursive pattern of protectionist reactions that will damage the international framework.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Immediate Release
March 1, 1982

Contact: Stephen Hayes
566-2041

Deputy Secretary McNamar Says Administration
will Hold Steady Course

Deputy Treasury Secretary R.T. McNamar today stated that the Administration intends to resist the pressure for short-run, quick-fix attempts at solving the nation's economic problems.

In addressing the annual meeting in Washington of the Association for Advanced Life Underwriting, Mr. McNamar said, "What is needed now is political courage -- a very scarce commodity in this town. There is a time to change and a time to remain resolute."

"This is the time to remain resolute in favor of sound long-term economic policies and to reject the irresponsible short-term political expediency, and the too often irresistable urge to do something new -- even if it is wrong," he said.

"Dramatic progress has been made on the inflation front, for example. Consumer price increases -- measured December over December -- fell from 12.4 percent in 1980 to 8.9 percent last year. By the final quarter of 1981, this inflation measure had further slowed to a 5.3 percent annual rate," he said.

"Producer price increases peaked early in 1980, and have fallen dramatically since early this year. For example, producer prices on intermediate goods rose at a 12.6 percent rate for all of 1980, but slowed to only a 2.5 percent annual rate in the last quarter of 1981," he said.

"Equally important, we have recently witnessed the first decline in the rate of wage inflation in a number of years. From

a high of 9.3 percent in 1980, the hourly earnings index for production work hours slowed to an 8.9 percent rate in the first half of 1981. A further drop to 7.5 percent in the second half of last year culminated in an increase of only 0.1 percent last month," he said.

"While inflation and interest rates have been declining, there can be no doubt that the economy is performing poorly. Although, unemployment fell to 8.5 percent in January, it may yet go to 10 percent before we get things turned around. Don't be surprised. We'll have poor economic numbers reported through April.

"In fact, the current downturn will be far worse than envisioned in our earlier scenarios. You can attribute that mainly to two things. First, due to uncertainty engendered by concern over Federal deficits and whether these would again be monetized by the Fed, interest rates have stayed high months longer than expected.

"Second, the first round of personal tax cuts was delayed until October 1 and reduced from 10 percent to only 5 percent. That amounts to only 1.25 percent for all of 1981. In fact, bracket creep and social security tax increases actually produced a $15 billion tax increase in 1981 despite the 5 percent cut. We have prevented even larger inflation-induced tax increases. Yet with all the Washington rhetoric we have not yet had a major tax cut. It finally comes in July 1982. In fact, as the recovery is starting, consumers will have almost $30 billion of additional disposable income," he said.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

March 1, 1982

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 4,807 million of 13-week bills and for $4,801 million of 26-week bills, both to be issued on March 4, 1982, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 3, 1982			26-week bills maturing September 2, 1982		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	96.876 a/	12.359%	12.93%	93.580	12.699%	13.76%
Low	96.848	12.469%	13.05%	93.527	12.804%	13.88%
Average	96.853	12.450%	13.03%	93.536	12.786% 2/	13.86%

a/ Excepting 3 tenders totaling $5,600,000.

Tenders at the low price for the 13-week bills were allotted 97%.
Tenders at the low price for the 26-week bills were allotted 45%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 66,485	$ 61,985	$ 93,610	$ 46,860
New York	7,898,910	3,609,460	9,599,575	4,044,485
Philadelphia	37,415	37,415	26,920	20,420
Cleveland	96,430	96,430	65,415	51,415
Richmond	42,325	42,325	69,365	50,365
Atlanta	54,460	54,460	79,140	49,340
Chicago	733,295	356,795	588,335	100,335
St. Louis	27,910	27,910	52,050	25,050
Minneapolis	28,340	28,250	55,735	22,735
Kansas City	42,500	42,500	41,945	41,945
Dallas	28,420	28,420	21,720	16,720
San Francisco	593,000	196,495	792,765	73,470
Treasury	224,085	224,085	258,305	258,305
TOTALS	$9,873,575	$4,806,530	$11,744,880	$4,801,445
Type				
Competitive	$7,691,100	$2,824,055	$ 9,296,565	$2,553,130
Noncompetitive	1,035,790	1,035,790	893,715	893,715
Subtotal, Public	$8,726,890	$3,859,845	$10,190,280	$3,446,845
Federal Reserve	1,092,885	892,885	1,000,000	800,000
Foreign Official Institutions	53,800	53,800	554,600	554,600
TOTALS	$9,873,575	$4,806,530	$11,744,880	$4,801,445

1/ Equivalent coupon-issue yield.
2/ The four-week average for calculating the maximum interest rate payable on money market certificates is 13.443%.

R-651

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 9:00 A.M. EST

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS
March 2, 1982

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). As you know, I appeared before the Senate Finance Committee and the House Ways and Means Subcommittee on Oversight last December and discussed in great detail the purpose and design of the leasing rules. I have brought with me a copy of that testimony and I request that it be entered in the record of this proceeding.

I will not repeat everything that I said in my earlier testimony, but I would like to reemphasize certain fundamental points about leasing in general, and as it may apply to small business in particular. At the outset, I would like to make it absolutely clear that we stand firm in our conviction that leasing is a necessary part of the President's tax program. We recognize that we have an uphill battle in educating the public on the merits of leasing, and we certainly welcome this opportunity to appear before you today to explain the purpose for the rules and to answer any questions you may have.

Background

As I indicated, the leasing rules are an integral part of the President's tax program to restore economic growth. Every lease is associated with spending for new equipment and much of this spending would not have otherwise occurred. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

"Safe harbor" leasing allows all companies, large and small, full access to the incentives in the recent tax bill for making new investments. Without these rules, there will be unequal competition for funds, new companies will face additional financial barriers, and there will be increased pressure for tax-motivated mergers and takeovers. Moreover, as I will discuss hereafter, we expect any additional financial burdens that would arise in the absence of leasing to fall heavily on small business.

The Investment Incentives of ERTA

To see the need for leasing, the operation of the investment incentives of ERTA must be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. The acceleration of deductions effectively lowers the cost of buying new equipment and thereby raises the after-tax rate of return on that investment.

This increase in the after-tax return is the primary investment incentive of the President's tax program. A problem arises, however, when these accelerated deductions become available at a time when the new equipment is producing little income. In that case, the deductions will serve their purpose only if they can be used to offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to a firm that is able to use them, the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans; and firms

with temporary losses, but profitable investment opportunities. Additionally, the more rapid write-offs for cost recovery under ACRS will moderately increase the number of currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

How Leasing Works

As an illustration of how a company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco, making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed to claim deductions under ACRS of $37,000 and an investment credit of $10,000. To use all of these tax benefits, Newco would need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from other assets, Newco would have to postpone using some or all of the ACRS benefit, which, in turn, may make Newco's after-tax return on the new investment less than that of its competitors. Stated otherwise, Newco's return from that investment would be lower than that of corporations which, for various reasons unrelated to the investment, may be able to use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms like Newco to invest in new equipment even though their investments have not yet produced large profits. With leasing, Newco has the option of retaining the ACRS deductions and credits, or it may sell the tax benefits associated with the equipment to another corporation. This allows Newco to use the equipment in its business and, at the same time, permits it to enjoy the benefits of the investment credit and accelerated deductions.

There are three important aspects of leasing which should be borne in mind. First, leasing creates no extra deductions or credits. The total deductions and credits taken by both parties to a lease transaction are the same as would have been taken if Newco had taxable income from other investments. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative (but much less desirable) way to accomplish the same result would be by an actual merger of Newco with a mature company wishing to reduce its tax liability.

Second, virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, in our case, Newco. This is because the purchasing company, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for the tax benefits is becoming very competitive. From our preliminary analysis of a small sample of sale and leaseback transactions closed in 1981, we have found that a high percentage of the tax benefits from leased property are being passed through to lessees. This percentage should increase as safe harbor leases become routine market transactions.

This is an important point because it means that the investment incentive inherent in ACRS remains where it should be, namely, in the hands of the firm that will undertake the new investment and employ the new equipment. Although the purchasing company claims the credits and ACRS deductions on its tax return, it pays for those credits and deductions. With this payment, and the tax saving from the excess of its rental payments over its interest receipts from the purchasing company, Newco can ultimately receive virtually all the benefits of ACRS.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not foster uneconomical or tax-motivated investments. Even with the lease agreement, Newco makes a substantial investment in the asset, and the income that asset generates will be taxed. Unless the asset produces sufficient income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as is provided to firms with taxable income. With those incentives equally available, firms are able to select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Leasing and Small Business

We are well aware of the various bills that have been introduced to repeal the leasing provisions. We are also mindful of the size of the projected budget deficits and the thought that a repeal of leasing would help to alleviate that deficit. While the repeal of leasing would reduce the

revenue loss in the short run, we believe that in the longer term, its repeal would do much to undercut the investment incentives adopted by the Congress last year as part of ERTA. As a result, investment in new plant and equipment would decline with a concommitant reduction in economic activity. If leasing is repealed, we expect much of the impact would fall on small business.

As I mentioned earlier, leasing is intended to help those firms which cannot fully utilize the tax benefits associated with new investments in plant and equipment. A typical firm in this category would include a new firm or a firm which does not have sufficient income from other assets to absorb the tax benefits. Firms in these categories are usually smaller companies. The ability of these firms to sell their tax benefits is an important source of financing, particularly in these times of tight money and high interest rates. This is especially important for small businesses because they typically finance their operations from current earnings or from borrowings, and tend to rely less on equity financing.

Thus, in relative terms, the retention and utilization of safe harbor leasing is at least as important to small companies as it is to larger ones. In this connection, while most of the attention on leasing has been on the reported transactions that have thus far been closed between large companies, we do not think that this is indicative of the entire class of companies that have or will benefit from leasing.

We understand from informal discussions with investment bankers and lawyers that because of the November 13, 1981 deadline for closing initial transactions, and because of the newness of the legislation, many brokers refused to consider small leases. The complexities of the legislation and the transactions made closing costs high and small leases uneconomical. However, we now understand that as the leasing industry becomes more familiar with the rules and the lease documents become standardized, lease brokers are turning their attention to smaller leases. This should make leasing available to all companies on an equal basis.

In addition, the information we have gleaned from the lease information returns indicates that many smaller companies have been able to use the leasing rules effectively even without the aid or assistance of large professional brokers and investment bankers. The nearly 16,500 lease information returns filed with the IRS through the beginning of last week represent an estimated 14,500 lease

transactions. (Some transactions, particularly the large ones, involve multiple leases.) Of these transactions, fewer than 500 represent agreements involving property worth more than $1 million. The remaining 14,000 transactions, or over 95 percent of the total, cover property worth less than $1 million. Most of these smaller transactions cover property worth less than $100,000, and involve "straight" or "leveraged" leases, that is, leases in which the lessee does not "sell" the property to the lessor.

We have not yet analyzed the data we have received on straight lease transactions, but we anticipate that the same positive benefits would flow to a user of equipment in those types of transactions that we are finding under a sale and leaseback arrangement. Many small companies lease their typewriters, copying machines, office furniture, automobiles, etc. Before safe harbor leasing, the savings realized by these companies through leasing versus buying the equipment depended in large part on the uncertain value of the property at the end of the lease term. By eliminating the need to take the value of the residual into account, the safe harbor rules have made leasing more efficient. As a result, more of the benefits of leasing should pass through to the users of the equipment. Note that many such leases would have taken place in the absence of the safe harbor rules, but would have been less beneficial to the lessees.

As I noted earlier, we have completed a preliminary analysis of a small number of sale and leaseback transactions. Our analysis indicates that about 88 percent of the tax benefits of leased property are being passed through to, or retained by, the users of the equipment. Although this sample is too small to generalize, and does not include any straight leases, it does indicate that the percentage of benefits passed through are about the same regardless of the size of the lease. Further, the benefits appear to pass through fairly uniformly over industries.

We are currently analyzing the remaining lease information returns and should be able to provide the Committee with additional data on the effect of leasing on small business within the next few weeks.

Leasing and the "At Risk" Rules

Before concluding my remarks, I would like to comment on one aspect of the leasing regulations that has drawn criticism from some small business groups, namely, the application of the "at risk" rules to leasing transactions.

Code section 465 limits the amount of losses that certain closely held companies may deduct with respect to an activity to the extent of the amount they have at risk in that activity. The concept of at risk was introduced in the Tax Reform Act of 1976. It was basically a measure to restrict tax shelters by altering the timing of deductions, so that a taxpayer could not claim deductions in excess of the amount of cash and recourse debt that he had invested in an activity at the end of any year. At risk has nothing to do with the calculation of deductions; it affects the timing of deductions by matching them dollar for dollar with the taxpayer's investment. As his investment increases, a taxpayer is allowed to claim excess deductions that have been suspended from earlier years when his investment was small.

Individuals, subchapter S corporations, and closely held businesses (in which five or fewer individuals own at least 50 percent of the stock) are subject to at risk. At risk now applies to all activities, including leasing of depreciable property. Leasing companies that meet certain requirements as to the volume of their business are exempt from at risk. In general, companies that enter into safe harbor leases will not qualify for this special exception.

The Economic Recovery Tax Act of 1981 extended the at risk rules to the investment tax credit. Although the at risk amount for the investment tax credit is separate from the at risk amount for ACRS and other deductions, it is similarly measured by the cash and recourse debt with which the property has been financed.

A taxpayer's amount at risk includes cash investments and recourse debt, as long as these amounts are not guaranteed against loss or borrowed from a related person or a person who has an interest in the activity other than as a creditor. Nonrecourse debt is counted in the at risk amount only as it is paid off.

Except in the case of a subchapter S corporation or a personal holding company, the new leasing rules do not expressly prevent closely held companies from engaging in leasing transactions. However, the regulations do provide that the at risk rules apply in determining the amount of deductions and credits a purchaser of tax benefits, i.e., a lessor, may claim. Because of these rules, any safe harbor lessee or lessor that is subject to the at risk rules will have restrictions placed on the timing of both the ACRS deductions and the investment credit that are generated by the lease. This means that some closely held companies may

be effectively excluded from safe-harbor leasing by operation of the at risk rules.

In a speech I delivered last October, I indicated that the at risk rules may not apply to closely held lessors in safe harbor leasing transactions. In developing the regulations, however, we concluded that the leasing regulations could not add an exception to the at risk statute without express statutory authority.

Various people representing the small business community have suggested that the leasing provisions should be amended to relax the at risk restrictions as they apply to safe harbor leasing transactions. With respect to the application of the at risk rules to the activity of the user of equipment, i.e., the lessee, we would strongly oppose any amendment which would exempt a lessee from at risk if it would otherwise be subject to those rules. Closely held businesses that are lessees should not be able to pass through the fully accelerated effect of ACRS deductions on the leased property or the full credit in the first year of the lease if the lessee would have been otherwise precluded from claiming the deductions and credit on its own return by virtue of the at risk rules. The effect of such an amendment would be to emasculate the at risk rules altogether.

A relaxation of the at risk rules as they apply to lessors in leasing transactions, however, involves different considerations. Initially, we question the need for such an amendment.

The cash flow generated by the accelerated write-offs and credits allowed under ACRS are intended to stimulate investment by reducing a firm's effective cost of capital. The incentive is lost, however, where a firm has no positive tax base against which it may use the tax benefits. Leasing is intended to restore that incentive in those cases by allowing a company to sell the tax benefits with respect to a new investment in equipment. While it is true that a lessor will presumably earn a positive return from investing in a leasing transaction, that return should be no more than that available elsewhere. The real beneficiaries of the new leasing rules are (and should be) the lessees, that is, the users of equipment which are selling the tax benefits. To that end, closely held companies are not disadvantaged by the regulations. Under the statute, anyone may be a lessee, including individuals. Although the at risk rules are applicable to lessees as well, this should not be a significant problem since we would expect most lessees which are small businesses will be at risk in their investments anyway.

Moreover, any profit earned by a lessor on a leasing transaction is payment to the lessor for advancing the money to the lessee for the ACRS deductions and credits to which the lessee was otherwise entitled. The effective exclusion of closely held companies as lessors discriminates in favor of large companies only to the extent that large companies have an additional investment option available to them. It certainly does not mean that closely held companies are denied the benefits of leasing.

It has been suggested that an amendment to ease the at risk rules is needed because small companies will only deal with other small companies. Thus, if small companies are prevented from entering leasing transactions as purchasers of tax benefits, many small companies as sellers of tax benefits will be unable to take advantage of the leasing provisions.

We question whether there is any natural hesitancy on the part of small companies to deal with large companies in a leasing transaction. Moreover, as I have indicated, we fully expect that lease brokers will be able to package the leasing of equipment to make the leasing of small amounts of equipment attractive to large companies.

On the other hand, we would agree that since the leasing provisions are market-oriented, there is no reason to curtail the universe of potential lessors by discriminating among corporations that are allowed to be lessors. Also, we are satisfied that there are sufficient safeguards within the leasing rules that a change in the at risk rules as they apply to lessors would not open any abuse the at risk rules were intended to prevent. At risk was intended principally to prevent individuals, partnerships, and closely held companies from artificially overstating the depreciable basis of their assets through the use of nonrecourse debt. It would not be possible to circumvent this purpose through a leasing transaction as long as the lessee continues to remain subject to at risk. This is because the timing and amount of the lessor's deductions may not exceed the deductions and credits that would be available to the lessee had the lessee not entered the lease in the first place.

Although we have doubts that an amendment to relax the at risk rules as they apply to lessors would have any appreciable affect on the benefits of leasing flowing to small companies, we would not oppose carefully developed legislation along those lines. However, before giving our approval to any such amendment, we would want to take a close look at the proposal as there may be special circumstances where we would not want the at risk rules modified.

Summary

It is not surprising that the celebrated leasing transactions have been those involving large, well-known corporations. These make news. But the safe harbor provision is especially important to the growth and continued independence of small businesses. Small businesses are already using the provision and many more will benefit from it, if the Congress does not overreact to publicity from a few unusual cases.

TREASURY NEWS

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<u>For Release Upon Delivery</u>
Expected at 2:00 p.m. EST

STATEMENT OF
J. GREGORY BALLENTINE
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
March 2, 1982

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear before you today to discuss S. 1887. This bill would allow a $300 refundable income tax credit to a domestic manufacturer for each automobile manufactured, beginning with model year 1984, on which an automatic safety airbag has been installed. In addition, a $300 excise tax would be imposed on the sale or first lease by a manufacturer, producer, or importer of an automobile on which an airbag has not been installed.

The Treasury Department is opposed to the enactment of S. 1887.

Airbags are a useful device and there is considerable evidence that they significantly reduce the probability of serious injury in frontal collisions. However, the principal beneficiaries of this increased safety would be the purchasers of new automobiles and their passengers. We believe it is appropriate that these potential buyers bear the real resource cost of acquiring the additional safety provided by airbags. S. 1887 hides much of this cost from potential buyers, imposing the cost on all taxpayers, whether new car buyers or not.

We recognize that there are valid arguments for some government intervention to promote the manufacture and use of some technologies that protect drivers and passengers from the effects of automobile accidents. We do not believe, however, it appropriate to use the tax system as proposed in this bill to subsidize the installation of airbags.

Over the next several years, it is unlikely that significant numbers of airbags would be installed, even if S. 1887 were enacted. The effects of S. 1887, in the short run, therefore, would be equivalent to imposing an excise tax on new automobiles. Such a tax would cause additional damage to the already depressed domestic automobile industry, and would be counter to the Administration's policy of lowering the tax burden on the American public. In this regard, our estimates indicate that the net effect of S. 1887 would be to raise $2.2 billion in revenue in Fiscal 1984.

In the long run, S. 1887 will encourage more installation of airbags by subsidizing a portion of their cost. It will do so, however, only by imposing a short term burden on the already beleaguered automobile industry and by forcing taxpayers in general to pay for safety devices which primarily benefit owners of new cars.

Revenue Estimate S. 1887

Airbag Excise Tax

($ billions)

	Fiscal Years			
	1984	1985	1986	1987
Excise on cars without airbags	2.8	2.9	3.1	3.2
Excise offset	0.6	0.8	0.8	0.8
Income credit for cars with bags	*	*	0.1	0.1
Total receipts effect	2.2	2.1	- 2.2	2.2

Office of the Secretary of the Treasury
Office of Tax Analysis

March 1, 1982

*Less than $50 million.

TREASURY NEWS

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File

REMARKS PREPARED FOR DELIVERY BY
THE HONORABLE R. T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
TO THE 25th ANNUAL MEETING
OF THE
ASSOCIATION FOR ADVANCED LIFE UNDERWRITING
WASHINGTON, D.C.
MARCH 1, 1982

It's an auspicious time to be here. It's been just over a year since President Reagan's inauguration and a lot has happened in that year. So much has happened, in fact, that it's hard to believe that the economic report and budget released recently are the first submitted by this Administration.

That's right, I said the first. After a year of budget battles, tax cuts, economic swings, and in another first, an actual shut-down of the Federal government for a day, I know that doesn't seem right. Nonetheless, it's true. All of that effort was devoted to undoing the excesses and bloated spending of the last ten years, and to reversing a lot of adverse trends that were a long time in the making.

The pace has been so frantic at times, that it's difficult to keep in mind the broader perspective of where we came from -- why we're in office -- and just where it is that we're going.

As I know you have heard it said before, "when you're up to your ass in alligators, it's hard to remember that your original objective was to drain the swamp!" Nowhere is that more true than in swampy Washington.

Today, then I would like to step back and regain some of that perspective -- talk about the problems we were elected to solve -- what we've done about them -- and where we go from here.

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The Problem

Specifically, let's examine the legacy of rapid and inconsistent monetary growth, stop-and-go fiscal policies, spending commitment piled upon spending commitment, and the constant growth in federal revenue caused by inflation and a counterproductive corporate and personal tax system.

The inflation rate as measured by the CPI almost tripled in four years to over 12 percent on a quarterly basis in 1980. Federal spending rose from $270 billion in 1974 to $660 billion in FY 81 and now claims 23 percent of GNP -- almost one dollar in every four generated by our massive economy.

Unfortunately, during this period not all the trends were rising. Productivity, for example, has long been in a major decline. The rate of productivity growth decreased from an annual average of 3.1 percent during the first 20-years after World War II to 0.7 percent in the 1973-80 period. And American jobs and investment went overseas as a result.

Real GNP growth, after averaging 4.2 percent in the 1960's, dropped to 3.2 percent in the 1970's, and plunged to minus 0.2 percent in 1980.

What we've been witnessing was a sort of slow, strangulating death of economic activity and productivity in this country -- continuing through both Democratic and Republican Administrations. Against this backdrop, the roller coaster events of the past two years take on a new perspective.

Academic economists define a recession as two successive quarters of real GNP decline. With this definition in hand they will record a sharp recession -- almost a collapse -- in 1980, followed by a brief recovery in late 1980 and early 1981, followed by the recession that we are in today.

My message is this: on taking office, the Reagan Administration inherited an economic situation that could be described as dismal.

Frankly, this is a mess that was so long in the making that it will be more than days, or weeks, or months, in the mending. But what we are trying to do is to re-define the relationship between the public and the private sectors and -- for a change -- redefine it in favor of the private sector.

And we want to redefine the roles of Federal, State and local governments -- for a change in favor of State and local governments. In short, we want to establish a long-term framework for the future of our economy and political system.

The President's Program for Economic Recovery

Let me briefly summarize the program at this point, then give you some idea of its current status and of the outlook for the future.

The program is composed of four carefully integrated parts which, if consistently implemented by Congress will ameliorate inflation, reduce the size of the federal government, and restore the kind of real economic growth that will benefit everyone from investor to industrialist, consumer to corporation, and hard hat to housewife.

The first element of the program is a non-inflationary monetary policy. And let's be clear, the Administration and the Fed are in full agreement about their announced monetary objectives.

However, when the Fed has been below their own announced targets, as they have been for considerable periods of time, we've suggested that they could speed up. And by the same token, during those periods when the money supply has grown faster than the Fed's own targets, we've suggested a slowing down. This is the "criticism of the Fed" you have and will continue to read about.

But what we want -- and what the Fed wants -- is a slow steady growth in the money supply. That will allow real GNP to grow without rekindling inflation. At the same time, this steady growth will allow our jittery financial markets to calm themselves and interest rates to come down steadily.

Second, there's the tax program. Let's look at some of its highlights. Buck Chapoton will be addressing you tomorrow so I won't discuss the tax program today.

Third, we're seeking to reduce unnecessary or unjustifiable federal regulations. The Federal Register was 25 percent smaller in 1981 than in 1980. The result is an initial saving to the economy of $16 billion, plus a recurring, annual saving estimated at $6 billion. Again that's cash that corporate borrowers won't be coming to market to seek.

Fourth, and finally, we want to slow the growth of the federal spending and actually reduce government's size as a proportion of the Gross National Product. In this way we can free real resources for the private sector -- capital that can be used to modernize and expand the productive elements of our society.

What's more, curbing the growth of federal spending now and in the future reduces competition for credit and alleviates pressure on the Federal Reserve to monetize the deficit and therefore contribute to inflation.

Despite our troublesome deficits we have, in fact, succeeded in initiating a period of budgetary discipline. From 1982 to 1984 the cumulative cuts already enacted will amount to $130 billion. Additional cuts totalling $26 billion in FY83 have been proposed in the budget just released. Along with management changes, user fees and certain tax revisions, these spending reductions will total $239 billion over the next three years.

Nonetheless, even with all this restraint, Federal government spending will continue to grow in real terms. And it's spending that causes outlays. All the talk about deficits is just shorthand for spending.

The budget we've just submitted will reduce the percent growth in federal outlays from 17.4 in Fiscal 1980 and 14.0 in 1981 to 10.4 in 1982. For the just released budget, the increase for 1983 is 4.5 percent. Still more cuts are needed.

Nor should anyone question our resolve to go back to the Hill again and again for more cuts in Federal spending, for more cuts in entitlement programs, and for a workable, bipartisan reform of the Social Security program. That's a sine qua non to long-term success.

In 1981 we've redefined and shifted the terms of debate and policy deliberation. The road to fiscal responsibility will be long and arduous, but the objective is clear.

Current State of the Economy

In fact, we now have some rather dramatic evidence that major battles in the war are being won even as we pass through this recession.

Dramatic progress has been made on the inflation front, for example. Consumer price increases -- measured December over December -- fell from 12.4 percent in 1980 to 8.9 percent last year. By the final quarter of 1981, this inflation measure had further slowed to a 5.3 percent annual rate.

Producer price increases peaked early in 1980, and have fallen dramatically since early this year. For example, producer prices on intermediate goods rose at a 12.6 percent rate for all of 1980, but slowed to only a 2.5 percent annual rate in the last quarter of 1981.

Equally important, we have recently witnessed the first decline in the rate of wage inflation in a number of years. From a high of 9.3 percent in 1980, the hourly earnings index for production work hours slowed to an 8.9 percent rate in the first half of 1981. A further drop to 7.5 percent in the second half of last year culminated in an increase of only 0.1 percent last month.

While inflation and interest rates have been declining, there can be no doubt that the economy is performing poorly. Although, unemployment fell to 8.5 percent in January, it may yet go to 10 percent before we get things turned around. Don't be surprised. We'll have poor economic numbers reported through April.

In fact, the current downturn will be far worse than envisioned in our earlier scenarios. You can attribute that mainly to two things. First, due to uncertainty engendered by concern over Federal deficits and whether these would again be monetized by the Fed, interest rates have stayed high months longer than expected.

Second, the first round of personal tax cuts was delayed until October 1 and reduced from 10 percent to only 5 percent. That amounts to only 1.25 percent for all of 1981. In fact, bracket creep and social security tax increases actually produced a $15 billion tax increase in 1981 despite the 5 percent cut. We have prevented even larger inflation-induced tax increases. Yet with all the Washington rhetoric we have not yet had a major tax cut. It finally comes in July 1982. In fact, as the recovery is starting, consumers will have almost $30 billion of additional disposable income.

Admittedly this economic downturn will try the American political will during a recession this winter and during an election year. As Henry Kissinger said of the American lack of patience: "Americans seem to have a proclivity to pull up the trees every few weeks to see if the roots are really growing."

Deficits

Probably the greatest single stimulus for pulling up the trees to check the roots is a concern in many quarters about the projected deficits. There's no question in anyone's mind that the outlook for the anticipated Federal deficits has deteriorated sharply from the projections that we made last spring.

This is not primarily due to the tax cuts, however. The basic cause of the projected deficit is the sluggish economic performance of 1980-81, and the continued growth in government spending in real terms. As a rough rule of thumb, whenever real growth falls off enough to produce an additional percentage point of unemployment, the deficit widens by about $25 billion as revenues fall and outlays rise on income maintenance programs.

Ironically, the second major reason the deficits will be temporarily higher than expected is because of the progress that has been made in fighting inflation.

Think about it. Due to the way in which most entitlement programs are indexed, including Social Security, Federal spending or outlays are linked to the previous year's inflation rate. By contrast Federal revenues are based on taxable income which is linked to the current year's inflation rate. So, the faster inflation comes down, the worse the budget deficit is for awhile.

These perverse incentives therefore must be broken by attacking their fundamental cause, the overall level and rate of growth in government spending -- a growth rate of over 16 percent in recent years.

That is what we are determined to do. We are not going to engage in more futile rounds of trying to raise taxes faster than Congress can raise spending. Congress has shown that it can win that race every time.

In the meantime, deficits are a part of the transformation process from high to low inflation. They can be financed out of the real growth and increased savings that will result from our program. In fact, the deficits that we project, while large in nominal dollars, are actually much smaller in relation to our total economy, that is, to GNP, than the deficits that occurred after the 1974-75 recession.

Part of the dismay over deficits is simply due to a phenomenon roughly analogous to what's being called sticker shock in the auto industry. That is, the rapid run-up in the scale of all economic numbers due to inflation. Current car buyers are replacing a car bought about five years ago. In that time, inflation has increased the price of all goods about fifty percent. Thus, the $9,000 car the buyer looks at today was a $6,000 car the last time he or she shopped. That's quite a big change to swallow at one time.

Similarly, in 1975-76, the last time we faced a recession-driven deficit, our total economy was about $1.5 trillion and the deficits averaged 3.5 percent of GNP or about $50 billion. Today our economy has swelled to about $3.0 trillion, and the same 3.5 percent of GNP would yield a deficit of $105 billion. And that's not far from the $90 billion where we are in Fiscal 1982 or even our proposed fiscal 1983 budget plus 10%.

For example, in the recovery year of 1976, the deficit was 4.0 percent of GNP, while our projected $92 billion deficit in 1983 will be only 2.7 percent of a much larger GNP. And, I might add that both inflation and interest rates declined in 1976 as they should this year and next.

We've financed such deficits before, and in the past we've done so without the increased savings that should result from the tax incentives passed last year. Specifically, to spur savings we've reduced the top marginal rates from 70 to 50 percent, had an across-the-board reduction in personal marginal rates and capital gains taxes, introduced ACRS, and expanded IRA/Keogh provisions, to name only the four most important changes. With those added incentives, our projected Federal deficit as a percent of private savings, whether measured on a gross or a net basis, will be totally consistent with historical experience.

The Policy Agenda for 1982

Just as these economic issues -- spending, taxes, and deficits -- shaped the policy agenda for 1981, they will continue to shape the Administration's agenda -- the policy debate -- for 1982.

There will also be some new initiatives for 1982. The Administration has proposed a package of tax changes, not contradictory to our basic tax program, but designed to remove a number of provisions of the tax code that are no longer warranted or that were made obsolete by the passage of the Economic Recovery Tax Act last year.

Another proposal, Enterprise Zones, provides tax incentives and relaxes government regulatory barriers to encourage economic growth in designated Zones. States and localities will be encouraged to add to the Federal tax and regulatory relief efforts with incentives of their own.

Finally, the President's New Federalism proposal is the concrete implementation of a theme he has advanced throughout his public career. This long term proposal, as well as every other domestic measure that the President proposed in his State of the Union Message, is molded by the same philosophical consistency that guided the economic program. Its unifying principle is the belief that government should assume only those responsibilities that individuals in the private sector cannot assume, and that each level of government should assume only those responsibilities that cannot be carried out at a lower level.

The Federal government has usurped power and responsibilities in recent years. Our economic program returns a lot of it to the individual and the private sector, and the New Federalism returns even more, along with the financial resources to pay for it, to State and local governments.

Both are a part of a long-term framework for the economic future I mentioned at the outset.

The Management Agenda for 1982

Our policy agenda, we hope, will also help shape your management agenda this year.

The key to the nation's economic recovery is not what we in the Government do; it's what you in business do in response to the restored economic incentives that were enacted last year.

For example, how well management and labor respond to an improved outlook for inflation will determine whether we lock in lower rates of inflation for the long term or not.

Inflation is no longer rising. It is falling -- and falling rapidly. It is important that wage settlements at all levels -- senior management, union, non-union, white collar -- begin to reflect these lowered inflationary expectations. Fortunately there are signs that this kind of adjustment is beginning in a number of industries, including autos, rubber, meatpackers, and trucking. I would pointedly say that the typically non-unionized service sectors like banking and insurance should also have lower aggregate salary budgets this year.

This type of adjustment in wage inflation is essential to improving the outlook for long-term productivity increases and renewed real growth.

The Outlook

How realistic is that outlook?

As I noted earlier, interest rates have trended downward since early September. And I think we can look forward to the basic downward trend in interest rates continuing -- albeit with unfortunate short-term fluctuations -- as the Fed continues to focus its policy toward achieving slower steady growth in the money supply.

Contributing to declining interest rates is an economic slowdown that is worse than we had anticipated and that has finally reduced loan demand. In fact, we are experiencing a recession that will bottom out probably in the early spring of 1982. But again the reported numbers will continue bad throughout April. Don't expect better.

By that time, lower interest rates should begin to help such sensitive areas as autos and housing. In addition, another 10 percent cut in personal rates will occur on July 1, and the business tax provisions should be worth over $10 billion in fiscal 1982, as well.

These tax reductions will do more than spur consumption demand. They'll increase cash flow or capital, adding to both individual and corporate ability and incentive to save. Remember, investment spending is spending too, and the wages paid in the investment goods industries will contribute to further saving and consumption spending.

Together these policies will result in an upturn beginning in the spring. Already the somewhat improved leading indicators may be foretelling that development. By the last half of the year, a very strong period of economic growth should be underway.

The real question is: What will happen as the recession ends? Will we face another round in the cycle of "stagflation" or will we emerge into a new era of noninflationary growth?

The answer to that question depends on how resolute we and the Congress are; and it depends on the response of management and labor to the incentives in the economic program. As I suggested earlier, we -- the Reagan Administration -- will stay on the long-term course. Inflation is still the enemy to be beaten. We are only winning battles. We have not yet won the war.

We intend to succeed. You have a stake in that success. And I'm asking you to join us by making sure that Congress knows the views of you, your policyholders, and your employees. If you don't participate you'll be ignored. I said that last year and it's even truer this year.

What is now needed is political courage -- a very scarce commodity in this town. There is a time to change and a time to remain resolute. I submit this is the time to remain resolute in favor of sound long-term economic policies and to reject the irresponsible short-term political expediency, and the too often irresistible urge to do something now -- even if its wrong.

I assure you the Reagan Administration will choose the long-term security and economic welfare of all the American people over the howls of the special interests, Congressional myopia, and tired policy prescriptions of this town's only newspaper. We don't promise a panacea, but we do have the patience and perseverance to work resolutely toward lower inflation.

Let me leave you with a thought to put our efforts to fight inflation in a broader context. Several prominent European leaders have visited Washington this month. Some privately express concern -- even alarm -- as to whether democratic governments with elected representatives can have the political will to cut social spending and resist the attraction of inflation to bail out the government. Yet, one told me in dead seriousness, "Do not waiver from the fight against inflation in America -- your government is the Free World's last hope."

I take him at his word. The Reagan Administration will consider responsible compromises. But we will not abandon our objectives or our principles. We will be consistent and we will succeed.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
March 2, 1982

CONTACT: Mary Boswell Watkins
566-2041

GOLD COMMISSION TO MEET

The Gold Commission will hold its seventh meeting on March 8, 1982.

Treasury Secretary Donald T. Regan will chair the meeting which will be open to the public. The meeting will begin at 10:00 a.m. in the Cash Room of the Main Treasury Department Building in Washington, D.C. The public is advised to use the Pennsylvania Avenue entrance to the Treasury Department.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. March 2, 1982

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 9,600 million, to be issued March 11, 1982. This offering will provide $ 300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 9,298 million, including $ 907 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities and $ 2,095 million currently held by Federal Reserve Banks for their own account. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 4,800 million, representing an additional amount of bills dated December 10, 1981, and to mature June 10, 1982 (CUSIP No. 912794 AT 1), currently outstanding in the amount of $ 4,716 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 4,800 million, representing an additional amount of bills dated September 10, 1981, and to mature September 9, 1982 (CUSIP No. 912794 AY 0), currently outstanding in the amount of $ 4,768 million, the additional and original bills to be freely interchangeable.

Both series of bills will be issued for cash and in exchange for Treasury bills maturing March 11, 1982. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average prices of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. 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.

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Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, March 8, 1982. 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 three decimals, e.g., 97.920. 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. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. 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, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on March 11, 1982, in cash or other immediately-available funds or in Treasury bills maturing March 11, 1982. 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 Section 454(b) of the Internal Revenue Code, the amount of discount at which these bills are sold is considered to accrue when the bills are sold, redeemed, or otherwise disposed of. Section 1232(a)(4) provides that any gain on the sale or redemption of these bills that does not exceed the ratable share of the acquisition discount must be included in the Federal income tax return of the owner as ordinary income. The acquisition discount is the excess of the stated redemption price over the taxpayer's basis (cost) for the bill. The ratable share of this discount is determined by multiplying such discount by a fraction, the numerator of which is the number of days the taxpayer held the bill and the denominator of which is the number of days from the day following the taxpayer's date of purchase to the maturity of the bill. If the gain on the sale of a bill exceeds the taxpayer's ratable portion of the acquisition discount, the excess gain is treated as short-term capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
WASHINGTON, D.C.

Wednesday, March 3, 1982

In recent years, innovation has brought major changes to the U.S. financial system. It is virtually certain that the future will bring additional changes to the structure of the financial industry and to the types of financial services which are available to the American public.

This burst of financial innovation has reinforced the notion that monetary policy has been (or is being) rendered ineffective as a tool for economic stabilization. However, the evidence that is provided to support this conclusion is largely anecdotal or impressionistic. People look at the rapid growth of new types of transfer accounts and money market mutual funds, and conclude that there must be a fundamental impact on monetary relationships.

There are the stories about nonbanking corporations moving into the provision of financial services that have traditionally been provided exclusively by banks and other depository institutions. At the same time, banks and other depository institutions seek, and in some instances have been given, authority to expand their realm of activities as well. The implication of all these anecdotes is that the nature of "money" in our economy is changing so rapidly that either (1) the Federal Reserve can no longer define money, let alone control it adequately, or (2) controlling money, if possible, is no longer a useful policy.

While all of these changes are undeniably going on and are important, they do not lead to either the conclusion that the ability of the Federal Reserve to conduct monetary policy is being hampered, or to the conclusion that the economic impact of monetary policy has been weakened. Effective monetary policy actions require only that there exist some economic variable -- be it the money supply, the monetary base, or the price of

carrots -- that meets two conditions:

First, it must be controllable -- and ideally with some precision -- by the Federal Reserve.[1] This condition eliminates a lot of potential candidates, including the price of carrots.

Second, it needs to be an economic variable that is related in a reliable way to the economy. I think that we sometimes lose sight of why it is that we are so concerned about controlling the money supply. We do not seek to control money growth just to give the Federal Reserve something to do, or because it is an interesting exercise. Money growth is important because it has a predictable impact on the growth of nominal GNP and the rate of inflation.

Consider the first condition. Relative to the thousands of pieces of economic data that we regularly collect in this country, there are but a handful of economic variables that the Federal Reserve can control to some degree. That small group includes, of course, several measures of the money supply, the monetary base, and several measures of bank reserves. The Federal Reserve has the power to exert some degree of direct control over all of these variables, though with varying degrees of precision. Some would also include interest rates or bank credit as candidates, but in my view the Federal Reserve cannot effectively control either with an acceptable level of precision over the long run.

In my opinion, the monetary base is a useful and reliable measure of the monetary actions of the Federal Reserve. The monetary base is simply the sum of certain items on the Federal Reserve's balance sheet and since they can exactly control the largest asset, their portfolio of government securities, the monetary base can be closely controlled even in the short run. This is less true of the money stock -- and the precision of control declines as we move from M1 out to the broader money measures, M2 or M3.

It is certainly true that financial innovations can change the assets that constitute transaction balances in our economy. At times, these changes have necessitated changes in the definitions of money, such as in 1981 with the introduction of nationwide NOW accounts. But with the information, and technical expertise available to the Federal Reserve, such adjustments can be, and have been, made. The particular menu of items which is included in the measure of "money" is not the most important issue. Instead, the major concern is to define a monetary aggegate that the Federal Reserve can control.

The crucial question therefore is, has financial innovation reduced the Fed's ability to control a particular monetary aggregate? Financial innovation has had no effect on controlling the monetary base. Despite the large growth of NOW accounts

in 1981, the ability of Federal Reserve to control the average growth of M1 was apparently unimpaired.

The relationship between the monetary base and M1 has remained extremely stable over the past decade, despite the much-talked about increased pace of financial innovation. This relationship is usefully summarized by the "money multiplier," which is simply the ratio of money to the monetary base. The table below illustrates the stability of the money multiplier since 1970. Column 1 gives the annual average of the money multiplier which, as can be seen in Column 2, has declined steadily, but the changes have varied only slightly from one year to the next. Furthermore, the largest possible change within any one year in the money multiplier (shown by the difference between its monthly maximum and minimum) is very small. The link between the base and the money supply did not become less predictable during the decade, as the pace of financial innovation has quickened. If financial changes were

Annual Movement in Money (M1) Multiplier

Year	Average of Monthly Money Multiplier	Year-to-Year Change	Difference Between Largest & Smallest Monthly Value
1970	2.913		.059
1971	2.881	-.032	.038
1972	2.875	-.006	.035
1973	2.852	-.023	.069
1974	2.763	-.089	.111
1975	2.685	-.078	.068
1976	2.636	-.049	.063
1977	2.622	-.014	.034
1978	2.596	-.026	.035
1979	2.583	-.013	.031
1980	2.543	-.040	.069

Source: "How Controllable is Money Growth?" by Anatol B. Balbach. Federal Reserve Bank of St. Louis *Review*, April 1981.

interfering with the Fed's ability to control M1 we would observe increased variation between changes in the base, which the Fed can control exactly, and money growth. The stability of the money multiplier shows this is not the case.

Now, to my second condition: that once we control money, it must be predictably and reliably related to the economic variables we really want to influence. If financial innovation has reduced the effectiveness of monetary policy we would expect to see greater variability in the relationship between money

and GNP; this relationship is represented by velocity, which is the ratio of nominal GNP to the money suppply.

While velocity does vary substantially from one quarter to the next, it has shown remarkably little variation over periods of several quarters and has had a constant trend growth of 3.1% per year since 1959. There is no sign that this relationship has been upset in recent years by financial innovation. Consider, for example, the two-year period from fourth quarter 1979 to fourth quarter 1981. This was certainly a period of some important changes in the financial system, including expansion of money market mutual funds. In that period, M1 grew at an average annual rate of 6.2%. The trend growth of velocity over the last twenty years would imply that nominal GNP would increase at 9.3% per year in 1980 and 1981 given this average rate of money growth. If financial innovation were causing changes in the link between money and GNP growth, actual GNP growth would have diverged in one direction or the other form this "predicted" 9.3%. Actually, GNP rose at a 9.5% rate in the period. If changes in the financial system were a cause of instability in the money-to-GNP relationship, I would have expected that instability to show up in 1980 and 1981.

One clear effect of recent financial innovation has been a wide divergence among the rates of growth of the various measures of money. This is nothing new. Since M2 contains a number of interest-sensitive components, variations in interest rates have always caused growth of M2 to diverge from that of M1. Before the introduction of MMC's, MMMF's and other items that pay a market-related rate of interest, M2 growth would slow when interest rates rose as funds were drawn out of savings accounts and into market instruments. Now, with the relaxation of interest rate ceilings and the inclusion in M2 of instruments that pay a market return, M2 grows more rapidly than M1 as interest rates rise.

This was the case during 1981, when M2 grew much more rapidly than M1B. However, this does not mean that the efficacy of monetary policy has been diminished because when M2 growth diverges from M1, GNP (which is what we want to influence) has not followed the path of M2, but instead has continued to follow M1 growth, defined to include NOW accounts. That is, the reliable and predictable relationship between M1 growth and GNP growth is not changed by divergent growth in M2. The 1981 experience only reaffirms this.

Differing rates of growth in M1 and M2 typically lead to questions and concerns about which monetary aggregate is the better guide to monetary actions. Returning to the two conditions I listed earlier, the money aggregate that is most controllable by the Federal Reserve and most reliably related to economic activity is, by either criterion, M1.

Divergence between M1 and M2 growth rates does not imply that money is less controllable or a less useful policy tool. In my view, it does demonstrate the superiority of the monetary base as a target for monetary policy and as a guide to Federal Reserve actions. In addition, differing M1 and M2 growth rates illustrate the futility of targetting, and attempting to control, more than one monetary aggregate. Multiple targets for monetary policy is confusing; it increases uncertainty about monetary control and reduces Federal Reserve accountability.

At the present time, I see no need for changes in regulations or in the Federal Reserve's powers to compensate for the effects of financial innovation. Certainly no one can foresee with accuracy the changes in the financial services industry that may be ahead. It is possible that, at some time in the future, financial innovation may affect the Fed's ability to control money or the fundamental relationship between money and economic activity. But to date, there is no concrete evidence that such changes have occurred. Changes in regulation to address financial innovation cannot, in my view, be supported on the ground of monetary control.

Arguments for changes in regulation might also be based on issues of equity between types of financial institutions and organizations. Whatever the motive -- whether out of perceived concern about monetary control or about equity -- action to stop or reduce the effects of financial innovation usually involve some addition to, or extension of government regulation. It is important to recognize that much of the financial innovation we have witnessed in recent years has been <u>in response to regulation</u>. MMMF's are probably the most successful example of such innovation. On the one hand, we are all aware of the problems associated with deregulating the financial industry too quickly. On the other hand, regulation encourages financial innovation which is designed to circumvent the regulations. Our financial history is filled with examples. Trying to stop or reduce innovation by imposing still more regulation is a losing battle.

It is also important to recognize that over the past decade economic conditions themselves have fostered financial innovation. Excessive money growth has caused accelerating inflation and repeatedly driven market interest rates to record highs. In combination with interest-rate ceilings and other regulatory barriers, inflation and high interest rates have encouraged financial innovation. From this perspective, financial innovation is a symptom of the inflationary problem which resulted from the monetary excesses of the past. The proper response is a more diligent effort to reduce money growth to a steady moderate pace, thereby assuring long-term price stability.

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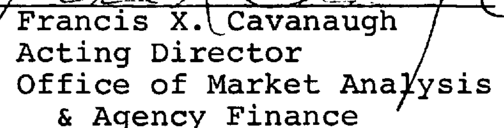
FOR IMMEDIATE RELEASE MARCH 1, 1982

The Treasury announced today that the 2-1/2 year Treasury yield curve rate for the five business days ending March 1, 1982, averaged 14.30% rounded to the nearest five basis points. Ceiling rates based on this rate will be in effect from Tuesday, March 2, 1982 through Monday, March 15, 1982.

Detailed rules as to the use of this rate in establishing the ceiling rates for small saver certificates were published in the Federal Register on July 17, 1981.

Small saver ceiling rates and related information is available from the DIDC on a recorded telephone message. The phone number is (202) 566-3734.

Approved 
Francis X. Cavanaugh
Acting Director
Office of Market Analysis
& Agency Finance

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
March 4, 1982

STATEMENT OF
THE HONORABLE JOHN M. WALKER, JR.
ASSISTANT SECRETARY (ENFORCEMENT & OPERATIONS)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
HOUSE COMMITTEE ON APPROPRIATIONS

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to meet with the Subcommittee and to discuss the plans which the Administration has to reassign the functions of the Bureau of Alcohol, Tobacco and Firearms (BATF) to the U.S. Secret Service and to the U.S. Customs Service and to discuss the budgetary requirements to carry out this reassignment. With me today are the Deputy Assistant Secretary for Enforcement, Robert E. Powis; former Deputy Assistant Secretary for Operations, John P. Simpson; and the heads of Treasury Bureaus: John R. Simpson, Director of the U.S. Secret Service; William von Raab, Comissioner of the U.S. Customs Service; and G.R. Dickerson, Director of the Bureau of Alcohol, Tobacco and Firearms.

It is the Administration's proposal to reassign the functions of alcohol and tobacco regulation, revenue protection and enforcement to the U.S. Customs Service and the functions of firearms and explosives enforcement and regulation to the U.S. Secret Service. We seek your support on this transfer.

R-659

This proposal for reassignment of functions is based on sound management decisions which will cut costs, lead to greater efficiency and produce solid law enforcement benefits. It is our intention by this reorganization to improve the criminal law enforcement functions now being performed by ATF. I firmly believe that the reassignment of duties to the Secret Service will result in the more efficient enforcement of the firearms, explosives and arson statutes. It is our intention to fully carry out these important law enforcement duties. The firearms and explosives work at ATF will be performed by approximately 1200 experienced Special Agents who will be transferred from ATF to the Secret Service. The criminal investigation personnel of the Secret Service will also be available for this important work. I wish to assure the Committee that the arson program, which is an outgrowth of the explosives statutes, will be maintained and carried out in an effective manner. ATF's four arson National Response Teams, which have been widely acclaimed for their expertise in determining the cause and origin of fires, will be reassigned to the Secret Service intact.

The targeting and investigation of hate groups, terrorists outlaw motorcycle gangs, and narcotics traffickers who illegally deal in firearms and explosives will continue.

The merger with the Secret Service will be accompanied by a number of administrative actions which will result in greater productivity and a greater concentration on the criminal misuse of firearms and explosives. Among these are the following:

1. The closure of a number of non-productive Posts of Duty offices;

2. The phasing out of the regional management structure in criminal enforcement;

3. Placing the tracing function under the supervision of criminal enforcement;

4. Transferring the regulatory compliance functions to criminal enforcement.

In addition to the enhancement of firearms enforcement, there are also significant law enforcement benefits which will accrue to the Secret Service. The most important of these is the fact that the Service will have more resources

available for its protective mission. This need was recognized in the Management Review performed by the Treasury Department following the assassination attempt on President Reagan on March 30, 1981.

There will be significant cost reductions realized by the reassignment of ATF functions by cutting administrative and management overhead and comingling resources in these areas presently in ATF with those in the receiving bureaus. There will also be significant cost reductions realized from shared space, equipment and laboratory facilities.

Another significant part of the proposal is the transfer to the Customs Service of the excise tax and the regulatory functions of ATF which pertain to alcohol and tobacco. Both agencies now collect substantial revenues, maintain laboratories for testing commodities, utilize all-in-bond procedures and have significant regulatory responsibilities. Customs already possesses significant expertise in the assessment of taxes on alcoholic beverages gained through its responsibilities and has calculated these taxes on imported wines and liquors and enforcement of labeling and other restrictions. In combining the collection of import duties with excise tax collection Customs will follow the practice of many Western nations. The addition of these duties will not adversely affect Customs border management activities.

The reassignment which has been described requires a minimum of $138 million for FY 1982. The Continuing Resolution, however, provides $115.7 million for the Bureau. If that figure is not raised, we would have to abandon reorganization plans and may have to RIF up to 1100 special agents. The actual number RIFed, of course, will depend on the months left for savings in the fiscal year as well as the magnitude of separation costs. Extensive furloughs may be necessary instead of some RIFs if separation costs are too high. The present budget for FY 1982 includes a supplemental request of $22.3 million. In addition, we requested the Congress to remove the requirement in the Continuing Resolution that $15 million be earmarked in FY 1982 exclusively to administer the Federal Alcohol Act. If this requirement is continued, we will have to increase our planned staffing from 100 to 400 positions for that activity.

The proposal to reassign ATF functions to other bureaus was based on the fact that the functions of alcohol and tobacco have no commonality of interest or purpose with the

criminal enforcement functions of firearms, explosives and arson. There are no identifiable reasons for these diverse functions to be performed in a single agency. This fact has been previously recognized within the Department. The diversity of functions has led to an inefficient organizational structure and to an unhealthy competition for resources between criminal enforcement activities and revenue protection and regulation in a declining budget picture.

Now is the time to make the break and to place the functions into bureaus more compatible with these responsibilities. Cost savings will be realized and law enforcement activity will be strengthened. The Administration urges the support of this Committee for the funding level which we need and the approval of our plan to reassign functions and personnel.

Background and Description of the Reassignment of Functions

I want to now describe the background to the reassignment of functions and the reassignment moves themselves in greater detail.

In July 1981, the Office of Enforcement and Operations within the Department undertook a management review of the enforcement functions of the Bureau. The most significant conclusions and recommendations of this review are as follows:

* * *

> "Whatever motivation there may have been in the past for placing the function of enforcement of firearms and explosives laws in the same bureau responsible for alcohol and tobacco revenue collection and regulation, it can no longer be rationalized today."

* * *

> "The firearms and explosives criminal enforcement and regulatory functions should be severed from ATF and those functions and personnel needed to perform them should be transferred to another Treasury enforcement bureau such as the Secret Service A study should be conducted to determine where the remaining functions of ATF criminal and regulatory enforcement could best be located."

* * *

Some of the other findings of the Management Review Study Group are listed as follows:

-- There exists within the Bureau an inefficient regional management structure that was created because of the diverse functions and does not operate well because of the lack of commonality of purpose and interest between these functions. This regional management structure has led to unhealthy competition for resources between criminal enforcement and regulatory enforcement.

-- There are too many criminal enforcement offices within ATF and many of them are non-productive with respect to firearms, explosives and arson cases. Approximately 40 to 50 of these offices should be closed with personnel reassigned to areas of the country where there is a high incidence of firearms and explosives cases and where the number of enforcement agents to do the job is insufficient.

-- The study found that there was generally low morale among criminal enforcement personnel brought on by budget cutbacks, media attacks and frequent program changes. Personnel did not have a sense of job security.

-- ATF is viewed by state and local law enforcement as the most cooperative of all the Federal enforcement agencies and its criminal enforcement activities are held in high regard by these agencies.

The Reorganization Plan

A plan was developed within the Department to reassign the functions of ATF and the people who perform them to the Secret Service and the Customs Service in a manner that would ensure both efficiencies in the form of reduced personnel and costs and also effectiveness in carrying out statutorily mandated enforcement, revenue protection, and regulatory functions. On November 12, 1981, Treasury formally announced this plan.

The plan developed calls for the reassignment of approximately 1731 Special Agents and administrative personnel to the Secret Service and either 719 or 1019 personnel to the U.S. Customs Service depending on the level of compliance required under the F.A.A Act.

Of the 1731 personnel reassigned to the Secret Service, approximately 1200 will be criminal enforcement Special Agents while the remaining 531 will provide administrative, technical and clerical support. The personnel transferred will carry out the enforcement and regulatory functions of the firearms, explosives and arson statutes. Present planning calls for the reassigned personnel to operate as a separate division of the Secret Service until such time as a full merger can be effectively accomplished. The full merger will depend upon the resolution of such matters as cross-training of personnel, transfer of property and equipment, shared space arrangements, development of a new organizational structure, etc.

The transfer of ATF functions related to alcohol and tobacco to the U.S. Customs Service will be accomplished by the reassignment of 719 personnel if there is to be compliance only with the mandatory provisions of the F.A.A. Act. In the event that full compliance with the non-mandatory features of the F.A.A. Act is mandated by the Congress, it will become necessary to transfer 1019 people to the Customs Service. It is envisioned that the personnel transferred will operate as a separate division until such time as they can be assimilated into the Customs Service. Full assimilation will depend on the resolution of problems such as cross-training of personnel, transfer of property and equipment, shared space, development of a new organizational structure, etc.

The plan also calls for the outplacement of approximately 250 ATF personnel to other bureaus. These outplacements will occur as a result of budget reductions wholly apart from any reorganization or transfer of functions. Plans are underway to outplace 100 regulatory inspectors in the 1854 series to the Internal Revenue Service. Approximately 150 criminal enforcement Special Agents in the 1811 series will be outplaced to the U.S. Customs Service and U.S. Secret Service. ATF agents outplaced to the Customs Service will be utilized in Customs' expanded enforcement role in control of the export of critical technology, export investigations and investigations of the financial dealings of major drug traffickers and their money launderers under the Bank Secrecy Act.

Benefits Resulting From Reorganization

The ATF reorganization and reassignment of functions to the U.S. Secret Service and U.S. Customs Service within the Treasury Department represents a sound management decision. When combined with needed office closings and other structural changes, it will achieve economies, result in a better allocation of law enforcement resources, maintain revenue protection and provide for the desired level of alcohol regulation. It is the logical result of Treasury's management review of ATF that revealed deficiencies, largely of an institutional nature, for which corrective action was required as well as the more general need for a more economic management of government resources.

The anomalous and at times counterproductive combination of resources devoted to disparate missions, alcohol and tobacco revenue protection and regulation on the one hand, and criminal investigations of firearms and explosives violations on the other, will be terminated. These resources and functions will now be allocated to agencies with goals that are fully compatible with the received functions.

When ATF personnel who are reassigned to the Secret Service for the firearms and explosives functions are fully merged into the Secret Service, the average field office will have a combined strength and capability well beyond what either agency has today. This strength will enable field offices of the new organization to devote more personnel not on full-time protective duty to priority investigations whether they are counterfeiting and check forging - the regular investigative duties of the Secret Service - or firearms, protective intelligence, explosives or arson-type matters. Absent protective needs, most of these personnel will be available for investigative work. Conversely, when there is a peak protective period or an urgent protective need occasioned by the visit of the President, Vice President or visiting head of state to a particular city, there will be greater personnel resources available in that city to satisfy that need.

Upon examination, the benefits to the reorganization both for the firearms/explosives function and the protective function are evident.

A. Benefits to Law Enforcement

We believe that the reassignment of the firearms and explosives functions to the Secret Service will result in a more efficient enforcement of the firearms, explosives and arson statutes with fewer people and less cost by the following measures:

1. By putting these functions into a strictly law enforcement organization as opposed to an organization that placed great emphasis on regulation and revenue protection of two commodities in areas totally unrelated to the enforcement of the firearms and explosives laws. The Secret Service is strictly a law enforcement organization. The 1100 field agents of the Secret Service made 6600 arrests in FY 1981 despite the fact that 45 percent of their time was devoted to protective activities. 1700 of these arrests were made in counterfeiting cases. These accomplishments indicate a field organization strongly oriented toward the working of criminal enforcement cases and a high level of productivity.

2. The transfer to the Secret Service should bring about a much-needed improvement in the morale and self-image of ATF personnel who are reassigned by placing them in an organization with a high level of morale and an excellent public image. These factors taken by themselves contribute to greater productivity.

3. The transfer to the Secret Service will facilitate the closing of non-productive Posts of Duty and the reassignment of some of the personnel from these offices to areas where firearms, explosives and arson violations are concentrated. In addition, these reassignments will permit a greater concentration on the firearms, explosives and arson activities of major traffickers, criminal figures, hate groups and terrorists.

4. This transfer will give the Secret Service the ability to draw on additional resources that are needed for its protective mission. The management review conducted by the Treasury Department in connection with the assassination attempt on President Reagan on March 30, 1981, stated that the protective responsibilities of the Secret Service have been expanding

in recent years while budgetary restraints reduced the number of special agents available for protective duties. It recommended that if the Secret Service is to continue to provide the level of protection equivalent to that which it has historically achieved, the manpower and financial resources available to the Secret Service for the performance of this function must be significantly increased. This review also found that there has been approximately a 15 percent overall decline in the Special Agent and Uniformed Division categories of the Secret Service since 1977. The utilization of ATF agents to support the Secret Service in the protective area is not new. ATF routinely supports the Secret Service during campaign years. During the 1980 Presidential Campaign, 600 ATF agents were used at various times in support of Secret Service protective activities.

5. The merger of ATF functions to the Secret Service will enhance intelligence gathering capabilities of the Service. Individuals and groups who threaten and attack Secret Service protectees need and acquire guns and explosives. ATF's criminal investigative work in these areas frequently uncovers individuals and groups of possible interest to the Secret Service. ATF's gun tracing abilities as demonstrated in the Hinckley case will greatly enhance Secret Service needs. ATF has a great deal of information on various hate groups and terrorist groups who have violated the firearms and explosives statutes. This information will be of great benefit to the Secret Service in its protective mission.

6. In order to be most effective in its protective mission, the Secret Service needs to maintain excellent working relations with state and local law enforcement throughout the country. ATF personnel have developed strong working relationships with State and local law enforcement which will benefit the Secret Service.

B. Regulatory and Revenue Protection Benefits

The Customs Service receipt of the excise tax and regulatory functions of ATF pertaining to alcohol and tobacco is a sound management decision. Both agencies collect substantial revenues, maintain laboratories for testing commodities, utilize

all-in-bond procedures and have significant regulatory responsibilities. In combining the collection of import duties with excise tax collection, Customs will follow the practice of most European countries. Apart from combining activities of common expertise, this reassignment of functions will also result in efficiencies by reducing administrative and management overhead and combining laboratory resources.

Some of the significant similarities and reasons which support the alcohol and tobacco functions going to Customs are listed as follows:

1. The taxes on alcoholic beverages are, in effect, commodity taxes which do not differ in any substantive way from specific rate duties assessed on imported commodities. The resource expertise and management disciplines necessary to collect Customs duties on importation are substantially similar to the expertise and disciplines required to collect taxes on alcoholic beverages.

2. Imported merchandise is retained in Customs custody and controlled by a system of bonds, seals, warehouses, and physical supervision at all times from importation to release into consumption. Alcoholic beverages are controlled by a similar system of physical and bond security until released into the commerce of the United States or exported with benefit to drawback.

3. BATF supervises manufacturing operations to control the use of taxable alcohol in nontaxable products with benefit of drawback or tax exemption. Customs likewise supervises manufacturing operations to control the use of imported materials in products to be exported with benefit of drawback. Both agencies employ similar audit and inspection disciplines for this purpose.

4. Customs already possesses significant expertise in the assessment of taxes on alcoholic beverages gained through its responsibilities for calculating these taxes on imported wines and liquors and enforcement of labeling and other restrictions.

5. Customs has 1 Headquarters and 8 field laboratories geographically dispersed which are already engaged in alcohol analysis.

6. Most cigars and cigarettes manufactured in the United States are produced in whole or in part from imported tobacco, which is stored in Customs bonded warehouses on the manufacturer's premises. Customs personnel are stationed in these warehouses and already have some familiarity with the manufacture of tobacco products.

7. The tax on cigarettes is relatively simple to control and administer, and elaborate production controls are not necessary for tax assessment and determination purposes.

C. Cost Benefits

The cost benefits derived from the reorganization result from administrative and management overhead savings, closing of unproductive field offices and outplacement of enforcement personnel, and from a planned reduction in the level of F.A.A. Act enforcement. Following a budget level of $138 million for FY 1982, the reassigned functions will be operated in FY 1983 at a level of $121 million. This will represent a savings of approximately $29 million from the FY 1981 level of $150 million. Specifically, these savings will be achieved from the more efficient use of the following resources:

Space and Equipment

Administrative and Management Overhead

Criminal Enforcement Personnel

Regulatory Enforcement Personnel

Arson Program

As I have previously stated I wish to assure the Committee that ATF's arson program, which is an outgrowth of the explosives statutes, will be maintained and carried out in an effective manner. The same number of investigative personnel will be utilized in this function in FY 1982 and FY 1983 as were utilized in FY 1981. ATF's four National Arson Response Teams, which have been widely acclaimed for their expertise in determining the cause and origin of fires, will be reassigned to the Secret Service intact.

This arson program will be carried out along policy guidelines which have been articulated in the past wherein assistance is rendered to state and local agencies who are experiencing

significant "arson-for-profit" schemes related to commercial or industrial interstate activities, especially those schemes perpetrated by organized crime, members of organized arson rings or violent criminals. Priority attention is focused on assistance to state and local agencies in situations that span multi-jurisdictional boundaries and exceed the capabilities of local authorities. Although arson is basically a local problem, it is evident that a coordinated effort among Federal, State and local agencies is needed in major cases. The investigative approach I have outlined, together with the assistance provided to State and local authorities, is consistent with what the Federal role should be in combatting arson and will continue to lead to significant accomplishments.

Illicit Alcohol and Cigarette Smuggling Enforcement

In connection with the reassignment of alcohol and tobacco functions of ATF to the Customs Service, 50 ATF personnel (40 criminal enforcement Special Agents and 10 support) will be transferred to the Customs Service to carry out the law enforcement efforts against illicit alcohol and cigarette smuggling. These personnel will be distributed in strategic locations where the incidence of these violations is the highest. There will be a small supervisory cadre at Customs Headquarters to oversee and coordinate these functions. Additional enforcement personnel will be located in New York because of the cigarette smuggling problem in that state. The remainder of these personnel will be based strategically at several locations in the Southeast. In these locations the enforcement personnel will be able to take advantage of the fact that this area is both the source for contraband cigarettes to the Northeast and the center of illicit alcohol production.

The Department's position with respect to the enforcement of the Contraband Cigarette Law (P.L. 95-575) is hereby stated as follows:

> "The law explicitly states its intention that primary responsibility for cigarette tax enforcement rests at the state level with the Federal effort to be concentrated in those cases which are beyond the jurisdiction and resource capability of state agencies."

Consistent with the intention of the Congress, the Department is retaining the capability to investigate cigarette smuggling in the event it becomes necessary to assist the states. Such assistance will be furnished to the states in

cases involving significant organized crime affiliated interstate smuggling operations which are beyond the state's jurisdiction and resource capabilities. The personnel referred to above who will be transferred to Customs will handle these investigations. Planning is underway to ensure that agents are experienced in the enforcement of the contraband cigarette law so as to ensure the continuance of strong Federal collaboration to the states in this area. Personnel reassigned will also be in a position to act in an advisory capacity to the cigarette enforcement community.

A brief history of ATF's involvement in the enforcement of the Contraband Cigarette Law will furnish some important background on this problem. ATF began enforcing the law in December 1978, with a goal of assisting State enforcement and revenue agents in efforts to collect all cigarette taxes as set forth by statute. ATF's efforts in 1979 and 1980, together with State enforcement agencies, drastically reduced the over-the-road smuggling of cigarettes into New York from locations such as Virginia, Kentucky and North Carolina ATF's program included a detailed analysis of the cigarette distribution system. This analysis revealed that the constant threat to cigarette tax evasion was not as a result of over-the-road smuggling but rather at the level of the cigarette stamping agent. To cope with this problem, ATF and the National Tobacco Tax Association (NTTA) initiated a program to encourage all states to use a Schedule C Reporting procedure to verify interstate shipments of cigarettes by interstate stamping agents.

Consistent with the recognition by Congress that cigarette tax diversion is primarily a State responsibility, ATF actively trained State and local officials in cigarette smuggling investigation techniques. 190 State and local officers received such training in 1980. Additional officers were trained in 1981 with a concentration on audit capabilities, since some of the states were not exercising adequate controls to ensure that proper taxes are paid on all cigarettes received by stamping agents within the state. These programs have had notable success. Several states, including New York, have reflected increases in cigarette tax revenues. If the alcohol and tobacco functions are reassigned to the Customs Service, Customs will continue to respond to requests for assistance in those cases where the enforcement problem is of such diverse nature that they are beyond state control.

Conclusion

The reassignment of functions outlined above is based on sound management principles and cost-effective planning. The firearms and explosives laws can be enforced more efficiently with fewer people in the right locations with existing Secret Service personnel available for priority firearms, explosives and arson cases. The Secret Service will have a larger manpower base to call on for unusual protective requirements and the flow of intelligence will be facilitated. The collection of excise taxes on alcohol and tobacco and the regulation of the alcohol industry to the degree mandated by Congress will not be impaired by the merger of these functions into the Customs Service while significant savings will be achieved.

We would appreciate the support of this Committee for the funding level which we need and by approving our plan to reassign functions and personnel. I now welcome the opportunity to answer questions you may have.

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press inquiries: 202-566-2615

FOR IMMEDIATE RELEASE

March 4, 1982

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Acting Secretary, Federal Financing Bank (FFB), announced the following activity for the month of January 1982.

FFB holdings of obligations issued, sold, or guaranteed by other Federal agencies on January 31, 1982 totaled $112.0 billion, an increase of $1.3 billion over the December 31 level. FFB increased holdings of agency debt issues by $0.04 billion, holdings of agency guaranteed debt by $1.0 billion, and holdings of agency assets purchased by $0.2 billion. A total of 176 disbursements were made during the month.

On January 29, FFB committed to lend $2.02 billion to the Great Plains Gasification Associates. Repayment of funds advanced under this commitment is guaranteed by the Department of Energy pursuant to the Federal Non-Nuclear Energy Research and Development Act of 1974, as amended.

Attached to this release is a table outlining FFB loan activity during January, a table outlining new FFB commitments to lend and a table summarizing FFB holdings as of January 31, 1982.

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BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF DEFENSE					
Israel 8	1/5	$6,817,646.00	9/1/09	14.265%	
Oman 4	1/6	3,800,000.00	5/10/89	14.464%	
Peru 5	1/6	9,037.19	3/15/86	14.350%	
Turkey 7	1/6	1,693,803.52	6/3/91	14.529%	
Egypt 1	1/8	630,100.00	9/1/09	14.722%	
Indonesia 7	1/8	1,719,950.00	3/20/90	14.769%	
Jordan 6	1/8	231,638.57	9/21/92	14.778%	
Philippines 7	1/8	146,617.42	9/10/87	14.624%	
Thailand 9	1/8	598,151.00	9/15/93	14.815%	
Tunisia 10	1/8	257,891.00	10/1/93	14.794%	
Israel 8	1/11	15,000,000.00	9/1/09	14.549%	
Israel 8	1/13	2,693,348.00	9/1/09	14.678%	
Jordan 6	1/13	2,823,622.02	9/21/92	14.791%	
Spain 4	1/13	1,899,323.00	4/25/90	14.782%	
Egypt 1	1/14	16,122,334.30	9/1/09	14.885%	
El Salvador 4	1/14	379,000.00	12/5/93	14.981%	
Liberia 6	1/14	627,259.34	3/21/86	14.861%	
Liberia 7	1/14	236,191.92	1/21/88	14.942%	
Sudan 3	1/14	4,339.15	2/24/11	14.853%	
Turkey 9	1/14	1,566,904.00	6/22/92	14.986%	
Turkey 11	1/14	470,000.00	12/22/10	14.856%	
Turkey 12	1/14	126,970.00	5/5/11	14.848%	
Korea 14	1/15	24,439,600.60	6/30/93	14.840%	
Malaysia 4	1/15	6,659,952.67	3/20/85	14.751%	
Malaysia 5	1/15	3,173,220.03	2/20/86	14.689%	
Peru 6	1/15	10,482.00	1/15/87	14.786%	
Spain 5	1/15	679,685.00	6/15/91	14.844%	
Turkey 6	1/15	1,059,558.11	6/3/88	14.806%	
Turkey 7	1/15	585,004.89	6/3/91	14.847%	
Dominican Republic 4	1/20	69,983.31	8/5/88	14.910%	
El Salvador 3	1/20	736,265.59	4/15/93	14.929%	
Philippines 7	1/20	189,732.00	9/10/87	14.893%	
Turkey 7	1/20	444,961.44	6/3/91	14.934%	
Honduras 6	1/22	749,601.00	4/25/91	14.857%	
Tunisia 8	1/22	58,661.00	7/10/88	14.910%	
Tunisia 9	1/22	4,514.00	10/1/88	14.902%	
Tunisia 10	1/22	128,237.00	10/1/93	14.814%	
Egypt 1	1/25	4,374,561.00	9/1/09	14.653%	
Egypt 1	1/26	1,305,583.40	9/1/09	14.615%	
Dominican Republic 4	1/27	1,820,336.00	8/5/88	14.761%	
Dominican Republic 5	1/27	1,961,584.00	4/30/89	14.754%	
Egypt 1	1/27	1,243,246.10	9/1/09	14.551%	
Jordan 6	1/27	1,433,804.40	9/21/92	14.716%	
Tunisia 9	1/28	1,401,383.23	10/1/88	14.714%	
Greece 13	1/28	16,950.00	9/22/90	14.700%	
Turkey 7	1/28	1,761,932.40	6/3/91	14.701%	
Israel 8	1/29	708,520.00	9/1/09	14.331%	
Morocco 8	1/29	561,773.00	9/21/93	14.431%	
Spain 4	1/29	96,350.00	4/25/90	14.425%	
DEPARTMENT OF EDUCATION					
Student Loan Marketing Assoc.	1/7	400,000,000.00	1/7/97	variable	
DEPARTMENT OF ENERGY					
Synthetic Fuels Guarantees - Defense Production Act					
TOSCO #9	1/4	1,244,163.23	10/1/07	14.063%	
TOSCO #10	1/11	3,056,107.46	10/1/07	14.585%	
TOSCO #11	1/18	3,618,852.59	10/1/07	14.868%	
TOSCO #12	1/25	736,751.48	10/1/07	14.699%	
Geothermal Loan Guarantees					
Northern California Municipal Power Authority #2	1/4	12,661,411.96	10/1/83	13.685%	14.153% an.
Synthetic Fuels Guarantee - Non-Nuclear Act					
Great Plains Gasification Assoc.#1	1/29	58,000,000.00	4/1/82	14.243%	

JANUARY 1982 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership	1/31	$450,000,000.00	1/31/97	14.295%	14.806% an.
	1/31	55,000,000.00	1/31/02	14.335%	14.849% an.
GENERAL SERVICES ADMINISTRATION					
Series M-081	1/8	119,961.90	7/31/03	14.757%	
DEPARTMENT OF HEALTH & HUMAN SERVICES					
Health Maintenance Organization Notes					
Block #20	1/26	4,137,363.82	various	14.753%	
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT					
Community Development Block Grant Guarantees					
*Lawrence, Massachusetts	1/4	2,661,600.00	1/1/88	13.982%	14.471% an.
Peoria, Illinois	1/6	250,000.00	2/1/83	13.975%	14.463% an.
Gary, Indiana	1/6	20,000.00	9/1/82	13.735%	13.862% an.
Sioux Falls, South Dakota	1/19	38,000.00	2/1/82	13.218%	
Washington County, Pennsylvania	1/19	411,322.71	9/15/82	14.395%	14.543% an.
Boston, Massachusetts	1/22	1,000,000.00	9/1/83	15.035%	15.600% an.
Altoona, Pennsylvania	1/29	200,000.00	7/31/83	14.443%	14.965% an.
Allentown, Pennsylvania	1/29	562,487.00	2/1/82	12.938%	
Lawrence, Massachusetts #2	1/29	100,000.00	1/1/83	14.055%	14.441% an.
Public Housing Authority Project Bonds					
Sale #17	1/8	70,529,217.74	various	14.539%	15.067% an.
RURAL ELECTRIFICATION ADMINISTRATION					
*Arkansas Electric #97	1/2	5,698,000.00	1/2/84	13.755%	13.526% qtr.
*Northern Michigan Electric #101	1/2	1,936,000.00	1/2/84	13.755%	13.526% "
*Colorado Ute Electric #78	1/4	4,495,000.00	1/4/84	13.755%	13.526% "
Corn Belt Power #94	1/4	423,000.00	1/4/84	13.755%	13.526% "
Corn Belt Power #166	1/4	77,000.00	1/4/84	13.755%	13.526% "
Cajun Electric #180	1/4	58,500,000.00	1/4/84	13.755%	13.526% "
Wabash Valley Power #206	1/5	29,911,000.00	1/5/84	13.995%	13.758% "
*South Mississippi Electric #3	1/7	125,000.00	1/7/84	14.315%	14.068% "
*South Mississippi Electric #90	1/7	431,000.00	1/7/84	14.315%	14.068% "
Basin Electric #137	1/8	25,000,000.00	1/8/84	14.455%	14.203% "
*Somerset Telephone #33	1/9	200,000.00	12/31/10	14.442%	14.190% "
*M&A Electric #111	1/9	200,000.00	1/9/84	14.235%	13.990% "
*Northern Michigan Electric #101	1/10	1,725,000.00	1/10/84	14.235%	13.990% "
*Wolverine Electric #100	1/10	989,000.00	1/10/84	14.235%	13.990% "
Wabash Valley Power #104	1/11	3,453,000.00	1/11/84	14.235%	13.990% "
Wabash Valley Power #206	1/11	2,292,000.00	1/11/84	14.235%	13.990% "
Northern Michigan Electric #183	1/11	2,813,000.00	1/11/84	14.235%	13.990% "
Wolverine Electric #182	1/11	2,203,000.00	1/11/84	14.235%	13.990% "
Soyland Power #165	1/11	4,385,000.00	1/11/84	14.235%	13.990% "
Allegheny Electric #175	1/11	3,974,000.00	1/31/84	14.255%	14.010% "
Colorado Ute Electric #78	1/11	880,000.00	1/11/84	14.235%	13.990% "
Eastern Iowa L&T	1/13	1,670,000.00	1/13/84	14.615%	14.357% "
Oglethorpe Power #74	1/14	$16,901,000.00	1/14/84	14.905%	14.637% "
Oglethorpe Power #150	1/14	14,975,000.00	1/14/84	14.905%	14.637% "
*Arkansas Electric #97	1/14	10,000.00	1/14/84	14.905%	14.637% "
*South Texas Electric #109	1/14	2,000,000.00	1/14/84	14.905%	14.637% "
*St. Joseph Tele. & Tele. #13	1/14	114,000.00	12/31/10	14.776%	14.513% "
*Western Illinois Power #99	1/15	4,859,000.00	1/15/84	14.835%	14.570% "
*East Kentucky Power #73	1/15	8,746,000.00	1/15/84	14.835%	14.570% "
*Oglethorpe Power #74	1/15	39,672,000.00	1/15/85	14.865%	14.599% "
Western Farmers Electric #133	1/18	7,400,000.00	1/18/84	14.935%	14.666% "
Western Illinois Power #162	1/18	9,509,000.00	1/18/84	14.935%	14.666% "
East Kentucky Power #188	1/18	3,732,000.00	1/18/84	14.935%	14.666% "
*Associated Electric #132	1/18	19,400,000.00	1/18/84	14.935%	14.666% "
Seminole Electric #141	1/20	11,874,000.00	1/20/84	14.915%	14.647% "

* Maturity extension

JANUARY 1982 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
East Kentucky Power #73	1/20	$300,000.00	1/20/84	14.915%	14.647% "
Big Rivers Electric #91	1/20	46,000.00	1/20/84	14.915%	14.647% "
Big Rivers Electric #136	1/20	20,000.00	1/20/84	14.915%	14.647% "
Big Rivers Electric #143	1/20	91,000.00	1/20/84	14.915%	14.647% "
Big Rivers Electric #179	1/20	5,653,000.00	1/20/84	14.915%	14.647% "
Colorado Ute Electric #96	1/21	1,145,000.00	1/21/84	14.145%	14.869% "
Basin Electric Power #137	1/22	25,000,000.00	1/22/84	15.085%	14.811% "
Northern Michigan Electric #101	1/22	167,000.00	1/22/84	15.085%	14.811% "
Sunflower Electric #174	1/22	6,000,000.00	1/22/84	15.085%	14.811% "
East Kentucky Power #140	1/22	360,000.00	1/22/84	15.085%	14.811% "
Cooperative Power #130	1/22	6,600,000.00	1/22/85	14.985%	14.714% "
*Dairyland Power #54	1/22	1,400,000.00	1/22/84	15.085%	14.811% "
*Big Rivers Electric #58	1/23	521,000.00	1/23/84	15.185%	14.907% "
*Big Rivers Electric #91	1/23	2,846,000.00	1/23/84	15.185%	14.907% "
*Big Rivers Electric #136	1/23	67,000.00	1/23/84	15.185%	14.907% "
*Brazos Electric Power #144	1/24	2,810,000.00	1/24/84	15.185%	14.907% "
Somerset Telephone #33	1/25	200,000.00	1/25/84	15.185%	14.907% "
Big Rivers Electric #179	1/25	2,050,000.00	1/25/84	15.185%	14.907% "
Chugach Electric #204	1/25	1,091,000.00	12/31/16	14.438%	14.186% "
Colorado Ute Electric #168	1/26	7,955,000.00	1/26/84	15.055%	14.782% "
Brazos Electric #108	1/26	468,000.00	1/26/84	15.055%	14.782% "
Brazos Electric #144	1/26	1,379,000.00	1/26/84	15.055%	14.782% "
Colorado Ute Electric #198	1/27	1,810,000.00	1/27/84	14.825%	14.560% "
Deseret G&T #211	1/27	22,101,000.00	2/2/84	14.825%	14.560% "
Wabash Valley Power #206	1/29	134,000.00	1/29/84	14.455%	14.203% "
Dairyland Power #54	1/29	1,465,000.00	1/29/84	14.455%	14.203%
North Carolina Electric #185	1/29	2,925,000.00	1/29/84	14.455%	14.203% "
Plains Electric G&T #158	1/29	10,000,000.00	1/29/85	14.455%	14.203% "
Plains Electric G&T #158	1/29	10,172,000.00	1/29/87	14.455%	14.203% "
Arizona Electric #60	1/29	2,956,000.00	12/31/16	14.169%	13.927% "
* Basin Elecric #88	1/30	158,000.00	1/30/85	14.385%	14.134% "
* Sierra Telephone #59	1/30	492,000.00	1/16/85	14.385%	14.134% "
* Corn Belt Power #94	1/31	300,000.00	1/31/84	14.365%	14.116% "
* Southern Illinois Power #38	1/31	360,000.00	1/31/84	14.365%	14.116% "
* East Kentucky Power #140	1/31	3,666,000.00	1/31/84	14.365%	14.116% "
* Basin Electric Power #87	1/31	10,545,000.00	1/31/85	14.385%	14.135% "
* Basin Electric Power #137	1/31	35,000,000.00	1/31/85	14.385%	14.135% "
* Allegheny Electric #93	1/31	2,867,000.00	1/31/85	14.385%	14.135% "
* Allegheny Electric #93	1/31	3,831,000.00	1/31/85	14.385%	14.135% "
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
South Shore EDC	1/6	210,000.00	1/1/97	14.312%	
Iowa Business Growth Co.	1/6	225,000.00	1/1/97	14.312%	
San Diego County DC	1/6	488,000.00	1/1/97	14.312%	
Jacksonville LDC	1/6	66,000.00	1/1/02	14.337%	
Wilmington LDC	1/6	73,000.00	1/1/02	14.337%	
South Shore EDC	1/6	105,000.00	1/1/02	14.337%	
St. Louis LDC	1/6	25,000.00	1/1/07	14.278%	
Pawtucket LCID	1/6	80,000.00	1/1/07	14.278%	
Greater Salt Lake Bus. Dist.	1/6	190,000.00	1/1/07	14.278%	
Long Beach LDC	1/6	229,000.00	1/1/07	14.278%	
Long Beach LDC	1/6	312,000.00	1/1/07	14.278%	
La Habra LDC	1/6	361,000.00	1/1/07	14.278%	
Small Business Investment Company Debentures					
National City Cap. Corp	1/27	1,000,000.00	1/1/87	14.925%	
Atalanta Investment Co.	1/27	1,000,000.00	1/1/92	14.815%	
Bando McGlocklin Invest. Co	1/27	1,000,000.00	1/1/92	14.815%	
BT Capital Corp.	1/27	1,000,000.00	1/1/92	14.815%	
Coastal Capital Corp.	1/27	450,000.00	1/1/92	14.815%	
Edwards Capital Corp.	1/27	600,000.00	1/1/92	14.815%	
Equilease Capital Corp.	1/27	1,000,000.00	1/1/92	14.815%	
Invesat Corp.	1/27	500,000.00	1/1/92	14.815%	
Midland Venture Cap. LTD.	1/27	1,000,000.00	1/1/92	14.815%	
Small Business Inv. Cap. INC.	1/27	500,000.00	1/1/92	14.815%	

*Maturity extension

JANUARY 1982 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
SPACE COMMUNICATIONS COMPANY (NASA Guaranteed)					
	1/20	$8,300,000.00	10/1/92	14.932%	15.489% an.
TENNESSEE VALLEY AUTHORITY					
Note #227	1/8	715,000,000.00	3/5/82	12.327%	
Note #230	1/29	5,000,000.00	5/7/82	13.441%	
Seven States Energy Corporation					
Note A-82-4	1/29	332,088,700.45	4/30/82	13.104%	
DEPARTMENT OF TRANSPORTATION					
National Railroad Passenger Corp. (Amtrak)					
Note #21	1/4	200,000,000.00	4/1/82	11.625%	
Note #29	1/4	562,508,000.00	4/1/82	11.625%	
Note #29	1/14	8,500,000.00	4/1/82	12.780%	
Note #29	1/15	4,500,000.00	4/1/82	12.690%	
Note #29	1/25	3,000,000.00	4/1/82	13.711	
Note #29	1/28	5,000,000.00	4/1/82	13.493%	
Section 511					
Milwaukee Road #2	1/26	567,063.00	6/30/06	14.624%	
United States Railway Association					
Note #30	1/30	150,300,000.00	4/30/82	12.938%	

FEDERAL FINANCING BANK

January 1982 Commitments

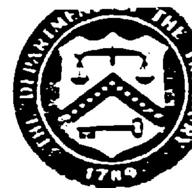
BORROWER	AMOUNT	GUARANTOR	COMMITMENT EXPIRES	MATURITY
Great Plains Gasification Assoc.	$2,020,000,000.00	DOE	6/1/87	Various
Erie, Pennsylvania	1,000,000.00	HUD	10/15/82	10/15/02
New Haven, Conn	2,000,000.00	HUD	9/1/83	9/1/03
Superior, WI	500,000.00	HUD	7/1/82	7/1/85
Sioux Falls, S.D.	370,000.00	HUD	5/3/82	5/3/87
Allentown, PA	954,107.00	HUD	2/1/82	2/1/87
Lawrence, Mass	1,138,400.00	HUD	1/1/83	1/1/88
Hammond, Ind.	4,139,970.00	HUD	5/1/84	5/1/88

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	January 31, 1982	December 31, 1981	Net Change 1/1/82-1/31/82	Net Change 10/1/81-1/31/82
On-Budget Agency Debt				
Tennesee Valley Authority	$11,435.0	$11,390.0	$45.0	$561.0
Export-Import Bank	12,741.3	12,741.3	-0-	332.0
NCUA-Central Liquidity Facility	90.2	90.2	-0-	-11.1
Off-Budget Agency Debt				
U.S. Postal Service	1,288.0	1,288.0	-0-	-0-
U.S. Railway Association	197.6	202.4	-4.7	-17.3
Agency Assets				
Farmers Home Administration	49,026.0	48,821.0	205.0	205.0
DHHS-Health Maintenance Org.	123.2	119.0	4.1	6.7
DHHS-Medical Facilities	150.5	150.5	-0-	-0-
Overseas Private Investment Corp.	23.6	24.3	-.8	-3.1
Rural Electrification Admin.-CBO	2,595.3	2,595.3	-0-	-0-
Small Business Administration	63.9	64.9	-.9	-3.4
Government-Guaranteed Loans				
DOD-Foreign Military Sales	9,776.7	9,702.8	73.9	629.1
DEd.-Student Loan Marketing Assn.	5,000.0	4,600.0	400.0	700.0
DOE-Defense Production Act (TOSCO)	48.6	39.9	8.7	48.6
DOE-Geothermal Loans	35.1	22.4	12.7	18.1
DOE-Hybrid Vehicles	2.2	2.2	-0-	0.1
DOE-Non-Nuclear Act (Great Plains)	58.0	-0-	58.0	58.0
DHUD-Community Dev. Block Grant	79.2	76.6	2.6	5.0
DHUD-New Communities	33.5	33.5	-0-	-0-
DHUD-Public Housing Notes	1,266.4	1,195.9	70.5	337.9
General Services Administration	411.2	412.0	-.7	-1.4
DOI-Guam Power Authority	36.0	36.0	-0-	-0-
DOI-Virgin Islands	29.6	29.9	-.3	-.3
NASA-Space Communications Co.	691.4	683.1	8.3	53.7
Rural Electrification Admin.	13,836.4	13,516.3	320.1	1,493.9
SBA-Small Business Investment Cos.	631.5	624.3	7.2	27.6
SBA-State/Local Development Cos.	13.7	11.4	2.4	8.5
TVA-Seven States Energy Corp.	1,021.6	1,014.7	6.9	107.4
DOT-Amtrak	893.2	844.2	49.0	113.3
DOT-Emergency Rail Svcs. Act	70.2	70.2	-0-	-0-
DOT-Title V, RRRR Act	119.4	118.8	.6	-4.2
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	111,965.4	110,697.9	1,267.4	4,665.1

*figures may not total due to rounding

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-20

FOR IMMEDIATE RELEASE
Friday, March 5, 1982

Contact: Charles Powers
(202)566-2041

STATEMENT BY SECRETARY OF THE TREASURY DONALD T. REGAN IN RESPONSE TO SENATORS DOLE/GRASSLEY TAX COMPLIANCE LEGISLATION

The legislation proposed by Senators Dole and Grassley is a serious attempt to close tax compliance loopholes and arrest the growth of the so-called "tax gap." I applaud their effort.

We will carefully review the legislation, its potential effectiveness and cost, and present the administration's position when congressional hearings are held later this month. However, I do believe the withholding of tax on interest and dividends will further public respect for the system.

Compliance with Federal tax law is a priority within the Treasury Department. In order for our voluntary tax system to remain one of the most successful in the world, American taxpayers should feel that all pay their fair and equitable share. Rather than increasing individual taxes, we must make sure taxes owed are collected.

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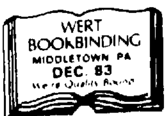
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