U.S. Dept. of the Treasury.

PRESS RELEASES.

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

FOR IMMEDIATE RELEASE June 3, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,001 million of 13-week bills and for $7,002 million of 26-week bills, both to be issued on June 6, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 5, 1985			26-week bills maturing December 5, 1985		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.97%	7.19%	98.238	7.14% a/	7.51%	96.390
High	7.06%	7.29%	98.215	7.18%	7.55%	96.370
Average	7.03%	7.26%	98.223	7.16%	7.53%	96.380

a/ Excepting 2 tenders totaling $3,000,000.
Tenders at the high discount rate for the 13-week bills were allotted 84%.
Tenders at the high discount rate for the 26-week bills were allotted 38%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 48,000	$ 48,000	$ 28,565	$ 28,565
New York	15,660,075	4,940,075	14,637,020	5,784,480
Philadelphia	23,155	23,155	17,620	17,620
Cleveland	49,970	49,970	26,900	26,900
Richmond	48,035	48,035	67,330	66,090
Atlanta	55,865	55,865	34,615	34,615
Chicago	1,115,760	256,600	1,117,550	267,550
St. Louis	70,070	50,070	66,300	26,300
Minneapolis	11,895	11,895	13,870	13,870
Kansas City	123,865	123,865	55,570	53,330
Dallas	44,110	44,110	28,235	18,235
San Francisco	1,771,590	1,013,790	894,285	339,065
Treasury	335,215	335,215	325,250	325,250
TOTALS	$19,357,605	$7,000,645	$17,313,110	$7,001,870
Type				
Competitive	$16,367,400	$4,010,440	$14,331,840	$4,020,600
Noncompetitive	1,207,705	1,207,705	821,770	821,770
Subtotal, Public	$17,575,105	$5,218,145	$15,153,610	$4,842,370
Federal Reserve	1,725,000	1,725,000	1,600,000	1,600,000
Foreign Official Institutions	57,500	57,500	559,500	559,500
TOTALS	$19,357,605	$7,000,645	$17,313,110	$7,001,870

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.

June 4, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,000 million, to be issued June 13, 1985. This offering will not provide new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,007 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 10, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated March 14, 1985, and to mature September 12, 1985 (CUSIP No. 912794 HY 3), currently outstanding in the amount of $7,072 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated June 13, 1985, and to mature December 12, 1985 (CUSIP No. 912794 JJ 4).

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.

The bills will be issued for cash and in exchange for Treasury bills maturing June 13, 1985. In addition to the maturing 13-week and 26-week bills, there are $8,354 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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 $1,440 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,590 million as agents for foreign and international monetary authorities, and $5,410 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, 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
Expected at 9:30 a.m. E.D.T.
June 5, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

It is my pleasure to present the views of the Treasury Department on S. 814, the Technical Corrections Act of 1985.

The Tax Reform Act of 1984 had an extremely broad scope, touching virtually every area of U.S. tax law, including time value of money tax accounting, corporate and partnership taxation, and the taxation of employee benefits, tax-exempt bonds, life insurance and life insurance companies, private foundations, and international business. The Tax Reform Act also included significant changes directed at simplification of the Code, as well as provisions as diverse as those involving luxury cars and the excise tax on sport fishing equipment.

Considering the scope and complexity of the Tax Reform Act, legislation implementing technical corrections seemed inevitable. Nevertheless, only a relatively modest number of technical corrections are included in the bill as introduced -- this is a compliment to the skills of the persons involved in the preparation and passage of the Tax Reform Act.

The Treasury Department supports virtually all of the proposed amendments included in S. 814. We will discuss in the order in which they appear in the bill those few provisions that we oppose or that we believe require modification or, at least, amplification. In addition, we will discuss several areas included in the Tax Reform Act that are not the subject of any provision in the bill, but which we believe require technical correction.

TECHNICAL CORRECTIONS ACT OF 1985

Dividends Received Deduction

Section 104(b)(1) of the bill would amend the holding period requirements applicable to stock owned by corporations claiming the dividends received deduction. Under current law, the dividends received deduction is provided to corporate owners */ of stock in order to limit the imposition of multiple taxation as dividends are paid by one corporation to another corporation. Corporate income generally is subject first to the corporate income tax and then to a shareholder level tax when the corporate earnings are distributed as dividends to noncorporate shareholders. The dividends received deduction provides the mechanism to ensure that significant additional corporate level tax is not imposed on intermediate distributions of earnings to corporate shareholders.

Under current law, however, the dividends received deduction is not allowed with respect to any dividend on any share of stock which is sold or otherwise disposed of in any case in which the taxpayer has not held such share for a specified time period, or to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in related property. These limitations were originally enacted in 1958 to deny a dividends received deduction in certain cases in which so-called tax arbitrage opportunities exist.

Generally, the price of a share of stock drops immediately after the stock becomes "ex-dividend," because the holder of the stock on the ex-dividend date, rather than the transferee, is entitled to receive the dividend. Absent a holding period requirement, a corporate taxpayer could acquire shares immediately prior to the date shares become ex-dividend and, following the ex-dividend date when the value of the shares has dropped by an amount approximately equal to the anticipated

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*/ The corporate dividends received deduction is provided only to the corporation that, under general principles of tax law, is determined to bear the benefits and burdens of ownership of corporate stock. For example, the dividends received deduction would not be available to the purported owner of stock purchased in a transaction that in form conveys ownership of the stock together with a right to "put" the stock to the seller, but in substance is a loan of the "purchase amount" secured by the transferred stock, irrespective of the issue discussed in this testimony.

dividend, the corporation could sell the shares at a loss. In such case, often called "dividend stripping," the corporate shareholder could claim the dividends received deduction with respect to the dividend, thereby making the dividend income almost tax-exempt, and could utilize the short-term capital loss resulting from the sale of the shares to offset against capital gain income.

As originally enacted, the required holding period was 16 days (91 days in the case of certain preferred dividends). The market risks associated with holding the shares for those periods were viewed as adequate to deter taxpayers from engaging in the tax-motivated transaction described above. The 16-day and 91-day holding periods, however, did not include periods during which the taxpayer reduced or eliminated the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell, substantially identical stock or securities. Such transactions could be utilized to "lock in" the sales price of stock and allow a corporate taxpayer to engage in dividend stripping with respect to a dividend payment, regardless of the period the stock is held.

For example, if stock is purchased immediately before the ex-dividend date at $100, a $10 dividend is declared with respect to the stock, and the taxpayer buys an option to sell the stock for $90, the taxpayer exercising the option is assured of a sales price equivalent to the fair market value immediately after the ex-dividend date, regardless of subsequent market movements affecting the value of the stock. Under current law, the dividends received deduction would be denied with respect to the $10 dividend to prevent such an abusive transaction. If the option is not exercised and the stock is not otherwise disposed of, however, no loss is recognized, the option has not provided the taxpayer with a tax arbitrage opportunity, and there is no reason to deny a dividends received deduction with respect to the $10 dividend.

A similar abuse exists in cases where a corporate taxpayer holds both "long" and "short" positions with respect to stock on the ex-dividend date. Absent a rule denying the dividends received deduction with respect to dividends received when an obligation to make corresponding payments exists regardless of whether a sale or other disposition occurs, a corporate taxpayer would claim that all of the dividends received with respect to the stock are subject to the dividends received deduction, while also deducting against ordinary income the amounts paid (generally equal to the dividends received) with respect to the short position.

The corresponding payment rule as originally enacted was limited to payments made with respect to short positions in "substantially identical stocks or securities." Because taxpayers were attempting to circumvent the statutory rules by acquiring dividend-paying common stock and entering into short sales of convertible preferred stock or convertible bonds of the same issuer and claiming that the positions were not "substantially identical," the Tax Reform Act expanded the corresponding payment rule to include payments made with respect to short positions in substantially similar or related property. In addition, the holding period requirement was extended from 16 days to 46 days, because Congress determined that the 16-day requirement was inadequate to deter dividend stripping (the 91-day holding period for certain preference dividends was retained). Further, the Tax Reform Act provides regulatory authority for the suspension of the holding period with respect to stock for any day the taxpayer has diminished the risk of holding the stock by holding one or more other positions with respect to substantially similar or related property. The Tax Reform Act, however, did not change the requirement that a sale or other disposition occur before the dividends received deduction would be disallowed for failure to satisfy the requisite holding period.

The proposed amendment, contained in section 104(b)(1) of the bill, would disallow the dividends received deduction where the holding period requirement is not met, irrespective of whether there is a sale or disposition of the stock. According to the "Description of the Technical Corrections Act," prepared by the staff of the Joint Committee on Taxation, this provision is intended to eliminate perceived administrative problems caused by the disposition requirement. In particular, present law does not indicate clearly whether the dividends received deduction is denied retroactively to all dividends received with respect to stock that is sold or disposed of before the required holding period is satisfied or whether the dividends received deduction is denied only with respect to the last dividend received prior to the sale or other disposition of the stock. If the former interpretation were to prevail, as assumed by the Joint Committee staff explanation, significant administrative burdens would clearly arise.

We believe that the statute as presently drafted does not provide explicit guidance concerning which dividends are denied the dividends received deduction upon the sale or other disposition of stock before the required holding period is satisfied. The policy underlying the dividends received deduction, however, suggests that present law should be interpreted to deny the dividends received deduction only with respect to dividends that provide the taxpayer with tax arbitrage opportunities. If corresponding payments are not made with respect to a short position in similar or related property, tax arbitrage opportunities are present only when there is a sale or disposition of the stock.

Under the proposed amendment, however, a corporation would be denied the dividends received deduction for all dividends received with respect to shares in a subsidiary or other corporation if the corporation has diminished its risk of loss by holding substantially similar or related property, regardless of whether the stock is held for 20 days or 20 years. While this result is appropriate and required by current law if the corporation also is making corresponding payments with respect to a short position in similar or related property, it is not appropriate in situations where only one dividend payment provides a tax arbitrage opportunity. Therefore, the proposed amendment does not further or clarify the Congressional purpose underlying the holding period requirement applicable to the dividends received deduction. Moreover, the proposed amendment, which would apply retroactively to stock the holding period for which began after the date of enactment of the Tax Reform Act, would impact significantly on corporations that enter into transactions to enhance yield and reduce the risk of market fluctuations with respect to stock held for long-term investment purposes.

In summary, we oppose the proposed deletion of the sale or other disposition requirement with respect to the dividends received deduction. We are not persuaded at this time that risk reduction absent tax arbitrage opportunities is a relevant criterion for purposes of denying the dividends received deduction.

If the Committee decides that some action in this area is necessary, however, we suggest that, rather than the approach adopted in the bill, consideration should be given to reducing a corporate taxpayer's basis in acquired shares, in a manner similar to that provided in section 1059, if the taxpayer does not hold the shares for the required period. Under section 1059, a corporate shareholder's adjusted basis in any share of stock that is held for one year or less is reduced by the nontaxed portion of any extraordinary dividend received with respect to such stock. If the nontaxed portion of an extraordinary dividend exceeds the shareholder's adjusted basis in the stock with respect to which the distribution was made, the excess is treated by the shareholder as gain from the sale or exchange or property. For purposes of determining whether stock has been held for one year or less, the general holding period suspension rules applicable for purposes of the dividends received deduction are applicable. All dividends that have ex-dividend dates within a period of 85 days are treated as one dividend with respect to the dividend-paying stock.

A similar rule could apply to adjust the basis of stock that is sold or otherwise disposed of before a corporate taxpayer has satisfied the requisite holding period. Under such a rule, the basis of the stock would be reduced by the nontaxed portion of all dividends received within a period of 85 days from the date of acquisition of the stock. Consistent with the policy underlying the dividends received deduction limitation, this approach would prevent a corporate taxpayer from creating an artificial loss on the sale or other disposition of the stock equivalent to the amount of the dividends included in the purchase price of the stock.

Multiple Trust Rule

The Tax Reform Act provides that under Treasury regulations two or more trusts shall be consolidated and treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose of the trusts is tax avoidance. The multiple trust rule is effective for taxable years beginning after March 1, 1984. Thus, it applies to existing trusts in taxable years beginning after March 1, 1984.

Although the bill would leave the substantive portion of the multiple trust rule intact, it would amend the effective date of the provision. In particular, section 106(a) of the bill provides that, in the case of any trust that was irrevocable on March 1, 1984, the multiple trust rule would apply only to the portion of the trust, if any, attributable to contributions made to corpus after March 1, 1984.

Prior to 1983, Treasury regulations provided that two or more trusts would be consolidated and treated as one trust under enumerated circumstances similar to the provisions of the multiple trust rule included in the Tax Reform Act. The Tax Court, however, held in 1983 that the Treasury regulations were invalid. In response to the Tax Court's decision, the multiple trust rule was enacted in the Tax Reform Act. Congress was concerned that, without the restrictions provided by the Treasury regulations, it would have been possible under the progressive tax rate structure for a taxpayer to reduce income taxes significantly by establishing multiple trusts for the same or similar beneficiaries. Congress sought to restrict this ability to reduce tax liability by expressly providing a statutory multiple trust rule.

We oppose the provision in the bill that would amend the effective date of the multiple trust rule for two reasons. First, the proposed amendment, in the Treasury Department's view, cannot be considered a technical correction. Rather, the amendment seeks to make a significant substantive change in the scope of the multiple trust rule. As enacted, the provision can operate to consolidate multiple trusts established before March 1, 1984, in the first taxable year beginning after that date. The proposed amendment would drastically reduce the number of trusts to which the provision is potentially applicable. Regardless of whether a broad grandfather rule would have been desirable in the provision as enacted, such an amendment cannot fairly be characterized as a technical correction.

Second, we believe the proposed amendment is overbroad. It must be recognized that the multiple trust rule can operate to consolidate two or more trusts for tax purposes only if, in addition to other requirements, a principal purpose of the trusts is tax avoidance. Accordingly, the proposed change in the effective date provision will provide relief only to trusts established with tax avoidance as a principal purpose. In particular, the amendment would permit taxpayers who established an unlimited number of trusts prior to March 1, 1984 to continue to reduce their tax liability significantly in all future taxable years.

While the Treasury Department is aware of certain classes of trusts for which relief from application of the multiple trust rule might be appropriate, we believe an amendment providing wholesale relief to all trusts created prior to March 1, 1984, many of which may be flagrant attempts artificially to reduce tax liability, is inappropriate and should not be included in the bill. We believe that any unjustified applications of the multiple trust rule can be avoided administratively. Nevertheless, we would be pleased to work with the Committee in drafting a narrower grandfather provision, if the Committee believes such relief should be provided by statute.

Definition of Listed Property

The Tax Reform Act imposed stricter recordkeeping requirements and limited accelerated cost recovery (ACRS) deductions and investment tax credit (ITC) allowances on "listed property." The term "listed property" includes passenger automobiles and other means of transportation, computers and peripheral equipment, property used for entertainment, recreation and amusement purposes and other types of property specified in Treasury regulations. Computers that are "used exclusively at a regular business establishment," however, are not listed property.

Section 112(e)(3) of the bill would provide that the exception for computers used exclusively at a regular business establishment would apply only to computers "owned or leased by the person operating such establishment." Although this provision is consistent with the legislative history of the Tax Reform Act, the Treasury Department opposes this amendment because it is contrary to the purposes of the underlying provision.

The proposed amendment will primarily affect computers owned by employees that are kept at the employer's place of business. If an employee's computer kept at the employer's place of business is classified as listed property, the employee must substantiate claimed business use of the computer under section 274(d) of the Code (rather than section 162 of the Code) and prove that the computer is for the convenience of the employer and is required as a condition of employment to be entitled to any deduction or credit for the computer. Congress imposed these additional requirements on listed property because of concerns that taxpayers were overstating deductions for property of a type that is susceptible to personal use. These concerns were particularly acute in the case of employees claiming deductions for property used in connection with their employment.

The original exclusion for computers kept at a regular business establishment reflected a judgment that the potential for personal use of such property is minimal. The Treasury Department believes this rationale applies equally whether a computer is owned by an employer or an employee. The compliance concerns that prompted Congress to enact stricter limits on listed property are not likely to be as great when an employee keeps a computer at the employer's place of business. Therefore, we recommend that this proposed amendment be deleted from the bill.

Gambling Activities Conducted by Nonprofit Organizations

Section 511 of the Code imposes a tax on the income derived by a tax-exempt organization from the conduct of an "unrelated trade or business." An unrelated trade or business is defined as a trade or business the conduct of which is unrelated to the purpose for which the organization has been granted exemption from Federal income tax. The Tax Reform Act provides that the term "unrelated trade or business" does not include conducting any game of chance by a nonprofit organization if (i) the organization's conduct of the game does not violate any State or local law, and (ii) as of October 5, 1983, there was a State law in effect that permitted the game of chance to be conducted only by nonprofit organizations. We understand that this provision was intended to apply only to gambling activities regularly conducted by nonprofit organizations located in North Dakota.

The Treasury Department opposed enactment of this provision as an inappropriate exception to the statutory definition of the activities that constitute an unrelated trade or business. Moreover, the Treasury Department did not believe it appropriate to enact a change in the substantive law that would apply to organizations located in one particular State without extending the special exemption to similarly situated organizations located in other States.

We understand that, since enactment of the Tax Reform Act, questions have arisen concerning whether this provision applies to States other than North Dakota. Section 133 of the bill would clarify Congressional intent by providing that the special exemption from the general rules defining an unrelated trade or business is available only if the State law restricting the operation of the particular game of chance to nonprofit organizations was originally enacted on April 22, 1977, the date the relevant law was enacted in North Dakota.

Given the Congressional intent to limit this provision of the Tax Reform Act solely to North Dakota, we agree that section 133 of the bill is within the proper scope of a technical corrections bill. We continue to believe, however, that the substantive provision is not a justifiable exception to the unrelated business income tax and that, in any event, the same rule should apply to all similarly situated taxpayers regardless of the State in which they are located. Finally, we note that under the general effective date provision of the bill the proposed amendment would apply as if it had been included in the Tax Reform Act. As described above, however, the provision as enacted applied on its face to nonprofit organizations located in any State in which a proper law was in effect as of October 5, 1984. Because nonprofit organizations located in States other than North Dakota with such laws in effect had no notice that the special exemption did not apply to them, transition rules providing appropriate relief should be adopted if the proposed amendment is enacted.

Definition of "Welfare Benefit Fund"

Section 151(a)(8) of the bill proposes to amend the definition of "welfare benefit fund" to exclude certain experience-rated arrangements between employers and insurance companies so that employer contributions to, reserves under, and refunds and dividends paid pursuant to such arrangements will not be subject to the various limitations on "welfare benefit funds" enacted by the Tax Reform Act. The general policy underlying these limits was to restrict the extent to which employers are able currently to accumulate amounts on a tax-favored basis in "welfare benefit funds" to provide future benefits to employees. (These limitations are commonly known as the "VEBA" rules.)

At this time, we oppose the proposed amendment and instead recommend that the original decision of Congress on this issue--that such arrangements be treated as "welfare benefit funds" only to the extent provided in Treasury regulations--be permitted to stand.

The Tax Reform Act generally limited the favorable tax treatment of welfare benefit funds by precluding the employer from currently deducting contributions to a "fund" to provide future benefits to active employees and by subjecting fund income to unrelated business income tax where the fund's reserves at year-end are in excess of actuarially justified levels to cover claims incurred but unpaid as of the end of such year. Certain modifications to these rules were made where an employer is accumulating amounts to provide post-retirement life insurance or health benefits to employees. The Tax Reform Act also provided that if any portion of a welfare benefit fund reverts to the benefit of the employer maintaining the fund, the amount of the reversion is subject to a 100 percent tax.

The Tax Reform Act contained a three-prong definition of the term "fund." First, any social club, voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust, or group legal services organization that is tax-exempt is a "fund." Second, any trust, corporation, or other organization not exempt from income tax is a "fund"; this rule was directed at taxable trusts and similar organizations.

Third, and most important for present purposes, the Tax Reform Act provided that "to the extent provided in regulations, any account held for an employer by any person" would be a "fund." This third prong was directed principally at accounts held by insurance companies whereby the insurance company effectively holds an employer's funds on a tax-favored basis to discharge the employer's future welfare benefit obligations. This arrangement enables the employer to gain the benefit of the favorable tax treatment provided to insurance company reserves.

Even though no regulations have been issued causing any account involving an insurance company to be treated as a "fund" under the third prong of the definition, section 151(a)(8) of the bill proposes to amend the third prong to exclude certain amounts held for the benefit of an employer by an insurance company if (i) there is no guarantee of a renewal of the contract and (ii) the only payments to which the employer or employees are entitled, other than current insurance protection, are experience-rated refunds or policy dividends that are not guaranteed and that are determined based upon factors other than the amount of the welfare benefits paid to (or on behalf of) the employees of the employer. The bill would make this exemption contingent on the employer including any experience-rated refund or policy dividend with respect to a policy year in income in the employer's taxable year in which the policy year ends.

The proposed amendment would thus exempt certain experience-rated arrangements with insurance companies from the definition of "fund". At this time, we do not believe that the proposed amendment is appropriate for several reasons.

First, the question of whether an account involving an insurance company should be treated as a "fund" or whether an employer's arrangement with an insurance company is bona fide insurance is a complex policy issue that requires significant in-depth study. Indeed, in this regard, we understand that certain insurance companies are now proposing changes to the amendment, indicating further the complexity of the issue and the importance of acting only after a complete examination. The insurance industry is concerned that the definition of "fund" not be overbroad. We are similarly concerned, however, that an inappropriate narrowing of the scope of the enacted limits may effectively permit insurance companies to offer arrangements and the associated tax advantages to employers that are not available on a self-funded or self-insured basis and thus may create significant competitive advantages for insurance companies over self-insured arrangements.

In the Tax Reform Act, Congress recognized that the "fund" issue could be properly resolved only after an intensive examination of the various arrangements offered by insurance companies. Unfortunately, the Treasury Department has only begun its examination of the extent to which employers' arrangements with insurance companies should be treated as "funds." We hope to be able to meet with insurance industry representatives over the next several weeks to discuss and examine the proposed amendment and the related issues more closely. Thus, we are not yet able to determine whether the proposal focuses on the appropriate factors or draws the proper distinctions. After the meetings, however, we will be better able to evaluate the proposal and to make specific recommendations regarding its substantive effects.

Second, we understand that the primary objection raised by insurance companies to treating certain experience-rated arrangements as "funds" is that a refund or policy dividend would be a reversion subject to a 100 percent excise tax. We concede that the reversion tax provision may be read to apply to reasonable and bona fide premium refunds and policy dividends. However, such payments are not within the scope of the original policy underlying the reversion tax. Thus, we would not object to amending the excise tax provision to clarify that reasonable and bona fide premium or contribution refunds and policy dividends, if taken into income by the employer in the year to which the refund or dividend relates, would be exempt from the 100 percent reversion tax.

Third, we understand that there is concern about the chilling effect the existing rule is having on the ability of the insurance companies to market experience-rated arrangements to employers. Evidently, some claim that employers are reluctant to enter into experience-rated arrangements due to their fear that such arrangements will be treated as "funds."

We have not received any data in support of this claim. Thus, we are unable to determine whether the claim is supported by the facts. In addition, given the complexity of the issues, the variety of the arrangements offered by insurance companies, and the vagueness of the proposed amendment, we are not convinced that the proposal would succeed in eliminating the claimed chilling effect. Nevertheless, we would not oppose amending the third prong of the "fund" definition to provide that, with the exception of certain arrangements that are commonly considered to be "funds" (e.g., retired lives reserves), an account held by any other person (such as the experience-rated arrangements that are within the proposed amendment) will not be treated as a "fund" before six months following the issuance of final regulations treating the account as a "fund." Such a delayed effective date, tied to final rather than proposed regulations, should be more effective than the proposed amendment at eliminating any current chilling effect involving employers' willingness to enter into experience-rated arrangements with insurance companies.

Qualified Employee Discounts

Under section 132 of the Code, as added by the Tax Reform Act, a qualified employee discount is, within certain limits, excluded from an employee's gross income. An employee discount is the "amount by which the price at which the property or services are provided to the employee by the employer is less than the price at which such property or services are being offered by the employer to customers." To be qualified, an employee discount must be with respect to property (other than real property or personal property of a kind held for investment) or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. If a discount does not fall within the definition of an employee discount, it cannot be a qualified employee discount and is includable in gross income (unless excludable under another statutory provision).

Section 153(a)(2) of the bill would amend the definition of qualified employee discount so that a discount would not be qualified unless the property or services provided by the employer are provided "to an employee for use by such employee." We believe the proposed amendment is an appropriate technical correction, which conforms the requirements of a qualified employee discount to the requirements of the related provisions governing no-additional-cost services. A no-additional-cost service, which also is excludable from an employee's gross income, must be a service provided by an employer to an employee "for use by such employee."

In addition, the technical correction is consistent with the structure of section 132. In particular, section 132(f)(2) provides that, for purposes of the no-additional-cost service and qualified employee discount provisions, use by an employee's spouse or dependent child shall be treated as use by the employee. If it were not required that a qualified employee discount must be limited to property or services provided for use by the employee, section 132(f)(2) would be meaningless as applied to qualified employee discounts.

The proposed amendment also is consistent with the statutory principle that only a certain class of employees is eligible for a qualified employee discount. If there were no requirement that the property or service be provided for the use of the employee, then an employee in the appropriate line of business of the employer could act as a conduit for anyone else, including, for example, an employee in a line of business not eligible for the qualified employee discount. In other words, the conduit employee could make the discounted purchase and immediately resell the property or the right to the service to another individual for the discounted price. Allowing the exclusion in such a situation would be inconsistent with the statutory limitations on the employees eligible for a qualified employee discount.

We note that in light of the statutory structure and underlying rationale of section 132, the same result could be reached by regulation without a technical correction. Nevertheless, we believe that this statutory clarification is appropriate.

We are, however, concerned with two aspects of the technical correction. First, we do not believe that the qualified employee discount exclusion should be denied where an employee gives property to a third party without any consideration. For example, if an employee working in a department store buys an item at a discount and gives it to his mother for Mothers' Day, the qualified employee discount exclusion should be available. Giving property or the right to a service to a third party as a gift should be considered use of the property or service by the donor. Again, although we believe we could reach this result without additional legislative guidance, we suggest that report language clarify this point.

Our other concern relates to the employer's withholding and employment tax obligations. If an employee is purchasing property as a conduit for a person who is ineligible for a qualified employee discount, the employee generally would be taxable on the discount. However, the employer may not know that the employee is reselling the property. In such cases, the employer does not have a withholding or employment tax obligation with respect to such taxable discount as long as at the time the discount was provided it was reasonable to believe that the employee would be able to exclude the discount from income. Employers must be able easily to determine under what circumstances it is reasonable to believe that the employee is not reselling the property and thus making the discount taxable. We believe that an employer should not be required to police use of the discounted property or services by employees as long as the employer has a bona fide policy, clearly communicated to employees, against resale by employees and the employer is not aware of facts that indicate this policy is not being observed. Again, appropriate committee report language would be helpful to confirm this point.

Interest Exclusion for ESOP Loans

The Tax Reform Act included a provision that permits banks, insurance companies and certain other lending corporations to exclude one-half of the interest earned on qualifying loans used by ESOPs or corporations to acquire employer securities. The exclusion applies to loans used to acquire employer securities on or after July 18, 1984.

Section 265(2) of the Code denies a taxpayer a deduction for interest on debt "incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." The Internal Revenue Service has made an administrative determination that a bank's liabilities to depositors are not incurred to purchase or carry tax-exempt obligations owned by the bank.

Section 291, however, disallows 20 percent of a bank's interest expense allocable to indebtedness "incurred or continued to purchase or carry obligations acquired after December 31, 1982, the interest on which is exempt from taxes." Section 154(c)(1) of the bill would amend section 291(e) to exclude interest exempt from tax under section 133 from the scope of section 291.

The Joint Committee Staff's General Explanation ("General Explanation") to the Tax Reform Act states that section 265 does not apply to interest on qualifying ESOP loans. This result is arguably correct for banks because interest exempt under the special ESOP provision included in the Tax Reform Act should be treated in the same manner as wholly tax-exempt interest on municipal bonds. The General Explanation, however, also states that section 291 does not apply to such loans, but notes that a technical correction would be necessary to exempt such interest from the provisions of section 291.

Reflecting the intention noted in the General Explanation, section 154(c) of the bill provides that interest on an obligation eligible for the exclusion available for ESOP loans will not be treated as tax-exempt interest for purposes of section 291. We believe that the proposed amendment is inconsistent with the purpose of section 291 and essentially treats interest income received by a bank that is exempt from tax under this provision more favorably than interest on municipal bonds. Interest received by banks that is exempt because the proceeds are used by a corporation or an ESOP to acquire employee securities should be treated in the same manner as interest on municipal bonds. Therefore, the Treasury Department opposes the proposed amendment to section 291(e).

Employer-Operated Eating Facilities

The Tax Reform Act expressly provides that gross income includes fringe benefits except as otherwise provided in the Code. The Treasury Department is concerned with the administrability of this rule as applied to meals provided to employees in subsidized employer-operated cafeterias. Although no provision relating to this problem is currently included in the bill, we suggest that the Committee consider an additional technical correction to simplify its administration.

Section 132 excludes from income any de minimis fringe. Section 132 provides explicitly that the operation of an eating facility by an employer for its employees is treated as a de minimis fringe if the facility is located on or near the business premises of the employer and the revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. This special cafeteria rule does not apply to officers, owners, or highly compensated employees, unless access to the facility is available on substantially the same terms to a nondiscriminatory class of employees.

If an employer-operated cafeteria fails either the direct operating cost test or the nondiscrimination test (and does not fall within the special section 119 exclusion for meals provided on the employer's premises for the employer's convenience), the value of the meals provided (net of any employee payments) will be taxable income to the employee. Accordingly, employers and employees will have to determine who received meals and how much those meals were worth.

We have explored the possible creation of administrative safe harbor valuations to eliminate the need for such detailed accounting, but have discovered significant problems concerning valuation of the total meals provided and allocation of the income (the excess of the total value over total revenues received) among the employees. For example, allocation of income pro rata among all employees would be unfair to employees who do not use the cafeteria frequently. On the other hand, although allocation of the income among all employees based on the number of times each used the cafeteria might be acceptable, many employers do not currently monitor who eats at the facility and the adoption of such a monitoring system would be burdensome and costly.

In light of these substantial administrative problems, we recommend consideration of a technical correction that would exclude from income any meals provided to an employee by his or her employer at an eating facility operated by the employer on or near the employer's premises, regardless of whether provided for the convenience of the employer. In conjunction with this amendment, we suggest an excise tax on the employer with respect to the subsidized portion of the meals. The excise tax rate would be set at a level that would approximate the taxes that would have been paid by the employees. Because the excise tax represents a proxy for the forgone employee taxes, consideration could be given to establishing one rate for facilities that do not discriminate in favor of officers, owners, or highly compensated employees and a higher rate for cafeterias that do not comply with the nondiscrimination provisions. The higher rate would be appropriate for cafeterias that fail the discrimination tests because officers, owners, and highly compensated employees are generally in higher income tax brackets than other employees. In our view, an excise tax regime would accomplish the intent underlying the fringe benefit provisions enacted in the Tax Reform Act, while avoiding significant administrative difficulties.

Interest Paid to Foreign Persons

The Treasury Department proposes additional provisions for the portion of the bill relating to the 30 percent withholding tax on U.S. source interest paid to foreign persons. The Tax Reform Act generally repealed this tax with respect to interest on portfolio obligations issued after July 18, 1984.

The most significant proposal would provide that only interest paid on an obligation issued pursuant to a public offering would qualify as "portfolio interest" eligible for repeal of the 30 percent tax. The legislation would be drafted to ensure that interest on debt that is in substance publicly offered and traded abroad would enjoy the exemption.

It has been suggested that this proposal does not constitute a technical correction. If this is determined to be correct, we nevertheless regard the proposal as good tax policy and would support its inclusion in another legislative vehicle if that were considered more appropriate.

The Treasury Department believes that the purpose of the repeal legislation was to provide direct access to the Eurobond market for U.S. borrowers. When Congress in effect repealed the withholding tax for several years beginning in 1971, it limited the exemption to interest on underwritten public issues of debt obligations in the Eurobond market. This market consists of publicly offered obligations which trade in an active secondary market. It does not include trade indebtedness and privately placed obligations, which generally are exempted by treaty provision.

The Treasury Department opposes unilateral repeal of the 30 percent tax on interest paid, for example, on trade indebtedness and obligations issued in private placements for two reasons. First, the policy basis for unilateral repeal with respect to publicly offered obligations does not apply to such obligations. Publicly offered obligations trade in an active secondary market. That is, the original holder of a publicly offered obligation may sell it to another person who lives in another country, who in turn may sell it to a third person who lives in yet a third country. Any or all of these countries may have a tax treaty with the United States which eliminates the U.S. withholding tax. There is no way, however, for the issuer of the obligation to ensure that it will be held by only residents of treaty countries who will not be taxed on the interest. The only way to ensure that foreign persons will not be taxed on publicly offered obligations, and that these obligations will be able to trade freely in the Eurobond market, is to eliminate the tax by statute.

This rationale simply does not apply to obligations placed with a few private holders or to trade indebtedness. If U.S. issuers of such obligations wish holders of their debt obligations to avoid the U.S. withholding tax, such issuers can feasibly target the obligations to residents of treaty countries. In this context, we believe it inappropriate as a matter of tax policy to exempt income from tax unilaterally, in the absence of overriding policy reasons. This is particularly true in the current fiscal environment.

The second reason we oppose repeal of the 30 percent tax on interest paid on trade indebtedness and privately placed obligations is that other countries generally have not repealed their interest withholding taxes on such obligations. Exemption for such obligations should be negotiated through tax treaties, whereby reciprocal treatment can be obtained for U.S. sellers of goods and U.S. persons wishing to undertake private borrowings.

In addition to the foregoing proposal, Treasury would suggest some minor clarifications relating to the effective date of repeal and certifications required for registered obligations. We would be pleased to discuss these issues with Committee staff.

Broker Reporting of Substitute Payments

The Tax Reform Act amended section 6045 by adding section 6045(d). This new provision requires brokers to furnish their customers with a written statement regarding certain substitute payments received by brokers on behalf of their customers.

Section 6678 generally imposes a penalty in the case of each failure to furnish a statement pursuant to various information reporting provisions, including section 6045(b). The Tax Reform Act inadvertently neglected to amend section 6678 specifically to provide a penalty for failure to furnish the statement required by section 6045(d). Similarly, section 6652 generally imposes a penalty of 5 percent of the gross proceeds required to be reported for intentional failures to file returns required by section 6045. Because section 6045(d), unlike section 6045 generally, requires "payments," not gross proceeds, to be reported, section 6652 appears inapplicable to a broker that intentionally disregards the return requirement under section 6045(d).

No changes correcting these oversights are included in the bill. Accordingly, we suggest that conforming amendments be made to sections 6652 and 6678.

TECHNICAL CHANGES TO THE RETIREMENT EQUITY ACT OF 1984

In 1984, Congress enacted significant legislation altering the tax-qualification requirements and the corresponding labor provisions for employer-maintained profit-sharing, stock bonus, pension, and annuity plans to provide greater protection to plan participants, to surviving spouses of deceased participants, and to former spouses of plan participants. The Administration supported the Retirement Equity Act and continues to support the policies reflected therein.

The Finance Committee, according to the press release announcing this hearing, is receiving comment on technical corrections to the Retirement Equity Act of 1984. The Committee, however, is not at this time considering a bill containing specific amendments. We believe that technical amendments to the Retirement Equity Act are necessary to clarify certain of the original provisions and to resolve certain issues that were not adequately addressed in the original legislation. Unfortunately, however, we have not yet completed our review of the Act to identify the amendments that should be made. We plan to complete this review and report our recommendations to you shortly.

We note, however, that a bill to make technical corrections to the Retirement Equity Act has been introduced in the House (H.R. 2110). As we testified before the Ways and Means Committee on May 16, 1985, although we generally support the provisions in H.R. 2110, we oppose two of the proposals contained in that bill. One of these two proposals would modify the rules governing whether a qualified plan may make a payment to an alternate payee (e.g., a former spouse) under a qualified domestic relations order before the plan participant has separated from service. The other proposal that we oppose would permit a spouse of a participant to waive irrevocably his or her right to consent to the participant's selection of a beneficiary of any remaining plan benefits upon the participant's death. We will discuss these issues further once we have completed our review.

* * * * *

This concludes my prepared statement. I would be pleased to respond to any questions.

TREASURY NEWS
partment of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE June 6, 1985

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $ 8,511 million of 52-week bills to be issued June 13, 1985, and to mature June 12, 1986, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.16%	7.68%	92.760
High -	7.19%	7.71%	92.730
Average -	7.18%	7.70%	92.740

Tenders at the high discount rate were allotted 40%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 17,680	$ 13,080
New York	18,901,435	7,055,635
Philadelphia	5,005	5,005
Cleveland	19,465	18,265
Richmond	53,425	39,825
Atlanta	28,130	18,130
Chicago	1,296,365	229,765
St. Louis	46,485	46,485
Minneapolis	13,100	13,100
Kansas City	43,970	41,370
Dallas	16,285	6,285
San Francisco	1,922,890	906,890
Treasury	117,505	117,505
TOTALS	$22,481,740	$8,511,340
Type		
Competitive	$19,935,965	$5,965,565
Noncompetitive	460,775	460,775
Subtotal, Public	$20,396,740	$6,426,340
Federal Reserve	2,000,000	2,000,000
Foreign Official Institutions	85,000	85,000
TOTALS	$22,481,740	$8,511,340

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TREASURY NEWS
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Remarks by
Secretary of Treasury
James A. Baker, III
before the
American Stock Exchange Washington Conference
Monday, June 10, 1985

I am pleased to be here. You people in this room represent some of the most dynamic companies in this nation. You are the people President Reagan has in mind when he speaks of American business experiencing a rebirth, of the American businessman striking out in new directions to expand our economy. You have gone "in search of excellence", and you have found it through hard work, imagination, and close attention to what the customer wants.

Thanks largely to the vision and hard work of people like you all across this country, President Reagan's economic policies are working. We've had over 2-1/2 years of rapid recovery and expansion. This has been accompanied by low inflation of almost exactly 4 percent -- something the so-called experts told us was impossible.

Now we are slowing a little, but a lull is to be expected after such an extended period of growth. We expect a pick-up for the third and fourth quarters of this year.

There are several factors which point to such future growth. The Federal Reserve began to accelerate money supply growth a few months back, and the effects of that on real economic activity should be felt soon.

The Fed, as you know, cut its discount rate recently, and various market interest rates also have dropped substantially since March.

In addition, the outlook for housing activity is positive, consumer spending appears to be moving ahead in the second quarter, and business capital spending remains at a high level.

However, lasting growth depends on sound free-market policies. That means opposing tax increases and protectionism, and cutting back regulations, and getting at the deficit by reducing government spending and encouraging economic growth.

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It also means reforming a tax system that is burdened with countless contradictions that hinder economic growth and create a widespread sense of unfairness.

According to a recent survey commissioned by the Internal Revenue Service, fully 80 percent of all taxpayers believe the present system benefits the rich and is unfair to the ordinary working man or woman.

President Reagan has proposed a fresh, clean new system, and we must work in a bipartisan fashion to reform the system as soon as possible.

The President's proposal has two key goals - pro-fairness and pro-growth.

Now, let's consider the first of the President's goals - pro-fairness, which in many ways could also be called pro-family.

The President's tax plan will virtually double the personal exemption to $2,000, raise the lowest bracket at which people are taxed, increase the earned income tax credit for low-income people, and expand the credit for the blind, elderly, and disabled.

By doing these things, the President's proposals would guarantee that virtually all families at or below the poverty line would be freed from taxation; in all, 2.5 million families with incomes under $15,000 would come off the tax rolls.

Moreover, nearly 60 percent of all families would have a tax reduction. Twenty percent would have no change, and 20 percent would have their taxes increased. All would be winners from a more efficient tax system that would create a more productive economy.

These rate reductions would be made possible by reducing special breaks in the system. There is nothing that so offends the average taxpayer's sense of fair-play than to hear of high-income individuals or successful businesses being able to avoid most or all taxation.

We therefore must work to broaden the income tax base so that everyone benefits from lower rates. That brings me to the second goal of the President's reform - pro-growth.

There was some concern among the business community that the Treasury reform proposal last year did not have enough incentive for investment.

We listened to those concerns, made changes, and we now want to assure the business community that the President's proposal very strongly promotes economic progress and capital formation.

It does this by reducing tax rates, and making allocation of resources more efficient.

We remember how cutting rates back in 1981 helped trigger the biggest economic boom in over 30 years. Cutting them further is clearly the best direction to go. It not only stimulates extra work, saving, and investment, but discourages tax shelters as well.

We want to bring the top individual rate down to 35 percent, and the corporate top rate down to 33 percent, while keeping the graduated corporate rate system. The top rate for capital gains would drop to 17.5 percent.

Our philosophy is that all investments should be encouraged equally, absent a compelling national interest to the contrary. The less the government plays favorites in the economy, the more efficient the economy is.

Therefore, under the President's plan, tax-induced distortions among different types of investment will be reduced in several ways:

The depreciation system would be revised to account explicitly for inflation and to reflect economic depreciation more accurately. To retain investment incentives, the depreciation allowances are accelerated relative to the economic depreciation outlined in the Treasury tax proposal last year.

All business tax credits, except for a more accurately targeted research and development credit and the foreign tax credit which prevents double taxation, would be eliminated.

Under our plan, the "inflation tax" on business inventories would be eased, and corporations would be permitted a 10 percent deduction for dividends paid.

Overall, our tax reform proposals will encourage capital formation and economic growth. We estimate the effective rate of taxation on capital would be reduced by nearly 20 percent.

By treating investment more equally, there would be a shift in the composition of investment which would improve the efficiency of the capital stock in producing output and extend the average life of capital. A longer average life of capital means that the same amount of gross investment yields more net investment and capital formation.

In the long run, by 1995, we estimate that our tax reform proposals will increase the Gross National Product by at least 1.5 percent. I want to note, however, that because of the inherent uncertainty in such long-range forecasts, we have not included this revenue growth in the official revenue forecasts of our plan.

In summary, the President's proposal will create a more efficient and vibrant economy. It would be a stronger economy in a fiercely competitive world economy.

We believe tax reform has a fair shot at passage this year, because there is substantial bipartisan agreement on its necessity. We owe the American people nothing less than our best efforts in getting it done.

Thank you.

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For Release Upon Delivery
Expected at 10:00 a.m., EDT
June 10, 1985

STATEMENT OF
MIKEL M. ROLLYSON
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
WAYS AND MEANS COMMITTEE
OF THE
HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on H.R. 1884. As I will explain in greater detail, the Treasury Department opposes the portion of the bill which provides rural letter carriers special rules to compute deductions for the use of vehicles in the collection and delivery of mail for taxable years beginning after December 31, 1984. The Treasury Department, however, generally does not oppose the relief which the bill affords rural letter carriers for taxable years beginning before January 1, 1985.

Current Law

A taxpayer may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. In addition, a taxpayer is generally entitled to claim depreciation deductions and the investment tax credit (ITC) for property used in a trade or business. If a taxpayer uses property for both business and personal purposes, the allowable deduction or credit is prorated based on the ratio of business use to total use. For example, if an individual drives his automobile 20,000 miles during a year and 15,000 miles are for business purposes, he or she may claim 75% of the deduction that would be allowable if the vehicle were used solely for business purposes.

Limitations apply, however, in the case of certain property placed in service after July 18, 1984. For an employee to be entitled to any deduction or credit for use in connection with his or her employment, the use of property must be for the convenience of the employer and required as a condition of employment. In addition, Congress has imposed certain limitations on the availability of the ITC and accelerated cost recovery (ACRS) deductions for certain types of property susceptible to personal use, including automobiles and other means of transportation. Under section 280F(b) of the Internal Revenue Code, the ITC and ACRS are not available unless the property is used more than 50 percent for business purposes.

In lieu of any deductions for depreciation or actual expenses of operating an automobile, a taxpayer may elect to compute the deduction for the business use of an automobile by using the standard mileage allowance established by the Internal Revenue Service. The standard mileage allowance for any taxable year is 20.5 cents per mile for the first 15,000 business miles per year and 11 cents per mile for every business mile in excess of 15,000 miles. A taxpayer may claim the investment tax credit even if he or she uses the standard mileage allowance to compute the deduction for the business use of the automobile, unless the limitations described above are applicable.

If an employer reimburses an employee for miles driven in connection with the employer's business at the rate established by the standard mileage allowance, the Internal Revenue Service has ruled that the employee is not required to include the reimbursement in income if the employee claims no deduction for such business use. If the employee claims a deduction based on the standard mileage allowance or for operating expenses and an allowance for depreciation, however, the employee must include any reimbursement from the employer in income.

Special Rules for Rural Letter Carriers

In February 1956, the Director of the Audit Division for the Internal Revenue Service wrote to the Secretary of the National Rural Letter Carriers' Association sanctioning a special rule for rural letter carriers in computing their deductions for automobiles used in collecting and delivering mail. The special rule essentially allowed rural letter carriers to multiply their business mileage by a factor ranging from 1.5 to 2 in computing allowable deductions. The multiple was based on the poor road conditions which rural letter carriers were required to travel.

The factor of 1.5 was allowable on average routes, while the factor of 2 was permittted "when bad roads and bad weather conditions prevail."

In September 1984, the Internal Revenue Service notified the National Rural Letter Carriers' Association that the multiples were not appropriate in computing the business use percentage of delivery vehicles and that the agency was reversing the position set forth in the 1956 letter. The Service stated that the publication of a general allocation method that assigns equal weight to business and personal miles (i.e., in Form 2106) and adoption of the standard mileage allowance after the 1956 letter was sent rendered the multiples obsolete.

H.R. 1884

The proposed legislation provides rural letter carriers with both prospective and retroactive special rules for computing deductions for the business use of their delivery vehicles. For taxable years beginning before January 1, 1985, a rural letter carrier may either claim a deduction equal to the "equipment maintenance allowance" paid to the rural letter carrier by the Postal Service during the taxable year or compute his or her deduction based on the arrangement described in 1956 letter from the Internal Revenue Service.

For taxable years beginning after December 31, 1984, a rural letter carrier may either use the standard mileage allowance or claim a deduction based on actual expenses plus depreciation. If the rural letter carrier opts for a deduction based on the standard mileage allowance, he or she may claim a deduction equal to 150 percent of the otherwise allowable deduction, but the investment tax credit is not available in such case. If the rural letter carrier bases the deduction on actual expenses, the limitations of section 280F(b) which deny the investment tax credit and the use of ACRS do not apply.

Discussion

The Treasury Department does not oppose the portion of H.R. 1884 which provides retroactive relief to rural letter carriers for taxable years beginning before January 1, 1985 to the extent it is reasonable to assume a letter carrier relied on the 1956 letter. We recognize that some taxpayers may have reasonably believed that the general rules were not applicable to them because of the Internal Revenue Service's stated position. Thus, if a rural letter carrier used the form which the Service sanctioned in the 1956 letter or computed his deduction on the same basis without using the form, we believe retroactive relief is appropriate. A special rule is not appropriate, however, where a rural letter carrier either claimed a deduction in excess of that allowed under the 1956 letter or claimed a deduction in accordance with the letter, but failed to include reimbursement payments in income. In such cases, the rural letter carrier cannot be said to have relied on the Service's 1956 letter and retroactive relief is not appropriate. Therefore, we urge this Subcommittee to confine the pre-1985 rules contained in H.R. 1884 to cases where a letter carrier used the form which the Service sanctioned or computed a deduction on the same basis.

After 1984, when the Internal Revenue Service notified the National Rural Letter Carriers' Association that the 1956 letter was invalid, special rules for rural letter carriers cannot be justified. The standard mileage allowance represents an approximate per mile cost of operating a vehicle. The figure is an average of the costs of operating vehicles with different values in various parts of the country and includes the cost of gas, repairs, and insurance as well as an amount for depreciation. The Internal Revenue Service publishes this figure to provide taxpayers an alternative to computing a depreciation allowance and keeping track of actual expenses. If the actual costs plus wear and tear associated with operating a delivery vehicle on country roads exceeds the standard mileage allowance, rural letter carriers, like all other taxpayers, are free to claim a deduction for depreciation plus actual expenses. A special mileage allowance for rural letter carriers based on unverified assumptions as to greater costs on account of rural road conditions is unwarranted and invites other taxpayers to petition for special rules based on unusual circumstances.

Similarly, exempting rural letter carriers from the limitations of section 280F(b) is without merit. Congress enacted section 280F(b) to deny the benefits of the ITC and ACRS when business use of certain property does not exceed 50 percent because these tax incentives are not warranted where the property was purchased primarily for personal purposes. This rationale is equally applicable to automobiles used by rural letter carriers. Under section 280F(b), if business use is not greater than 50 percent, the taxpayer is entitled to depreciate the property on a straight line basis. In the case of an automobile, the straight-line recovery period is five years. This method of depreciation, while not as generous as ACRS, is adequate to cover actual depreciation.

For these reasons, we oppose the special rules provided to rural letter carriers in H.R. 1884 for taxable years after 1984. The existing rules generally applicable to other taxpayers are equitable and should apply equally to rural letter carriers.

* * * *

This concludes my prepared remarks. I would be happy to respond to your questions.

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REMARKS OF THE HONORABLE JOHN M. WALKER, JR.
ASSISTANT SECRETARY (ENFORCEMENT AND OPERATIONS)
U.S. DEPARTMENT OF THE TREASURY
AT THE
ANTI-TERRORISM, ESPIONAGE AND CRIME WORLD CONFERENCE
WASHINGTON, D.C.

June 5, 1985

Top Management's Role in Setting Direction and Policy to Protect the Assets and People of an Organization: A Governmental Perspective

This morning, we have heard from distinguished experts on the worldwide trends in terrorist activity. From these hard and chilling facts, there is one inescapable conclusion for high-level officials, whether in government or private industry and it is this: in 1985, no responsible leader can dismiss lightly the threat of an attack on the people for whom he is responsible and on the assets that comprise his organization. This is particularly true for those of us whose positions involve international activities.

This panel will explore some of the issues that confront the policy-level official who faces the responsibility of providing protection from, and possibly responses to, this type of threat. I am pleased to have with me on this panel Steve Van Cleave, who will share with us his expertise on risk assessment and intelligence analysis, and Mike Ackerman, who will address us on the value of political risk assessment.

Before we begin discussions of these particular topics as a panel, I would like to give you some background on the subject of protection from the governmental standpoint, and in particular, the Treasury standpoint. I will then discuss how the lessons we have learned can be applicable to the development of any security force. Finally, I will raise a few issues in this area that we may consider as a panel.

From the governmental standpoint, as you are probably aware, a great number of agencies have key roles in protecting the personnel, citizens, and property of the United States from terrorist acts. The State Department has the lead interagency role outside of our country, and the FBI has the chief investigative role against domestic terrorist activities and organizations.

The entire intelligence community, the Vice President's office, and the Departments of Treasury and Justice have key roles as well and are members of the Interdepartmental Group on Terrorism. This group, chaired by the State Department, is the interagency body that deliberates on policy issues involving potential or actual terrorist activities. The Joint Chiefs of Staff, the Department of Energy, and the FAA are also members, and other agencies participate on particular topics within their jurisdiction or expertise.

On the international front, the State Department conducts the Anti-Terrorism Assistance Program, with two goals:

> First, to strengthen bilateral relationships to enhance cooperation in the prevention of, and the effective response to, terrorist incidents.
>
> Second, to provide training and assistance to aid participating nations in defending against terrorist threats and attacks. In addition to the short-term goal of readiness, this effort has the long-term goal of making participating countries less appealing targets for terrorists.

The Treasury Department participates in this assistance program by providing training on specific topics. U.S. Customs, for example, gives instruction in document examination and personnel screening as related to protection against terrorist incidents. Planning for future Customs courses in contraband enforcement and counter-terrorist financial enforcement techniques is underway. Also, in this program, the Bureau of Alcohol, Tobacco and Firearms provides expertise in establishing bomb security programs and in conducting post-blast investigations.

But the Treasury bureau that has the largest role in dealing with security against terrorism is the U.S. Secret Service.

As you are aware, the Secret Service is responsible for protecting the President, the Vice President, their families, former Presidents and their families, visiting heads of state from foreign countries, Presidential and Vice Presidential candidates and nominees, and other persons as the President may direct. In addition, the Uniformed Division of the Secret Service has responsibility for protecting more than 400 foreign diplomatic facilities in the Washington, D.C. area.

In recent years, we have made substantial changes in the Secret Service's protective operations. While I cannot go into detail on each of these changes, I would like to describe, in general terms, how we have shifted our emphasis in protective work.

Historically, much of the Secret Service's protective work focused on the threat of the lone assassin. Indeed, throughout the 1960's and 1970's, up to 1981, the Service's experience has been with just such an attacker: Lee Harvey Oswald, Sirhan Sirhan, Arthur Bremer, Sara Jane Moore, Squeaky Fromm and John Hinckley. Although we must still be on guard against the loner, today an equally serious threat is imposed by a terrorist attack -- a coordinated, politically-motivated attack on one of the Secret Service's protectees.

We have responded to this additional threat in a number of ways. For instance, we have refined the mechanisms by which the Secret Service receives intelligence from other agencies. We have revised and strengthened the training in protective work that each agent receives. We have increased the size of our agent force. We have greatly enhanced our threat countermeasures, including measures to thwart the use of stand-off weapons, such as rockets and automatic weapons, particularly with respect to possible attacks on motorcades and secured areas. At the White House, we have installed new physical barriers, deployed magnetometers, and made other physical improvements to deter and prevent terrorist attacks. In addition to the Agent's traditional ability to cover and evacuate a protectee from the zone of an assault, the Secret Service Agent is now also trained to contain and nullify attacks.

On the interagency front, Treasury has provided its views on protective problems and, in particular, on the protection of diplomatic facilities to Secretary of State Shultz and to his Advisory Panel on Overseas Security, which is chaired by Admiral Bobby Inman. I might note here the substance of our suggestions to the Inman Panel concerning the diplomatic security apparatus within the State Department.

Since I believe that any enduring improvement should concentrate on the permanent building of morale and professionalism among the protective forces, I have recommended to Admiral Inman that:

1) The State Department establish a separate security agency with an individual, professional identity -- and with criminal investigative jurisdiction -- within the Department of State. As a beginning,

this would place a State Security Agency in conceptual parity with other Federal law enforcement agencies such as the FBI, the Secret Service, the Customs Service, and ATF.

2) The Director of that agency should not have a maze of intervening layers and parallel concurrences to confront on security matters vital to the functioning of U.S. foreign diplomatic operations. His authority should come directly from the Secretary of State, who should appoint him, and he should report to the Secretary through a single Assistant Secretary or Under Secretary.

Finally, we felt that security decisions should not be compromised in the field and thus urged that the overseas Security Agent-in-Charge at an American embassy have the final field authority for in-country security decisions. We recognize that this recommendation will not be met with favor by the career foreign service.

These recommendations reflect what I believe to be the indispensable prerequisites for a top quality protective agency, based upon four years' experience with the Secret Service. In my view, the abilities that make the U.S. Secret Service the outstanding protective agency that it is today derive from a carefully-crafted combination of skills and functions within the Service.

The Service's agents operate both in the street-wise world of criminals and investigations, as well as in the realm of protective operations. The experience of conducting painstaking criminal investigations and the exposure to the dangers and unpredictability of the criminal street world make for a skilled protective officer. It refines his or her perceptiveness, alertness and attention to subtleties, all of which are essential to meeting the demands of producing a secure environment.

Yet, the best possible personnel training and experience cannot be a substitute for intelligence. To be effective, a protective agency must have an aggressive program for acquiring, analyzing -- and pursuing to a conclusion -- all forms of intelligence that appear relevant to the protective mission. The Secret Service has just such a program.

So with highly trained and experienced personnel, and with a solid intelligence program, what are the key components of a successful approach to protection, such as we find at the Secret Service? As I see it, they are as follows:

1) proactive investigations of possibly dangerous individuals and of sources of threat information;

2) extreme thoroughness of site preparation through protective advances, including pre-advances, intelligence advances, motorcade advances, and site surveys;

3) technical expertise and the application of state-of-the-art technology, to provide both active and passive countermeasures to physical and technical threats against protected persons and facilities. Examples are K-9 bomb detection, magnetometers, and technical countermeasures; and finally,

4) intensive, continuous training, including regular requalification and in-service exercises, throughout an agent's career. This is critical for each agent on active protective detail, as well as each agent on other assignments who may be called on for protective assignment.

Having mentioned key elements in what I believe to be the optimum approach to structuring a protective agency, let me now shift to the role of top management in ensuring appropriate levels of protection.

In protection, as in other matters, the senior management must establish goals, set priorities, and develop and maintain the institutional ability to achieve the goals as prioritized. Specifically, in the realm of protection and security, the top manager, whether in government or the private sector, must answer the following hard questions:

1. What is the nature of the threat? Is it directed against property, or people, or both? What is the profile of the attacker? What is the likely motive?

2. What would be the consequences of protective failure?

3. What or who is it that we need to protect?

4. Are some protectees simply more deserving of protection than others--not because of their inherent worth but because of the nature of the consequences of a protective failure as to them?

5. How does one allocate as between protectees or environments?

6. How does one mobilize the appropriate level of effective resources to counter the threat or threats?

7. Finally, what is the balance to be struck between personal security on the one hand and freedom of movement and association on the other?

In the governmental context, these issues are addressed in part through Congressional action; for example, in legislating the permanent protectees and in providing funding; and in part through executive action, in setting priorities and establishing policies for protective operations.

With regard to priorities, no free society can undertake the financial as well as political and social costs of giving individual protection to all who might need it, including all elected Federal officials, all political appointees, all civil servants, all military officers, or all members of the foreign diplomatic community. Resources are simply not available. Moreover, in addition to expense, protection imposes its own special burdens and restrictions on the protectee and on the environment in which he operates. In some cases, these restrictions defeat the protectee's primary objectives and are simply too onerous to be worth it.

Similarly, policy-level officials in government must assess the nature of the threat, which may vary according to the individual protected, his status and the duties with which he is charged. Special circumstances may make a given individual more vulnerable than another in a similar position. An example may be a DEA agent, such as the late Agent Camarena, who was targeted and murdered in Mexico because of the nature of his particular investigative work in a particular country.

In other situations, the mere office or status held by an individual, rather than his personal abilities in carrying out his duties, may be sufficient to place him in a constant state of jeopardy. Thus, for example, an American diplomat in a certain part of the world may become a target of terrorists solely because he is an American diplomat.

The governmental policymaker in the security field must also make difficult choices regarding the consequences of failure.

The consequences of an assassination of a U.S. President may be not only to disrupt governmental processes but also to upset financial markets, alter foreign relations and raise the risks of international conflict. By way of comparison, the slaying of a foreign diplomat in the United States has different consequences. At stake in such a case are our international obligations to preserve the norms and instrumentalities of international relations. There is also our country's need to receive reciprocal security treatment from the host governments of our diplomatic posts around the world.

In the private sector, business leadership must resolve similar issues. As you are all aware, terrorism poses dangers to businessmen abroad that can be as grave as those facing a governmental official. Businesses, like government, must make difficult judgments regarding their protective needs and the means of fulfilling them. They must conduct the risk assessments for their personnel and their installations and take into account considerations such as those that I have discussed. My fellow panelists are experts in this area, and I look forward to hearing their views.

Thank you very much.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 10, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,010 million of 13-week bills and for $7,011 million of 26-week bills, both to be issued on June 13, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 12, 1985			26-week bills maturing December 12, 1985		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.17%	7.40%	98.188	7.34%	7.73%	96.289
High	7.23%	7.47%	98.172	7.36%	7.75%	96.279
Average	7.21%	7.45%	98.177	7.35%	7.74%	96.284

Tenders at the high discount rate for the 13-week bills were allotted 34%.
Tenders at the high discount rate for the 26-week bills were allotted 3%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 50,710	$ 50,710	$ 46,865	$ 27,465
New York	14,757,660	5,645,860	16,801,160	6,190,140
Philadelphia	36,600	36,600	18,445	18,445
Cleveland	62,030	62,030	32,025	32,025
Richmond	91,340	84,380	79,530	50,495
Atlanta	52,835	52,835	196,955	35,225
Chicago	1,186,750	271,450	1,195,615	214,150
St. Louis	88,335	48,335	41,405	21,405
Minneapolis	63,085	63,085	39,330	15,080
Kansas City	162,745	110,305	47,525	44,725
Dallas	39,840	39,840	21,375	16,375
San Francisco	1,249,860	209,860	1,513,190	56,190
Treasury	334,690	334,690	289,575	289,575
TOTALS	$18,176,480	$7,009,980	$20,322,995	$7,011,295
Type				
Competitive	$14,772,575	$3,606,075	$17,223,505	$3,911,805
Noncompetitive	1,232,475	1,232,475	818,390	818,390
Subtotal, Public	$16,005,050	$4,838,550	$18,041,895	$4,730,195
Federal Reserve	1,774,230	1,774,230	1,700,000	1,700,000
Foreign Official Institutions	397,200	397,200	581,100	581,100
TOTALS	$18,176,480	$7,009,980	$20,322,995	$7,011,295

1/ Equivalent coupon-issue yield.

B-169

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M. EDT
Tuesday, June 11, 1985

TESTIMONY OF THE HONORABLE
JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I thank you for your kind invitation to appear here today to discuss tax reform. With the Committee's permission, Mr. Chairman, I would like to submit for the record not only my full testimony but also the text of the President's May 28 address to the nation and a copy of the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.

I last appeared before this Committee on the 23rd of January in connection with my nomination by the President to be Secretary of the Treasury. Since then I have spent a great deal of time consulting with your Chairman and with members -- from both sides of the table -- as we developed the President's proposals. Before going any further, I would like to thank each of you for sharing your insights with us. Although we may not have embraced every one of your ideas, we did learn and benefit a great deal from our discussions with you.

On May 28th, the President announced his proposals for sweeping changes in the federal income tax structure. In his address to the nation, he emphasized the importance of this to all of us when he said:

> "No other issue goes so directly to the heart of our economic life; no other issue will have more lasting impact on the well-being of your families and your future."

I want to stress that these proposals are the President's. He reviewed our recommendations, considered the options, and made all of the final decisions. The President stands squarely behind these proposals. As you know, since they were announced, the President has been using his very commanding power of persuasion to communicate the benefits of these proposals to the American people. To date, we have been greatly encouraged by the responses.

In his State of the Union Address earlier this year, the President enumerated the following tax reform goals:

- o Tax reform should not be a tax increase in disguise;
- o Personal tax rates should be reduced by removing many preferences, with a top rate no higher than 35 percent;
- o Corporate tax rates should be reduced while maintaining incentives for capital formation;
- o Individuals with incomes at or near the poverty level should be exempt from income tax; and
- o The home mortgage interest deduction should not be jeopardized.

Today, I am prepared to discuss with you the Administration's specific proposals for remodeling our tax structure to achieve those goals.

Reform proposals, however, should also conform to certain basic principles of taxation which this Administration has supported consistently. The first of these, low rates of tax, is essential in order to further stimulate work effort, to encourage savings and investment, to reward invention and innovation, and to discourage unproductive tax shelters. Low tax rates, which can be obtained only if the taxable income base is broadened, are especially important because, to the extent a certain source or use of income remains favored by the tax law, the distortion left by this bias will be kept small.

Second, not only must we not allow tax reform to be a tax increase in disguise, as the President has warned, but also we must not let tax revenues decline and worsen the deficit. In other words, tax reform must be revenue neutral and should be judged on its own merits. This is a particularly sound principle because it imposes discipline upon those who would like to retain special tax concessions found in current law. In a revenue neutral setting, the price of retaining any special tax benefit is higher tax rates generally.

Some have suggested that we have been too conservative in our insistence on revenue neutrality. They claim that our view of the economy is static because we fail to take credit for additional tax revenues from increased growth and favorable behavioral responses that will result from tax reform. This line of argument is only partly correct; and even then the disagreement is over political judgment and not economic principles.

It is standard practice at Treasury to assume that taxpayers' behavior will be affected by any tax proposals. Indeed, many of the figures in our year-by-year analysis of the revenue impact of the President's plan over the next five years -- Appendix C to the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity -- would be different if we had not made these assumptions.

We have, however, decided not to include the growth effects of reform in measuring revenue neutrality. In the long run, by 1995, we expect our proposals to improve real GNP, but we have not included this additional growth in our revenue estimates. We have used identical macro-economic assumptions in calculating current law revenues and revenues under the President's proposals. We realize this is a conservative approach but we also recognize that this decision makes us immune to charges that we cooked the numbers to pay for a tax reduction with bogus revenues from an overly-optimistic forecast. I am comfortable associating myself with the President's observation that if it is revenue neutral on a static basis, it will end up actually providing more revenues for the simple reason that the base of the economy will be expanded.

Fairness for families is the third principle we have established for tax reform. As the President has said, fairness for families means that those with poverty-level incomes should not have to pay any income tax. It also means that the value of the personal exemption must be restored, that the earned income credit for the working poor must be strengthened and indexed for inflation, and that the discrimination against spouses working in the home and wanting to save through an IRA must be eliminated.

A fourth principle for tax reform is economic neutrality to stimulate growth. Economic neutrality for growth requires that all income be taxed uniformly and consistently by being subject to the same rules of taxation. In a simple world, this calls for eliminating all deductions, exemptions, and credits that favor certain sources or uses of income. In a more practical setting this means that some incentives will be provided through the tax code. The tax system, however, should not be used to favor one person, one investment, one business, or one use of income over any other.

Simplicity is the fifth principle we have identified as important. Discussions with ordinary taxpayers reveal that the complexity of our tax laws contributes as much as any other factor to the perception that the system is unfair. Most taxpayers feel that they are paying more than their fair share of the federal income tax and that the system is so difficult to comprehend that there is nothing they can do about it. Others who are more sophisticated or who can afford to hire clever advisors use complex provisions to reduce their tax bills.

The last principle guiding our design of tax reform is the need for a fair and orderly transition. We have recognized all along that fundamental reform of the scope being recommended by the President could result in serious short-term economic dislocations, unless planned carefully. This concern is not a valid reason to avoid undertaking reforms. It is, however, a good reason to take care that the transition from current law to proposed law is as smooth as is practicable. If we would permit abrupt shifts in tax burdens and in the allocation of economic resources to create substantial hardships for individual taxpayers or for isolated sectors of the economy, reform would be impossible and unwise.

We recognize, of course, that it is the prerogative of the tax-writing committees of Congress to design appropriate transition rules and we look forward to working with this Committee to develop transition rules that you determine will be necessary to implement the President's proposals in a manner that will minimize unanticipated effects.

The Need For Fundamental Tax Reform

The current body of Federal tax law, commonly identified as the 1954 Code, is now some thirty years old. Over the span of three decades the law has been tinkered with so often and weighed down by so many amendments that its original drafters may have difficulty recognizing it. Although we are not recommending outright repeal of the current code, we are recommending that instead of more tinkering, we should make some very basic, fundamental changes to remodel the code. These changes will eliminate the need for some complicated rules; they will help restore free-market principles to economic decision-making; and they will streamline tax calculations for many individuals.

The average taxpayer has become convinced that others benefit from this growing complexity and that he or she does not. He or she understands very well that as long as the tax laws permit others to shelter income and thereby avoid paying a fair share of tax, then he or she must make up the difference by paying a greater share. It is not possible to separate the fairness issue, the neutrality issue, and the simplicity issue. Every new amendment to fine-tune this thirty-year old tax code serves only to worsen the public's perception of fairness. The time is right for starting anew with the fresh approach that fundamental reform offers.

Let us not, however, underestimate the task. The remodeling of our tax laws that the President has recommended is an undertaking not to be lightly considered. Although the process leading to enactment of fundamental tax reform legislation is started, and, with full bipartisan cooperation, can be completed this year, the task will be arduous and time-consuming.

We cannot expect to succeed unless we all are convinced that there is a clear and compelling need for reform.

We have only to listen to the ordinary taxpayer to learn that such a need does exist. Taxpayers across the country are dissatisfied with the current tax system because they believe it is unfair; they know it is too complicated; and they suspect that it impedes growth because it discourages risk taking and innovation and encourages wasteful tax shelter investments instead of rewarding honest toil.

<u>High Income Taxpayers</u>

People are justifiably outraged by stories of those with high incomes paying little or no income tax. We thought it was important to discover whether such horror cases are common or rare. To find out, we examined tax returns of individuals and families with incomes of $250,000 or more in 1983. Ranked by income, these represent roughly the top one-fourth of one percent of all households in the United States. We selected tax returns on the basis of their positive sources of income only, that is, income before deducting any offsetting losses. Our findings may -- or may not -- surprise you.

o Thirty thousand of these high-income families, representing 11 percent of this group, paid taxes amounting to less than 5 percent of their positive-source income.

o Fewer than half of all the high income tax returns we examined reported tax liabilities that most people would consider to be a fair share at this income level -- 20 percent or more of positive-source income.

o Among the very highest incomes -- those with positive-source incomes greater than $2 million in 1983 -- only 37 percent paid as much as 20 percent of positive-source income in tax, and 11 percent paid a tax rate that was lower than 5 percent.

Other evidence of unfairness that troubles the average taxpayer is the knowledge that two individuals or two families with the same income and the same ability to pay tax frequently pay very different amounts of tax because they derive their income from different sources or they spend their income for different purposes. Examples are all too common:

o Individuals who spend their incomes on tax-preferred consumption, such as seminars held aboard cruise ships, pay less tax than others with equal incomes who save or who consume unfavored goods and services.

- o People who make leveraged investments in depreciable property, sometimes without personal liability on the debts, generate up-front deductions bigger than amounts placed at risk, and pay lower rates of tax than others with equally large earnings who do not invest in tax shelters.

- o Major corporations, for example those using accounting techniques to accelerate deductions and defer income, sometimes pay markedly lower rates of tax on their vast incomes than the average blue collar and white collar employee working for those corporations pays on his or her income.

Complexity and Inefficiency

There is also a pervasive feeling that complexity breeds unfairness, that the tax system must be unfair because it is so complex. Most taxpayers feel that they have to pay more than their fair share of tax because complexities in the system give unwarranted benefits to others. According to a recent survey commissioned by the Internal Revenue Service, fully 80 percent of all taxpayers believe the present tax system benefits the rich and is unfair to the ordinary working man or woman, and a majority of the respondents felt that the system is too complicated.

The plain truth is that the people are right. The system is too complex and is unfair. Families and individuals with the same income now pay widely differing amounts of tax and those with very different incomes quite often pay the same rate of tax. The American people don't want a tax system that works this way. It is disturbing to the deep-rooted American sense of fair play. They also don't want a tax system that is so complex that half of them feel they must pay professionals just to help them figure what they owe the IRS. Above all, they don't want a tax system that, although nominally progressive, favors the wealthy who are able to take unfair advantage of the complexities of the law.

A less obvious consequence of the seemingly capricious way in which some income is taxed heavily while other income is taxed lightly or not at all is the economic inefficiency caused by interference with the market allocation of resources. Investors and businesses, both large and small -- but especially those paying high rates of tax -- are beginning to recognize what economists have been saying all along: the flow of capital into low-taxed sectors of the economy is artificially high and capital investment in high-taxed sectors is artificially low. As a result, capital is misallocated from more productive to less productive investments.

No matter how well intentioned the original reasons for these built-in biases, their existence influences not only the amount of goods and services produced in each sector of the economy, but also the way businesses are organized and financed, and the way capital is raised and employed in the production process. The most insidious aspect of this is that by interfering with the free market, we are misallocating resources so that growth is retarded and the economy fails to achieve its full potential.

The President's Tax Proposals

The President has responded to the demands of the American taxpayers with a comprehensive set of tax reform proposals designed for fairness, growth, and simplicity. These proposals do not represent yet another attempt to tinker with current law. Instead they are intended to remodel current law.

Mr. Chairman, this morning I would like to discuss the most important aspects of our plan. A complete and detailed description of each proposal can be found in the report which the President has transmitted to the Congress.

Marginal Tax Rates

The President proposes to reduce individual income tax rates by replacing the current schedule of 14 marginal tax rates (15 for single returns), ranging from 11 percent to 50 percent, with a simple 3-bracket system having rates of 15, 25, and 35 percent. These marginal tax rate reductions complete the work begun in 1981, when we reduced marginal tax rates by almost 25 percent. Approximately 69 percent of all taxable returns will pay the 15 percent marginal rate of tax, 28 percent will pay the 25 percent bracket rate, and only 3 percent will pay the 35 percent top rate.

When President Reagan was elected in 1980, marginal tax rates ran as high as 70 percent. Now the maximum rate will be exactly half as high. In 1981 our critics argued that reducing tax rates 25 percent across-the-board would have devastating effects on the economy, making it impossible to bring inflation under control and crowding out investment. Instead, we have reduced inflation by two-thirds, from over 12 percent to 4 percent. In the last two and one-half years we have seen employment rise by nearly 8 million, or 6.3 million above the previous peak in 1981. We have seen real growth last year at its highest rate since 1951. We have seen 30 straight months of economic expansion. We have seen a greater recovery in capital spending than for any prior postwar recovery period. And, we have seen the prime rate drop to its lowest level in over 6 years.

It seems to me that back in 1981 we must have done something right. The American worker and the American businessman are telling us better with their actions than any speech writer or politician could do with predictions and promises. What they are telling us, reflected in those statistics I just cited, is that incentives do work. Lower tax rates do encourage hard work and savings. Lower tax rates do make it more worthwhile for the entrepreneur and the investor to innovate and take risks. Lower tax rates do have a less distorting influence on economic decisions -- even under a flawed tax structure that grants favors for certain sources and uses of income -- because the rewards for bucking free-market allocations of resources are small.

Like the 1981 across-the-board rate cuts, the President's plan for a straight-forward three-rate structure capped at 35 percent is pro-taxpayer primarily because it is pro-growth. What is good for the economy is necessarily good for the American taxpayer because higher productivity means higher real incomes and a better standard of living for all.

Fairness to Families

The President calls this proposal to remodel the tax laws a pro-family proposal. It is.

We are living in a pro-family society and any social or economic policy that does not recognize the importance of the American family is doomed to failure. Families comprise the basic structure of our vast middle class and it is the middle class family that bears the bulk of the tax burden. The poor are below the income tax threshold and the rich, even though they may pay sizeable tax bills, bear a small share of the total tax burden because they are so few in number.

Middle class families will benefit directly from reduced marginal tax rates. Just as important, they will take comfort in the fact that the highest rate they will ever face is just 35 percent. It is an integral part of the American dream to look forward to the day when an investment in human capital -- the college education -- or an investment in physical capital -- the new business venture -- may someday yield a big payoff. It is satisfying to know that when that day comes the government will never again be in a position to take more than 35 cents of every dollar earned.

By throwing out many special deductions, exemptions, and credits that benefit relatively few individuals, we have been able to abandon high tax rates for the benefit of all taxpayers. We are not, however, abandoning features of current law that are justified, make good sense, and provide widespread family benefits. Instead, we are seeking to strengthen such provisions.

For example, we propose raising the value of the personal exemption to almost twice its current level and we recommend expanding the income bracket to which a zero rate of tax applies. The per capita personal exemption would be raised in 1986 from $1,080 to $2,000 and the zero bracket amount would be raised from $3,670 to $4,000 for all married taxpayers filing joint returns and from $2,480 to $3,600 for families headed by one parent.

Taken together, these proposals guarantee that families living in poverty and families whose incomes are near the poverty level will no longer be required to pay federal income tax. For families somewhat better off, this means that the amount of income that can be received tax free is substantially raised. For instance, under the President's plan a family of four will pay no tax on the first $12,000 of income received, whereas they could begin paying tax with less than $8,000 of income under current law. Indeed, if the $12,000 consists entirely of earnings, this family of four will actually receive an earned income credit refund of $200, even though no tax would have been paid.

To help low income families with dependents, the President proposes raising the earned income tax credit and indexing it for inflation. Even though $1.8 billion worth of these credits was claimed on individual income tax returns in 1983, the latest year for which data are available, the credit is no longer adequate to provide a general work incentive and to offset payroll taxes levied on low income workers. The changes recommended by the President will raise the maximum credit to an indexed $700 from an unindexed $550 current-law cap.

Itemized Deductions

The right to itemize certain expenses and deduct them from income subject to tax is a longstanding feature of our income tax but one that can generate inequity. In our review of currently deductible expenses, we carefully evaluated the relative merits of each deduction against the cost -- in terms of higher tax rates, perceived unfairness, or administrative complexity. The benefits of low rates of tax are so great that there must be a truly compelling reason to retain preferential tax treatment for any use of income.

We propose repealing the deductions for state and local taxes. Only one-third of all taxpayers itemize deductions and this group includes most high-income families and very few low-income families. As a result, the cost of a family's state and local tax burden that is borne by the Federal government increases as the family's marginal tax rate increase. Thus, the deduction can convert a state or local tax that is designed to be proportional into one that is regressive.

We propose retaining deductions for home mortgage interest on a principal residence, charitable contributions, medical expenses, and casualty losses.

And, we propose limiting deductions for still other expenses. Interest other than mortgage interest on a principal residence will be limited to investment income plus $5,000, and miscellaneous expenses such as other investment expenses, union dues, tax return preparation fees, certain educational expenses, and unreimbursed employee business expenses will be deductible only to the extent that, together, they exceed a 1-percent-of-income floor. For most families, the loss of these repealed or scaled-back deductions will be more than offset by reduced tax rates and increased levels of the personal exemption and the zero bracket amount.

Officials from states and localities that levy high rates of tax have been outspoken in their condemnation of our proposed elimination of deductions for state and local taxes. They argue that repeal of the deduction will be unfair to citizens of high-tax states, that repeal will constitute a tax on a tax, that repeal will require massive cutbacks in public services supplied by state and local governments, and that taxpayers in some states will face huge tax increases.

Repeal appears unfair to those speaking on behalf of the high-tax jurisdictions only because current law is so biased in their favor. In truth, repeal will restore fairness among states and localities and, within jurisdictions, among itemizers and non-itemizers.

The arguments advanced by the high-tax states are not persuasive for several reasons. First, since two-thirds of all taxpayers do not itemize their deductions, the deduction is a subsidy for those few who do itemize. Second, since there are 35 states with relatively low tax rates, the deduction is a subsidy for those living in the few high-tax states. Third, since those that do itemize are concentrated in the high income brackets, the deduction is a subsidy directed at a relatively small number of high income taxpayers. Fourth, because so many states base their income taxes on Federal tax concepts and definitions, base broadening at the Federal level will produce an opportunity for revenue gain for the conforming states. This should alleviate any concern that these states will be forced to cut back on services financed by state income taxes.

Last, even families living in high-tax states -- those states in which the per capita tax savings from deductibility exceeds the average for the country as a whole -- will not suffer tax increases if their incomes are at the median for their state.

The attached table shows that the median income family living in each of the 15 high-tax states (plus the District of Columbia) and currently itemizing deductions will realize a tax cut under the President's proposals. Median income non-itemizers and itemizers living in the other 35 lower-tax states will have even larger tax reductions.

With respect to charitable contributions, we find the arguments in favor of retaining the itemized deduction to outweigh those against retention. This Administration has tried very hard to establish the notion that Uncle Sam cannot always be looked upon as the provider of last resort for those in need, whether they be businesses, cultural institutions, or needy individuals. Help must come from the private sector, and not always from the public sector. In keeping with this idea, however, government should encourage private sector initiatives. Consequently, we recommend keeping the itemized deduction for charitable contributions. However, the deduction for charitable contributions made by those who do not otherwise itemize deductible expenses would be repealed one year ahead of its scheduled expiration because its cost in terms of forgone tax revenue and compliance cannot be justified by any evidence of induced giving.

The deductibility of interest expense associated with indebtedness on a principal residence has been retained under our proposal because of the central importance of home ownership to values cherished by the American family. The deduction of other interest expenses, including interest on debt incurred for investments as well as for consumption, will be limited to $5,000 plus investment income. Although the vast majority of families will never be affected by this latter limitation, it will prevent taxpayers from deducting substantial tax shelter interest expense from income that would otherwise be subject to current tax.

A recognition that a spouse working at home performs valuable service to the family is long overdue in our tax rules governing retirement savings. Under current law, a spouse working in the home is discriminated against by being limited to an annual tax deduction of only $250 for savings set aside for retirement. A spouse working outside the home may set aside up to $2,000 tax free. We are proposing that this discrimination be dropped by allowing a spouse working at home the same $2,000 retirement savings deduction to which spouses earning income outside the home are eligible.

The tax treatment of Social Security benefits will remain unchanged. Military allowances and veterans' disability payments will remain wholly tax free, as will parsonage allowances and the insurance activities of fraternal benefit societies.

Taken as a whole, the President's proposal to reform the tax code will remove much of the complexity from the tax calculations of the typical family. Because some deductions and exclusions are swapped for lower tax rates, far fewer families will need to itemize their deductions in order to obtain the lowest tax for which they are liable. Those who elect to report itemized deductions will drop from one-third of all current-law tax returns to one-fourth of all tax returns filed under the President's plan. Of the remaining three-fourths, many could have the IRS compute their tax bills for them if they so desired. This return-free system, which would be entirely optional, would be made possible by a combination of (1) the improved use of information reported by employers and payers of other forms of income and (2) the simpler rules for determining tax liability once income is known. When fully implemented, the return-free system could save taxpayers an estimated 71 million hours in actual return preparation time and $1.6 billion in fees now paid for professional tax return preparation.

Taxpayer Examples

The typical family, consisting of a mother and father with two dependent children and earning the median income of $33,600 in 1986, will receive a tax cut of $394, or more than 11 percent of their $3,454 tax bill under current law. This tax cut results from lower tax rates and the more generous personal exemption being more than enough to make up for the loss of state and local tax deductions totaling $2,200 (the average for such families) and an estimated $300 increase in income subject to tax due to including the first $25 per month of a family's employer-paid health insurance premiums.

A young person just starting out and supporting himself or herself on earnings of only $10,000 will discover our program provides a tax reduction of $98, again a cut of more than 11 percent from the current law liability of $863. In this example, the marginal tax rate will remain at its current law value of 15 percent. However, what is important to this young individual, full of hope for future success, is that under the President's plan, the 15 percent rate will continue to apply up until taxable income reaches $18,000. In contrast, under current law, taxable income of $18,000 would be taxed at 8 different marginal rates, ranging from 11 percent up to, and including, 23 percent.

An elderly couple living out their retirement years on Social Security benefits of $9,000 and a pension of $6,000, supplemented by interest income of $3,000, and dividends of $1,000, will not be required to pay any federal income tax under our program. Since their current law tax of $199 will be eliminated, their tax change represents a cut of 100 percent.

Not everyone will have a tax reduction under our proposals, but 79.3 percent of all families and individuals will have their taxes cut -- or they will experience no change because they remain nontaxable. The other 20.7 percent who will see their tax bills rise by an average of 17 percent do not, however, look much like the people in the three situations just described. Most are not sympathetic cases. In every instance, those whose taxes will increase under our proposals are enjoying -- to a greater or lesser degree -- special current law tax benefits or concessions that are not used by the majority.

The two charts appended to my testimony summarize the impact of the President's proposals on individual taxpayers. Chart 1 shows that 79.3 percent of all families will either receive a tax reduction or experience no change in tax, while 20.7 percent will have their taxes increased. The average change in individual income taxes for all families will be a reduction of 7.0 percent. This overall change, together with the breakdown by income level, appears on Chart 2. All families with less than $20,000 of income will receive, on average, tax reductions of 18.3 percent. Those with income in the $20,000 to $50,000 range will experience a 7.2 percent average reduction. Those with family income greater than $50,000 will have their taxes cut by 5.8 percent.

Taxes on Business and Capital Income

In order to enhance growth, the President proposes that the top tax rate for corporations be reduced to 33 percent, just below the top individual tax rate of 35 percent. Broad incentives for capital formation will be retained, but business tax preferences that favor only certain sectors of the economy or that favor only certain forms of investment should, absent compelling national interest to the contrary, generally be eliminated.

Incentives for Economic Growth and Neutrality

The President's plan for remodeling the tax system places great emphasis on stimulating growth through capital formation. Investment incentives are maintained through a system of depreciation allowances that is accelerated relative to economic depreciation. Incentives for innovation and risk-taking will be strengthened by targeting more accurately the credit for research and experimentation and by providing a 50 percent exclusion for individual long-term capital gains. Thus, under the President's proposals, the top rate of tax paid on capital gains by individuals would be reduced from 20 percent to 17.5 percent.

Like growth, economic neutrality is fundamental to the President's plan. This means that all investment should be encouraged equally; the tax system should not be used to implement an implicit industrial policy by encouraging investments in some sectors and in some depreciable asset categories more than others. Under the President's plan, tax-induced distortions among different types of investment will be reduced in several ways:

- o The investment tax credit, which is available for investment in equipment, but generally not for investment in structures, would be repealed;
- o All other business credits, except for the foreign tax credit that is required to prevent double taxation of foreign source income and the credit for research and experimentation, would be eliminated;
- o Businesses would be allowed to use LIFO inventory accounting without the obligation of conforming their tax and financial accounting reports or to use FIFO inventory accounting indexed to reflect changes in the value of cost of goods sold from inventories;
- o Corporations would be permitted to deduct dividends paid to their shareholders, limited for now to 10 percent of dividends paid; and
- o The depreciation system would be revised to account explicitly for inflation and to reflect economic depreciation more accurately, while preserving important investment incentives.

The incentives for all investment that will be provided through the system of depreciation allowances the President is proposing deserve special attention. The current law accelerated cost recovery system (ACRS), in combination with the investment tax credit (ITC), discriminates in favor of investment in machinery and equipment -- especially long-lived heavy machinery and ships -- and against investment in industrial structures and in assets with short economic lives, such as high tech equipment that can become obsolete more rapidly than anticipated.

This discrimination is especially severe in periods of low inflation. The ACRS allowances, which were introduced, in part, as offsets for inflation, can overcompensate for inflation and generate negative effective tax rates on income from investments, especially when combined with the ITC. While incentives for investment are desirable, we should not provide tax treatment that is more favorable than tax exemption.

In place of the ITC and the ACRS system, the President is proposing an improved capital cost recovery system (CCRS). CCRS will distinguish among assets by assigning them to 6 separate classes, each of which carries a different depreciation rate and a different recovery period. For example, short-lived equipment, class 1 property, is assigned a 55 percent depreciation rate and 4-year recovery period. At the other extreme, structures in class 6 are assigned a 4 percent rate of depreciation and a 28-year recovery period. The CCRS system will explicitly account for inflation by allowing deductions for the real, inflation adjusted, cost of an asset, rather than for historical costs only, as under current law. As a result, the effective tax rates I just mentioned will no longer depend on the rate of inflation; an important departure from current law.

All depreciation rates are deliberately set higher than would be required for economic depreciation, but in such a way that a corporation subject to the 33 percent corporate tax would pay a uniform 18 percent effective tax rate on income from any investment in equipment. (This rate will be 17 percent, once account is taken of the deduction for dividends paid.) The 25 percent effective tax rate on income from investment in structures, although lower than the current law rate, is somewhat higher than the rate on investment in equipment, reflecting the national priority for investment in equipment. In addition, debt financing is more common for structures than it is for equipment. Since leverage effectively reduces the effective rate of tax on income from investments, the disparity in effective rates is reduced when financing practices are considered.

The effective tax rate on income from inventories will be the statutory marginal rate, 33 percent in the case of large corporations. Though somewhat above the effective tax rates yielded by investments in equipment and structures, this effective rate will be well below the effective rate produced under current law.

Under current law, corporate income that is distributed to shareholders bears two taxes, first at the corporate level and then again at the shareholder level. This double taxation of dividends causes under-investment in the corporate sector and in the economy as a whole; it encourages the use of debt finance even when equity finance may be more appropriate, and it impedes the efficient allocation of the nation's capital. Though only a modest step toward eliminating these distortions, the deduction for 10 percent of dividends paid would be an important start in reversing this misguided tax policy.

Denial of Unforeseen Rate Reduction Benefits with Respect to Certain Pre-1986 Investments

Accelerated depreciation allows businesses to defer tax, to the extent of the acceleration. That deferral is the basic advantage provided by accelerated depreciation, and is entirely proper as a stimulus to investment. But when tax rates are reduced, as proposed by the President, the combination of deferred tax liabilities and rate reductions results in benefits that taxpayers did not foresee at the time they undertook investment, and which were not necessary to justify the investment. For large corporations, this unintended benefit would be 13 percent of the excess of tax depreciation over economic depreciation -- the difference between the current top corporate rate of 46 percent and the proposed 33 percent -- when the corporate rate is reduced.

The President is proposing that taxpayers whose total depreciation deductions taken between January 1, 1980, and December 31, 1985, are less than $400,000 would not be subject to any rate-reduction recapture. However, those who receive this unintended benefit and whose deductions exceed the $400,000 threshold could be affected by a rate recapture rule on deductions for assets placed in service before January 1, 1986. This rule would not affect the cost of new capital. Moreover, the tax after applying the recapture rule should be roughly equal to the tax anticipated at the time the depreciable assets were acquired.

Energy Industry

Current law treatment of the oil and gas industry causes more resources to be allocated to energy development than under a totally neutral system. This treatment has been maintained because of a concern for national security that recognizes the importance of readily accessible domestic sources of oil and gas and decreased reliance on unreliable foreign sources. Accordingly, the President's plan for tax reform carefully balances the principle of economic neutrality and fairness against the need to retain incentives for exploration and development of energy resources.

Percentage depletion is not an efficient subsidy for the provision of energy resources. The President proposes to phase out the allowance for percentage depletion over a 5-year period. However, for stripper wells (producing fewer than 10 barrels of oil per day), which account for some 15 percent of domestic production and which would more likely be irreversibly plugged and abandoned without preferential tax treatment, percentage depletion would be continued. It would not be retained, however, for royalty owners.

In order to assure the exploration for and discovery and development of domestic oil and gas resources, the current treatment of intangible drilling costs for successful wells, as well as dry holes, will be retained. At the same time, however, the preference associated with immediate expensing will be included in a meaningful way in a tightened minimum tax, in order to assure that all taxpayers pay a fair share.

Minimum Taxes

Nothing upsets the average American taxpayer's sense of fair play more than hearing about high-income individuals or successful businesses being able to avoid income tax altogether by pyramiding special tax concessions, one on top of the other, to an extent never intended by Congress. Because any practical program for tax reform will not close every loophole and dismantle every shelter that may permit this kind of unpopular abuse, the President is wisely recommending strengthened minimum taxes for both corporations and individuals.

The minimum tax for both corporations and individuals would be a 20 percent alternative tax on an income base that would be expanded to include preferences retained for oil and gas exploration and development. Eight percent of intangible drilling costs, without the income offset contained in current law, would be included in the minimum tax base. This amount equals the estimated value of the deferral benefit produced from current expensing of intangible drilling costs. Elimination of the income offset, which frequently reduces the intangible drilling costs tax preference to zero under current law, will assure that the preference for intangible drilling costs is properly reflected in the minimum tax income base. In addition, the expanded minimum tax income base will include the untaxed appreciation component of property donated to charity and preferences resulting from the combination of net interest expense and the excess of personal property depreciation deductions allowed under CCRS over those that would be allowed under a pure system of economic depreciation.

Economic Impact

Analysis by the Treasury Department indicates that these proposals should have a favorable impact on capital formation and economic growth. According to our estimates, the overall effective tax rate on equity-financed capital will be almost 20 percent lower than under current law. Although it is true that repeal of the investment tax credit will raise the effective tax rate on some equipment, this is more than offset by the substantially lower effective tax rate on industrial and commercial structures and inventories. Thus, under the President's plan, there should be a shift in the composition of investment toward more industrial and commercial structures and inventories, producing a correspondingly longer average life of capital. A longer average life of capital will improve economic efficiency and encourage greater total investment since the same amount of gross investment will yield more net investment and capital formation.

Conclusion

I would like to reiterate my opening remarks. The proposals I have discussed today are the President's. They reflect his decisions and he stands squarely behind them.

The process by which the Administration arrived at this particular set of proposals marks the beginning of a grass roots campaign for tax reform. Over the past few months since the Treasury Department's proposals for fundamental tax reform were made public, we have held hundreds of meetings with different groups of individuals, academicians, and business leaders in order to benefit from their thoughts on tax reform. These meetings provided constructive criticisms of the original Treasury proposals and thoughtful ideas concerning alternatives.

There is a growing awareness of the importance of tax reform to the long-run strength of the economy, even among groups that are particularly favored by current law, and, consequently, would be disfavored by a switch to a more neutral tax structure. Although they realize there may be short-term economic dislocations to which they must adjust, the overall benefits of fundamental tax reform are too great for them to ignore.

The President's final proposals also reflect meetings with leaders of Congress, authors of Congressional tax reform legislation, and members of the tax-writing committees of Congress. I have said all along that we will not be able to succeed unless we mount a bipartisan effort and obtain firm commitments from members on both sides of the aisle.

Finally, it is the American people who want, and who deserve, a new tax structure. They want simplicity and fairness -- and they want it now. They deserve a system of taxation that encourages invention, innovation, and savings for the future -- and they deserve it now.

We cannot risk the breakdown in our democratic institutions that the President warned could occur when a government begins taxing above a certain level of the people's earnings. Our form of government cannot survive if people cannot place their trust in it.

With bipartisan dedication and support from the American public, together we can implement the kind of tax structure Americans want and deserve -- a system that promotes growth, that is simple, and that, most importantly, is perceived to be fair and is fair.

Mr. Chairman, we appreciate your firm commitment to significant tax reform. The President and those of us charged with providing him with advice on tax policy are also committed. Moreover, we share with you a determination to seize this rare moment when Republicans and Democrats may come together to create a tax system that is simpler for many, fairer and more growth-oriented for all.

We have enjoyed working with you and members of the Committee as we have developed the President's proposals. We look forward to working with you as you begin the task of translating these proposals into law.

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Percent of Returns Not Itemizing State and Local Taxes and Percentage Tax Reduction for Median Income Families in High-Tax States 1/

State	Percent of Returns Not Itemizing Taxes Paid 2/	Percentage Tax Reduction for Median Income Families Under the President's Proposal 2/	
		Non-Itemizers	Itemizers
California	62.8%	-26.5%	-10.2%
Colorado	55.3	-26.8	-14.0
Connecticut	66.2	-24.5	-13.7
Delaware	58.8	-26.3	-11.1
District of Columbia	65.8	-23.1	-9.4
Hawaii	65.6	-26.2	-12.0
Maryland	55.3	-26.2	-11.8
Massachusetts	65.9	-27.6	-12.6
Michigan	59.1	-24.1	-6.0
Minnesota	58.4	-25.5	-8.6
New Jersey	64.9	-25.4	-12.1
New York	56.1	-25.2	-4.2
Oregon	60.3	-21.5	-7.2
Rhode Island	68.2	-23.7	-12.8
Virginia	65.9	-26.1	-11.1
Wisconsin	63.2	-23.5	-6.4
U.S. Total	66.6%	-23.8%	-9.2%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 11, 1985

1/ High-tax states are defined as states with per capita tax savings from deductions of state and local taxes greater than the U.S. average.
2/ 1982 law, 1982 levels.
3/ Hypothetical one-earner couple with two dependents earning the estimated median income in their state in 1986.

Note: The favorable pattern shown here is similar for non-itemizers in other states and even more favorable for itemizing taxpayers living in the low-tax states.

Chart 1

FAMILIES WITH TAX CHANGE
Under the President's Proposal

(As a Percent of All Families)

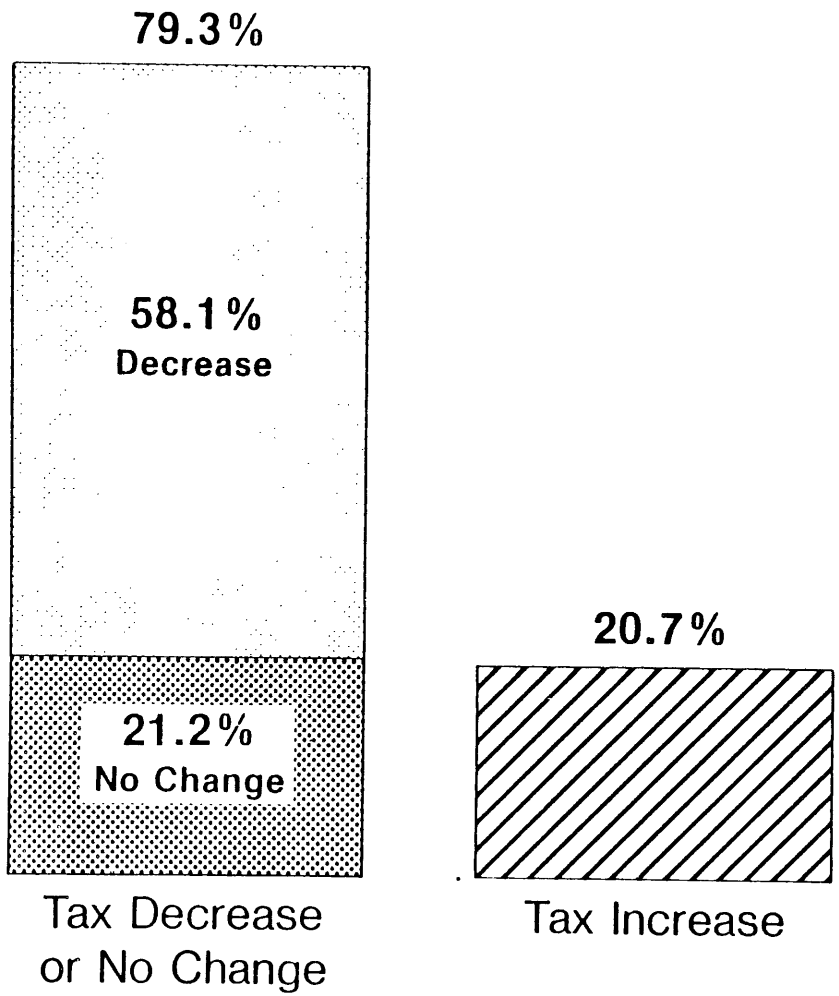
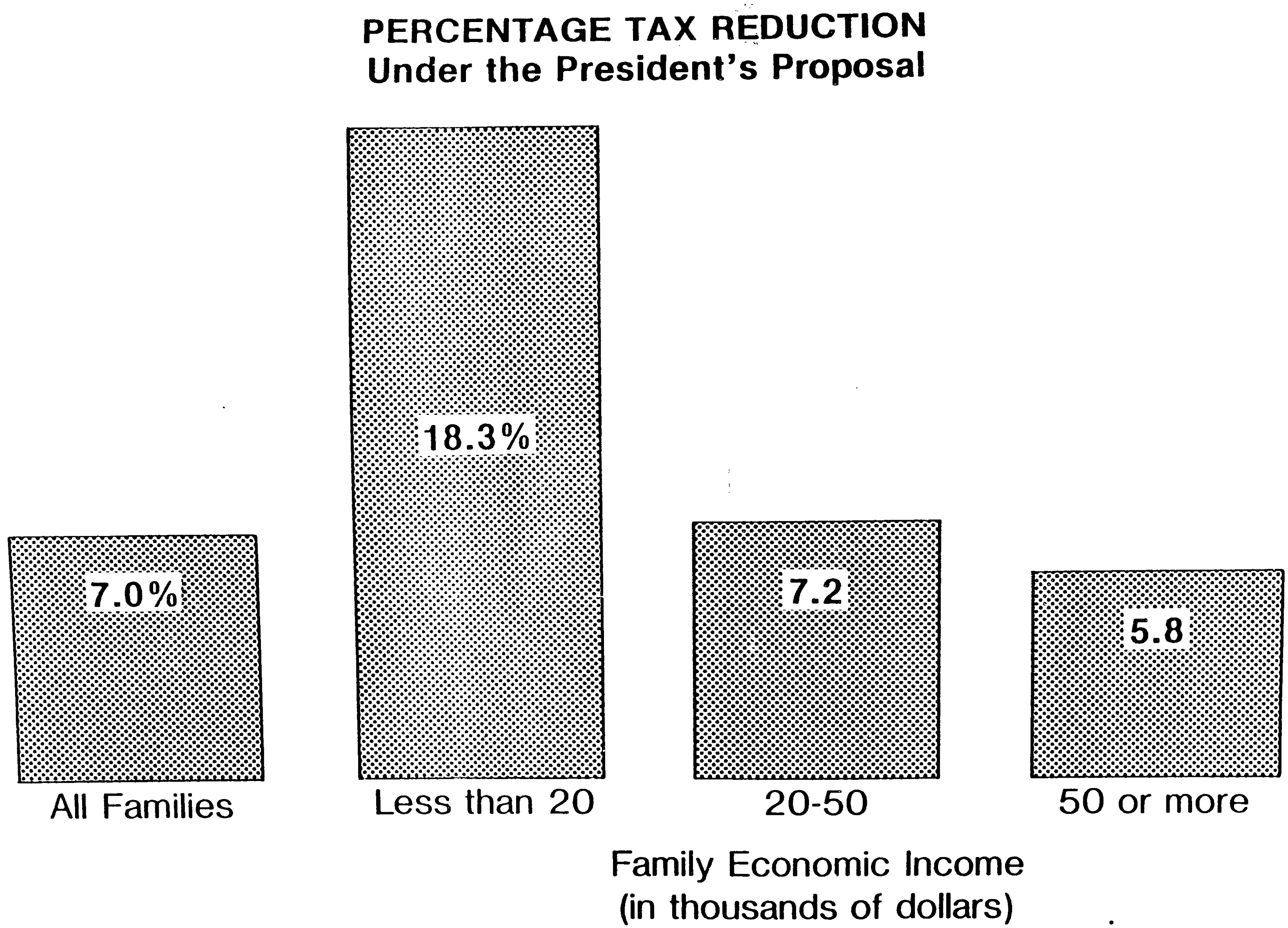


Chart 2



PERCENTAGE TAX REDUCTION
Under the President's Proposal
7.0%
18.3%
7.2
5.8
All Families
Less than 20
20-50
50 or more
Family Economic Income
(in thousands of dollars)

TREASURY NEWS

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FOR RELEASE UPON DELIVERY
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STATEMENT OF
THE HONORABLE RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FAMILY FARMS
OF THE
SENATE SMALL BUSINESS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the use of tax-exempt industrial development bonds ("IDBs") as a source of capital for small businesses. I will discuss our concerns about the growth in the use of tax-exempt bonds for nongovernmental purposes, the reasons we believe these uses are undesirable, the reasons past limitations placed on nongovernmental bonds have not fully solved the problems caused by the growth of these bonds, and the method by which we believe the use of tax-exempt bonds for such purposes should be prevented.

The Growth of Tax-Exempt Financing for Nongovernmental Purposes

The original purpose of the federal income tax exemption for interest earned on obligations of state and local governments was to allow those governments to finance their governmental needs at a reduced interest cost. Since 1979, however, over one-half of all long-term tax-exempt bonds issued have been to provide proceeds for the direct benefit of private businesses, certain tax-exempt organizations, or individuals, rather than to provide proceeds for use by states and local governments and their political subdivisions. I will refer to these tax-exempt bonds, in which the governmental issuer is only a conduit for private borrowing, as "nongovernmental bonds."

Chart 1 shows the volume of long-term tax-exempt bonds issued in the years 1975 through 1983. Nongovernmental bonds issued in 1975 totalled only $9 billion, accounting for 29 percent of the long-term tax-exempt bond market. In 1983, nongovernmental bonds totalled $57 billion and accounted for 61 percent of the long-term tax-exempt bonds issued in that year. Thus, the volume of nongovernmental bonds issued in 1983 was more than six times the volume of those bonds issued in 1975--only eight years earlier.

The volume of different types of nongovernmental tax-exempt financing in recent years is shown in Table 1. The table shows the following:

- Small-issue IDBs began growing rapidly in 1978 and 1979. Small-issue IDBs issued in 1975 totalled $1.3 billion, growing by a factor of more than 11, to $14.6 billion issued in 1983.

- Pollution control IDBs, multi-family rental housing IDBs, and private exempt entity (hospital and university) bonds were the main nongovernmental uses of tax-exempt financing in the early 1970s. Their use has grown steadily from $4.8 billion in 1975 to $21.5 billion in 1983.

- Mortgage subsidy bonds ("MSBs") for owner-occupied homes became widely used in 1977. MSBs grew from $1 billion in 1977 to $11 billion in 1983.

- Rapid recent growth has occurred in the issuance of student loan bonds, which grew from $0.1 billion in 1976 to $3.3 billion in 1983.

The growth of nongovernmental bonds can be attributed to three principal factors. First, as interest rates rose in the late 1970s, borrowers searched for lower cost financing tools, and they tapped tax-exempt financing as a method of reducing their interest costs. Even with today's lower interest rates, however, tax-exempt bonds continue to offer a clear cost advantage to the borrower. Thus, borrowers who learned to use tax-exempt financing during times of high interest rates are not abandoning it now in times of lower rates.

Second, more governments began issuing tax-exempt bonds for nongovernmental activities as they observed their neighboring jurisdictions doing so. This competition between states for economic development eventually forced all states and most governmental units to begin offering nongovernmental bonds. States and other governmental units had little to lose from these offerings because tax-exempt financing for private businesses and individuals involved no liability on the part of the issuer and no cost to the issuer.

Finally, some of the increase in nongovernmental bonds may be attributable to reductions in direct expenditures or loan guarantees by the federal government. The growth in private hospital bond volume in the middle 1970s probably was partly due to the cutback of the Hill-Burton program, which provided federal funds for hospital construction. Similarly, the recent blossoming of student loan bonds is likely due in part to the tightening of income eligibility requirements for federally guaranteed student loans. Thus, tax-exempt financing has been an indirect means of obtaining federal subsidies, without explicit congressional approval and sometimes in direct contravention of federal budget policies that gave rise to cuts in direct expenditures or loan guarantees.

Reasons Use of Nongovernmental Tax-Exempt Bonds is Undesirable

There are a number of reasons why the use of nongovernmental bonds is undesirable and therefore should be prohibited. First, the exemption from federal income tax of interest on state and local government obligations exists as a matter of comity between the federal government and state and local governments. This tax exemption is intended to lower the cost to state and local governments of financing governmental facilities, such as schools, roads, and sewers. The enormous growth of nongovernmental bonds has increased the supply of tax-exempt obligations, thereby exerting upward pressure on tax-exempt interest rates. Econometric studies that have estimated the effect of an increase in the supply of tax-exempt bonds on tax-exempt yields, holding all other factors constant, have found that tax-exempt yields increase when supply increases. Higher tax-exempt interest rates in turn increase the costs of state and local governments in financing governmental projects and thus may cause reductions in services or increases in state and local taxes. Moreover, these increased costs are borne by all state and local governments that issue tax-exempt bonds--not only those issuing nongovernmental bonds.

Second, the issuance of nongovernmental bonds is undesirable because tax-exempt bonds result in substantial present and future revenue losses by attracting capital away from alternative investments, the return on which would be taxable. Tax-exempt bonds produce a revenue loss not only in the year of their issuance, but also in each year that they remain outstanding. Because nongovernmental bonds increase the volume of tax-exempt bonds, they increase this revenue loss. Nongovernmental bonds will reduce tax revenues by nearly $10 billion in this fiscal year. The revenue loss from small issue IDBs issued in 1983 alone will be $450 million in this fiscal year and will eventually total $8 billion over the entire period these bonds are outstanding. If this lost revenue is to be made up, income tax rates applicable to nonexempt income must be maintained at higher levels than they otherwise would be during the period while the bonds are outstanding. These higher tax rates tend to slow economic growth now and far into the future.

Third, nongovernmental bonds are undesirable because tax-exempt financing is typically used by private businesses and individuals who would not receive direct assistance from either the federal or state governments. One example is the use of small-issue IDBs to make lower cost funds available to private businesses. The issuance of such bonds for these purposes results in a federal subsidy equal to the tax revenue lost as a result of the nontaxable status of the interest received from these bonds. The federal government cannot afford to provide such indiscrimate subsidies in these times of budgetary constraint. In this regard, tax-exempt financing in many cases is being used as a substitute for direct federal subsidies, direct loans, and loan guarantees, often after direct subsidy and credit programs have been eliminated or curtailed. Much of the savings to the federal government from reducing direct expenditures is lost when indirect federal subsidies are obtained through tax-exempt financing.

Fourth, even if a particular type of private beneficiary of tax-exempt bond financing is intended to receive a federal subsidy, nongovernmental tax-exempt financing is an inherently inefficient means of providing such subsidy. This is true because the interest cost savings to the borrower intended to be subsidized typically is far less than the revenue loss to the federal government resulting from the lender's not being taxed on the interest received from the bonds. Studies show that for every $2 of interest cost savings to the party who uses the tax-exempt bond proceeds, the federal government usually foregoes more than $3 of tax revenues. In other words, at least one-third of the benefit of tax-exempt financing generally is captured by financial intermediaries and high-bracket investors who hold the tax-exempt bonds. A direct subsidy program could provide the same subsidy to the intended beneficiary at a lower cost to the federal government or a larger subsidy to the intended beneficiary at the same cost to the federal government.

Finally, nongovernmental bonds are undesirable because they have anti-competitive and distortive effects on the economy. Activities receiving tax-exempt financing have a significant advantage over their competitors, who must raise capital with higher-cost taxable obligations. Yet, the availability of tax-exempt financing for nongovernmental persons depends upon which jurisdictions have the necessary programs in place and upon the ability of persons to navigate the various legal and regulatory procedures of state and local law. These factors have little relation to the value or efficiency of particular activities and ought not to influence the allocation of capital among sectors of the economy.

Past Approaches to Limit the Use of Tax-Exempt Financing for Nongovernmental Purposes

Congress has tried with varying success to place limitations on the use of nongovernmental bonds. One approach has been to limit tax-exempt financing to specified activities that are believed to serve a public purpose or to particular beneficiaries who are thought to be worthy of a subsidy. This approach was followed in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), through which Congress prohibited the use of small-issue IDBs for retail food and beverage service facilities, automobile sales or service facilities, and recreation or entertainment facilities. This list of prohibited facilities was lengthened significantly by the Tax Reform Act of 1984 (the "1984 Act").

Another approach to limiting the growth of nongovernmental bonds is to require that issuers exercise greater responsibility in determining whether a project financed with tax-exempt bonds serves a significant local purpose. Congress adopted such a restriction in TEFRA by requiring that all IDBs be approved by a voter referendum or by an elected official following a public hearing.

A third approach that has been tried in the past is to reduce the total tax incentives available to users and issuers of nongovernmental tax-exempt bonds. In TEFRA, Congress reduced the benefit of tax-exempt financing by requiring certain IDB-financed property to be depreciated on a straight-line basis. Furthermore, in the 1984 Act Congress limited the arbitrage profit that can be earned on certain IDBs by requiring the rebate of such earnings to the United States.

Finally, in the 1984 Act Congress adopted a state-by-state volume cap on student loan bonds and most IDBs. This volume cap limits the dollar amount of certain types of bonds that may be issued in any year.

None of these restrictions is the optimal solution to the problems created by nongovernmental bonds, however. The state-by-state volume cap limits the total amount of the federal subsidy made available to certain nongovernmental persons, but it does not eliminate the subsidy nor does it eliminate the other undesirable effects of nongovernmental bonds. Indeed, there is currently no volume limitation on tax-exempt financing for Section 501(c)(3) organizations, and it is the category of nongovernmental bonds that grew the most since 1981. Moreover, the volume cap does not apply to multi-family rental housing IDBs.

The methods used in the past to restrict tax-exempt bonds also fail to address the fundamental problems raised by nongovernmental bonds. Although these efforts may have reduced the revenue loss that would have resulted if no limitations were in place, they did nothing to improve the efficiency of the subsidy, and the high volume of nongovernmental bonds has resulted in still higher financing costs for governmental projects. In fact, by drawing arbitrary lines between projects that qualify and those that do not, certain of these methods may actually exacerbate the distortive effects that nongovernmental bonds have on the economy.

Therefore, we believe it is appropriate, as part of the President's tax reform proposal, to consider a more fundamental change in this area of the law.

The President's Tax Reform Proposal

In general, the President's proposal would deny tax exemption to any obligation issued by a state or local government where more than one percent of the proceeds were used directly or indirectly by any nongovernmental person. In essence, this proposal would prevent the issuance of tax-exempt bonds to finance any facility other than facilities to be owned and operated by the state or local governmental unit. Thus, roads, parks, and government office buildings could continue to be financed by tax-exempt bonds, but bonds could no longer be issued on a tax-exempt basis to finance facilities intended for private use.

Under any given set of tax rates, elimination of nongovernmental bonds would cause the spread between long-term tax-exempt and long-term taxable interest rates to increase, due to a lower volume of tax-exempt obligations. Thus the value of the federal subsidy provided to governmental activities financed with tax-exempt bonds would increase. This increased spread results because there will be a large reduction in the supply of new tax-exempt bonds and, due to other parts of the President's proposal, there will be cutbacks in alternative tax shelters and a greater demand by property and casualty insurance companies for tax-exempt bonds. This increase in the spread between long-term tax-exempt and long-term taxable interest rates will occur despite the lower marginal tax rates and changes in the ability of banks to deduct the costs of borrowings to carry tax-exempt bonds, which are also part of the President's proposal.

The proposal would, of course, increase financing costs for nongovernmental persons currently receiving tax-exempt financing, including eligible small businesses and farmers. Such increase, however, would simply remove a tax-created distortion in how the market allocates capital among all nongovernmental persons. Moreover, the undesirable effects of providing a federal subsidy through nongovernmental bonds apply with equal force to bonds issued for small businesses and farmers. During this time of fiscal constraint, inefficient, economically distortive, and ill-targeted tax expenditures of this type should be eliminated.

Conclusion

For the reasons discussed above, the Treasury Department strongly favors the elimination of tax-exemption for nongovernmental bonds. We regard the elimination of this federal subsidy program as a key part of the President's tax reform proposal.

This concludes my prepared remarks. I would be happy to respond to your questions.

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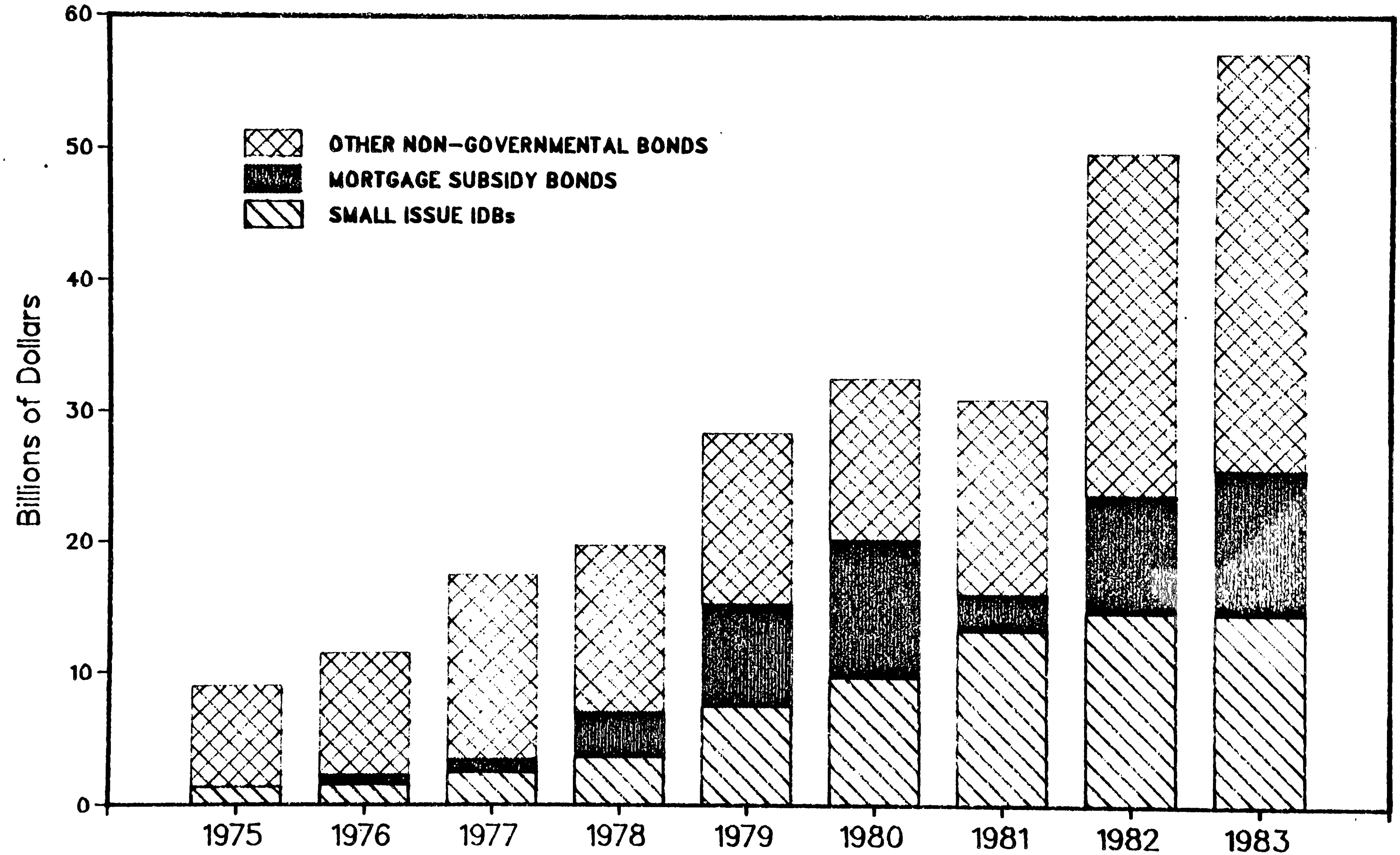
CHART 1
Long Term Tax-Exempt Bond Issues for Private Purposes - 1975 to 1983



Office of Tax Analysis, Department of the Treasury, June 11, 1985

Table 1

Volume of Long-Term Tax-Exempt Bonds by Type of Activity, 1975-1983

(In billions of dollars)

	Calendar Years								
	1975	1976	1977	1978	1979	1980	1981	1982	1983
Total issues, long-term tax exempts 1/	30.5	35.0	46.9	49.1	48.4	54.5	55.1	84.9	93.3
Nongovernmental tax exempts	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1
Housing bonds	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0
Single-family mortgage subsidy bonds	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0
Multi-family rental housing bonds	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3
Veterans general obligation bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7
Private exempt entity bonds 2/	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7
Student loan bonds	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3
Pollution control industrial development bonds	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5
Small-issue industrial development bonds	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6
Other industrial development bonds 3/	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0
Other tax-exempt bonds 4/	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2

Office of the Secretary of the Treasury — June 11, 1985

Note: Totals may not add due to rounding.

* $50 million or less.

1/ Total reported volume from Credit Markets (formerly the Bond Buyer) adjusted for privately placed small-issue IDBs.

2/ Private-exempt entity bonds are obligations of Internal Revenue Code Section 501(c)(3) organizations such as private nonprofit hospitals and educational facilities.

3/ Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

4/ Some of these may be nongovernmental bonds.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M. June 11, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,000 million, to be issued June 20, 1985. This offering will result in a paydown for the Treasury of about $7,052 million, as the maturing bills total $21,052 million (including the 17-day cash management bills issued June 3, 1985, in the amount of $7,052 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 17, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated March 21, 1985, and to mature September 19, 1985 (CUSIP No. 912794 HZ 0), currently outstanding in the amount of $7,046 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated June 20, 1985, and to mature December 19, 1985 (CUSIP No. 912794 JK 1).

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.

The bills will be issued for cash and in exchange for Treasury bills maturing June 20, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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. Federal Reserve Banks currently hold $1,781 million as agents for foreign and international monetary authorities, and $3,538 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

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Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

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

REASURY NEWS
irtment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
June 12, 1985

Contact: Bob Levine
(202) 566-2041

TREASURY ON ARGENTINE BRIDGE LOAN

The U.S. Department of the Treasury welcomed today the announcement by the Government of Argentina of its agreement with the management of the International Monetary Fund on a new economic program. The Treasury Department believes that this program can provide a basis for the restoration of economic growth and a viable balance of payments position in Argentina.

An arrangement to provide short-term bridge financing to Argentina in support of its economic program is being negotiated at this time. While the arrangement is not yet finalized, it is expected that bridge financing totaling approximately $450 million will be provided to Argentina in the next few days. The U.S. Department of the Treasury is prepared to join other monetary authorities in participating in such a bridging arrangement.

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'REASURY NEWS
artment of the Treasury • Washington, D.C. • Telephone 566-2041

)R IMMEDIATE RELEASE
ıne 12, 1985

Contact: Brien Benson
(202) 566-2041

SECRETARY BAKER ASKS INCREASED DRUG ENFORCEMENT FUNDS

Secretary James A. Baker, III today issued the following statement ɘquesting additional drug enforcement funds from Congress:

I am pleased to announce our plans to increase the resources ɘvoted to drug interdiction by the U.S. Customs Service, the Internal ɘvenue Service and the Bureau of Alcohol, Tobacco and Firearms.

The Department of the Treasury is working with the Congress as ɘll as the Departments of Justice and Transportation, to add ɔnsiderable resources to the war on drugs. These additional resources ill greatly aid the Treasury in carrying out its law enforcement ɘsponsibilities.

In total, the proposal will (as the Attorney General explained) ɗd $101.6 million and over 2,000 positions to the Departments of ıstice, Treasury, and Transportation.

For Customs, we plan to add $26.8 million to help prevent the llegal importation of drugs into the country. These funds will be ɜed primarily to strengthen our air and marine interdiction programs.

For air interdiction, we are adding $8.4 million, an increase of)% above the original FY 1985 amount of $44 million, to provide ɗditional radar and communications equipment.

For marine interdiction, we are adding $10.2 million, an increase ꞁ 29%, to provide for interceptor vessels and additional radar and ɔmmunications support.

For IRS, ATF and Customs, we are adding $6.5 million to enhance ıe Florida Organized Crime Drug Enforcement Task Force, a joint ɾogram to attack drug money as well as the importation and istribution of illegal drugs.

The U.S. Customs Service has been highly successful in its efforts ɔ interdict drugs coming into the country. In 1984, Customs seized ver 27,000 lbs. of cocaine, almost six times the amount seized in)80.

With all the public attention that has recently been focused on ɔmprehensive tax reform, it is important that we not overlook that the ɾeasury Department is also deeply committed to reducing drug abuse in ıis country. We view these additional resources as evidence of our trong commitment.

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

FOR RELEASE AT 4:00 P.M. June 12, 1985

TREASURY TO AUCTION $9,250 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,250 million of 2-year notes to be issued July 1, 1985. This issue will provide about $1,250 million new cash, as the maturing 2-year notes held by the public amount to $8,000 million, including $335 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the maturing 2-year notes, there are $3,116 million of maturing 4-year notes held by the public. The disposition of this latter amount will be announced next week. Federal Reserve Banks as agents for foreign and international monetary authorities currently hold $1,161 million, and Government accounts and Federal Reserve Banks for their own accounts hold $1,299 million of maturing 2-year and 4-year notes.

The $9,250 million is being offered to the public, and any amounts tendered by Federal Reserve Banks for their own accounts, or as agents for foreign and international monetary authorities, will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

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

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Attachment

B-175

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED JULY 1, 1985

June 12, 1985

<u>Amount Offered:</u>

To the public	$9,250 million

<u>Description of Security:</u>

Term and type of security	2-year notes
Series and CUSIP designation	Series W-1987 (CUSIP No. 912827 SJ 2)
Maturity date	June 30, 1987
Call date	No provision
Interest 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	December 31 and June 30
Minimum denomination available	$5,000

<u>Terms of Sale:</u>

Method of sale	Yield Auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

<u>Key Dates:</u>

Receipt of tenders	Wednesday, June 19, 1985 prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Monday, July 1, 1985
b) readily collectible check	Thursday, June 27, 1985

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
Expected at 9:00 a.m.
June 13, 1985

Testimony
of the
Honorable James A. Baker, III
Secretary of the Treasury
before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to be here this morning to present the Administration's views on the need to reform the financial services industry in a way which promotes the safety and soundness of our financial system while still advancing competitive equity among institutions as well as consumer convenience and welfare. I greatly appreciate the Chairman's willingness to accommodate my schedule by allowing me to appear at this time rather than earlier in the hearings.

The Administration has worked closely with you and the other members of the Committee in recent years to achieve important banking reforms and to define the agenda for future reform. In my new capacity as Secretary of the Treasury I look forward to an even closer relationship with the Committee.

Notable progress already has been realized from our common efforts to modernize the structure of our financial markets. For example, the nearly complete phasing out of deposit interest rate ceilings has permitted all our depository institutions to become stronger competitors for funds and has virtually brought an end to the once-serious problem of disintermediation. Also, with enactment of the Garn-St Germain Depository Institutions Act of 1982, our thrift institutions were provided the legal flexibilities needed by astute managements to maintain profitability throughout the interest rate cycle. Most recently, the "Financial Services Competitive Equity Act" (S. 2851), as approved by the Senate last year, laid out a comprehensive road-map for the future that was largely in keeping with the Administration's own principles originally proposed in the "Financial Institutions Deregulation Act" ("FIDA", S. 1609).

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I congratulate you, Mr. Chairman, and the Committee on your 89 to 5 vote in the Senate last year. S. 2851 embodied significant accomplishments that could not have happened without your leadership and the Committee's hard work. Indeed, I think that all of our progress to date is indicative of the fact that the deliberative mechanism of Congress is effective and that future reforms ought to be realized likewise, rather than through excessive institutional experimentation or ad hoc regulatory initiatives.

Certainly, much remains to be done. Extending services to and protecting consumers, promoting competitive equity in product and geographic markets, updating and rationalizing the regulatory system, and reforming the deposit insurance system are issues that need to be addressed. I look forward to exploring these issues with the Committee and am hopeful that, working together, we can adopt changes that will serve well the nation's financial system and the public.

The Need for Comprehensive Banking Legislation

The Administration's position on the need for comprehensive banking legislation is essentially unchanged from last year. Indeed, the need to modernize our banking laws and enable banks and thrifts to extend their activities to compete with other financial services providers is more important now than it has been during the last several years given the rapid pace of changes in both technology and the marketplace. We generally supported S. 2851 and are prepared to support a similar bill this year. We have some suggestions for broadening the scope of permissible activities.

As you have noted many times already, Mr. Chairman, the issues are well defined, thanks to the extensive hearings this Committee conducted last year, and they have not changed in substance. As you have heard from every witness at these hearings, the events of the marketplace have pressured the regulatory system and may continue to do so. If Congress does not act to resolve the confusion in the financial services industry, we believe that a combination of state legislative initiatives and legal innovations arising from competitive pressures may cause further fragmentation of the financial system.

Some commentators are suggesting that, in light of the recent court decisions on nonbank banks, there is less of a need for prompt Congressional action. I disagree. Court decisions, use of loopholes by aggressive financial firms, and regulatory actions are no substitute for legislation. Only legislation can address, in a comprehensive and rational manner, the many complicated policy questions that are involved in delineating the future structure of the financial services industry.

In terms of priorities, we believe that any legislative action should be comprehensive. At a minimum, the new banking bill should authorize additional products and services for depository institution holding companies and address the questions of qualified thrift lenders, nonbank banks, and interstate banking.

Recent problems of privately insured thrifts in Ohio and Maryland underscore the need for restructuring our financial system in a manner which will enhance its viability for the future. Safety and soundness of the financial system is our highest priority. As we have explained more thoroughly in previous testimony, the holding company framework proposed by the Administration in FIDA and incorporated in S. 2851 is designed to further that objective by insulating the federally-insured depository from the potentially higher risks of nonbanking activities and thereby not increase the risk exposure of the federal deposit insurance funds. The holding company requirement has the further advantages of preventing the federally-insured depository from using its lower cost of funds unfairly to subsidize nonbanking activities and promoting equal regulation of functionally equivalent activities. We believe the holding company requirement is the best means, keeping in mind the objectives of safety and soundness, of providing financial institutions with additional product and service authority.

New Products and Services

There are a number of reasons why we believe banking organizations should be given authority to offer new products and services.

First and foremost, legislation that increases a holding company's product line would benefit consumers by providing them with a wider choice of financial services at competitively lower prices.

Second, new products and services would enable depository organizations to compete for customers on an equal basis with less regulated firms, thereby stemming the erosion of their customer base. One should not ignore the fact that today there are virtually no banking-type products or services that the securities and insurance industries cannot offer their customers. Outdated laws that continue to restrict banking organizations to offering customers strictly banking services only would perpetuate the market advantage that the securities and insurance industries already have. The result would be economic atrophy of depository institutions.

Third, the marketplace will not tolerate an irrational structure. As we have seen, consumer-driven market pressures inevitably find ways around laws based on artificial distinctions among financial service providers.

Finally, preempting state authority over state-chartered banks -- for example, the Dodd amendment in S. 2851 -- is not the best way to deal with the confusion arising from state deregulation. Such an approach is an unnecessary encroachment on the dual banking system, which is a vital source of innovation and dynamic competition. A better solution would be to take the pressure off the states by allowing banks to engage in new activities through holding companies.

In addition to the activities proposed in S. 2851, we would urge you to include two others -- (1) authority to sponsor, distribute and advise mutual funds, and (2) authority to engage in activities "of a financial nature" as determined by the Federal Reserve. Both were proposed by the Administration in FIDA. We believe these two activities are needed to promote competitive equity and benefit consumers. "Financial nature" activities, in particular, would create a framework for depository institution holding companies to evolve with their competition.

Nonbank Banks

Originally, the nonbank bank was viewed as a vehicle by which nonbank institutions such as retailers, securities firms and the like could make a limited entry into banking. More recently the nonbank bank has been viewed as a means by which bank holding companies could circumvent existing statutory restrictions on interstate banking provided the Federal Reserve authorizes them to do so. The nonbank bank loophole has been a source of confusion and competitive inequity. Nevertheless, it has created opportunities for enhanced product and geographic competition to the benefit of financial services consumers. The Administration takes the position that these procompetitive benefits would be better realized in the form of expanded holding company powers and interstate banking.

Qualified Thrift Lenders

We do not oppose the concept of a qualified thrift lender test like that proposed in S. 2851 to qualify for the unitary thrift holding company exemption. However, in the interest of competitive equity we believe the exemption should be kept as narrow as possible and essentially be tied quite tightly to residential real estate lending. Savings banks should be required to have the same portion of their loans in residential real estate as savings and loan associations but because of their traditionally more diversified portfolios they should be given a generous time period to reach that required level.

We continue to have serious reservations about the broad service corporation exemption because it permits some financial service firms to diversify within the depository institution rather than through the holding company, thereby creating competitive inequities between such firms and firms subject to holding company regulation.

Interstate Banking/Regional Banking Compacts

Now that the Supreme Court has confirmed that states can join together to form regional compacts we believe Congress should turn its attention to the development of a trigger mechanism for nationwide interstate banking. The five year trigger adopted by the House Banking Subcommittee on Financial Institutions seems to me to be a reasonable time period for regional banks to make the transition to full interstate banking.

Mr. Chairman, in connection with relaxing the geographic restrictions on banking, there has been renewed interest in the limitations on financial industry concentration that you proposed in S. 2181 last year. Our position on this issue is unchanged. The Administration is not convinced that size is inherently bad or that current antitrust laws are inadequate to deal with concerns about the potential for undue concentration of resources. Accordingly, we do not believe that any restrictions on institutions' size other than those under existing antitrust provisions are necessary.

Net Worth Certificate Program

The emergency thrift acquisition and net worth certificate programs authorized by the Garn-St Germain Act expire in October of 1985. S. 2851 did not consider the emergency acquisition provision that allowed for interstate acquisitions of qualified depository institutions. Given the need to protect the insurance funds and the Administration's position that interstate banking should proceed as soon as possible, we would favor extending the duration of the emergency acquisition program and liberalizing the conditions under which commercial banks can qualify for this program. Under current law, the FDIC can arrange for interstate mergers of qualifying open thrifts or closed commercial banks. The Administration would permit interstate acquisitions of both qualified thrifts and commercial banks that are failing, but still open.

S. 2851 would have extended the net worth certificate program for three years and expanded it to include a small class of agricultural banks. Given the current condition of the thrift industry, the Administration is willing to discuss a short-term extension of the net worth program. However, broadening the program to include agricultural banks, as S. 2851 would have done, is not necessary, especially given the assistance already available to the agricultural sector.

Other Issues

There are two other issues we believe Congress should address in the near term, but only after it has resolved the issues I already have discussed.

First, while the deposit insurance system has satisfied the goal of maintaining stability of the financial system over the past 50 years, there is concern that economic changes like volatile interest rates associated with changing levels of inflation, and the potential increase in riskiness of large institutions, may threaten the ability of the insurance funds to fulfill their goals. The Administration addressed these concerns in a January 1985 report entitled Recommendations for Change in the Federal Deposit Insurance System, prepared by a Working Group of the Cabinet Council on Economic Affairs. The Report contains recommendations relating to: (1) risk-related premiums, (2) a significantly higher capital requirement, (3) consistent reporting requirements and prompt disclosure of material events, (4) a review of the appropriate size of the funds and extension of insurance premiums to cover deposits payable in foreign offices, and (5) continued improvement of the examination, supervision, and enforcement functions of the regulatory agencies. This is the first time any Administration has comprehensively studied the deposit insurance system. The study seems timely in light of the changing economic environment and recent problems in the bank and thrift industries. The Administration's study is in addition to two earlier studies by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board that were required by the Garn-St Germain Act.

Second, the Vice President's Task Group on Regulation of Financial Services soon will transmit to Congress legislative proposals based on its July 1984 report, the Blueprint for Reform. The Task Group's recommendations were unanimously adopted by the 13 member group and represent a balanced program for restructuring the financial services regulatory system. Enactment of the Task Group's proposals would significantly strengthen the effectiveness of the regulatory system, while at the same time reducing unnecessary costs for regulated firms. By improving our regulatory capabilities, the Task Group's proposals would help ensure the long-run stability of our financial system.

Conclusion

In conclusion, Mr. Chairman, I again urge you to act soon on much-needed legislation to enhance the economic viability and thereby the safety and soundness of our financial institutions. Such legislation would also benefit consumers, promote competitive equity, and resolve the confusion in the financial services industry. While there may be a consensus in Congress that loopholes must be closed, I believe there also is strong sentiment in the Senate and the financial services industry that a "loophole closer" alone will not suffice. We think it is important for the Congress to continue to demonstrate leadership on these issues. We at the Treasury Department will assist you in any way we can.

* * * * *

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

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE June 12, 1985

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of April 1985.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $148.7 billion on April 30, 1985, posting an increase of $1.2 billion from the level on March 31, 1985. This net change was the result of increases in holdings of agency assets of $0.9 billion, holdings of agency-guaranteed debt of $0.2 billion and holdings of agency debt of $0.1 billion during the month. FFB made 315 disbursements during April.

Attached to this release are tables presenting FFB April loan activity, new FFB commitments entered during April and FFB holdings as of April 30, 1985.

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FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
ON-BUDGET AGENCY DEBT					
TENNESSEE VALLEY AUTHORITY					
Advance #452	4/1	$ 295,000,000.00	4/8/85	8.585%	
Advance #453	4/4	190,000,000.00	4/15/85	8.575%	
Advance #454	4/8	450,000,000.00	4/18/85	8.535%	
Advance #455	4/15	170,000,000.00	4/22/85	8.445%	
Advance #456	4/18	425,000,000.00	4/24/85	8.185%	
Advance #457	4/22	153,000,000.00	4/29/85	8.175%	
Advance #458	4/24	35,000,000.00	5/1/85	8.175%	
Advance #459	4/24	389,000,000.00	5/2/85	8.175%	
Advance #460	4/29	180,000,000.00	5/6/85	8.195%	
Advance #461	4/30	217,000,000.00	5/6/85	8.225%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #314	4/1	45,000,000.00	7/1/85	8.615%	
+Note #315	4/3	25,000,000.00	7/1/85	8.635%	
+Note #316	4/12	15,000,000.00	7/11/85	8.445%	
+Note #317	4/12	2,500,000.00	7/11/85	8.445%	
+Note #318	4/16	22,200,000.00	7/15/85	8.475%	
+Note #319	4/18	1,000,000.00	6/10/85	8.185%	
Note #320	4/25	500,000.00	5/23/85	8.135%	
Note #321	4/25	550,000.00	7/22/85	8.135%	
+Note #322	4/29	6,600,000.00	7/29/85	8.215%	
OFF-BUDGET AGENCY DEBT					
UNITED STATES RAILWAY ASSOCIATION					
*Note #33	4/1	75,257,025.29	7/1/85	8.615%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership					
	4/1	40,000,000.00	4/1/05	12.015%	12.376% ann.
	4/3	150,000,000.00	4/1/95	11.825%	12.175% ann.
	4/8	190,000,000.00	4/1/95	11.875%	12.228% ann.
	4/15	15,000,000.00	4/1/05	11.785%	12.132% ann.
	4/15	400,000,000.00	4/1/90	11.175%	11.487% ann.
	4/15	100,000,000.00	4/1/95	11.555%	11.889% ann.
	4/22	150,000,000.00	4/1/95	11.285%	11.603% ann.
	4/22	35,000,000.00	4/1/00	11.465%	11.794% ann.
	4/22	20,000,000.00	4/1/05	11.585%	11.921% ann.
	4/30	200,000,000.00	4/1/90	11.085%	11.392% ann.
	4/30	400,000,000.00	4/1/95	11.595%	11.931% ann.
	4/30	75,000,000.00	4/1/00	11.795%	12.143% ann.
	4/30	10,000,000.00	4/1/05	11.895%	12.249% ann.
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Botswana 4	4/1	230,027.31	7/25/92	8.835%	
Egypt 6	4/1	4,288,698.56	4/15/14	11.936%	
El Salvador 7	4/1	204,030.00	6/10/96	11.781%	
Peru 10	4/2	359,700.58	4/10/96	11.765%	
Greece 15	4/2	1,757,464.35	6/15/12	11.815%	
Greece 14	4/5	1,180,368.15	4/30/11	12.045%	

+rollover
*maturity extension

FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual	INTEREST RATE (other than semi-annual)
Foreign Military Sales (Cont'd)					
Indonesia 10	4/5	$ 4,104,669.56	3/20/93	10.656%	
Turkey 14	4/5	2,967,820.00	11/30/12	11.929%	
Turkey 14	4/8	2,521,253.16	11/30/12	11.922%	
Egypt 6	4/10	483,732.66	4/15/14	11.955%	
Gabon 6	4/11	1,574,478.00	2/15/90	10.166%	
Greece 14	4/11	1,177,550.00	4/30/11	11.885%	
Jordan 11	4/11	660,737.56	11/15/92	11.645%	
Jordan 12	4/11	6,767,266.00	2/5/95	11.569%	
Egypt 6	4/15	677,635.96	4/15/14	11.695%	
Turkey 14	4/15	749,788.76	11/30/12	11.595%	
Egypt 6	4/16	1,538,663.35	4/15/14	11.675%	
Korea 19	4/16	133,722.10	6/30/96	11.085%	
Dominican Republic 5	4/18	22,528.36	4/30/89	10.795%	
Ecuador 5	4/18	12,938.95	5/25/88	10.485%	
Greece 14	4/18	1,467,810.23	4/30/11	11.645%	
Greece 15	4/18	8,831.50	6/15/12	11.465%	
Morocco 13	4/18	237,039.65	5/31/96	11.095%	
Niger 2	4/18	135,807.30	10/15/90	8.675%	
El Salvador 7	4/22	157,794.36	6/10/96	11.295%	
Liberia 10	4/22	50,300.00	5/15/95	11.275%	
Thailand 10	4/22	65,498.00	7/10/94	11.265%	
Turkey 15	4/22	7,000,000.00	5/31/13	11.294%	
Egypt 6	4/23	33,019,483.99	4/15/14	11.485%	
Philippines 10	4/23	144,189.00	7/15/92	10.505%	
Portugal 1	4/29	1,769,525.50	9/10/94	10.975%	
Somalia 4	4/29	1,922,429.41	11/30/12	11.662%	
Spain 5	4/29	228,888.09	6/15/91	11.015%	
Turkey 14	4/29	2,162,458.58	11/30/12	11.605%	
Turkey 15	4/29	5,314,492.00	5/31/13	11.595%	
Morocco 11	4/30	219,492.84	9/8/95	11.595%	
Morocco 12	4/30	142,830.04	9/21/95	11.575%	
DEPARTMENT OF ENERGY					
Geothermal Loan Guarantees					
*NPN Partnership	4/1	9,293,000.00	9/30/85	9.320%	
*Niland Geothermal, Inc.	4/1	2,533,000.00	9/30/85	9.320%	
Synthetic Fuels - Non-Nuclear Act					
Great Plains Gasification Assoc. #133A	4/1	252,000,000.00	10/1/85	10.005%	
#133B	4/1	129,000,000.00	7/1/85	9.405%	
#133C	4/1	11,000,000.00	1/2/86	10.255%	
#134	4/15	5,000,000.00	1/2/86	9.815%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
Atlanta, GA	4/1	740,000.00	2/1/86	9.485%	9.666% ann.
Santa Ana, CA	4/2	600,000.00	8/15/86	10.085%	10.339% ann.
Hammond, IN	4/10	131,429.00	5/1/86	9.595%	9.825% ann.
Provo, UT	4/11	482,983.00	8/1/85	8.675%	
Somerville, MA	4/11	39,670.00	5/1/85	8.505%	
Birmingham, AL	4/16	250,000.00	9/1/03	11.574%	11.909% ann.
Lynn, MA	4/16	92,048.03	8/15/85	8.615%	
Dade County, FL	4/17	108,000.00	7/15/85	8.325%	
Detroit, MI	4/17	2,326,832.00	9/1/85	8.485%	
El.zabeth, NJ	4/17	437,100.00	12/15/85	8.755%	8.849% ann.
Long Beach, CA	4/17	77,000.00	8/1/85	8.365%	

*maturity extension

FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
Community Development (Cont'd)					
Santa Ana, CA	4/22	$ 1,335,955.80	8/15/86	9.325%	9.542% ann.
Santa Ana, CA	4/23	995,500.00	8/15/86	9.215%	9.427% ann.
St. Louis, MO	4/23	1,000,000.00	2/15/86	8.705%	8.851% ann.
Rochester, NY	4/25	100,000.00	8/31/04	11.522%	11.854% ann.
Woonsocket, RI	4/25	201,000.00	8/1/86	9.255%	9.469% ann.
Ponce, PR	4/29	216,828.00	8/1/85	8.215%	
DEPARTMENT OF THE NAVY					
Ship Lease Financing					
Bobo	4/15	55,751,403.64	4/22/85	8.445%	
*Bobo	4/15	121,385,596.36	7/15/85	8.465%	
*Hauge	4/15	127,806,502.52	7/15/85	8.465%	
*Kocak	4/15	106,462,912.85	7/15/85	8.465%	
*Obregon	4/15	107,879,688.62	7/15/85	8.465%	
*Baugh	4/15	124,202,449.12	7/15/85	8.465%	
*Anderson	4/15	120,680,368.76	7/15/85	8.465%	
Bobo	4/24	55,751,403.64	5/30/85	8.175%	
Defense Production Act					
Gila River Indian Community	4/3	271,881.99	10/1/92	11.474%	11.314% qtr.
	4/25	226,763.80	10/1/92	10.920%	10.775% qtr.
RURAL ELECTRIFICATION ADMINISTRATION					
North Carolina Electric #268	4/1	26,001,000.00	6/30/87	10.645%	10.507% qtr.
Tex-La Electric #208	4/1	3,272,000.00	4/1/87	10.555%	10.419% qtr.
Saluda River Electric #271	4/1	10,854,000.00	6/30/87	10.645%	10.507% qtr.
New Hampshire Electric #270	4/1	1,985,000.00	6/30/87	10.645%	10.507% qtr.
Wolverine Power #274	4/1	20,544,000.00	6/30/87	10.638%	10.500% qtr.
Kansas Electric #282	4/1	5,554,000.00	6/30/87	10.635%	10.497% qtr.
Corn Belt Power #138	4/1	993,000.00	4/1/87	10.555%	10.419% qtr.
Corn Belt Power #292	4/1	474,000.00	6/30/87	10.645%	10.507% qtr.
*Wabash Valley Power #104	4/1	9,670,000.00	4/1/87	10.555%	10.419% qtr.
*Wabash Valley Power #206	4/1	438,000.00	4/1/87	10.555%	10.419% qtr.
*Southern Illinois Power #38	4/1	2,000,000.00	6/30/87	10.630%	10.492% qtr.
*Wolverine Power #101	4/1	2,584,000.00	4/1/87	10.555%	10.419% qtr.
*Wolverine Power #183	4/1	4,039,000.00	3/31/88	10.925%	10.780% qtr.
*Wolverine Power #233	4/1	14,717,000.00	4/1/87	10.555%	10.419% qtr.
*Colorado Ute Electric #168	4/1	15,815,000.00	4/1/87	10.555%	10.419% qtr.
*Tex-La Electric #208	4/1	1,965,000.00	4/1/87	10.555%	10.419% qtr.
*Basin Electric #232	4/1	1,368,000.00	4/1/87	10.555%	10.419% qtr.
North Carolina Electric #189	4/1	8,725,000.00	6/30/87	10.645%	10.507% qtr.
*Allegheny Electric #93	4/1	603,000.00	6/30/87	10.621%	10.484% qtr.
*Allegheny Electric #175	4/1	2,099,000.00	3/10/88	10.905%	10.760% qtr.
*Allegheny Electric #175	4/1	5,804,000.00	3/31/88	10.925%	10.780% qtr.
*Allegheny Electric #175	4/1	51,000.00	4/1/87	10.555%	10.419% qtr.
*Allegheny Electric #255	4/1	16,657,000.00	4/1/87	10.555%	10.419% qtr.
*Allegheny Electric #255	4/1	4,820,000.00	4/1/87	10.555%	10.419% qtr.
*Allegheny Electric #255	4/1	12,047,000.00	4/1/87	10.555%	10.419% qtr.
*San Miguel Electric #110	4/2	12,000,000.00	4/2/87	10.575%	10.439% qtr.
*Basin Electric #137	4/2	35,000,000.00	4/2/87	10.575%	10.439% qtr.
*Wolverine Power #182	4/3	3,205,000.00	4/4/88	10.965%	10.819% qtr.
*San Miguel Electric #110	4/8	7,269,000.00	4/8/88	10.995%	10.848% qtr.
South Mississippi Electric #90	4/8	609,000.00	6/30/87	10.722%	10.582% qtr.
South Mississippi Electric#289	4/8	10,000,000.00	6/30/87	10.735%	10.595% qtr.
*Sunflower Electric #174	4/9	10,000,000.00	4/9/87	10.615%	10.478% qtr.
*Wolverine Power #101	4/10	985,000.00	4/10/87	10.505%	10.371% qtr.
*Wolverine Power #182	4/10	1,011,000.00	4/11/88	10.895%	10.751% qtr.
*Wolverine Power #183	4/10	1,271,000.00	4/11/88	10.895%	10.751% qtr.
*Wabash Valley Power #104	4/11	459,000.00	4/11/87	10.435%	10.302% qtr.
*Wolverine Power #233	4/11	5,993,000.00	4/13/87	10.435%	10.302% qtr.

*maturity extension

FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
*Kansas Electric #282	4/11	$ 927,000.00	6/30/87	10.507%	10.373% qtr.
*Wabash Valley Power #206	4/11	4,042,000.00	4/13/87	10.435%	10.302% qtr.
Vermont Electric #303	4/12	74,000.00	1/2/18	11.610%	11.446% qtr.
Central Electric #131	4/15	90,000.00	4/15/87	10.265%	10.137% qtr.
Chugach Electric #257	4/15	3,034,000.00	6/30/87	10.355%	10.224% qtr.
*Wabash Valley Power #252	4/15	787,000.00	4/15/87	10.265%	10.137% qtr.
*New Hampshire Electric #192	4/15	975,000.00	4/15/87	10.265%	10.137% qtr.
*Oglethorpe Power #150	4/15	539,000.00	4/15/87	10.265%	10.137% qtr.
*Oglethorpe Power #246	4/15	18,275,000.00	4/15/87	10.265%	10.137% qtr.
*Deseret G&T #170	4/15	1,417,000.00	3/31/88	10.625%	10.488% qtr.
*Deseret G&T #170	4/15	1,378,000.00	4/2/88	10.625%	10.488% qtr.
East Kentucky Power #291	4/16	600,000.00	6/30/87	10.304%	10.175% qtr.
*South Mississippi Electric #3	4/17	70,000.00	6/30/87	10.050%	9.927% qtr.
*Wabash Valley Power #206	4/18	93,000.00	4/20/87	10.065%	9.941% qtr.
Central Electric #128	4/18	236,000.00	4/20/87	10.065%	9.941% qtr.
Central Electric #243	4/18	982,000.00	4/20/87	10.065%	9.941% qtr.
Tex-La Electric #208	4/18	1,650,000.00	4/20/87	10.065%	9.941% qtr.
Oglethorpe Power #150	4/18	274,000.00	4/20/87	10.065%	9.941% qtr.
Oglethorpe Power #246	4/18	18,145,000.00	4/20/87	10.065%	9.941% qtr.
Deseret G&T #211	4/19	3,896,000.00	4/20/87	9.855%	9.737% qtr.
*Colorado Ute Electric #203	4/19	988,000.00	4/19/87	9.855%	9.737% qtr.
New Hampshire Electric #270	4/19	780,000.00	6/30/87	9.935%	9.815% qtr.
Western Farmers Electric #261	4/19	16,000,000.00	1/2/01	11.250%	11.096% qtr.
*Central Electric #128	4/22	1,036,000.00	4/22/87	9.935%	9.815% qtr.
*Colorado Ute Electric #96	4/22	2,984,000.00	4/22/87	9.935%	9.815% qtr.
*Basin Electric #137	4/22	20,000,000.00	4/22/87	9.935%	9.815% qtr.
New Hampshire Electric #270	4/23	646,000.00	6/30/87	9.945%	9.824% qtr.
Allegheny Electric #255	4/23	3,988,000.00	6/30/87	9.945%	9.824% qtr.
Tri-State G&T #250	4/23	10,927,000.00	6/30/87	9.945%	9.824% qtr.
*South Mississippi Electric #4	4/24	1,132,000.00	6/30/87	10.090%	9.966% qtr.
*Wolverine Power #233	4/25	496,000.00	4/27/87	9.935%	9.815% qtr.
*Colorado Ute Electric #168	4/25	27,000,000.00	4/25/87	9.935%	9.815% qtr.
North Carolina Electric #268	4/29	11,932,000.00	6/30/87	10.105%	9.980% qtr.
*Tex-La Electric #208	4/29	600,000.00	4/29/87	10.005%	9.883% qtr.
Basin Electric #232	4/29	591,000.00	4/29/87	10.005%	9.883% qtr.
Plains Electric G&T #300	4/30	4,078,000.00	6/30/87	10.173%	10.047% qtr.
Kamo Electric #148	4/30	782,000.00	4/30/87	10.095%	9.971% qtr.
Kamo Electric #209	4/30	795,000.00	4/30/87	10.095%	9.971% qtr.
Kamo Electric #266	4/30	1,788,000.00	6/30/87	10.184%	10.058% qtr.
Central Iowa Power #295	4/30	8,500,000.00	6/30/87	10.195%	10.068% qtr.
Kansas Electric #282	4/30	768,000.00	12/31/15	11.758%	11.590% qtr.
*Allegheny Electric #93	4/30	4,221,000.00	6/30/87	10.171%	10.045% qtr.
*Allegheny Electric #93	4/30	2,850,000.00	6/30/87	10.171%	10.045% qtr.
*Allegheny Electric #175	4/30	2,632,000.00	4/11/88	10.585%	10.449% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
N.E. Louisiana Indus., Inc.	4/10	32,000.00	4/1/00	11.864%	
Alabama Comm. Dev. Corp.	4/10	40,000.00	4/1/00	11.864%	
Bus. Dev. Corp. of Nebraska	4/10	40,000.00	4/1/00	11.864%	
Cleveland Citywide Dev. Corp.	4/10	44,000.00	4/1/00	11.864%	
Mahoning Valley Ec. Dev. Corp.	4/10	70,000.00	4/1/00	11.864%	
Brattleboro Dev. Credit Corp.	4/10	74,000.00	4/1/00	11.864%	
Panhandle Area Council, Inc.	4/10	79,000.00	4/1/00	11.864%	
Rural Missouri, Inc.	4/10	95,000.00	4/1/00	11.864%	
N.W. Piedmont Dev. Corp.	4/10	114,000.00	4/1/00	11.864%	
Eastern Ohio Dev. Council, Inc.	4/10	132,000.00	4/1/00	11.864%	
St. Louis County LDC	4/10	139,000.00	4/1/00	11.864%	
Iowa Business Growth Co.	4/10	140,000.00	4/1/00	11.864%	
Empire State CDC	4/10	144,000.00	4/1/00	11.864%	
N.E. Kingdom Dev. Corp.	4/10	147,000.00	4/1/00	11.864%	
Columbus Countywide Dev. Corp.	4/10	147,000.00	4/1/00	11.864%	

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FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Gr. Spokane Bus. Dev. Assoc.	4/10	$ 162,000.00	4/1/00	11.864%	
Alabama Comm. Dev. Corp.	4/10	173,000.00	4/1/00	11.864%	
Cert. Dev. Co. of Mississippi	4/10	182,000.00	4/1/00	11.864%	
St. Louis County LDC	4/10	183,000.00	4/1/00	11.864%	
Region Eight Dev. Corp.	4/10	185,000.00	4/1/00	11.864%	
Fargo-Cass Cty Indus Dev Corp	4/10	190,000.00	4/1/00	11.864%	
Lake Cty. Ec. Dev. Corp.	4/10	200,000.00	4/1/00	11.864%	
Long Island Dev. Corp.	4/10	221,000.00	4/1/00	11.864%	
Rural Missouri, Inc.	4/10	298,000.00	4/1/00	11.864%	
Rural Missouri, Inc.	4/10	389,000.00	4/1/00	11.864%	
San Diego County LDC	4/10	401,000.00	4/1/00	11.864%	
St. Louis County LDC	4/10	500,000.00	4/1/00	11.864%	
River East Progress, Inc.	4/10	500,000.00	4/1/00	11.864%	
Catawba Regional Dev. Corp.	4/10	500,000.00	4/1/00	11.864%	
Rural Missouri, Inc.	4/10	500,000.00	4/1/00	11.864%	
Topeka/Shawnee Cty. Dev. Corp.	4/10	19,000.00	4/1/05	11.984%	
Nine County Dev., Inc.	4/10	21,000.00	4/1/05	11.984%	
Pittsburgh Countywide Corp, Inc	4/10	51,000.00	4/1/05	11.984%	
Illinois Sm. Bus. Growth Corp.	4/10	53,000.00	4/1/05	11.984%	
Columbus Countywide Dev. Corp.	4/10	59,000.00	4/1/05	11.984%	
Birmingham Citywide LDC	4/10	61,000.00	4/1/05	11.984%	
Georgia Mountains Reg. E.D.C.	4/10	61,000.00	4/1/05	11.984%	
Texas Cert. Dev. Co. Inc.	4/10	68,000.00	4/1/05	11.984%	
Nine County Dev., Inc.	4/10	78,000.00	4/1/05	11.984%	
Peoria Ec. Dev. Assoc.	4/10	79,000.00	4/1/05	11.984%	
Cincinnati LDC	4/10	81,000.00	4/1/05	11.984%	
East Texas Reg. Dev. Co.	4/10	82,000.00	4/1/05	11.984%	
Illinois Sm. Bus. Growth Corp.	4/10	91,000.00	4/1/05	11.984%	
St. Louis Local Dev. Co.	4/10	93,000.00	4/1/05	11.984%	
Long Island Dev. Corp.	4/10	95,000.00	4/1/05	11.984%	
Mid-Atlantic Cert. Dev. Co.	4/10	95,000.00	4/1/05	11.984%	
Greater Evanston Dev. Co.	4/10	95,000.00	4/1/05	11.984%	
Columbus Countywide Dev. Corp.	4/10	102,000.00	4/1/05	11.984%	
Hamilton County Dev. Co., Inc.	4/10	103,000.00	4/1/05	11.984%	
Los Medanos Fund	4/10	104,000.00	4/1/05	11.984%	
Kisatchie Delta R.P&D Dis., Inc	4/10	112,000.00	4/1/05	11.984%	
Middle Flint Area Dev. Corp.	4/10	112,000.00	4/1/05	11.984%	
Detroit Ec. Growth Corp. LDC	4/10	118,000.00	4/1/05	11.984%	
N. Kentucky Area Dev. Dis., Inc	4/10	119,000.00	4/1/05	11.984%	
CSRA Local Dev. Corp.	4/10	125,000.00	4/1/05	11.984%	
Enterprise Dev. Corp.	4/10	139,000.00	4/1/05	11.984%	
Michigan CDC	4/10	147,000.00	4/1/05	11.984%	
Verd-Ark-Ca Dev. Corp.	4/10	158,000.00	4/1/05	11.984%	
Opportunities Minnesota, Inc.	4/10	163,000.00	4/1/05	11.984%	
Gr. Spokane Bus. Dev. Assoc.	4/10	174,000.00	4/1/05	11.984%	
Cen. Upper Peninsula BDC, Inc.	4/10	177,000.00	4/1/05	11.984%	
St. Louis County LDC	4/10	179,000.00	4/1/05	11.984%	
Granite State Ec. Dev. Corp.	4/10	189,000.00	4/1/05	11.984%	
Cleveland Area Dev. Fin. Corp.	4/10	193,000.00	4/1/05	11.984%	
City-Wide Sm. Bus. Dev. Corp.	4/10	200,000.00	4/1/05	11.984%	
Cert. Dev. Co. of Mississippi	4/10	205,000.00	4/1/05	11.984%	
Bay Colony Dev. Corp.	4/10	210,000.00	4/1/05	11.984%	
Old Colorado City Dev. Co.	4/10	211,000.00	4/1/05	11.984%	
Indiana Statewide CDC	4/10	212,000.00	4/1/05	11.984%	
Greater Salt Lake Bus. Dis	4/10	231,000.00	4/1/05	11.984%	
Mass. Cert. Dev. Corp.	4/10	252,000.00	4/1/05	11.984%	
Nine County Dev., Inc.	4/10	265,000.00	4/1/05	11.984%	
Alabama Comm. Dev. Corp.	4/10	268,000.00	4/1/05	11.984%	
Long Island Dev. Corp.	4/10	272,000.00	4/1/05	11.984%	
Mass. Cert. Dev. Corp.	4/10	283,000.00	4/1/05	11.984%	
Indiana Statewide CDC	4/10	290,000.00	4/1/05	11.984%	
E.D.F. of Sacramento, Inc.	4/10	294,000.00	4/1/05	11.984%	
South Ga. Area Dev. Corp.	4/10	312,000.00	4/1/05	11.984%	
Wisconsin Bus. Dev. Fin. Corp.	4/10	317,000.00	4/1/05	11.984%	
Asheville-Buncombe Dev. Corp.	4/10	358,000.00	4/1/05	11.984%	
Mass. Cert. Dev. Corp.	4/10	378,000.00	4/1/05	11.984%	

FEDERAL FINANCING BANK

APRIL 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Lapeer Dev. Corp.	4/10	$ 423,000.00	4/1/05	11.984%	
Rural Missouri, Inc.	4/10	446,000.00	4/1/05	11.984%	
Evergreen Com. Dev. Assoc.	4/10	481,000.00	4/1/05	11.984%	
San Diego County LDC	4/10	500,000.00	4/1/05	11.984%	
Upper Rio Grande Dev. Co.	4/10	500,000.00	4/1/05	11.984%	
Metropolitan Gr. & Dev. Corp.	4/10	500,000.00	4/1/05	11.984%	
Orig. Aurora & Colorado Dev. Co	4/10	35,000.00	4/1/10	12.028%	
Areawide Dev. Corp.	4/10	40,000.00	4/1/10	12.028%	
Ark-Tex Reg. Dev. Co., Inc.	4/10	57,000.00	4/1/10	12.028%	
Columbus Countywide Dev. Corp.	4/10	66,000.00	4/1/10	12.028%	
Ark-Tex Reg. Dev. Co., Inc.	4/10	75,000.00	4/1/10	12.028%	
MSP 503 Dev. Corp.	4/10	79,000.00	4/1/10	12.028%	
MSP 503 Dev. Corp.	4/10	90,000.00	4/1/10	12.028%	
Evergreen Com. Dev. Assco.	4/10	126,000.00	4/1/10	12.028%	
Arrowhead Reg. Dev. Corp.	4/10	142,000.00	4/1/10	12.028%	
La Habra Local Dev. Co., Inc.	4/10	144,000.00	4/1/10	12.028%	
Louisville Ec. Dev. Corp.	4/10	147,000.00	4/1/10	12.028%	
Gr. Salt Lake Bus. District	4/10	147,000.00	4/1/10	12.028%	
Lake County Ec. Dev. Corp.	4/10	168,000.00	4/1/10	12.028%	
Bus. Dev. Corp. of Nebraska	4/10	180,000.00	4/1/10	12.028%	
Ocean State Bus. Dev. Authority	4/10	189,000.00	4/1/10	12.028%	
Mass. Cert. Dev. Corp.	4/10	189,000.00	4/1/10	12.028%	
Treasure Valley CDC	4/10	191,000.00	4/1/10	12.028%	
Orig. Aurora & Colorado Dev. Co	4/10	203,000.00	4/1/10	12.028%	
Tucson Local Dev. Corp.	4/10	229,000.00	4/1/10	12.028%	
San Diego LDC	4/10	231,000.00	4/1/10	12.028%	
Mass. Cert. Dev. Corp.	4/10	231,000.00	4/1/10	12.028%	
Mahoning Valley Ec. Dev. Corp.	4/10	235,000.00	4/1/10	12.028%	
Bay Area Employment Dev. Co.	4/10	244,000.00	4/1/10	12.028%	
South Shore Ec. Dev. Corp.	4/10	263,000.00	4/1/10	12.028%	
No. Virginia LDC, Inc.	4/10	265,000.00	4/1/10	12.028%	
No. Virginia LDC, Inc.	4/10	282,000.00	4/1/10	12.028%	
Peoria Ec. Dev. Assoc.	4/10	288,000.00	4/1/10	12.028%	
Phoenix Local Dev. Corp.	4/10	291,000.00	4/1/10	12.028%	
San Diego County LDC	4/10	303,000.00	4/1/10	12.028%	
San Francisco Indus. Dev. Fund	4/10	368,000.00	4/1/10	12.028%	
Evergreen Com. Dev. Assoc.	4/10	378,000.00	4/1/10	12.028%	
Ocean State Bus. Dev. Authority	4/10	420,000.00	4/1/10	12.028%	
Northern Virginia LDC	4/10	420,000.00	4/1/10	12.028%	
Ocean State Bus. Dev. Authority	4/10	433,000.00	4/1/10	12.028%	
San Diego County LDC	4/10	500,000.00	4/1/10	12.028%	
Bay Colony Dev. Corp.	4/10	500,000.00	4/1/10	12.028%	
Bay Area Bus. Dev. Co.	4/10	500,000.00	4/1/10	12.028%	
Small Business Investment Company Debentures					
Pioneer Investors Corporation	4/24	500,000.00	4/1/88	10.245%	
ESLO Capital Corporation	4/24	500,000.00	4/1/90	10.785%	
New West Partners	4/24	900,000.00	4/1/90	10.785%	
Allied Investment Corporation	4/24	2,500,000.00	4/1/95	11.245%	
Omega Capital Corporation	4/24	500,000.00	4/1/95	11.245%	
767 Limited Partnership	4/24	1,500,000.00	4/1/95	11.245%	
Wood River Capital Corporation	4/24	9,000,000.00	4/1/95	11.245%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-85-07	4/30	472,456,779.93	7/31/85	8.215%	

FEDERAL FINANCING BANK
APRIL 1985 Commitments

BORROWER	GUARANTOR	AMOUNT	EXPIRES	MATURITY
Erie, PA	HUD	$ 1,000,000.00	10/15/85	10/15/03
Newport News, VA	HUD	6,000,000.00	2/15/86	2/15/92
Sugar Land Telephone	REA	26,231,000.00	12/31/87	12/31/12

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	April 30, 1985	March 31, 1985	Net Change 4/1/85-4/30/85	Net Change—FY 1985 10/1/84-4/30/85
On-Budget Agency Debt				
Tennessee Valley Authority	$ 14,051.0	$ 13,910.0	$ 141.0	$ 616.0
Export-Import Bank	15,689.5	15,689.5	-0-	-0.4
NCUA-Central Liquidity Facility	220.4	279.1	-58.7	-48.5
Off-Budget Agency Debt				
U.S. Postal Service	1,087.0	1,087.0	-0-	-0-
U.S. Railway Association	73.8	51.3	22.3†	22.3†
Agency Assets				
Farmers Home Administration	60,641.0	59,756.0	885.0	1,130.0
DHHS-Health Maintenance Org.	112.9	112.9	-0-	-3.2
DHHS-Medical Facilities	132.0	132.0	-0-	-0-
Overseas Private Investment Corp.	8.3	8.3	-0-	-2.7
Rural Electrification Admin.-CBO	3,727.7	3,727.7	-0-	191.0
Small Business Administration	35.8	36.4	-0.6	-4.3
Government-Guaranteed Lending				
DOD-Foreign Military Sales	17,654.1	17,604.2	49.8	543.2
DEd.-Student Loan Marketing Assn.	5,000.0	5,000.0	-0-	-0-
DOE-Geothermal Loan Guarantees	12.4	12.4	-0-	6.2
DOE-Non-Nuclear Act (Great Plains)	1,457.0	1,441.0	16.0	167.0
DHUD-Community Dev. Block Grant	260.1	251.5	8.5	51.8
DHUD-New Communities	33.5	33.5	-0-	-0-
DHUD-Public Housing Notes	2,146.2	2,146.2	-0-	-32.3
General Services Administration	411.3	411.3	-0-	-2.0
DOI-Guam Power Authority	35.6	35.6	-0-	-0.4
DOI-Virgin Islands	28.3	28.3	-0-	-0.4
NASA-Space Communications Co.	887.6	902.3	-14.7	-67.0
DON-Ship Lease Financing	764.2	764.2	-0-	764.2
DON-Defense Production Act	4.9	4.4	0.5	1.8
Rural Electrification Admin.	20,894.2	20,730.4	163.8	307.1
SBA-Small Business Investment Cos.	943.8	932.5	11.4	83.5
SBA-State/Local Development Cos.	508.7	483.8	25.0	154.2
TVA-Seven States Energy Corp.	1,570.6	1,604.5	-33.9	15.1
DOT-Section 511	153.8	153.8	-0-	-5.8
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	$ 148,722.5	$ 147,506.9	$ 1,215.5	$ 3,886.3

*figures may not total due to rounding
†reflects adjustment for accrued interest

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

FOR IMMEDIATE RELEASE June 14, 1985

TREASURY ANNOUNCES CHANGE TO GENERIC CUSIPS FOR STRIPS

Effective July 29, 1985, the Department will begin assigning a single CUSIP number for each interest payment date for Interest Components issued under the STRIPS (Separate Trading of Registered Interest and Principal of Securities) program. A generic CUSIP number will be assigned to all Interest Components paying interest on the same date, including those previously issued with specific CUSIP numbers. Separate CUSIP numbers will continue to be assigned to each Principal Component.

During the weekend of July 27-28, the Treasury and Federal Reserve Banks will convert the specific CUSIP numbers currently assigned to Interest Components to a single CUSIP number for each payment date. On and after July 29, the designated generic CUSIP numbers will be used for maintaining and trading Interest Components, as well as for future issues of Interest Components having the same payment dates.

Federal Reserve Banks will make available to financial institutions a list of the generic CUSIP numbers for interest payment dates, and a table for conversion of current multiple CUSIP numbers (for a specific payment date) into the generic CUSIP numbers. The change to generic CUSIP numbers may require financial institutions to revise their internal recordkeeping systems. Financial institutions should direct any questions regarding the conversion process to their local Federal Reserve Bank.

The change to generic CUSIP numbers will further increase the liquidity of the STRIPS program by substantially reducing the number of CUSIP designations, and thus transactions, thereby reducing transaction costs and at the same time broadening the marketability of STRIPS.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 17, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,002 million of 13-week bills and for $7,007 million of 26-week bills, both to be issued on June 20, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 19, 1985			:	26-week bills maturing December 19, 1985		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.70%	6.91%	98.306	:	6.88%	7.23%	96.522
High	6.75%	6.96%	98.294	:	6.91%	7.26%	96.507
Average	6.73%	6.94%	98.299	:	6.90%	7.25%	96.512

Tenders at the high discount rate for the 13-week bills were allotted 62%.
Tenders at the high discount rate for the 26-week bills were allotted 64%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 42,650	$ 42,650	:	$ 27,165	$ 27,165
New York	15,232,330	5,517,410	:	16,336,450	5,876,090
Philadelphia	27,945	27,945	:	18,460	18,460
Cleveland	51,535	51,535	:	27,600	27,600
Richmond	50,335	47,755	:	47,925	47,065
Atlanta	44,820	41,300	:	35,730	32,850
Chicago	1,411,045	391,025	:	1,471,765	435,165
St. Louis	72,270	52,270	:	38,525	18,525
Minneapolis	14,690	14,690	:	13,470	13,470
Kansas City	65,185	65,085	:	49,000	48,360
Dallas	36,240	34,340	:	23,175	21,375
San Francisco	2,516,810	412,810	:	1,113,675	191,275
Treasury	302,950	302,950	:	249,570	249,570
TOTALS	$19,868,805	$7,001,765	:	$19,452,510	$7,006,970
Type					
Competitive	$16,578,855	$3,711,815	:	$16,271,765	$3,826,225
Noncompetitive	1,107,295	1,107,295	:	730,745	730,745
Subtotal, Public	$17,686,150	$4,819,110	:	$17,002,510	$4,556,970
Federal Reserve	1,839,455	1,839,455	:	1,750,000	1,750,000
Foreign Official Institutions	343,200	343,200	:	700,000	700,000
TOTALS	$19,868,805	$7,001,765	:	$19,452,510	$7,006,970

1/ Equivalent coupon-issue yield.

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TREASURY NEWS
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FOR RELEASE AT 10:30 A.M.
June 18, 1985

Contact: Brien Benson
566-2041

TREASURY ANNOUNCES PENALTIES AGAINST FOUR BANKS UNDER BANK SECRECY ACT

The Department of the Treasury today announced civil penalties against four New York banks that voluntarily disclosed to Treasury failures to report currency transactions from 1980 to 1984 as required by the Bank Secrecy Act.

The four banks, the penalty amounts and the number of reporting failures were: Chase Manhattan Bank, $360,000 (1,442 reports); Manufacturers Hanover Trust Company, $320,000 (1,393 reports); Irving Trust Company, $295,000 (1,242 reports) and Chemical Bank, $210,000 (857 reports). Each failure to report was subject to a maximum civil penalty of $1,000 during the period in question.

John M. Walker, Jr., Assistant Secretary of the Treasury (Enforcement and Operations), said: "The penalties imposed against Chase, Manufacturers Hanover, Irving and Chemical, while substantial and indicative of the seriousness with which we view reporting failures, were in each case less than 25% of the amount that could have been imposed."

"These reduced penalties were appropriate," Mr. Walker said. "While each case differed to some degree on its facts, all four banks had histories of substantial compliance and reporting procedures, self-initiated their own investigations and, upon learning of reporting failures, promptly and voluntarily came forward and disclosed them to Treasury. Moreover, each has taken corrective measures to avoid future reporting problems.

"Compliance failures, whatever the cause, are extremely serious," Mr. Walker said. "They deprive Treasury of a vital weapon in the battle against organized crime and drug trafficking and must be corrected."

The Bank Secrecy Act requires that financial institutions report to Treasury within 15 days all currency transactions of $10,000 or more. These reports are computerized and then used by Treasury enforcement task forces in financial investigations directed against organized crime, drug trafficking, money laundering and tax evasion.

The Act carries civil and criminal penalties. Until the passage of the Comprehensive Crime Control Act in October, 1984, the maximum criminal penalties were one-year imprisonment and a $1,000 fine or both. The 1984 Act increased the criminal penalties to five years and $250,000. Where more than $100,000 was unreported as part of a pattern of illegal activity, the criminal penalty is imprisonment for five years and a $500,000 fine. The civil penalty of $1,000 per violation was increased to $10,000.

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Bank	Number of Reporting Failures	Amount of Currency Unreported	Civil Penalty
Chase Manhattan Bank	1,442	$852,852,762	$360,000
Manufacturers Hanover Trust	1,393	$139,761,697	$320,000
Irving Trust	1,242	$309,824,072	$295,000
Chemical Bank	857	$25,839,835	$210,000

FACT SHEET

<u>Overview</u>. Since the passage in 1970 of the Currency and Foreign Transactions Reporting Act (Bank Secrecy Act), there have been 38 cases in which banks or employees of banks have been convicted of violations of financial reporting regulations.

Currently some 140 cases involving possible reporting violations by banks have been turned over by Treasury's Assistant Secretary for Enforcement and Operations to the IRS for possible criminal investigation. (No further details or timetables about these cases are available.)

<u>Reporting requirements</u>. Under the 1970 Currency and Foreign Transactions Reporting Act:

1) All financial institutions located in the Unites States must file Currency Transaction Reports (CTRs) with the IRS for all cash transactions (e.g., deposits, disbursements, transfers) exceeding $10,000, whether domestic or international. Casinos with annual revenues exceeding $1 million are included in this requirement. The most significant exemptions are:

-- domestic bank-to-bank transactions;

-- deposits and withdrawals, consistent with standard business volume, by retail businesses dealing primarily in cash (this exemption does not include auto, boat or plane dealers);

-- deposits and withdrawals, consistent with normal business volume, by sports arenas, amusement parks, bars, restaurants, hotels, theaters and vending machine companies;

-- other transactions exempted by the Secretary of the Treasury.

A CTR must include the amount and denominations of currency and the name, address, and social security number of the parties for whom the transaction is conducted.

2) All financial institutions located in the United States must file Currency and Monetary Instrument Reports (CMIRs) with the Customs Service for all international transactions involving cash or negotiable instruments in bearer form (such as checks or stock certificates) of $10,000 or more. A CMIR must indicate the amount of money and the institution or person to whom it was transferred. The only exemptions are those specifically granted by the Secretary.

<u>Use of Bank Secrecy Act data</u>. Data included in CTRs (submitted to IRS) and CMIRs (submitted to Customs) is collated and analyzed at the Treasury Financial Law Enforcement Center (TFLEC), located at the Customs Service. The information generated is used to support ongoing investigations and to help develop leads for new investigations involving money laundering, tax evasion and other criminal offenses.

Brief chronology of financial reporting requirements.

1970 -- Currency and Foreign Transactions Reporting Act (Bank Secrecy Act) passed.

1972 -- Implementing regulations issued. Act and regs challenged in court.

1974 -- U.S. Supreme Court upholds Act and regs.

1980 -- Operation Greenback initiated by Treasury to investigate money surplus in Florida.

Reporting requirement regs strengthened: exempt list tightened, and regs extended to all foreign transactions, including those between banks.

1984 (Oct.) -- Comprehensive Crime Control Act, including amendments to 1970 Bank Secrecy Act, passed. The Act strengthens civil penalties, clarifies Customs' search authority, authorizes payment for information, authorizes wiretaps, and makes Bank Secrecy Act violations grounds for prosecution under racketeering statutes.

1985 (June 13)-- Administration's bill, "Money Laundering and Related Crimes Act of 1985", announced.

Recent Puerto Rican raid. On June 6, 1985, more than 200 federal and Puerto Rican law enforcement agents, in the largest operation of its kind in U.S. history, raided several Puerto Rican banks and thrifts and arrested 16 people who were subsequently indicted for illegal activities related to money laundering and drug trafficking.

The cases stem from an 18 month undercover operation code-named TRACER, conducted by a federal investigative task force known as Operation Greenback-Puerto Rico, a joint effort of the IRS, the Customs Service and various components of the Department of Justice.

The defendants face fines of up to $2,510,000 and prison terms of up to 30 years.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 18, 1985

Treasury Participates in Multilateral Bridge Financing for Argentina

The U.S. Department of the Treasury today announced its participation, in cooperation with the monetary authorities of eleven other countries, in an arrangement to provide short-term financing to Argentina. Financing under this arrangement totals $483 million, of which the Treasury, through the Exchange Stabilization Fund, will provide $150 million under a swap agreement with Argentina.

The multilateral financing is being provided in light of Argentina's new economic program, which has recently been agreed with the management of the International Monetary Fund. This program is being submitted to the IMF Executive Board for formal approval by mid-August. Under the program, Argentina is expected to qualify for IMF balance of payments financing which will enable Argentina to repay the multilateral bridge financing and support the implementation of its economic program.

The monetary authorities cooperating in this financing arrangement are:

The U.S. Treasury Department
The Central Banks of:

- Austria
- Belgium
- Brazil
- Canada
- Denmark
- France
- Italy
- Japan
- Mexico
- Spain
- Venezuela

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TREASURY NEWS

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FOR RELEASE AT 4:00 P.M. June 18, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,000 million, to be issued June 27, 1985. This offering will provide about $50 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,949 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 24, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated March 28, 1985, and to mature September 26, 1985 (CUSIP No. 912794 JA 3), currently outstanding in the amount of $7,048 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated December 27, 1984, and to mature December 26, 1985 (CUSIP No. 912794 HQ 0), currently outstanding in the amount of $8,587 million, the additional and original bills to be freely interchangeable.

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.

The bills will be issued for cash and in exchange for Treasury bills maturing June 27, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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. Federal Reserve Banks currently hold $1,474 million as agents for foreign and international monetary authorities, and $2,453 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, 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 566-204

FOR RELEASE AT 4:00 P.M. June 18, 1985

TREASURY ANNOUNCES NOTE AND BOND OFFERINGS
TOTALING $17,000 MILLION

The Treasury will raise about $13,875 million of new cash by issuing $6,500 million of 4-year notes, $6,000 million of 7-year notes, and $4,500 million of 20-year 1-month bonds. This offering will also refund $3,116 million of 4-year notes maturing June 30, 1985. The $3,116 million of maturing 4-year notes are those held by the public, including $826 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the maturing 4-year notes, there are $8,000 million of maturing 2-year notes held by the public. The disposition of this latter amount was announced last week. Federal Reserve Banks, as agents for foreign and international monetary authorities, currently hold $1,161 million, and Government accounts and Federal Reserve Banks for their own account hold $1,299 million of maturing 2-year and 4-year notes. The maturing securities held by Federal Reserve Banks for their own account may be refunded by issuing additional amounts of the new 2-year and 4-year notes at the average prices of accepted competitive tenders.

The $17,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

The 20-year 1-month bond will become eligible for STRIPS (Separate Trading of Registered Interest and Principal of Securities) on February 18, 1986. Generic CUSIP numbers will be assigned to the Interest Components created from the bond in accordance with the pertinent interest payment date list which will be effective July 29, 1985.

Details about each of the new securities are given in the attached "highlights" of the offerings and in the official offering circulars.

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Attachment

B-18

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC OF 4-YEAR NOTES, 7-YEAR NOTES, AND 20-YEAR 1-MONTH BONDS

June 18, 1985

Amount Offered:			
To the public....................	$6,500 million	$6,000 million	$4,500 million
Description of Security:			
Term and type of security.......	4-year notes	7-year notes	20-year 1-month bonds
Series and CUSIP designation....	Series M-1989 (CUSIP No. 912827 SK 9)	Series F-1992 (CUSIP No. 912827 SL 7)	Bonds of 2005 (CUSIP No. 912810 DR 6)
Issue date	July 1, 1985,	July 2, 1985	July 2, 1985
Maturity date....................	June 30, 1989	July 15, 1992	August 15, 2005
Call date........................	No provision	No provision	No provision
Interest rate....................	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield.................	To be determined at auction	To be determined at auction	To be determined at auction
Premium or discount..............	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates...........	December 31 and June 30	January 15 and July 15 (first payment on January 15, 1986)	February 15 and August 15 (first payment on February 15, 1986)
Minimum denomination available..	$1,000	$1,000	$1,000
Terms of Sale:			
Method of sale...................	Yield Auction	Yield Auction	Yield Auction
Competitive tenders..............	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders..........	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor.....................	None	None	None
Payment through Treasury Tax and Loan (TT&L) Note Accounts...	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Payment by non-institutional investors......................	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions.........	Acceptable	Acceptable	Acceptable
Key Dates:			
Receipt of tenders.............	Tuesday, June 25, 1985, prior to 1:00 p.m., EDST	Wednesday, June 26, 1985, prior to 1:00 p.m., EDST	Thursday, June 27, 1985, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)			
a) cash or Federal funds......	Monday, July 1, 1985	Tuesday, July 2, 1985	Tuesday, July 2, 1985
b) readily collectible check..	Thursday, June 27, 1985	Friday, June 28, 1985	Friday, June 28, 1985

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

FOR IMMEDIATE RELEASE
June 19, 1985

CONTACT: ART SIDDON
(202) 566-2041

UNITED STATES AND TUNISIA SIGN INCOME TAX TREATY

The Treasury Department today announced the signing of an income tax treaty between the United States and the Tunisian Republic. The treaty was signed in Washington D.C., on June 17, 1985, by Secretary of State, George Shultz, and His Excellency Baji Caid Essebsi, Minister of Foreign Affairs of the Tunisian Republic. The Convention will be submitted to the Senate for its advice and consent to ratification. There is not now in force an income tax treaty between the two countries.

The proposed treaty is based on the provisions of the 1977 OECD Model convention on double taxation of income and the United States Model income tax convention of 1981. It also takes into account the UN Model income tax convention. The provisions of the proposed treaty are similar in most respects to those of the U.S. model, but they have been adapted to reflect Tunisia's status as a developing country.

The proposed treaty limits the tax each country may impose on investment income derived by residents of the other country to not more than 14 percent on direct investment dividends, 20 percent on portfolio dividends, 15 percent on royalties and 15 percent on interest. However, interest derived by the other government or a wholly-owned government instrumentality, such as the U.S. Export-Import Bank, is exempt from tax at source, as is interest on loans to the Government of the Tunisian Republic and interest on bank loans with a maturity of at least seven years.

The proposed treaty also provides rules concerning the taxation of business profits, income from real property, transportation income, employment income, pensions, social security benefits and capital gains.

In addition, the proposed treaty contains provisions for avoiding double taxation and for cooperation between the tax authorities of the two countries to prevent tax evasion.

The proposed treaty will enter into force on the date on which the instruments of ratification are exchanged. The provisions concerning withholding taxes will take effect on the following January 1, or on the first day of the fourth month thereafter, whichever comes sooner. The provisions concerning other taxes will apply to taxable years beginning on or after December 31 of the year of entry into force.

A limited number of copies of the proposed treaty are available from the Public Affairs office, room 2315, Treasury Department, Washington, D.C., 20220, telephone (202) 566-2041.

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TREASURY NEWS
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Release Upon Delivery
Expected at 9:00 a.m., E.D.T.
June 19, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

It is my pleasure to be here today along with other Administration representatives to discuss the revenue initiatives included in the President's fiscal year 1986 budget proposal. I will present the views of the Treasury Department on the issue of whether the temporary increase in the cigarette excise tax should be extended. Other Administration officials will discuss specifically the user fees proposed in the President's budget.

The current tax rate of 16 cents per pack of 20 cigarettes is scheduled to be reduced to 8 cents per pack on October 1, 1985. Our position is that the excise tax should be allowed to decline to 8 cents per pack on October 1 in accordance with current law.

The Administration generally is opposed to any form of Federal tax increase at this time. Fees imposed for the use of Federal Government property or services, however, are an appropriate means of compensating the Federal Government for the expenses incurred in making such property or services available to the public, and thus other Administration witnesses will be testifying this morning in support of certain user fees.

Discussion

Excise taxes are imposed upon cigars, cigarettes, and cigarette papers and tubes manufactured in or imported into the United States. In general, the manufacturer or importer is liable for these taxes when the products are removed from the factory or released from customs custody. The rate of tax imposed on small cigarettes (weighing no more than 3 pounds per thousand) removed from bonded premises before January 1, 1983 and after September 30, 1985 is $4 per thousand, which is equivalent to a tax of 8 cents per pack of 20 cigarettes. The rate of tax imposed on large cigarettes (weighing more than 3 pounds per thousand) is $8.40, which is equivalent to a tax rate of 16.8 cents per pack of 20 cigarettes. The Tax Equity and Fiscal Responsibility Tax Act of 1982 temporarily increased the rate of tax on small cigarettes to $8 per thousand, which is equal to a tax rate of 16 cents per pack. Similarly, the rate of tax imposed on large cigarettes was temporarily increased to $16.80 per thousand, which is equal to a tax rate of 33.6 cents per pack. These temporary increases are scheduled to expire on September 30, 1985.

Excise taxes on tobacco discriminate against consumers who prefer to spend a portion of their incomes on these products. Moreover, the excise taxes on tobacco are regressive because low income individuals spend a larger percentage of their income on these products than wealthier individuals. According to the 1980-81 Consumer Expenditure Survey Diary Data, tobacco expenditures are 2.4 percent of income for the quintile of the population with the lowest income, but are only .4 percent of the income for the quintile of the population with the highest income.

In addition, state and local governments currently impose excise taxes on cigarettes. In 1984, revenue from these taxes equalled $4.3 billion. To the extent that higher Federal taxes on tobacco products reduce tobacco consumption, they could restrict the ability of such governments to raise revenue from these sources.

In summary, the Treasury Department favors the scheduled termination of the temporary increase in the excise taxes on tobacco products on September 30, 1985.

* * *

This concludes my prepared remarks on the cigarette excise tax. I would be happy to respond to your questions.

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

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m. EDT
Wednesday, June 19, 1985

STATEMENT OF
CHARLES E. McLURE, JR.
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE BANKING SUBCOMMITTEE ON
ECONOMIC STABILIZATION

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss the capital gains provisions of The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity. I would like to present a prepared statement which describes the proposed changes and discusses them briefly, and then I will be glad to answer your questions.

Proposed Changes

The major change in the tax treatment of capital gains proposed by the Administration is a reduction in the exclusion rate on nondepreciable assets from 60 percent to 50 percent. Coupled with the proposed reduction in individual rates, this will result in a reduction in the maximum individual tax rate on long-term capital gains from 20 percent to 17.5 percent. The Administration also proposes that preferential capital gain treatment no longer be accorded to depreciable property used in a trade or business. However, note that depreciable assets placed in service prior to January 1, 1986 would not be subject to the new rule.

The Administration proposes no changes in the limitation on the deductibility of capital losses against an individual's ordinary income, which would remain at $3,000 per year (with carry forward permitted). The current provisions which allow rollover of gain on certain sales of principal residences and a $125,000 exclusion on housing gains for taxpayers 55 years of age or older would be retained. Also, the holding period for long term capital gains would be left unchanged at six months, and the corporate tax rate on capital gains would be left unchanged at 28 percent.

Finally, the Administration proposes that, beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991, rather than take the proposed 50 percent exclusion. This election would be effective for all capital gains recognized by a taxpayer in a particular year.

Discussion of the Proposed Changes

The proposed treatment of capital gains on nondepreciable assets realized between July 1, 1986 and December 31, 1990 is roughly similar, although slightly more generous, than under current law. Thus, the proposal is conceptually different from the original Treasury proposal to index the basis of capital assets for inflation and then tax real capital gains at ordinary income rates.

The primary difference between the two approaches is that an exclusion or a "preferential rate" applied to nominal capital gains provides an approximate adjustment for the fact that the inflationary component of a nominal capital gain is inappropriately subject to tax; with indexing, the inflationary component of the gain is simply removed from the tax base. The relative tax burden on a given real gain under the two approaches varies in a complex way which depends on inflation rates, real rates of appreciation, and holding periods. In general, the Administration proposal will be more generous than indexing for low rates of inflation, high real rates of appreciation, and long holding periods.

The original Treasury proposal to tax real capital gains at ordinary income rates reflected a desire to introduce an explicit adjustment for inflation and to achieve the reduction in complexity associated with eliminating preferential treatment of a particular type of income. These concerns were viewed as outweighing the concern that the elimination of the exclusion might have adverse effects on innovation, investment, capital formation, and growth.

However, many individuals and businesses expressed a strong concern that we underestimated the negative effects of our initial proposal, especially with respect to high risk investments by individual entrepreneurs and venture capitalists. Moreover, several individuals have suggested to us that the complexity and potential for abuse with indexing might be sufficiently great to outweigh the simplicity benefits obtained from taxing real capital gains as ordinary income. The proposed 50 percent exclusion provides a way to continue incentives for entrepreneurship, risk-taking, and investment, while the delay of indexing until 1991 provides us with more time to evaluate various criticisms of indexing.

The Administration proposal is likely to have a more positive effect than the original proposal on the supply of venture capital to new and emerging firms. Successful venture capital investments have very high rates of real appreciation, and thus will be treated more generously under a 50 percent exclusion than they would have been under the original Treasury proposal. Venture capitalists tell us that the capital gains tax reductions in 1978 and 1981 were critical to the dramatic increases in the supply of venture capital in recent years. The further reductions proposed by the Administration should stimulate further increases in the supply of venture capital, which will be of particular benefit to the new and emerging firms which are among the most dynamic and innovative elements of our economy. Similarly, the proposed 50 percent exclusion should encourage investment by individual entrepreneurs who forego stable sources of income and start high risk enterprises on the expectation that the return will be higher than average.

The effect on more traditional investments is difficult to predict. Historically, investors would have fared better in the 1970s and early 1980s under an indexing scheme than with the current exclusion. However, since inflation has subsided in recent years, indexing is less critical now than it was in the recent past. Moreover, representatives from the securities industry insist that individuals invest only if they have the expectation that their investment will earn above-average real returns. To the extent such investors are concerned primarily with the tax treatment of highly successful investments, they will view the 50 percent exclusion as more generous than indexing and thus be more likely to supply funds to equity markets. Such increased investment would stimulate capital formation and economic growth.

Another benefit of the reduced capital gains tax rates proposed by the Administration is that the so-called "lock-in" effect will be reduced. Under current law, taxpayers do not pay tax on accrued capital gains until they are realized, and can avoid tax completely when gains are transferred at death. Thus, the taxation of gains results in an impediment to sales of assets with accrued gains. Rate reductions reduce this impediment, and thus increase realizations. Treasury revenue estimates suggest that the increased realizations induced by the rate cut are sufficiently large that the rate reduction has little or no net effect on capital gains tax revenues over the 1986-1990 period.

Finally, under current law, depreciation deductions are taken against ordinary income and losses on depreciable property are treated as ordinary losses. Under the proposal, such property will benefit from depreciation allowances which are both accelerated relative to economic depreciation and indexed for inflation. For such assets, the Administration believes that further preferential treatment would be inappropriate, and that the benefits of accelerated and indexed depreciation allowances will be sufficiently large that the elimination of preferential capital gains treatment will not have a significant negative effect on investment. Moreover, the elimination of capital gains treatment on depreciable assets will eventually eliminate the need for the highly complex recapture rules of current law.

* * *

This concludes my prepared remarks. I will be happy to answer your questions.

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

KEYNOTE ADDRESS OF THE HONORABLE JOHN M. WALKER, JR.,
ASSISTANT SECRETARY (ENFORCEMENT AND OPERATIONS)
U.S DEPARTMENT OF THE TREASURY
AT THE
LAW AND BUSINESS SEMINAR ON THE BANK SECRECY ACT
AND BANK FRAUD STATUTES
WASHINGTON, D.C.
June 13, 1985

The Bank Secrecy Act from the Perspective of Treasury Enforcement

I am most pleased to have the opportunity to participate in this seminar, in particular because it addresses a subject that is a high priority for Treasury law enforcement: the use of the Bank Secrecy Act in the effort to combat money laundering.

Our discussions will serve a most worthwhile purpose by contributing to a greater understanding of this topic, and by addressing the means of achieving effective compliance programs for financial institutions. In my remarks this morning, I want to discuss three topics:

° First, I want to set forth the reasons why strong action against money laundering, right now, is in the national interest and also in the interests of our financial community.

° Second, I will discuss Treasury's enforcement posture regarding the Bank Secrecy Act. I will do so only briefly, since enforcement policy as a general matter will be addressed in more detail during the program this morning.

° Finally, I will mention some of the steps that a bank or other financial institution can take to avoid becoming the unwitting accomplice of a money launderer.

I will begin by considering the threat that money laundering poses. It is no secret that money laundering erodes public trust and confidence in financial institutions. It fosters tax evasion. And, worst of all, it goes hand-in-hand with all other forms of organized crime.

With respect to organized crime, as a nation we now stand at a crossroads. I say this because we face a critical choice regarding the level of this crime that we will tolerate in our society. We can move forward, taking advantage of the momentum we now have, or we can lose the war to drug traffickers and other organized criminal syndicates.

Let me explain what I mean by momentum. Over the last two or three years, we have seen an unprecedented level of public support for law enforcement generally, and for enforcement against money laundering in particular. The views of Congress have reflected this public support, as evidenced by the passage of the Comprehensive Crime Control Act last fall.

My concern, however, is this: If the past is any indication, the public will soon become disenchanted if rhetoric and heightened public attention are not followed by demonstrated success. The public has told us that they are especially concerned about drugs and drug-related crime. And as the public response to the Bank of Boston case so clearly demonstrates, the law-abiding citizens of our country do not take kindly to any association between money laundering and financial institutions. Recent events have opened their eyes to the pervasive, corrupting influences of drug trafficking and other criminal enterprises. Whereas they used to conceive of organized crime as a mysterious, underground network that operated far from their daily lives, they are now seeing it for what it is: a threat to their well-being and that of their children. They also see it as a means for criminals to generate enormous wealth at the expense of honest, hard working citizens.

We cannot afford to let this momentum slip away, for with it will go the public support that we must have to continue our struggle against the criminal enterprises that have been allowed to flourish for too long.

The financial institutions that many of you represent, together with those of us in law enforcement, have a key role in this struggle. Expressed in simple terms, the role is this: We must deny the money launderer the access to our financial system that he now enjoys.

For a money launderer, this access is crucial. The enormous amounts of currency involved make it extremely difficult for him to operate without a financial institution. Specifically,

- he must convert small bills, the transactional currency of drug deals and most other forms of organized crime, to a form that can be readily transferred and will not arouse suspicion;

- he must arrange for payments on behalf of his clients, whether in the United States or abroad;

- he must return crime proceeds to his clients in a form that can be readily spent and will not attract the attention of law enforcement;

- and typically, he seeks to accomplish all of this in ways that allow him to avoid paying taxes as well. Money laundering that involves commingling of funds with those of a legal enterprise can, to some extent, avoid the use of a financial institution. But few drug traffickers are interested in paying taxes on their gross receipts. And what is more, gross receipts that exceed those customary for a given business are a tip-off to the IRS that money laundering is occurring.

So for all these reasons, the financial institution--be it a commercial bank, savings and loan, securities broker, or currency exchange--is the primary target of the money launderer. What we know about the extent of money laundering bears this out.

According to the President's Commission on Organized Crime, $50 - $75 billion is earned in the United States each year from drug trafficking alone. This points to a money laundering problem of enormous proportions.

We also have other indications that money laundering has a powerful grip on our society. Last year, the Florida Federal Reserve recorded a $6 billion surplus. The other Federal Reserves, as is normal, recorded deficits. As Florida is still the hub of this nation's drug trafficking industry, the huge surplus is not surprising. But it is disturbing.

Another indication is the size of the so-called "underground economy". IRS estimates that it amounts to $100 billion a year or more. We also know that more money is in circulation in $100 bills -- $60 billion worth -- than in any other denomination. And the $100 bill is not even considered a transactional form of currency.

So far, I have been addressing the problem of money laundering from a practical standpoint. Now I want to analyze it from an ethical and moral standpoint.

Beyond the legal obligations to comply with the Bank Secrecy Act, there is an ethical obligation incumbent on a financial institution. That obligation is not to further, wittingly or unwittingly, the interests of organized crime. In my view, every financial institution shares this obligation, just as every citizen in a community shares the obligation to prevent crime on its streets.

The proceeds that a drug money launderer seeks to deposit and have wired to an overseas bank haven are the fruits of his crime. They are generated by clients who are, in all probability, in the drug business. They are in the business of exploiting heroin addicts and pushing drugs on our youth. The money they launder ultimately finances new drug importing ventures. It corrupts justice. It feeds other forms of organized crime. In the midst of discussions of regulations and reporting, we must not lose sight of these hard facts.

The financial institution has another reason why it should do all it can to prevent money laundering from gaining a foothold. Clearly, any institution whose name surfaces in a negative connection with money laundering stands to suffer a loss of prestige. I am sure that all of you are aware of the implications for the institution's financial health. Law-abiding customers may be repelled by the taint resulting from an association with organized crime, whether real or perceived. In short, a bank's standing in the community it serves is one of its most valued assets. Once lost, it is not easily regained.

All of the considerations I have discussed are reflected in the enforcement posture that Treasury has assumed with regard to the Bank Secrecy Act. As the Act is our major statutory weapon against money laundering, we at Treasury are compelled to take steps to ensure that the Act performs the function Congress intended. Because it cannot do so without a high degree of compliance with reporting requirements, Treasury considers a violation of these requirements to be a serious matter.

Fortunately, as a result of considerable effort by Treasury, compliance by financial institutions has improved greatly over the last few years. Whereas only 121,000 Currency Transaction Reports, or "form 4789s", were filed in 1979, over 700,000 were filed last year. We expect that over a million Form 4789s will be filed in 1985. I would not want to convey the impression, however, that our compliance problems have been solved. We still have a long way to go in achieving full compliance, and to a great extent, our future success here depends on the efforts of the banking community.

We realize that financial institutions, like any regulated industry, are subject to numerous reporting requirements. And it is a goal of this Administration to reduce unnecessary paperwork burdens wherever and whenever possible. The reporting under the Bank Secrecy Act, however, is more than justified by government's legitimate interest in the information it contains. That information is of the highest usefulness to law enforcement.

When analyzed at the Treasury Financial Law Enforcement Center, which is located at U.S. Customs, the reporting information supports financial investigations by task forces all across the country. It strengthens ongoing investigations, and it provides leads for new ones. It is indispensable to our efforts to ferret out organized crime.

A few statistics illustrate this point. The President's 13 Organized Crime Drug Enforcement Task Forces have been in operation for only 22 months. Yet in this short time period, they have resulted in the indictment of approximately 5000 individuals, more than 1900 of which have already been convicted. The charges stem from high-level narcotics violations, racketeering, Bank Secrecy Act violations, violations under the Continuing Criminal Enterprise sections of Title 21, and offenses under the Internal Revenue Code. Financial investigation techniques play a role in two out of three task force cases. The analyses conducted by the Treasury Financial Law Enforcement Center, based on the reporting information, make these financial investigations possible.

The recent indictments of 17 persons in connection with alleged money laundering and drug trafficking through Puerto Rican financial institutions are an example of the Task Force concept at work, involving the FBI, DEA, IRS, and U.S. Customs in a coordinated attack on drug trafficking, money laundering and organized crime.

In addition to the 13 Presidential Task Forces, Treasury has 40 task forces of its own, located across the country, that are entirely directed to financial investigations. The IRS and Customs agents on these task forces have had considerable success in uncovering and prosecuting currency-related crimes. Since 1980, they have disrupted or destroyed 18 major money laundering organizations, which laundered a documented total of $2.8 billion.

Even though these enforcement results are significant, they must be seen against the enormously high levels of organized crime and money laundering in our society, as indicated by the estimates I quoted earlier.

President Reagan's overall strategy against organized crime is making great strides. But to go further we must achieve the goal I have described -- to deny the criminal the use of our financial institutions.

Admittedly, this is difficult task, for a number of reasons:

- First, because all organized crime depends on money laundering, those who wash crime proceeds will resort to any conceivable scheme, limited only by the human imagination, to evade the probing eye of government.

- Second, it is an extremely lucrative business. It attracts a highly sophisticated class of criminal, one who appears as a legitimate businessman or other professional. As a result, unwary or untrained bank employees can be deceived into thinking the money launderer is a law-abiding customer.

- Third, the complexity of our financial systems affords countless means of concealing illicit cash among legitimate financial activities.

But these factors do not mean that a bank or other institution cannot protect itself from becoming a conduit for laundered crime proceeds.

I would now like to mention some of the measures that every financial institution should take, if it has not done so already:

- The first step, of course, is the proper filing of all reporting forms, for transactions past and present. This is not merely a matter for the bank's tellers and their supervisors. The responsibility for ensuring compliance must be assumed at high levels of management, and the commitment to ensure compliance must be made clear to all employees. Self-auditing should be a matter of course, both for reporting and for the recordkeeping required.

- Exempt lists must receive detailed scrutiny. A bank must ask itself, is every company listed on them a retail business that would be expected to deposit large amounts of cash? Are there dollar limits on each exemption, and are they commensurate with amounts that are reasonable and customary for the type of business involved? Are there adequate background checks of new customers who want to be on the lists? Is a high level official responsible for overseeing the process of exemption?

- The issue of exempt lists has come into the public eye recently, in part because of the Bank of Boston case. Some of you might know that the exempt list is a key mechanism by which some criminals seek to escape reporting. In the Miami area, high-level drug dealers have been known to buy whole businesses just because such businesses have exempt list status at a bank. This gives you an idea of what it is worth to a criminal to get around the Bank Secrecy Act.

- A bank must also ask itself whether its employees are adquately trained to recognize suspicious transactions, even those below the reporting threshold. It is not uncommon, for instance, for criminals to conduct numerous transactions under $10,000 to avoid reporting. Another common scheme is the exchange of cash for cashiers checks, or cashiers checks purchased with checks not drawn on an individual's own account.

- Additionally, a bank should require adequate identification before completing large cash transactions. And do employees know whom to contact when they notice suspicious activity?

In this connection, as you know, I have recently written to the Chief Executive Officers of our country's banks and savings and loans. In my letter, I state that suspicious activity should be reported to the Criminal Investigation Division at your local IRS office.

It takes vigilance to keep the money launderer from using a Bank for his own purposes. I would like to mention, in this context, that we have received excellent cooperation from many banks, and I hasten to add that Treasury stands ready to assist in any way we can.

Many of you may have questions concerning the best course to follow when a bank discovers that its compliance program has not been fully successful. In addition to taking remedial measures, the bank is obliged to file reports to Treasury for the past transactions involved. And we urge banks to come forward. We look favorably on voluntary disclosure, and while we do not grant amnesty in such cases, we do take the voluntary disclosure into account in our efforts to reach a just and fair disposition of every case. The greater the level of cooperation on the part of the bank, the more favorably we are inclined to view the bank's overall situation with regard to liability.

Finally, in establishing and refining its compliance programs, we urge that banks and other financial institutions not confine their thinking to the legal obligations, but also bear in mind the moral and ethical considerations that I have mentioned.

None of you, I am sure, would fail to take quick action if you learned that drug traffickers, through some unusual situation, were selling drugs in the very lobby of your bank or that of your clients. The drug dealer who uses a bank to conceal his illicit proceeds is doing this much and more. More than simply using the lobby to commit his crimes, he is using the employees, the established ties with other financial institutions, the various banking services, all in support of his own corrupt enterprise. And once again, I do not have to mention that as he does so he is not particularly concerned about the effect his activities may ultimately have on the reputation of the institution itself.

In conclusion, we all have a stake in suppressing the money laundering that is now far too prevalent in our financial system. I appreciate your kind attention this morning, and I also appreciate your demonstrated interest in working together to respond to this challenge.

Thank you very much.

TREASURY NEWS

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

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
June 20, 1985

STATEMENT BY JOHN J. NIEHENKE
ACTING ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION AND FINANCE OF THE
HOUSE COMMITTEE ON ENERGY AND COMMERCE

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to provide the views of the Treasury Department on H.R. 2032, "The Public Securities Act of 1985," which would provide a comprehensive new system of regulation of the government securities market.

To summarize our position, Mr. Chairman, while we may wish to request some further legislation in this area, Treasury strongly opposes legislation such as H.R. 2032, for three reasons:

1. Existing market self-correcting mechanisms have in the past proven effective in adapting to market problems, are currently at work to address recent difficulties, and generally are more flexible, responsive, and less costly than a broad brush regulatory approach.

2. The Treasury securities market under the regulation and monitoring of the Treasury Department is the largest, most liquid, and most efficient securities market in the world. This efficiency produces the lowest possible debt financing costs for the government

and is achieved through a delicate balance of preserving system integrity and relying on competitive market forces.

3. Broad legislation, such as H.R. 2032, would create an overlap of regulatory responsibilities between the Department and other governmental bodies and would diffuse authority, restrict responsiveness to marketing opportunities, and likely confuse market participants.

While we are opposed to additional legislation in the government securities market at this time, we believe that any legislation which is enacted should recognize Treasury's current comprehensive responsibility for regulating and monitoring this market and continue to vest such regulatory oversight responsibility with the Department.

Legislative proposals in this area seem to have been prompted by the recent problems in the government securities market, including the failure of the ESM dealer firm.

The SEC Executive Summary details the extensive efforts that the market and current regulators have and are taking to address the problems identified in the ESM & BBS failures. These efforts have convinced Treasury that major legislation is not necessary. Also, the steps Treasury plans to take in the book-entry system, which are outlined later in my statement, would appear to achieve the essential objectives of H.R. 2032.

The Treasury Department has carefully monitored market developments. We are of course concerned about losses stemming from the ESM and BBS failures. However, there has been no perceptible impact on the government securities market from these failures.

Furthermore the traditional bases for regulations in the securities market -- concern with the quality of the security or the issuer, or the protection of individual investors -- are inappropriate to the Federal securities market. On the other hand, legislation such as H.R. 2032 could have a significant adverse effect on the overall market and thus on the Treasury's cost of borrowing. The annual interest on the public debt, currently about $175 billion, is the third largest item in the Federal Budget. Also, when interest rates on Treasury securities increase, other market interest rates increase. Corporate and municipal securities are generally priced using Treasuries as the standard, because Treasuries are the highest quality and the most liquid instruments. There is thus a broad public interest in assuring that the Treasury's ability to manage the public debt in the most cost-effective manner is not impaired.

H.R. 2032

H.R. 2032 would amend section 15B of the Securities Exchange Act of 1934 to expand the authority of the Municipal Securities Rulemaking Board to include dealers in Treasury securities and government agency securities.

Thus the entire Federal securities market, which is currently exempt from the securities laws, would be regulated by the expanded MSRB, subject to the oversight of the Securities and Exchange Commission. The MSRB, which was established by Congress in 1975 to regulate the municipal securities market, would be given broad, additional powers to determine the eligibility of private financial institutions to continue to participate in the Federal securities market and to set capital requirements, acceptable trading practices, and recordkeeping and reporting requirements. MSRB rules would be subject to enforcement by the SEC and other regulatory agencies.

The Treasury is the agency responsible for the management of the public debt under the provisions of the public debt laws enacted by Congress, namely the Second Liberty Bond Act of 1917 as amended. (Certain of those powers are vested directly in the President and delegated to the Secretary of the Treasury). Under that Act the Treasury has issued the various marketable and nonmarketable bills, notes, bonds and other securities that comprise the public debt, which is currently over $1.7 trillion. Those securities are exempt from the provisions of the Securities Exchange Act of 1934, which established a system of regulation of trading in non-Federal securities, which now includes both corporate and municipal issues.

The Treasury sees no need to change the exemption of Federal securities from the 1934 Act, and the Department is strongly opposed to legislation, such as H.R. 2032, which would effectively repeal that exemption.

It would be inappropriate to subject trading in Treasury securities to SEC regulation under the 1934 Act because:

--First, there have been no significant problems for individual investors in the Treasury securities market. Thus there is no need to broaden the individual investor protection purposes of the 1934 Act to include Treasury securities. The recent problems in the government securities market, most notably the failure of ESM, which led to the Ohio thrift institution crisis, were apparently caused by fraud, bad business judgment, and a failure of State regulation. The victims of ESM were institutional investors, thrifts and municipalties, which are subject to regulation or oversight, at the Federal or State level, which should protect the individual depositors and taxpayers who rely on those institutions. Those problems are now being dealt with through the normal process of self-correction by the market itself and by the State regulators, various banking regulators, and standard setting bodies such as the Government Finance Officers Association, the Government Accounting Standards Board, and the American Institute of Certified Public Accountants. Any remaining need for additional Federal legislation, and the nature of that legislation, should be determined after the market adjusts and those Federal, State, and private bodies have been given a chance to make the necessary corrections.

--Second, the Treasury securities market is the largest and most efficient market in the world, with unparalleled depth, breadth, and liquidity. It has served us well in minimizing the cost of financing the public debt, and we should not risk the reduction in efficiency which could result from unnecessarily burdensome and costly regulation.

--Third, Treasury securities are standard instruments of a single issuer, the United States Government, unlike the thousands of varied corporate and municipal issues, and there is no question as to either the credit quality or public acceptance of Treasury securities.

--Fourth, it is the Department's responsibility to regulate Treasury securities under existing public debt statutes. Those statutes permit the President, and the Secretary of the Treasury, to finance the budget deficits at the lowest possible cost to the taxpayer. This objective, to minimize the cost of financing the public debt, is the primary purpose of the government securities market, and it should not be compromised by subjecting the market to additional, costly regulation.

To the extent it becomes appropriate to impose additional constraints on the Treasury securities market, that should be done by broadening the existing rules of the Treasury. If additional legislation is determined necessary, such legislation should clarify or broaden Treasury's authority, not empower another agency to duplicate the functions of the Treasury.

Problems of Overlapping Regulation

The Treasury has broad authority to determine the terms and conditions of its issues and the manner and form in which they are sold. Under this authority, the Treasury has prescribed certain rules, e.g., as to when-issued trading in Treasury securities, which has been a controversial matter in recent years. Under H.R. 2032, conflicting when-issued trading rules could be imposed on Treasuries by the expanded Municipal Securities Rulemaking Board. Thus Treasury might prescribe a one-week pre-auction trading period in order to allow sufficient time for the market to trade a new issue, develop liquidity, increase demand, and establish the price in competitive trading so that all potential investors, large and small, will be able to bid more sucessfully in the auction and hence enable the Treasury to obtain the best possible price. But, under H.R. 2032, the expanded MSRB might decide that one week is too long a trading period, perhaps because of concerns that "excessive" speculation might occur.

Such conflicting rules or official opinions could result in confusion in the market, inadequate liquidity, and higher interest rates on the public debt.

Another example of a controversial market practice, and potential conflict between the Treasury and any new regulatory body, is the recently developed zero-coupon market, which now exceeds $50 billion. As recently as 1981 this market was insignificant. At that time considerable concern was expressed about the opportunities for fraud and confusion in the market as unsuspecting investors might be sold a Treasury bond from which all interest coupons had been stripped. However, because of apparent demand for zero-coupon instruments, the Treasury reversed a longstanding position of opposition to the practice of stripping interest coupons from Treasury securities. Thus in 1982 major investment banking firms began, with Treasury's concurrence, large-scale conversions of Treasury securities into zero-coupon instruments. The market quickly developed to its present size to the benefit of IRA and other investors throughout the country as well as Treasury. In fact, the market developed so well that the Treasury decided to encourage its expansion by inaugurating its new STRIPS program -- the most significant debt management innovation of this Administration -- with 10-year notes and 30-year bonds issued in February 1985, which were the first issues eligible for separate book-entry trading of interest and principal components as zero-coupon instruments. On the one 30-year bond issue the Treasury saved an estimated $431 million over the life of the issue. In fact, the Treasury will realize billions of dollars of interest savings from the zero-coupon market. Any new regulatory body that would have blocked or delayed the development of the zero-coupon market would have cost the taxpayers a great deal of money. We question whether the Treasury would retain sufficient flexibility to permit the private market to develop, and to react promptly to changing market conditions and realize the savings from such debt management innovations, if we were required to gain the support of a separate regulatory body.

Consequently, it would clearly not be in the public interest, in the case of Treasury securities, to attempt to distinguish between the responsibilities of the issuer and the responsibilities of the market regulator. In the case of Treasury securities, the issuer and the regulator are and should remain one and the same.

We believe that the Treasury is well-equipped to manage the debt. It has been doing the job for almost 200 years. We have extensive resources and expertise within our Department as well as the 36 Federal Reserve Banks and branches throughout the country which, by law, act as fiscal agents of the Treasury. The Treasury also has extensive day-to-day market contacts and a formal debt management advisory committee of senior private market professionals who regularly advise the Department on debt financing matters.

The Treasury does not believe that granting additional powers to an expanded MSRB, a body established in 1975 to make rules for the municipal market to protect individual investors, will lead to more effective management of the government securities market. Your Committee has received extensive testimony on the differences between the tax-exempt municipal market and the taxable Treasury market. It is difficult to imagine two more different markets in terms of investor groups, trading practices, number of issuers, and the nature of the instruments themselves.

A basic issue is whether the public interest is better served by charging one agency or two with the responsibility of maintaining an orderly, efficient, and safe government securities market to minimize the cost of financing the public debt. To duplicate these functions would surely add to the cost of regulation, confusion in the market, and thus to the cost of the debt.

Protection of Individual Investors

The Treasury recognizes the need for the securities laws to protect individual investors from fraud and sharp practices in the corporate and municipal markets. The Treasury itself has two major and long-established facilities which assure individual investors access to Treasury securities with absolutely no risk from fraudulent or bad business practices by market participants:

--First, investors in Treasury securities may buy registered marketable notes and bonds directly in the Treasury's auctions, by mail or at the Treasury or Federal Reserve Banks on a competitive or noncompetitive basis. Individuals may purchase these securities in amounts as low as $1,000, and they may acquire them up to $1,000,000 on a noncompetitive basis at the average auction price.

--Second, the Treasury provides a special facility for investors who wish to have their Treasury bills held for them in book-entry form directly by the Treasury. Investors using the Treasury System need not deal with any dealer or other middleman.

The needs of individual investors are now met by the Treasury through these facilities, as well as by the United States Savings Bonds Program. Given the absence of direct individual involvement in market failures to date, plus these special Treasury facilities for individuals, we see no need for legislation to provide additional protection for individual investors in Treasury securities.

Protection of Institutional Investors

We recognize that many smaller institutional investors lack the financial expertise to participate in Treasury auctions on a competitive basis. Thus, Treasury permits institutional investors, like individuals, to submit noncompetitive bids in amounts up to $1,000,000 per offering.

Also, institutional investors, such as municipal treasuries and thrifts, and the individual taxpayers and depositors who rely on those institutions, are now protected by both Federal and State regulation or supervision of deposit institutions and municipal finance officers. While there have been obvious problems recently with municipalities and thrifts in the government securities market, the essential remedies are to improve business practices as well as regulation and enforcement in those areas.

Thus the current debate over the need for regulation in the government securities market has nothing to do with the quality of the security or the issuer or the protection of individual investors -- which are the traditional bases for securities market regulation. Instead, the apparent concern is over fraudulent practices by certain securities dealers and questionable business judgment by thrifts and municipalities entering into repurchase agreements with such dealers. While the SEC is now empowered to act in cases of fraud, even in the government securities market, and the thrifts and municipalities are already regulated or supervised, there is an apparent concern that existing regulators will not do their job and that we cannot rely on the self-corrective forces in the market itself. Yet I know that this Committee is well aware that other failures of government securities firms in recent years have in fact led to self-corrections by the market and by existing regulatory bodies, e.g., the change in the market practice of accounting for accrued interest in the wake of the failure of Drysdale Government Securities, Inc. in 1982 and the changes in regulations governing thrift institutions' participation in the GNMA forward market in the wake of the many problems in that area in the late 1970s. In one case, however, the failure of Lombard Wall, Inc., a legislative remedy was deemed necessary by Congress to clarify the status of repurchase agreements in bankruptcy cases. We see no basis for assuming that the problems earlier this year in the government securities market will not also be dealt with effectively by the market itself or by its present regulators. As indicated earlier in my statement, that process is well under way.

The Treasury has also taken a number of steps to reduce the potential for fraud and increase the efficiency of the government securities market:

-- The Treasury supported legislation to eliminate unregistered bearer securities, which became effective in January 1983, thus reducing the potential for fraud, tax evasion, and other illegal activities.

-- The Treasury announced its plans earlier this year to eliminate definitive registered securities, so that beginning in July 1986 new issues of Treasury securities will be available only in book-entry form. In this connection, the Treasury is establishing an expanded book-entry system at the Philadelphia Federal Reserve Bank which will provide a facility for individuals and institutional investors who are not active traders to have their securities held directly by the Treasury.

-- The Treasury is also considering expanded access to the commercial book-entry system, which is administered by the Federal Reserve Banks as fiscal agents of the Treasury. We are considering including government securities dealers in this system, in which case all dealers holding securities for customers may be required by the Treasury's revised book-entry regulations to have a securities account at the Federal Reserve.

Expanded Commercial Book-Entry System

The Treasury has been concerned for many years about the need to expand its book-entry system at the Federal Reserve. Almost all purchases and sales of Treasury marketable securities, including repurchase agreements, are conducted on the commercial book-entry system, which includes both the accounts at the Federal Reserve and the accounts at other financial institutions. Currently only depository institutions have direct access to book-entry securities accounts at the Federal Reserve. Other institutions, such as dealers, are required to hold their securities indirectly through book-entry accounts at depository institutions with accounts at the Federal Reserve. This has led to a many-tiered system in which Bank A has an account at a Federal Reserve bank, Dealer B has an account with Bank A, and Municipality C has an account with Dealer B. In other cases, Small Bank D without a securities account at a Federal Reserve bank might have an account with Bank E. Since all such financial institutions are custodians of Treasury securities and subject to Treasury's book-entry regulations, the Treasury has been concerned about assuring the integrity of such a many-tiered system. Thus the Treasury has been considering collapsing the tiers to provide greater access to direct securities accounts at the Federal Reserve.

With the advent of full book-entry in 1986, no investors in new Treasury securities will be permitted to purchase them in physical, definitive form. This final step to full book-entry provides an opportunity to reexamine the structure of and access to the book-entry system.

We could collapse the tiers by requiring the dealers and other book-entry custodians to have on-line securities accounts at the Federal Reserve in order to hold Treasury securities for their customers. However, since there is no plan to grant non-depository institutions access to the mechanism to transfer <u>funds</u> over the Federal Reserve's wire transfer system, clearing banks would still perform their role in security clearance. In fact, it may be necessary, in order to prevent the extension of credit to dealers on an unsecured basis, for securities initially to be held in the clearing bank's account before being transferred to the dealer's account at the Federal Reserve.

If, after further study and consultation, we require dealers and other book-entry custodians to have securities accounts at Federal Reserve banks, we will, of course, insist on certain qualifying standards, including registration and identification of personnel of the firm. We would share this information with the SEC and other financial institution regulators in order to assure that certain personnel who should be barred from the market are not permitted to use our custodial system. We would also expect to establish standards of capital adequacy, recordkeeping, and auditing, as well as appropriate provisions for segregation or collateralization. We would plan to rely on the Federal Reserve or other existing regulatory bodies to inspect dealers and enforce our rules.

Measures to assure the integrity of the expanded book-entry system are essential to our fundamental objective of financing the public debt in the most cost-effective manner. It should be emphasized that the questions relating to the elimination of new issues of definitive securities and expanded access to securities accounts at Federal Reserve banks would have had to have been addressed even in the absence of recent government securities dealer failures. The Treasury must be concerned about its business relationship with its custodians, and both the Treasury and the ultimate beneficial owners of book-entry Treasury securities share a common interest that the middlemen perform their duties as book-entry custodians honestly and well.

Since the measures contemplated for the book-entry system would also meet the essential objectives of H.R. 2032, we see no need for such legislation. To the extent measures proposed by Treasury in the book-entry context require additional authority under the Second Liberty Bond Act, Treasury is prepared to request such legislation. We expect to complete our studies of the expanded book-entry system later this year, at which time we will determine whether to propose further legislation.

THE TREASURER OF THE UNITED STATES
WASHINGTON, D.C. 20220

File

TESTIMONY OF KATHERINE D. ORTEGA
TREASURER OF THE UNITED STATES
BEFORE THE
SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
JUNE 18, 1985

Introduction

Mr. Chairman, I am pleased to be here today to testify on the Currency Design Act which proposes altering the authorities of the Secretary of the Treasury with regard to the design of U. S. currency and coins. In your deliberations, we welcome you to call upon Treasury's experience and understanding of the issues relating to the issuance of a counterfeit deterrent currency. Robert J. Leuver, Director of the Bureau of Engraving and Printing, and Joseph R. Carlon, Assistant Director for Protective Research, U. S. Secret Service, are with me today to discuss this proposed legislation.

Background

Mr. Chairman, the Bureau of Engraving and Printing and the U. S. Secret Service, along with the Federal Reserve System, have been engaged in research and development activities for several years for the purpose of improving the security of U. S. currency from counterfeiting by the ever-evolving technologies in the field of reprographics. As with all research and development programs, we have looked into a wide variety of deterrent devices and techniques, and over the period of the program have narrowed its focus to about four or five final candidate strategies. This Committee was briefed in closed-door session on November 2, 1983, on the directions we were taking in our research and development activities, and open hearings were held on this matter on July 24, 1984. Since that time, our activities have continued and we are nearing the point where a recommendation can be made to the Secretary of the Treasury on the matter. Additionally, we have responded to private Congressional requests for information and briefings.

At this point, let me state clearly that any change to our currency will be made solely to protect it from counterfeiting by these evolving technologies. Also, when the new currency is issued, there will not be a recalling or demonetizing of existing currency unless Congress were to enact legislation requiring it. It is important to note that Treasury is not and will not ask for such legislation.

The responsibilities of the interagency Advanced Counterfeit Deterrence Committee, which I chair, are aligned as follows:

1. Assessment of the severity and pace of the threat: U. S. Secret Service.

2. Technical, production, and design issues: Bureau of Engraving and Printing.

3. Distribution, authentication of issued currency, and replacement issues: Federal Reserve System.

Twelve to eighteen months will be needed following the Secretary's approval of the Committee's recommendations before issuance can begin. This will be utilized for further Congressional consultation, public education, production tooling, and inventory building. The earliest that any new currency can be issued is 1988. Given the amount of time the Federal Reserve Board needs to distribute the new currency, this timetable will ensure the integrity of our currency system.

Currency

As we stated last year, the authority to determine the form and tenor of currency and other U. S. securities has been vested in the Secretary of the Treasury since the inception of a national currency in 1862. This authority granted to the Secretary to determine the form and tenor of U. S. currency includes Federal Reserve notes issued under the Federal Reserve Act of 1913. The Congress has also identified the Secretary as the Government official responsible for adoption of devices and safeguards against counterfeiting and for the detection and apprehension of counterfeiters. Since the institution of a national currency printed by the Treasury Department, design changes have been rare, and those changes have been handled with utmost caution. For example, the current series of portraits on U. S. currency was chosen in the late 1920's by a citizen's advisory panel rather than a single Government official or the Congress.

We fully understand the interest of Congress in this sensitive matter. Nevertheless, there are two basic exceptions we feel should be included in the bill: (1) There should be an explicit exemption for changes needed to protect U. S. currency from emerging counterfeiting or other security threats, (2) Changes such as signature changes, series changes, other minor changes to the technical design of the note must be exempted from the requirement for Congressional approval so that they may be done expeditiously on a regular schedule. We see these exceptions as necessary because Treasury must retain the authority to act in the event of a sudden problem before it reaches such proportion that public confidence in U. S. currency becomes shaken, and it must also retain the normal authorities necessary for routine management of the currency system.

Coinage

With respect to coinage, the first provision of Section 3 of the bill would amend Section 5112(d)(2) of Title 31, United States Code, so as to prohibit the Secretary of the Treasury from adopting a new design for existing coins unless the design has been authorized by law. We do not believe that this provision is necessary. Section 5112(d)(2) presently permits the Secretary to change the design of an existing coin only after 25 years of the adoption of the design for that coin. This authority was initially granted to the Secretary by Congress in 1890. The legislation was passed amid a popular consensus that the designs of the then existing coins were not a source of national pride, and that the Secretary should possess the flexibility to adopt improvements.

In the 95 years that the Secretary has possessed this authority, changes in coin design have been undertaken only after careful consideration. The Secretary has not exercised the authority granted in this provision since 1958, when then Secretary Anderson approved a change in the reverse of the penny to commemorate the 150th anniversary of President Lincoln's birth. The record shows, therefore, that the Secretary has exercised the discretion the statute vests in him in a judicious and responsible manner. There is every reason to believe that this fine record will continue. Therefore, we believe that the elimination of the Secretary's authority in this area is unwarranted.

A second difficulty is presented by the wording of the bill, which could be interpreted to mean that the actual engraving of a new coin (and not just its design concept) must be approved by Congress. As coinage legislation usually describes in general terms the type of design to be depicted on a coin, a second Congressional enactment could be required. We do not believe that the bill actually contemplates such a cumbersome procedure, but the bill is not clear on this point.

The second portion of Section 3 of the bill would grant final approval of the design of a coin to the Commission of Fine Arts. Currently, Executive Order No. 3524, dated July 28, 1921, requires that the views of the Commission of Fine Arts be solicited prior to the final determination of the design of a coin. The Department has consistently abided by its obligation to consult with the members of the Commission on these matters and has found their expertise useful. Nevertheless, we believe that the question of the appropriate design for the coins of the United States is the type of public matter the final responsibility for which should be vested in a public official. Moreover, we note that granting final approval to the Commission would necessarily result in prolonging the decision making process. Accordingly, we oppose this provision of the bill.

Conclusion

Mr. Chairman, the Treasury fully understands your interest and position in these matters, and we look forward to working closing with the Congress on this important issue. As you know, the public is acutely aware of and sensitive to any changes in its money, and the Department would welcome Congressional help and support in its efforts to develop designs that meet security requirements as well as public acceptance.

This concludes my statement, Mr. Chairman. I will be pleased to respond to any questions.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 19, 1985

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,252 million of $17,168 million of tenders received from the public for the 2-year notes, Series W-1987, auctioned today. The notes will be issued July 1, 1985, and mature June 30, 1987.

The interest rate on the notes will be 8-1/2%. The range of accepted competitive bids, and the corresponding prices at the 8-1/2% interest rate are as follows:

	Yield	Price
Low	8.48% 1/	100.036
High	8.54%	99.928
Average	8.51%	99.982

Tenders at the high yield were allotted 59%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 52,435	$ 50,435
New York	14,536,715	7,574,905
Philadelphia	33,540	33,540
Cleveland	223,770	223,770
Richmond	64,270	64,270
Atlanta	116,255	114,845
Chicago	1,021,270	227,810
St. Louis	150,185	138,185
Minneapolis	42,015	42,015
Kansas City	130,875	130,875
Dallas	18,175	18,175
San Francisco	773,835	628,395
Treasury	4,335	4,335
Totals	$17,167,675	$9,251,555

The $9,252 million of accepted tenders includes $924 million of noncompetitive tenders and $8,328 million of competitive tenders from the public.

In addition to the $9,252 million of tenders accepted in the auction process, $535 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $799 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

1/ Excepting 2 tenders totaling $180,000.

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'REASURY NEWS
ıartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 20, 1985

U.S. CHINA JOINT ECONOMIC COMMITTEE TO MEET

The U.S.-China Joint Economic Committee will hold its fifth annual meeting in Washington on June 24-26. Treasury Secretary James A. Baker, III and Chinese Minister of Finance Wang Bingqian will serve as co-chairmen of the session.

The Committee was established in 1979 shortly after the establishment of diplomatic relations between the United States and China. Its purpose is to review developments in economic relations between the United States and China and to exchange information on trends in the economies of the two countries.

In addition to the Treasury Department other agencies represented are: the departments of State, Commerce and Agriculture; the Agency for International Development; the Export-Import Bank; the U. S. Trade Representative; the National Security Council; the Office of Management and Budget; the Overseas Private Investment Corporation; the Trade Development Program; and the Federal Reserve Board.

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TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:15 A.M. E.D.T.
Friday, June 21, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE
ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to discuss with you the impact of our federal tax laws on the implementation of domestic energy policy.

Current tax law contains many provisions specifically relating to the extractive industries. In addition, the energy and minerals industries are highly capital intensive, and compete for funds in the securities markets, and are thus also affected by those tax laws which relate to the taxation of alternative investments. And, of course, the overall level of tax rates also affects individual aftertax disposable income, and thus demand for the products of these industries, as well as the specific tax burdens faced by each company. Accordingly, the scope of this hearing is very broad, cutting across much of the business-oriented provisions of our tax code.

No review of the impact of the tax laws on the energy sector can ignore the President's proposal on tax reform. The President's Proposal on tax reform generally seeks to encourage investment in all industries by lowering tax rates and by providing a generous capital cost recovery system which allows adjustment for inflation. The proposal also recognizes the importance of maintaining a healthy domestic energy and minerals industry. For this reason the proposal maintains some, but not all, of the tax benefits currently available to investors in the extractive industries. Moreover, general economic effects which may be expected to result from its adoption, such as a reduction in interest rates and an increase in the rate of economic growth, should benefit all industries, including the extractive industries.

In the balance of my testimony, I will describe the current tax law and the changes suggested in the President's tax reform proposal. For convenience, I will discuss each of the several energy and mineral industries separately, in the order of their relative importance to the nation's energy use. Although I shall focus on those proposals which directly affect the extractive industries, I again want to stress that the impact cannot be divorced from the overall beneficial economic implications of these proposals.

I. Oil and Gas.

Oil and gas currently supplies approximately 67% of the nation's energy needs. Under current law, the treatment of investment in oil and gas extraction depends upon the nature of the expenditure. Lease acquisition costs and most geological and geophysical costs are required to be capitalized as depletable assets. These costs are recovered though cost or percentage depletion (if allowed). Investment in lease equipment and drilling rigs, as well as tangible drilling costs (which include the cost of casing and wellhead) are treated as five year ACRS depreciable property, and qualify for the investment tax credit. Intangible drilling costs, which include the costs of preparing the site for drilling, and the cost of labor, fuel, and materials used in the drilling process and in the installation of the casing and wellhead, may generally be expensed in the year incurred. Integrated oil companies must, however, capitalize 20% of the intangible drilling costs on successful wells. These capitalized costs may be amortized over 36 months.

Under current law, independent producers and royalty owners may claim percentage depletion with respect to 1,000 barrels per day of oil production or the equivalent amount of gas production. Integrated companies are not entitled to claim percentage depletion. Percentage depletion is a deduction based, not on the actual depletable costs incurred, but rather on the gross income from production, calculated on a property-by-property basis. The deduction is equal to fifteen percent of the gross income, limited however to 50% of the taxable income from the property, and further limited to 65% of the taxpayer's taxable income. Unlike cost depletion, or all other methods of capital recovery, percentage depletion may be claimed even after all the depletable costs have been written off.

The tax treatment of oil and gas extraction income under the President's proposal is predicated on the desire to encourage domestic exploration and development, while at the same time reducing those special tax benefits which primarily serve to reward owners of the richer or more prolific mineral deposits. In particular, the President's tax reform proposals call for:

1. The continued expensing of intangible drilling costs (including dry hole costs) for independent producers, and the current law expensing of 80% of such costs, with a 36 month amortization of the balance, for integrated oil companies. The intangible drilling cost tax preference is tightened by removing the net income offset, as I will describe in greater detail. In addition it is proposed that this tax preference also apply to the corporate alternative minimum tax.

2. The phase out of percentage depletion over five years, except for stripper oil and gas production by independent producers (but not royalty owners). Depletable assets will be eligible for cost depletion, adjusted for inflation.

3. The continued expensing of qualified tertiary injectant expenses.

4. The use of an inflation-adjusted capital cost recovery system (CCRS) depreciation, in place of ACRS depreciation for depreciable equipment. Oil and gas equipment would be treated as class 3 assets, which is slightly more favorable, under expected inflation rates, than five year ACRS recovery. For example, at an assumed 5% inflation rate the net present value of the CCRS deductions are approximately 92% of the cost of the asset, whereas the present value of the ACRS deductions are approximately 84% of the cost. The investment tax credit would, however, be repealed for all assets, including those employed in the oil and gas business.

Treasury and the Department of Energy estimate that these proposals, together with the lower tax rates and other aspects of the President's proposal, should result in less than a one percent reduction in domestic oil and gas production. Since only independent producers (and royalty owners) may currently claim percentage depletion, only such producers would be adversely affected by its repeal. Because percentage depletion is to be retained for stripper wells, even the impact on domestic oil and gas production by independent producers should be quite modest.

Some may argue against the repeal of percentage depletion by noting that any reduction in existing tax benefits would reduce the amount of investment which might be made in oil and gas drilling. In a sense this is true in that any tax payment would reduce the amount of funds any person in the oil business would otherwise be able to reinvest. However, there has been a dramatic decline in oil and gas investment due to falling oil prices even under current tax policy, which suggests that petroleum economics, rather than cash flow, is a primary determinant of industry investment. In addition, royalty owners currently claim approximately half of the total oil and gas percentage depletion, and approximately another ten percent is claimed by independent producers with repect to stripper oil production, for which percentage depletion may continue to be claimed under the President's proposal. Thus the maximum loss in reinvestment by those engaged in oil production resulting from the repeal of percentage depletion is at most only forty percent of the total amount claimed.

Percentage depletion does provide some incentive for exploration and development. However, because it is directly related to gross income, percentage depletion tends to favor owners of more productive wells, and its benefit also increases with the price of oil. Thus, allowing percentage depletion to owners of the most successful wells, who do not need such incentives to develop their properties, cannot be justified. The loss of percentage depletion would have the most adverse impact on the more marginal wells -- those producing less than 10 barrels of oil per day -- and therefore might cause premature abandonment of such stripper wells (and once abandoned, the remaining reserves are essentially lost). To avoid this loss, the President's proposal allows percentage depletion to continue to be claimed by independent producers with respect to production from such wells.

Others may argue that the President's proposal is "too easy" on oil and gas producers. While it is true that allowing expensing of intangible drilling costs does treat such investment differently from the treatment of investment in depreciable assets, it is also true that capitalization of such costs would significantly alter the economics of a drilling venture. Fewer exploratory ventures would be undertaken, and the number of dry holes which may be tolerated before abandonment of the project would be reduced. As a result, the search for new domestic oil reserves would decline, and ultimately so too would domestic oil and gas production. This would leave the nation more vulnerable to possible foreign supply disruptions.

The President's proposal is also predicated on the notion that all citizens should pay their fair share of tax. For this reason the intangible drilling cost tax preference has been modified. Under current law this preference item is reduced by the taxpayer's net oil and gas income, with the result that those producers with sufficient extraction income could entirely wipe out this tax preference item. This net oil and gas income offset would be eliminated in the President's proposals. The tax preference instead would be the difference between the amount of intangible drilling cost on successful wells which may be expensed and the present value of the deductions which may be claimed by treating such cost as CCRS class 3 depreciable property (which is how tangible drilling costs are treated under the proposal). As noted earlier, the present value of the CCRS class 3 deductions is 92% of the amount expensed, leading to the proposed 8% intangible drilling cost tax preference. Moreover, it is proposed that this tax preference item also apply to the alternative corporate minimum tax.

II. Coal

Coal supplies approximately 24% of the nation's energy needs. Current law taxation of investment in coal and other hard mineral extraction depends upon the nature of the expenditure. Exploration and development expenditures may generally be expensed. In the case of a corporation, 20% of these costs must be capitalized and recovered as five year ACRS depreciable property. The expensed exploration costs (but not the expensed development costs) must be recaptured when production begins, generally by reducing the amount of depletion which may be claimed. The excess of the exploration and development costs expensed over the deduction which would have been claimed had such costs been capitalized and amortized over 10 years is a tax preference item for the noncorporate alternative minimum tax.

Percentage depletion may currently be claimed by all taxpayers with an economic interest in the property. The percentage of gross income from mining which is allowed for coal is 10%, and is further subject to a 50% net income limitation. Corporate taxpayers must reduce the percentage depletion claimed in excess of their basis in the property by 15%. Taxpayers receiving coal royalty income may generally claim long term capital gain treatment for such income. Such taxpayers cannot, however, also claim percentage depletion with respect to such income.

Consistent with the objective of maintaining incentives for undertaking risky coal exploration and development within the context of a more neutral tax treatment of all business activity, the President's proposal calls for:

1. The continued expensing of hard mineral exploration and development costs by non-corporate producers, and the current law expensing of 80% of these costs for corporate producers (with the balance of these costs depreciated as five year ACRS property).

2. The phase-out of percentage depletion over five years. Cost depletion, adjusted for inflation, would be used instead.

3. The phase-out of capital gain treatment of coal royalty income.

4. The treatment of mining equipment as CCRS class 3 depreciable property. As noted, such treatment is more somewhat more favorable than that provided by five year ACRS recovery.

5. The inclusion of the current law mineral exploration and development expense tax preference (the excess of the amount expensed over the amount that would be claimed if amortized over 10 years) for the proposed corporate alternative minimum tax.

Some may argue that the loss of percentage depletion may also result in the abandonment of some marginal mines, and thus percentage depletion should be allowed for such mines, just as it is proposed to continue percentage depletion for stripper well production. The Administration is, of course, aware of the depressed state of much of the mining industry, and for this reason has proposed a phase-out of percentage depletion. Nevertheless, there are several reasons for not proposing continuation of percentage depletion. First, because of the net income limitation, it is more difficult to identify a class of mines whose production currently qualifies for percentage depletion and which would likely be abandoned if percentage depletion were lost. Second, whereas premature abandonment of stripper wells generally leads to the permanent abandonment of the reserves, those mines which may be shut down can more readily be reopened when economic conditions improve.

III. <u>Electric Power</u>

Electricity is largely produced from coal, gas, and oil. Nuclear power supplies about 5% of the nation's energy needs. Under current law, some electric generating equipment qualifies as five year ACRS property. Other investment, which is treated as public utility property with a class life of not more than 25 years, is treated as 10 year ACRS property, while investment in public utility property with a class life greater than 25 years is treated as 15 year ACRS property. In general, all such investment qualifies for the investment tax credit. In order to encourage state regulators to allow the benefits of accelerated depreciation and tax credits to be passed on to the stockholders, and thus allow regulated utilities to compete in the market for funds, certain "normalization" requirements apply.

Under the President's proposal, the investment tax credit would be repealed, and investment in depreciable property would be depreciated using the Capital Cost Recovery System (CCRS). Public utility property (other than autos, trucks, computers, etc., which are treated as CCRS class 1 and 2 property) would generally be treated as class 4 or 5 property. Because of the indexation for inflation, such treatment is somewhat more favorable than the corresponding ACRS treatment (excluding the effect of the loss of the investment tax credit). Corresponding normalization rules are also proposed.

Under current tax law, electric generating facilities are frequently financed, at least in part, through the use of tax-exempt bonds even where the facility is privately owned. In general, the President's proposal would deny tax exemption to any obligation issued by a state or local government where more than one percent of the proceeds were used directly or indirectly by any nongovernmental person. Thus, if power sales contracts to non-exempt persons exceed 1%, the interest would be taxable. In essence, this proposal would prevent the issuance of tax-exempt bonds to finance any facility other than facilities to be owned and operated by the state or local governmental unit. Thus, public roads, parks, and government office buildings could continue to be financed by tax-exempt bonds, but bonds could no longer be issued on a tax-exempt basis to finance facilities intended for private use.

IV. Renewable and Alternative Energy Sources

Hydropower, solar, wind, and other sources of energy provide about 4% of the nation's energy needs. Since 1978 Congress has adopted a number of tax measures designed to provide incentives for individuals and businesses to conserve energy and to encourage the development of renewable and alternative energy sources. These incentives were deemed necessary because oil and gas price controls understated the replacement cost of those energy sources. Because of price controls, consumers did not have the incentive to invest in energy conservation. Furthermore, low oil and gas prices discouraged investment in alternative fuels. The energy tax incentives were enacted as temporary provisions that were designed to provide a bridge between the period in which energy prices were controlled and the period in which energy prices would be set in a free marketplace.

Under current law, three major categories of tax incentives remain temporarily available for businesses:

1. Energy Investment Tax Credits. Solar, wind, geothermal property and ocean thermal property qualify for a 15 percent energy investment tax credit in addition to the regular ITC. Certain hydroelectric generating property qualifies for an 11 percent credit. Qualified intercity buses and biomass property are eligible for a ten percent energy credit. These energy credits terminate on December 31, 1985.

A ten percent energy investment tax credit was available for certain other types of energy property but this credit generally expired on December 31, 1982. However, if such energy property qualifies under "affirmative commitment" rules, the credit continues to be available until December 31, 1990. Under these rules, projects requiring two or more years for completion will continue to be eligible if (a) all engineering studies were completed and all necessary permits filed before January 1, 1983, (b) binding contracts for 50 percent of specially designed equipment are entered into before 1986, and (c) the project is completed and placed in service before 1991. In addition, in the case of hydroelectric generating property, the credit is available through December 31, 1988, if an application has been filed with the Federal Energy Regulatory Commission before January 1, 1986.

2. Production Tax Credits. A credit of up to $3 per barrel of oil equivalent, adjusted for inflation, is available for certain qualifying fuels. In general, the credit is available for qualifying fuels produced from facilities placed in service after December 31, 1979, and before January 1, 1990, and sold after December 31, 1979, and before January 1, 2001. The credit phases out as the average wellhead price of domestic crude oil rises from $23.50 to $29.50 per barrel, adjusted for inflation. The maximum credit and the phaseout range are adjusted for inflation. Qualifying fuels include (a) oil produced from shale and tar sands, (b) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, (c) synthetic fuels produced from coal, (d) fuel from qualified processed wood, and (e) steam from solid agricultural byproducts.

3. Alcohol Fuels Credit and Excise Tax Exemptions.

a) Alcohol fuels mixtures. Present law provides a six cents per gallon exemption from the nine cents excise tax on gasoline and a similar six cents per gallon exemption from the 15 cents diesel fuel excise tax if the taxable products are blended in a mixture with at least ten percent alcohol ("gasohol"). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). The provision terminates after December 31, 1992.

b) Alcohol fuels. Present law provides a nine cents per gallon exemption from the excise tax on special motor fuels for a fuel consisting of at least 85 percent alcohol derived from a source other than petroleum or natural gas and a four and one-half cents per gallon exemption if the source is natural gas. The provision terminates after December 31, 1992.

c) Alcohol production credit. A 60 cents per gallon income tax credit is provided for alcohol used in gasohol mixtures with gasoline, diesel fuel, and special motor fuels. A like credit is allowed for alcohol used as a fuel other than in a qualified fuels mixture. A lesser credit of 45 cents per gallon is provided for alcohol of at least 150 proof but less than 190 proof. The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). This credit terminates on December 31, 1992, and may be carried forward for 15 years, but not to a tax year beginning after December 31, 1994. If a production credit is claimed with respect to alcohol, the exemption from the gasoline and special fuels excise taxes is not allowed.

d) Taxicabs refund. A four cents per gallon exemption from the excise tax on gasoline, diesel fuel and special motor fuels is provided if used in certain taxicabs that are rated at above-average fuel economy. The exemption expires on September 30, 1985.

In addition, under current law there are two categories of residential energy credits:

1. Conservation credits. A 15 percent credit is available to individuals for the first $2,000 of expenditures for certain energy conservation equipment, such as insulation or storm windows and doors, for a maximum credit of $300.

2. Renewable energy credits. A 40 percent credit is available to indivduals for the first $10,000 of expenditures for solar, wind or geothermal energy property, for a maximum credit of $4,000.

To be eligible for the residential energy tax credits, expenditures must be with respect to the taxpayer's principal residence. In the case of the residential conservation credits the residence must have been in use before April 20, 1978. The credits expire on December 31, 1985. Unused credits may be carried over through 1987.

Under the President's proposals for tax reform most of these credits would be allowed to terminate as called for under current law. In the case of the production credits, however, the period of availability would be shortened from a current law termination date of January 1, 2001 to January 1, 1990.

Since the enactment of these subsidies, world oil and gas supply conditions have eased. Domestic crude oil prices have been decontrolled and natural gas prices have been partially decontrolled. Individuals and businesses have succeeded in reducing their energy usage. Even if it were felt that conservation and the development of alternative fuels should be encouraged, energy tax credits are not particularly effective for such purpose. Subsidies provided for alternative fuel are significantly in excess of the price that should be paid for replacement of crude oil. For example, with an alcohol fuel production credit of 60 cents per gallon, the Federal government is paying a subsidy of $25.20 (in addition to the price paid by the consumer) in order to save a barrel of oil currently valued at under $30.

The energy tax credits also add to the complexity of our tax laws and impose additional administrative burdens upon the Internal Revenue Service. A taxpayer compliance study with respect to individual income tax returns for taxable year 1979 disclosed that of $473 million of taxpayer claims for energy tax credits, $126 million in claims would have had to be disallowed had the Internal Revenue Service been able to fully audit all returns. Taxpayers failed to claim only $26 million in credits that they were otherwise entitled to claim. Thus, by Internal Revenue Service estimates, more than one-quarter of the amount of energy credits claimed by taxpayers for 1979 should not have been allowed.

Finally, many of the conservation improvements subsidized by the residential energy credits would have been made without the tax credits because of decontrol and the increase in world oil prices since 1979. Thus, in many cases, tax credits have served merely to reduce the tax burden of middle- and upper-income households, rather than to encourage additional energy conservation efforts.

In light of these changes in energy economics, it is the policy of this Administration to rely upon the free operation of the marketplace to allocate resources efficiently and to determine energy use. If business investment is to be encouraged--and certainly that has been a primary goal of this Administration--then it should generally be encouraged through broad-based tax reduction. Thus, except to the extent that national security interests require the continued search for oil and gas reserves, the most effective government policy is not one specifically targeted toward subsidizing conservation or conventional and alternative fuel production, but one which improves the overall economic outlook and investment climate by reducing tax rates and expanding capital investments generally within the economy. To that end, the President's proposal calls for the temporary tax incentives available under present law to terminate as scheduled.

V. Conclusion.

The primary thrust of the President's proposal is to encourage investment and economic growth by reducing tax rates and broadening the tax base. At the same time, some existing incentives for undertaking risky exploration and development investment are retained. Some may criticize these proposals for being too generous to the extractive industries, while others may decry any change in the existing tax law. The U.S. is not now energy independent, and is not likely to ever be entirely self-sufficient in energy and mineral production.

While the tax laws may be used to encourage somewhat greater domestic production, and thus minimize the potential adverse effects of foreign energy supply disruptions, they cannot, and should not, be used to replace market forces in the allocation of resources. The President's proposal encourages the continued search for the nation's oil, gas, and mineral resources. It does so through certain direct incentives, and also by generally encouraging economic growth. While it may be possible to encourage even greater investment in the energy industries through direct tax incentives, too great a distortion of the allocation of capital is likely to result from such an approach, producing less economic growth for all American free enterprise.

TREASURY NEWS

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STATEMENT OF
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DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the use of tax-exempt industrial development bonds ("IDBs") to provide private business with capital for the acquisition or construction of multifamily residential rental projects. After a brief description of current law governing the issuance of IDBs for the purpose of financing such projects, I will discuss our concerns about the growth in the use of IDBs for this purpose, and the reasons we believe Congress should reevaluate the tax-exempt status of these bonds. Finally, we will suggest that Congress carefully consider the President's proposal to repeal the tax-exemption for such bonds.

In addition, we are taking this opportunity to provide you with preliminary tabulations of the data available on private activity bond volume in 1984. These tabulations are set forth in the Appendix.

Description of Current Law

State and local government obligations are classified as IDBs if the bond proceeds are to be used in a trade or business of a person other than a government or a tax-exempt entity and if the payment of principal or interest on the bonds is derived from or secured by money or property used in a trade or business. Interest on IDBs as a general rule is taxable, but interest on two categories of IDBs is tax exempt: (1) IDBs that qualify as exempt small issues, and (2) IDBs issued to finance certain exempt activities.

A qualifying residential rental project is an exempt activity. Interest on an IDB is therefore exempt from Federal income taxation if substantially all the proceeds of the IDB are used to provide a qualifying residential rental project. A residential rental project qualifies for tax-exempt financing only if 20 percent or more of the units in the project are occupied by individuals of low or moderate income. This set-aside requirement is reduced to 15 percent if the project is located in a targeted area--that is, an area that is either (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under the criteria established for mortgage subsidy bonds.

The term "low or moderate income" is determined by the Secretary of the Treasury in a manner consistent with Section 8 of the United States Housing Act of 1937. Treasury regulations provide that occupants of a dwelling unit generally are considered individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development ("HUD"). HUD determines median incomes for areas based upon families of four and then adjusts these incomes for smaller and larger families.

Uncertainty regarding how median income is to be determined has undermined the Congressional intent that these projects be targeted to benefit low or moderate income persons. Treasury regulations do not make clear that median income is to be determined by reference to the HUD adjustments for family size. Indeed, many issuers have concluded that it is not necessary to make such adjustments. Under such an interpretation of the regulations, an apartment is considered rented to a qualified person even if rented at a market rate to a single person whose income does not exceed 80 percent of the median income for a family of four. We will issue revisions to these regulations shortly to clarify that this adjustment must be made. The revised regulations will be prospective only.

Whether occupants satisfy the low or moderate income test for purposes of the 20 percent (or 15 percent) set-aside requirement is determined at the time they first occupy a unit in a project. If the occupants satisfy the low or moderate income test at that time, they will continue to qualify as long as they continue to reside in the project, without regard to their income levels in subsequent periods. When a qualifying occupant leaves the project, the unoccupied unit will continue to be a qualifying unit at least until it is reoccupied; at that time the status of the unit is determined by the income level of the new occupants.

The 20 percent (or 15 percent) set-aside requirement must be met continuously during at least a 10-year period that begins when 10 percent of the units are occupied (or the IDBs are issued). The 10-year period is extended in several circumstances, for instance, the continuation beyond that time of any Section 8 assistance. The project also must provide residential rental housing (but without any set-aside requirement) for the longer of the period described above or the term of the IDBs.

In general, for these purposes a project is a building or part thereof that contains units having complete living facilities, together with related facilities such as parking lots, trash disposal equipment, and swimming pools. Projects with units that are to be used on a transient basis do not qualify, however.

IDBs issued to finance residential rental projects permit the developers of those projects to receive additional Federal tax benefits that are denied to the developers of other tax-exempt financed facilities. These additional benefits are the ability to retain arbitrage profits rather than rebate them to the Federal government, the ability to benefit from a Federal guarantee, and an exception from the general rule that tax-exempt bond financed property is not eligible for accelerated cost recovery deductions, but rather must be depreciated on the straight-line method over the ACRS life of the property. In addition, these bonds are not subject to the state-by-state volume cap applicable to most other IDBs.

Growth of IDBs for Multifamily Rental Housing

The original purpose of the Federal income tax exemption for interest earned on obligations of state and local governments was to allow those governments to finance their governmental needs at a reduced interest cost. Since 1979, however, over one-half of all long-term tax-exempt bonds issued have been to provide proceeds for the direct benefit of private businesses, certain tax-exempt organizations, or individuals, rather than to provide proceeds for use by state and local governments and their political subdivisions. I will refer to these tax-exempt bonds, in which the governmental issuer is only a conduit for private borrowing, as "nongovernmental bonds."

Chart 1 of the appendix shows the volume of long-term tax-exempt nongovernmental bonds issued in the years 1975 through 1984. Nongovernmental bonds issued in 1975 totalled only $9 billion, accounting for 29 percent of the long-term tax-exempt bond market. In 1984, reported nongovernmental bonds totalled $72.5 billion and accounted for 63 percent of the long-term tax-exempt bonds issued in that year. Thus, the volume of nongovernmental bonds issued in 1984 was more than eight times the volume of those bonds issued in 1975--only nine years earlier.

The volume of different types of nongovernmental tax-exempt bonds issued in recent years is shown in Table 1 of the appendix. A part of the growth in volume of nongovernmental bonds of course has been in IDBs issued for multifamily residential rental projects. The table shows that multifamily residential rental IDBs grew from $0.9 billion in 1975 to $5.1 billion in 1984--representing growth by a factor of 5.67.

The growth of IDBs for multifamily residential rental projects can be attributed to three principal factors. First, as interest rates rose in the late 1970s, developers searched for lower cost financing tools, and they tapped tax-exempt financing as a method of reducing their interest costs. Even with today's lower interest rates, however, tax-exempt bonds continue to offer a clear cost advantage to developers.

Second, more State and local governments began issuing IDBs for multifamily residential rental projects as they observed their neighboring jurisdictions doing so. This competition between jurisdictions eventually forced all states to begin offering such financing. States and other governmental units have little to lose from these offerings because tax-exempt financing for private developers involves no liability on the part of the issuer and no cost to the issuer.

Finally, part of the increase in the issuance of IDBs for multifamily residential rental projects may be attributable to reductions in direct expenditures by the Federal government. Table 1 of the appendix shows that the largest growth in IDBs for multifamily residential rental projects occurred in 1982. Although this was a period of falling interest rates accompanied by a general increase in housing construction, part of the growth in IDBs issued for multifamily residential rental projects during this period probably was due to the substantial cutback in 1981 in the Section 8 subsidy program for new construction and rehabilitation of low income housing. To the extent tax-exempt financing serves as a substitute for such direct subsidies, it is in direct contravention of Federal budget policies that gave rise to elimination of the Section 8 new construction program.

Reasons the Tax Exemption of IDBs Issued to Finance Multifamily Residential Rental Projects Should be Reevaluated

There are a number of reasons why Congress should reevaluate the tax exemption of IDBs used to finance multifamily residential rental projects. My discussion today will not repeat all the reasons stated in the President's Tax Proposals for repealing the tax exemption of all nongovernmental bonds, but rather will focus on reasons that are distinct to multifamily residential rental IDBs.

1. Revenue Loss.

The tax exemption of IDBs used to finance multifamily residential rental projects should be reexamined because it results in substantial present and future revenue losses by attracting capital away from alternative investments, the return on which would be taxable. The revenue loss from such IDBs issued in 1983 alone will be $180 million in the 1985 fiscal year and will total $2.6 billion over the entire period these bonds are outstanding. While this revenue loss is not overwhelming on its own, these bonds represent only one of many types of nongovernmental bonds, all of which together produce an aggregate revenue loss that is very large indeed. Furthermore, the potential revenue loss from IDBs to finance multifamily residential rental projects is unlimited, since these bonds are exempt from the state-by-state volume cap adopted in the Tax Reform Act of 1984 for most other IDBs. If this lost revenue is to be made up, income tax rates applicable to nonexempt income must be maintained at higher levels than they otherwise would be during the period while the bonds are outstanding.

2. Inefficiency.

The tax exemption of IDBs for multifamily residential rental projects should be reexamined because the subsidy such bonds provide to low and moderate income housing is extremely inefficient. This inefficiency occurs for three principal reasons. First, the interest cost savings to the developer of the project typically are far less than the revenue loss to the Federal government resulting from the lender's not being taxed on the interest received from the bonds. Studies show that for every $2 of interest cost savings to the party who uses tax-exempt bond proceeds, the Federal government usually foregoes more than $3 of tax revenues. In other words, at least one-third of the benefit of tax-exempt financing generally is captured by financial intermediaries and high-bracket investors who hold the tax-exempt bonds.

Second, IDBs issued to finance multifamily residential rental projects are inefficient because the subsidy represents a production incentive provided to the developer of the project rather than a subsidy provided directly to the tenants. Such a production incentive cannot be expected to be passed on to tenants in the form of lower rents except through the operation of general market forces that tend to push rents lower as the supply of rental units increase. In less than perfect rental markets, only a fraction of the subsidy is passed on to tenants through this means, with the remainder being retained by the developer. Moreover, to the extent the subsidy is passed on to tenants, it inures to the benefit of all tenants in the affected rental markets and not just to low or moderate income tenants of the project. Congress has recognized the relative inefficiency of production subsidies in its repeal of authorization for Section 8 new construction, a program under which payments were made directly to the developer, and its subsequent adoption of the HUD housing voucher program.

Third, the subsidy made available through these bonds is inefficient because it is not highly targeted. As a result, the portion of the subsidy passed on to tenants through lower rents is not directed entirely to the moderate or low income tenants in the project because the entire project--not just the 20 percent portion occupied by low or moderate income persons--receives subsidized financing. Congress has eliminated this inefficiency in related areas. For example, the costs incurred in rehabilitating residential rental units can be recovered under section 167(k) over a five-year period, but this recovery method is available only for those units occupied by low or moderate income persons, and not for other units.

3. <u>"Double Dipping."</u>

The third reason that the availability of tax exemption of IDBs used to finance residential rental projects should be reevaluated is that such projects are permitted this subsidy in addition to other Federal tax benefits denied to other tax-exempt financed facilities. These additional benefits are the ability to retain arbitrage profits, the ability to benefit from Federal guarantees, and an exception from the restrictions on the use of ACRS deductions applicable to other tax-exempt financed property. Congress has recognized that such "double dipping" may result in over-subsidization of many projects that would be undertaken with less subsidy, causing additional inefficiencies and distortions in the allocation of capital. Accordingly, the Internal Revenue Code prevents such "double dipping" for other types of tax-exempt bonds.

4. Difficulty of Administration.

A final reason to reevaluate tax exemption of bonds issued to provide low or moderate income residential rental projects is the difficulty and expense of administering the law in this area. The Internal Revenue Service relies primarily on voluntary compliance with the tax laws governing the issuance of tax-exempt bonds, as it does with most other areas of the tax laws. Indeed, the Internal Revenue Service has been aided in its administration in this area by reputable bond counsel and underwriters who historically have carefully adhered to statutory requirements and administrative pronouncements in connection with issuance of tax-exempt bonds, and in some cases have gone beyond such explicit requirements. For example, many bond counsel require the developers of multifamily residential rental projects to certify on a monthly or quarterly basis to the issuer that the 20 percent (or 15 percent) set-aside requirement has been satisfied and to provide the issuer with copies of the income certifications of any new low or moderate income tenants. The recent growth in the volume of nongovernmental bonds appears, however, to have been accompanied by somewhat more aggressive positions on the part of issuers and bond counsel. Unfortunately the Internal Revenue Service lacks the resources to audit a meaningful percentage of the vast numbers of bonds issued each year. In addition, there may understandably be a reluctance to terminate the tax exemption of a particular bond issue because the consequences fall upon the innocent bondholders, not those responsible for the failure to meet the statutory requirements for exemption. Notwithstanding these limiting factors, the Internal Revenue Service formalized a program in 1979 for examining selected tax-exempt bond issues and has had numerous bond issues under examination since that time. This program has led to a number of closing agreements with respect to issues that were found to violate the statutory requirements for exemption, resulting in collection of $40 million in revenues.

For the reasons described above, we believe tax-exemption for IDBs used to provide low and moderate income residential rental projects should be reevaluated. In this regard, we suggest that Congress carefully consider the President's Tax Proposals, which propose a fundamental change in this area of the law.

The President's Tax Reform Proposal

In general, the President's proposal would deny tax exemption to any obligation issued by a state or local government where more than one percent of the proceeds were used directly or indirectly by any person other than a governmental unit. In essence, this proposal would prevent the issuance of tax-exempt bonds to finance any facility other than facilities to be owned and operated by the state or local governmental unit. Thus, roads, parks, and government office buildings could continue to be financed by tax-exempt bonds, but bonds could no longer be issued on a tax-exempt basis to finance facilities intended for private use, such as multifamily residential rental projects.

The proposal would have a beneficial effect on state and local governments issuing bonds for governmental purposes by increasing the value of the Federal subsidy provided to governmental activities financed with tax-exempt bonds. This would come about as the result of the reduction in the supply of new tax-exempt bonds under the proposals, as well as cutbacks in alternative tax shelters and a greater demand by property and casualty insurance companies for tax-exempt bonds under the proposals. This benefit is expected to occur despite the decrease in demand for tax-exempt bonds caused by lower marginal tax rates and changes in the ability of banks to deduct the costs of borrowings to carry tax-exempt bonds, which are also part of the President's proposals. On balance, these factors will tend to increase the spread between long-term tax-exempt and long-term taxable interest rates and correspondingly the value of the subsidy.

The proposal would, of course, increase financing costs for developers of multifamily residential rental projects currently receiving tax-exempt financing. Such increase, however, would simply remove a tax-created distortion in the market's allocation of capital among all nongovernmental persons.

If Congress determines that Federal assistance is desirable to provide rental housing for low or moderate income tenants, it could of course provide direct Federal assistance to them. If this were done, a larger share of the Federal subsidy would inure to the low or moderate income tenants because direct assistance would bypass the bondholders and developers who now reap a substantial portion of the subsidy provided through tax-exempt financing. Moreover, the amount of a direct subsidy could be determined directly by Congress rather than relying on the tax-exempt bond market. In addition, the subsidy could be limited to the period in which it is needed, rather than being extended for the entire life of a tax-exempt bond. The HUD housing voucher program is an example of a promising direct subsidy program that provides low-income families with supplemental funds to purchase housing in the private housing market.

Conclusion

For the reasons discussed above, the Treasury Department strongly favors the elimination of tax-exemption for IDBs for multifamily residential rental projects.

This concludes my prepared remarks. I would be happy to respond to your questions.

* * * *

APPENDIX

Private Activity Tax-Exempt Bond Volume in 1984

Preliminary data for private activity tax-exempt bonds issued during calendar year 1984 show the volume of long-term private activity bonds totalled $72.5 billion, compared to $57.1 billion in 1983. Private activity tax-exempt bonds accounted for 63 percent of the estimated volume of long-term tax-exempt bond issues in 1984.

Table 2 shows the total face amount of long-term tax-exempt IDBs, student loan bonds, and bonds for private non-profit organizations issued in 1984 and compiled from the required information reporting form. 1/ The volume (face amount) of long-term bonds subject to the reporting requirement was $56.8 billion to which $15.7 billion of mortgage subsidy and qualified veterans' housing bonds must be added, 2/ for a total private activity bond volume of $72.5 billion.

The total volume of all long-term tax-exempt bonds issued in 1984 is estimated to be $115.1 billion. The published total of $101.8 billion reported by the *Bond Buyer* is adjusted for the large volume of privately-placed small issue IDBs. The $13.2 billion difference between the volume of small issue and industrial park IDBs reported to the IRS and the volume of "industrial aid" bonds reported by the *Bond Buyer* is added to the *Bond Buyer's* total. Private placements of other tax exempt bonds would mean that the estimated total volume of tax-exempt bond issues is understated.

Table 3 shows the face amount and new issue volume of the different reported private activity bonds. The bonds are separated into short-term obligations with maturities of one year or less and long-term obligations. The new issue volume equals the amount of funds received (purchase price) in excess of any proceeds used to retire outstanding obligations. Data from other sources generally report the face amount of bonds. The state volume limitation on student loans and certain IDBs restricts the new issue volume. New issues represent the increase in outstanding private activity tax-exempt obligations (not including non-refunding retirements).

The five largest categories of private activity tax-exempt bonds issued in 1984 are small issue IDBs, bonds issued for private, non-profit hospital and education facilities (section 501(c)(3) organizations), pollution control IDBs, sewage and waste disposal IDBs, and multifamily rental housing IDBs. Thirty-one percent of the reported new issue total, or $16.7 billion, was issued for private businesses under the small issue

IDB exemption. Bonds for section 501(c)(3) organizations totalled $0.1 billion, pollution control IDBs and sewage disposal IDBs totalled $7.6 billion and $6.6 billion, and multifamily rental housing IDB new issues totalled $5.0 billion.

Table 4 shows the percentage change in new issue volume of reported private activity bonds between 1983 and 1984. New issue volume grew by 37 percent in a single year. The main growth occurred in the issuance of IDBs. The largest absolute and percentage changes occurred in the issuance of pollution control IDBs and sewage and waste disposal IDBs. Some of the increase is attributable to bonds that would otherwise have been issued in 1985, but were issued in 1984 to avoid the proposed restrictions on arbitrage and full year effect of the state volume limitation in 1985 enacted in the 1984 Tax Act.

Table 5 shows the total reported new issue volume by type of bond for each state. The volume is reported for all private activity tax-exempt bonds subject to the information reporting requirement, including multifamily rental housing IDBs, private exempt entity bonds, and certain airport and dock and convention IDBs which are excluded from the state volume limitation. No data is available identifying the bonds issued in 1984 which were subject to the 1984 volume limitation. Although the volume limitation was in effect in 1984, it did not apply to obligations issued in 1984 for projects for which inducement resolutions were adopted before June 19, 1984 and for certain other grandfathered obligations.

1/ Issuers of tax-exempt IDBs and tax-exempt bonds for student loans and for private, non-profit organizations are required to report selected information about the bonds to the IRS. Issuers must file IRS Form 8038 within 45 days of the end of the calendar quarter in which the obligation is issued. The reporting requirement, effective January 1, 1983, provided the first comprehensive data on private activity tax-exempt bonds. Comparable data for periods before 1983 are not available.

2/ The 1984 Tax Act extended the information reporting requirement to mortgage subsidy bonds and qualified veterans' housing bonds.

Chart 1

Long Term Tax-Exempt Bond Issues for Private Purposes - 1975 to 1984

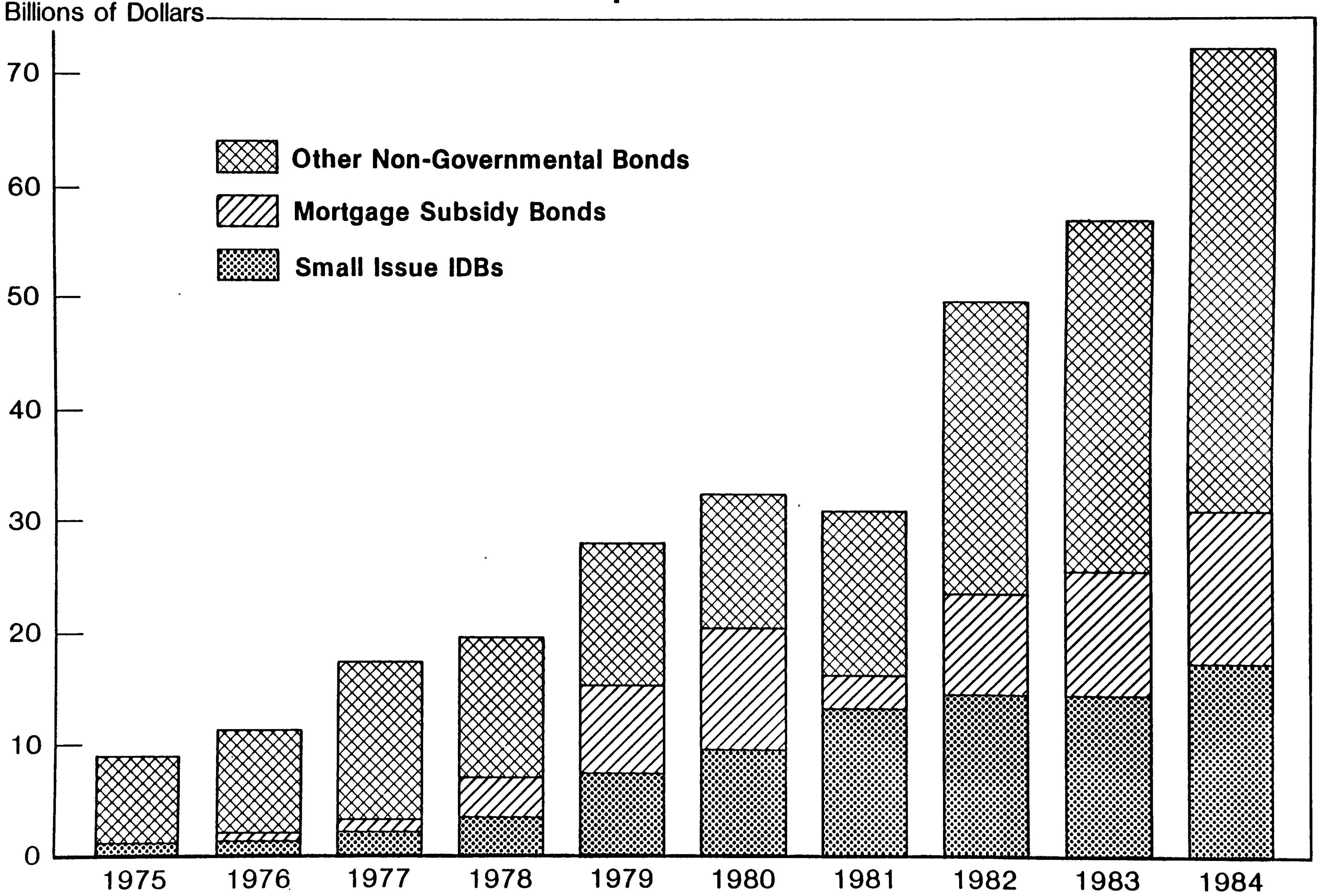

Chart 2

Volume of Long-Term Tax-Exempt Bonds Issued in 1984

(Amounts in $Billions)

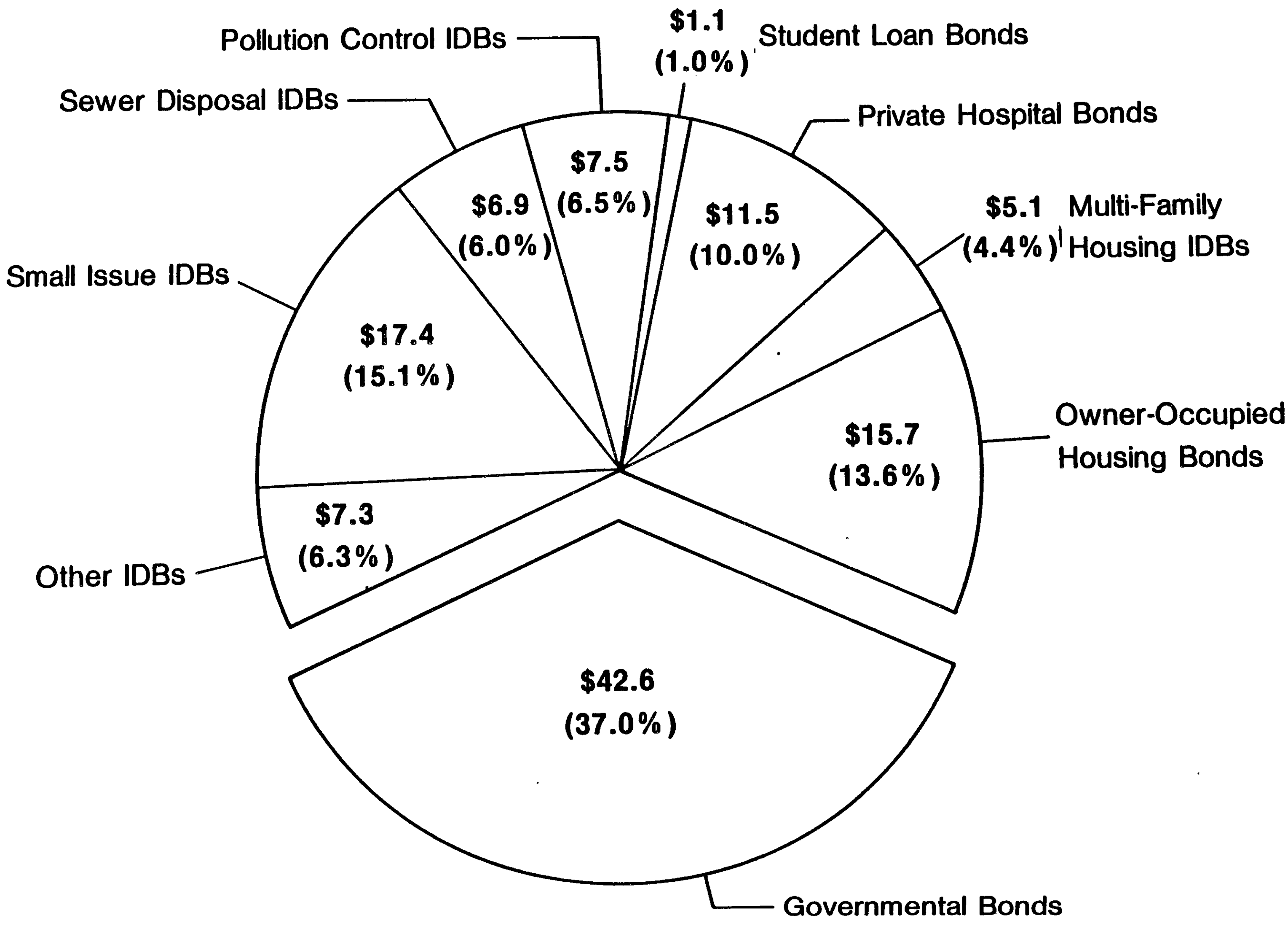

Table 1

Volume of Long-Term Tax-Exempt Bonds by Type of Activity, 1975-1984

(In billions of dollars)

	Calendar Years									
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Total issues, long-term tax exempt bonds 1/.....	30.5	35.0	46.9	49.1	48.4	54.4	55.1	84.9	93.3	115.1
Nongovernmental tax exempt bonds................	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1	72.5
Housing bonds...............................	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0	20.8
Single family mortgage subsidy bonds.......	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0	13.5
Multi-family rental housing IDBs...........	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3	5.1
Veterans' general obligation bonds.........	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7	2.2
Private exempt entity bonds 2/..............	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7	11.6
Student loan bonds..........................	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3	11.1
Pollution control IDBs......................	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5	7.5
Small issue IDBs............................	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6	17.4
Other IDBs 3/...............................	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0	14.0
Other tax-exempt bonds 4/......................	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2	42.6

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Note: Totals may not add due to rounding.

* $50 million or less.

1/ Total reported volume from Bond Buyer Municipal State Book (1985) adjusted for privately placed small issue IDBs.

2/ Private-exempt entity bonds are obligations of Internal Revenue Code Section 501(c)(3) organizations such as private nonprofit hospitals and educational facilities.

3/ Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

4/ Some of these may be nongovernmental bonds.

Table 2

VOLUME OF LONG-TERM PRIVATE ACTIVITY TAX-EXEMPT BONDS
DURING CALENDAR YEAR 1984
(Face amount of bonds)

	Billions of Dollars
Total Reported Private Activity Bonds 1/	$ 56.8
Nonreported Private Activity Bonds	
Single-family mortgage subsidy bonds 2/	13.5
General obligation veterans' housing bonds 2/	2.2
Total Private Activity Bonds 3/	$ 72.5
Total Estimated Tax-Exempt Bond Volume 4/	$115.1
Private Activity Bonds as Percent of Total Estimated Tax-Exempt Bond Volume	63.0%

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1/ Preliminary data compiled from Form 8038. See Table 2 for the list of reported private activity tax-exempt bonds, which include all tax-exempt industrial development bonds, student loan bonds, and bonds issued for private, nonprofit organizations.
2/ Preliminary data from the Office of Financial Management, HUD. Information reporting is required for those bonds issued after 1984.
3/ Nongovernmental bonds, as defined by the President's proposal, would include more obligations than those reported as private activity bonds.
4/ The estimated total volume adjusts the $101.8 billion total reported in the Bond Buyer Municipal Stat Book (1985) for privately placed small issue IDBs. The additional volume equals the face amount of reported small issue and industrial park IDBs ($17.7 billion) minus the publicly reported volume of "industrial aid" bonds in the Bond Buyer ($4.5 billion), or $13.2 billion.

Table 3

Total Volume of Reported Private Activity Tax-Exempt Bonds by Type of Bond, 1984

(In millions of dollars)

Type of bond	Face amount			New issues 1/		
	Total	Short-term	Long-term	Total	Short-term	Long-term
Total 2/	$71,797	$14,991	$56,806	$53,086	$5,580	$47,506
Student loan bonds	1,688	539	1,149	1,680	539	1,141
Private exempt entity bonds 3/	14,737	3,211	11,526	10,055	1,371	8,684
Industrial development bonds:						
Industrial park IDBs	406	28	378	230	26	204
Small issue IDBs	17,643	283	17,361	16,739	248	16,491
Multi-family rental housing IDBs	5,192	103	5,089	5,028	27	5,001
Sports facility IDBs	595	0	595	534	0	534
Convention facility IDBs	133	0	133	39	0	39
Airports, docks, wharves and mass commuting facility IDBs	6,034	1,036	4,998	3,770	221	3,549
Sewage and waste disposal IDBs	8,856	1,910	6,945	6,601	914	5,686
Pollution control facility IDBs	14,882	7,358	7,523	7,616	2,187	5,429
Water furnishing facility IDBs	149	6	142	136	2	134
Hydroelectric generating facility IDBs	94	0	94	92	0	92
Mass commuting vehicles IDBs	49	44	4	49	44	4
Local heating and cooling facility IDBs	299	0	299	105	0	105
Electric energy and gas facility IDBs	1,041	472	569	413	0	413

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Note: Preliminary data compiled from Form 8038. Details may not add to total due to rounding.

1/ New issue volume equals the purchase price of the bonds minus proceeds used to retire earlier issues.

2/ Only includes total for bonds subject to the information reporting requirement. The 1984 Tax Act required information reporting on mortgage subsidy bonds and qualified veterans' housing bonds issued after 1984. Other nongovernmental bonds, such as consumer loan bonds, are not reported.

3/ Private exempt entity bonds include bonds issued for I.R.C. Section 501(c)(3) organizations, principally private nonprofit hospitals and educational facilities.

Table 4

Percentage Change in New Issue Volume of Reported Private Activity

Tax-Exempt Bonds Between 1983 and 1984

Type of bonds	Total new issues 1/ (In millions) 1983	1984	Percentage Change 1983-1984
Total private activity bonds 2/	$38,869	$53,086	36.6%
Student loan bonds	3,086	1,680	-45.6
Private exempt entity bonds	8,096	10,055	24.2
Industrial development bonds	27,688	41,352	49.4
Industrial park IDBs	190	230	21.1
Small issue IDBs	13,689	16,739	22.3
Multifamily housing IDBs	5,337	5,028	-5.8
Sports facility IDBs	220	534	142.7
Convention facility IDBs	246	39	-84.2
Airports, docks, etc. IDBs	2,089	3,770	80.5
Sewage and waste disposal IDBs	1,442	6,601	357.8
Pollution control facility IDBs	3,411	7,616	123.3
Water furnishing facility IDBs	91	136	49.5
Hydroelectric generating facility	60	92	53.3
Mass commuting vehicle IDBs	13	49	276.9
Local heating and cooling facility IDBs	85	105	23.5
Electric energy and gas facility IDBs	815	413	-49.3

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Note: Preliminary data for 1984 compiled from Form 8038. Final data for 1983 bond issues is presented "Private Activity Tax-Exempt Bonds, 1983," Statistics of Income Bulletin, Volume 4, Number 1, Summer 1984.

1/ New issue volume equals the purchase price of the bonds minus proceeds used to retire earlier issues.

2/ Only includes total for bonds subject to the information reporting requirement.

Table 5

Volume of Reported New Issue Private Activity Tax-Exempt Bonds 1/ By State, 1984
(In millions of dollars)

State	Total 2/	Student loan bonds	Exempt entity bonds 3/	Industrial Development Bonds: Small issue and industrial park	Rental housing	Sports and convention	Airport and docks	Sewage and waste disposal	Pollution control	Electric and gas	Other IDB's
United States total 2/	$53,086	$1,680	$10,055	$16,969	$5,028	$573	$3,770	$6,601	$7,616	$413	$382
Alabama	1,046	-	338	365	-	-	29	55	260	-	-
Alaska	119	-	-	89	2	-	27	-	-	-	-
Arizona	1,360	-	319	318	66	13	20	402	198	-	25
Arkansas	209	-	44	102	17	-	4	29	13	-	-
California	3,899	426	783	492	927	1	339	552	309	-	71
Colorado	797	-	246	218	113	74	1	20	117	-	9
Connecticut	482	-	79	203	71	-	8	35	72	-	15
Delaware	326	-	8	134	7	-	-	-	168	10	-
Florida	3,746	12	748	541	470	24	417	1,002	214	315	3
Georgia	2,537	-	31	745	223	-	-	524	1,016	-	-
Hawaii	159	-	82	-	-	-	66	-	-	11	-
Idaho	72	37	5	18	-	-	4	-	9	-	-
Illinois	2,445	132	477	728	96	-	887	38	85	-	2
Indiana	1,237	-	315	357	25	-	53	87	400	-	-
Iowa	293	11	4	186	40	52	-	-	-	-	-
Kansas	468	-	38	178	39	-	-	100	114	-	-
Kentucky	669	41	113	218	4	-	163	61	69	-	-
Louisiana	1,528	196	195	406	104	-	41	198	389	-	1
Maine	77	-	-	60	14	3	-	-	-	-	-
Maryland	1,271	14	164	561	407	-	62	-	62	-	-
Massachusetts	1,326	122	506	503	22	-	49	112	11	-	-
Michigan	1,541	-	248	631	66	-	-	426	97	-	74
Minnesota	1,165	60	78	585	123	94	15	172	39	-	-
Mississippi	407	-	42	111	20	-	-	149	84	-	-
Missouri	1,284	-	357	383	204	3	41	61	235	-	-
Montana	195	68	26	59	-	-	-	13	29	-	1
Nebraska	294	-	116	110	4	3	61	-	-	-	-
Nevada	165	-	9	21	63	-	-	-	13	18	41
New Hampshire	285	5	45	90	22	-	-	15	108	-	-
New Jersey	2,055	-	252	1,009	30	9	85	293	339	31	6
New Mexico	174	-	13	59	20	-	65	-	17	-	-
New York	3,457	-	1,004	1,149	314	80	342	174	343	-	51
North Carolina	771	-	38	349	73	-	22	9	280	-	-
North Dakota	232	128	27	20	3	-	2	19	33	-	-
Ohio	1,291	-	271	661	64	-	29	42	220	-	4
Oklahoma	363	-	3	116	112	-	3	128	-	-	-
Oregon	302	-	105	78	-	4	26	57	3	18	10
Pennsylvania	3,756	200	782	1,480	53	38	25	606	571	-	3
Rhode Island	413	-	86	60	33	-	17	210	-	-	6
South Carolina	847	-	18	301	36	-	5	261	227	-	-
South Dakota	115	49	23	42	-	-	-	-	-	-	-
Tennessee	1,281	-	146	679	215	-	234	-	3	-	3
Texas	4,356	25	1,447	769	402	3	476	334	881	-	19
Utah	619	-	-	165	52	145	-	90	155	-	13
Vermont	118	-	32	72	-	9	-	1	-	4	-
Virginia	1,849	88	129	996	287	7	68	234	39	-	-
Washington	492	46	50	100	122	5	85	50	27	5	1
West Virginia	192	-	61	80	26	-	-	-	25	-	-
Wisconsin	524	20	152	309	10	7	-	2	23	-	-
Wyoming	365	-	-	45	-	1	-	-	319	-	-
Others	112	-	1	20	26	-	-	41	-	-	24

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Note: Preliminary data compiled from Form 8038. Details may not add to total due to rounding.

1/ New issue volume equals the purchase price of the bonds minus proceeds used to retire earlier issues.
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3/ Private exempt entity bonds include bonds issued for I.R.C. Section 501(c)(3) organizations, principally private nonprofit hospitals and educational facilities.

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STATEMENT BY SECRETARY OF THE TREASURY
JAMES A. BAKER, III
AT THE TOKYO MEETING OF
THE FINANCE MINISTERS AND CENTRAL BANK GOVERNORS
OF THE
GROUP OF TEN
JUNE 21, 1985

Chairman Takeshita, Managing Director de Larosiere,
Fellow Ministers and Governors:

This meeting marks the conclusion of nearly two years of effort on the part of our Deputies to review the operation of the international monetary system and to consider the need for improvements in the system. The report before us highlights both the strengths and weaknesses of the current system and recommends a number of steps to improve its functioning. It is our task to review the Deputies' findings, to assess their recommendations, and to consider whether additional steps are needed to foster international cooperation and provide a better international framework for growth and stability.

The task assigned our Deputies in September 1983 was not an easy one. Yet under the able guidance of Chairman Dini, and despite sharp differences of views at times, the Deputies have succeeded in developing a common assessment of the current international monetary system and an agreed approach on which to build improvements. I would like to take this opportunity to commend Chairman Dini and the Deputies for their work.

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I think we can all agree that the current international monetary system has provided a useful framework for responding to the multiple global economic shocks of the 1970s and early 1980s. Without a flexible system, adjustment to the dramatic increases in oil prices and high inflation, as well as the subsequent global recession and debt crisis, would have been considerably more difficult and probably more costly. Despite these challenges, the current system has provided a framework for the continued expansion of world trade and global growth.

I believe that the basic elements of the current system, and the principles encompassed in the IMF Articles of Agreement, remain sound. Nevertheless, the current system has not been as stable as we would have liked, and we should not be complacent about the problems which do exist. Since becoming Secretary of the Treasury, I have become increasingly aware of the close interaction of our economies and of the potential impact of policies in one country on the ability of other governments to pursue their own domestic policy objectives. Our economies today are more open than ever before to external influences -- and appropriately so. We all gain from trade and capital flows across our borders. The open trade and payments system bequeathed to us by the founders of the Bretton Woods system has been central to the economic successes we have all achieved since WWII, and the liberalization that has occurred during the last twenty years, particularly in capital markets, has taken us to a point from which we cannot -- and should not -- turn back.

Nevertheless, rapid shifts in capital flows can lead to exchange rate volatility. Large exchange rate movements can and do have a major impact on trade, and require at times a painful reallocation of domestic resources. The U.S. trade community, as you all know, has become increasingly vocal in its concern about the large U.S. trade deficit, the strength of the dollar, and its difficulties in competing on the basis of normal comparative advantage in the goods sector.

We are all living in a more volatile and interdependent world economy. And the critics are right: we do need to improve the stability of the monetary system, as an essential framework for international trade and global economic growth. This doesn't mean capital controls -- which our Deputies have properly rejected. And it doesn't require the imposition of trade barriers to isolate our economies from the external world. Such measures are damaging to ourselves as well as to others and merely bring on retaliation in kind.

Our Deputies in their report have, I believe, pointed us in the right direction. Stronger international surveillance, a greater convergence of economic performance, measures to improve the stability of capital flows, and efforts to strengthen the monetary character of the IMF and its cooperation with the World Bank are all important.

The steps upon which the Deputies have actually been able to agree are modest ones. This is not due to any lack of vision or effort on their part, but to the difficulties inevitably found in strengthening international cooperation. The Deputies' report represents a solid basis on which to build for the future as we continue our efforts to strengthen the system. Their recommendations are sound ones. We should endorse them and move promptly toward their implementation by the international community.

But this shouldn't be the end of the road. True monetary stability can only be achieved if we, as Ministers and Governors of the key industrial countries, develop the political will to tackle the difficult economic problems which each of us faces. And we must tackle them within a framework of international cooperation, not in isolation from one other but allowing each of us to reinforce both the desire and the capacity of the others to do what is needed. This is essential if real stability is to be attained.

Domestic Economic Policies

The key lesson of the 1970s was the need to revamp domestic economic policies as the basis for longer-term growth and stability. Our governments recognized that global economic stability required, first and foremost, stability within our own economies. And this in turn required sound economic policies designed to achieve non-inflationary growth and a greater convergence of economic performance among the major countries.

Those fundamental precepts -- sound policies at home and convergent performance internationally -- have been reaffirmed at successive Economic Summits of the major industrial nations and remain sound today. As our Heads of State committed at the Versailles Summit, and I quote:

> We accept a joint responsiblity to work for greater stability of the world monetary system. We recognize that this rests primarily on convergence of policies designed to achieve lower inflation, higher employment and renewed economic growth, and thus to maintain the internal and external values of our currencies.

The adoption of policies to reduce inflation, control government expenditures, and deregulate our economies has helped considerably in restoring a basis for sustainable longer-term growth, both in our own countries and in a number of developing countries whose access to international credit had been sharply curtailed.

- -- Between 1980 and 1984 inflation in the seven major industrial countries fell from 12.2 to 4.5 percent.

-- During that period, growth in these countries increased from less than 1 to 5.1 percent.

-- The aggregate non-oil LDC current account deficit has dropped from $108 billion in 1981 to $38 billion in 1984.

-- Non-oil LDCs also grew at a surprising 4.2 percent last year, and restored growth in their imports to nearly 6 percent.

Despite this considerable progress, as the OECD Ministerial and the Bonn Economic Summit recognized this spring, we all still have more work to do in restoring the domestic economic stability which is a prerequisite to international stability -- particularly in the areas of fiscal policy, levels of government expenditure, international trade, and structural adjustment. Firm and early action to extend our efforts into these areas is essential.

International Surveillance

The revised IMF Articles of Agreement provide for firm IMF surveillance over members in order to promote a stable system of exchange rates. These provisions for IMF surveillance, however, have not been fully developed.

The Deputies recognize in their report that strengthened mechanisms and procedures for international surveillance provide the key means of encouraging the adoption and implementation of sound economic policies, which in turn will contribute to a more effective functioning of the international monetary system and an expanding world economy. The Deputies therefore have suggested a number of steps which could be taken to strengthen IMF surveillance.

I strongly support these proposals and would urge you to both endorse them and participate actively in the strengthened procedures. By way of precedent, I plan to meet with the Managing Director and the IMF Article IV team at the end of the U.S. Article IV consultations to emphasize the importance we give to these consultations.

Although these measures can be useful, I am somewhat disappointed that the Deputies did not go further in this area. If surveillance is to be really effective, we may need to look beyond the recommended measures. For example, I noted the reluctance of other governments to participate in an arrangement which could strengthen considerably the effectiveness of IMF surveillance by enhancing public awareness of the international implications of domestic policies. I recognize the utility of confidential discussions with IMF staff and with the Managing Director, and have no intent to undermine that essential confidentiality. But we can all benefit from both private and occasional public exposure to criticism. I therefore urge you to give further consideration to the concept of increased publicity -- particularly the release of an abbreviated version of the Managing Director's Summing Up of Article IV consultations.

Finally, I would like to emphasize that we believe that the provision for special or supplemental surveillance consultations is an important one. Such consultations should be based on the Managing Director's qualitative assessment that developments in a range of areas indicate the need for discussions with the member country. The Executive Board should review and revise as necessary current provisions for special or supplemental consultations along these lines, as part of a comprehensive review and revision of the principles and procedures for surveillance.

Financial Stability

The liberalization and integration of domestic capital markets has transformed the international financial system and facilitated an enormous expansion in the size and complexity of capital flows between countries. The increased availability of external financing has contributed to world economic growth, the efficient allocation of global savings, and orderly balance of payments adjustments. However, the rapidly expanding role of international markets can also magnify the consequences of domestic policy mistakes; for example, by permitting a country to postpone needed economic adjustments until its creditworthiness is impaired.

The path to greater stability in international financial markets points to the need for improved economic policies in all countries. The major borrowers must implement effective adjustment programs to restore their creditworthiness and reduce financing requirements to sustainable levels. The pursuit of sound, consistent policies by the major industrial countries would help reduce wide swings in the availability of international liquidity. Steps are also needed to improve the functioning of the private capital markets by further deregulation and liberalization to facilitate the efficient flow of global savings and by increasing the amount of data available to permit more informed judgments by lenders.

The global economy does not face a general shortage of liquidity. Global reserves have, in fact, increased by an average of 10 percent per year since 1982. LDC reserves have grown even faster - an average of 16 percent per year. While a number of countries face financing problems, this is due primarily to problems of creditworthiness. In these circumstances, we do not believe that unconditional financing in the form of an SDR allocation is the appropriate response, and continue to oppose an allocation.

The changes in the international financial system over the past ten years have affected fundamentally the rationale for the SDR as a supplementary source of international liquidity. We strongly support, therefore, the intention of the IMF to undertake a comprehensive review of the SDR.

Role of the IMF

The IMF plays a central role in dealing with current economic problems and improving the functioning of the system over the longer-term. In recent years, the Fund has responded in a timely and effective manner to the international debt problem. Since 1981, more than 100 countries have received over $40 billion in temporary balance of payments financing in support of their adjustment efforts. The IMF's policy advice has helped in the formulation and implementation of the sound domestic policies necessary for the restoration of growth and sustainable external positions. The Fund "seal of approval" serves as an important catalyst for other lenders to reschedule existing debts and provide new financing.

The recent increase in resources provided the Fund will enable it to fulfill its responsibilities for the foreseeable future. The measures proposed by our Deputies to strengthen IMF surveillance will provide the Fund with an effective instrument to encourage sound policies in the countries where IMF financing is unnecessary or inappropriate. However, the IMF's ability to promote sound, consistent policies in all countries depends fundamentally on the IMF's credibility as a sound, prudent institution. And that, in turn, depends on restoring the IMF's role as a source of temporary balance of payments financing and dealing effectively with the problems of prolonged use and arrears.

The efforts of the IMF and World Bank to respond to LDC problems has resulted in some overlap in their activities and heightened the importance of close, continuing cooperation. Some steps have been taken to improve cooperation and the Deputies' report contains suggestions for additional measures which the institutions should be encouraged to implement. However, we should go further.

The Interim Committee meeting in Seoul will be considering a report by the Managing Director on the possible uses of the resources that will be available following repayment of loans that have been made by the Trust Fund. The United States believes that an important opportunity exists to use IMF and World Bank resources and expertise in a coordinated response to the economic and balance of payments problems of low income developing countries. In particular, the IMF and World Bank could work together in developing a comprehensive economic adjustment program for certain countries, incorporating both demand management and structural reforms to deal with the protracted balance of payments problems of these countries. The

United States will present some ideas to move in this direction as part of the preparations for the October meetings of the Interim and Development Committees in Seoul.

Conclusion

In sum, our Deputies have done a commendable job in analyzing the system and in preparing recommendations for improving it. The individual steps which are proposed are not major ones. But they do go in the right direction, and can help strengthen the framework upon which we must build a better means of international cooperation.

Our first task now must be to implement these recommendations. But that is not our only task. We must continue our efforts to improve the capacity of the system to encourage and foster the kinds of policies which will produce greater international economic stability. We need to do so through both bilateral and multilateral channels, keeping in mind that it becomes easier to strengthen policies at home if others are doing so as well. In that way, the efforts of each are supported by the efforts of the group as a whole. And we all benefit from the process.

If we can first agree on the measures recommended by our Deputies, and then move forward to build on this framework in a new spirit of cooperation, I believe we can enhance the stability of the international monetary system and assure a more productive and growing global economy.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 a.m., E.D.T.
June 24, 1985

STATEMENT OF
DENNIS ROSS
DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on two bills currently before the Finance Committee: S.203, a proposal to provide a one-time amnesty from criminal and civil tax penalties and for one-half of the interest owed for certain taxpayers who pay previous underpayments of Federal tax during the amnesty period; and S.205, a bill that would permit taxpayers to designate $1 of any overpayment of income tax, or to contribute other amounts, for payment to a National Organ Transplant Trust Fund. If I may, I will address first the taxpayer amnesty bill.

TAXPAYER AMNESTY

The Noncompliance Problem

No problem facing our tax system today is more pressing than the need to maintain voluntary compliance with our tax laws. Our revenue raising efforts depend upon taxpayers honestly reporting their income and paying their fair share of tax. Although the great bulk of American taxpayers are honest, the facts concerning the level of taxpayer noncompliance are disturbing. Some estimates of tax revenues to be lost in 1985 alone due to noncompliance by taxpayers engaged in legal activities exceed $90 billion, or roughly half the current budget deficit. The percentage of noncomplying individuals has been estimated at twenty percent, and increasing steadily. As much as ten percent of all corporate income may be going unreported.

The Treasury Department has been actively exploring ways to close the so-called "tax gap" between actual tax liabilities and reported tax liabilities. In that process we have given careful consideration to a taxpayer amnesty, an approach that has been tried recently by a number of States. In the typical amnesty program, taxpayer amnesty has been coupled with a proposal for tougher enforcement of the tax laws. Advocates of taxpayer amnesty believe that the combined incentives of reduced tax liability and more aggressive future enforcement will bring forward many taxpayers who have illegally concealed their income, raising significant revenue at low cost.

A Flawed Approach

Our analysis of various amnesty programs has led us to conclude that we should not enact taxpayer amnesty at the Federal level. Our conclusion is based principally on concerns over the actual and perceived fairness of a Federal amnesty program, and thus over the possible adverse effects of an amnesty program on taxpayer morale and compliance. In addition, we question whether an amnesty program would raise significant revenue in the short run, and indeed, are concerned that amnesty could be a long-run revenue loser.

A Question of Fairness

The issue of fairness must be paramount in any consideration of an amnesty program, since taxpayer compliance with the tax laws ultimately rests on taxpayers' belief that those laws are fundamentally fair. As this Committee is well aware, there is much discussion at present over how we may improve the fairness of the tax system. The Administration has recently proposed a comprehensive reform of the tax system for fairness, simplicity and growth. We believe that the strong public support for that proposal reflects a widespread belief that the fairness of the system can and must be improved.

We have serious concern that enactment of a Federal amnesty program would raise additional doubt in the public's mind about the fairness of the current tax system. The great majority of taxpayers, those who have dutifully complied with the law and paid their fair share of tax, are likely to feel cheated when others, who knowingly broke the rules, are allowed to escape punishment and indeed, to the extent interest on overdue tax liabilities is forgiven, profit from their wrong. This natural, common sense reaction would inevitably lead to a certain cynicism about the tax laws and the importance of complying with them in the future. We cannot overstate the threat such attitudes pose to a tax system that depends on taxpayers honestly reporting their own liability for tax.

Effect on Revenues

The success of several State amnesty programs in increasing current revenue has caused many to ask whether an anmesty program would have the same effect at the Federal level. After studying the various State programs, we find no evidence that a Federal amnesty program would raise significant additional current revenue.

State amnesty programs have varied in the taxpayers they cover, in the taxes, penalties or interest that they forgive, and in their provision for increased future enforcement efforts or penalties. However, the greatest success seems to have been achieved where amnesty is accompanied by a significantly increased risk that tax delinquents will be apprehended in the future. Many States that tried amnesty programs did so at a time when enforcement of their tax laws had been somewhat lax. As a consequence, it is not clear that the additional revenues collected would not have been collected had tougher enforcement measures been in place all along. In contrast with these States, the Federal government has pursued aggressive enforcement policies for many years. We thus question whether a Federal amnesty program would provide an additional incentive for those currently outside the law to come forward.

Other factors also suggest that the Federal experience with amnesty would differ from that of the States. The history of strict enforcement at the Federal level is likely to result in a greater reluctance for taxpayers to confess to Federal than to State authorities. The risk of unexpected consequences, including costly administrative proceedings, could be more difficult to gauge at the Federal than at the State level. In addition, because there would be more dollars at stake federally, many taxpayers would be financially unable to wipe the slate clean.

Possible Adverse Long-Term Revenue Effect

We also believe that a Federal amnesty program could have a substantial negative effect on long-term revenues. A taxpayer amnesty, even if described as a "one-time" program, would lead taxpayers to wonder whether it might be repeated and thus to question the importance of continued compliance with the tax laws. Somewhat perversely, the more revenue the program raised in the short run, i.e., the greater its apparent success, the more likely taxpayer perceptions that it would be repeated.

We believe the tax system's ability to raise revenue must ultimately suffer from any program that casts doubt on the need for and importance of taxpayer compliance with the law. An amnesty program would gamble with our tax system's most important asset, the willingness of taxpayers to obey the law. This willingness rests in large part on taxpayers' belief that noncompliance will not be tolerated. The small, and very likely short-run revenue gain that might come from an amnesty program is not worth the risk that taxpayers' belief in the integrity of the system would be weakened.

Suggested Approach

Our conclusion that a Federal amnesty program would be unwise should not be taken to indicate a lack of concern with the existing problem of taxpayer noncompliance. To the contrary, the problem of the tax gap requires, and is receiving in-depth study. As you know, we believe that many problems concerning noncompliance are rooted in the unfairness and complexity of the current tax laws. That is why it is imperative that we stay on the road to fundamental tax reform. Tax reform that improves the fairness of the system and lowers tax rates would be a significant step in our efforts to improve compliance and reduce the size of the tax gap.

NATIONAL ORGAN TRANSPLANT TRUST FUND

S.205 would employ the tax return system to facilitate taxpayer contributions to a National Organ Transplant Trust Fund. However worthy the purposes of a National Organ Transplant Trust Fund, we oppose use of the tax system and the return process for goals that are wholly unrelated to the raising of tax revenue. You should note that we have, on the same grounds, proposed repeal of the existing Presidential Campaign Check-off as part of fundamental tax reform. Provisions such as these, though seemingly harmless when considered alone, add significantly to the complexity of the tax system. The question of support for a National Organ Transplant Trust Fund should be pursued in another manner.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 24, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,022 million of 13-week bills and for $7,020 million of 26-week bills, both to be issued on June 27, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 26, 1985			26-week bills maturing December 26, 1985		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.01%	7.24%	98.228	7.19%	7.56%	96.365
High	7.10%	7.33%	98.205	7.24%	7.62%	96.340
Average	7.06%	7.29%	98.215	7.24%	7.62%	96.340

Tenders at the high discount rate for the 13-week bills were allotted 16%.
Tenders at the high discount rate for the 26-week bills were allotted 100%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 134,735	$ 84,735	$ 113,810	$ 43,810
New York	13,787,850	5,095,450	16,125,700	5,790,700
Philadelphia	26,360	26,360	14,080	14,080
Cleveland	44,055	44,055	123,070	123,070
Richmond	59,255	57,575	63,190	58,190
Atlanta	49,600	49,600	50,850	48,850
Chicago	1,255,090	518,970	1,015,115	174,615
St. Louis	69,555	49,555	45,565	25,565
Minneapolis	41,040	41,040	34,810	34,810
Kansas City	84,610	84,610	42,155	42,155
Dallas	46,390	46,390	22,515	12,515
San Francisco	1,857,310	643,310	1,479,245	460,245
Treasury	279,885	279,885	191,340	191,340
TOTALS	$17,735,735	$7,021,535	$19,321,445	$7,019,945
Type				
Competitive	$15,156,990	$4,442,790	$16,657,990	$4,356,490
Noncompetitive	1,024,795	1,024,795	659,855	659,855
Subtotal, Public	$16,181,785	$5,467,585	$17,317,845	$5,016,345
Federal Reserve	1,253,150	1,253,150	1,200,000	1,200,000
Foreign Official Institutions	300,800	300,800	803,600	803,600
TOTALS	$17,735,735	$7,021,535	$19,321,445	$7,019,945

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.

June 25, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,000 million, to be issued July 5, 1985. This offering will provide about $325 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,679 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, July 1, 1985. The two series offered are as follows:

90-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated October 4, 1984, and to mature October 3, 1985 (CUSIP No. 912794 HM 9), currently outstanding in the amount of $14,919 million, the additional and original bills to be freely interchangeable.

181-day bills for approximately $7,000 million, to be dated July 5, 1985, and to mature January 2, 1986 (CUSIP No. 912794 JL 9).

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.

The bills will be issued for cash and in exchange for Treasury bills maturing July 5, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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. Federal Reserve Banks currently hold $1,215 million as agents for foreign and international monetary authorities, and $2,900 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

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

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 1:30 P.M. EDT
Wednesday, June 26, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
OF THE SENATE GOVERNMENTAL AFFAIRS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the treatment under the Federal income tax system of amounts paid for State and local taxes. As you know, current law allows taxpayers who itemize deductions to deduct their payments for State and local income, sales and real and personal property taxes without regard to whether the taxes were incurred in carrying on a trade or business or income-producing activity. In addition, although nonitemizing as well itemizing taxpayers can deduct State and local taxes (other than income taxes) incurred in carrying on a trade or business or which are attributable to property held for the production of rents and royalties, State and local taxes attributable to other income-producing property are deductible only by itemizing taxpayers.

The President's Tax Reform Proposal. Under the President's Tax Proposals to Congress for Fairness, Growth, and Simplicity, the itemized deduction for State and local income taxes and other taxes not incurred in carrying on a trade or business or income-producing activity would be repealed. State and local taxes (other than income taxes) which currently are an itemized deduction but which are incurred in carrying on an income-producing activity would be aggregated with certain other miscellaneous expenses and would be deductible above a threshold of one percent of adjusted gross income.

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Repeal of the itemized deduction for State and local taxes is supported by each of the President's tax reform proposals' stated objectives of fairness, growth, and simplicity. The current deduction is unfair in that it skews the distribution of Federal income tax burdens as between high tax and low tax States and localities and as between itemizing and nonitemizing taxpayers. Equally important, the tax revenues currently lost to the deduction must be recaptured if tax rates are to be lowered significantly. Our ability to improve incentives for growth and to simplify the tax system through tax reform is ultimately dependent on lowering the current, unnecessarily high marginal tax rates.

Fairness. Analysis of the deduction for State and local taxes appropriately begins with the question of its fairness. The critical fact in considering whether a deduction for State and local taxes is fair in the context of a Federal tax system is that the level of the deduction is controlled by the individual tax policies of countless State and local governments. Because of the deduction, each of those State and local governments is able through its own tax policies to affect significantly the share of Federal income taxes paid by its residents. Since States and localities vary significantly in the type and extent of public services which they choose to finance through State and local taxes, the effect of the deduction is to shift significantly the burden of Federal income taxes from high tax States and localities to low tax States and localities.

The benefit of the State and local tax deduction to individual taxpayers also depends on whether the taxpayer itemizes deductions. Repeal of the State and local tax deduction would not directly affect the two-thirds of taxpayers, typically those with low or middle incomes, who currently do not itemize deductions. Conversely, under current law, and indeed, under any rate structure designed to achieve a given amount and distribution of Federal income taxes, nonitemizers must pay higher taxes in order for itemizing taxpayers to deduct their State and local taxes.

Need for Lower Marginal Tax Rates. Aside from the issue of fairness, the revenues at stake with respect to the State and local tax deduction are critically important to our efforts to reduce marginal tax rates. Under current law, the deduction for State and local taxes is projected to result in a revenue loss of approximately $33 billion in 1987, increasing to $40 billion by 1990. Unless those revenues are recaptured through a repeal of the State and local tax deduction, a significant reduction in marginal tax rates will not be possible within the constraint of revenue neutrality. We should not lose sight of the fact that lower tax rates are the keystone of fundamental tax reform, and that lower rates will, in and of themselves, do much to reduce the significance of tax considerations in personal and commercial decisionmaking and thus to promote fairness, growth, and simplicity.

"Tax on a Tax" Argument. Some have said that the deduction for State and local taxes should not be repealed because repeal would amount to imposing a "tax on a tax." We believe this argument is more rhetorical than real. It is contradicted by the practice of most States with respect to their own tax systems: 43 states and the District of Columbia impose a personal income tax, yet 28 of these jurisdictions do not permit a deduction for Federal income tax, and many also allow no deduction for local taxes. Similarly, of the 46 States that impose a corporate income tax, 39 do not permit a deduction for Federal income taxes.

Others have argued that repeal of the State and local tax deduction is inconsistent with the allowance of a credit for certain taxes paid to foreign governments. This asserted analogy between foreign taxes and State and local taxes is unsound. The foreign tax credit is an integral part of a system of international taxation in which primary taxing authority is generally ceded to the country where income is earned. Thus, U.S. residents are allowed a foreign tax credit for foreign taxes paid just as foreign taxpayers earning income in the U.S. are generally allowed a credit in their home country for U.S. taxes paid. In contrast to this international system in which primary taxing authority is ceded to one country, our Federal system of government necessarily involves different levels of government applying tax to the same taxpayers and the same income. The deductibility of taxes paid to overlapping domestic jurisdictions thus is not an issue of double taxation but rather of the extent to which each such jurisdiction is able to define its own tax base. As indicated above, most States assert this authority for themselves by denying a deduction for Federal income taxes.

Effect on State and Local Spending. Many of those who have argued for retention of the deduction for State and local taxes contend that repeal would make it much more difficult for States and localities to raise necessary revenue. In fact, however, only one-fifth of total State and local spending is financed by taxes that are taken as an itemized deduction under current law. Moreover, assuming the current seven percent annual growth rate in State and local spending continues, recent estimates indicate that repeal of the deduction would not reduce the level of State and local spending, but would merely slow its rate of growth. Thus, a National League of Cities study found that total State and local spending is about two percent higher because of the existence of the deduction of State and local taxes. Similarly, a study by the Congressional Research Service predicted that total State and local expenditures would be only 1.5 percent lower if the deduction were repealed. Both of these studies assume that nonitemizers exert no control over State and local spending and tax decisions; thus, they represent upper bounds on the estimated effects. Since the figures represent averages, the effect on particular States and localities could be higher or lower.

If additional Federal assistance to State and local governments is desirable, provision of that assistance through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local spending increases by less than fifty cents for every dollar of revenue loss. Moreover, the deduction benefits high-income communities more than low-income communities. Finally, the deduction is not targeted to specific categories of State and local spending, but is as much a subsidy for spending on recreational facilities as for public welfare spending.

Effect on Taxpayers. Repeal of the deduction for State and local taxes is an essential element of the President's proposals for fundamental tax reform. Those proposals include offsetting reductions in marginal rates and many other changes. Much has been said and written about who will "win" and who will "lose" under the President's proposals, and in particular about the impact of repealing the State and local tax deduction. In all of this, it is well to bear in mind that if the President's proposals were adopted, 79 percent of taxpayers would pay the same amount or less tax than they do under current law, and that all will benefit from a system that is fairer and simpler and encourages growth.

This concludes my prepared remarks. I would be happy to respond to any questions that you might have at this time.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 25, 1985

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $ 6,542 million of $16,586 million of tenders received from the public for the 4-year notes, Series M-1989, auctioned today. The notes will be issued July 1, 1985, and mature June 30, 1989.

The interest rate on the notes will be 9-5/8%. The range of accepted competitive bids, and the corresponding prices at the 9-5/8% interest rate are as follows:

	Yield	Price
Low	9.70%	99.756
High	9.72%	99.691
Average	9.72%	99.691

Tenders at the high yield were allotted 87%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 56,311	$ 15,311
New York	13,730,699	5,627,784
Philadelphia	13,182	13,182
Cleveland	383,106	97,862
Richmond	44,001	24,001
Atlanta	108,716	93,201
Chicago	808,584	189,164
St. Louis	234,075	214,075
Minneapolis	29,024	25,748
Kansas City	74,426	73,426
Dallas	9,492	5,492
San Francisco	1,093,232	161,444
Treasury	1,205	1,205
Totals	$16,586,053	$6,541,895

The $6,542 million of accepted tenders includes $ 741 million of noncompetitive tenders and $ 5,801 million of competitive tenders from the public.

In addition to the $ 6,542 million of tenders accepted in the auction process, $410 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $500 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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JUN 26 1985

Filed

'REASURY NEWS

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

REMARKS BY
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THE REAGAN ECONOMIC PROGRAM
(standard speech)

It is a pleasure to be with you today to discuss the economic outlook for the United States and the Administration's goal to restore a stable fiscal climate to promote long-term non-inflationary growth in the American economy.

The Problem

For many years, the United States economy has not been growing fast enough. We need more jobs and more production for our people, for a rising standard of living, and for a stronger national defense.

From 1973 to 1982 the U.S. economy grew at a real rate of 1.9 percent, just one-half the 3.8 percent real growth rate from 1950 to 1973 and far below the 4.5 percent growth rate achieved between 1962 and 1969. If we continue to grow at only about 2 percent, our GNP, which was just under $3.1 trillion in 1982, will rise in real value to only $3.6 trillion by 1990, adjusted for inflation. If we regain the momentum of the 1960s, real GNP will rise to $4.4 trillion by 1990, in 1982 dollars. The gain would be more than doubled and output levels would be more than 20 percent higher than in the slower growth case, all within 8 years.

The President's program addressed our Nation's most basic problem: our lack of growth. The first question in designing the program was, "Why are we not growing?" We were not growing because the sources of growth had been obstructed by Federal policy errors. The mechanics of those errors involved the tax code and its interaction with inflation, and the appropriation and misuse of resources by the government.

The Program

To correct the errors of the past, and to restore economic growth and full employment while reducing inflation, a four-part program was created. It consists of:

1. A stringent budget policy to release resources to the private sector for investment and growth.

2. An incentive tax reduction policy to increase the supply and lower the cost of labor and capital -- to encourage work effort, saving and investment.

3. A non-inflationary monetary policy to end inflation and reduce the higher interest rates and disincentives that inflation and the tax code combine to produce.

4. A regulatory reform program to reduce the enormous regulatory inefficiencies and costs that are holding back production and raising prices.

It is our goal to restore economic growth and reduce inflation at the same time. We do not accept the inevitability of having either inflation or unemployment always with us. This is the old notion of the Phillips curve, which preaches an inevitable trade-off between inflation and unemployment. The Phillips curve has misled policymakers to believe that it takes unemployment to fight inflation, and inflation to fight unemployment. Consequently, when inflation was the primary concern, all policy tools were put on "stop." When unemployment was the main problem, all policy tools were put on "go." The result of these "stop-go" policies was the worst of both worlds, inflation and unemployment rising together over time, business cycle after business cycle. (Chart 2)

The flaw in the Phillips curve logic is quite simple. One cannot hit two targets with one arrow. Since we have two basic economic targets, we need to have one policy arrow aimed at reducing inflation, and one aimed at promoting real economic growth.

Monetary policy has been aimed primarily at reducing inflation, although there are benefits for real growth as well. The goal is a moderate and steady growth of the money supply at rates consistent with stable prices. Stable prices, in turn, help to keep taxes from rising, reduce interest rates, and promote real growth. An unchanging policy of moderate and steady money growth is the only way permanently to restore confidence, lower inflation and inflationary expectations, and bring interest rates down.

Fiscal policy has been aimed at promoting real growth. Lower production costs and more goods on the shelves will help fight inflation, but the main purpose of cutting taxes, spending and regulation is to improve output, employment, and living standards.

Framework for Analysis

Those who think of fiscal policy in Keynesian demand management macroeconomic terms have a difficult time understanding our program. In a Keynesian framework, tax cuts are supposed to increase disposable income and consumer spending to stimulate demand. Tax cuts are analyzed in terms of the number of dollars injected into the economy. Increased government spending performs the same function. Keynesians see our tax cuts as inflationary, our spending reductions as contractionary.

The Administration thinks of fiscal policy in classical and microeconomic terms. Government spending is the true tax burden. Government spending diverts labor, capital, and output from the private sector to the public, whether it is paid for by taxing or borrowing. A reduction in government spending is stimulative, because it returns real and financial resources to the private sector. Compared to government, it is the private sector which is the more efficient and which has the greater propensity to use funds for growth-creating capital investment and innovation.

Tax reduction is not a stimulus to demand; it does not directly increase spending power. In the absence of government spending reduction, tax reduction is offset dollar-for-dollar by higher government borrowing. There is no injection of money; what the government gives out with one hand it takes back with the other. A tax reduction per se is neither inflationary nor stimulative. Only if additional government debt is purchased by the Federal Reserve, which thereby increases the money supply, is there any new money injected into the economy. But that is monetary policy, not fiscal policy.

The real impact of tax policy is determined by the micro-economic structure of a tax change, not the dollar amount. Tax rates (as opposed to tax receipts) can affect the relative prices of various goods, and the relative rewards to various activities. We seek to raise the after-tax rewards to growth activities such as labor, savings, and investment relative to leisure and consumption.

Our analysis is straight out of classical price theory. By lowing the tax wedge, we hope to induce a greater supply of labor and capital inputs to enter the market, at lower gross costs to the firm but higher net reward to the suppliers of labor and capital. Hence the term supply side economics. A tax on butter and a subsidy on margarine raise the gross price of butter relative to margarine to the consumer, and reduce the net price of butter relative to margarine for the producer. This causes consumers and producers to shift somewhat, at the margin, away from consumption and production of butter toward consumption and production of margarine. Behavior changes even if the tax and subsidy exactly cancel in dollar amounts so that there is no change in the government budget totals.

In precisely the same way, the income tax affects two very important relative prices: the relative price of goods versus leisure, and the relative value of current consumption versus saving for future consumption. An individual may use his limited time either working for money with which to buy goods, or for leisure. Rising tax rates on money earnings mean a rising relative price, in terms of time, of goods compared to leisure. Consumption of goods, and the work effort put into acquiring them, falls, while the consumption of leisure increases.

Similarly, rising tax rates on interest or dividend income, or on the purchase or future profits of capital goods, reduce the reward to saving and investment. This raises the cost of shifting earnings or purchases to the future, increasing the relative price of future consumption versus current consumption. Saving, investment, and economic growth rates decline.

It is far more important to analyze what a proposed tax change does to the reward or rate of return to labor or saving and investment than to look at the dollar amount of the tax change. Our tax program works by changing incentives and relative prices, not be injecting purchasing power. In fact, our tax reductions have been largely offset, in dollar terms, by bracket creep due to inflation and by previously scheduled payroll tax increases for social insurance programs. Only the incentive effects from the design of the program remain.

Tax rate reduction is needed to provide incentives to work, save, and invest. Over the years, inflation has destroyed incentives by raising tax rates on individuals and businesses, reducing the reward to labor and capital. Both the business and personal tax reductions in the Economic Recovery Tax Act of 1981 are essential elements in restoring these rewards and promoting growth.

Those who think of business only in terms of large corporations forget the millions of partnerships, proprietorships, and subchapter S corporations whose profits are taxed at the individual level at individual tax rates. The decisions of these owner-investors and entrepreneurs are heavily influenced by the personal rate reductions and estate and gift tax reforms enacted in 1981.

The notion that business tax cuts promote investment while personal tax cuts promote consumption is completely misguided. The old categories of business vs. personal tax cuts make no sense at all. They should be replaced with a concept that distinguishes tax changes which enhance the after-tax rate of return to labor and to capital from tax changes which primarily seek to redistribute existing income.

Labor is the biggest factor of production in the economy. The personal tax changes will have a profound effect on willingness to work and on wage and fringe benefit demands at the bargaining table.

Capital is owned by people. All saving and investment ultimately depends on the rate of return to capital after it reaches the individual, be he a shareholder, bondholder, owner of a small business, or a child with his first savings account.

Personal Taxes and Inflation

The rising tax rates that we have experienced in recent years have greatly increased the size of government revenues. The United States has not had an inflation-adjusted or indexed tax code. Every year without a cut in tax rates, inflation has driven taxpayers into higher tax brackets. Because of the progressive tax rate structure, each 10 percent cost-of-living increase pushes a taxpayer's tax bill up by 16 percent. That extra 6 percent goes straight to Washington as a windfall from inflation, a reward for government's failure to control inflation. That is hardly the sort of incentive an economist of any persuasion wants to see!

It is not just the average tax rate that is of concern, however. Inflation raises the average tax rate by raising the marginal tax rate. The marginal tax rate is each taxpayer's top tax bracket, the highest bracket his particular income reaches. It is the rate at which the last dollar earned, and the next dollar of any additional income earned, will be taxed.

Taxes and inflation combine to depress growth by pushing taxpayers into higher marginal tax rate brackets. This so-called "bracket creep" has been reducing incentives to save and to work. It is the marginal tax rate on additional income which affects our decisions about saving or consuming; about investing in ordinary bonds or in tax exempt issues; about working above ground, underground, or not working at all.

Consequently, the outstanding and essential attribute of the 1981 individual tax changes is that they were reductions in marginal tax rates. Marginal tax rates were reduced by roughly 25 percent (23 percent with compounding) over three years, from the previous range of 14 percent at the bottom and 70 percent at the top to a range of 11 percent to 50 percent. The first 5 percent reduction occurred October 1, 1981, followed by a 10 percent reduction on July 1, 1982 and a further 10 percent cut on July 1, 1983. The first whole year in which the tax cut was fully effective was 1984.

Starting in 1985, the exemptions and tax brackets will be adjusted for inflation, or indexed, to prevent bracket creep in the future. This will end Washington's 6 percent incentive to inflate and will preserve the incentives to work and save contained in the marginal rate reductions. This is the single most important feature of the Administration's tax program.

We often hear that we work the first five months of the year for the Government, and then we start to work for ourselves. But that is backwards. In fact, the first part of the year we work for ourselves. We begin working for the government only when our income reaches taxable levels. After that, the more we earn, the more we work for the government, until the rising marginal tax rates on extra income discourage us from further work effort, or further saving and investment.

Marginal tax rates rose sharply on most taxpayers between 1965 and 1981. Rebates, increased personal exemptions, and larger standard deductions did not prevent this. There were a dozen changes in exemptions or deductions between 1965 and 1981. Each lowered the tax on the first few dollars of each person's income, while leaving the remainder taxed at increasing marginal rates.

In 1965, the average family of four earning $7,800 was in the 17 percent tax bracket. It was permitted to keep 83 cents of every extra dollar earned by working harder or saving more. By 1981, before passage of the Economic Recovery Tax Act (ERTA), the average family of four earning about $26,275 was in the 24 percent bracket, keeping only 76 cents of each extra dollar. Without ERTA, the family would have been in the 28 percent bracket by 1984, keeping only 72 cents on the extra dollar of earnings. With ERTA, the marginal tax rate is 22 percent, with the family keeping 78 cents on the extra dollar. The rate will be held fixed by indexing unless real income rises.

The family of four with twice the average income was in the 22 percent bracket in 1965, and in the 43 percent bracket in 1981 before ERTA. The family would have just reached the 49 percent bracket by 1984 or 1985. With ERTA, that bracket is 38 percent, and indexed.

The adverse disincentive effects of high marginal tax rates may appear as refusal to accept overtime work; as pressure for shorter hours, longer vacations and sheltered fringe benefits rather than straight pay increases; as a shift of savings out of ordinary investments into less productive tax shelters or into consumption. Savings incentives and work incentives are both affected.

The adverse effect of inflation and rising marginal tax rates on personal saving can be seen in the plunge in the personal savings rate since 1976. (Chart 5)

In 1965, a saver in the 25 percent tax bracket could get 4 percent interest at a time of 2 percent inflation. After losing 1 percentage point to the tax collector and 2 points to inflation, the saver retained a 1 percent real after-tax reward for saving.

In 1980, the same saver would have been in the 32 percent tax bracket and could have earned 15 percent on a Treasury bill. The tax collector took away nearly 5 percentage points. Inflation was 13 percent. The saver lost 3 percent after taxes and inflation. It is no wonder that personal saving rates fell from the 7.5 to 9 percent range of the 1967 to 1975 period to between 5 and 6 percent in 1979 and 1980.

The Reagan program has lowered marginal tax rates and inflation, and has raised the real reward to saving. The personal savings rate has stabilized. We hope that, as confidence in the economic recovery builds, and inflationary fears abate, the savings rate will approach its former levels.

The adverse effects of high and rising marginal tax rates on work incentives are illustrated by paraphrasing President Coolidge's question: "If we had a tax system which took 20 percent of your wages on Monday, 30 percent of your wages on Tuesday, 40 percent of your wages on Wednesday, and so on up to 70 percent of your wages on Saturday, how many days a week would you work?" Well, figuratively speaking, more and more workers are beginning to quite around noon on Thursday.

One can turn that question around, and rephrase it in a way that shows its relevance to U.S. employment, labor costs, and the balance of payments. If we had that kind of a tax system, with 50 percent, 60 percent and 70 percent tax rates on Thursday, Friday, and Saturday, what kind of wage or salary would a worker demand from his company before he would consent to work those last three days.

Marginal tax rates on wages, interest, and dividends are part of the cost of hiring labor or raising capital. Marginal tax rates, Federal, state and local, are a real cost of doing business in the United States, as opposed to doing business somewhere else. Marginal tax rates are part of the price of U.S. products, as opposed to the price of a product from somewhere else.

Over the last 15 years, inflation, bracket creep and payroll tax hikes have sharply increased the pre-tax cost to the firm of giving a worker a one dollar after-tax wage increase. A typical worker now faces 40 percent to 44 percent tax rates on added income. This is the sum of social security and Federal marginal income tax rates, plus state and local taxes at the margin. It is up sharply from the late 1960s, when the marginal rates would have been roughly 26 percent to 30 percent.

Consequently, it now costs a firm more than $1.70 to compensate a worker for a $1.00 increase in the cost of living. This is up from about $1.40 in the late 1960s. With indexing it will drop back to a bit less than $1.40 again. Without indexing, it will rise to $2.00 by the late 1980s, and to $2.50 or higher in the 1990s. Any wage increase, whether merely COLA's or a real wage hike, would send taxes rising and tend to push labor costs up faster than the prices the firm receives for its products.

Very few firms can afford to pay their largest factor of production an increase sharply in excess of the cost of living. After all, the cost of living is measured as the rise in the prices that firms receive for their products. When costs rise faster than prices, the result is layoffs strikes, or both. Profits, employment, or real wages would fall continually over time in the absence of extraordinary productivity increases. The competitive position of U.S. labor in the world economy would suffer.

Put another way, an average worker must ask for an 11.5 percent wage hike on his total earnings to keep pace after tax with 10 percent inflation. It would take productivity growth of 1.5 percent per year to make this possible without layoffs. This was just the average productivity growth between 1963 and 1982. Thus, at 10 percent inflation, the government would be laying claim to 100 percent of a worker's potential real wage gain!

Bracket creep has poisoned labor relations for years and helped to price U.S. labor out of world markets. The invisible third party at every bargaining table has been the tax collector, using bracket creep to drive a tax wedge deeper and deeper between labor and management over time. Marginal rate reduction, followed by indexing of the exemptions, deductions and tax brackets for inflation starting in 1985, will help prevent this deterioration in the competitive situation of U.S. labor in the future. Without indexing, the process would merely be arrested for three years by the marginal rate reductions only to resume.

Business Taxes and Inflation

Corporate taxes and inflation interact to restrict economic growth by interfering dramatically with the tax treatment of plant, equipment, and inventories. This was the single most urgent tax problem in the business sector. It was this problem at which the business provisions of the ERTA were carefully targeted.

Depreciation deductions for recovery of the investment in capital are based on the original cost of the facilities; these deductions, therefore, do not increase as inflation proceeds. Less and less of the real cost of replacing plant and equipment is deductible, and more and more of the taxable profit reported by business is really phantom profit due entirely to underdepreciation of capital. As a consequence, the real rate of tax on real profits tends to be far higher than the apparent rate of tax. Price-Waterhouse has done a study of 157 major firms reporting inflation-adjusted financial data under new guidelines issued by the Financial Accounting Standards Board. Adjusting depreciation deductions for current rather than historical costs, the true effective tax rate on corporate profits was 53 percent in 1979, higher than the statutory rate of 46 percent, and sharply higher than the apparent rate, after all credits, of 39 percent.

This average, however, hides a wide range of results. It is the capital intensive industries which were hit the hardest by the old depreciation rules. According to the Price-Waterhouse study, the real effective tax rate in 1979 was only 28 percent on financial corporations and 36 percent on pharmaceuticals, while it hit 72 percent for automotive firms, 75 percent for petroleum, and 78 percent for utilities. Even worse, when dividends are added to tax liabilities, many firms were paying out more than 100 percent of their real economic profits. Utilities, for example, paid out over 500 percent of their real after-tax profits. They are, in effect, in the process of liquidation. The automotive firms, on a replacement cost basis, paid dividends equal to 139 percent of real after-tax profits in 1979, and the situation was even worse in 1980 and 1981. They were not liquidating as fast as utilities, but they were doing so in a far more obvious fashion.

Corporate profits, after tax and adjusted to exclude inventory profits and to reflect depreciation at replacement cost over the economic lives of fixed capital, declined sharply in the late 1970s. By 1980, real profits were lower in absolute terms than in 1968. (Chart 7) The decline in the rate of return on investment has been dramatic. (Chart 8) Partly as a consequence, the economy expanded the fastest in labor intensive or technology intensive sectors, and least rapidly, if at all, in capital intensive areas. From 1969 to 1981, the number of full- and part-time wage and salary workers outside of agriculture increased by nearly 21 million. Roughly 6,000, less than 3 hundredths of 1 percent, were in manufacturing!

As the return on investment fell, there was a roughly parallel decline in the economy's capital-labor ratio -- the real net capital stock per worker. Because of the importance of capital in modern production processes, the growth of output per hour -- productivity -- fell in similar fashion, holding down real wages. (Charts 9 & 10) These are trends which the 1981 tax changes sought to reverse by accelerating depreciation and by increasing the investment tax credit.

<u>Implementing the Program</u>

It was our hope to balance a disinflationary monetary policy with a pro-growth tax cut and spending restraint policy. We wanted to produce a smooth transition from stagflation to steady non-inflationary growth with rising employment. Unfortunately, we were unable to bring about the necessary coordination of policies.

The Administration initially called for a gradual reduction in the rate of growth of money from nearly 8 percent in the 1978 - 1980 period to 7 percent in 1981, 6 percent in 1982 and so on for four years. Instead, we received three-quarters of the four-year goal for monetary restraint in the first year, helping to trigger the 1981 recession. In addition, the erratic behavior of the money supply and money markets kept interest rates much higher than we would have liked.

We had hoped for a 30 percent tax rate reduction, 10 percent a year for three years, beginning January 1, 1981. Instead, just as the 1981 recession was beginning, Congress cut the first stage of the tax cut to 5 percent and delayed it until October 1, 1981. This produced only a 1-1/4 percent rate reduction in calendar year (tax year) 1981. Later installments of the tax cut were delayed until July 1 of 1982 and 1983.

This reduction and stretching out of the tax cut reduced its impact considerably. In fact, bracket creep and payroll tax increases in 1981 and 1982 resulted in a net tax increase in 1981 over 1980, and a tax cut in 1982 which still left most families paying more tax in real terms than in 1980. Not until 1983 was there a net tax cut from 1980 tax levels for most individuals.

The upshot, of course, was that the restrictive portions of the program came into place early and forcefully, while the stimulative aspects of the program were delayed. Recession widened the deficit. Also, spending reduction has been less than we requested. We hope and expect that the completion of the tax program, further spending cuts, a steadier monetary policy and reductions in interest rates will bring all parts of the program into balance and give us a solid decade of steady growth without inflation and falling deficits.

The Economic Recovery

The current economic recovery is showing every sign of meeting that goal of increasing real growth while reducing inflation.

Lower taxes, lower inflation and higher productivity have raised real wage growth even as nominal wage growth has slowed. (Chart 11) Real wage growth was disappointingly low in the 1970s and real wages actually fell (fourth-quarter-to-fourth-quarter) in 1978, 1979, 1980, and 1981. Since then, they have turned around. The change is even more dramatic on an after tax basis.

GNP rose strongly in the first two years of the recovery, which was stronger than the post-war average, and which displayed an earlier than usual increase in capital spending in spite of the level of interest rates. (Chart 12) There have been fears that high interest rates would cause the recovery to be unbalanced, with little recovery in housing, business fixed investment, autos and other consumer durables. In fact, housing has been strong. Furthermore, this has been an investment-led recovery with business fixed investment rising at more than twice the average rate of Post-Korean War recoveries. Consumer spending has been roughly average. (Chart 13)

We have ended the upward ratcheting of inflation. This is the first recovery in over twenty years in which inflation is below its previous trough. The CPI rose only 4 percent 1984. This is far below the 13.3 percent increase in 1979 and the 12.4 percent increase in 1980. (Chart 14)

Unemployment has fallen and employment has risen at record rates in this recovery. Employment has risen by more than 8 million since December, 1982, and is now at near record levels. (Chart 15)

The stock market reflects increased confidence in the recovery; the rise in share prices has greatly facilitated a surge in new issues and a dramatic increase in venture capital. (Chart 16)

Interest rates are down sharply from their 1980 and 1981 peaks reflecting the drop in inflation. The prime rate had been as high as 21.5 percent, and Treasury bill rates had exceeded 16 percent. (Chart 17)

These figures indicate the progress we have made in achieving our policy's twin goals of faster real growth and lower inflation.

Budgets, Deficits and Interest Rates

Of course, we still have problems. Real interest rates remain higher than we would like, waiting further spending restraints by Congress and a steadier monetary policy. However, some of the rise in real interest rates in the last few years is the result of economic strength, not a cause of economic weakness.

When interest rates are negative in real terms, that is, less than the rate of inflation as in the late 1970s, it is often a reflection of a collapse in investment demand. Note the positive real interest rates in the booming 1960s following the Kennedy tax cuts compared to the negative real interest rates in the high tax, high inflation late 1970s. (Chart 18)

The level of investment is determined by the real after-tax rate of return on capital, not by the financial market real interest rate. (Chart 18a) Property taxes and federal and state income taxes have more of an impact on investments than do market interest rates. It would be futile to raise taxes on capital to lower interests to promote investment. The direct effects of the tax increase would reduce investments by more than any plausible indirect effect on financial markets could raise investment. The lower tax rates after 1981 raised the rate of return on all types of capital investment. Unfortunately, there is widespread confusion on this point.

Indeed, the real rate of return on capital helps to set the real interest rate. The lower tax rates after 1981 raised the rate of return on all types of capital investment. The after tax marginal product of capital (the value to the investor of an additional machine or building) is the basis of the real interest rate. As the marginal product rose, many formerly unattractive investment projects became profitable. Firms willingly bid up the real interest rate to put the additional plant and equipment into place, sharing these higher rewards with savers to attract funds. (Chart 19) Thus, a portion of the rise in real rates reflects the higher after tax rate of return on plant and equipment, and a renewed eagerness to invest which is necessary for real growth.

The Administration is very concerned about budget deficits. They are a sign that the government is overspending, and taking too much of the economy's scarce resources. It is government spending which crowds out the private economy, and raises interest rates.

What the government spends in a year is the measure of the physical resources (manpower, goods and services) and the corresponding financial resources that the government diverts or redirects for its own purposes. Whether government spending is paid for by taxing or borrowing, it crowds out consumption and investment in the year it occurs. 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. (Chart 20)

Nor is it true that taxing takes the money out of consumption, while government borrowing takes it out of investment. Both investors and consumers pay taxes, and both borrow. Corporate investment decisions regarding plants and equipment are affected by the corporate income tax, the investment tax credit (ITC) and depreciation schedules. Unincorporated businesses and subchapter S corporation investment plans are governed by marginal personal income tax rates, the ITC and depreciation schedules. Consumer borrowing is a major source of funds for consumption spending, which is sensitive to credit conditions.

Spending, rather than the deficit itself, seems to be the primary fiscal influence on interest rates. Economic researchers have emphasized this repeatedly. That is why deficits used to be called "deficit spending". Deficit reduction per se will not necessarily lower interest rates. Deficit reduction is certain to lower interest rates and encourage growth only if it comes from spending cuts. Substituting a tax increase for deficit finance to allow government to keep spending is not likely to promote growth.

Excessive government spending, not tax cuts, is the source of the deficit. The tax code we have in place will generate as much revenue over the long term as the government should reasonably be allowed to spend. We project long-term receipts averaging 19.4 percent of GNP between 1988 and 1990 under our proposals. This compares with 18.8 percent from 1964 through 1979. In fact, except for the peak recession years of 1980 -- 1982, peacetime receipts have seldom been higher. Receipts will be in line with, or even higher than historical levels.

Meanwhile, spending, on- and off-budget, is far above its historical levels. It was 25.1 and 23.8 percent of GNP in 1983 and 1984, respectively. This compares to 20.5 percent from 1964 through 1979. We project on- and off-budget outlays averaging 23.4 percent of GNP between 1985 and 1987 under our proposals, falling to 21.5 percent between 1988 and 1990. (Charts 21 & 22) Thus, without determined efforts at spending restraint, spending will remain well above long-term averages for several years to come. If major budget changes are to be made, they should be in spending levels, not taxes.

Obviously, we have not slashed taxes. In fact, most of the 1981 tax cut was needed just to offset rising tax rates caused by bracket creep and by payroll tax increases enacted in 1977. In addition, there were the 1982 tax bill (TEFRA), the gasoline tax increase, the 1983 social security amendments and the 1984 tax bill as part of the deficit "downpayment". Of our $1,488 billion tax cut through 1988, only $12 billion remains, just over $1 billion per year over 9 years. (Chart 23)

For the average family, the tax cuts have barely offset on-going bracket creep and payroll tax hikes. Without the tax cuts, the total federal tax burden would have risen from less than 16 percent of income in 1978 to over 21 percent of income in 1988. Instead, the family's long run tax burden will level off at 16.8 percent of income, just above its 1980 level of 16.6 percent of income. Repeal of indexing would send the tax burden soaring as under prior law. (Chart 24)

Government borrowing is considered bad for growth because it absorbs national savings that could be better used for investment. Fortunately, strong economic growth and the 1986 budget proposals will cause the deficit and Federal borrowing to begin falling over time. Gross private saving by businesses and individuals -- even without counting large state and local surpluses and foreign capital inflows -- will soar relative to the deficit. The surpluses available for investment will be $450 billion in 1984, and $900 billion in 1990, doubling in six years. (Chart 25)

National savings is used either for capital investment or for financing the government deficit. Nonetheless, the notion that <u>any</u>

means of reducing the deficit frees up saving for investment is a myth. (Chart 26) A cut in government spending does have that effect. However, tax increases usually depress saving by more than they cut the deficit, and investment falls.

First, tax increases slow the economy, so that a portion of the expected revenue does not materialize. Second, Congress inevitably spends at least some of any projected revenue increase. The deficit falls by less than the tax increase. On the savings side of the equation, a business tax increase reduces business saving (retained earnings and depreciation) by the full amount of the tax increase. Investment falls. This "flow of funds" result is just as microeconomic theory would predict: a tax change which reduces the value of new plant and equipment by raising their after-tax cost will discourage investment.

A personal tax increase, especially one due to bracket creep in which after-tax interest income falls, may cause a substantial drop in saving out of total income (not just out of the lost tax money) because saving has become less rewarding. In addition, personal tax increases provoke higher wage demands and lower business savings. The combined effect is likely to be a drop in total saving by as much or more than the tax increase. Investment falls. This result is just as microeconomic theory would predict: a tax increase which reduces the amount or raises the cost of labor available for capital to work with will reduce the value of capital goods and cut investment.

The budget deficit is reason for concern, but not hysteria. The deficit is manageable; it can and will be reduced without destroying the tax incentives needed for growth. There are several ways of putting the budget deficit into perspective. This is essential if any sense is to be made of the discussion of deficits and interest rates.

Economists are urging us to bring the deficit down at least to about 2 to 2-1/2 percent of GNP, about $110 to $140 billion by the end of the decade. This is a sustainable level. The debt burden would be falling relative to GNP, and debt service would be falling relative to the budget and tax receipts. This reduction in the burden of debt service cost would then help close the remaining budget gap overtime. In fact, we plan to do better than that.

The budget deficit was driven up by the recessions of 1980 and 1981-82. It is expected to fall sharply as a share of GNP as GNP expands and the deficit shrinks. The FY 1985 deficit is expected to be nearly 1 percent of GNP less than its FY 1983 peak of 6.5 percent. Under the 1986 budget, it is expected to be 4.3 percent of GNP in FY 1986, less than three percent of GNP by 1988 and less than 1.5 percent by 1990. (Chart 27)

State and local surpluses of 1 to 1.5 percent of GNP will offset much of the projected Federal budget deficit. By 1989 or 1990, state and local surpluses will cover most of the Federal borrowing. Total government will be largely out of the credit market on balance. (Chart 28)

The effects of recession and inflation need to be eliminated to see the real deficit picture. Economists generally make these adjustments, and add in state and local surpluses, to judge the impact of the economically relevant real total government deficit on the economy. The real total government deficit is roughly one percent of GNP, and is projected to move even lower by 1990. (Charts 29a, 29b, and 30 illustrate the process using July 1984 mid-session numbers.)

The high employment budget deficit corrects for the temporary effect of recession. The recession accounted for over half of the peak FY-1983 deficit, and is still adding about $50 billion to the FY-1984 deficit.

Inflation exaggerates the deficit by raising interest rates. Lenders demand an inflation premium to compensate for the decline in real value of the principal due to inflation. This shows up on budget as higher interest outlays on government debt, while the corresponding drop in the real value of the debt is not counted. In 1984 the real value of the debt is rising by about $40 billion less than the current deficit implies.

Thus, the 1984 real high employment Federal deficit was about $80 billion, not much above the current state and local surplus of $50 billion.

The Federal debt is not high compared to GNP, and will soon level off as a share of GNP under the deficit downpayment plan. At the end of WWII, the Federal debt held by the public and the Federal Reserve was 119 percent of GNP. It fell to about 25 percent of GNP in 1974 before rising in the recessions of 1974-75, 1980, and 1981-82. Under the budget projection, the debt will peak at about 40 percent of GNP, about the same level as in 1964. With the spending restraint we have asked for, the debt would be falling relative to GNP by the end of the decade. (Charts 31, 32)

Growth is the key to deficit reduction and a lower debt burden. Any policy which threatens the recovery, such as major tax increases or overly tight money, could easily make the deficit picture much worse.

What Really Governs Interest Rates

Inflation is the primary influence on interest rates. Interest rates and inflation have come down in recessions even as recessions have driven deficits higher. The last recession has been no exception. About half of the current deficit is due to the recession In expansions, deficits fall even as interest rates tend to rise. Thus, it is far too simplistic to say that deficits necessarily raise interest rates. (Chart 33)

It is outyear deficits rather than current deficits which are of more concern to the financial markets. Even here, however, nominal and estimated real interest rates have fallen even as projected deficits have risen. (Chart 34)

One reason for the lack of a direct relationship between deficits and interest rates is that government and private borrowing tend to move in opposite directions. Total borrowing remains relatively constant. Currently, total borrowing is about as high as in 1977-79. (Chart 35) In recessions, private borrowing falls while government borrowing rises, while the opposite occurs in expansions. With a tax cut, private borrowing falls as government borrowing rises. In fact, corporate cash flow has improved dramatically with the tax cuts and the recovery. In 1983, firms were net savers, drawing down debt. (Chart 36) A tax increase would lower government borrowing, but it would force more investors and consumers into the credit market.

Although deficits and spending have grabbed much of the attention lately, one must not forget that inflation and monetary policy are the primary determinants of interest rates. Inflation premiums are built into interest rates. For years, interest rates and inflation have risen and fallen together. However, following the Federal Reserve's change in operating methods in late 1979, which was supposed to reduce money supply fluctuations and financial market uncertainty, interest rates shifted up relative to inflation. (Chart 37)

This jump in real interest rates began in early 1980, before the 1980 recession, before the election, before the tax cuts, before the 1981-82 recession, and before the sharp rise in the deficits which the recessions produced. Clearly, factors other than the deficit have been at work in raising interest rates.

In fact, monetary volatility increased after the Fed's 1979 policy change. A number of researchers point to the sharp increase in volatility of the money supply, bond prices and interest rates as a cause for the jump in the real interest rate. This "volatility" or "risk premium" is thought to be adding two to four percent to nominal and real interest rates. This is clearly of major concern to the financial markets. (Chart 38)

The Administration has supported moderate, steady money growth. However, for a variety of reasons, the Fed was within its target ranges for M1 only 54 of the 156 weeks, or 35 percent of the time, between January 1981 and January 1984. In addition, it is not clear that the target ranges have always been the appropriate ones. There has also been more of a stop-go pattern to money growth than we had hoped to see. (Chart 39) We continue to support steady and predictable money growth, low inflation, and gradually falling interest rates. Monetary stability is essential to continued economic recovery and long-term growth.

Monetary instability has been partially responsible for the wide savings in the dollar on the foreign exchange markets since the end of the Bretton Woods system of fixed exchange rates, particularly since 1976. (Chart 40) From January 1977 to October 1978, the trade-weighted dollar lost value rapidly (10.9 percent annual rate) as accelerating money growth (8.0 percent annual rate) and a worsening current account balance led to an over-supply of dollars. As inflation accelerated, worldwide demand for the dollar fell, and the dollar continued weak through 1980.

From October 1980 to July 1982, sharply slower money growth (4.8 percent annual rate) and lower inflation led to a rapid climb in the dollar (19.9 percent annual rate), as confidence in its purchasing power was restored and people worldwide began trying to rebuild their dollar holdings in the face of tight supply. Faster money growth from July 1982 to June 1984 (10.4 percent annual rate) accommodated the worldwide dollar build-up and slowed the dollar's advance (6.6 percent annual rate). A renewed slowdown in money growth from June 1984 to December 1984 (4.1 percent annual rate) led to a renewed surge in the dollar (23.5 percent annual rate).

Faster money growth since December 1984 finally caught up with the dollar in late February, and the dollar fell back in March to its December levels. It is to be hoped that a more stable monetary policy and a steadier dollar will benefit hard-pressed sectors of the U.S. economy. Agriculture and mining have suffered from commodity price declines related to tight money and the strong dollar. Exporters and import competing industries have also had difficulty coping with the rapid climb in the dollar's value.

Monetary stability is essential to a stable economy. Rapid changes in money growth rates show up in real output and employment a few months later. (Chart 41) The Federal Reserve reduced the rate of growth of money in the last half of 1983 and the first half of 1984 to prevent the economy from overheating. Impatient for the economy to slow down, the Fed then prevented any growth in M1 from early June to early November. As a result, third quarter GNP grew at only a 1.6 percent annual rate. Although the fourth quarter GNP recovered to grow at 4.3 percent, the first quarter slumped again to a 1.3 percent growth rate, over the three quarters, growth averaged only 2.4 percent, not fast enough to reduce unemployment. This excessive tightening was monetary overkill that could lead to recession, had monetary policy not eased in the last half of the fourth quarter. Growth is too valuable from both a social and budgetary perspective to risk losing it.

Lack of growth has been responsible for much of 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 1983 deficit would have been roughly $125 billion lower. Growth is the best way to balance the budget while promoting rising real income and employment.

Growth is the name of the game. It is both the goal of our program and the best means of achieving that goal by generating the budget reductions and private sector profits, savings and investment needed for growth. It is a self-reinforcing process. To hasten that process, the Congress must hold the line on spending and taxes, and the Federal Reserve must provide more reasonable growth of money and credit. Our problems are manageable if all parts of government pursue sensible policies.

1.

THE REAGAN ECONOMIC PROGRAM

A stringent budget policy designed to release resources to the private sector for investment and growth.

An incentive tax policy designed to increase the supply of labor and capital resources -- to encourage work effort, saving and investment.

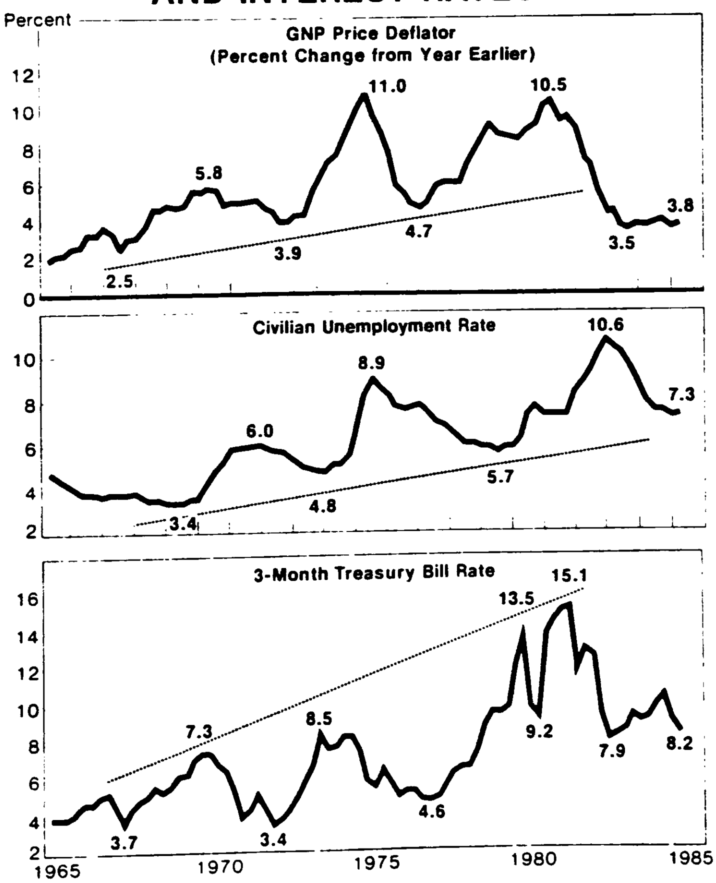
A non-inflationary monetary policy to end inflation and reduce the higher interest rates and disincentives that inflation and the tax code combine to produce.

A regulatory reform program to reduce the inefficiencies and enormous costs that are holding back production and raising prices.

August 22, 1984-A40

2.

INFLATION, UNEMPLOYMENT AND INTEREST RATES*



• Quarterly data from 1965-I to 1985-I

April 19, 1985 A50a

PERSONAL TAXES AND INFLATION

- Because of the progressive tax rate structure, each 10 percent rise in inflation has pushed up personal tax receipts by 16 percent. Between 1965 and 1980 Congress offset about one-half of the rise in the average rate of tax with occasional tax cuts. Because of the nature of the tax cuts, marginal rates continued to rise.

- In 1965, a median income family of four faced a marginal tax rate of 17 percent. By 1981, the marginal rate was 24 percent, and without the Reagan tax cuts would have risen to 28 percent by 1984 -- an increase of 65 percent in the tax rate applied to additional earnings. A family of four with twice the median income encountered a 22 percent marginal tax bracket in 1965. That rate had nearly doubled to 43 percent by 1981 and would have been 49 percent by 1984. This does not include rising payroll and state and local taxes. Clearly, the after-tax reward to additional saving or work effort was falling sharply over time.

- If those trends had been allowed to continue, virtually every family paying income tax, even those in the bottom bracket, would have been paying some tax at the top wage and salary tax bracket rate of 50 percent by the year 2000, not two decades away.

- The Reagan tax cuts were designed to arrest the continuing rise in marginal tax rates. Starting in 1985, the exemptions and tax brackets are being adjusted for inflation, i.e., indexed, to prevent bracket creep in the future. This is designed to end Washington's 6 percent incentive to inflate and to preserve the incentives to work and save contained in the Administration's tax reduction program.

January 30, 1985-A15

ADVERSE EFFECTS OF INFLATION AND RISING MARGINAL TAX RATES ON WAGE COSTS AND COLLECTIVE BARGAINING

Over the last 15 years, inflation, bracket creep and payroll tax hikes have sharply increased the pre-tax cost to the firm of giving a worker a one dollar after-tax wage increase.

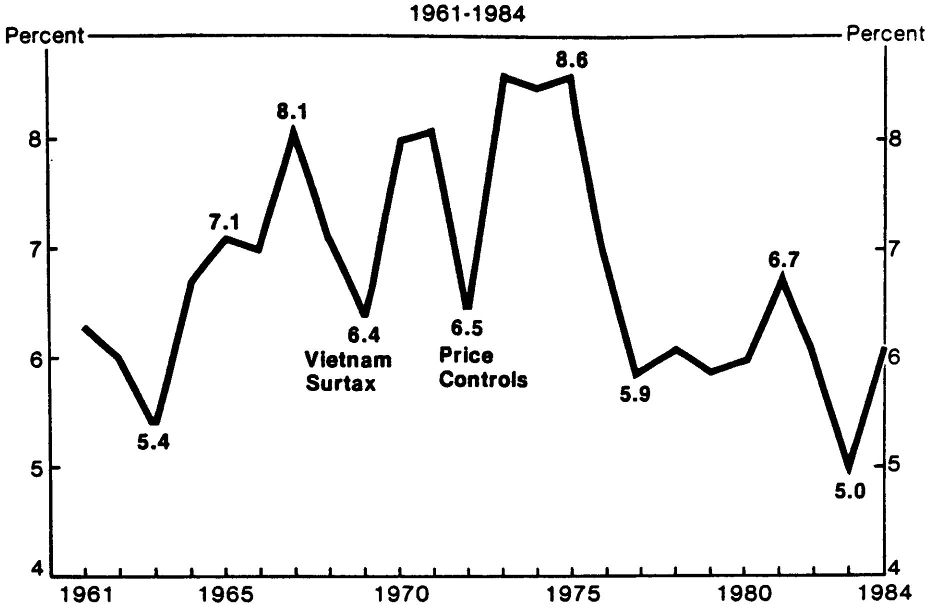
A median income worker now faces 40 percent to 44 percent tax rates on added income. This is the sum of social security and Federal marginal income tax rates, plus state and local taxes at the margin. (Marginal rates would have been roughly 26 percent to 30 percent in the late 1960's.)

Consequently, it now costs a firm more than $1.70 to give a worker a $1.00 after-tax wage increase. Yet, workers will understandably bargain for real increases in their take home pay in the face of inflation. The invisible third party at the bargaining table has been the tax collector, using bracket creep to drive a tax wedge deeper and deeper between labor and management over time. The same process helps to price U.S. labor out of world markets.

August 22, 1984-A43

PERSONAL SAVING RATE

1961-1984



January 25, 1985-A51

ADVERSE EFFECTS OF INFLATION AND RISING MARGINAL TAX RATES ON SAVINGS INCENTIVES 6.

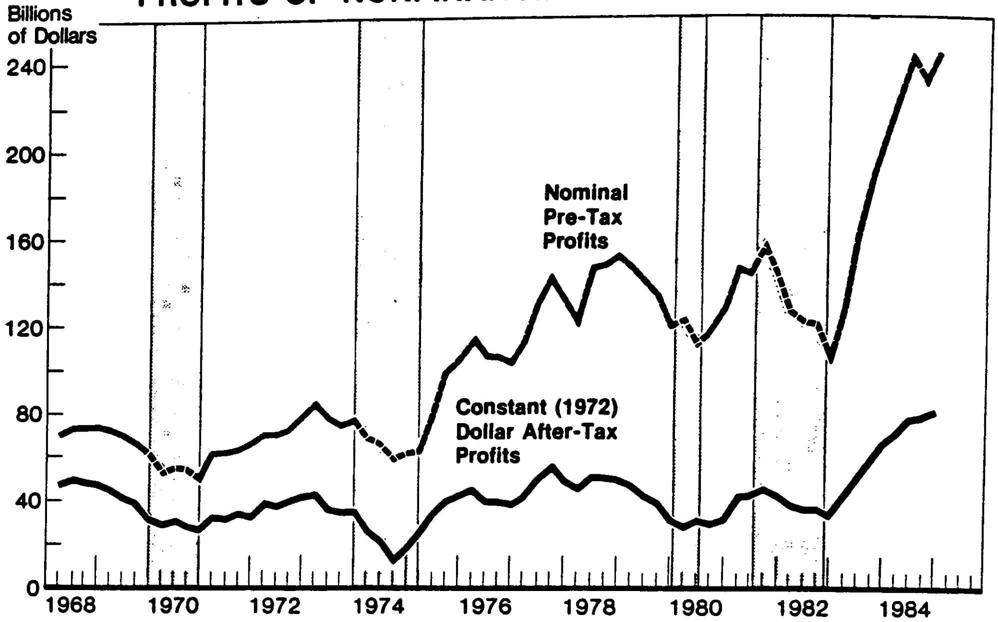
In 1965, a saver in the 25 percent tax bracket could get 4 percent interest at a time of 2 percent inflation. After losing 1 percentage point to the tax collector and 2 points to inflation, the saver retained a 1 percent real after-tax reward for saving.

In 1980, the same saver would have been in the 32 percent tax bracket and could have earned 15 percent on a Treasury bill. The tax collector took away nearly 5 percentage points. Inflation was nearly 13 percent. The saver lost 3 percent after taxes and inflation.

It is no wonder that the personal saving rate declined fairly steadily over the period.

August 22, 1984-A42

PROFITS OF NONFINANCIAL CORPORATIONS*

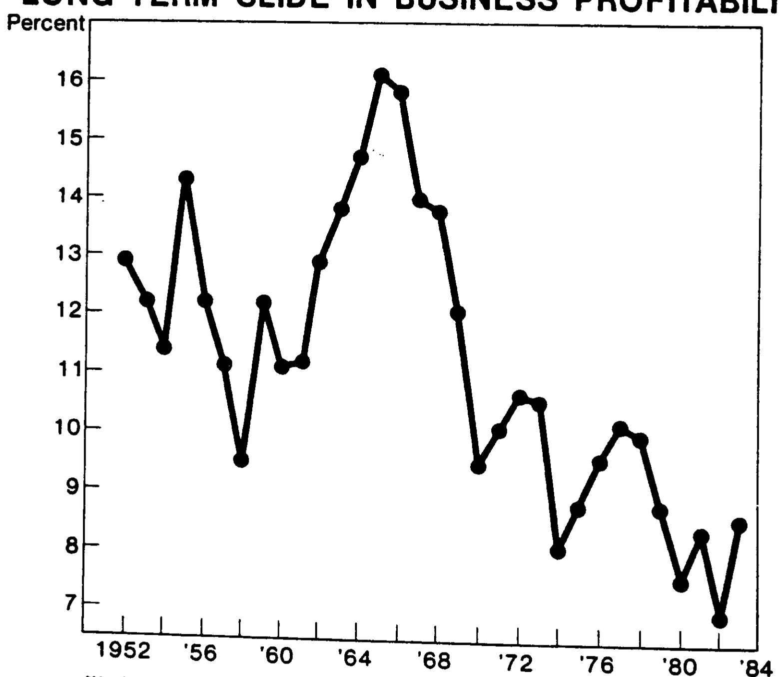


*Profits from domestic operations adjusted to exclude inventory profits and to reflect depreciation at replacement cost over economic lives of fixed capital.

April 19, 1985-A409

8.

LONG-TERM SLIDE IN BUSINESS PROFITABILITY*



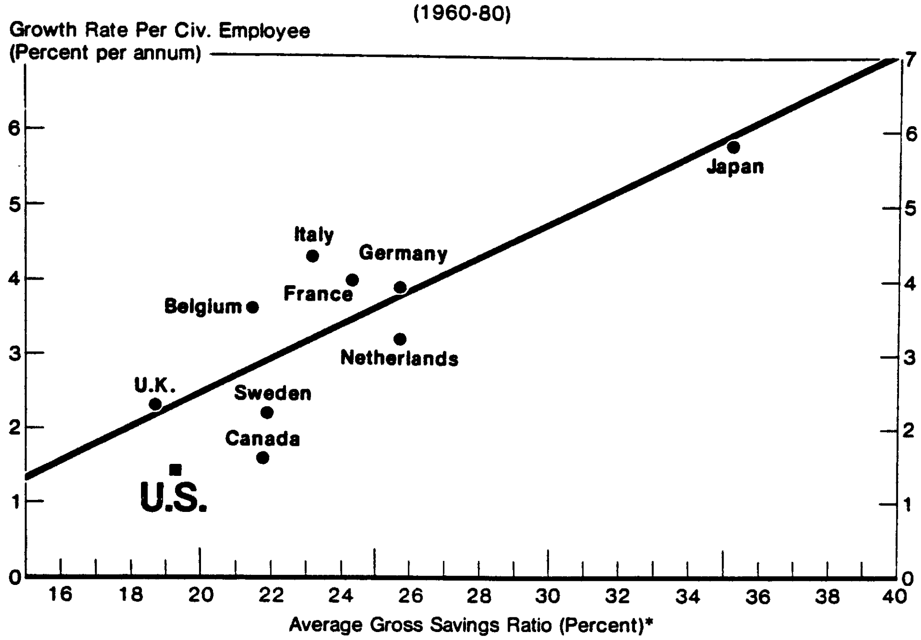
*Nonfinancial corporations. Pretax profits (with inventory valuation and capital consumption adjustments) plus net interest as a share of the net stock of reproducible fixed capital at replacement cost.

August 22, 1984-A36

9.

U.S. HAD ONE OF THE LOWEST RATES OF SAVINGS AND PRODUCTIVITY GROWTH

(1960-80)



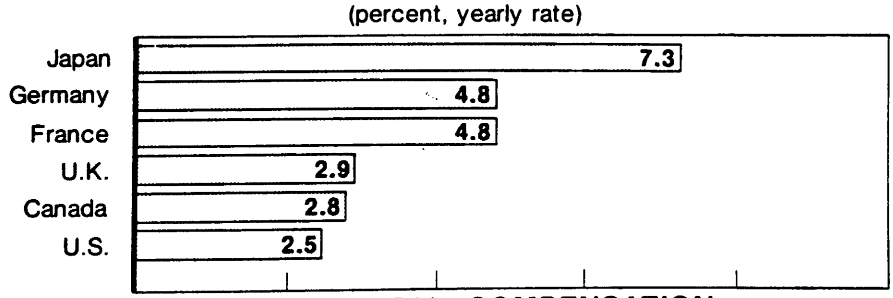
*Personal, business, and government savings.

January 4, 1985-A4

10.

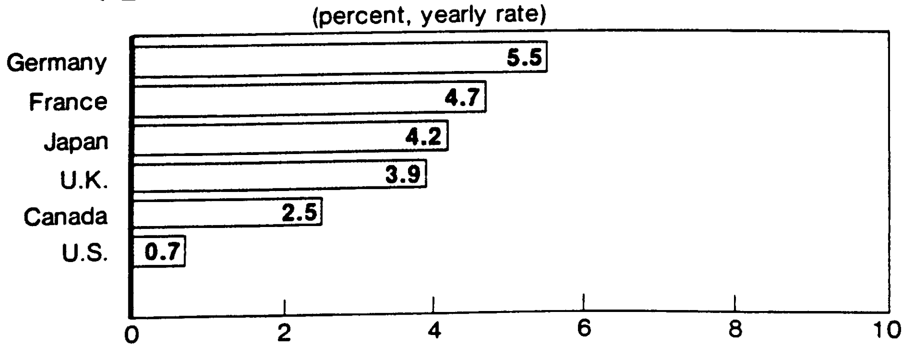
GROWTH OF PRODUCTIVITY IN MANUFACTURING, 1970-1980

(percent, yearly rate)



GROWTH OF REAL COMPENSATION PER HOUR IN MANUFACTURING, 1970-80

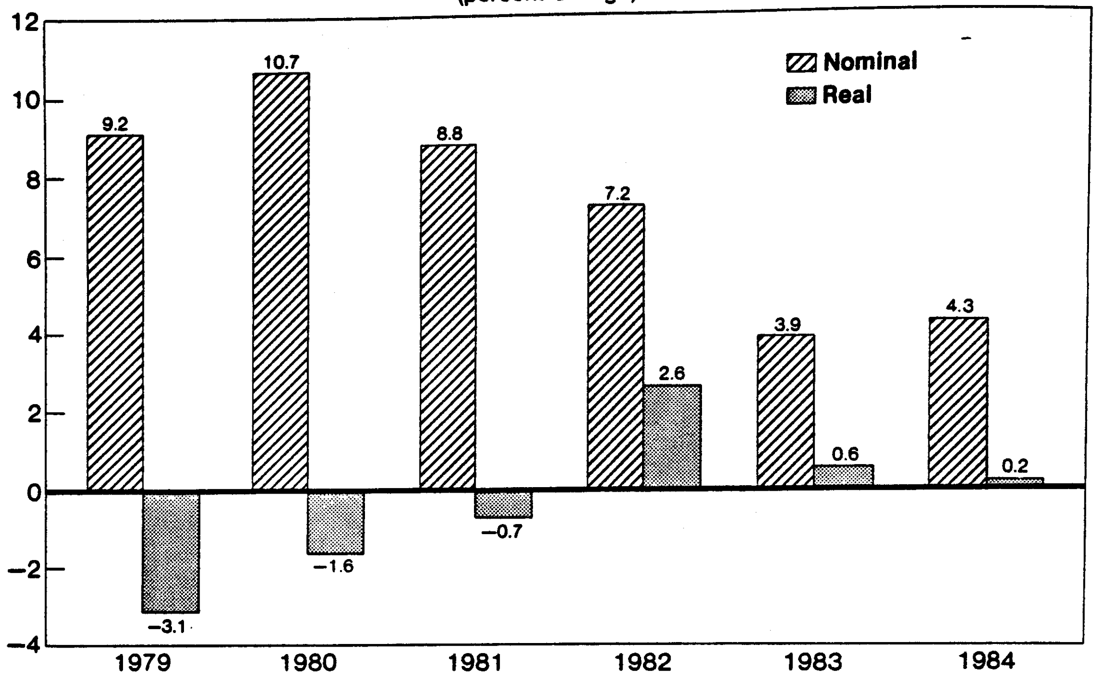
(percent, yearly rate)



June 27, 1983 A29

GROWTH OF NOMINAL AND REAL COMPENSATION IN THE PRIVATE NONFARM BUSINESS SECTOR

(percent change)

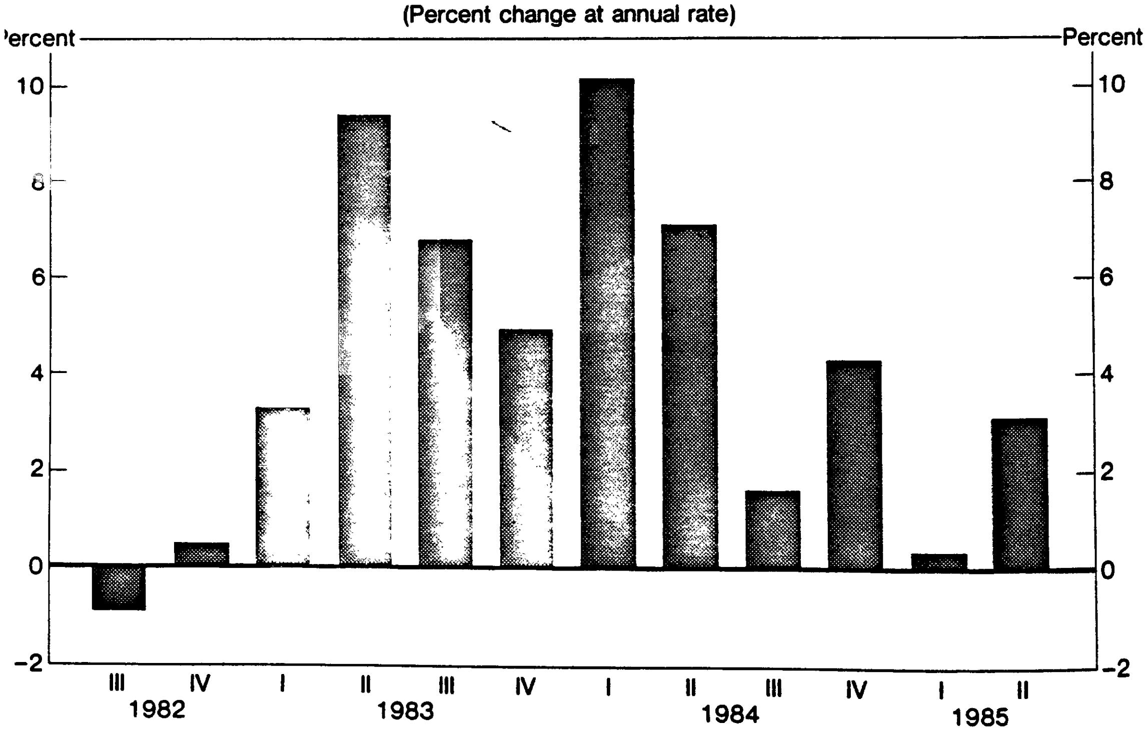


Note: Measured fourth quarter to fourth quarter.

April 19, 1985-A409

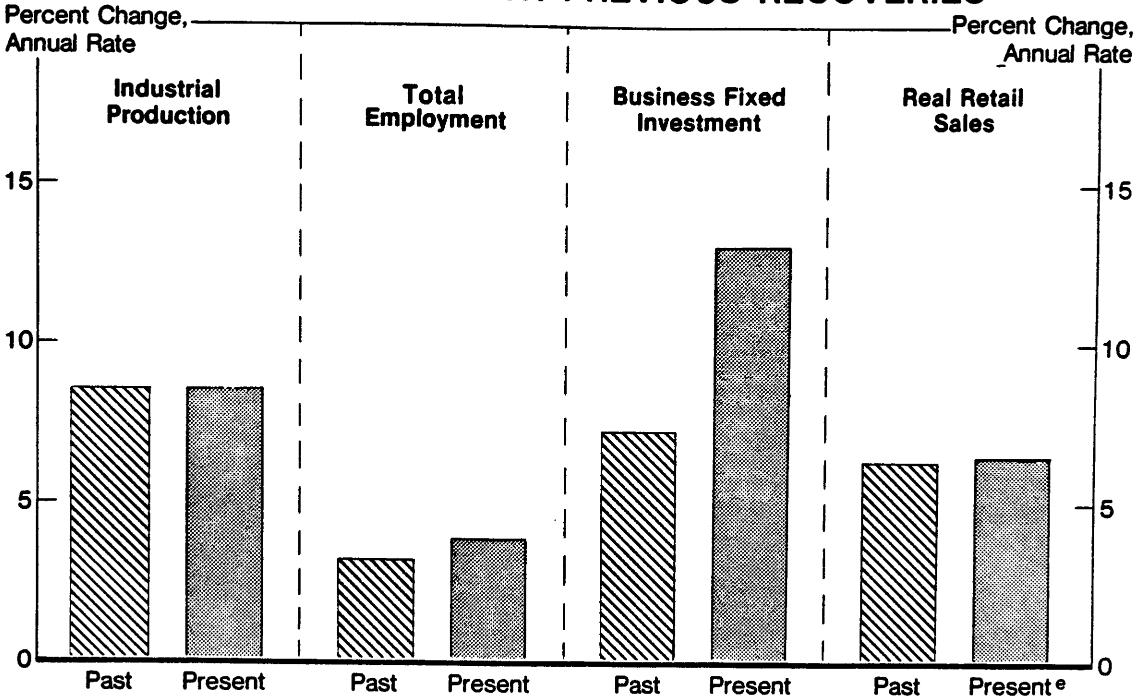
RECENT CHANGES IN REAL GNP

(Percent change at annual rate)



June 24, 1985-A49

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



* Recoveries since the mid-1950's excluding the short-lived 1980 recovery and the recovery commencing in 1958 which lasted for twenty-four months. First thirty months for industrial production, real retail sales and payroll employment. First nine quarters for business fixed investment.

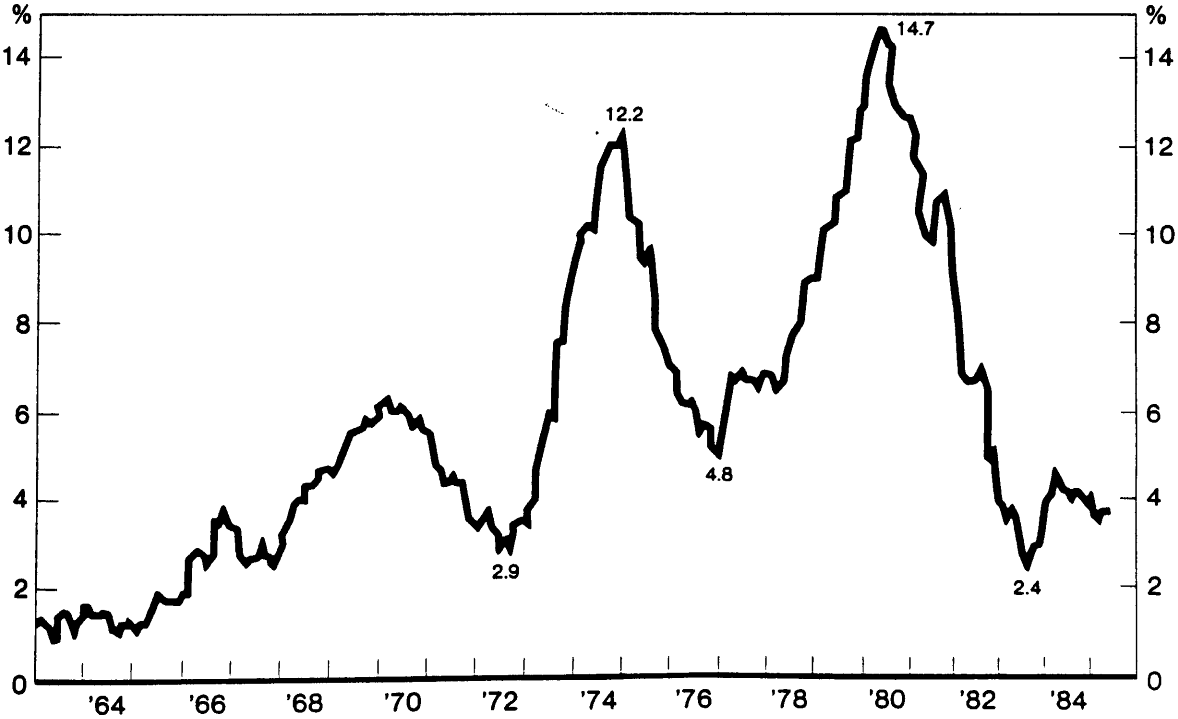
e — estimate

June 20, 1985-A44a

CONSUMER PRICE INDEX

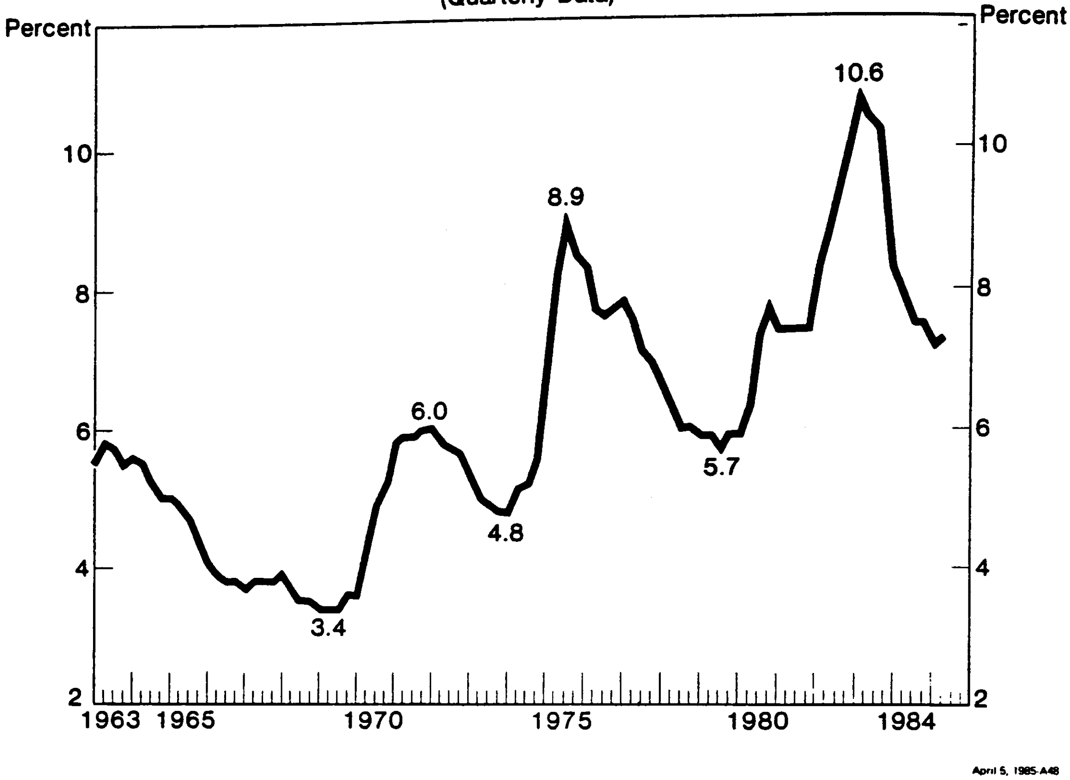
(Monthly data, percent change from year earlier)

14.

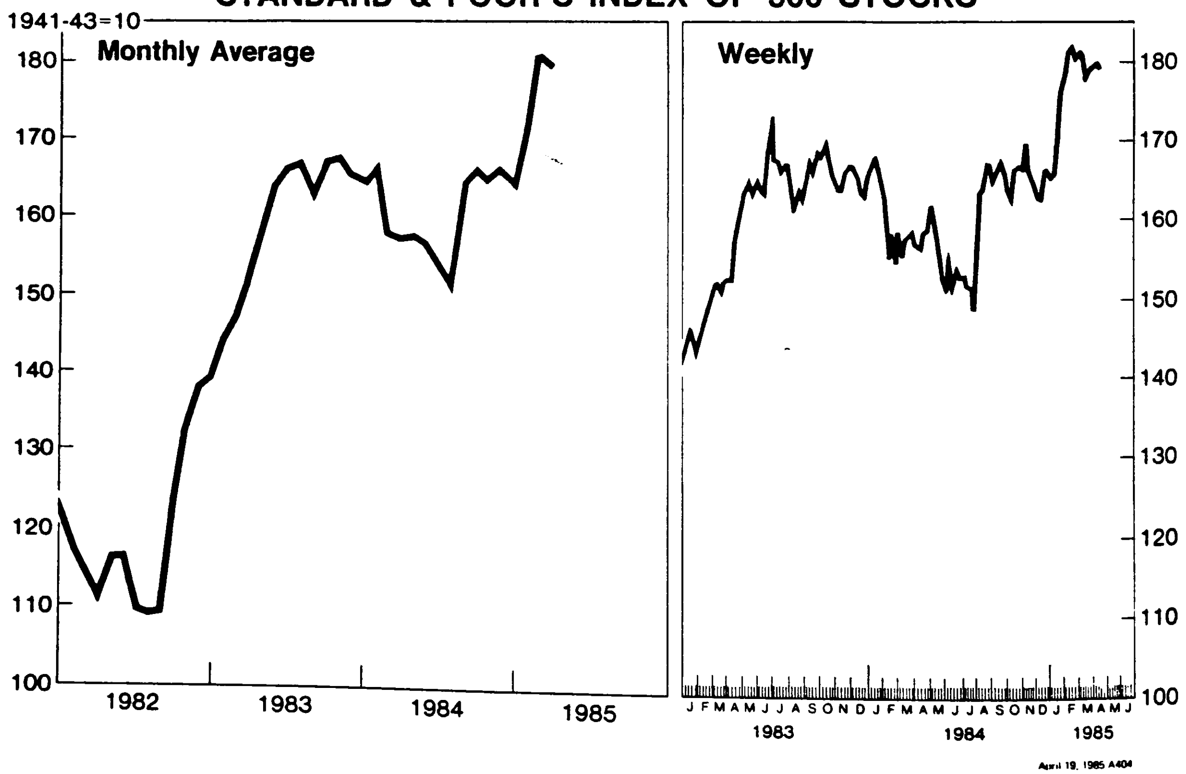


June 24 1985 A27

UNEMPLOYMENT RATE
(Quarterly Data)

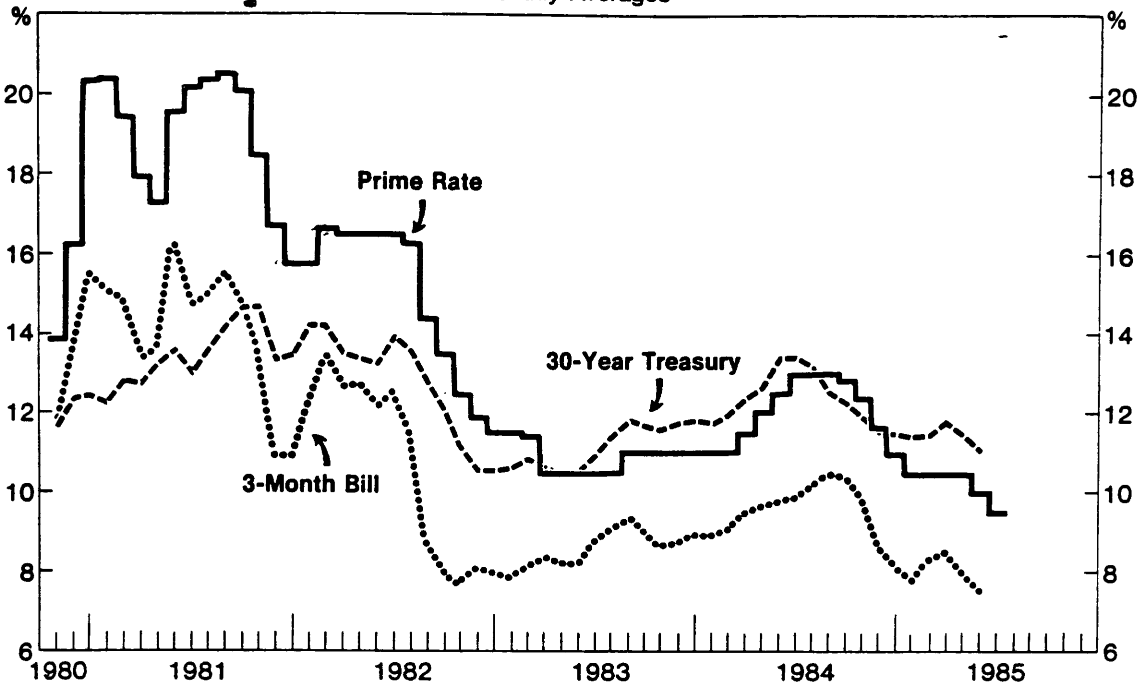


STANDARD & POOR'S INDEX OF 500 STOCKS



SHORT TERM INTEREST RATES

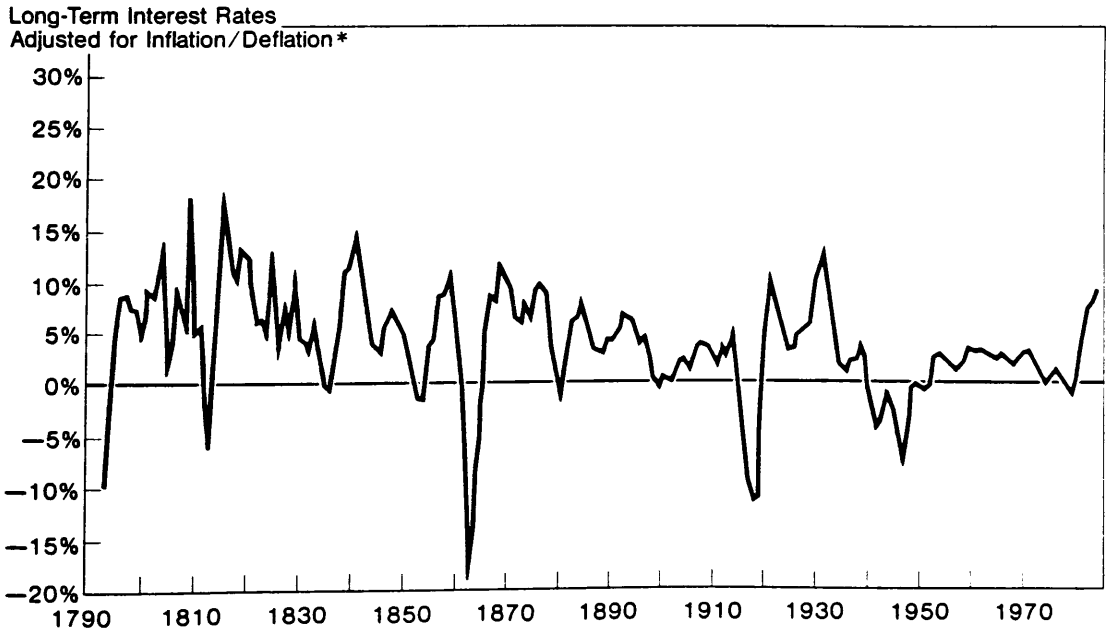
Monthly Averages



June 24, 1985-A401a

18.

REAL INTEREST RATES, 1790-1984



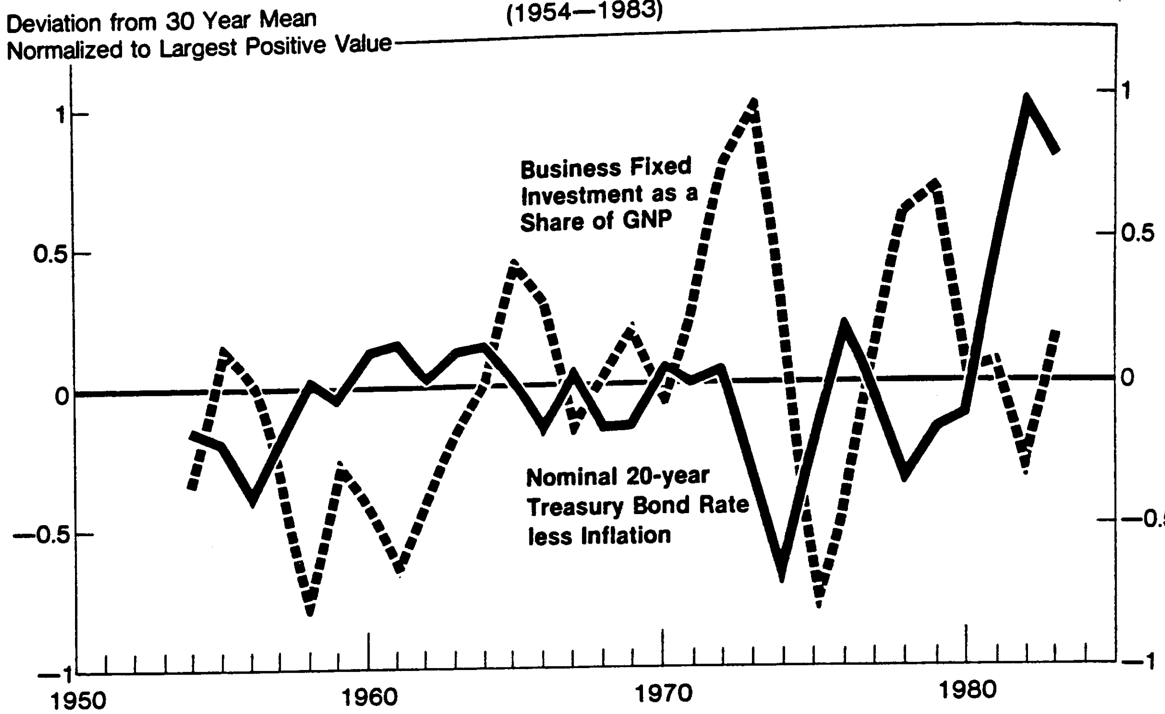
* Inflation/deflation level employed based on three-year centered moving average of annual changes in Consumer Price Index.

Source: Financial Analysts Journal, January-February, 1981 (updated).

January 15 1985 A37

REAL INTEREST RATE AND THE RATE OF INVESTMENT

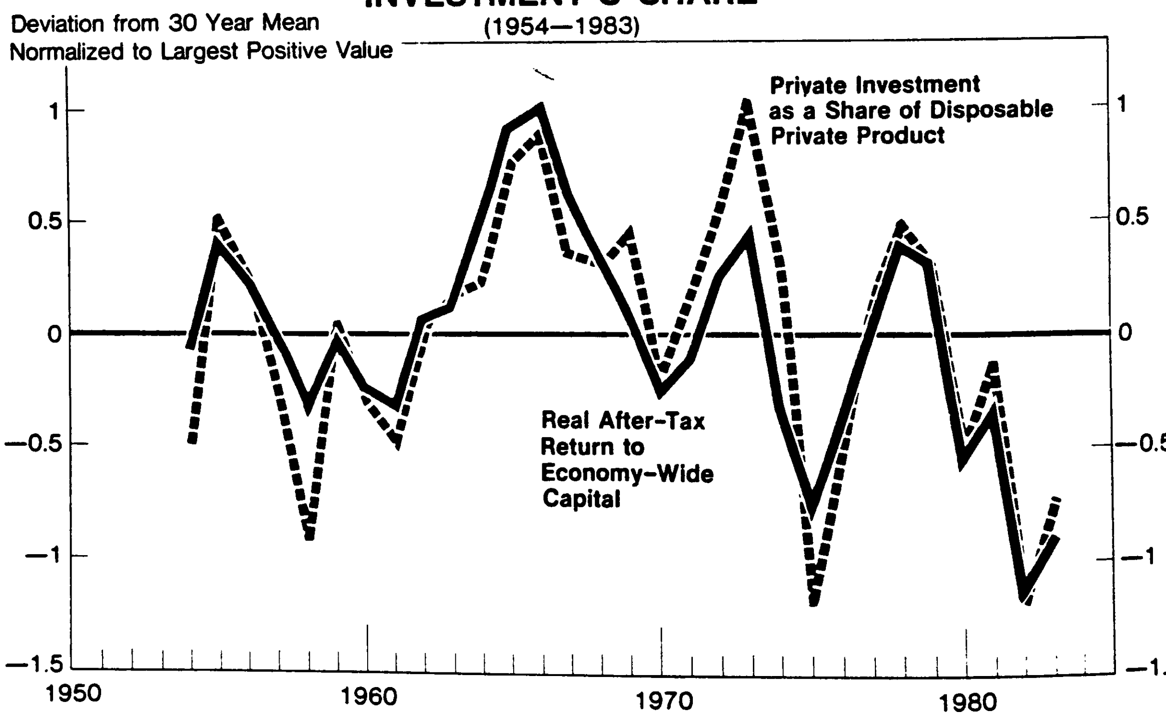
(1954—1983)



February 8, 1985 A412

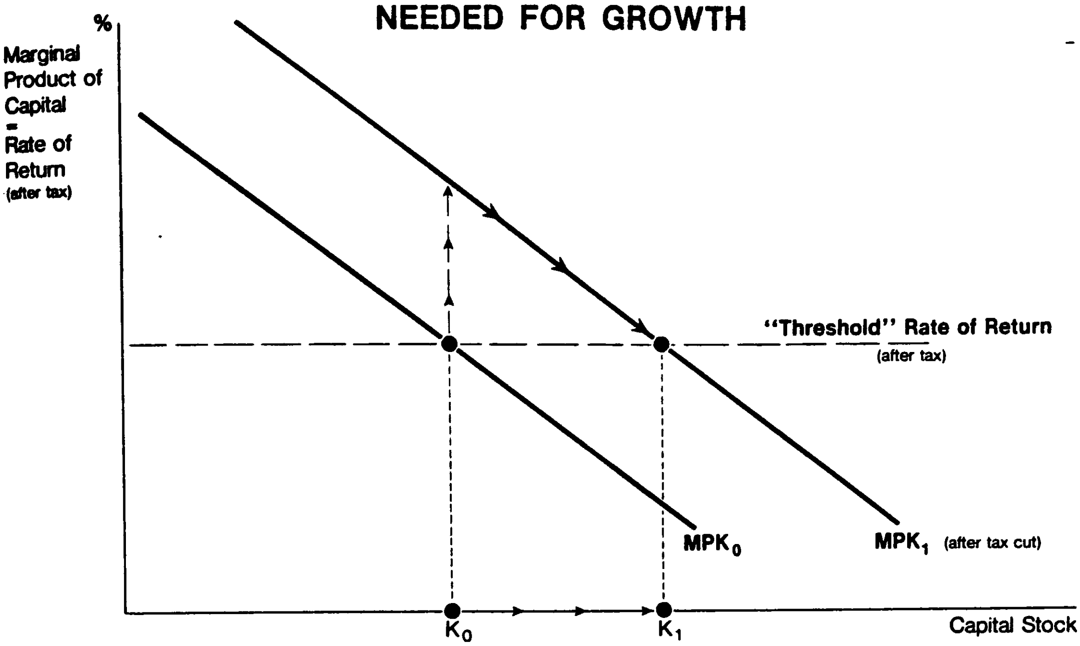
REAL AFTER-TAX RETURN TO CAPITAL AND INVESTMENT'S SHARE

(1954—1983)



February 8 1985 A413

HIGHER REAL RETURNS TO CAPITAL, HIGHER REAL INTEREST RATES FOR SAVERS, NEEDED FOR GROWTH

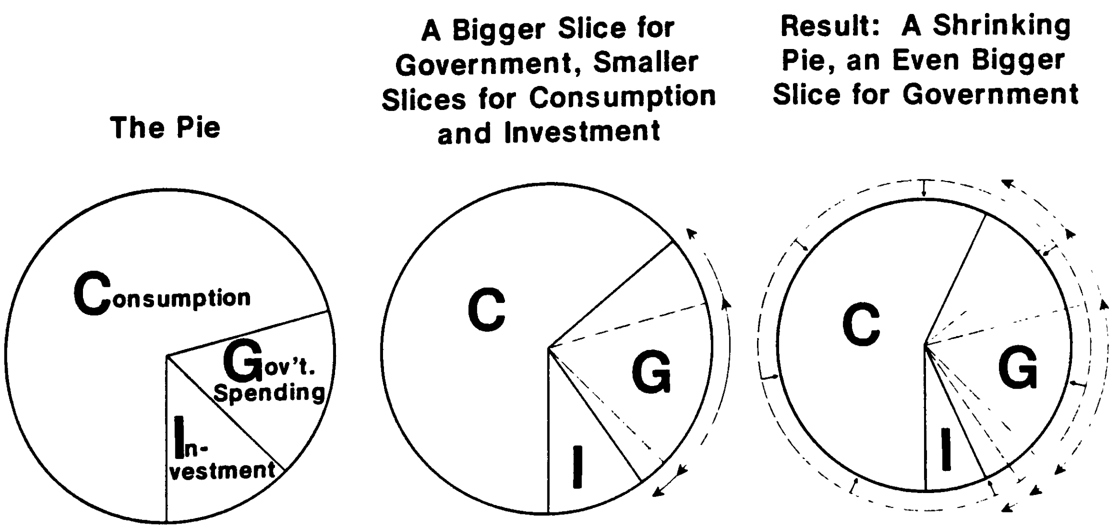


1 — Tax cut raises profitability of capital investment.
2 — More capital projects exceed threshold rate of return.
3 — Firms bid up interest rates to attract more savings.
4 — Savings and investment rise; capital stock grows.

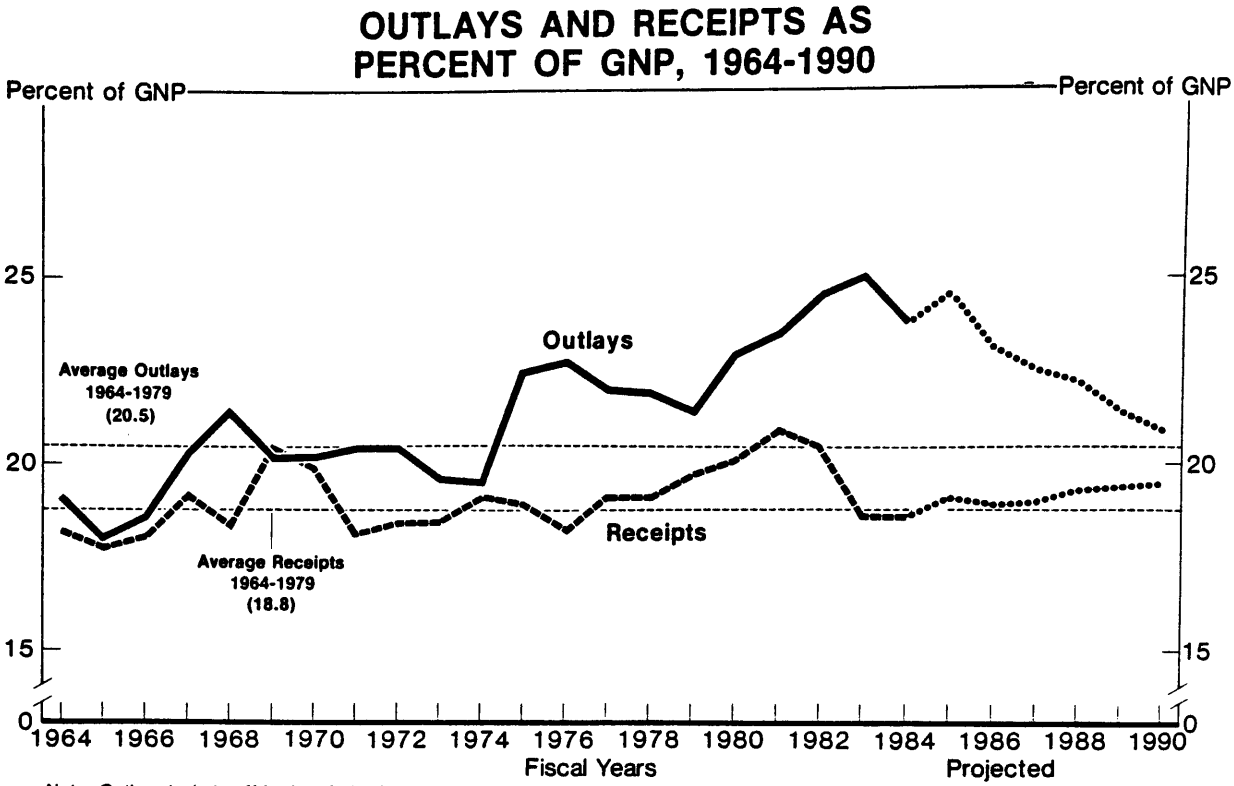
August 22, 1984-A78

20.

GOVERNMENT SPENDING DOES THE "CROWDING OUT"



August 22, 1984 A59



Note: Outlays include off-budget federal entities.

April 19, 1985-A54a

OUTLAYS AND RECEIPTS AS PERCENT OF GNP

	Receipts	Outlays*
1988 - 1990	19.4	21.5
1985 - 1987	19.0	23.4
1984	18.6	23.8
1983	18.6	25.1
1982	20.3	24.5
1981	20.8	23.5
1980	20.1	22.9
1964 - 1979 (avg.)	18.8	20.5

*Including off - budget spending.

April 19, 1985-A54

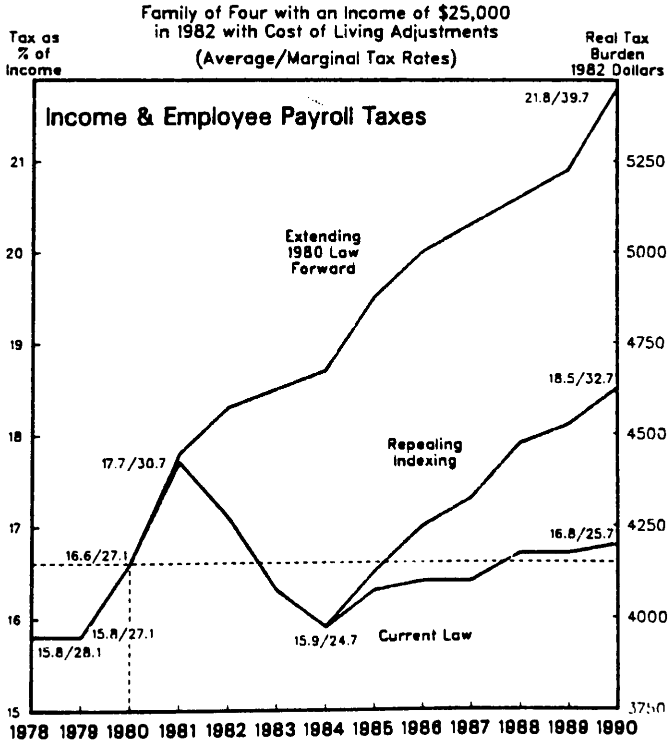
WHAT IS LEFT OF THE TAX CUT?
FY 1981 — FY 1989
($ billions)

			Fiscal Years 1981 through 1989
Tax Cut:	Economic Recovery Tax Act of 1981 (ERTA)		—$1,488 billion
Tax Increases:	Inflation-Induced Bracket Creep	+$650	
	1977 Social Security Tax Rate Increases	+$287	
	Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	+$311	
	Gasoline Tax Increase	+$ 28	
	1983 Social Security Amendments	+$ 90	
	"Downpayment"	+$101	
	Other	+$ 9	
Total Tax Increases			+$1,476 billion
Net Tax Cut			—$ 12 billion
Nine Year Average Net Tax Cut			—$ 1.4 billion

August 22, 1984-A57

24.

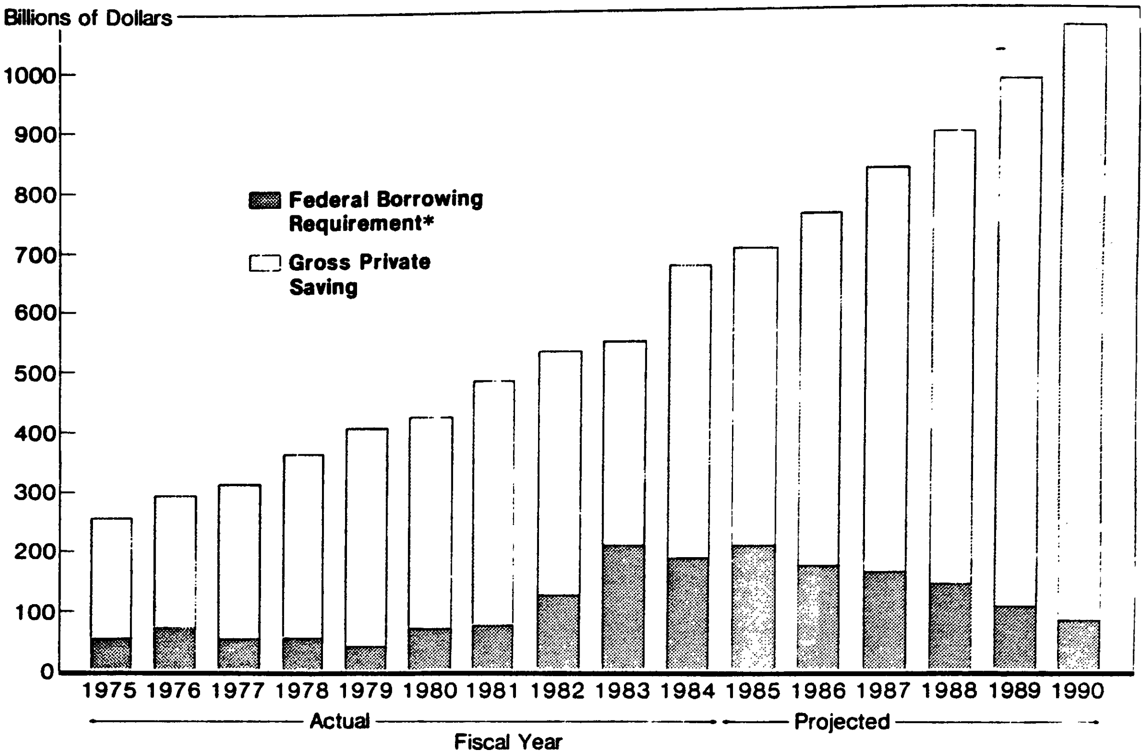
Real Tax Burden
Family of Four with an Income of $25,000 in 1982 with Cost of Living Adjustments
(Average/Marginal Tax Rates)



August 22, 1984-A47

25.

PROJECTED BORROWING REQUIREMENT IN RELATION TO PRIVATE SAVING



*Total budget deficit including off-budget entities.

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

Figures are based on economic projections underlying the FY-1986 budget.

April 19, 1985 A411

26.

FREEING UP SAVINGS FOR INVESTMENT MYTH VS. REALITY

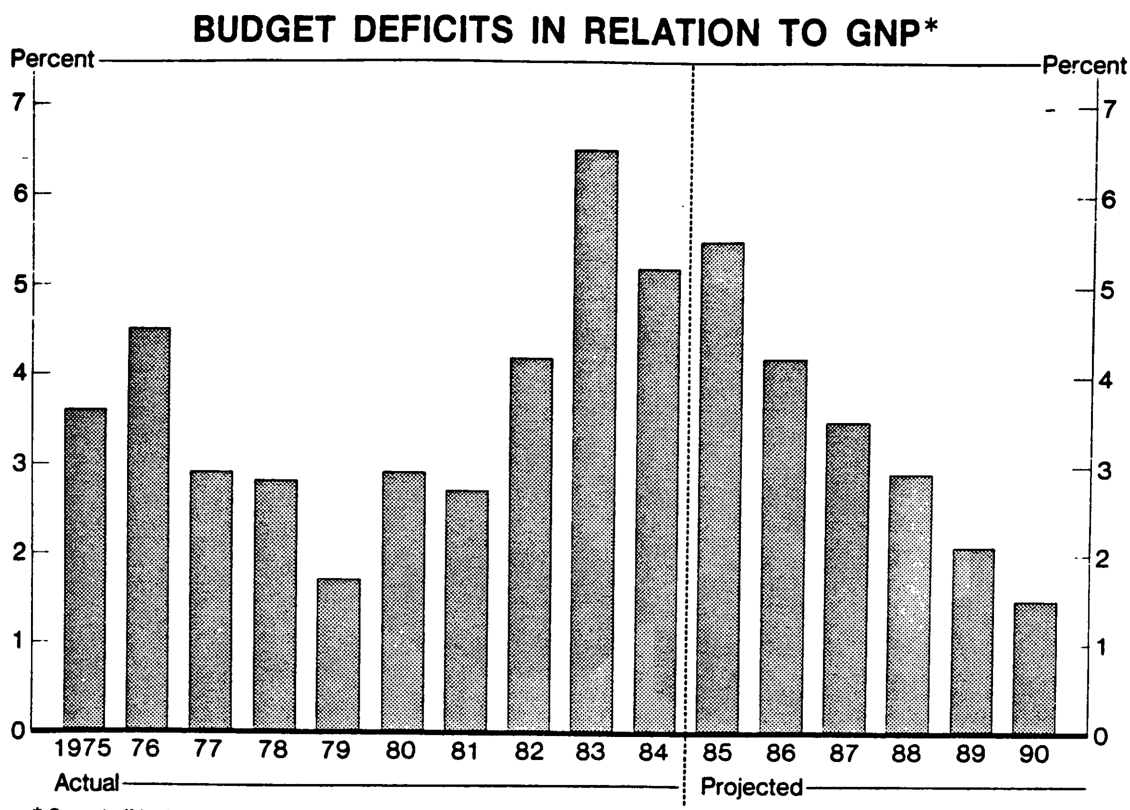
naive view	Investment	+	Deficit	=	Saving
	↑		↓		–

	Investment +	(Gov't Spending	− Taxes)	= Personal Saving	+ Undistributed Profits	+ Capital Consumption Allowances
spending cut	↑	↓	–	–	–	–
tax increase (naive)	↑	–	↑	–	–	–
business tax increase (reality)	↓	↑	↑↓	–	↓	↓
individual tax increase (reality)	↓	↑	↑↓	↓	↓	–

Cutting Government spending frees up saving and investment rises.

Tax increases depress saving and GNP and encourage further Government spending; investment falls.

August 22 1984-A55

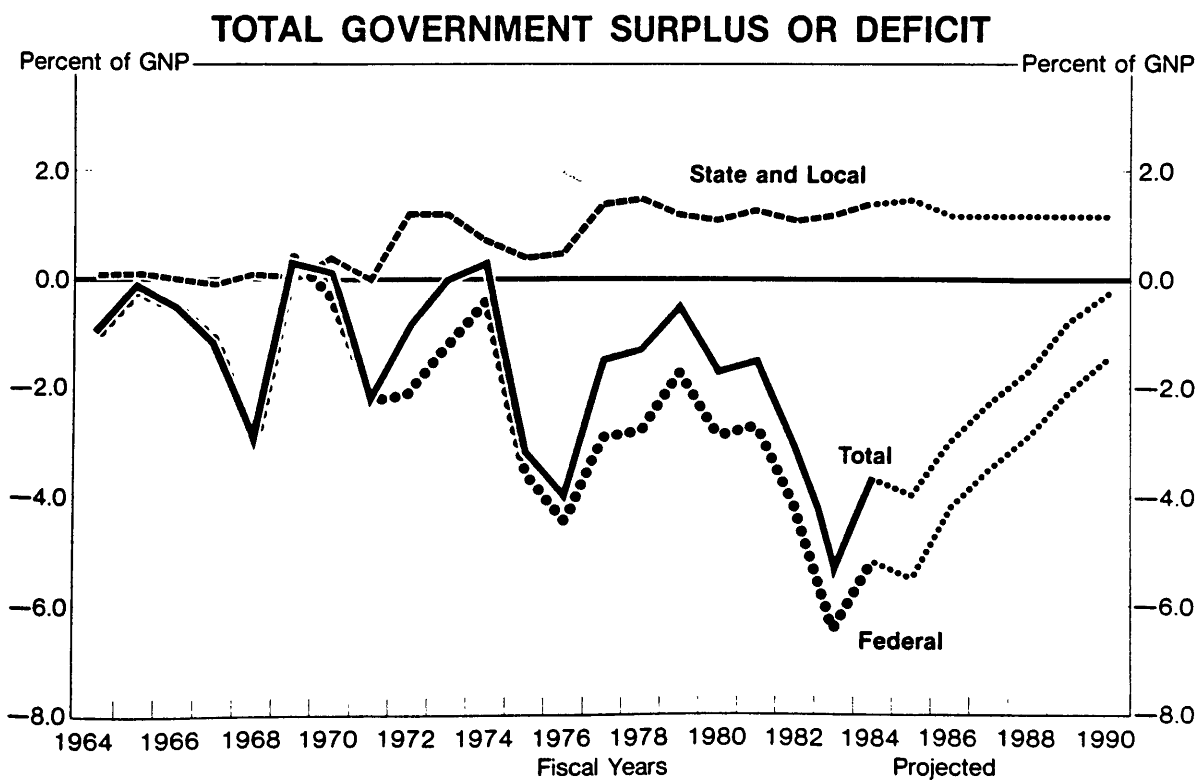


* On and off budget as percent of fiscal year GNP. FY-1986 Budget, Feb. 4, 1985.

Fiscal year 1985 deficit includes a one-time accounting adjustment for certain securities guaranteed by HUD.

April 19, 1985-A410

27.

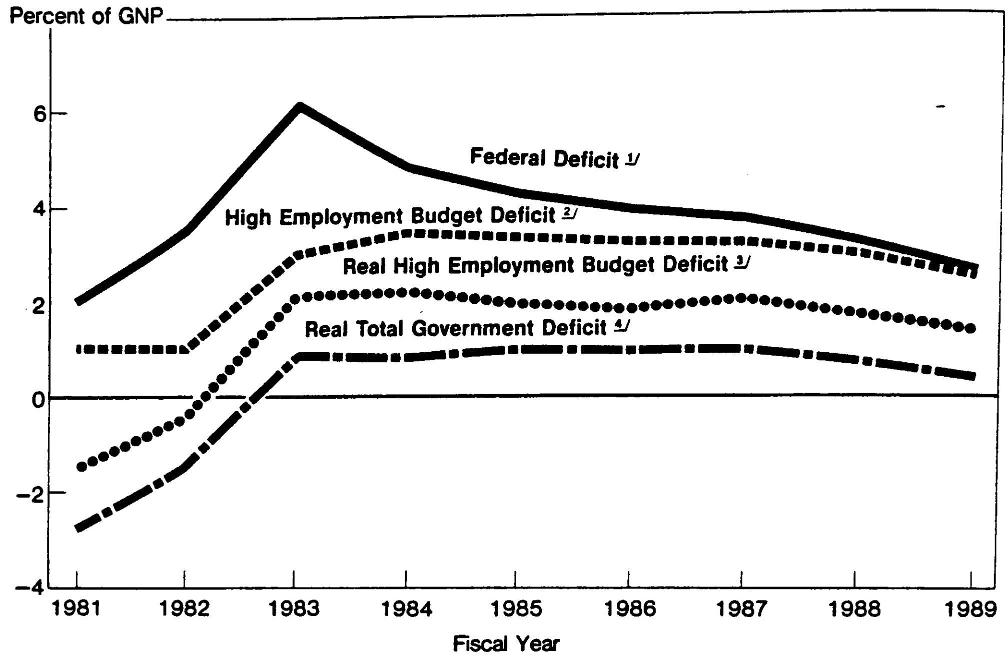


28.

Note: Federal deficit on unified basis, on-and-off budget, state and local on National Income Basis.

April 19, 1985 A75

MEASURES OF THE DEFICIT AS SHARES OF GNP



1/ Federal on-budget deficit. Projections are from Mid-Session Review.

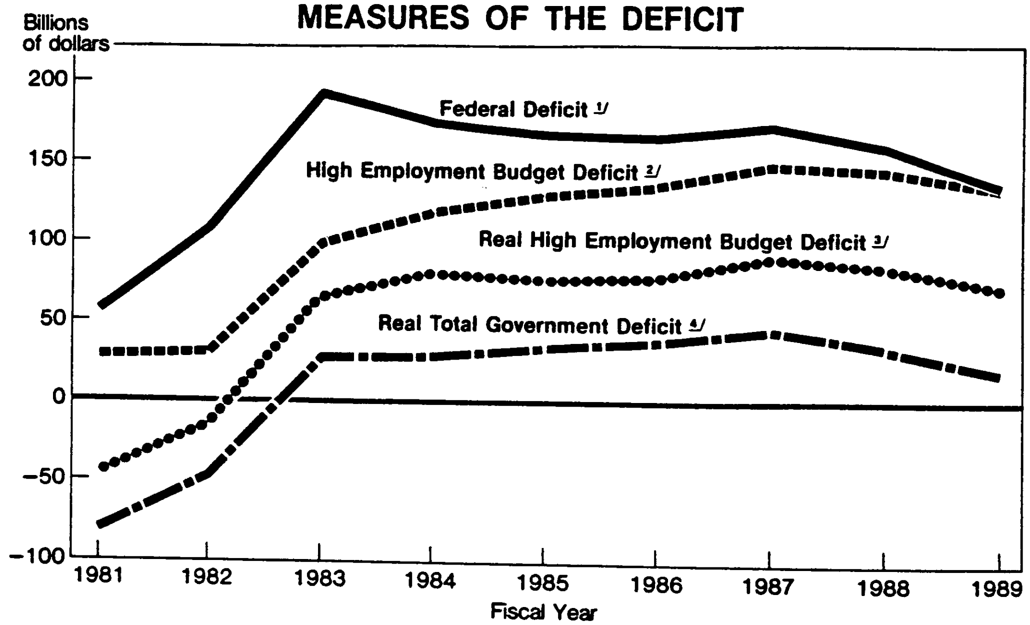
2/ High Employment Budget Deficit —— Federal deficit adjusted for recession and unemployment in excess of six percent.

3/ Real High Employment Budget Deficit —— High Employment Budget Federal deficit adjusted for impact of inflation on value of debt outstanding held by the public and the Federal Reserve.

4/ Real Total Government Deficit —— Real-High Employment Budget Federal deficit less projected State and local surpluses.

August 22, 1984-A80

MEASURES OF THE DEFICIT



1/ Federal on-budget deficit. Projections are from Mid-Session Review.

2/ High Employment Budget Deficit —— Federal deficit adjusted for recession and unemployment in excess of six percent.

3/ Real High Employment Budget Deficit —— High Employment Budget Federal deficit adjusted for impact of inflation on value of debt outstanding held by the public and the Federal Reserve.

4/ Real Total Government Deficit —— Real High Employment Budget Federal deficit less projected State and local surpluses.

August 22, 1984-A79

MEASURES OF THE DEFICIT

Fiscal Year	GNP	Federal Deficit on Budget[1]	High Employment Budget Deficit[2]	Inflation Adjustment	Real High Employment Budget Deficit[3]	State and Local Surplus	Real Total Government Deficit[4]	Federal Deficit on Budget[1]	High Employment Budget Deficit[2]	Real High Employment Budget Deficit[3]	Real Total Government Deficit[4]
	Billions of Dollars							Percent of GNP			
1981	2886	—58	—28	72	44	37	80	—2.0	—1.0	1.5	2.8
1982	3046	—111	—31	43	12	34	47	—3.6	—1.0	0.4	1.5
1983	3221	—195	—98	31	—67	38	—28	—6.1	—3.0	—2.1	—0.9
1984	3596	—174	—121	41	—80	52	—28	—4.8	—3.4	—2.2	—0.8
1985	3945	—167	—130	54	—75	41	—34	—4.2	—3.3	—1.9	—0.9
1986	4291	—166	—136	57	—78	40	—38	—3.9	—3.2	—1.8	—0.9
1987	4654	—173	—150	60	—91	46	—44	—3.7	—3.2	—2.0	—1.0
1988	5033	—160	—147	62	—85	50	—35	—3.2	—2.9	—1.7	—0.7
1989	5423	—139	—136	62	—74	52	—22	—2.6	—2.5	—1.4	—0.4

Note: ("—" indicates deficit, positive numbers are surpluses)

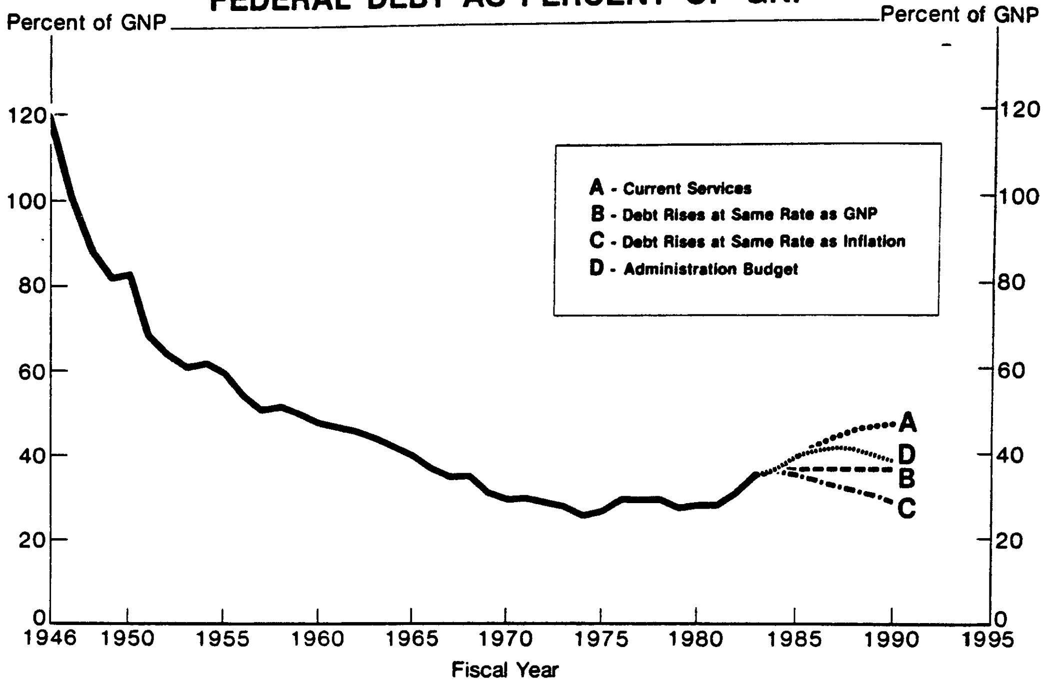
[1] Federal on budget deficit. Projections are from Mid-Session Review.

[2] High Employment Budget Deficit ——Federal deficit adjusted for recession and unemployment in excess of six percent.

[3] Real High Employment Budget Deficit —— High Employment Budget Federal deficit adjusted for impact of inflation on value of debt outstanding held by the public and the Federal Reserve.

[4] Real Total Government Deficit —— Real High Employment Budget Federal deficit less projected State and local surpluses.

FEDERAL DEBT AS PERCENT OF GNP



Note: Debt held by the public, including the Federal Reserve.

April 19, 1985 A62

ANNUAL DEFICITS* UNDER VARIOUS DEBT TARGETS 32.

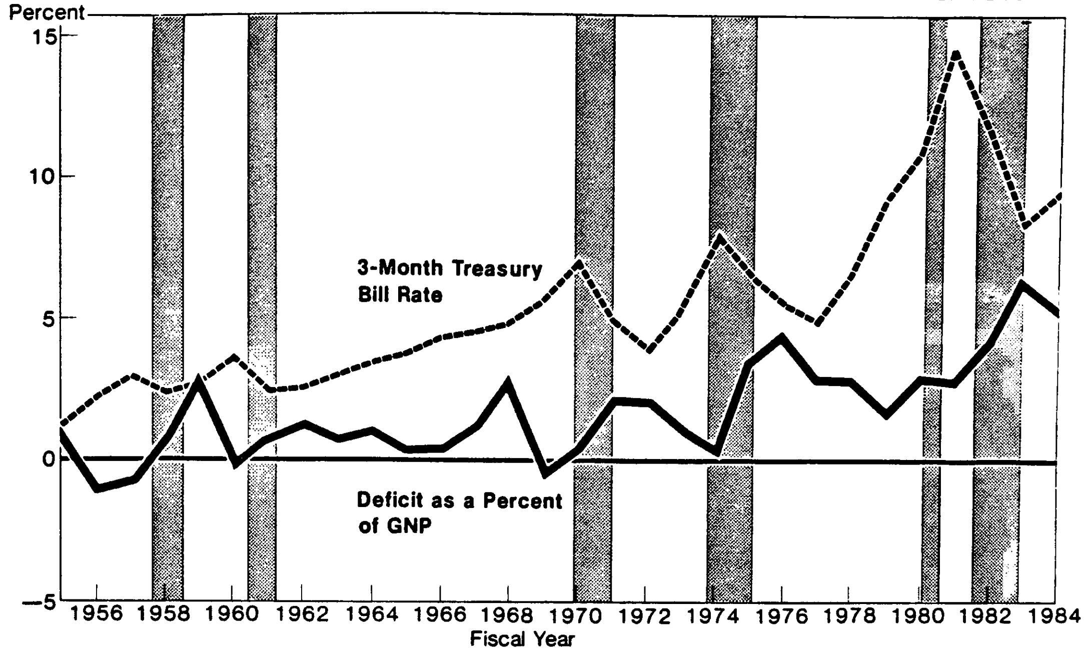
(billions of dollars)

Fiscal Year	A Current Services	B Debt a Constant Share of GNP, Rising at Same Rate as GNP	C Debt of Constant Real Value, Rising with Inflation (GNP Deflator)	D Administration Budget for FY-1986
1985	$224	$105	$50	$213
1986	230	119	57	177
1987	246	129	60	161
1988	248	136	59	143
1989	233	140	57	109
1990	224	139	54	85

Note: Deficits include off budget items. Debt held by the public, including the Federal Reserve.
*Current service deficits are from the February Budget for FY 1986; other figures are from the April Update.

April 19, 1985 A61

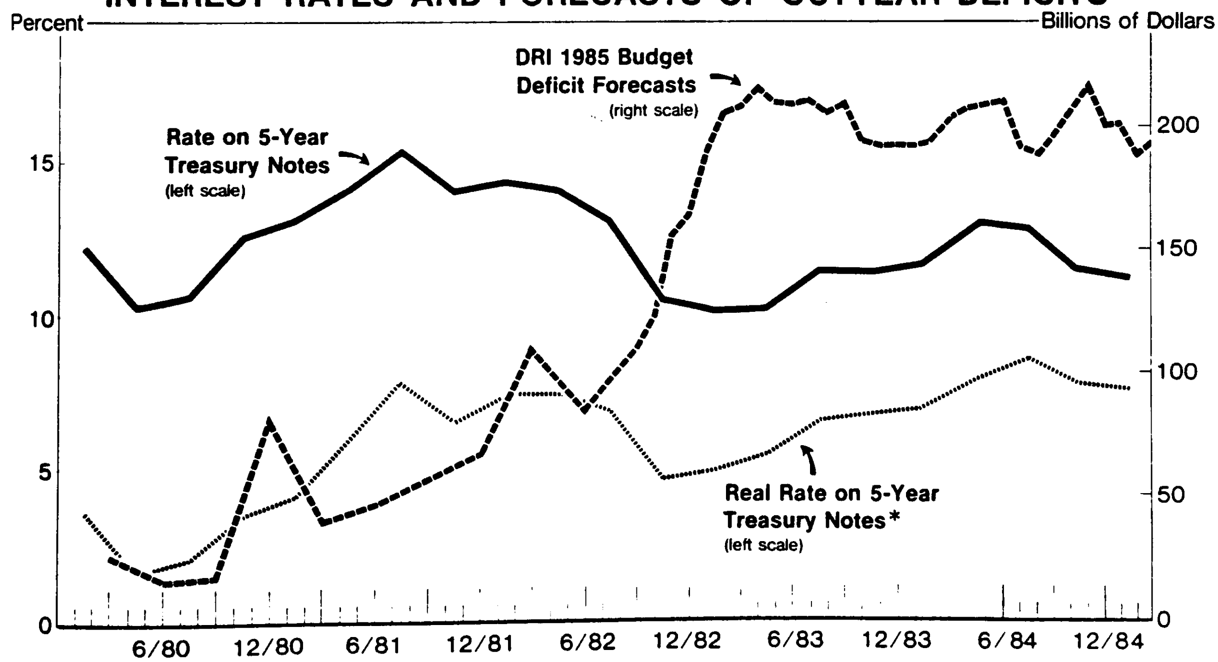
INTEREST RATES AND THE RELATIVE SIZE OF THE DEFICIT



January 15, 1985 A406

34.

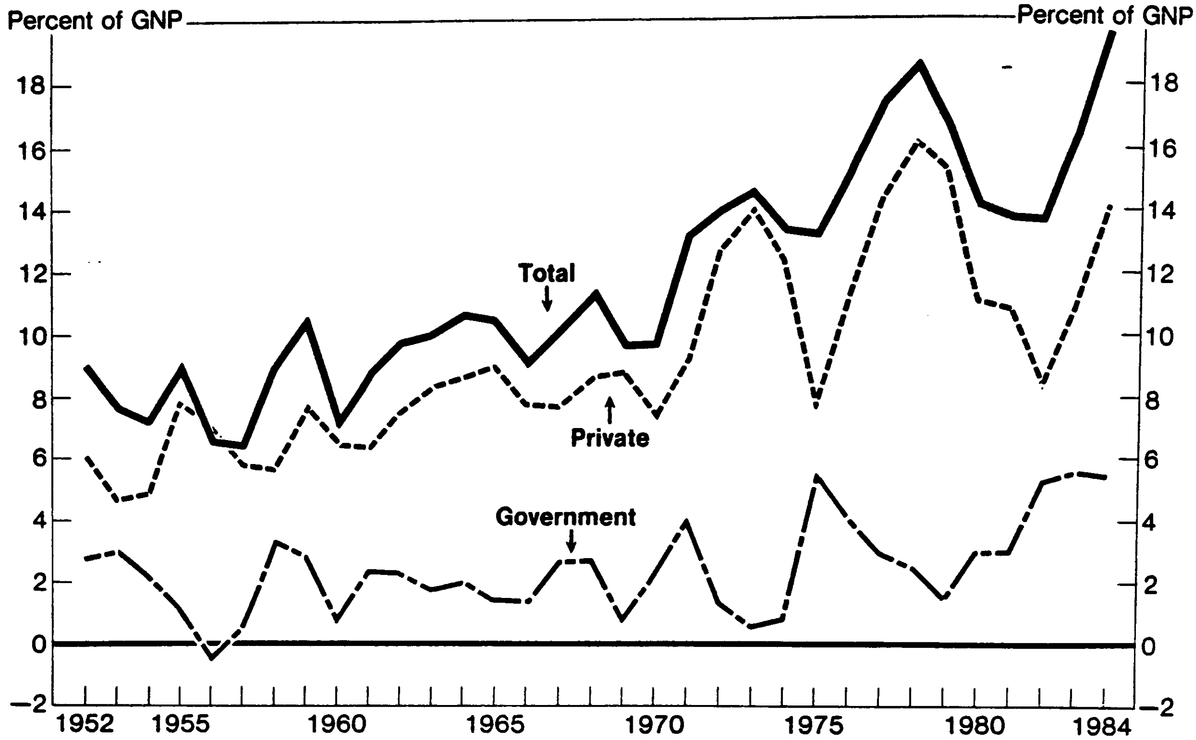
INTEREST RATES AND FORECASTS OF OUTYEAR DEFICITS



* Nominal interest rate less DRI forecast of inflation through 1985.

April 19 1985 A53

GOVERNMENT SECTOR AND PRIVATE SECTOR BORROWING*



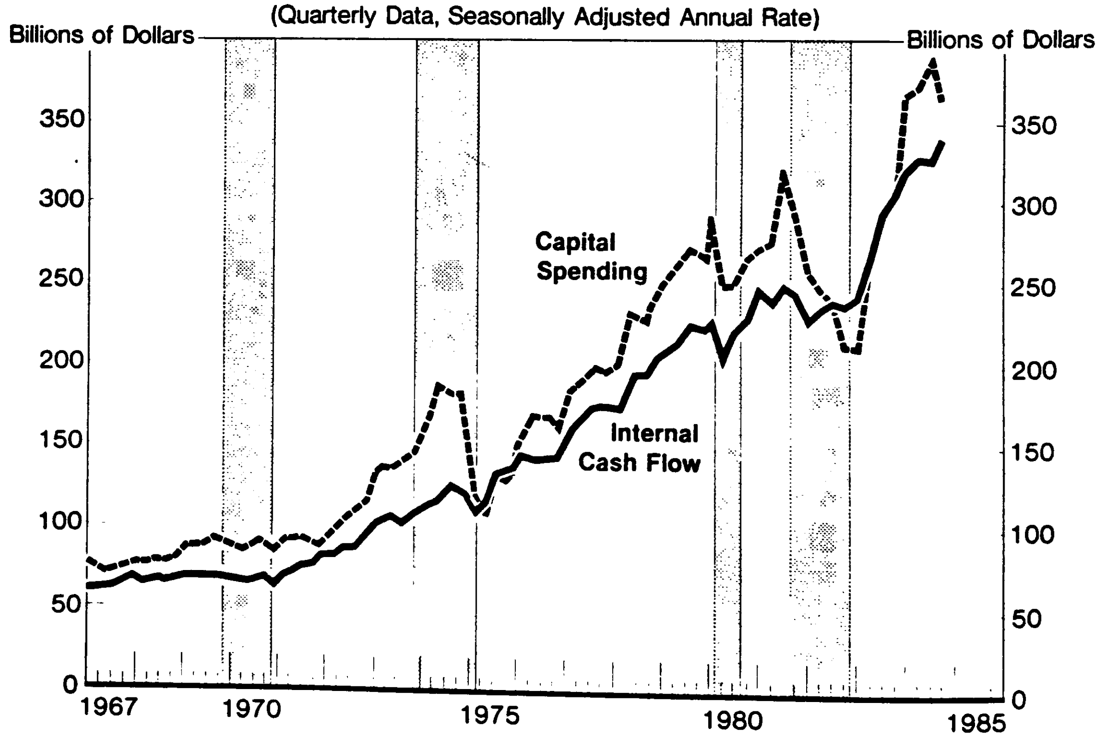
* By Nonfinancial Sectors

April 19, 1985-A328

EXTERNAL CORPORATE FINANCING REQUIREMENTS

(Quarterly Data, Seasonally Adjusted Annual Rate)

36.

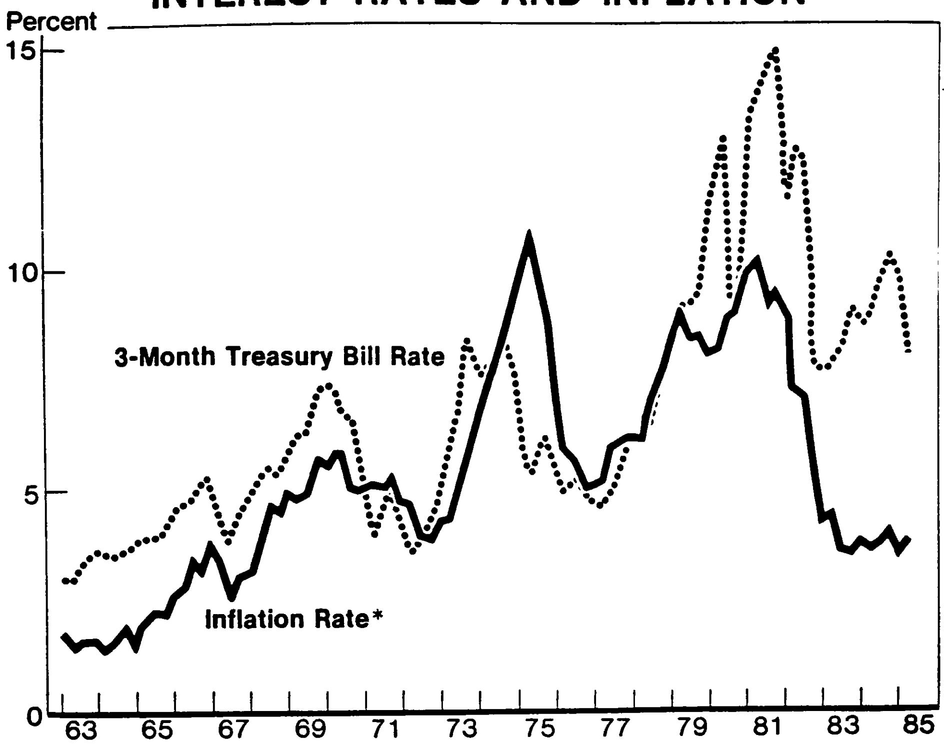


Source: Federal Reserve flow of funds accounts.

April 19, 1985-A64

37.

INTEREST RATES AND INFLATION

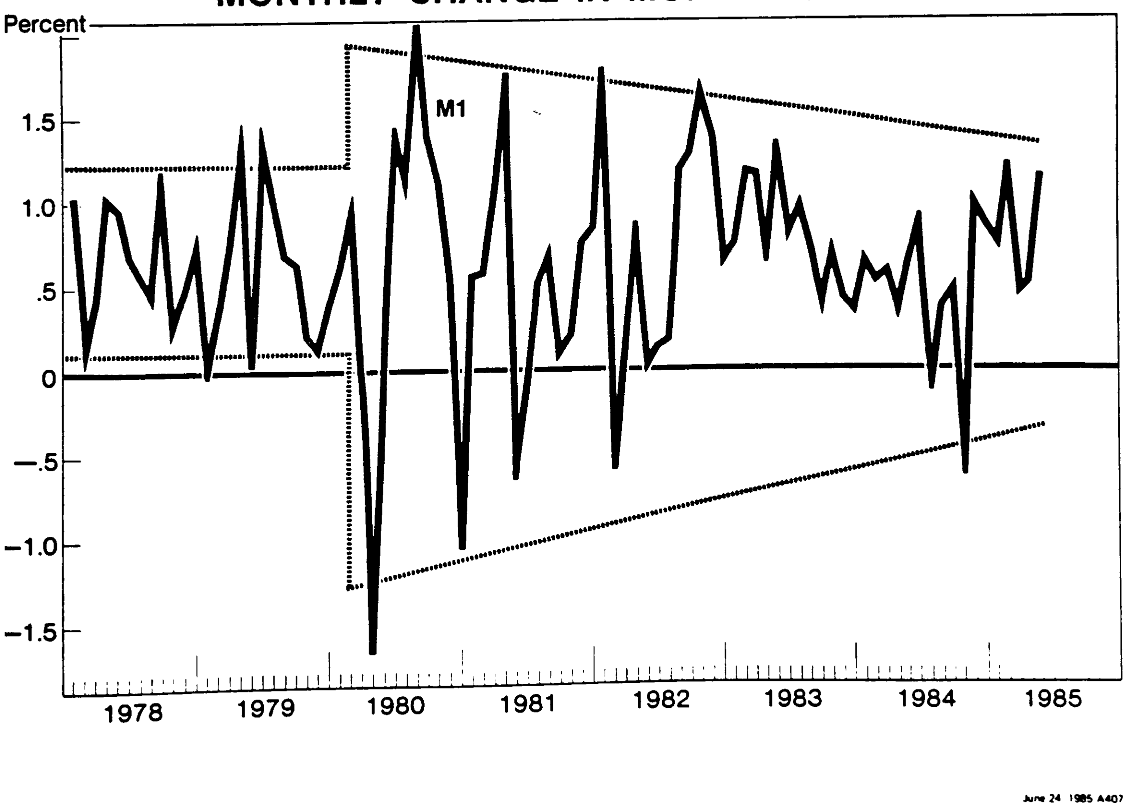


*Growth from year earlier in GNP deflator.
Plotted quarterly.

April 19, 1985-A28

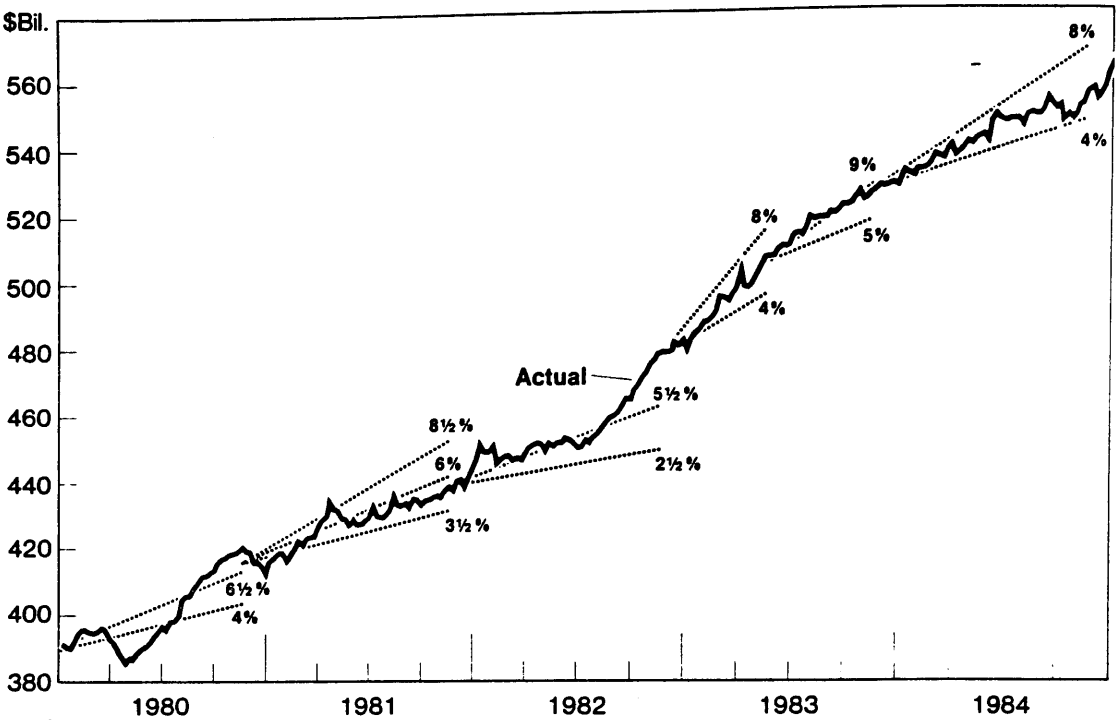
33.

MONTHLY CHANGE IN MONEY SUPPLY



June 24 1985 A407

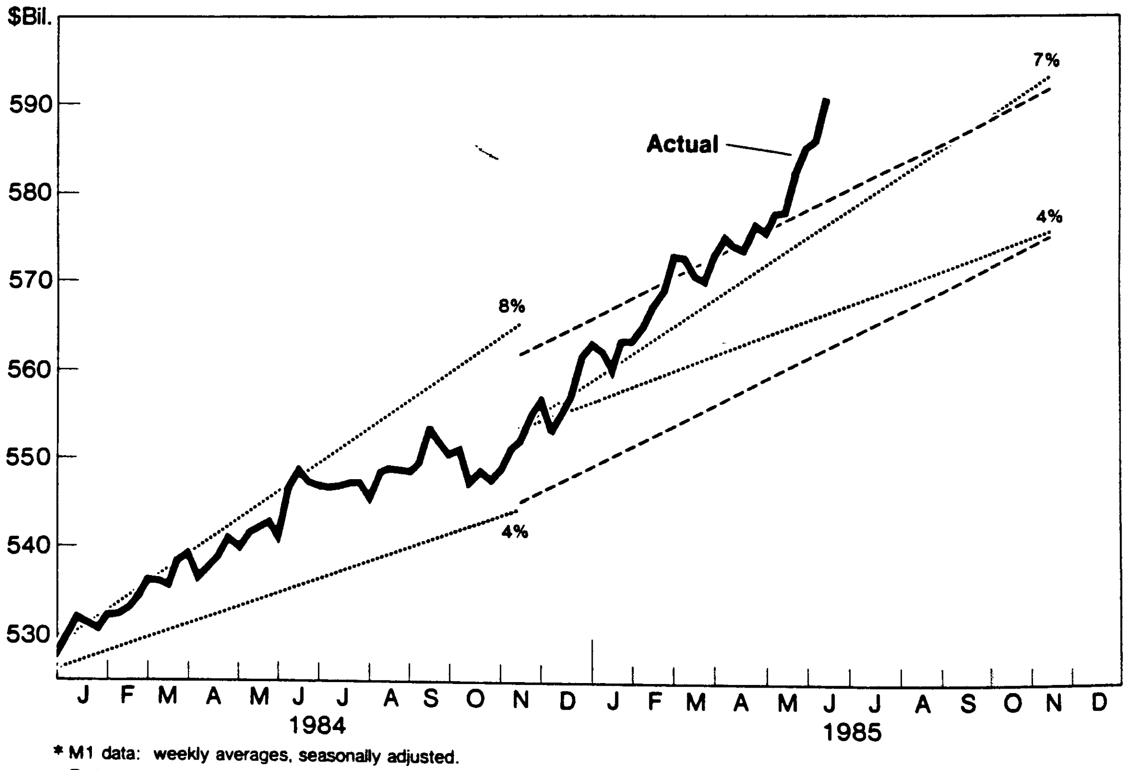
M[1] VERSUS TARGET RANGE*



*M1 data: weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.
In 1981 both M1-B and M1-B "shift adjusted" ranges are shown: the M1-B range is 6—8½%; the M1-B "shift adjusted" range is 3½—6%.

March 26, 1985-A400a

M1 VERSUS TARGET RANGE*



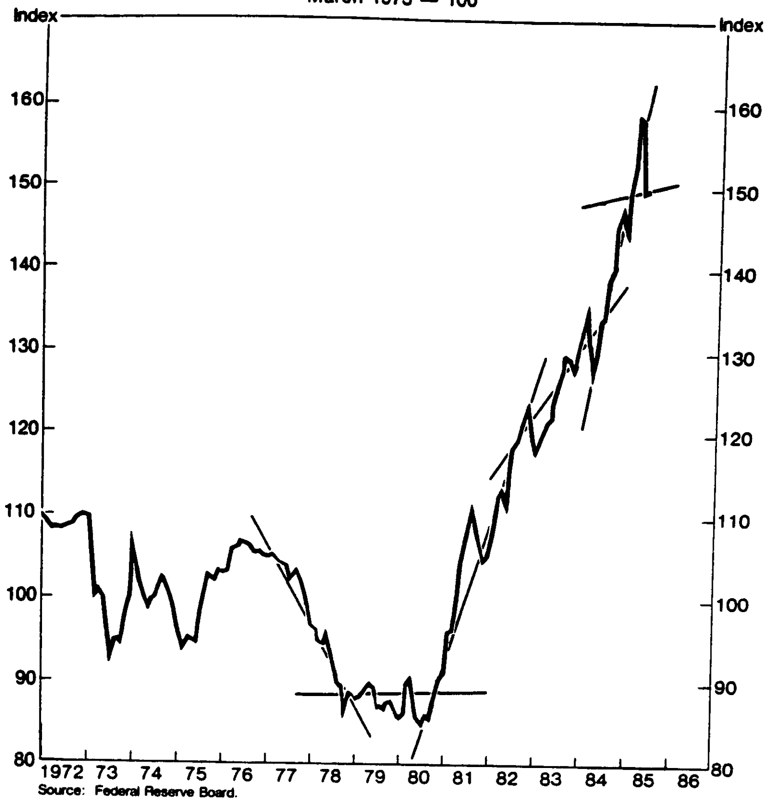
* M1 data: weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.

June 21, 1985 A400

40.

TRADE-WEIGHTED VALUE OF THE DOLLAR

March 1973 = 100



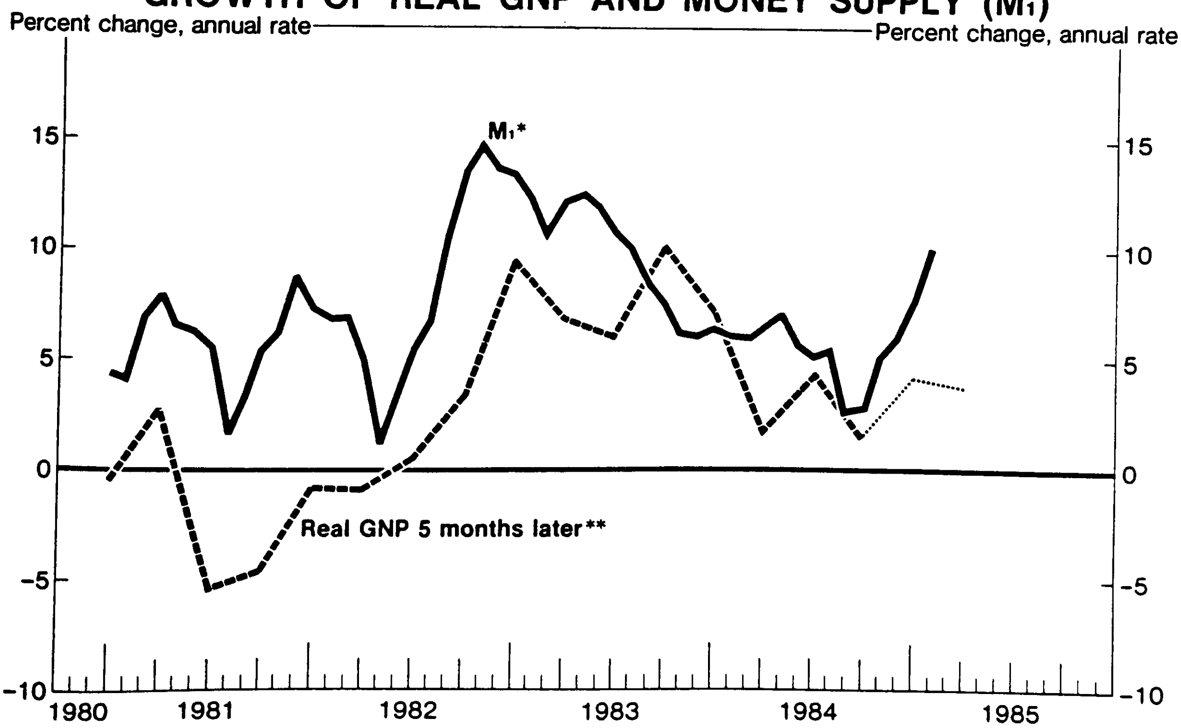
Monetary Growth and the Value of the Dollar

(percent change at an annual rate)

	M1	Trade-Weighted Value of the Dollar
January 1977 — October 1978	8.0	—10.9
October 1978 — October 1980	7.8	0.3
October 1980 — July 1982	4.8	19.9
July 1982 — June 1984	10.4	6.6
June 1984 — December 1984	4.1	23.5
December 1984 — May 1985	9.7	1.1

41.

GROWTH OF REAL GNP AND MONEY SUPPLY (M_1)



*M_1 smoothed by a centered 5 month moving average.

**Projections of real GNP in the second and third quarters of 1985 are the Blue Chip consensus, 4/10/85.

April 19 1985 A405

TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 26, 1985

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $ 6,025 million of $ 15,674 million of tenders received from the public for the 7-year notes, Series F-1992, auctioned today. The notes will be issued July 2, 1985, and mature July 15, 1992.

The interest rate on the notes will be 10-3/8%. The range of accepted competitive bids, and the corresponding prices at the 10-3/8% interest rate are as follows:

	Yield	Price
Low	10.37% 1/	100.006
High	10.41%	99.810
Average	10.40%	99.859

Tenders at the high yield were allotted 76%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 39,820	$ 14,820
New York	13,313,943	5,111,939
Philadelphia	11,353	11,353
Cleveland	349,895	168,695
Richmond	33,256	19,016
Atlanta	33,516	25,556
Chicago	958,018	244,418
St. Louis	235,616	213,616
Minneapolis	12,268	11,668
Kansas City	53,371	51,371
Dallas	11,013	11,013
San Francisco	620,982	140,022
Treasury	1,249	1,249
Totals	$15,674,300	$6,024,736

The $ 6,025 million of accepted tenders includes $ 740 million of noncompetitive tenders and $ 5,285 million of competitive tenders from the public.

In addition to the $ 6,025 million of tenders accepted in the auction process, $265 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

1/ Excepting 1 tender of $5,000.

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

FOR IMMEDIATE RELEASE June 27, 1985

RESULTS OF AUCTION OF 20-YEAR 1-MONTH TREASURY BONDS

The Department of the Treasury has accepted $4,510 million of $13,533 million of tenders received from the public for the 20-year 1-month bonds auctioned today. The bonds will be issued July 2, 1985, and mature August 15, 2005.

The interest rate on the bonds will be 10-3/4%. The range of accepted competitive bids, and the corresponding prices at the 10-3/4% interest rate are as follows:

	Yield	Price
Low	10.73%	100.098
High	10.76%	99.852
Average	10.75%	99.934

Tenders at the high yield were allotted 92%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 21,919	$ 1,919
New York	12,091,867	3,916,687
Philadelphia	385	385
Cleveland	107,092	15,892
Richmond	14,673	5,673
Atlanta	15,929	13,929
Chicago	638,428	156,348
St. Louis	198,267	198,267
Minneapolis	16,409	13,844
Kansas City	21,644	20,644
Dallas	3,208	2,128
San Francisco	403,003	164,083
Treasury	205	205
Totals	$13,533,029	$4,510,004

The $4,510 million of accepted tenders includes $503 million of noncompetitive tenders and $4,007 million of competitive tenders from the public.

B-200

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

FOR IMMEDIATE RELEASE
June 28, 1985

CONTACT: Art Siddon
(202) 566-2041

UNITED STATES AND INDIA
TO DISCUSS INCOME TAX TREATY

The Treasury Department today announced that representatives of the United States and India will meet in New Delhi during the week of July 22, 1985, to resume negotiations of a treaty to avoid double taxation.

There is presently no such treaty in effect between the United States and India. Prior negotiations, most recently in 1977, did not result in the conclusion of a treaty. Following preliminary discussions in Washington in April 1985, the Government of India invited a U.S. delegation to New Delhi to resume negotiations.

The negotiations are expected to be based on the U.S. and Indian Model treaties and on the Model Convention prepared by the United Nations for treaties between developed and developing countries. The issues to be discussed will include the taxation by each country of income derived there by residents of the other country, whether from business activity, personal services or investment, as well as assurances of nondiscrimination in tax matters and provisions for administrative cooperation between the tax authorities of the two countries.

Interested persons are invited to send written comments and suggestions concerning the forthcoming negotiations to Steven R. Lainoff, International Tax Counsel, U.S. Treasury, Room 3064, Washington, DC 20220.

This notice will appear in the Federal Register of July 1, 1985.

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TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON June 28, 1985

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $8,500 million of 364-day Treasury bills to be dated July 11, 1985, and to mature July 10, 1986 (CUSIP No. 912794 KN 3). This issue will provide about $100 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $8,408 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, July 9, 1985.

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.

The bills will be issued for cash and in exchange for Treasury bills maturing July 11, 1985. In addition to the maturing 52-week bills, there are $13,971 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 currently hold $1,296 million as agents for foreign and international monetary authorities, and $5,043 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate 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 $275 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-1.

B-202

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, 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 July 1, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,002 million of 13-week bills and for $ 7,004 million of 26-week bills, both to be issued on July 5, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 3, 1985			:	26-week bills maturing January 2, 1986		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.98%a/	7.20%	98.255	:	7.06%	7.42%	96.450
High	7.01%	7.23%	98.248	:	7.09%	7.45%	96.435
Average	7.00%	7.22%	98.250	:	7.08%	7.44%	96.440

a/ Excepting 1 tender of $1,700,000.

Tenders at the high discount rate for the 13-week bills were allotted 42%.
Tenders at the high discount rate for the 26-week bills were allotted 90%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 56,450	$ 56,450	:	$ 38,915	$ 38,915
New York	15,563,335	6,065,185	:	15,459,270	5,930,050
Philadelphia	31,700	31,700	:	21,710	21,710
Cleveland	56,100	56,100	:	32,900	32,900
Richmond	54,330	44,330	:	56,640	55,590
Atlanta	36,165	35,165	:	33,565	32,565
Chicago	1,018,430	156,430	:	1,061,785	154,640
St. Louis	53,335	33,335	:	44,955	21,455
Minneapolis	13,745	13,745	:	14,380	14,380
Kansas City	48,210	46,710	:	65,725	62,725
Dallas	44,615	34,615	:	35,045	25,045
San Francisco	1,687,255	119,255	:	1,088,955	290,955
Treasury	308,995	308,995	:	323,075	323,075
TOTALS	$18,972,665	$7,002,015	:	$18,276,920	$7,004,005
Type					
Competitive	$16,052,020	$4,081,370	:	$15,121,860	$3,848,945
Noncompetitive	1,107,575	1,107,575	:	950,820	950,820
Subtotal, Public	$17,159,595	$5,188,945	:	$16,072,680	$4,799,765
Federal Reserve	1,500,310	1,500,310	:	1,400,000	1,400,000
Foreign Official Institutions	312,760	312,760	:	804,240	804,240
TOTALS	$18,972,665	$7,002,015	:	$18,276,920	$7,004,005

An additional $9,040 thousand of 13-week bills and an additional $19,460 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-203

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 1, 1985

CONTACT: Art Siddon
(202) 566-2041

OECD Sector Understanding on Export Credits for Large Civil Aircraft

Treasury Secretary James A. Baker III announced today that the United States and the European Community have reached an understanding on new financing terms for exports of large civil aircraft that will complement the OECD Arrangement on Export Credits.

The new agreement represents an improvement over current arrangements by providing for a 12-year financing option in addition to the present 10-year financing, a commitment to avoid distortion of competition, and a prohibition against mixed credits. One of the most important features of the arrangement is the provision for automatically adjusting minimum interest rates, close to market rates that will vary with yields on 10-year Treasury bonds as well as other governments' long-term bond yields. Minimum interest rates in the new understanding will be 120 basis points above 10-year U.S. Treasury bond yields for the 10-year option and 175 basis points above the 10-year Treasury bond yields for the 12-year option.

Official credit financing for large civil aircraft thus far has been governed by the terms of a separate understanding for large commercial jet aircraft. This earlier understanding provided for a single rate of interest at 12 percent, a minimum cash payment of 15 percent, and a maximum repayment period of 10-years. Consequently, the latitude for subsidization in this important sector has been great.

The highlights of the new large aircraft understanding, which became effective July 1, 1985, are as follows:

Scope

The arrangement covers large civil aircraft (generally with more than a 70 seat capacity) manufactured by Boeing, McDonnell-Douglas, and Airbus Industry.

Credit Terms

-- Minimum Cash payment: 15 percent of the aircraft total price.

-- Maximum Repayment Term: 12-years.

-- Minimum Interest Rates: Although the understanding provides for an initial phase-in period, yields on 10-year U.S. Treasury bonds have fallen below the level that would trigger the final minimum interest rates. Therefore, on July 1, 1985, the minimum interest rate in U.S. dollars for the 10-year financing option will be the yield on 10-year U.S. Treasury bonds plus 120 basis points; for the 12-year option, the minimum interest rate will be the yield on 10-year U.S. Treasury bonds plus 175 basis points.

-- The minimum interest rate for the "currency cocktail" (consisting of Deutsche Mark, French Franc, UK Pound Sterling) will be based on the 10-year government bond yields for each of the currencies (in proportion to the composition in the cocktail) plus the same spreads as for the U.S. dollar. For financing in ECU, the minimum rate has tentatively been set at the long-term ECU yield less 20 basis points plus the margins applicable to financing in U.S. dollars.

-- Maximum Amount of Official Support: The total amount of official support shall not exceed 85 percent of the total price. The percentage of the aircraft financed at the minimum interest rates of the agreement are a maximum of 62.5 percent when repayment is spread over the entire life of the financing and a maximum of 42.5 percent when repayment of the loan is spread over the later maturities.

Interest Rate Adjustments:

Interest rates will be adjusted every two weeks (when the average differs by 10 basis points or more) based on the previous two weekly average of government bond yields.

Adjustments Between 10- and 12-Year Minimum Interest Rates

If in the first year, two-thirds or more of the total number of sales take place at either the 10- or 12-year option, a 15 basis point adjustment will be made to the spread over the 10-year option in order to provide some equivalency between the two options. A subsequent adjustment is provided for in the following year, if one option or another continues to be preferred.

Tied-Aid Credits

Participants will not provide mixed credits or tied-aid credits, give grants or provide any other kind of financing at credit conditions more favorable than in the aircraft agreement.

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

FOR RELEASE AT 4:00 P.M.

July 2, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued July 11, 1985. This offering will provide about $425 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,971 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, July 8, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated April 11, 1985, and to mature October 10, 1985 (CUSIP No. 912794 JB 1), currently outstanding in the amount of $6,848 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated July 11, 1985, and to mature January 9, 1986 (CUSIP No. 912794 JM 7).

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.

The bills will be issued for cash and in exchange for Treasury bills maturing July 11, 1985. In addition to the maturing 13-week and 26-week bills, there are $8,408 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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 $931 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,206 million as agents for foreign and international monetary authorities, and $5,118 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

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

Public announcement will be made by the Department of the Treasury of the amount and yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE

July 8, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,209 million of 13-week bills and for $7,204 million of 26-week bills, both to be issued on July 11, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 10, 1985			26-week bills maturing January 9, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.88%a/	7.10%	98.261	6.97%b/	7.33%	96.476
High	6.94%	7.16%	98.246	7.01%	7.37%	96.456
Average	6.92%	7.14%	98.251	7.00%	7.36%	96.461

a/ Excepting 3 tenders totaling $9,805,000.
b/ Excepting 1 tender of $1,000,000.

Tenders at the high discount rate for the 13-week bills were allotted 61%.
Tenders at the high discount rate for the 26-week bills were allotted 61%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 43,615	$ 43,615	$ 38,745	$ 38,745
New York	16,958,070	5,938,210	17,050,360	5,627,610
Philadelphia	27,730	27,730	22,060	22,060
Cleveland	50,600	50,600	146,405	146,405
Richmond	44,470	41,030	58,220	58,220
Atlanta	60,220	53,940	46,735	40,235
Chicago	1,095,450	284,950	1,000,930	397,480
St. Louis	55,865	35,865	46,720	36,720
Minneapolis	21,915	11,915	23,955	13,955
Kansas City	73,980	73,980	65,830	64,830
Dallas	42,555	40,605	34,545	27,595
San Francisco	1,577,445	262,055	1,178,205	326,585
Treasury	344,880	344,880	403,735	403,735
TOTALS	$20,396,795	$7,209,375	$20,116,445	$7,204,175
Type				
Competitive	$17,286,775	$4,099,355	$16,953,425	$4,041,155
Noncompetitive	1,183,885	1,183,885	1,091,520	1,091,520
Subtotal, Public	$18,470,660	$5,283,240	$18,044,945	$5,132,675
Federal Reserve	1,717,935	1,717,935	1,600,000	1,600,000
Foreign Official Institutions	208,200	208,200	471,500	471,500
TOTALS	$20,396,795	$7,209,375	$20,116,445	$7,204,175

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
July 9, 1985

STATEMENT BY JOHN J. NIEHENKE
ACTING ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to provide the views of the Treasury Department on H.R. 2521, a bill to authorize the Federal Reserve Board to regulate the government securities market and H.R. 1896, a bill to authorize the Federal Reserve to regulate the activities of government securities dealers. While the bills differ in many important respects, both bills would vest in the Board broad authority to establish a comprehensive new system of regulation of the government securities market.

The Treasury Department believes that such a broad regulatory mandate is unnecessary and inappropriate. We are also concerned that many of the specific regulatory actions which would be taken by the Federal Reserve Board under H.R. 2521 would duplicate actions which the Treasury itself plans to take under its proposal to register government securities dealers as custodians of Treasury securities. This duplication of functions would confuse the market and add to the cost of Treasury financing.

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Treasury Proposal

As I indicated in my June 20 testimony on H.R. 2302, the Treasury, as the issuer of the obligations of the United States, must be concerned about the integrity of the government securities market. Investor confidence in that market is essential to achieve our objective that the government's debt be financed at the lowest possible cost to the American taxpayer. Yet our June 20 proposal for Treasury registration and supervision of its custodians, including dealers, has been criticized on the basis that there is a conflict of interest between Treasury's role as issuer and Treasury's plans to provide for greater investor protection. We would agree that there would indeed be a conflict between our interest in minimizing the cost of financing the debt and the objectives of those so concerned with investor protection that they would overregulate and thus add to financing costs. However, we cannot accept the proposition that we should risk adding to the current $175 billion annual interest cost of the public debt -- which is borne by all taxpayers -- in order to provide excessive protection. The Treasury is now charged by Congress with the efficient management of the public debt. To charge another agency with the responsibility for protection of the investors in Treasury securities will lead to an inevitable conflict between the two agencies, uncertainty in the market, and higher financing costs.

We believe that the Treasury's current proposal to expand the book-entry system would clearly be a more cost-effective means of increasing investor confidence in the market and accomplishing the essential regulatory objectives of the proposed bills.

The Treasury has been reviewing for many years the question of expanding its book-entry system at the Federal Reserve. Almost all purchases and sales of Treasury marketable securities, including repurchase agreements, are conducted on the commercial book-entry system, which includes both the accounts at the Federal Reserve and the accounts at other financial institutions.

Ownership of Treasury securities on the book-entry system is evidenced by a bookkeeping entry in the accounts of the custodians rather than by physical securities. Currently only depository institutions have direct access to book-entry securities accounts at the Federal Reserve. Other institutions, such as dealers, are required to hold their securities indirectly through book-entry accounts at depository institutions with accounts at the Federal Reserve. This has led to a many-tiered system in which Bank A has an account at a Federal Reserve bank, Dealer B has an account with Bank A, and Municipality C has an account with Dealer B. In other cases, Small Bank D without a securities account at a Federal Reserve bank might have an account with Bank E. Since all such institutions are book-entry custodians of Treasury securities and subject to Treasury's book-entry regulations, the Treasury has been concerned about assuring the integrity of such a many-tiered system. Consequently, the Treasury has been considering collapsing the tiers, thus providing a means to assure all investors that their securities are held by a custodian directly in a securities account at the Federal Reserve. Investors now concerned about fraud or failure of any one of the book-entry custodians, including regulated institutions in the many tiers between the investor and the Treasury, would gain confidence from knowing there is just one middleman between them and the Federal Reserve.

The Treasury announced its plans earlier this year to eliminate definitive registered securities, so that beginning in July 1986 new issues of Treasury securities will be available only in book-entry form. With the advent of full book-entry in 1986, no investors in new Treasury securities will be permitted to purchase them in physical, definitive form. This final step to full book-entry provides an opportunity to accomplish our ultimate objectives for the structure of and access to the book-entry system.

Our proposal is to require dealers and other book-entry custodians generally to have on-line <u>securities accounts</u> at the Federal Reserve in order to hold Treasury securities for their customers. However, since there is no plan to grant nondepository institutions access to the mechanism to transfer <u>funds</u> over the Federal Reserve's wire transfer system, clearing banks would still perform their role in security clearance. In order to prevent the extension of credit to dealers on an unsecured basis, we would expect that securities would be held initially in the clearing bank's account before being transferred to the dealer's account at the Federal Reserve.

Any dealers or other book-entry custodians with securities accounts at Federal Reserve banks would be subject to certain qualifying standards, including registration and identification of personnel of the firm. Treasury would share this information with the SEC and other financial institution regulators in order to assure that firms employing certain personnel who should be barred from the market are not permitted to act as Treasury custodians. We would also expect to establish standards of financial responsibility, recordkeeping, and auditing, as well as appropriate provisions for segregation of customers' securities. We would rely on the Federal Reserve or other existing regulatory bodies to inspect dealers and enforce rules.

As I noted earlier, measures to assure the integrity of the expanded book-entry system are essential to our fundamental objective of financing the public debt in the most cost-effective manner. It should be emphasized that the questions relating to the elimination of new issues of definitive securities in 1986 and expanded access to securities accounts at Federal Reserve banks would have had to have been addressed even in the absence of recent government securities dealer failures. The Treasury must be concerned about its business relationship with its custodians. Both the Treasury and the ultimate beneficial owners of book-entry Treasury securities share a common interest that the dealers and other custodians perform their duties as book-entry custodians honestly and well.

Since the measures contemplated for the book-entry system would also meet the essential regulatory objectives of H.R. 1896 and H.R. 2521, we see no need for such legislation. We expect to complete our plans for the expanded book-entry system over the next several months, at which time we plan to submit legislation to Congress to clarify Treasury's authority under the public debt statutes (31 U.S.C. 3121) to require designated custodians of Treasury securities to meet the qualification standards discussed above.

H.R. 2521 and H.R. 1896

While we plan to request some further legislation in this area, Treasury strongly opposes broad legislation such as H.R. 2521 and H.R. 1896 for the following reasons:

--First, it must be recognized that the Government securities market is quite different from markets for other securities. It would be inappropriate to regulate the Government securities market without recognizing, for example, that this market is almost entirely an institutional market and that the underlying securities present no credit risk to purchasers. Thus there has not been a need in the Government securities market for legislation to protect individual investors. Government securities are exempt from the provisions of the Securities Exchange Act of 1934, which established a system of regulation of trading in non-Federal securities, which now includes both corporate and municipal issues. In fact, there have been no significant problems for individual investors in the government securities market. The recent problems in the market, most notably the failure of ESM, which led to the Ohio thrift institution crisis, involved institutional investors, thrifts and municipalities, which are subject to regulation or oversight, at the Federal or State level, which should protect the individual depositors and taxpayers who rely on those institutions. As indicated, in the SEC report of June 20, 1985, those problems are now being dealt with through the normal process of self-correction by the market itself and by the State regulators, various banking regulators, and standard setting bodies such as the Government Accounting Standards Board. This process, in conjunction with the measures we plan to undertake with respect to the book-entry system, should be allowed to work without the imposition of an additional regulatory scheme.

--Second, the Treasury securities market is the largest and most efficient market in the world, with unparalleled depth, breadth, and liqudity. It has been relatively free of problems. It has served us well in minimizing the cost of financing the public debt, and it has served investors well by providing an unquestionably safe, highly liquid investment. We should not risk the reduction in efficiency, and added costs to the taxpayer, which could result from unnecessarily burdensome and costly regulation.

--Third, Treasury securities are standard instruments of a single issuer, the United States Government, unlike the thousands of varied corporate and municipal issues, and there is no question as to either the credit quality or public acceptance of Treasury securities.

--Fourth, it is the Treasury's responsibility, under existing public debt statutes, to finance the budget deficits and debt at the lowest possible cost to the taxpayer. This objective, to minimize the cost of financing the public debt, is the primary purpose of the government securities market and, in our view, the primary public interest for consideration by the Congress. It should not be compromised by subjecting the market to excessive and conflicting regulations. To the extent it becomes appropriate to impose additional constraints on the Treasury securities market, that should be done by broadening the existing rules of the Treasury.

Mr. Chairman, the government securities market must remain liquid and efficient to absorb quickly increasing levels of debt. To retain these characteristics, the market must also have the confidence of its participants. We are convinced that our proposed conversion to a total book-entry system, coupled with the types of measures I have discussed here today, will fully meet both these goals, and thus the goals of the bills before you.

That concludes my prepared statement, Mr. Chairman. I will be happy to respond to your questions.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 8, 1985

CONTACT: Art Siddon
(202) 566-2041

TREASURY DEPARTMENT RELEASES PROPOSED UNITARY TAX LEGISLATION

The Treasury Department today issued for public comment draft legislation that would require certain corporations to file annual information returns with the Internal Revenue Service reflecting their computation of State income taxes in the various States. The draft legislation also would permit the Federal government to share the information return and other taxpayer information with State tax agencies. These information returns could be shared with states to aid in State tax enforcement activities provided the State does not require the corporation to compute State income taxes under the worldwide unitary method of apportionment.

The draft legislation is patterned after the recommendations of the Worldwide Unitary Taxation Working Group organized by the Treasury Department to resolve conflicts among State taxing authorities, multinational corporations, and foreign governments. The Final Report of the Working Group was released on August 31, 1984.

The Treasury Department requests interested parties to provide written comments on the draft legislation prior to August 15, 1985. After reviewing comments, the Treasury Department will seek to have the legislation introduced in Congress when it convenes after its August recess. In addition, the Treasury Department indicated that it will request approval through the Office of Management and Budget to seek a supplemental appropriation as suggested in the Working Group's Final Report to strengthen Internal Revenue Service enforcement activities related to international business operations and to implement the State tax enforcement assistance program.

Written comments on the proposed spreadsheet reporting legislation should be directed to the Office of Tax Policy, Room 3108, U.S. Treasury Department, Washington, D.C. 20220.

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B-208

Summary of Proposed Unitary Tax Spreadsheet Legislation

- The proposed legislation would:

  -- Require certain companies to file with the IRS a "domestic disclosure spreadsheet," an information return reporting the calculation of their State tax liability in each State.

  -- Permit State tax authorities in States not requiring worldwide unitary taxation and certain multistate tax agencies to obtain from the Federal government the domestic disclosure spreadsheet and other taxpayer information necessary to administer State tax laws.

- The corporations required to report are those domestic and foreign corporations that (i) are required to file a U.S. corporate tax return and (ii) together with their affiliates have more than $1 million in sales, payroll, or assets in any foreign country or have in excess of $250 million in worldwide assets. U.S. subsidiaries of large foreign multinationals would be required to report, but the foreign parent corporation would not be required to report unless it is directly conducting business in the United States.

- The taxpayer information available to qualifying States and certain multistate tax agencies from the Federal government will include:

  -- The domestic disclosure spreadsheet information return.

  -- Information obtained from foreign countries under the exchange of information provisions of U.S. tax treaties if and to the extent treaties permit. In all cases treaties will need to be amended before treaty information will be available for disclosure to the States.

  -- Federal returns and other taxpayer information already available to States under existing law.

- States and multistate tax agencies will be able to obtain this information directly from the Federal government or, in some cases and subject to appropriate safeguards, from other States or multistate agencies that have previously obtained the information from the Federal government pursuant to the legislation.

- Spreadsheet returns and treaty information will be made available only to qualified States and certain multistate agencies acting on their behalf. (All States will continue to have access to the taxpayer information available under current law whether or not they are qualified States.) A State, whether or not it is a qualified State, will not be entitled to spreadsheet returns and treaty information with respect to a taxpayer that actually files on a worldwide unitary basis in that State.

- Following the Working Group Report definitions, the proposed legislation defines a qualified State as any State not requiring unitary reporting for operations beyond the water's edge. A qualified State, however, would be permitted to require worldwide unitary reporting if a corporation fails to provide the State with the information on its dealings with foreign affiliates necessary for the State to determine the corporation's tax liability on a separate accounting basis.

- The definition of the water's edge group generally follows the recommendations contained in the Working Group Report. However, the definition of foreign tax haven companies which may be included in the water's edge group is largely left to Treasury regulations.

- The Working Group left two major issues unresolved. These are whether a State can tax dividends received by a company within the water's edge group from foreign corporations, including affiliates, and whether affiliated U.S. companies having more than 80 percent of their sales, payroll and assets attributable to operations outside the United States ("80-20 companies") should be included in the water's edge group. While the legislation does not explicitly take a position on these unresolved issues, a State would not fail to be a qualified State merely because it taxes the operations of 80-20 companies or because it taxes dividends paid by foreign subsidiaries.

PROPOSED UNITARY TAX LEGISLATION

Sec. 1. Subpart A of part III of subchapter A of Chapter 61 of the Internal Revenue Code of 1954 (relating to information returns) is amended by adding immediately after section 6039 the following section:

"SECTION 6039 A. Information with Respect to Certain Multistate and Multinational Corporations --

"(a) General Rule - A reporting corporation shall file, within 90 days of the due date (including extensions thereof) of its Federal income tax return for the taxable year, a return disclosing information relating to its State income tax returns for State taxable years ending with or within the taxable year of such corporation for Federal income tax purposes. Such return shall include the reporting corporation's income tax liability to each State in which it is liable to pay income tax, its income subject to tax in each State, the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each State, each corporation in which the reporting corporation, or any corporation owning 50 percent or more of the outstanding voting stock of the reporting corporation, owns, directly or indirectly, more than twenty percent of the combined voting power of all classes of stock entitled to vote, and such other related information as the Secretary may by regulation prescribe.

"(b) Reporting by Related Corporations--

"(1) Reporting by Common Parent of Affiliated Group - If a reporting corporation is a common parent of an affiliated group of corporations, it shall file a return disclosing the information described in subsection (a) with respect to each includible corporation in such affiliated group. Such information shall be filed for the State taxable year of each includible corporation ending with or within the common parent corporation's taxable year for Federal income tax purposes.

"(2) Reporting by Other Related Corporations-- If a reporting corporation is a member of a controlled group of corporations that includes a foreign corporation that is described in section 6103(d)(4)(G) but is not required to file a Federal income tax return, then such reporting corporation shall, in filing the return required by this section, include the information that such foreign corporation would be required to file under this section if it were a reporting corporation. This paragraph shall not apply if such reporting corporation and such foreign corporation are included in a return described in paragraph (1).

"(c) Definitions -

"(1) Reporting Corporation - (A) In general. For purposes of this section, the term "reporting corporation" means a corporation that is required to file a Federal income tax return for the taxable year, and that

"(i) makes aggregate payments of at least $1,000,000 as compensation for services rendered in any single foreign country during the taxable year;

"(ii) owns assets situated in any single foreign country with an aggregate fair market value of at least $1,000,000 as of the close of the taxable year;

"(iii) has gross sales occurring in any single foreign country of at least $1,000,000 during the taxable year; or

"(iv) owns assets with an aggregate fair market value, as of the close of the taxable year, of at least $250,000,000.

The Secretary shall have authority at any time to increase by regulation any dollar threshold set forth in this paragraph. The allocation of compensation payments, property, or sales to or among foreign countries shall be determined under regulations prescribed by the Secretary.

"(B) Application of definition to Related Corporations. For purposes of applying subparagraph (A) to related corporations--

"(i) compensation paid by, property owned by, or sales made by members of an affiliated group of corporations shall be treated as if paid, owned, or made directly by the common parent corporation; and

"(ii) compensation paid by, property owned by, or sales made by members of a controlled group of corporations that are not members of the same affiliated group of corporations shall be consolidated and attributed to each member of such controlled group that is required to file a Federal income tax return.

"(2) Affiliated Group - For purposes of this section, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is required to file a Federal income tax return for the taxable year if

"(i) stock possessing more than 50 percent of the combined voting power of all classes of stock entitled to vote of each of the includible corporations (except the common parent corporation) is owned directly or indirectly by one or more of the other includible corporations within the affiliated group; and

"(ii) the common parent corporation owns directly stock possessing more than 50 percent of the voting power of all classes of stock entitled to vote of at least one of the other includible corporations.

"(3) Includible Corporation - For purposes of this section, with respect to any taxable year, the term "includible corporation" means (i) any domestic corporation, other than a corporation exempt from tax under section 501, (ii) any corporation incorporated in the Commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands, (iii) any corporation defined in section 922, (iv) any foreign corporation that is required to file a Federal income tax return with respect to such taxable year, or (v) any other foreign corporation that is described in section 6103(d)(4)(G).

"(4) Controlled Group - For purposes of this section, the term "controlled group" has the meaning given to such term by section 267(f)(1), except that the determination shall be made without regard to section 1563(b)(2)(C).

"(d) Status of Return - If the information return filed pursuant to subsection (a), or any information reflected on such return, is disclosed or made available to a State tax agency (as defined in section 6103(d)(4)(C)), or to any common or designated agency (as defined in sections 6103(d)(4)(A) and (B)) in which a State participates, the return may thereupon be treated, if and to the extent provided by the laws of such State, as if originally filed with such State for purposes of the imposition of civil or criminal penalties under the laws of such State for negligence, fraud, or a material understatement of income or of tax liability.

"(e) Dollar Penalty for Failure to Comply -

"(1) In general - If with respect to any taxable year a reporting corporation fails to comply substantially with the requirement of subsection (a) on or before the due date specified in subsection (a), such corporation shall pay a penalty of $1,000.

"(2) Increase in penalty where failure continues after notification - If any failure described in paragraph (1) continues for more than 90 days after the date on which the Secretary mails notice of such failure to the reporting corporation, such corporation shall pay a penalty (in addition to the penalty imposed by paragraph (1)) of $1,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period. The increase in penalty under this paragraph shall not exceed $24,000.

"(3) Penalties in addition to any penalty that may be imposed under State law - Nothing in this subsection shall preclude any State from imposing any fines or penalties for negligence, fraud, or understatement of income or of tax liability in accordance with the laws of that State."

Sec. 2. Section 6103 of the Internal Revenue Code of 1954 (relating to confidentiality and disclosure of returns and return information) is amended by--

(a) revising subsection (d) to read as follows:

"(d) <u>Disclosure to State Officials, Etc</u>.

"(1) In general.-- Upon compliance with the procedures and requirements of paragraph 2, returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 45, 51, and 52 and subchapter D of chapter 36, returns described in section 6039A, and return information obtained by the Internal Revenue Service from any foreign government, or agency or department thereof, under the exchange of information provisions of any income tax treaty, estate and gift tax treaty or agreement described in section 274(h)(6)(C), to which the United States is a party, shall be open to inspection by, or disclosure to, any State tax agency for the purposes of, and only to the extent necessary in, the administration of the tax laws of a State, including any procedures with respect to locating any person who may be entitled to a refund. Notwithstanding the preceding sentence:

"(A) return information obtained under treaties or section 274(h)(6)(C) agreements shall be open to examination or disclosure only to the extent such examination or disclosure is permitted by, and shall be subject to any limitation imposed by, the relevant treaty or agreement; and

"(B) neither section 6039A returns nor return information obtained under a treaty or section 274(h)(6)(C) agreement shall be disclosed to a State tax agency if

"(i) the State is not a qualified State within the meaning of section (d)(4)(E); or

"(ii) any taxpayer included in the section 6039A return, or any taxpayer to which the return information relates, files, or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that State.

Returns and return information described in this paragraph (1) relating to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall also be open to inspection by or disclosure to any common agency or the designated agency.

"(2) Procedures and restrictions. -- (A) Persons to whom information may be disclosed--Except as the Secretary shall prescribe by regulation, inspection shall be permitted, or disclosure made, under paragraph (1) only upon written request by the head of the State tax agency, common or designated agency, and only to the respresentatives of such agency designated in such written request as the individuals who are to inspect or to receive the returns or return information on behalf of such agency. Such representatives shall not include any individual who is the chief executive officer of a State or who is neither an employee or legal representative of such agency nor a person described in subsection (n). Returns and return information shall not be disclosed under paragraph (1) to the extent that the Secretary determines that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

"(B) Disclosure of returns and return information relating to section 6039A reporting corporations by State tax agencies, common and designated agencies-- A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation, may disclose such returns and return information to a State tax agency of any other State, provided:

"(i) the State to which the information is to be disclosed is a qualified State;

"(ii) no taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that other State; and

"(iii) the State tax agency of such other State has entered into an applicable nondisclosure agreement with the Secretary that satisfies the requirement of paragraph (2)(C).

"(C) Nondisclosure agreement-- A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall be required to execute a non-disclosure agreement with the Secretary prohibiting the disclosure of such returns or return information or of any data, information or conclusion extracted from or based upon such returns or return information, to any State tax agency if

"(i) the State is not a qualified State within the meaning of section (d)(4)(E), or

"(ii) any taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files, or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that State.

The agreement shall also prohibit any State tax agency obtaining such returns or return information from using the returns or return information in connection with its examination of any taxpayer which files on a worldwide unitary basis in that State. The required nondisclosure agreement shall contain such additional terms and conditions as the Secretary shall prescribe.

"(D) Use of information obtained by State tax agencies-- A State shall not use any section 6039A return or any return information obtained under a treaty or section 274(h)(6)(C) agreement in connection with its examination of any taxpayer that files on a worldwide unitary basis in that State.

"(3) Disclosure to State audit agencies.-- Returns or return information described in paragraph (1) obtained by any State tax agency may be open to inspection by, or disclosure to, officers and employees of a State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State tax agency. Notwithstanding the preceding sentence, return information obtained under a treaty or section 274(h)(6)(C) agreement shall not be open to inspection by or disclosure to any State audit agency.

"(4) Definitions.--

"(A) Common agency.-- For purposes of this section, the term 'common agency' means a joint or common agency, body, or commission which has been designated under the laws of four or more qualified States to represent such States collectively in the administration of the corporate income tax laws of those States and which has executed a non-disclosure agreement of the type described in paragraph (d)(2)(C).

"(B) Designated agency.--- For purposes of this section, the term 'designated agency' means that agency which has been or may be designated under the laws of a plurality of all qualified States, to obtain from the Internal Revenue Service and process on behalf of such States returns and related return information, including returns described in section 6039A, and which has executed a non-disclosure agreement of the type described in paragraph (d)(2)(C).

"(C) State tax agency.-- For purposes of this section, the term 'State tax agency' means any agency, body, commission or other body charged under the laws of a State with responsibility for the administration of State tax laws.

"(D) State audit agency.--For purposes of this section, the term "State audit agency" means any State agency, body, commission, or entity which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

"(E) Qualified State--For purposes of this section, the term 'qualified State' means a State that the Secretary determines does not require taxpayers to compute tax on a worldwide unitary basis, except where:

"(i) a company fails to comply with the requirements of section 6039A or with the legal and procedural requirements of the income tax laws of such State;

"(ii) neither the taxpayer nor the government of the relevant foreign country provides to the State, within a reasonable period after proper request, information sufficient to determine the arm's-length nature of transactions between any corporation described in section (d)(4)(F) and any other foreign corporation which is a member of the same controlled group of corporations (within the meaning of section 6039A(c)(4)); or

"(iii) separate accounting, after necessary and appropriate adjustments, fails to prevent the evasion of taxes or clearly reflect income.

A determination by the Secretary under this paragraph shall be conclusive and not subject to review by any court.

"(F) Worldwide Unitary Basis --- For purposes of this section, the term 'worldwide unitary basis' means that in computing state income tax a corporation or related group of corporations includes or is required to include in the income base on which the tax is calculated an allocated share of the income of corporations other than:

"(i) domestic corporations more than 50 percent of the voting stock of which is owned directly or indirectly by a corporation that is a member of the affiliated group;

"(ii) domestic corporations that have made an effective election under section 936;

"(iii) corporations defined in section 922;

"(iv) corporations organized in the commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands;

"(v) foreign corporations if (I) such corporation is subject to State income tax in at least one state by virtue of its business activities in that state; and (II) such corporation has (a) at least $10,000,000 in compensation payments for services rendered, sales or purchases during its most recent Federal taxable year or property with a fair market value of at least $10,000,000 as of the last day of its most recent Federal taxable year, assignable to one or more locations in the United States, or (b) the average of the percentages of such corporation's property (valued as of the last day of its most recent Federal taxable year), compensation payments for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that is assignable to one or more locations in the United States is at least 20 percent.

"(vi) foreign corporations described in section (d)(4)(G).

"(G) Certain foreign corporations -- A foreign corporation is described in this subparagraph if such corporation --

"(i) is a member of a controlled group of corporations (within the meaning of section 6039A(c)(4)) that includes at least one reporting corporation (within the meaning of section 6039A) that is not described in this subparagraph (G);

"(ii) either carries on no substantial economic activity or makes at least

(a) 50 percent of its sales,

(b) 50 percent of its payments for expenses other than payments for intangible property, or

(c) 80 percent of all of its payments for expenses,

to one or more corporations that are described in clauses (i) through (v) of subparagraph (F) and that are within the controlled group of corporations referred to in clause (i) of this subparagraph; and

"(iii) under standards established in regulations to be prescribed by the Secretary, is not subject to substantial foreign tax on its net income.

(b) Striking "subsection (e)(1)(D)(iii)" in subsection (a)(3) and inserting in lieu thereof "paragraph (1) of subsection (d), subsection (e)(1)(D)(iii)".

Sec. 3. The second sentence of section 274(h)(6)(C)(i) of the Internal Revenue Code of 1954 (relating to exchange of information agreements) is amended to provide as follows:

Except as provided in clause (ii), an exchange of information agreement shall provide for the exchange of such information (not limited to information concerning nationals

residents of the United States or the beneficiary
untry) as may be necessary and appropriate to carry out
d enforce the tax laws of the United States, the tax laws
beneficiary country (whether criminal or civil proceed-
gs) and if the parties to the agreement agree, the tax
ws of the several States of the United States, including
formation which may otherwise be subject to nondisclosure
ovisions of the local law of the beneficiary country (such
provisions respecting bank secrecy and bearer shares).

Sec. 4. Effective Date. The amendments made by
ction 1, Section 2 and Section 3 shall be effective for
xable years beginning after December 31, 1985.

TECHNICAL EXPLANATION OF UNITARY TAX LEGISLATION

:he proposed legislation would implement the undertaking of :partment of the Treasury in the Final Report of the ride Unitary Taxation Working Group (the "Working Group :"). The Working Group Report contemplates that the :ment of the Treasury will seek legislation requiring :ations to report certain information regarding their State .ability to the Federal Government and establishing lures for sharing that information with qualifying States. ırpose of the proposed reporting and information-sharing ;ions (new section 6039A and amended section 6103(d), :tively) is to permit the States to improve their taxation .tinational corporations.

ι. Section 6039A.

. In general. New section 6039A would require that a ·ting corporation" file an information return with the ıal Revenue Service. The information return would include :porting corporation's income tax liability in each State, ıount of its income subject to tax in each State, and the l of calculation by which it computed its income subject to ı each State (e.g., the amount of property, payroll and allocated to each State and the allocation factors used in :ing those amounts). It is contemplated that these items be contained in a domestic disclosure spreadsheet developed : Treasury in accordance with the Working Group Report. In .on to the spreadsheet information, a reporting corporation be required to disclose the name of each corporation in it or any corporation owning 50% or more of its voting owns a 20% or greater interest and any other information 'ed to be reported under regulations promulgated by the :ary.

:. Definition of reporting corporation. A corporation not be required to file a section 6039A return unless it reporting corporation" for the taxable year. In general, a 'ation would be a "reporting corporation" if it is required .e a Federal income tax return for the year and satisfies .e of four business activity thresholds: (i) $1,000,000 in payments for compensation in a single foreign country; 1,000,000 in assets in a single foreign country; (iii) gross sales of $1,000,000 in a single foreign country; or otal worldwide assets of $250,000,000, without regard to on. The principles for applying these tests would be ped under regulations; it is anticipated that in the case ts (i) - (iii) these regulations would utilize the ement and sourcing rules used for State tax purposes in the m Division of Income for Tax Purposes Act.

A corporation required to file a Federal income tax return would not be able to utilize subsidiaries to avoid the requirements of section 6039A. Thus, in the case of an affiliated group of corporations with a common parent corporation, the numerical thresholds would be applied on a consolidated basis by attributing payments of compensation, ownership of property, or sales made by subsidiaries directly to the common parent. This attribution rule would apply to all subsidiary corporations that are within the same controlled grou of corporations (within the meaning of section 267(f)(1)), provided the common parent corporation is required to file a Federal income tax return for the year.

To prevent circumvention of the numerical thresholds of section 6039A by brother-sister corporations, similar rules woul apply in cases where the common parent is not required to file a Federal income tax return. These aggregation rules would apply to the extent that 50 percent or more of the stock of each such corporation is owned, directly or indirectly, by the same person In such a case, the corporations' property, payroll, and sales would be aggregated and attributed to each such corporation required to file a Federal income tax return for purposes of determining its status as a "reporting corporation" under sectio 6039A.

3. Filing by affiliated groups. Section 6039A(b) would require that any reporting corporation that is also the common parent of an affiliated group of corporations file the section 6039A return on behalf of all includible corporations in its affiliated group. In addition, the common parent corporation would be required to aggregate the property, payroll, and sales of the other includible corporations in the affiliated group in determining whether the threshold requirements for classificatio as a reporting corporation are met.

For purposes of section 6039A, an "affiliated group" would consist of a chain of "includible corporations" connected throug voting stock ownership of at least 50 percent with a common parent corporation that is required to file a Federal income tax return for the year (and subject to reporting under section 6039 either directly or through attribution from its subsidiaries). Thus, a foreign corporation not engaged in a U.S. trade or business generally could not be the common parent of an affiliated group for purposes of section 6039A. Each reporting corporation would be included in only one affiliated group, either as the common parent or as a subsidiary; a first-tier subsidiary of one affiliated group would not be treated as a common parent with respect to the second- and third-tier subsidiaries for purposes of the section 6039A return requirements.

A corporation would be defined as an "includible
ration," and therefore included within an affiliated group,
 is (i) a domestic corporation that is not exempt under IRC
; (ii) a corporation incorporated in the Commonwealth of
o Rico, Guam, American Samoa, or the United States Virgin
ds; (iii) a foreign sales corporation within the meaning of
922; (iv) any foreign corporation required to file a Federal
e tax return with respect to the taxable year; or (v) any
 foreign corporation that is not otherwise required to file
eral income tax return if it carries on no substantial
nic activity or if 50 percent or more of its sales are made
e or more members of the same affiliated group, or if 50
nt of its expenses (computed without regard to payments for
gible property) or 80 percent of all its expenses are
red with respect to products or services acquired from one
re members of the same affiliated group. A foreign
ration would not be classified as an includible corporation
 clause (v) (proposed sections 6039A(c)(3)(v) and
d)(4)(G)) unless, under standards established in regulations
 prescribed by the Secretary, it is not subject to
antial foreign tax on its net income. Under these
itions a foreign corporation engaged in a U.S. trade or
ess could constitute a reporting corporation, in which case
uld be required to file a section 6039A return with respect
s U.S. subsidiaries, its foreign subsidiaries otherwise
red to file a Federal income tax return, and any of its
gn subsidiaries falling within the definition of "includible
ration" by reason of section 6039A(c)(3)(v). It would not
quired to report with respect to its other non-U.S.
diaries, although it would be required to disclose the
ence of such subsidiaries.

5. <u>Additional requirements for related corporations.</u> In
ion to the requirements that apply for corporations within
ffiliated group, section 6039A would require that a
ing corporation related to a foreign corporation described
ction 6039A(c)(3)(v) and 6103(d)(4)(G) include information
ining to such foreign corporation on its section 6039A
n. The information to be included would be the information
the foreign corporation would be required to file if it were
orting corporation. Thus, if a reporting corporation has
ntial dealings with a related foreign corporation that is
therwise required to file a Federal income tax return but is
ibed in section 6103(d)(4)(G), the reporting corporation's
on 6039A return would include the spreadsheet information on
elated foreign corporation (assuming the two corporations
ot members of a larger "affiliated group" for purposes of
on 6039A). This requirement would not apply if the foreign
ration is required to file a Federal income tax return; in
case, the attribution of property, payroll, and sales
en related corporations would ensure that the foreign

corporation would constitute a reporting corporation in its own right, and it would be directly responsible for filing its own section 6039A return.

For purposes of this requirement, two corporations would be treated as owned by the same person if they are connected throug ownership of 50 percent or more of their outstanding voting stoc by the same person, whether directly or indirectly.

6. Filing Deadlines. A reporting corporation's section 6039A return would be due 90 days from the due date (including extensions) of its Federal income tax return. The information included on a reporting corporation's section 6039A return generally would deal with the corporation's Federal taxable year In the unusual situation where the taxpayer's State and Federal taxable years are different, the section 6039A return would cove State taxable years ending within the taxpayer's Federal taxable year. If a reporting corporation is required to include on its section 6039A return State tax information pertaining to related corporations, such information would be required for the taxable years of the related corporations that end with or within the reporting corporation's taxable year. The section 6039A return filed by a reporting corporation on behalf of a related foreign corporation not otherwise required to file a Federal income tax return would reflect information for the foreign corporation for the year ending with the reporting corporation's taxable year or for the calendar year ending within the reporting corporation's taxable year.

7. Penalties. Section 6039A(e) imposes penalties for failure to substantially comply with the reporting obligation. As suggested by the Working Group Report, these penalties are identical to those currently imposed in connection with the information reporting required by section 6038, and are in addition to any fines or penalties that may be imposed under State law. Moreover, if a section 6039A return is disclosed to a State the State may treat the return as originally filed with it for purposes of imposing any such State fines or penalties.

B. Section 6103(d).

The second portion of the proposed legislation would amend section 6103(d) of the Code to provide new rules regarding the access of States to taxpayer information collected by and in the possession of the Internal Revenue Service. Although the legislation's primary purpose is to make available to States the information returns required by section 6039A, it also controls the availability to States of other taxpayer return information with respect to section 6039A reporting corporations gathered or generated by the Service, including information received under exchange-of-information agreements with other countries.

1. State access to return information. The proposed
lation would amend section 6103(d)(1) by adding the section
 information return to the return information to which
s are permitted access. State access to section 6039A
mation returns would be subject to four significant
fications. First, State access to a section 6039A
mation return would be subject to the same restrictions
cable under present section 6103 to the disclosure of
al income tax returns to State governments. Second, section
 returns would not be disclosed to any State that is not a
ified State." Third, a section 6039A return would not be
osed to a State if the reporting corporation filing such
n, or any other affiliated corporation included on such
n, computes its income tax liability on a worldwide unitary
 in such State. Fourth, a section 6039A return would not be
osed to a State unless the State has executed a
sclosure agreement with the Department of the Treasury. In
al, this agreement would permit information sharing between
s, but it would prohibit disclosure of the section 6039A
n to any State that would not otherwise be eligible to
ve such information under the requirements contained in this
raph. This agreement would also prohibit use of a section
 return to audit any unrelated taxpayer that computes its
e tax liability on a worldwide unitary basis in the State
ving such return.

With respect to Federal income tax returns and other
nation to which the States already have access under section
d), the legislation would amend current law to permit the
ng of such information between States. Such information
ng would be permitted only with respect to corporations that
reporting corporations" within the meaning of section 6039A.
ver, a State would not be permitted to share such
nation with another State unless such other State is a
fied State and the taxpayer to which such information
es does not compute its income tax liability in such State
worldwide unitary basis.

2. State access to treaty information. Section 6103(d)(1)
permits States to obtain access to returns and return
nation obtained by the Secretary under treaty
nge-of-information provisions. Treaty information would be
osed to a State only to the extent permitted by the relevant
 and would be subject to any limitations imposed by such
. In addition, disclosure of such information would be
t to the same restrictions and limitations applicable to
sclosure of section 6039A returns. Thus, if a corporation
es its State income tax liability on a worldwide unitary
 in a State, such State would not be entitled to receive any
-derived information with respect to such corporation.

3. Definition of qualified State. A State is not entitled to receive section 6039A return information or treaty informatio unless it is a "qualified State." Section 6103(d) would define qualified State as any State that does not require taxpayers to compute State income tax liability on a worldwide unitary basis. Qualified States could require worldwide unitary apportionment under three limited circumstances. First, worldwide unitary apportionment could be required if the taxpayer materially fails to comply with the requirements of section 6039A and applicable State law. Incidental procedural failures by a taxpayer, standing alone, would not justify imposition of worldwide unitar apportionment. Second, worldwide unitary apportionment could be required by a qualified State if the State is unable to obtain the records necessary to audit the taxpayer's State tax returns. This would occur only if (i) the taxpayer refuses to provide information regarding transactions between members of its water' edge group and related companies outside the water's edge group, and (ii) treaty exchange-of-information procedures are not available to the State through the Internal Revenue Service. Third, a qualified State could require worldwide unitary apportionment if the State determines, after necessary and appropriate adjustments, that separate accounting by the taxpaye and its affiliates fails to clearly reflect income or to prevent the evasion or avoidance of taxes. It is expected that separate accounting will yield appropriate results in virtually all cases

4. Definition of worldwide unitary basis. As discussed above, a State will not meet the definition of a qualified State unless its use of the worldwide unitary method of taxation is limited to specified circumstances. Moreover, even if the State is a qualified State, its access to section 6039A return information and treaty-derived information is limited to those taxpayers that do not compute their State income tax liability o a worldwide unitary basis in that State.

For purposes of these rules, the term "worldwide unitary basis" would be defined by section 6103(d)(4)(F) in a manner consistent with the water's edge limitation contained in the Working Group Report. In general, a corporation will be considered as being taxed on a worldwide unitary basis if, in computing income subject to tax, it includes an allocated share of the income of corporations other than the following enumerate corporations: (i) domestic corporations more than 50 percent o the voting stock of which is owned, directly or indirectly, by a member of the affiliated group; (ii) domestic corporations eligible for the possessions tax credit under section 936; (iii) foreign sales corporations (FSC) within the meaning of section 922; (iv) corporations organized in the Commonwealth of Puerto Rico, Guam, American Samoa, or the United States Virgin Islands; or (v) foreign corporations described in section 6103(d)(4)(F)(v or (G).

Under section 6103(d)(4)(F)(v), a State could include a gn corporation in a unitary group without violating the wide unitary prohibition if the foreign corporation has at $10,000,000 in compensation payments for services rendered, , or purchases during its most recent Federal taxable year, operty with a fair market value of at least $10,000,000 as e last day of its most recent Federal taxable year, nable to one or more locations in the United States, or if verage of the percentages of the corporation's property, nsation payments, and sales that are assignable to one or locations in the United States is at least 20 percent. In r of these cases, inclusion of the foreign corporation in a 's edge unitary group is permissible only if the foreign ration is subject to income tax in at least one State by e of its business activities in that State.

Section 6103(d)(4)(G) would permit the inclusion of a gn corporation within a water's edge group if it is a member controlled group of corporations that includes at least one ting corporation and if it has no substantial economic ity or has the requisite degree of economic dealings with members of the water's edge unitary group. A foreign ration otherwise subject to inclusion in the water's edge under these rules would be excluded from such group if, standards to be established in regulations to be prescribed e Secretary, it is subject to substantial foreign tax on its ncome. Although the Working Group Report suggested that the nination of whether the corporation pays substantial foreign ould be based on the nominal foreign tax rate, the Treasury tment does not believe that such a formulation is adequate ould expect to base required regulations on factors in ion to the applicable nominal foreign tax rate.

The proposed legislation takes no position on whether a led 80/20 corporation (defined in the Working Group Report J.S. corporation which has no more than 20 percent of its ty or payroll attributable to sources within the United s) could be included in a water's edge group. Such ations would be within the statutory definitions of ting corporation" and "includible corporation" in section however, and the inclusion of such corporations in a y combination would not violate section 6103(d)'s ctions against use of the worldwide unitary method. These sions should not be viewed as an endorsement by the Treasury inclusion of such corporations in a unitary group.

n addition, the proposed legislation remains neutral on the on whether dividends received from a foreign corporation s not a member of a permitted water's edge unitary group taxed to the recipient as part of its water's edge unitary income. Again, the fact that the inclusion of such nds in a group's consolidated income does not violate the restriction on the use of the worldwide unitary method should no be viewed as indicating that the Treasury believes the taxation of such dividends is appropriate.

6. Common agencies; designated agency. Any information with respect to a section 6039A reporting corporation that may be disclosed to a State under section 6103(d) may also be disclosed to a common agency or to the designated agency. A common agency is an agency designated by four or more qualified States to assist in the administration of the income tax laws of such States. At any given time, the designated agency is the agency designated by a plurality of the qualified States to assist in the administration of the income tax laws of such States. Only one designated agency will be recognized by the Federal government at any given time.

A common agency or the designated agency may obtain the section 6103(d) information only upon the execution of the nondisclosure agreement that qualified States are required to execute in order to obtain such information. Thus, a common agency that obtains a section 6039A return or other Federal income tax return or treaty information would be precluded from making any such return or information available to any State if such State is not a qualified State or if any corporation covered by such return or information files, or is part of a group of related corporations that file, an income tax return on a worldwide unitary basis in such State.

The prohibition against disclosure would apply to any information made available to the common or designated agency pursuant to section 6103(d). Thus, a common agency receiving a copy of a taxpayer's Federal income tax return would not be permitted to make available any information reflected on such return to any State unless such State is a qualified State and the taxpayer does not compute its income tax liability on a unitary basis in such State. Moreover, a common or designated agency would not be permitted to make recommendations or suggestions regarding audits of taxpayers to any State tax agency based upon returns or return information in the common or designated agency's possession unless the State is a qualified State and the taxpayer does not compute its State income tax liability on a worldwide unitary basis in such State.

TECHNICAL EXPLANATION: ERRATA

PAGE	CORRECTION
3	Subheading numbered "5" should be numbered "4"
4	Subheadings numbered "6" and "7" should be numbered "5" and "6," respectively
8	Subheading numbered "6" should be numbered "5"

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.

July 9, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued July 18, 1985. This offering will provide about $475 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,923 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, July 15, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated April 18, 1985, and to mature October 17, 1985 (CUSIP No. 912794 JC 9), currently outstanding in the amount of $6,735 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated July 18, 1985, and to mature January 16, 1986 (CUSIP No. 912794 JN 5).

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.

The bills will be issued for cash and in exchange for Treasury bills maturing July 18, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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. Federal Reserve Banks currently hold $1,209 million as agents for foreign and international monetary authorities, and $2,709 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-209

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, 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 July 9, 1985

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $8,506 million of 52-week bills to be issued July 11, 1985, and to mature July 10, 1986, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.07%	7.58%	92.851
High -	7.10%	7.61%	92.821
Average -	7.09%	7.60%	92.831

Tenders at the high discount rate were allotted 1%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 11,885	$ 11,885
New York	19,703,500	8,094,740
Philadelphia	4,960	4,960
Cleveland	12,885	12,885
Richmond	47,680	16,180
Atlanta	28,440	12,440
Chicago	1,034,790	81,540
St. Louis	87,680	72,680
Minneapolis	10,275	10,275
Kansas City	33,060	29,860
Dallas	13,810	8,810
San Francisco	1,236,825	21,875
Treasury	128,060	128,060
TOTALS	$22,353,850	$8,506,190
Type		
Competitive	$19,974,365	$6,126,705
Noncompetitive	479,485	479,485
Subtotal, Public	$20,453,850	$6,606,190
Federal Reserve	1,800,000	1,800,000
Foreign Official Institutions	100,000	100,000
TOTALS	$22,353,850	$8,506,190

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

For Immediate Release

THE TAX "REVOLUTION" AND THE PACE OF REFORM:
PARALYSIS OR PROGRESS?

remarks by
Richard G. Darman
Deputy Secretary of the Treasury

before
The Administrative Assistants Association
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and
Women in Government Relations

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The Bear in the Arcade

The other day I saw an undoubtedly learned obituary in the editorial section of the New York Times. It seemed to analyze the "Death of Tax Reform." I didn't read it. (I try not to read the Times.) But I felt relieved: I knew we must be making progress.

We're at that stage in the process of "revolution" when, upon hearing shots fired, many presume there must be fatalities -- when, in some quarters, the crowd begins to run; and when, among instant historians, debate begins to rage as to how key battles were lost.

But to my ears at least, the sounds of early Summer have hardly risen to the level of the guns of August -- or in this case, the likely guns of the Fall. Indeed, the sounds I've heard seem to be more like the pops of a shooting arcade. And tax reform is like the target bear. It gets "hit". It rises, pauses, turns a bit -- and then it keeps on going.

Freeze-framed Goonies

One reason the bear may at times seem momentarily frozen is that, although we live in a motion picture world, it is reported to us in single, still snapshots -- one day at a time: Snap -- "Tax Plan Termed Unfair to Middle Class;" snap -- "Two-earner Families Hit;" snap -- "Depreciation System Loses Additional Revenue" . . . and so on.

This is bound to mislead the uninitiated and unsettle the fainthearted viewer. It is a bit like freezing frames in the Spielberg film, The Goonies. For those who haven't seen the movie, it's a fast-moving comic melodrama in which a group of well-meaning kids, "the Goonies," encounter one potential horror after another -- only to come out as heroes who save their community in the end. If tax reform commentators were movie critics, many would probably leave the theater while the Goonies are still underground -- before the gold is found, and before the pirate ship floats off to the horizon. Admittedly, some of the Goonies themselves might be inclined to leave were it not for the calming influence of their youthful leader who, at one particularly precarious point, says: "It's OK. Even Goonies make mistakes. Just don't make another!"

"Revolution" -- American-style

A second reason the bear may at times seem frozen in its tracks is that its course is not as swift and certain as may initially have been suggested. It was, after all, set in motion with easy talk of "revolution" -- as if the bear might dance quickly across all lines of sight on the way to a Rose Garden signing ceremony.

This, of course, would have been a ridiculous expectation. But inflated expectations are perhaps an inescapable corollary of the American style of political rhetoric.

It is almost as if we need rhetorical excess in order to motivate ourselves. Be that as it may, we use the term "revolution" rather freely. And we have used it again with the launching of tax reform. This is perhaps the twenty-fifth major "revolution" launched since President Kennedy launched his "revolution of hope." We average about one per year.

This is not without some irony:

- It is ironic that, for all our talk of "revolution," we enjoy remarkable stability. Indeed, our stability borders on what is viewed at times as "paralysis". It has been expressed, for example, in the recent snapshot commentary on the budget "stalemate" (a stalemate that, no doubt, will pass). And it was expressed, more generally, in the once-fashionable (but now forgotten) view of the Carter period that American checks and balances had grown so stultifying that we needed to adopt some better approximation of p[illegible] government.

- It is ironic also that, for all our talk of "paralysis," we manage to enjoy substantial change. Indeed, the remarkable thing about our checked-and-balanced democracy is that it suffers from neither "paralysis" nor "revolution"; but rather, it seems relentlessly to adapt through continuous, incrementalist movement forward.

Just a Few Pops

That said, one might ask: where now is tax reform on the continuum from "paralysis" to "revolution"? Is the bear, in fact, making progress?

From my perspective, the bear is moving along a bit better than one might reasonably have expected. It has well survived the publication of a 461-page description and analysis that amounts to a detailed targeting guide for interested marksmen. And, notwithstanding the predictable pops in the shooting gallery, its progress is being pushed on a bipartisan basis -- not only by the pioneering tax reformers, but also by the chairmen of the House and Senate tax-writing committees.

Clearly none of the shots has been disabling -- for reasons suggested by this review of the most noted pops.

- <u>The alleged "unfairness" pop</u>:

  The first shot -- the "unfairness" pop -- was fired by partisans who found themselves in an awkward position. They saw that the President's proposals curtail tax shelters, raise business taxes and give the largest percentage deduction in tax liabilities to those in the lowest income categories. To maintain critical distance, they apparently felt obliged to exhibit a conspicuous interest in middle-income taxpayers. They suggested that people in the middle were being hurt to pay for various "give-backs" to business and the rich.

  But their argument was not fully sustainable. They used "Treasury I" as a basis for comparison. Yet, as a practical matter, that proposal was recognized as unviable, and current law is generally taken to be the appropriate comparative referent. Even using Treasury I as a referent, however, the "give-back" premise would not withstand analysis: Many of the so-called "give-backs" were to such groups as disabled veterans, fraternal benefit associations, workers in employee fringe benefit plans, and the beneficiaries of charity. And the so-called business "give-backs" were largely financed by offsetting changes in other corporate tax proposals -- reducing dividend deductibility, dropping interest indexing, and eliminating the windfall gain from deferred taxation of excess depreciation.

Further, it is simply not the case that middle-income taxpayers as a group would be hurt. The overwhelming majority would benefit from the President's reform proposals. And, compared with a 7.0 percent reduction overall, those in the $20,000-50,000 income range would receive a larger than average tax reduction of 7.2 percent.

It is admittedly the case that those in the over $200,000 income category would get a still larger estimated average decrease: 10.7 percent. This is not nearly as large a percentage decrease as those under $20,000 would get (18.3 percent); and it is not close to the 35.5 percent average reduction that those under $10,000 would get.

But if this becomes a bit of a perceptual problem nonetheless, I should note that the problem is hardly fundamental. A change of $1.4 billion in the upper income tax liability could bring it exactly into line with the average. Indeed, this is a small enough change to be effected by estimating correction -- as, for example, by using more dynamic assumptions about the effects of rate reductions, or by allocating business tax increases to the ultimate individual taxpayers. Even using conventional estimating assumptions, the problem might disappear merely as a result of minor modifications in the reform proposals that may emerge from the legislative process.

In any case, the problem is thoroughly manageable. In the end, the public perception of "fairness" will not turn on minor statistical technicalities. When a bill is endorsed as "fair" on a solid bipartisan basis -- as I expect one can be -- I believe the public will tend to concur in the judgment of its fairness.

- <u>The state-and-local pop</u>:

The target of the next high-visibility pop was anticipated: the proposed non-deductibility of state and local taxes.

We expected to be able to hold our own on this for two good reasons. First, the proposal is key to the reduction of personal income tax rates. Without it, there are few, if any, viable ways to reduce rates substantially. And without substantial rate reduction, there is little prospect of meaningful reform. Second, the proposal is important in its own right as a matter of fairness. The present system of deductibility favors a small number of high-income itemizers at the expense of the very large majority who do not itemize; and, more particularly, the current system especially favors high-income itemizers in a few high-tax states -- at the expense of all the rest.

We anticipated that even among higher tax states there would be some who would recognize and affirm the overall merit of reform -- not just in general, but for their states in particular. And we have been pleased that many state and local officials from higher tax states have indicated their willingness to support non-deductibility in the context of overall reform.

What we did not anticipate was just how highly concentrated the source of the popping on this issue would be. That concentration has served to make the fairness point more clearly and compellingly than any way we might have imagined. Indeed, we ourselves originally contemplated using the reenactment of the Boston tea party as a metaphor for "revolution." But, on balance, I'm happy that New York beat us to it.

- <u>The "retroactive" "punitive" pop</u>:

Another early pop in the gallery came from some corporate shooters who didn't like the windfall depreciation recapture proposal. Some of them termed it "retroactive" and "unconstitutional" -- apparently misunderstanding both the proposal and the case law on this issue. Some also termed it "punitive" -- mistakenly seeing it as a $56 billion tax increase relative to current law. It is, in fact, a very much smaller increase relative to current law -- resulting from what is no more than a partially accelerated repayment schedule for deferred obligations. The 56 billion dollar number relates not to current law, but to the proposed law under which the maximum corporate tax rate would be 33 percent.

As the proposal has become better understood, the popping has quieted. Indeed, the character of criticism on this issue has shifted away from outright opposition, and toward a discussion of alternative ways to structure a windfall recapture.

- <u>The working-mom-and-pop pop</u>:

A more recent pop has come from analysis of the composition of the prospective tax losers. This analysis suggests that a substantial number of such losers would be two-earner families with children.

It is important to note that overall, under the President's proposals, winners would outnumber losers by almost 4 to 1. Even so, one would not wish to create an avoidable working-mom-and-pop pop.

It appears that the problem derives in considerable measure from the interaction of two proposals: the new rate structure and the change from the current declining child care credit to a simple child care deduction. If necessary, it should be possible to design a satisfactory technical correction without prohibitive cost.

• <u>The "competitiveness" pop</u>:

A somewhat less resonant pop has been heard from some of those who profess an interest in U.S. competitiveness and who happen to be in the "smokestack" portion of the U.S. manufacturing sector. They allege that tax reform will disadvantage the U.S. competitively.

Unlike the "smokestack" manufacturers (who themselves include some favorable exceptions such as Bethlehem Steel), many other manufacturers with an interest in competitiveness are basically supportive of the President's proposals. These manufacturers range from the IBMs, 3Ms, GMs and the fast-growing members of the American Business Conference to the thousands of smaller-scale entrepreneurs and venturers who contribute most to America's growth.

Without meaning to suggest that an interest in competitiveness is inappropriate, however, I would suggest that concern about competitiveness need not be linked to tax reform. There are several appropriate objectives for tax reform that are more relevant at this stage than improving competitiveness. And there are many potential contributors to the solution of the U.S. trade problem that are more important than the U.S. tax system. These include the various factors that affect the dollar's relationship to other currencies, the openness of the trading system, and the efficiency of U.S. production.

Yet clearly, no tax reform should be enacted that would affect overall U.S. competitiveness adversely. And as it happens, the President's proposals would have a <u>favorable</u> overall effect upon U.S. competitiveness. The cost recovery system would compare favorably with most industrialized countries. The 33 percent corporate tax rate would be at the low end of the range among our major trading partners. The overall cost of capital would decrease relative to current law. The R&D credit and the reduced capital gains rate would encourage greater innovation and productivity growth. The curtailment of shelters, the personal rate reductions, and the spousal IRA modification would increase savings and productive investment somewhat. A more neutral depreciation system would, over time, increase efficiency through more market-oriented capital investment. And the perception of increased fairness could reasonably be expected to increase labor efficiency by reducing worker alienation.

So while increased competitiveness is not a principal objective of the President's tax reform proposals, it is nonetheless a test that can satisfactorily be met.

• <u>The "revenue neutrality" pop</u>:

The pop of current interest seems to be a pop that has not yet really been triggered. It involves the objective of "revenue neutrality." Some have suggested that the President's proposals would not meet this test.

The Administration has committed itself unequivocally to revenue neutrality. So the issue is, in large measure, a technical issue of estimating.

Estimating is, of course, highly uncertain and highly arguable. But to be sure that tax reform did not founder on an issue of estimates, we decided at the outset to try to neutralize this issue by avoiding any controversial, unconventional estimating procedures.

Most notably, we have consistently said that we would measure revenue neutrality on a basis that uses the same macro-economic assumptions for the analysis of the new proposals as are used for the analysis of current law. This is in spite of the fact that we and many thoroughly respectable outside economists believe that tax reform will increase long-term economic growth. We have also said that we will treat with respect the work of the traditional tax estimating staff of the Congress's Joint Committee on Taxation.

We look forward to the Joint Committee's estimates without yet knowing whether they will amount to a pop. If their estimates suggest that our proposals are not revenue-neutral within a reasonable margin of error, we will work with the Congress to make them revenue-neutral. So, without knowing whether there will be another pop or not, we are confident the bear will keep on moving forward.

In addition to the technical dimension of revenue estimating, there is also a political dimension that some have pointed to. They have suggested that whatever the technical estimates of the President's proposals, political dynamics will tend to reduce the revenue base as compromises are struck.

This, of course, is a realistic concern. But we have been encouraged by two things. First, as a general matter, there seems to be a broad political consensus that tax reform must proceed on a revenue-neutral basis. Second, as an extremely important particular matter, Chairman Rostenkowski has indicated that he will insist on revenue-neutrality in the mark-up process: any proposed amendment must itself be revenue-neutral. That is, any "give-back" proposal must, in one way or another, be self-financing.

This approach will impose an extremely valuable discipline on the process. Indeed, if the draft on the table has a maximum rate of 35 percent and all proposed amendments must be revenue-neutral, the chances of the ultimate bill amounting to significant reform become extremely high.

The only way to stop the bear would be to shut off the game.

The Deficit-Before-Taxes Switch

The one way to shut off the game is to press the delay switch. And the easiest way to delay seems to be to rest on the argument that the deficit must be satisfactorily reduced before rate-reducing tax reform should move forward.

This argument involves two false premises:

- The first is a variant on the "Congress-can't-walk-and-chew-gum-at-the-same-time" theme. It is patently false. Congress has demonstrated again and again that it can not only walk and chew gum simultaneously, it can also play the equivalent of the glockenspiel. Admittedly, the harmonics are often a bit off. But there is at least a forward march.

- The second false premise is that a fully satisfactory set of deficit-reducing measures will be enacted in the foreseeable future. I noted that the recent budget stalemate will soon pass; and I do not in any respect mean to suggest that reaching agreement in the budget conference is not important. But the likely agreement will still leave much to be done. There will be the implementing legislation to enact in September. If that is not all satisfactorily resolved, there will be a struggle over the continuing resolution. And in any case, even with the implementing legislation, there will be the continuing prospect of deficits well in excess of $100 billion. More will have to be done. And to suggest that tax reform should wait for the responsible completion of the budget process is to suggest what may be a rather long wait.

For these reasons, we are especially pleased that key Congressional leaders have committed themselves to a firm tax reform timetable. Chairman Rostenkowski has pledged to deliver a bill by mid-October. Speaker O'Neill has said that the House will not be responsible for preventing tax reform this year. And Chairman Packwood has said that if the Senate gets a bill by October 15, the President (and the American people) can have tax reform by Christmas.

Commitment to such a timetable was key to our success in 1981 -- and it is key to success this year. It may seem ambitious to some. But it is both responsible and doable.

The Full-Length Movie

But what if tax reform is delayed beyond this year nonetheless? Does the game really stop?

I think not. It might just become more difficult for a while. The substantive and conceptual character of the reformist interest might be expected to shift; and coalitions would probably have to be restructured.

But tax reform is part of a somewhat longer running movement (or should one say "movie"?) than is assumed by those who think of it as having been launched with the President's proposals. It has arisen, in part, as a response to people's dissatisfaction with the growth of government and inflation in the '70s. This dissatisfaction was met in part by the 1981 tax bill. The movement has arisen also out of dissatisfaction with the structure of economic incentives and with the perceived unfairness of our present system. The response to these causes of dissatisfaction has yet to be enacted.

Yet a response is bound to come. The dissatisfaction with the present system is unsustainably high and will demand a remedy from our democracy.

Indeed, the present tax system is in the process of self-destruction. The high rate structure causes excessive sheltering, which only increases the alienation of the majority who do not benefit from shelters. As alienation increases, voluntary compliance continues to fall. And as the Congress attempts to enact tougher compliance measures within the framework of the present system, they are repealed before they can be implemented -- as dissatisfaction increases further.

Fortunately, the American political system does not allow self-destruction. It just operates like a Spielberg melodrama and heightens the suspense before finding its way out of the latest trial or tribulation. This seems to be an inescapable characteristic of a pluralistic democracy in which substance and politics are inextricably linked.

The Paddington Face of Reform

So the bear will keep on coming in its relentless pursuit of progress. The only question is whether it may have to wait so long that it changes its fundamental character along the way. There is no good reason that it should have to do so.

Right now, it is basically a friendly bear. So let me leave you with a final metaphor: Think of its face as a Paddington. And let me close with the words of an undoubtedly great, but regrettably anonymous, tax reformer -- the words worn by every Paddington bear: "Please look after this bear. Thank you very much."

TREASURY NEWS

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REMARKS OF THE HONORABLE JOHN M. WALKER, JR.
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U.S. DEPARTMENT OF THE TREASURY
AT THE
SHOWCASE PROGRAM OF THE
INTERNATIONAL BUSINESS AND BANKING COMMITTEES
ANNUAL MEETING OF THE AMERICAN BAR ASSOCIATION
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The Extraterritorial Reach of U.S. Laws: A View from the Perspective of the Treasury Department

It is indeed a pleasure to be here this morning to participate on a panel that will explore one of the most intriguing and perplexing issues in international law today. While you will be hearing from experts in the fields of Banking Law and International Law who will explore the leading cases with you, I would like to take this opportunity to discuss extraterritoriality from the Federal government's policy perspective and to highlight some aspects of the issue that are of particular interest to the Treasury Department.

To begin this discussion, I would like to provide a brief survey of the extraterritoriality problem with particular emphasis on law enforcement and then outline some of the developments in the steps the United States is taking in its willingness to ease the kinds of difficulties that we have seen. Finally, I will offer some observations regarding the ways in which our courts have wrestled with extraterritorial issues.

In the most well-known and most dramatic illustration of the problem, the U.S. imposed sanctions in 1982 against Poland and the Soviet Union in connection with the Soviet natural gas pipeline that reached subsidiaries and licensees of U.S. companies located abroad. As we know, that problem was resolved through diplomatic means. But the underlying issues have arisen in other areas. The United States has clashed with Switzerland over foreign evidence production in the Marc Rich fraud investigation and with Canada, the Bahamas and the Cayman Islands in the Bank of Nova Scotia case as we have sought bank records relating to narcotics. Disputes have arisen over the unlicensed reexport of critical technology from the country to which the goods were exported from the United States.

Antitrust investigations, both by U.S. grand juries and in the course of private actions, have sought records from foreign countries and would impose sanctions, including treble damages, against persons engaged in anticompetitive conduct abroad, even though such conduct is perfectly legal in the country where it occurred. Other examples abound as we seek records for tax administration, money laundering investigations or customs fraud.

All of these events have in common what has come to be called extraterritoriality, or "E.T." But this term is perhaps misleading in that it emphasizes too much the role of territory as the situs of conduct in jurisdictional matters. Historically, territoriality is but one facet of the traditionally recognized bases for jurisdiction in international law among others such as nationality, protection of security interests, and universal crimes. The common thread is not territoriality, but rather the requirement of some genuine link between the country exercising the jurisdiction and the foreign person or conduct in question.

Therefore, a more accurate term for the problem confronting us would be conflicts of transnational jurisdiction, by which I am referring to controversies between nations over the exercise of regulatory, investigative and enforcement jurisdiction over conduct and property located beyond the borders of the state exercising that jurisdiction. And the term "jurisdiction", of course, must be seen in its various international contexts. We are concerned here with such varied powers as jurisdiction to adjudicate a conflict, jurisdiction to prescribe a rule of law, jurisdiction to compel the production of evidence, and regulatory jurisdiction.

At the outset, we might consider why extraterritorial reach has become as important, and also as controversial, as it is today. One reason, clearly, is that extraterritorial issues can be seen as an outgrowth of burgeoning international trade. Similarly, other forms of business activity as well as corporate relationships have become increasingly international in scope, and this trend is bound to continue.

Moreover, in the context of federal government policies in recent years, the United States has relied increasingly on the imposition of controls and sanctions to achieve its foreign policy, international trade, and national security objectives. In a world in which military options are usually foreclosed and infrequently considered, it is not surprising that countries resort to economic sanctions as a means of effectuating their foreign policies. An October 1983 study by the Institute for International Economics aptly documents this trend. The study counted only 20 instances in which sanctions were imposed, by all nations, in the 36 years between 1914 and 1950. In the decade of the 1950's, there were 12 instances. The number grew to 21 in the 1960's, and to 34 in the 1970's. In this decade, the upward trend appears to be continuing, with 12 instances of sanctions occurring prior to mid-1983. Issues of conflicts of jurisdiction are an almost inevitable consequence of this trend.

Additionally, conflicts of jurisdiction are a necessary consequence of our country's response to the threat of crime. Just as all forms of sophisticated conduct designed to violate or evade our nation's laws may occur abroad in whole or in part, so also law enforcement, to be at all effective, must be able to find evidence, locate persons and investigate conduct that, although found on the territory of another, harms U.S. interests or persons. To take just one example, we know that organized crime has gone international, and that the money laundering that fuels organized crime pays no heed to national boundaries. In particular, drug trafficking has reached such gigantic proportions, in an international sense, that a strictly territorial approach to jurisdiction is wholly inadequate. In short, the imperatives of law enforcement in our society will never permit the elimination of transnational jurisdictional conflicts. These conflicts are here to stay. While E.T. is a fact of life, it is not a welcome one in the international community.

Indeed, the enactment of blocking statutes, such as those of the U.K., Australia, Canada, South Africa, France, and Switzerland, bear witness to the international unpopularity, not only of the United States' assertion of jurisdiction, but of its willingness to exercise it.

The state of uncertainty and disequilibrium in the international economic and legal order caused by jurisdictional conflicts can place a private party in the impossible dilemma of having to comply with conflicting laws. It also has the potential for harm to international relations. Thus it requires the economic, legal and political leadership of all interested countries to continue to search to find ways to handle what is a highly complex and difficult situation.

As Secretary Shultz put it in a speech to a Bar Association in May of 1984, "The question we face ... is not whether extraterritorial reach should be permissible, but how and when it should be done." He noted that, "Since the threat of extensive application of domestic law -- be it U.S. or European law -- to entities or persons abroad has the potential to harm the fabric of the global economic system, it is imperative that we manage the problem of conflicts of jurisdiction."

I would now like to review with you measures currently underway in the Executive Branch that are designed to deal with E.T.

Managing Jurisdictional Conflicts by the Executive

First, I want to make clear that the Executive Branch is in broad agreement on the need for an approach of moderation and restraint when contemplating actions that can be expected to lead to conflicts with the laws and policies of the other nations. This is precisely the position that our delegation expressed last month to the OECD's Committee on International Investment and Multinational Enterprise. We expressly agree with the OECD approach of respecting and accommodating the interests of other member countries by incorporating the principle of comity into administrative and regulatory decisions.

But we must insist that the approach of moderation and restraint be a mutual one. The balancing of vital interests by policymakers may, and often must, lead to results that do not accord with an analysis based on territorial considerations. We accordingly urge that actions by other nations in response to the reach of U.S. jurisdiction also be guided by principles of comity. For example, enactment of so-called "blocking statutes" may be unavoidable as nations seek to protect what they regard as their significant interests. But the invocation of these statutes should be subject to considerations of moderation, restraint, and accommodation. And, for the most part, I think it is fair to say that we have seen considerable deference to these principles.

The Executive Branch of the United States is moving to manage E.T. in five basic areas of endeavor.

First, in its dealings with foreign governments, the United States has pursued the "practical approaches" to the resolving of jurisdictional differences that were endorsed at the 1984 OECD Ministerial meeting. These include bilateral arrangements, such as the mutual legal assistance agreements in place with Switzerland, the Netherlands, and Turkey and on the drawing board with Canada, Colombia, Italy and Morocco. They include the anti-trust agreements in place with Canada, Australia and West Germany, the recent narcotics-related information exchange agreement covering Cayman Island banks and a similar arrangement with Switzerland that has been in place for a decade now.

These arrangements are proceeding smoothly. My office, in conjunction with the Departments of Justice and State, is currently seeking or planning to seek several new international agreements that will allow us access to records for use in financial investigations. We have also had consultations with the Canadian government on issues of concern to the enforcement of national security export controls. Moreover, a U.S.-Canada subpoena working group now meets to review the status of outstanding efforts to obtain evidence for criminal prosecutions. My colleague, Jonathan Fried, will be discussing these procedural responses in his presentation today.

A second area of executive activity has been to create better inter-agency coordination to ensure that there is full consideration of the foreign policy implications of conflicts before executive or administrative action is taken and to provide for advance notice and consultation to affected countries. At present, a procedure is under review by the highest levels of government that would require advance notification to the State Department of planned actions in order to solicit the views of that Department and to allow for appropriate diplomatic contact.

Thirdly, the Executive Branch has been careful to shape proposed legislation with a view to ameliorating friction caused by jurisdicational contacts. Just last month, Treasury and Justice sent to Congress a bill that would make money laundering punishable as a separate offense. While the bill covers foreign money laundering transactions, it applies to non-U.S persons abroad only if the transactions are tied to an element of conduct in the U.S. Moreover, such transactions must be carried out with actual knowledge of their money laundering consequences. Conduct in "reckless disregard" would be punishable only if it occurs in the U.S.

Another example is the amended Export Administration Act, which is currently on the President's desk. It places some limits on the imposition of foreign policy controls and prevents the interruption of existing contracts or export licenses except in special circumstances. The Administration is also giving serious consideration to legislation introduced by Senator DeConcini that attempts to avoid international jurisdictional conflicts in antitrust cases with international implications by requiring judges to consider the application of principles of comity and providing for detrebling of damages.

Forthly, the Executive Branch, at the Departmental level, is today in fact fully considering potential extraterritorial effects prior to taking action with a view to minimizing jurisdictional disputes.

A few examples from Treasury's administration of sanctions under the International Emergency Economic Powers Act (IEEPA) will illustrate this point.

The IEEPA, like its companion statute, the Trading with the Enemy Act, has a broad extraterritorial reach. In each of the following situations, Treasury took steps to limit this extraterritorial reach to the extent consistent with the purpose of the sanctions.

Many of you are familiar with the sanctions that our country imposed against Iran after the taking of American hostages in Tehran in 1979. Our immediate response was the Iranian asset freeze, which commenced on November 14, 1979.

The question arose whether Iran had a blockable interest in dollar deposits, located in the United States, that were owned by foreign banks that themselves held dollar-denominated accounts for Iran. It was and is Treasury's position that the Act authorizes blocking of these "cover accounts," and in past embargoes such accounts were indeed blocked. It was also clear to us that such an action would be viewed as highly intrusive, and would in all likelihood be challenged, by the host countries of those banks. Accordingly, Treasury effectively "unblocked" these U.S.-situs dollar deposits by issuing a general license for them at the time we promulgated the regulations.

Another potential challenge arose regarding the branches and subsidiaries of U.S. entities abroad. Many of these had claims against Iran as well as assets in which Iran had an interest. Treasury anticipated challenges in foreign courts with respect to the blocked assets. To avoid this, and to mitigate the burden of the exercise of jurisdiction, Treasury licensed set-offs against the Iranian claims, to the extent authorized under local law. The effect was to unblock a substantial number of assets held by branches or subsidiaries of U.S. firms abroad.

A further mitigating step was taken one week after the hostage crisis had begun. Cognizant of the disruptive effect of blocking foreign-situs, foreign-denominated deposits held by foreign branches and subsidiaries of U.S. banks, Treasury unblocked deposits in foreign currencies while maintaining a freeze on dollar accounts.

These are only some of the ways we sought to eliminate or minimize foreign conflicts of laws in the case of the Iranian sanctions. And in retrospect, the steps taken were a factor in minimizing jurisdictional problems arising from the asset freeze and trade embargo.

There was another, more intangible factor as well: a policy consensus. Our allies and trading partners appreciated the clear and substantial interest of the United States in securing the release of the hostages. This factor, I would suggest, was largely absent in the case of the foreign policy export controls imposed on oil and gas equipment in response to Soviet actions in Poland.

In constructing the Nicaraguan sanctions earlier this year, our government again took special measures to avoid conflicts of jurisdiction with third countries potentially affected. The embargo against Nicaragua, you may recall, prohibits Nicaraguan-origin goods and services from entry in the U.S., it prohibits U.S. exports to Nicaragua, directly or indirectly, and it precludes aircraft or vessels of Nicaraguan registry from entering U.S. territory.

We have followed an overall course of moderation and restraint in this embargo with regard to jurisdictional conflicts. For example, we allow overseas branches and subsidiaries of U.S. firms to import Nicaraguan goods and to export to Nicaragua. These "offshore transactions" can even be effectuated in the U.S. and still be legal, provided the goods never enter or leave the U.S. You might say that we followed a pure "territorial" approach in the case of Nicaragua. Furthermore, the embargo does not apply to imports or exports that are substantially transformed abroad. In addition, preexisting contracts were honored where U.S. payment for Nicaraguan goods had been made and where interruption of exports to Nicaragua would work an unmitigable hardship on the U.S. exporter.

Fifth and finally, the government is working to resolve the underlying policy differences between nations that create the jurisdictional conflicts. For instance, the policy conflict inherent in the regulation of exports to the Soviet bloc for national security reasons has been sharply reduced through a series of high level meetings of COCOM, the Coordinating Committee on Export Controls consisting, in the main, of the NATO allies.

In the field of antitrust, we have been able to reach the notice and assistance agreements referred to earlier because we have been able to jointly articulate a certain attitude toward competition policies and comity. Similarly, law enforcement mutual assistance agreements have been reached because of a policy consensus on criminal conduct.

The "Balancing-of-Interests" Test

I would like to turn briefly to the ways in which courts have dealt with transnational jurisdictional conflicts. We are all familiar with the so-called "balancing-of-interests" test, which has its roots in considerations of comity and in the choice of law analysis that is well established in domestic conflict of laws cases. A line of cases beginning with Timberlane Lumber and Mannington Mills employs this test in an attempt to resolve conflicts based upon the principles of comity. The test, however, has encountered both praise and criticism.

On the positive side, I think we would all agree that the Timberlane approach has considerable strengths. First of all, it recognizes that in transcending a strictly territorial approach, we need a means of adjusting the exercise of jurisdiction to the rights and prerogatives of the other affected states. Its use of the inherent flexibility of comity -- as more than mere courtesy or good will, less than an absolute obligation -- seems essential to any lasting solution to the problem of international jurisdictional conflicts.

Second, and more specifically, this test creates a framework under which a court can give appropriate weight to the interests involved and assess the degree of conflict between the law and policies of the U.S. and those of other countries. The analysis, in its various formulations, includes specific factors that guide a court's inquiry into jurisdictional questions.

This latter strength, the weighing of interests, is also the source of the test's weakness, and the basis for much of the criticism. In requiring a court to take into account the relative interests of the countries involved, and to assess their relative importance to those countries, along with other factors, the test may require a difficult foray into the thicket of international politics and U.S. foreign policy.

In such cases, we clearly need a reliable procedure for getting the right foreign policy considerations before the court. If we want courts to give these views great deference -- and we do want this -- we should not make them resort to reading tea leaves provided by the lawyers, whose concern for the sovereign's interests is at best derivative. Two recent and familiar cases amply demonstrate this.

The first is the Second Circuit's recent decisions in the Allied Bank case, and because this case is probably familiar to most of you, I will not dwell on the details. Also, my fellow panelist Bruce Nichols will be discussing other aspects of this case in some detail.

What is significant for this discussion is the problem posed by the initial decision of the Second Circuit, later reversed upon rehearing, that considered U.S. foreign policy toward Costa Rica to be consistent with a moritorium that was imposed by the Costa Rican government. This moritorium prohibited Costa Rican banks from making payments due under loan agreements with a syndicate of U.S. and foreign banks. The court had reached this conclusion based on Congressional and executive policy statements indicating that the U.S. had a strong interest in providing assistance to Costa Rica.

The United States joined other amici in petitioning for rehearing. At stake was more than the contract rights of the creditor banks: the initial decision threatened the orderly resolution of the international debt crisis by discouraging further private lending to debtor countries, which is essential to a long-term, orderly debt repayment process.

The decision upon rehearing gave no effect to the moritorium. Had it done otherwise, the negative implications for the orderly process of international debt resolution would have had unfortunate and lasting consequences.

I cite this case only to show that our current method of getting foreign policy considerations before our courts is in need of improvement. In Allied, it took the cumbersome procedural mechanism of a rehearing to make the correct U.S. foreign policy considerations available as a factor in the comity analysis.

A second example of this need for improvement is provided by Judge Starr in his dissent in the Laker Airways case. He concluded that the District Court would have been better served had it invited the Executive Branch to submit its views regarding the litigation. Those views, the judge asserted, might well have had an important bearing upon the court's determination of U.S. sovereign interests in the case.

I do not mean to imply that our courts are not equipped to adjudicate complex questions of international jurisdiction and comity. On the contrary, there are many complex and arcane fields of expertise with which Federal courts must deal. They are able to do so if the expertise beyond their training is accessible to them. It is sometimes asserted that issues involving comity are better off left to the Executive Branch, but I think this argument misses the point. The long-term development of principles of international law owes most of its vitality to decisions of courts in individual countries.

In summary, I believe our future progress in alleviating the difficulties associated with issues of international jurisdiction will depend on three things. First, we must permit and encourage our courts to adjudicate jurisdictional conflicts on the basis of law and comity, and to obtain, and give great weight to, the views of the Executive in appropriate cases. Second, we must build on our progress in managing extraterritorial effects -- through interagency coordination, through mutual assistance treaties and other bilaterals, through notification, through consultation, and through reduction of policy differences. Finally, in the Executive and Legislative Branches, we must continue to use moderation and restraint in planning and implementing actions that we can predict will lead to possible conflicts of jurisdiction of international scope.

Thank you sincerely for your kind attention.

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

FOR IMMEDIATE RELEASE

July 15, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,203 million of 13-week bills and for $7,224 million of 26-week bills, both to be issued on July 18, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 17, 1985			:	26-week bills maturing January 16, 1986		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.05%	7.28%	98.218	:	7.18%	7.55%	96.370
High	7.07%	7.30%	98.213	:	7.20%	7.58%	96.360
Average	7.06%	7.29%	98.215	:	7.20%	7.58%	96.360

Tenders at the high discount rate for the 13-week bills were allotted 58%.
Tenders at the high discount rate for the 26-week bills were allotted 95%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 38,850	$ 38,390	:	$ 33,490	$ 33,490
New York	17,131,155	6,182,775	:	17,187,865	5,985,315
Philadelphia	30,295	30,295	:	26,060	26,060
Cleveland	56,205	51,090	:	34,465	34,465
Richmond	70,790	48,290	:	136,170	97,970
Atlanta	55,370	42,870	:	55,280	37,980
Chicago	1,049,875	136,575	:	941,240	345,040
St. Louis	71,005	51,005	:	60,410	20,410
Minneapolis	36,840	11,840	:	44,435	43,185
Kansas City	73,890	66,690	:	59,570	59,370
Dallas	43,925	33,925	:	33,275	23,275
San Francisco	1,602,190	175,190	:	1,599,465	120,140
Treasury	333,940	333,940	:	397,210	397,210
TOTALS	$20,594,330	$7,202,875	:	$20,608,935	$7,223,910
Type					
Competitive	$17,737,500	$4,446,045	:	$17,789,085	$4,504,060
Noncompetitive	1,211,800	1,211,800	:	1,068,850	1,068,850
Subtotal, Public	$18,949,300	$5,657,845	:	$18,857,935	$5,572,910
Federal Reserve	1,309,030	1,209,030	:	1,400,000	1,300,000
Foreign Official Institutions	336,000	336,000	:	351,000	351,000
TOTALS	$20,594,330	$7,202,875	:	$20,608,935	$7,223,910

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 a.m. EDT
July 15, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the netting of income and losses by farm cooperatives. This hearing is in response to a floor amendment to the supplemental appropriations bill for fiscal year 1985, as reported recently by the Senate Committee on Appropriations. That amendment directed the Treasury Department to study cooperative netting issues. While our study has just commenced, I will share with you today the issues and tax policy considerations that have been identified. The Department of Agriculture, while not testifying here today, also may submit to this Subcommittee further information regarding the importance of netting to farm cooperatives. I would like to note at the outset that, while farm cooperatives are undoubtedly the largest and most prominent cooperatives in existence today, the issues under examination at this hearing are germane to numerous activities conducted by cooperatives, not just farm activities.

It is frequently the case that when special rules are incorporated in the tax code to accommodate uniquely situated taxpayers, such as farm cooperatives, taxpayers have a tendency to expand those rules beyond the bounds of their intended task. As a consequence, responsible administrators must restrain the freedom with which taxpayers interpret the boundaries of such rules. This, in turn, typically involves a careful balancing of competing concerns.

The issue under study today, the practice of netting by farm cooperatives, requires just such a balancing. The practice is in some circumstances inextricably linked with the fundamental purposes of legitimate cooperatives, but in other circumstances netting may not be in the interest of the cooperative patrons and may indirectly contribute to the goals of those who would undermine the integrity of our system of corporate taxation. In order to establish a framework for understanding Treasury's attempt to strike an appropriate balance between these competing considerations, I will outline our normal system of corporate taxation, summarize the reasons for which farm cooperatives have received special treatment, and describe the history of the special statutory treatment of cooperatives. Finally, I will illustrate the tension between cooperative taxation and regular corporate taxation and describe why we feel it is appropriate for some constraints to be placed on the manner in which cooperatives are permitted to net income and loss from different activities.

Taxation of Corporations

In general, corporations are taxed on their earnings and owners of corporations are taxed when corporate earnings are distributed to them. Since distributions of corporate earnings are not deductible, distributed earnings are in effect taxed twice. This regime of "two-tiered" taxation applies to the great majority of corporations in America. Some closely held corporations with very simple capital structures may elect to be treated similarly to partnerships, and certain kinds of investment companies may avoid the corporate level tax by regularly distributing their earnings. But, as a general rule, business corporations and their owners are subject to a two-tier tax.

Throughout the history of our tax system, corporations have attempted to avoid one tier of tax by shifting corporate income to their shareholders. The Congress, the Internal Revenue Service, and the courts have acted to thwart those attempts where the income was actually earned by the corporation. Thus, if a corporation manufactures goods and distributes those goods to its shareholders, who then sell the goods at a profit, the profit will be taxed at the corporate level and the shareholders will be treated as receiving a taxable dividend.

Special Status of Farm Cooperatives

Before describing the special treatment of farm cooperatives under the Internal Revenue Code, I would like to outline briefly the role of farm cooperatives as it has been described to the Treasury Department by representatives of the agricultural community.

First, a farm cooperative provides a vehicle through which small farmers can combine to benefit from efficiencies of scale, increased market power, and enhanced capital formation opportunities. Second, a diversified farm cooperative can enable its members to insulate themselves to some extent from the volatility and uncertainty of agricultural production and distribution. Third, the cooperative form enables farmers to obtain these benefits without relinquishing control or profits to equity investors whose interests might not coincide with those of the farmers.

In order to accomplish these objectives, farm cooperatives usually are organized so that shares of capital stock or other equity interests are owned by patrons in amounts roughly proportional to patronage with each equity owner being limited to a single vote. Net earnings also typically are allocated in accordance with patronage. With such a structure, a farm cooperative is more likely than an ordinary investor-owned corporation to serve the interests of its patrons.

The current Internal Revenue Code encourages farmers, and others, to utilize the cooperative form to obtain these benefits. It permits the corporate level tax to be eliminated where the cooperative's profits are attributable to activities conducted for the mutual benefit of all of its patrons, provided those profits are in fact distributed or allocated equitably to the patrons.

History of Tax Rules Governing Cooperatives

Subchapter T of the Internal Revenue Code contains the rules providing relief to certain cooperatives from the two-tier tax. Those rules govern the taxation of most cooperatives, including farm cooperatives. By its terms, Subchapter T applies to farm cooperatives described in section 521 and, in general, other corporations "operating on a cooperative basis." According to section 521, farm cooperatives also must be "organized and operated on a cooperative basis." Although section 521 states generally that a farm cooperative meeting the requirements of that section is exempt from taxation, the apparent exemption is explicitly qualified by a reference to Subchapter T, which provides that farm cooperatives are subject to the regular corporate tax. Thus, Subchapter T applies only to organizations that operate on a cooperative basis, and, subject to certain special deductions allowed under Subchapter T, those organizations are all subject to the corporate tax.*/

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*/ The "exemption" from tax provided farm cooperatives described in section 521 is not a true exemption. Rather, section 521 cooperatives are entitled to deduct (1) dividends paid on capital stock and (2) amounts paid to patrons on a patronage basis from earnings derived from business done for the United States or from other nonpatronage sources. Non-exempt cooperatives are not entitled to these deductions.

Subchapter T was enacted in 1961 because of Congress's concern that cooperative patronage income was escaping taxation entirely. This concern arose because of the liberal treatment of non-exempt cooperatives by the Internal Revenue Service. For many years, despite the absence of any specific statutory provisions, the Service had permitted a non-exempt corporation operated on a cooperative basis to deduct from its income certain qualifying amounts of patronage earnings that were retained by the corporation, provided they were allocated to patrons pursuant to a pre-existing obligation. However, some courts held that a non-interest-bearing certificate representing the patron's conditional right to receive retained amounts allocated to his account had contingent value only and therefore was not taxable when distributed to the patron. As a result, patronage income allocated to patrons by means of non-interest-bearing certificates escaped current taxation at both the corporate and patron levels.

In order to ensure that all patronage income would be taxed currently, Congress enacted Subchapter T. The provisions of Subchapter T generally codified the prior administrative practice with respect to the requirements for deductible distributions of patronage earnings. They made it clear, however, that all patronage income must be includable in the taxable income of either the cooperative or the patrons, and established rules for determining the circumstances in which the tax incidence of patronage income has been shifted from the cooperative to its patrons, as well as the time for reporting that income. If an organization either is not operated on a cooperative basis or does not comply with the specific requirements regarding the payment of patronage earnings to patrons, the organization cannot avail itself of the special Subchapter T deductions for distributions to patrons.

An important condition on the deductibility of patronage earnings, both under Subchapter T and under prior administrative practice, is that the allocation of the earnings be made pursuant to a pre-existing obligation to the patron. Section 1388 expressly provides that a "patronage dividend" means:

> an amount paid to a patron by [a cooperative] under an obligation of such [cooperative] to pay such amount, which obligation existed before the [cooperative] received the amount so paid.

Thus, if a cooperative distributes patronage earnings to its patrons, but had the discretion to use those earnings for purposes other than making that distribution, the distribution is not a deductible patronage dividend.

Use of the Cooperative Form to Avoid the Corporate Tax

It does not follow, of course, that a corporation should be permitted to escape the corporate tax on its profits simply by calling itself a cooperative, if the activities from which it derives its profits are not conducted for the mutual benefit of all of its patrons. Indeed, it has been held that a cooperative may not offset nonpatronage earnings with patronage losses and thereby avoid the corporate tax on the earnings derived from nonpatronage activities. Farm Service Coop. v. Commissioner, 619 F.2d 718 (8th Cir. 1980). The Farm Service case makes it clear that nonpatronage income is to be taxed at the corporate level. Similarly, there are instances in which patronage income should be taxed at the corporate level. The mere fact that all of a corporation's profits are distributed on the basis of patronage should not negate the corporate tax.

It is not difficult to see how patronage of a corporation ostensibly organized as a cooperative may be used in an attempt to eliminate the corporate tax in situations where that tax unquestionably should be imposed. Assume, for example, that a corporation is owned by shareholder/patrons. The corporation sells $10,000 worth of widgets to 1,000 of its shareholder/patrons and earns a $1,000 profit on those sales. Assume also that the corporation markets $20,000 worth of shirts produced by five of its shareholder/patrons and pays those patrons $21,000 for those shirts, creating an offsetting $1,000 loss. If the five patrons who produce shirts effectively control the corporation (because voting is on a patronage basis or because no widget patron has enough of a stake in the corporation to make voting worthwhile), and no distribution of the profit on the widgets is made to the widget patrons, it appears that the shirt patrons have used their patronage of the corporation as a device for distributing to themselves the $1,000 profit earned by the corporation from widget sales.

If the corporation in this example is taxed as an ordinary corporation, the artificial loss created by the excessive payments for shirts will be recharacterized as a nondeductible dividend and the corporation will be taxed on its $1,000 profit from the sale of widgets. However, if the corporation can successfully maintain that it is a cooperative, some would argue that those shareholders in control of the corporation may decide that the corporation has no profit -- by netting the $1,000 "loss" from shirt sales against the $1,000 profit from widget sales -- and that the government has no right or power to question that decision. Moreover, some would argue that the corporation is a cooperative as long as the persons controlling the use of the corporation's profits are patrons of the corporation (which the five shirt producers are) and the corporation is contractually obligated to distribute its profits (if any) to its patrons in proportion to their patronage. In the example above, if the "loss" from shirt sales is respected as a loss, as opposed to a disguised dividend, the corporation has no profits to distribute. While it may appear that the widget patrons should be entitled to the $1,000 profit that arose from their patronage, the corporation will assert that it satisfies the requirement that profits are distributed in proportion to patronage.

The targeted distribution of profits to particular patrons can, in many cases, be accomplished with equal facility even if all patrons exercise equal voting rights. Assume, for example, that a cooperative corporation has 100 patrons, each of whom has a single vote. Sixty of the patrons market wheat through the cooperative, and forty of the patrons market corn. During the year, the cooperative loses $1,000 from its transactions with wheat patrons (by virtue of excessive advances) and earns $1,000 from its transactions with corn patrons. The cooperative's bylaws give the board of directors the discretion either to pay a $1,000 patronage refund to the corn patrons (and charge the $1,000 loss to the wheat farmers' capital accounts) or to "net" the profits and losses and determine that the cooperative has no net earnings to distribute. The wheat patrons, who hold 60 percent of the votes, can cause the board to take the latter action. In fact, in some circumstances it appears that the corn patrons may not even be informed that this has been done. Operation of a cooperative corporation in this manner serves to transfer corporate profits to the controlling wheat patrons. Since a $1,000 dividend distribution to the wheat patrons would not be deductible by the corporation, the corporation should have taxable income of $1,000.

I do not mean to suggest that farm cooperatives avoid corporate tax by operating in the manner of the hypothetical widget seller or the hypothetical wheat and corn cooperative. I simply want to point out that there must be some limits on the operation of cooperatives in order to prevent inappropriate avoidance of the corporate tax. The difficulty is in identifying cases where abuse has occurred, and in developing fair, administrable rules that can be applied in all cases.

The Netting Issue

Although the term "netting" generally refers to the offsetting of losses against profits, as a technical matter we have identified four separate netting issues. The first issue is whether and in what situations a cooperative may, without losing its cooperative status, shift wealth from one group of patrons to another by using profits from the former's patronage to subsidize patronage losses from the latter. The second issue is whether a cooperative that sustains losses from one category of patronage and earns profits from another category of patronage may deduct the losses from the profits in computing its corporate taxable income. The third issue is whether a cooperative may be said to have a "pre-existing obligation" to pay patronage dividends to the patrons of a profitable activity if it has the discretion either to distribute those profits to the patrons whose patronage generated the profits or to net the profits against losses from another activity, thereby using the profits to subsidize those losses. The fourth issue is whether a farm cooperative that operates both purchasing and marketing activities, and nets losses from one against profits from the other, may qualify as an "exempt" farm cooperative described in section 521.

In attempting to resolve these issues administratively, the Treasury Department must weigh the legitimate needs of cooperatives against the government's responsibility to apply the corporate tax to business organizations that are not the intended beneficiaries of Subchapter T.

The Importance of Netting to Farm Cooperatives

Since diversification of risk is a significant function of farm cooperatives, it is axiomatic that, to some extent, profits from some patronage activities wil be used to offset losses from other patronage activities. In general, no abuse will exist where a cooperative's members agree in advance that patrons of an activity that produces unanticipated losses will not be required to repay those losses but instead will be cushioned by profits from other patronage activities. In such cases, both of the first two netting issues mentioned above come into play; wealth is transferred from the profitable patrons to the loss patrons, and patronage profits and losses will be netted for tax purposes.

Similarly, there may be numerous legitimate reasons why a cooperative's members may agree in advance that the cooperative's directors have the discretion to subsidize losses from some patronage activities with profits from other activities. The shifting of wealth from profit-generating patrons to loss-generating patrons that occurs through discretionary netting may be fully consistent with the purposes for which cooperatives are encouraged, particularly if the patrons are fully aware that the discretion exists and are periodically given information describing in adequate detail the netting that has been effected. Nonetheless, under the provisions of the present tax code, one of the consequences of giving the directors this discretion is that the deduction for patronage dividends may be limited or even eliminated as a result of the cooperative failing to meet the pre-existing obligation requirement.

Unbridled and unreported discretion, on the other hand, can lead to the abuses described above. For example, if a cooperative is controlled by patrons of one of its activities, management may choose to net profits and losses in years in which that activity generates a loss, but not in other years. If the patrons of the cooperative's other activities are not informed of management's netting practices, they will not know that a portion of the profits generated by their patronage has been appropriated systematically by the controlling patrons.

Judicial Decisions

On several occasions, the courts have addressed the tax consequences of the allocation by cooperatives of profit and loss among their patrons. Some have asserted that these cases resolve the netting issues discussed above, and thus that these issues are inappropriately raised by the Service. While these judicial decisions have a bearing on the netting issues that are the subject of this Subcommittee hearing, we are strongly of the view that they do not resolve these issues.

In Associated Milk Producers, 68 T.C. 729 (1977), the Tax Court rejected the Service's contention that a cooperative must always recoup an economic loss from the particular patron whose patronage created the loss. In the Associated Milk Producers case, the court found that the loss had been caused by bad management and it would have been injudicious for the cooperative to attempt to recoup the entire loss from those persons who were patrons in the loss years. Under those circumstances the court held that it was a reasonable management decision to charge the losses against patronage income from subsequent years.

In Ford-Iroquois FS, Inc., 74 T.C. 1213 (1980), the Tax Court held that the taxpayer, a non-exempt farm cooperative, was entitled to apply losses incurred in 1971 and 1972 in its grain marketing and storage operations against income earned in 1973 from its farm supply operations. In reaching this conclusion, the court stressed that there was substantial overlap between the patrons of the loss operations and the patrons of the profitable operation, and also that the cooperative's members had frequent contact with the board of directors, received annual financial reports from the cooperative, and appeared to find the allocations fair.

In Lamesa Cooperative Gin, 78 T.C. 894 (1982), the Tax Court rejected the Service's contention that a cooperative's recapture income from the sale of depreciated equipment must be allocated to patrons in accordance with patronage during the years in which depreciation deductions were claimed. The court also held that it was not inequitable for the cooperative to allocate a small amount of net income from its purchasing activities in accordance with patronage of its marketing activities. In the case of the allocation of recapture income, the court found that it would have been impossible to match the income precisely with prior patronage and that the cooperative's decision to allocate the income in accordance with patronage in the year of sale was reasonable and equitable. Similarly, in connection with the allocation of purchasing income, the court found that the patrons of the purchasing and marketing activities were not significantly different and that the small size of the purchasing activity made it reasonable not to account for the activity separately.

Some may assert that the Ford-Iroquois and Lamesa cases preclude the Service from asserting that marketing and purchasing operations must be accounted for separately by an exempt cooperative. It should be noted, however, that the Ford-Iroquois case did not involve an interpretation of section 521 of the Code, which reasonably can be read to require such separate accounting. Moreover, in reaching its decision in Lamesa, the Tax Court stated that the exempt cooperative's purchasing activity was so small relative to its marketing activity that maintaining separate accounting records with respect to the separate activities might have cost the cooperative almost as much as its entire profit from the purchasing activity. The court also stated:

> Boards of directors of cooperatives do not have carte blanche to make whatever allocations they choose, but we believe respondent should recognize that directors have some discretion, some flexibility, in the exercise of business judgment. Only when unreasonable exercise of that discretion appears should the board's weighing of the equities be overturned by this Court. (78 T.C. at 906).

The Position of the Treasury Department

The Treasury Department is not, as a matter of tax policy, opposed to farm cooperatives conducting their business through flexible and adaptable management policies, nor is the Treasury opposed to the netting inherent in risk diversification. However, Treasury does have concerns with proposals to give cooperatives and, indirectly, their boards of directors, carte blanche netting powers.

Treasury believes that the Internal Revenue Service should have the authority to examine the activities of any cooperative corporation and take appropriate action where abuse is uncovered. As pointed out, it is possible for patrons who are in control of a cooperative corporation to use that control to extract dividends in the guise of patronage losses. Abuse of the cooperative form of operation in this way must not be insulated from the scrutiny of the Internal Revenue Service. Any legislative or administrative clarification of the cooperative netting issues will have to recognize that disguised dividends of this type cannot under any circumstances be availed of to avoid the corporate tax.

In addition, as I have also illustrated, without adequate safeguards requiring advance consent from patrons or at least regular reports to patrons regarding how profits and losses from various patronage activities are to be netted, it is possible, through their discretionary netting powers, for those persons who control a cooperative corporation to shift wealth systematically to themselves or favored patrons from other uninformed patrons. Such activity is inconsistent with the intent of Subchapter T to provide limited relief from the corporate tax to cooperatives operated for the mutual benefit of all of their patrons. The Internal Revenue Service should not be powerless to act if it uncovers such abuses.

The present statutory scheme for taxing cooperative corporations places some limitations on discretionary netting. Because abuses can arise from discretionary netting, we do not believe that the Service is in error when it interprets these limitations strictly. Thus, we do not believe the Service's interpretation of the pre-existing obligation lmitation is unreasonable. That is, when discretion is granted to a cooperative's management to net losses of one activity against profits from a second, to the extent of the loss from the second activity the cooperative does not have the required pre-existing obligation to distribute profits to the patrons of the first activity, and, therefore, cannot treat the entire distribution as a deductible patronage dividend if it chooses not to net.

Finally, I wish to point out that some of our concerns regarding the cooperative netting issues would be diminished if there were legislative or administrative rules that insured that all patrons were adequately informed about the netting decisions of the cooperative.

Treasury believes, however, that the netting issues that are the subject of this hearing can and should be resolved administratively, through the regulations and rulings process. If no such administrative guidelines are promulgated, abuses of the type we have described surely will spread and new abuses will develop. Accordingly, Treasury will continue to explore, in cooperation with the Department of Agriculture and the cooperative industry, the feasibility of establishing these administrative guidelines. If the Congress, however, decides that these issues should be resolved legislatively, we believe it should simultaneously clarify some of the other major unresolved issues involving the taxation of cooperatives that are unrelated to the netting issue.

That concludes my prepared remarks. I would be pleased to respond to any questions.

federal financing bank NEWS
WASHINGTON, D.C. 20220
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July 15, 1985

FOR IMMEDIATE RELEASE

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of May 1985.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $149.7 billion on May 31, 1985, posting an increase of $1.0 billion from the level on April 30, 1985. This net change was the result of increases in holdings of agency assets of $0.8 billion and holdings of agency-guaranteed debt of $0.5 billion. Holdings of agency debt declined by $0.3 billion during the month. FFB made 260 disbursements during May.

Attached to this release are tables presenting FFB May loan activity, new FFB commitments entered during May and FFB holdings as of May 31, 1985.

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FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
ON-BUDGET AGENCY DEBT					
TENNESSEE VALLEY AUTHORITY					
Advance #462	5/1	$ 330,000,000.00	5/8/85	8.135%	
Advance #463	5/6	425,000,000.00	5/3/85	8.105%	
Advance #464	5/8	347,000,000.00	5/16/85	8.155%	
Advance #465	5/13	285,000,000.00	5/20/85	8.115%	
Advance #466	5/13	155,000,000.00	5/22/85	8.115%	
Advance #467	5/16	336,000,000.00	5/23/85	7.805%	
Advance #468	5/20	262,000,000.00	5/27/85	7.765%	
Advance #469	5/23	339,000,000.00	6/1/85	7.655%	
Advance #470	5/27	274,000,000.00	6/3/85	7.535%	
Advance #471	5/31	56,000,000.00	6/6/85	7.535%	
Advance #472	5/31	105,000,000.00	6/10/85	7.535%	
Power Bond Series 1985 C	5/22	150,000,000.00	5/31/15	10.945%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #323	5/3	8,950,000.00	8/1/85	8.145%	
+Note #324	5/6	2,100,000.00	6/10/85	8.105%	
+Note #325	5/9	15,000,000.00	8/7/85	8.215%	
Note #326	5/13	1,369,000.00	8/12/85	8.145%	
Note #327	5/16	7,205,000.00	8/14/85	7.805%	
+Note #328	5/20	15,000,000.00	8/23/85	7.775%	
+Note #329	5/20	900,000.00	8/19/85	7.765%	
+Note #330	5/23	500,000.00	8/21/85	7.655%	
+Note #331	5/24	15,000,000.00	8/23/85	7.615%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership					
	5/1	20,000,000.00	5/1/05	11.825%	12.175% ann.
	5/6	85,000,000.00	5/1/95	11.335%	11.656% ann.
	5/9	225,000,000.00	5/1/95	11.385%	11.709% ann.
	5/9	15,000,000.00	5/1/05	11.715%	12.058% ann.
	5/16	200,000,000.00	5/1/95	11.015%	11.318% ann.
	5/16	15,000,000.00	5/1/05	11.365%	11.688% ann.
	5/21	100,000,000.00	5/1/90	10.155%	10.413% ann.
	5/21	50,000,000.00	5/1/95	10.685%	10.970% ann.
	5/28	150,000,000.00	5/1/90	10.155%	10.413% ann.
	5/28	450,000,000.00	5/1/95	10.695%	10.981% ann.
	5/28	100,000,000.00	5/1/00	10.925%	11.223% ann.
	5/28	60,000,000.00	5/1/05	11.085%	11.392% ann.
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Turkey 15	5/1	391,822.65	5/31/13	11.695%	
Botswana 2	5/2	225,588.71	1/15/88	8.135%	
Greece 15	5/2	2,976,789.11	6/15/12	11.445%	
Korea 19	5/2	30,894,000.00	6/30/96	11.121%	
Jordan 7	5/6	102,681.19	3/16/90	10.835%	
Jordan 9	5/6	18,507.76	11/25/91	11.165%	
Liberia 10	5/7	93,120.66	5/15/95	11.305%	
Philippines 10	5/7	6,243,835.74	7/15/92	10.687%	
El Salvador 7	5/9	724,209.08	6/10/96	11.395%	
Jordan 12	5/9	3,286,755.00	2/5/95	11.255%	
Niger 2	5/9	50,000.00	10/15/90	8.714%	

+rollover

FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual	INTEREST RATE (other than semi-annual)
Foreign Military Sales (Cont'd)					
Peru 8	5/9	$ 646,635.57	12/15/88	10.437%	
Thailand 11	5/9	783,638.00	9/10/95	11.055%	
Jordan 10	5/13	455.87	3/10/92	8.705%	
Jordan 11	5/13	34,540.00	11/15/92	9.925%	
Peru 9	5/13	303,732.20	9/15/95	10.918%	
Jordan 8	5/15	52,530.00	11/22/90	10.645%	
Spain 5	5/16	262,380.00	6/15/91	10.525%	
Morocco 9	5/17	270,998.23	3/31/94	10.884%	
Morocco 13	5/17	490,667.01	5/31/96	10.515%	
Greece 14	5/21	1,151,000.00	4/30/11	11.015%	
Jordan 8	5/21	56,298.65	11/22/90	10.285%	
Malaysia 8	5/23	617,750.00	7/31/91	9.414%	
Turkey 15	5/24	26,351,589.35	5/31/13	11.082%	
Egypt 6	5/28	5,942,270.49	4/15/14	11.033%	
Turkey 16	5/28	82,383,311.24	7/15/13	10.948%	
Jordan 12	5/29	3,104,515.00	2/5/95	10.413%	
Thailand 9	5/29	350,061.82	9/15/93	10.475%	
Thailand 11	5/29	3,945,296.30	9/10/95	10.266%	
Turkey 16	5/29	4,280,901.49	7/15/13	10.922%	
Zaire 2	5/29	171,668.00	9/22/93	8.125%	
Peru 9	5/30	22,921.22	9/15/95	10.315%	
Philippines 10	5/30	717,359.00	7/15/92	9.965%	
El Salvador 7	5/31	631,325.74	6/10/96	10.528%	
DEPARTMENT OF ENERGY					
Synthetic Fuels - Non-Nuclear Act					
Great Plains Gasification Assoc. #135	5/13	4,000,000.00	1/2/86	9.345%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Somerville, MA	5/1	1,753,770.00	5/1/90	10.646%	10.929% ann.
*Utica, NY	5/1	740,000.00	5/1/95	11.285%	11.603% ann.
Newport News, VA	5/6	315,312.00	2/15/86	8.715%	8.851% ann.
Syracuse, NY	5/6	70,000.00	7/1/03	11.412%	11.738% ann.
Tacoma, WA	5/6	70,000.00	10/15/03	11.427%	11.753% ann.
Dade County, FL	5/7	261,800.00	7/15/85	8.105%	
Ingelwood, CA	5/15	670,000.00	8/1/86	8.945%	9.145% ann.
Pasadena, CA	5/15	2,931,753.83	7/15/85	7.985%	
Santa Ana, CA	5/15	720,009.00	8/15/86	8.985%	9.187% ann.
Lynn, MA	5/15	231,338.36	8/15/85	7.895%	
Long Beach, CA	5/17	1,505,000.00	8/1/85	7.735%	
Mayaguez, PR	5/17	77,000.00	8/1/85	7.735%	
Hialeah, FL	5/21	12,500.00	12/1/85	7.955%	7.973% ann.
Ponce, PR	5/21	95,807.00	8/1/85	7.615%	
San Diego, CA	5/21	250,000.00	8/1/85	7.615%	
South Bend, IN	5/23	249,609.57	2/15/86	8.075%	8.178% ann.
+Hammond, IN	5/31	416,667.00	5/1/86	8.135%	8.286% ann.
DEPARTMENT OF THE NAVY					
Ship Lease Financing					
Pless	5/1	103,000,000.00	7/15/85	8.245%	
Pless	5/1	57,000,000.00	5/30/85	8.245%	
+Bobo	5/30	55,751,403.64	6/7/85	7.605%	
+Pless	5/30	57,000,000.00	6/7/85	7.605%	

*maturity extension
+rollover

FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
Defense Production Act					
Gila River Indian Community	5/30	$ 210,278.71	10/1/92	10.059%	9.936% qtr.
OREGON VETERAN'S HOUSING					
Advance #1	5/29	60,000,000.00	9/30/85	7.550%	
RURAL ELECTRIFICATION ADMINISTRATION					
*San Miguel Electric #110	5/2	2,500,000.00	5/2/87	9.955%	9.834% qtr.
Saluda River Electric #271	5/2	3,933,000.00	6/30/87	10.035%	9.912% qtr.
Corn Belt Power #292	5/3	512,000.00	6/30/87	10.065%	9.941% qtr.
*Wolverine Power #100	5/6	601,000.00	6/30/87	9.935%	9.815% qtr.
Colorado Ute Electric #203	5/6	620,000.00	5/6/87	9.835%	9.717% qtr.
Sitka Telephone #213	5/7	1,200,000.00	5/7/87	9.825%	9.707% qtr.
*Cooperative Power #130	5/7	15,895,000.00	5/7/87	9.825%	9.707% qtr.
Tex-La Electric #208	5/7	1,440,000.00	5/7/87	9.825%	9.707% qtr.
*Central Electric #131	5/8	90,000.00	5/8/87	9.785%	9.668% qtr.
*Sunflower Electric #174	5/8	7,537,366.60	5/8/87	9.785%	9.668% qtr.
Western Farmers Electric #196	5/8	1,239,000.00	5/8/87	9.785%	9.668% qtr.
*Basin Electric #87	5/9	71,452,000.00	12/3/85	8.584%	8.494% qtr.
United Power #159	5/10	1,325,000.00	5/11/87	9.795%	9.678% qtr.
United Power #212	5/10	365,000.00	5/11/87	9.795%	9.678% qtr.
*Wolverine Power #233	5/10	11,460,000.00	5/11/87	9.795%	9.678% qtr.
*Kansas Electric #216	5/10	1,200,000.00	12/31/16	11.522%	11.361% qtr.
*Wabash Valley Power #206	5/10	5,722,000.00	5/11/87	9.795%	9.678% qtr.
*Wolverine Power #101	5/13	1,228,000.00	5/13/87	9.745%	9.629% qtr.
*Wolverine Power #182	5/13	1,750,000.00	5/11/88	10.075%	9.951% qtr.
*Wolverine Power #183	5/13	2,336,000.00	5/11/88	10.075%	9.951% qtr.
Northwest Iowa Power #279	5/15	103,000.00	6/30/87	9.646%	9.532% qtr.
*Oglethorpe Power #246	5/15	27,257,037.46	5/15/87	9.595%	9.483% qtr.
Deseret G&T #211	5/17	5,603,000.00	5/17/87	9.435%	9.326% qtr.
New Hampshire Electric #270	5/17	456,000.00	6/30/87	9.465%	9.356% qtr.
Kansas Electric #282	5/17	512,000.00	12/31/15	11.177%	11.025% qtr.
East Kentucky Power #140	5/20	1,130,000.00	5/20/87	9.495%	9.385% qtr.
*Upper Missouri G&T #172	5/22	895,000.00	5/22/87	9.235%	9.131% qtr.
Oglethorpe Power #246	5/23	16,284,000.00	5/26/87	9.235%	9.131% qtr.
*S. Mississippi Electric #3	5/23	21,000.00	6/30/87	9.231%	9.127% qtr.
*S. Mississippi Electric #4	5/23	1,131,000.00	6/30/87	9.233%	9.129% qtr.
Associated Electric #260	5/24	58,650,000.00	1/2/01	10.749%	10.608% qtr.
Brazos Electric #230	5/28	978,000.00	5/28/87	9.255%	9.150% qtr.
*Southern Illinois Power #38	5/28	1,000,000.00	6/30/87	9.280%	9.175% qtr.
*Basin Electric #87	5/29	609,000.00	12/3/85	7.884%	7.808% qtr.
Tex-La Electric #208	5/30	632,000.00	6/1/87	9.175%	9.072% qtr.
Washington Electric #269	5/30	123,000.00	6/30/87	9.194%	9.091% qtr.
North Carolina Electric #268	5/30	10,753,000.00	6/30/87	9.215%	9.111% qtr.
Kamo Electric #266	5/31	1,129,000.00	6/30/87	9.174%	9.071% qtr.
Allegheny Electric #255	5/31	1,452,000.00	6/30/87	9.185%	9.082% qtr.
Kansas Electric #282	5/31	573,000.00	12/31/15	10.794%	10.652% qtr.
*Oglethorpe Power #246	5/31	13,145,000.00	6/1/87	9.155%	9.053% qtr.
*Tex-La Electric #208	5/31	700,000.00	1/2/18	10.802%	10.660% qtr.
Plains Electric G&T #300	5/31	635,000.00	6/30/87	9.165%	9.062% qtr.
*Basin Electric #232	5/31	1,633,000.00	12/3/85	7.835%	7.760% qtr.
*Allegheny Electric #93	5/31	9,000.00	6/30/87	9.162%	9.059% qtr.
*Allegheny Electric #93	5/31	2,706,000.00	6/30/87	9.162%	9.059% qtr.
*Allegheny Electric #175	5/31	3,255,000.00	5/11/88	9.455%	9.346% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Texas Panhandle Reg. Dev. Corp.	5/8	30,000.00	5/1/00	11.291%	
Texas Panhandle Reg. Dev.	5/8	37,000.00	5/1/00	11.291%	
St. Louis County LDC	5/8	39,000.00	5/1/00	11.291%	

*maturity extension

FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Bus. Dev. Corp. of Nebraska	5/8	$ 44,000.00	5/1/00	11.291%	
Iowa Business Growth Co.	5/8	57,000.00	5/1/00	11.291%	
Worcester Bus. Dev. Corp.	5/8	63,000.00	5/1/00	11.291%	
E. Texas Regional Dev. Corp.	5/8	72,000.00	5/1/00	11.291%	
Deep East Texas Reg. CDC	5/8	92,000.00	5/1/00	11.291%	
Ashtabula County 503 Corp.	5/8	93,000.00	5/1/00	11.291%	
West Virginia CDC	5/8	126,000.00	5/1/00	11.291%	
The Bus. Dev. Corp. of Nebraska	5/8	128,000.00	5/1/00	11.291%	
St. Louis LD Co.	5/8	139,000.00	5/1/00	11.291%	
South Shore Ec. Dev. Corp.	5/8	146,000.00	5/1/00	11.291%	
Washington Com. Dev. Corp.	5/8	156,000.00	5/1/00	11.291%	
Cascades West. Fin. Ser. Inc.	5/8	172,000.00	5/1/00	11.291%	
Androscoggin Valley C.of Govts.	5/8	180,000.00	5/1/00	11.291%	
Granite State Ec. Dev. Corp.	5/8	198,000.00	5/1/00	11.291%	
S.W. Penn. Ec. Dev. Dis.	5/8	208,000.00	5/1/00	11.291%	
SCEDD Dev. Co.	5/8	210,000.00	5/1/00	11.291%	
The Bus. Dev. Corp. of Nebraska	5/8	212,000.00	5/1/00	11.291%	
Maine Dev. Foundation	5/8	221,000.00	5/1/00	11.291%	
Hamilton County Dev. Co., Inc.	5/8	281,000.00	5/1/00	11.291%	
Ocean State Bus Dev Auth, Inc	5/8	332,000.00	5/1/00	11.291%	
Rural Missouri, Inc.	5/8	348,000.00	5/1/00	11.291%	
Gr. Hartford Bus Dev Cen, Inc	5/8	399,000.00	5/1/00	11.291%	
Commonwealth Sm Bus Dev Corp	5/8	455,000.00	5/1/00	11.291%	
St. Louis County LD Co.	5/8	39,000.00	5/1/05	11.456%	
S.W. Penn. Ec. Dev. Dis.	5/8	51,000.00	5/1/05	11.456%	
Wilmington Indus. Dev., Inc.	5/8	63,000.00	5/1/05	11.456%	
Gr. North-Pulaski LDC	5/8	73,000.00	5/1/05	11.456%	
Gr. Evanston Dev. Co.	5/8	74,000.00	5/1/05	11.456%	
Wilmington Indus. Dev., Inc.	5/8	77,000.00	5/1/05	11.456%	
St. Louis County LDC	5/8	77,000.00	5/1/05	11.456%	
Coon Rapids Dev. Co.	5/8	80,000.00	5/1/05	11.456%	
Jefferson County LDC	5/8	84,000.00	5/1/05	11.456%	
Opportunities Minnesota Inc.	5/8	84,000.00	5/1/05	11.456%	
Mid-East CDC, Inc.	5/8	86,000.00	5/1/05	11.456%	
E.D.F. of Sacramento, Inc.	5/8	91,000.00	5/1/05	11.456%	
C.D.C. of Mississippi	5/8	92,000.00	5/1/05	11.456%	
Gold Country CDC, Inc.	5/8	95,000.00	5/1/05	11.456%	
Gr. Spokane Bus. Dev. Assoc.	5/8	105,000.00	5/1/05	11.456%	
Long Island Dev. Corp.	5/8	112,000.00	5/1/05	11.456%	
N. Kentucky Area Dev. Dis, Inc.	5/8	116,000.00	5/1/05	11.456%	
San Diego County LDC	5/8	135,000.00	5/1/05	11.456%	
The Corp for ED of Des Moines	5/8	146,000.00	5/1/05	11.456%	
Ocean State Bus. Dev. Auth.	5/8	147,000.00	5/1/05	11.456%	
Ark-Tex Reg. Dev. Co., Inc.	5/8	152,000.00	5/1/05	11.456%	
E.C.I.A. Bus. Growth, Inc.	5/8	153,000.00	5/1/05	11.456%	
E.C.I.A. Bus. Growth, Inc.	5/8	169,000.00	5/1/05	11.456%	
Alabama Community Dev. Corp.	5/8	179,000.00	5/1/05	11.456%	
Opportunities Minnesota, Inc.	5/8	181,000.00	5/1/05	11.456%	
Bay Area Employment Dev. Co.	5/8	191,000.00	5/1/05	11.456%	
Mid City Pioneer Corp.	5/8	210,000.00	5/1/05	11.456%	
BDC S.Bend/Mishawaka/St.Joseph	5/8	216,000.00	5/1/05	11.456%	
Forward Dev. Corp.	5/8	231,000.00	5/1/05	11.456%	
Urban County Comm. Dev. Corp.	5/8	254,000.00	5/1/05	11.456%	
Gr. Bakersfield LDC	5/8	263,000.00	5/1/05	11.456%	
Region E Development Corp.	5/8	264,000.00	5/1/05	11.456%	
Washington, D.C. LDC	5/8	270,000.00	5/1/05	11.456%	
Treasury Valley CDC	5/8	277,000.00	5/1/05	11.456%	
Long Island Dev. Corp.	5/8	295,000.00	5/1/05	11.456%	
E.D.F. of Sacramento, Inc.	5/8	298,000.00	5/1/05	11.456%	
Ohio Statewide Dev. Corp.	5/8	320,000.00	5/1/05	11.456%	
Long Island Dev. Corp.	5/8	340,000.00	5/1/05	11.456%	
E.D.F. of Sacramento, Inc.	5/8	378,000.00	5/1/05	11.456%	
Los Angeles LDC, Inc.	5/8	382,000.00	5/1/05	11.456%	
N.E. Missouri CDC	5/8	443,000.00	5/1/05	11.456%	

FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Gr. Spokane Bus. Dev. Assoc.	5/8	$ 483,000.00	5/1/05	11.456%	
Kisatchie Delta R.P.&D.D., Inc.	5/8	498,000.00	5/1/05	11.456%	
Newport News Pulse Dev. Corp.	5/8	500,000.00	5/1/05	11.456%	
Gr. Spokane Bus. Dev. Assoc.	5/8	500,000.00	5/1/05	11.456%	
Big Lakes Certified Dev. Co.	5/8	47,000.00	5/1/10	11.523%	
St. Louis LDC	5/8	66,000.00	5/1/10	11.523%	
Urban Business Dev. Corp.	5/8	81,000.00	5/1/10	11.523%	
Dev. Corp. of Mid. Georgia	5/8	90,000.00	5/1/10	11.523%	
Richmond Renaissance Dev. Corp.	5/8	90,000.00	5/1/10	11.523%	
Uniform Region Nine CDC	5/8	96,000.00	5/1/10	11.523%	
Lake County Ec. Dev. Corp.	5/8	112,000.00	5/1/10	11.523%	
Provo Metro. Dev. Corp.	5/8	114,000.00	5/1/10	11.523%	
Ark-Tex Reg. Dev. Co., Inc.	5/8	131,000.00	5/1/10	11.523%	
Cumberland-Allegheny CIF, Inc.	5/8	136,000.00	5/1/10	11.523%	
E. Texas Reg. Dev. Co.	5/8	144,000.00	5/1/10	11.523%	
Centralina Dev. Corp., Inc.	5/8	147,000.00	5/1/10	11.523%	
Warren Redev. & Planning Corp.	5/8	168,000.00	5/1/10	11.523%	
San Diego County LDC	5/8	184,000.00	5/1/10	11.523%	
La Habra LDC, Inc.	5/8	211,000.00	5/1/10	11.523%	
Gr. Southwest Kansas CDC	5/8	229,000.00	5/1/10	11.523%	
St. Louis County LDC	5/8	234,000.00	5/1/10	11.523%	
Centralina Dev. Corp., Inc.	5/8	244,000.00	5/1/10	11.523%	
Warren Redev. & Planning Corp.	5/8	252,000.00	5/1/10	11.523%	
San Diego County LDC	5/8	289,000.00	5/1/10	11.523%	
Wilmington Indus. Dev., Inc.	5/8	289,000.00	5/1/10	11.523%	
Bay Area Business Dev. Co.	5/8	294,000.00	5/1/10	11.523%	
Bay Area Employment Dev. Co.	5/8	315,000.00	5/1/10	11.523%	
New Castle County E.D.C.	5/8	336,000.00	5/1/10	11.523%	
Bay Area Business Dev. Co.	5/8	357,000.00	5/1/10	11.523%	
New Haven Com. Invest. Corp.	5/8	420,000.00	5/1/10	11.523%	
San Diego County LDC	5/8	432,000.00	5/1/10	11.523%	
San Diego County LDC	5/8	441,000.00	5/1/10	11.523%	
Barren River Dev. Council, Inc.	5/8	500,000.00	5/1/10	11.523%	
Bay Colony Dev. Corp.	5/8	500,000.00	5/1/10	11.523%	
Metro Area Dev. Corp.	5/8	500,000.00	5/1/10	11.523%	
Small Business Investment Company Debentures					
CMNY Capital Co. Inc.	5/22	1,700,000.00	5/1/88	9.475%	
Chestnut Capital Corporation	5/22	500,000.00	5/1/88	9.475%	
Doan Resources Ltd Partnership	5/22	1,000,000.00	5/1/88	9.475%	
Chestnut Capital Corporation	5/22	1,000,000.00	5/1/90	10.155%	
Associated Capital Corporation	5/22	250,000.00	5/1/92	10.565%	
Associated Capital Corporation	5/22	500,000.00	5/1/95	10.685%	
Capital Corp. of Wyoming, Inc.	5/22	300,000.00	5/1/95	10.685%	
Clinton Capital Corporation	5/22	3,000,000.00	5/1/95	10.685%	
European Development Cap. LP	5/22	1,000,000.00	5/1/95	10.685%	
Financial Opportunities, Inc.	5/22	700,000.00	5/1/95	10.685%	
First Connecticut SBIC	5/22	3,300,000.00	5/1/95	10.685%	
First Ohio Capital Corporation	5/22	1,000,000.00	5/1/95	10.685%	
Hamco Capital Corporation	5/22	1,000,000.00	5/1/95	10.685%	
Mesirow Capital Corporation	5/22	1,000,000.00	5/1/95	10.685%	
North Star Ventures, Inc.	5/22	750,000.00	5/1/95	10.685%	
RIHT Capital Corporation	5/22	3,000,000.00	5/1/95	10.685%	
Red River Ventures, Inc.	5/22	500,000.00	5/1/95	10.685%	
Winfield Capital Corporation	5/22	600,000.00	5/1/95	10.685%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
+Note A-85-08	5/31	568,259,159.45	8/30/85	7.615%	

+rollover

FEDERAL FINANCING BANK

MAY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF TRANSPORTATION					
Section 511—4R Act					
Delta Transportation Co.	5/9	$ 2,500,000.00	5/8/05	11.564%	

FEDERAL FINANCING BANK
MAY 1985 Commitments

BORROWER	GUARANTOR	AMOUNT	COMMITMENT EXPIRES	MATURITY
Delta Transportation Co.	DOT	$ 2,500,000.00	5/9/85	5/6/05
Pasadena, CA	HUD	3,110,000.00	7/15/85	7/15/91
South Bend, IN	HUD	1,376,547.00	2/15/86	2/15/92
Binghamton, NY	HUD	7,300,000.00	9/15/87	9/15/93
Hammond, IN	HUD	416,667.00	5/31/86	5/31/91
Council Bluffs, IA	HUD	2,000,000.00	5/1/86	5/1/93
Wilmington Trust Co. (Pless)	NAVY	185,000,000.00	4/15/90	1/15/10
Oregon Veteran's Housing	TREASURY	300,000,000.00	5/1/86	3/31/87

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	May 31, 1985	April 30, 1985	Net Change 5/1/85-5/31/85	Net Change--FY 1985 10/1/84-5/31/85
On-Budget Agency Debt				
Tennessee Valley Authority	$ 14,154.0	$ 14,051.0	$ 103.0	$ 719.0
Export-Import Bank	15,689.5	15,689.5	-0-	-0.4
NCUA-Central Liquidity Facility	219.6	220.4	-0.8	-49.3
Off-Budget Agency Debt				
U.S. Postal Service	720.0	1,087.0	-367.0	-367.0
U.S. Railway Association	73.8	73.8	-0-	22.5†
Agency Assets				
Farmers Home Administration	61,611.0	60,641.0	970.0	2,100.0
DHHS-Health Maintenance Org.	112.2	112.9	-0.6	-3.9
DHHS-Medical Facilities	132.0	132.0	-0-	-0-
Overseas Private Investment Corp.	8.3	8.3	-0-	-2.7
Rural Electrification Admin.-CBO	3,536.7	3,727.7	-191.0	-0-
Small Business Administration	35.0	35.8	-0.8	-5.1
Government-Guaranteed Lending				
DOD-Foreign Military Sales	17,784.1	17,654.1	130.0	673.2
DEd.-Student Loan Marketing Assn.	5,000.0	5,000.0	-0-	-0-
DOE-Geothermal Loan Guarantees	12.4	12.4	-0-	6.2
DOE-Non-Nuclear Act (Great Plains)	1,461.0	1,457.0	4.0	171.0
DHUD-Community Dev. Block Grant	262.7	255.6	7.1	54.4
DHUD-New Communities	33.5	33.5	-0-	-0-
DHUD-Public Housing Notes	2,146.2	2,146.2	-0-	-32.3
General Services Administration	410.6	411.3	-0.7	-2.7
DOI-Guam Power Authority	35.6	35.6	-0-	-0.4
DOI-Virgin Islands	28.3	28.3	-0-	-0.4
NASA-Space Communications Co.	887.6	887.6	-0-	-67.0
DON-Ship Lease Financing	924.2	764.2	160.0	924.2
DON-Defense Production Act	5.1	4.9	0.2	2.0
Oregon Veteran's Housing	60.0	-0-	60.0	60.0
Rural Electrification Admin.	21,003.4	20,894.2	109.2	416.3
SBA-Small Business Investment Cos.	953.5	943.8	9.7	93.2
SBA-State/Local Development Cos.	527.5	508.7	18.8	172.9
TVA-Seven States Energy Corp.	1,589.6	1,570.6	19.0	34.1
DOT-Section 511	152.8	153.8	-1.0	-6.8
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	$ 149,747.2	$ 148,718.1	$ 1,029.1	$ 4,910.9

*figures may not total due to rounding
†reflects adjustment for capitalized interest

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

FOR RELEASE AT 4:00 P.M. July 16, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued July 25, 1985. This offering will provide about $800 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,607 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, July 22, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated April 25, 1985, and to mature October 24, 1985 (CUSIP No. 912794 JD 7), currently outstanding in the amount of $6,515 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated January 24, 1985, and to mature January 23, 1986 (CUSIP No. 912794 JP 0), currently outstanding in the amount of $8,556 million, the additional and original bills to be freely interchangeable.

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.

The bills will be issued for cash and in exchange for Treasury bills maturing July 25, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates 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. Federal Reserve Banks currently hold $883 million as agents for foreign and international monetary authorities, and $2,284 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-216

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

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.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

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 yield 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 $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

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 the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. 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. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, 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 AT 4:00 P.M. July 17, 1985

TREASURY TO AUCTION $9,250 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,250 million of 2-year notes to refund $8,369 million of 2-year notes maturing July 31, 1985, and to raise about $875 million new cash. The $8,369 million of maturing 2-year notes are those held by the public, including $496 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,250 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $479 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.

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

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED JULY 31, 1985

July 17, 1985

Amount Offered:	
To the public	$9,250 million
Description of Security:	
Term and type of security	2-year notes
Series and CUSIP designation	Series X-1987 (CUSIP No. 912827 SM 5)
Maturity date	July 31, 1987
Call date	No provision
Interest 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	January 31 and July 31
Minimum denomination available	$5,000
Terms of Sale:	
Method of sale	Yield Auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable
Key Dates:	
Receipt of tenders	Wednesday, July 24, 1985 prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Wednesday, July 31, 1985
b) readily collectible check	Monday, July 29, 1985