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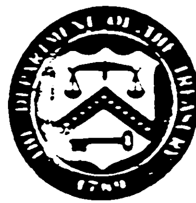
TREASURY NEWS



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

TEXT AS PREPARED

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the 1988 Annual Meetings of the
African Development Bank and Fund
Abidjan, Cote D'Ivoire
June 1, 1988

Mr. Chairman, Distinguished Governors, President N'Diaye, ladies and gentlemen:

It is a pleasure for me to address the participants in the Twenty-Fourth Annual Meeting of the African Development Bank and the Fifteenth Annual Meeting of the African Development Fund. Since becoming a member in 1983, the United States has strongly supported the work of the Bank and it is a special privilege for me to be the first U.S. Governor to attend an annual meeting. This is a continent of dynamic peoples and unbridled promise, and I am particularly honored to meet with you here in the host country of the African Development Bank.

The generous hospitality that President Houphouet-Boigny and the people of Cote D'Ivoire have extended to us is deeply appreciated by my delegation.

I would also like to congratulate President N'Diaye, who will soon complete his third year as President of the premier development finance institution of Africa. His dynamic leadership and vision of a prosperous and vibrant Africa give us confidence that Africa's future is bright.

We are all here today because of our strong interest and determination to help the people of Africa build more prosperous and more productive lives for themselves and their families. This common goal is the theme of my remarks today and the theme of U.S. efforts in Africa and in the African Development Bank.

B-1438

Problems Facing the Region in the 1980's

Mr. Chairman, the 1980's witnessed the emergence of urgent efforts by many African governments to return to a path of economic growth. Their determination to resume growth has been assisted by an intensive international effort based on a recognition that the region's economies were clearly deteriorating.

These pressures included a precipitous drop in the export price of primary commodities, the resulting increased levels of debt to GNP and export ratios, the legacy of unproductive policies of the statist economic model, and crushing famine which swept through large areas of the region.

Slow or negative economic growth, coupled with rapidly growing populations, balance of payments and fiscal problems were all signs of fundamental economic crisis. The adverse external influences, weather and climatic patterns and unsustainable economic policies all combined to demonstrate the fragility of African economies.

African governments had believed, by and large, that the state was the mechanism through which economic development could be achieved. In most countries, the role of the government became pervasive. Industry and initiative were stifled. Governments became the main source of employment for the educated; they controlled agricultural production and marketing; they controlled international trade; they entered into production on their own; they protected inefficient industry, controlled prices and mandated income levels through various price mechanisms; and they imposed taxes on producers and on exporters while urban consumers and importers were subsidized.

Resources were no longer invested where they were most productive. Savings declined, exports were discouraged and imports encouraged. Economic growth and development stopped.

Response of African Governments and the International Community

In response to this deepening economic crisis, African governments and the international community joined together to begin putting in place policies and institutional arrangements which could restore growth and development.

In tracing the emergence of this response, it is appropriate that I mention first that during this decade of the 1980's, the African Development Bank was opened to non-regional membership. The resources of the African Development Fund were also strengthened. The World Bank and the IMF engaged African governments in intensive dialogue on their economic policies. This formed the basis of an international understanding that increased external assistance would be made available to support those countries willing to carry out fundamental programs of economic reform.

An emergency Special Facility for Africa was organized under the World Bank to provide additional financing for economic reforms. As the linkages between the structural and macroeconomic requirements of economic management became more clearly defined, the World Bank and the IMF enhanced their cooperation by instituting their joint program of Policy Framework papers. Under this approach, African and other low-income countries design comprehensive economic programs that can attract external financing. These papers have become an invaluable tool for coordinating external bilateral and multilateral assistance.

As part of this process, the IMF put in place its Structural Adjustment Facility to support reforms, and subsequently expanded that facility substantially with the financial support of many IMF member governments. Fifty percent of IDA-8's resources are available to support African projects and policy reform efforts, and a large part of that assistance will flow in conjunction with IMF Structural Adjustment Facility financing in the context of the Policy Framework process. Adding further momentum, bilateral aid agencies recently pledged over $6 billion in co-financing for World Bank coordinated adjustment programs in the most severely "debt-distressed" countries of the region.

For Africa, the problems of indebtedness often have been pronounced and in some cases they remain very serious. Through Paris Club reschedulings, the United States and other official creditors are providing significant debt relief in support of economic programs. The Paris Club has also begun to extend grace and repayment terms for low-income, heavily-indebted countries in a further effort to be responsive to Africa's economic problems.

In this context, while we recognize that the rescheduling of interest payments provides temporary liquidity relief, the build-up of rescheduled debt often presents a difficult problem for the poorest countries. This is one of the most difficult issues which the Paris Club has wrestled with, given the different financial and legal requirements within which each of the creditor governments must operate. In our case, for example, United States laws, policy, and budgetary realities constrain us.

However, to help address this problem, I would like to announce today the willingness of the United States to expand the range of options within the Paris Club so that creditor governments which are in a position to do so can -- on a case-by-case basis -- provide concessional interest rate reschedulings for the poorest countries. Other countries might make a contribution toward relief by considering a broader range of maturities for rescheduled debt than is currently the case. Together, we believe these changes can produce substantial new relief for the poorest countries.

I should emphasize that permitting such differentiation, which is a departure from strict pari passu privileges, represents a significant addition to the options available to the Paris Club to address dire debt situations in the poorest countries. It is consistent with our case-by-case approach to addressing debt problems in developing countries and thus is not a generalized approach. It is a special technique available to assist only the poorest of the poor in a further effort to support their return to stability and growth.

Commitment to Reform Process and Economic Progress

In my contacts with Africa's economic and political leaders, I am encouraged by the depth of their commitment to economic reform not only for the present but for the long term, extending into the 1990s and beyond.

I know that pursuit of such reforms requires a large measure of political courage. The commitment to reform is sustained by a realization that failure to adapt an economy -- failure to reform -- is to consign people to conditions of famine, debt, stagnation, and political unrest. The truth is that the cost of not adjusting far outweighs the cost of adjusting.

Although many serious problems remain for Africa, we are beginning to see positive results from the combination of financing and adjustment. It is clear that many African governments are slowly but surely beginning the process of reversing years of depressed economic growth, declining per capita income, weak export sales, and difficulties in managing their debt servicing. In countries with sustained economic reform programs, growth more than doubled to some 4 percent a year during 1986-87. Sadly, countries not pursuing economic reforms saw their growth rates cut in half -- to less than 1 percent per year. During 1984-86, per capita food production rose 4.2 percent in countries pursuing economic reforms; for those not pursuing reforms the growth rate was only 2.4 percent.

Needs for Future Development

In addressing Africa's needs, we are reaching broad agreement that macro-economic and structural reforms provide a necessary basis for more efficient use of resources. They establish a climate within which more fundamental economic problems can be addressed. However, for sustained growth and development, more is needed on many fronts.

If agricultural production is to keep up with, let alone exceed, population growth, new technologies must be found. Scientists must be trained, research capabilities strengthened, seed varieties developed, and land management techniques improved dramatically. Health and basic education needs to be given a higher degree of priority and support.

Domestic and regional financial systems must be nurtured, strengthened and allowed to feed the African entrepreneurial spirit. Markets for exchange of goods must be allowed to develop and function free of excessive regulation and price controls. Regulatory and economic environments must be made hospitable to foreign investment which carries with it technological and managerial skill. There is an urgent need for the private sector to be allowed to function and grow.

And, as in every other region of the world, proper management of Africa's natural resources requires increased attention. Much of Africa is in an environmental crisis.

We must act on the fact that environmental conservation is not only a social issue but an economic necessity. The concepts of environmental conservation, economic growth and development must be treated as an integrated whole if we are to fulfill our vision for the future prosperity of Africa and the other regions of the world.

The Global Economic Environment

These multiple objectives represent an ambitious undertaking for Africa and its leaders. Of course, we all recognize that the health of the global economy plays a large role in determining the future vitality and direction of African economic growth.

Mr. Chairman, I believe it is important to note that in the past year there have been a number of positive developments in the industrial world that should help provide for a more supportive global economic environment and continued market growth for exports from the African countries. Real GNP in the industrial countries grew 3 percent last year, the fifth year of expansion; and another year of 3 percent growth is projected for 1988. External imbalances of the largest industrial countries are being reduced and inflation remains low.

In the United States, we are working hard to resist protectionist pressures and, in this regard, we consider that progress in the Uruguay Round is an absolute necessity, if we are to maintain an open global trading system that can benefit developed and developing countries alike.

In reviewing industrial country efforts to assist Africa I would like to mention that the United States continues to provide significant levels of financial assistance for policy reform and development programs in Africa despite our need to continue reducing our own fiscal deficit.

We are providing almost $1 billion in bilateral economic assistance and food aid to Sub-Saharan Africa in the current fiscal year. In the multilateral area, we have pledged $2.9-billion to IDA-8, $720 million to the fourth general capital increase to the African Development Bank, and $315 million to the fifth replenishment of the African Development Fund.

Role of the African Development Bank

Among the institutions and programs which address the developmental and economic problems facing Africa, the African Development Bank group plays a prominent role.

Since joining the Bank, the United States has worked to be a constructive partner and to encourage the adoption of policies and practices which we believe can improve the efficiency and effectiveness of the Bank Group.

On occasion, we have been highly critical of specific loans and policies proposed by the Bank. Clearly, our criticism does not reflect an absence of support for the Bank or its mission, but rather our commitment to the Bank as a more effective channel of assistance to encourage Africa's development efforts.

In this context, I would like to review a number of issues which we believe will be central to the Bank's ability to affect the well-being of Africa.

Policy Based Lending

The first is policy-based lending. Sectoral and structural adjustment loans must promote and support the adoption of sound policies in borrowing countries. We believe this is an important tool for the Bank in reinforcing its commitment to economic reform in Africa.

We believe, however, since this is a relatively new activity for the Bank, that it must proceed cautiously. The volume of such lending cannot expand quickly, and the Bank must ensure that its adjustment lending is coordinated with others, including where appropriate, the World Bank Group, the IMF and bilateral agencies. International financial institutions must be partners who can share their experience with each other. They must not be competitors in the development process.

Loan Quality

The United States believes that further progress needs to be made in improving the quality of overall lending. In our opinion, the Board has been asked to fund too many projects that will not contribute to economic growth.

We encourage management to work to ensure that projects are priority investments and have the necessary conditions to ensure their success. We ask that management put in place a stronger system to ensure that loans that come to the Board are developmentally and economically sound.

Private Sector

We believe the Bank must play a much stronger role in development of the private sector within Africa. Unfortunately, too often we find that projects are proposed for public sector activities which have dismal records of performance. Accordingly, we strongly welcome the establishment of the President's Roundtable of African Businessmen to assist the Bank in identifying ways in which it can play a much stronger role in assisting the private sector.

Financial Management

The Bank has taken a number of steps to correct potential financial problems, but we are concerned that it is not moving quickly enough in this area. Management has presented proposals to the Board which will alleviate interest and exchange rate risks associated with Bank lending. We hope they can be implemented quickly.

We also believe the rising levels of administrative expenses and arrears can damage the Bank's financial standing. We encourage members to support the Bank by providing their capital subscriptions on time and we also encourage the Bank to institute firm measures aimed at reducing the level of loan arrears and the growth in administrative expenses.

Environment

The Bank has made progress in preserving Africa's environment and we believe the Bank has a major role to play in this area. We recognize that the Bank must continue to operate within budget constraints and therefore my own government is making available an environmental specialist to the Bank. Over time, we hope the Bank will be in a position to develop its own permanent cadre of environmental experts.

I also urge the Bank to proceed with the proposed joint Bank-NGO outreach project which will provide positive support to our environmental goals.

Conclusion

Together we have undertaken an ambitious set of challenges for the African Development Bank, for African governments seeking to achieve sustained economic growth and for the international donor community at large. To date, the performance of each offers the basis for optimism.

The Bank's challenge is to play an increasingly strong role in helping African countries develop and reform their economies in order to achieve economic growth. We believe the coming years will be a crucial test -- and we believe the Bank can fulfill its mandate with distinction.

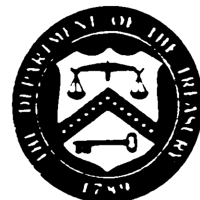
Many African governments have accepted the challenge to implement comprehensive reform programs, often with very satisfying results. Some governments are just beginning the process of economic adjustment and reform. And a number of governments have yet to begin the process. To them -- the governments still at the door -- we extend a special message of encouragement, and we stress what I am sure is our collective willingness to work actively with you to support efforts toward adjustment and sustainable growth.

And finally, my government, along with the international donor community at large, has accepted the challenge to work with Africa to help you achieve your economic goals. These goals are ambitious -- to end hunger, restore sustainable economic growth and provide a positive standard of living for all Africans for the coming decades and well into the future.

I thank you for the honor of being able to join you here today as part of this great African endeavor. In concluding, I want to assure you that you have the continuing warm regard and support of my country as you work to ensure the future success of Africa and its proud people.

Thank you.

TREASURY NEWS



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FOR IMMEDIATE RELEASE June 1, 1988

RESULTS OF TREASURY'S AUCTION
OF 9-DAY CASH MANAGEMENT BILLS

Tenders for $4,005 million of 9-day Treasury bills to be issued on June 7, 1988, and to mature June 16, 1988, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	6.92%	7.03%	99.827
High	6.96%	7.07%	99.826
Average	6.94%	7.03%	99.827

Tenders at the high discount rate were allotted 53%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	27,500,000	3,422,100
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	--	--
Chicago	1,650,000	179,500
St. Louis	--	--
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	1,310,000	403,000
TOTALS	$30,460,000	$4,004,600

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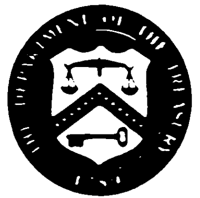
TREASURY NEWS



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FOR IMMEDIATE RELEASE June 2, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $8,776 million of 52-week bills to be issued June 9, 1988, and to mature June 8, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.08%*	7.59%	92.841
High -	7.09%	7.60%	92.831
Average -	7.08%	7.59%	92.841

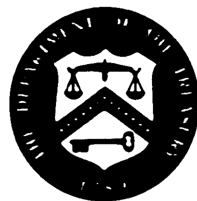
* Excepting 1 tender of $1,375,000.
Tenders at the high discount rate were allotted 11%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 19,100	$ 19,100
New York	23,794,355	7,979,955
Philadelphia	13,670	13,670
Cleveland	24,920	24,920
Richmond	20,625	16,735
Atlanta	13,055	13,055
Chicago	1,599,785	198,940
St. Louis	17,010	13,120
Minneapolis	11,330	11,330
Kansas City	30,675	30,675
Dallas	18,245	8,795
San Francisco	1,344,755	289,555
Treasury	156,415	156,415
TOTALS	$27,063,940	$8,776,265
Type		
Competitive	$23,323,125	$5,035,450
Noncompetitive	513,915	513,915
Subtotal, Public	$23,837,040	$5,549,365
Federal Reserve	3,200,000	3,200,000
Foreign Official Institutions	26,900	26,900
TOTALS	$27,063,940	$8,776,265

B-1440

TREASURY NEWS



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For Immediate Release:
June 3, 1988

Contact: Charley Powers
566-8773

TREASURY DEPARTMENT ASSESSES PENALTY AGAINST
SAN ANTONIO SAVINGS ASSOCIATION

The Department of the Treasury announced today that San Antonio Savings Association (SASA) has agreed to a settlement that requires it to pay a civil penalty of $60,000. The settlement is based on its failure to report 12 currency transactions as required by the Bank Secrecy Act.

Gerald L. Hilsher, Deputy Assistant Secretary (Law Enforcement), and Helen Milburn Eversberg, United States Attorney for the Western District of Texas, announced the penalty, which represented a complete settlement of the civil liability of the bank for the period between January 1, 1982 and December 31, 1986.

This case originated through an investigation by the Internal Revenue Service, Criminal Investigation Division and the United States Attorney's office for the Western District of Texas. The IRS said that there was no evidence of criminal activity by SASA related to these violations. SASA cooperated fully during the investigation and has made changes to ensure future compliance with the Bank Secrecy Act.

The Bank Secrecy Act requires banks and other designated financial institutions to keep certain records, to file Currency Transaction Reports with Treasury on all cash transactions by or through the financial institution in excess of $10,000, and, under some circumstances, to file reports on the international transportation of currency or other monetary instruments in bearer form or the equivalent. The purpose of the reports and records required under the Bank Secrecy Act is to assist the Government's efforts in criminal, tax and regulatory investigations and proceedings.

B-1441

TREASURY NEWS

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TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY
EXPECTED AT 1:15 P.M. CDT

Remarks by
Secretary of the Treasury
James A. Baker, III
To the 1988 International Monetary Conference
Chicago, Illinois
Monday, June 6, 1988

Economic Policy Coordination and International Monetary Reform

I am delighted to have this chance to speak once again to this distinguished group of financial leaders. And I particularly welcome the opportunity to hear some of your thoughts on the eve of the Toronto Economic Summit. In order that we can get in as much discussion as possible in the question-and-answer session, I promise to make my remarks reasonably brief.

The Development of Economic Policy Coordination

This year's Economic Summit begins in less than two weeks. As I am sure you know, there are really two economic summits, and both occur simultaneously.

The first Summit will take place in the meeting rooms where the heads of state and their finance ministers confer. Another may play out on the television screen, where reporters and commentators speculate on all the possibilities for conflict among the major actors.

I can't tell you what you can expect in this second, hypothetical summit. But I can offer you some insight as to what you can expect in the real Summit.

Much of the real Summit will focus on the economic coordination process that was initiated in 1985 to give our international economic system some sense of direction and discipline.

In 1986, I spoke briefly on the subject of coordination when this conference was held in Boston. At that time, the process of coordination was relatively new. In the intervening two years, we have gained some experience with the process. I would like to discuss with you what has taken place over the last few years since the inception of the process; remark briefly on how the process is doing; and tell you why I believe the coordination process (and not some more sweeping change) provides the best way to achieve reform of the international monetary system.

Ever since cracks began to appear in the post-war monetary system developed in the 1940s, there have been intensive efforts to create a new international monetary order. These efforts subsided for a while with the development of the flexible or floating exchange rate system. But as weaknesses in the flexible rate system permitted the growth of large, unsustainable imbalances, interest in some sort of international monetary reform began to grow once again.

Our response to these developments was to strengthen international economic policy coordination among the industrial countries. The need for coordination developed from two major considerations. First, today's economies are far more interdependent than they were just a decade ago, creating a greater need for coordinating domestic economic policies. Second, while the flexible rate system clearly needed more discipline and structure, the system of fixed rates was clearly too rigid to adequately reflect changes going on in the international economy. Coordination represented a practical compromise between the shortcomings of flexible rates and the rigidity of fixed rates.

Building the Process

The 1985 Plaza Agreement represented the first major step in the coordination effort. It involved an agreement by the G-5 on the direction national economic policies and exchange rates should take to facilitate growth and external adjustment. More fundamentally, it represented a new commitment by the major industrial countries to work together more intensely to achieve global economic prosperity, and thereby enable each country to better achieve its own domestic objectives.

The success of the Plaza Agreement created momentum that led to further progress. At the Tokyo Summit, we developed a framework for multilateral surveillance of our economies using economic indicators. The IMF Managing Director was invited to participate in these meetings, thus assuring that a truly global perspective was taken. Further, a new group was formed, the G-7, in order to bring to bear the political leadership of the Heads of State or Government on the coordination effort. This commitment at the highest political levels has been crucial to progress to date, and it will be essential for maintaining momentum in the period ahead.

At the Venice Summit last year, the coordination process was strengthened further by the adoption of arrangements involving the development of medium-term objectives and performance indicators to assess policies and performance.

Thus the major industrial countries have now developed a political mechanism to enhance their ability to coordinate economic policies. And although the process is still very young, there is already ample evidence that it is bearing fruit. Both fiscal and monetary policies are being framed in an international as well as a domestic context. As a consequence, the United States has taken measures to reduce the budget deficit, increase domestic savings and improve competitiveness. The major surplus countries, Japan and Germany, have taken steps to improve domestic demand and reduce reliance on export-led growth. There have been coordinated interest rate actions. Cooperation in exchange markets has been intensified based on specific understandings.

As a result, the world economy is on a much more solid footing. Growth continues, but is now more balanced and is supportive of the adjustment process. Inflation remains low, and external imbalances are being reduced. The U.S. trade figures for March provide evidence that these imbalances are now declining in nominal as well as real terms.

The coordination process was seriously tested last fall in the wake of the October stock market crash. It would have been easy for each of us to turn inward and focus on short-term measures to address immediate domestic needs. Instead, the G-7 pulled together and intensified its efforts to find a compatible and reinforcing set of policies to achieve common goals. These efforts (which were conducted privately between Ministers and Governors over a period of weeks) were reflected in the December statement of the G-7, thereby demonstrating the resilience of the coordination process in the face of adversity. Since that time, strengthened underlying policy actions have been reflected in enhanced stability of exchange markets.

Strengthening Coordination and Reforming the System

As this process of coordination among the major industrial nations has been developing, questions continue to be raised about the need for "more fundamental monetary reform." This is natural. We certainly do not have a perfect monetary system, nor total coordination of our policies. We cannot afford to rest on our laurels. We need further strengthening and reform of the system.

What form and direction should this take? It is tempting to consider sweeping, revolutionary changes in the system -- particularly the exchange rate part of the system. But it is far from clear that such changes are desirable or practical.

While it may be difficult to recognize reform when it emerges gradually in a step-by-step fashion, I think that further strengthening of our process of coordination is the best means of achieving further reform of the monetary system.

What are the characteristics of this step-by-step or incremental approach to monetary reform which make it the best option available?

- First, it combines flexibility with greater commitment and obligation. Countries have committed to this process at the highest political level, and they have obligations to develop medium-term economic objectives, along with performance indicators to assess progress toward the objectives. At the same time, it involves no ceding of sovereignty.

- Second, it recognizes that reform of the system is not simply a matter of exchange rates or reserve assets. Exchange rates certainly are a key variable. Ultimately, however, the test of an international monetary system is whether it can help foster an open and growing world economy. This involves appropriate fiscal, monetary and structural policies as well as exchange rates. The indicator system we have developed covers this full range of policies.

- Third, the system can encourage corrective policy action through the use of indicators and peer pressure without relying on automatic trigger devices.

- Fourth, the burden of adjustment is not biased toward or away from domestic policies or exchange rates, as was the case in the par value and early flexible rate regimes, respectively. In 1985 and 1986, coordination stressed the role of exchange rates. In 1987 and so far in 1988, the emphasis has shifted to changes in underlying policies. It is no mean feat that this shift was conducted without a major breakdown in the system.

- Fifth, the coordination and indicator process contains symmetry by focusing on surplus as well as deficit countries. Symmetry is a long sought after -- and necessary -- element in international monetary arrangements. Efforts to build it into the system through various automatic techniques have failed in the past, and would likely fail again. In contrast, the indicator system now in place provides a structured but judgmental framework for assessing the need for actions by deficit and surplus countries alike.

- Sixth, the final attribute that I would cite is credibility. In today's era of global economic integration and instant communications, credibility is key. An attempt to make an abrupt or major change in the structure of the system by imposing a detailed set of formal constraints might well be viewed by the markets as overly ambitious and unsustainable, and such an approach might not give adequate regard to political realities or the force of financial flows.

The global economy is too dynamic, and the forces of change too strong, to be able to look ahead with great certainty and envision a highly defined international monetary structure that will fit the world economy of 1995 as well as that of 2005.

We must therefore move cautiously but steadily ahead, always alert to further improvements in the process and the system. In this connection, the major industrial countries agreed in April to develop a commodity price indicator. This indicator will supplement the existing national indicators in assessing and reaching judgments about economic policies and performance. It will be used as an analytical tool in examining global price trends, not as an automatic trigger for policy action or an anchor for currencies.

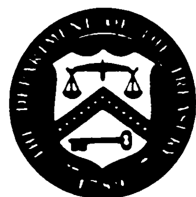
We will need to continue to consider other measures, such as broadening the coordination process to cover structural reforms in such areas as tax reform, financial market liberalization, and deregulation of labor markets; and the use of "monitoring zones" for key indicators such as growth and trade balances to help in assessing an economy's performance.

Conclusion

So to conclude, I would submit that our process of international economic policy coordination has reformed and strengthened the international monetary system. We have created a political mechanism that has brought discipline and structure to international economic policy-making. And our approach has worked -- not perfectly of course. But I strongly suspect the world economy is better off today than we would have been had we not followed this course. And I think additional progress will be achieved in the future.

Many of those who earlier had doubted this process have seen its benefits. As a result, coordination now has broader support and momentum that should carry it into the future, well beyond the terms of current administrations in the G-7 countries. We have come a long way in a few short years, and policy coordination should provide a sound framework for achieving meaningful and effective reform during the years ahead.

Thank you.

TREASURY NEWS 

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FOR IMMEDIATE RELEASE
June 6, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,436 million of 13-week bills and for $6,411 million of 26-week bills, both to be issued on June 9, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 8, 1988			:	26-week bills maturing December 8, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.42%	6.62%	98.377	:	6.67%	7.00%	96.628
High	6.45%	6.65%	98.370	:	6.72%	7.05%	96.603
Average	6.44%	6.64%	98.372	:	6.72%	7.05%	96.603

Tenders at the high discount rate for the 13-week bills were allotted 31%.
Tenders at the high discount rate for the 26-week bills were allotted 81%.

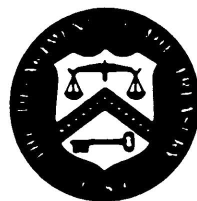
TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 39,740	$ 39,740	:	$ 29,950	$ 29,950
New York	22,337,900	5,541,150	:	20,726,730	5,249,840
Philadelphia	29,755	29,755	:	16,725	16,725
Cleveland	35,310	35,010	:	29,860	29,860
Richmond	43,685	43,685	:	30,255	30,255
Atlanta	31,145	30,745	:	27,840	27,840
Chicago	1,506,045	97,545	:	1,568,395	338,445
St. Louis	22,415	18,415	:	29,870	27,680
Minneapolis	12,520	7,520	:	14,235	13,285
Kansas City	26,875	26,875	:	46,665	46,665
Dallas	36,755	26,755	:	31,625	25,675
San Francisco	1,632,775	191,025	:	1,212,645	239,255
Treasury	348,145	348,145	:	335,950	335,950
TOTALS	$26,103,065	$6,436,365	:	$24,100,745	$6,411,425
Type					
Competitive	$22,564,885	$2,898,185	:	$19,654,880	$1,965,560
Noncompetitive	961,950	961,950	:	857,165	857,165
Subtotal, Public	$23,526,835	$3,860,135	:	$20,512,045	$2,822,725
Federal Reserve	2,508,030	2,508,030	:	2,150,000	2,150,000
Foreign Official Institutions	68,200	68,200	:	1,438,700	1,438,700
TOTALS	$26,103,065	$6,436,365	:	$24,100,745	$6,411,425

1/ Equivalent coupon-issue yield.

B-1443

TREASURY NEWS



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

FOR RELEASE AT 4:00 P.M.
June 7, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued June 16, 1988. This offering will result in a paydown for the Treasury of about $4,625 million, as the maturing bills total $ 17,413 million (including the 9-day cash management bills issued June 7, 1988, in the amount of $4,005 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 13, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated March 17, 1988, and to mature September 15, 1988 (CUSIP No. 912794 QM 9), currently outstanding in the amount of $6,884 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated June 16, 1988, and to mature December 15, 1988 (CUSIP No. 912794 QX 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 June 16, 1988. 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 $1,759 million as agents for foreign and international monetary authorities, and $4,290 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

For Release on Delivery
June 9, 1988

STATEMENT OF THE HONORABLE GERALD L. HILSHER
DEPUTY ASSISTANT SECRETARY (LAW ENFORCEMENT)
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

June 8, 1988

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to testify before the Committee today about the Committee's draft bill which would revise the Bank Secrecy Act and the Right to Financial Privacy Act. We understand that this bill will be put forward by the Committee for inclusion in the House Omnibus Drug legislation. While the Department of the Treasury is generally in agreement with the Committee's bill, we have some comments that we hope you will consider carefully. We also would like to discuss the legislative proposals with respect to the Bank Secrecy Act and related statutes that have been developed by Treasury under the auspices of the National Drug Policy Board. These proposals will be forwarded to Congress very shortly. Finally, I would like to update the Committee on Treasury's activities in the area of financial and Bank Secrecy Act enforcement since our testimony last May.

Before I begin, I want to commend you, Mr. Chairman, and the Committee for your continued interest in effective administration and enforcement of the Bank Secrecy Act. Over the years, you and the Committee have played a vital role in making the financial community aware of its responsibilities for full compliance with the Bank Secrecy Act and of the consequences of violating its requirements. You also have been most responsive when Treasury has sought to enact new legislation to enhance its authority for ensuring compliance with the Bank Secrecy Act and to prevent money laundering activities.

B-1445

The Committee's bill sets forth two new Bank Secrecy Act provisions, 31 U.S.C. 5325 and 5326. First, I would like to discuss proposed section 5325, which is aimed at one method of money laundering, specifically "smurfing," through the cash purchase of monetary instruments -- cashiers' checks, bank checks, travelers' checks and money orders. This provision was drafted by Congressman Torres.

The intent of proposed Section 5325 is to require identification from money launderers who are not account holders at the financial institutions where they purchase monetary instruments with cash. Under the Bank Secrecy Act, the only identification records currently required for individuals who do not engage in currency transactions in excess of $10,000 are those that pertain to new accounts. Thus, under the Act, a customer who does not have an account relationship with a financial institution can engage in currency transactions under the $10,000 reporting threshold without being detected by the Government and, often, by the financial institution.

Proposed section 5325 would require financial institutions to obtain identification and maintain a record of cash purchases of these monetary instruments by nonaccount holders. To comply with this requirement, Treasury envisions that financial institutions would need merely to maintain a chronological log of the cash purchases of these instruments. This log would be reported to Treasury upon request.

Treasury believes that the requirements of proposed Section 5325 will be a useful deterrent to the practice of smurfing through the purchase of monetary instruments and will not be overly burdensome for financial institutions. In fact, Treasury has recommended that a proposal similar to Congressman Torres' proposal be included in the Administration's recommended legislative proposals being developed in the National Drug Policy Board.

Treasury does, however, have some recommendations that we believe would improve section 5325. First, we recommend that Treasury's authority to require the financial institution to provide Treasury with a report of the identification information it has obtained be made explicit in the statute. Second, we urge the

Committee to delete any reference to a specific dollar amount at which the identification information would be required from the statute. Rather, we would prefer for the Secretary of the Treasury to be given the authority to determine an appropriate amount by regulation. In this way, Treasury will be able to respond more easily to changing law enforcement needs.

Under the second proposed provision, section 5326, the Secretary of the Treasury would be able to issue an order to target financial institutions in certain geographic locations for special reporting of currency or monetary instrument transactions in an amount less than $10,000 for a limited period of time. The location would be selected based upon a determination by the Secretary that there may exist a high level of drug money laundering activity in that area. A request from a Treasury law enforcement "currency group" or joint financial investigative task force would trigger such a determination.

Under this proposal, Treasury would be able to require all financial institutions to file currency reports at an amount lower than the normal $10,000 reporting threshold under the Bank Secrecy Act. The purchasers of these instruments would have to provide the identification required under the Bank Secrecy Act. Treasury envisions that the form to be used for making these reports would be the Currency Transaction Report ("CTR") which is filed on Form 4789, and that no new form would be developed. The report then would be separated from the usual CTRs and analyzed by a team of Treasury investigators or analysts working in the currency group or in a joint financial task force in the targeted location.

Because time would be of the essence in maximizing the utility of the information obtained pursuant to a targeting order, Treasury is pleased to see that the bill exempts any order issued pursuant to proposed section 5326 from the normal delayed effective date provisions required for regulations under the Administrative Procedure Act ("APA").

The implementation of a request to target a limited geographic area does present some practical problems for Treasury as well as the affected financial institutions. First, Treasury would have the responsibility for quickly identifying all the financial institutions to be targeted in the specific geographical area. While it would not be difficult for Treasury to identify the affected banks, it would be difficult for Treasury to identify certain categories of nonbank financial institutions, e.g. currency exchanges and check cashers. Second, Treasury would have to transmit notice of the order by letter to all the affected institutions. Finally, the targeted institutions would have to educate their tellers and other employees very quickly, as to the new reporting requirements and any additional recordkeeping procedures.

Despite the practical difficulties in implementing any order, Treasury believes that the information obtained could be highly useful to law enforcement officials. On-the-spot analysis of the information may very well lead to the breakup of money laundering organizations. For this reason, Treasury is anxious to develop and refine the concept. Treasury recognizes, however, that a

significant drawback to any approach that is limited geographically will result in driving money launderers on to new locations where law enforcement officials and financial institutions may not be as sensitive to patterns of money laundering.

While we cannot judge with certainty the outcome of this kind of targeting, Treasury hopes that next year, we will be able to come back and report favorably to the Committee on its utility.

In addition to the amendments to the Bank Secrecy Act contained in the Committee's bill, Treasury hopes that you will consider including a number of technical corrections to the Money Laundering Control Act of 1986, Subtitle H of the Anti-Drug Abuse Act of 1986, Pub. L. 99-570, in the bill.

First, 31 U.S.C. 5312 needs to be amended to correct a numbering error. As you know, that provision sets forth a list of the types of financial institutions subject to the Bank Secrecy Act. When the Postal Service was added to the list of financial institutions in the Money Laundering Control Act of 1986, a numbering error resulted. This error needs to be corrected.

Another technical correction relating to the Postal Service is also necessary. When the Postal Service was added to the list of institutions subject to the Bank Secrecy Act, no corresponding change was made to 31 U.S.C. 5318(a). That section currently authorizes the Secretary of the Treasury to delegate enforcement responsibility for Bank Secrecy Act compliance only to "supervising agencies." Because the Postal Inspection Service, as part of the Postal Service, cannot be considered a supervising agency under current law, the Secretary may not delegate enforcement authority for Bank Secrecy Act compliance by the Postal Service to the Postal Inspection Service. Therefore, an amendment is needed to add the Postal Inspection Service to the list of agencies to which Treasury can delegate enforcement authority.

The bill also should be modified to correct an inadvertent omission that arose in connection with the 1986 revision to the civil penalty provision for violations by financial institutions of the reporting requirements of the Bank Secrecy Act, 31 U.S.C. 5321(a). As you recall, in the 1986 Act, the amount of a civil penalty that could be assessed against a financial institution for reporting violations was raised to an amount keyed to the underlying unreported funds. At the same time, however, the daily penalty for violations by financial institutions of procedures promulgated by Treasury under 31 U.S.C. 5318 was inadvertently dropped. The bill should be modified to reinsert the daily penalty of $10,000 for violations of procedures.

There is also a critical need for revision to the recordkeeping provisions of the Bank Secrecy Act, 12 U.S.C. 1829(b) (applicable to insured banks), and 12 U.S.C. 1951-1959 (applicable to nonbank financial institutions). Violations of the recordkeeping provisions of the Bank Secrecy Act can be as deleterious to law enforcement as violations of the reporting provisions.

Nevertheless, there is currently no civil penalty applicable to insured banks which violate the recordkeeping provisions. There should be a civil penalty for both willful violations of the recordkeeping provisions up to a maximum of $10,000 and a maximum $500 penalty for negligent violations of these provisions by these institutions. Also, the penalty applicable to nonbank financial institutions subject to the Bank Secrecy Act for recordkeeping violations should be raised from a maximum of $1,000 per violation to $10,000 per violation and a $500 negligent penalty added. The definition of nonbank financial institutions subject to the penalty also should be amended to cover all types of nonbank financial institutions under the Bank Secrecy Act. At this time, institutions such as casinos are not covered.

Although not within this Committee's jurisdiction, but certainly of interest to the Committee, would be Treasury's recommendation to revise the Internal Revenue Code to complement Treasury's Bank Secrecy Act authority. This revision would provide all law enforcement officials, and not only the IRS, with access to reports filed under section 6050I of the Internal Revenue Code.

Section 6050I, which is similar to Section 5313 of the Bank Secrecy Act, requires cash reporting of amounts in excess of $10,000 received in "trades or businesses" other than those covered by the Bank Secrecy Act. Clearly these reports are, in many instances, of comparable utility to law enforcement, especially in drug cases, e.g., reports on the cash purchase of motor vehicles or real estate. Unfortunately, however, the IRS disclosure restrictions in Internal Revenue Code section 6103 currently do not allow analysis of the information or law enforcement access on a par with Bank Secrecy Act information.

Treasury strongly recommends that an amendment be made to section 6050I to exempt returns filed under that provision from the disclosure restrictions of section 6103. This will enable law enforcement to analyze section 6050I returns with Bank Secrecy Act reports as part of Treasury's financial data base, and permit Treasury to disseminate these reports to law enforcement agencies to the same extent as Bank Secrecy Act reports. Enforcement responsibility for section 6050I would remain with IRS. Section 6050I reports (like Bank Secrecy Act reports) would be exempt from the Freedom of Information Act.

Finally, we recommend that an anti-structuring provision be added to section 6050I that is comparable to the Bank Secrecy Act anti-structuring provision applicable to customers who structure transactions to evade the Bank Secrecy Act reporting requirements, 31 U.S.C. 5324, and that a willful violation of section 6050I be punished as a felony offense, and not just a misdemeanor. This proposal has been suggested for inclusion in the National Drug Policy Board legislative proposals.

I would like to turn now to the Committee's proposed amendments to the Right to Financial Privacy Act ("RFPA"). While Treasury shares the Committee's concerns with protecting the financial privacy of individuals, Treasury believes that in today's climate, we must, in some limited areas, reevaluate the appropriate balance between the right to financial privacy and the legitimate needs of Federal law enforcement. Treasury remains sensitive to protecting the privacy rights of individuals within the context of law enforcement.

Treasury, therefore, is very pleased that the bill does include a revision to the RFPA that would allow information and records relating to possible crimes against financial institutions or against supervisory agencies by insiders to be provided by the financial institution or supervisory agency to the Department of Justice without notice to the insider. As you are well aware, prior notice would enable the alleged wrongdoer to transfer assets or otherwise impede the investigation. As Treasury has testified before the Committee, we firmly agree with you on the need for this measure.

While the draft bill similarly provides that possible violations by insiders of the Bank Secrecy Act may be reported by a financial institution or supervisory agency to the Secretary of the Treasury without notice, Treasury would like to point out that, at least with respect to officers, directors and employees, existing law already clearly authorizes such disclosures. This is because, under section 1101(6)(H) of the RFPA, Treasury is a supervisory agency for purposes of Bank Secrecy Act enforcement. Section 1113(b) sets forth that "[n]othing in this chapter [RFPA] prohibits ... disclosure to any supervisory agency of financial records or information in the exercise of supervisory, regulatory or monetary functions with respect to a financial institution." Under delegations from Treasury, bank supervisory agencies routinely examine institutions and report to Treasury possible Bank Secrecy Act violations by financial institution officers, directors, and employees and provide supporting financial records, where necessary, without notice. Financial institutions also disclose information and records about their own past noncompliance to Treasury without reference to the RFPA. We strongly urge you to emphasize in the Committee report that this is not a change to existing law.

Unfortunately, the law is not as clear, and an amendment to the RFPA is very much needed, to permit financial institutions to report possible violations of the Bank Secrecy Act by their customers, i.e., in situations where the bank suspects that its customer has violated 31 U.S.C. 5324, the anti-structuring provision of the Bank Secrecy Act. If the bank is not implicated in the possible anti-structuring violation, broad disclosure to Treasury arguably may not be within the exercise of Treasury's "supervisory functions ... with respect to a financial institution." Banks then only would be able to provide Treasury with the limited suspicious transaction information allowed by section 1103(c) of the RFPA.

Generally, without access to the underlying customer account records and other information about the customer, this limited information would not be adequate to establish probable cause that the anti-structuring provisions of the Act have been violated. Without probable cause, Treasury cannot proceed to seize funds that are on deposit with financial institutions. Instead, Treasury would have to issue a summons to the institution for the account records and other information and provide notice of the summons to the customer. Notice to the customer would be fatal to the investigation and seizure action, because once the customer has knowledge of the summons, he can withdraw the money on deposit or wire transfer it to a foreign jurisdiction.

For these reasons, we would urge you to include a provision in the RFPA that would allow a financial institution to report, in good faith, all available information and to disclose records with respect to possible violations of the Bank Secrecy Act by customers, without notice to the customer and without fear of civil liability.

If an amendment to the RFPA is made which permits financial institutions to disclose information without customer notice, it is imperative that a corresponding amendment be made that protects a financial institution from civil liability to the customer under State law if the disclosure is made in good faith. Without this federal preemption, financial institutions will be faced with the possibility of civil liability under State financial privacy laws, and they will be deterred from cooperating with law enforcement. As I will discuss later in this statement, cooperation from the financial community in reporting suspicious transactions is an increasingly important aspect in the attack against the financial infrastructure that supports the drug trade.

There is one technical amendment that is needed to the RFPA. When Congress amended the suspicious transaction provision, section 1103(c), in the 1986 Act, to specify what information a financial institution could give relating to possible violations of law or regulation, a good faith preemption clause was included.

However, an ambiguity was created about whether financial institutions are protected from liability for good faith reports of possible violations of law or regulation when the violations involve corporations or corporate accounts. Although the legislative history makes it clear that Congress contemplated that situations involving corporations would be covered, the RFPA itself does not apply to corporate privacy. See Sen. Rep. No. 894, 99th Cong., 2d Sess. 15-16 (1986). A reference needs to be made in section 1103(c) to expressly cover corporations. We have provided the Committee staff with draft language to this effect.

The Bank Secrecy Act Requirements and Enforcement Organization

Before I proceed to update the Committee on Treasury's initiatives in the area of Bank Secrecy Act and financial enforcement, I would like to explain briefly, by way of background, what the Bank Secrecy Act is and Treasury's enforcement role in the area of Bank Secrecy Act and related financial enforcement matters.

As you know, the Bank Secrecy Act was enacted in 1970 and gives the Department of the Treasury broad authority to require the maintenance of records and the filing of reports that have been determined to have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. In passing the Bank Secrecy Act, Congress hoped to lessen the impediment to U.S. law enforcement authorities posed by stringent foreign bank secrecy laws. Congress also hoped that the reporting of the sources, volumes, and movements of domestic and international currency would betray a wide variety of criminal activity, including drug trafficking and tax evasion. These hopes have been borne out.

The authority given to Treasury in the Bank Secrecy Act is generally not self-executing, but must be implemented by regulations promulgated by the Secretary in his discretion. Since the inception of the Bank Secrecy Act, Treasury, in exercising this regulatory authority, has been acutely concerned with striking the appropriate balance between the needs of the law enforcement agencies and the costs of compliance to the financial community.

With this in mind, Treasury has imposed three major reporting requirements under the Act. Briefly, these reports are:

(1) The Currency Transaction Report (CTR) -- This requires that designated types of financial institutions report all types of cash transactions by, through or to the institutions in excess of $10,000. Financial institutions subject to this requirement include banks, savings and loans, credit unions, securities brokers and dealers, foreign currency brokers and several categories of miscellaneous financial institutions such as casinos, check cashers and currency exchanges.

(2) The Currency or Monetary Instrument Report (CMIR) -- This requires that all persons report the import or export of currency or monetary instruments in excess of $10,000 into or out of the United States.

(3) The Foreign Bank Account Report (FBAR) -- This requires that all persons subject to the jurisdiction of the United States make an annual report of their interests in foreign bank accounts.

Finally, the Act and the regulations require financial institutions to maintain a variety of records (such as copies of signature cards, bank statements, and checks drawn for more than $100) for a five-year period. Records required to be kept under the Bank Secrecy Act, unlike the Bank Secrecy Act reports, generally may be examined by law enforcement authorities only for the purpose of assuring compliance with the Act's requirements; in other cases, authorities must obtain subpoenas or comply with other legal provisions. As I discussed above in connection with the need for recordkeeping penalties, the recordkeeping provisions, less well known than the reporting provisions, are of great value to law enforcement in the creation of a "paper trail."

The Secretary of the Treasury has delegated to the Assistant Secretary (Enforcement) overall responsibility for Bank Secrecy Act enforcement. Within my office, the responsibility for coordination of Bank Secrecy Act enforcement and policymaking rests with the Office of Financial Enforcement. That office is also responsible for imposition of civil penalties under the Bank Secrecy Act, which I will discuss shortly.

Enforcement is accomplished through a complex series of delegations emanating from and supervised by my office which I will briefly describe:

- The IRS Currency and Banking Reports Division is responsible for the computerization of the CTRs and FBARs. The IRS Examination Division is responsible for compliance examination of miscellaneous financial institutions for which examination authority has not otherwise been delegated.

- The IRS Criminal Investigation Division ("IRS-CID") is responsible for the investigation of all criminal cases (except CMIR cases) under the Bank Secrecy Act for all types of financial institutions.

- The United States Customs Service is responsible for the computerization of the CMIRs and for civil and criminal enforcement of the CMIR provisions. In addition, Customs also maintains the combined data base

for all Bank Secrecy Act information. The Customs Financial Intelligence Branch is responsible for the analysis and dissemination of Bank Secrecy Act data for a variety of law enforcement purposes.

- Examination of Bank Secrecy Act compliance is generally delegated to the various regulatory agencies that have responsibility for supervising financial institutions. The Office of the Comptroller of the Currency is responsible for the examination of national banks, the Federal Reserve System for State member banks, the Federal Home Loan Bank Board for insured savings and loans, the National Credit Union Administration for Federal and Federally insured credit unions, the Federal Deposit Insurance Corporation for State banks that are not members of the Federal Reserve, and the Securities and Exchange Commission for federally regulated brokers and dealers.

Enforcement of the Bank Secrecy Act

Treasury views the Bank Secrecy Act as a law enforcement "tool," and enforcement of its provisions as the "grinding wheel" that sharpens the tool. Thus, in the past three years, Treasury has been more vigorous than ever before in initiating investigations and levying civil penalties against financial institutions for civil violations of the Bank Secrecy Act. Since June, 1985, Treasury has levied civil penalties totalling over $16 million for Bank Secrecy Act violations in thirty-nine cases involving financial institutions. In a number of these cases, the civil penalty was assessed against bank holding companies that owned more than one bank that had violations. Thus, these thirty-nine penalties actually involved one hundred and seven banks that Treasury concluded had violated the Act. Moreover, twenty-nine of these penalties exceeded $100,000 -- an indication that the violations to which the penalties pertained were neither isolated nor infrequent.

In addition, in the past five years, IRS-CID has steadily increased the number of investigations and prosecutions for criminal violations of the Bank Secrecy Act. The number of indictments have increased from 29 in 1982 to 236 in 1987, and convictions have also increased from 25 to 153 during that same time period.

Another aspect of Bank Secrecy Act enforcement that is sometimes overlooked, but is no less vital for an effective compliance program, is the commitment of the United States Customs Service to enforcement of the Bank Secrecy Act requirements for CMIRs. During Fiscal Year 1987, Customs conducted a total of 2,138 seizures of currency and monetary instruments totalling $192,382,985 for violations of CMIR requirements. Through April, in Fiscal Year 1988, Customs has conducted a total of 641 seizures totalling $56,323,737, for violations of the CMIR requirements.

The Financial Database

The CTRs, CTRCs, and the FBARs are filed with the Internal Revenue Service and placed on a computer at the IRS Detroit Data Center. The CMIR reports are filed with the U.S. Customs Service and are processed in Newington, Virginia. These reports, when combined, form what we call the Treasury Financial Database. The Financial Database is accessible to Customs and IRS agents and financial analysts for targeting suspicious currency transactions, investigative case support, tax examination and collection, and a host of other law enforcement uses.

Both Customs and the IRS have rule-based, artificial intelligence ("A-I") systems massaging the data contained in the financial database, along with data received from the field. These A-I systems are based on rules of suspicious indicators, for instance, persons whose many CTRs list differing occupations, social security numbers, and addresses, and whose transactions involve multiple accounts or transactions at a variety of financial institutions. According to the expert rules used by the A-I system, certain occupations are more suspicious than others, and those that are more suspect are measured against the frequency and amounts of financial transactions. CTRs filed by financial institutions for amounts below the $10,000 report threshold, e.g. a $9,900 CTR, are considered suspicious by the A-I computer, because we have learned from experience that financial institutions often file such reports because they believe the currency transactions to be suspicious.

The A-I computer applies these and other rules against the database automatically and highlights certain "targets" for further analysis by human financial intelligence analysts, and ultimately for referral to the field for further investigation. To date, over 270 targets representing reportable CTR activity exceeding $201.9 million and reportable CMIR activity exceeding $21.6 million have been generated by the A-I systems.

The Treasury Financial Database also can be used for law enforcement purposes unrelated to tracking suspicious financial transactions. Project Warrant is an operation being conducted through the Customs Financial Intelligence Branch which seeks to match information on fugitives against the database in the hope of locating escapees, persons under indictment, or persons for whom an arrest warrant has been issued. One notable success story for Project Warrant was the arrest, in November of 1987, of an escaped convicted murderer who had been a fugitive since 1984. The leads provided to the State police from the financial activity identified in the Project Warrant report culminated in the subject's arrest at the residence of one of his children. The address was obtained from a CTR filed in 1984 when the subject conducted a financial transaction.

We have been asked by many in the financial community and by Congress, "Does anyone even look at the information that we send to Detroit?" I hope you can see now that we do, and furthermore, how very important it is that the identity of the customer of a financial institution be verified and that the CTR be filled in completely, including the occupation and address blanks.

Utility of Bank Secrecy Act

Now that I have described how the financial intelligence divisions of IRS and Customs review and analyze this information, I would like to describe how these reports have proved highly useful for civil and criminal law enforcement purposes. Particularly in recent years, these reports have provided law enforcement authorities with investigative leads, information that corroborates other sources of information about criminal activities, and probative evidence in Federal criminal cases. Perhaps the most prominent example of the reports' utility can be found in United States v. Badalamenti (also known informally as the "Pizza Connection" case). That case involved the smuggling of substantial quantities of heroin into the United States by members of Italian and U.S. organized criminal groups. In the course of their investigation of heroin trafficking, Federal authorities discovered a number of CTRs that reflected large cash transactions by a Swiss national with stockbrokers in New York. These reports eventually led to the discovery of an extensive money-laundering operation that involved the transfer of tens of millions of dollars through investment houses and banks in New York City to financial institutions in Switzerland and Italy.

Ultimately, twenty individuals involved in the heroin network and money laundering enterprise were convicted in Federal court on various charges, including heroin trafficking, conspiracy, racketeering and Bank Secrecy Act violations. All received prison sentences ranging from fifteen to forty-five years. In addition, the Swiss national was convicted and imprisoned by Swiss authorities for violations of Swiss law relating to his money laundering activities.

The Government also has made substantial use of the Bank Secrecy Act to prosecute a number of leading money launderers in the United States and abroad. In recent years, for example, the Government has successfully prosecuted Isaac Kattan-Kassin, whose money laundering organization handled gross proceeds estimated at $200 million to $250 million per year; Ramon Milian-Rodriguez, who transported approximately $146 million in cash from the United States to Panama over a nine-month period; Eduardo Orozco, whose money laundering organization laundered more than $150 million over a four-year period; and Barbara Mouzin, who master-minded and operated a large West Coast money laundering business for cocaine traffickers.

In some instances, even a single CTR can provide significant investigative leads for criminal investigators. In one case, the Internal Revenue Service analyzed a single CTR and determined that the individual listed on the CTR had not filed a tax return. Subsequent investigation disclosed the existence of a massive heroin distribution and money laundering organization, operating primarily throughout southern California, which provided false information to the financial institutions that filed CTRs on their transactions. Eventually, the IRS arrested more than a dozen persons associated with the organization, seized in excess of $2 million in currency at various domestic banks, and charged the organization with income tax evasion involving $27 million in income over a three-year period.

Although many of the examples cited above involved large-scale money laundering for drug traffickers, Bank Secrecy Act reports are also highly useful in identifying or proving other types of financial crimes, for instance, bank fraud and embezzlement. In one recent case, for example, analysis of reports filed by a bank provided a number of leads as to the disposition of tens of millions of dollars that had been embezzled from the bank through such devices as illegal loans. In another recent case, Federal investigators discovered that a husband and wife had failed to file a CMIR form for the $125,000 in cash that they took out of the United States. Further investigation determined that the wife had embezzled millions of dollars from the savings and loan association in Texas at which she had been employed.

These examples amply demonstrate the substantial utility of Bank Secrecy Act reports. In addition, unlike grand jury subpoenas or court orders, the reports provide a constant stream of data on large domestic and international movements of cash and ensures that law enforcement agents obtain valuable information on suspicious transactions in a timely fashion.

Suspicious Transaction Reporting

Treasury, and I know that this Committee, expects more from financial institutions than mere compliance with the Bank Secrecy Act. We expect vigilance on the part of financial institutions to make timely reports of suspicious transactions. As you have heard us say many times, Treasury needs legitimate financial institutions to be partners with Federal law enforcement. Our message on this score has had very gratifying results with many banks and some securities brokers. Suspicious transaction reports have experienced a great upsurge in the last year. In addition, banks regulated by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have filed almost 300 Criminal Referral Forms or Reports of Apparent Crime.

A case in point that you have read about recently was the record-breaking drug seizure of 45 tons of marijuana and hashish on the barge Intrepid in San Francisco Bay. The seizure was a direct result of referrals of suspicious transactions to the Internal Revenue Service by the Bank of America and other banks. These reports prompted the Northwest Organized Crime Drug Enforcement Task Force to commence an investigation that led to the seizure of the barge.

This case commenced when, on August 7, 1987, an unidentified man entered the North Napa Branch of the Bank of America and tried to deposit $12,000 in cash into the account of a Napa Valley mortgage institution. Bank officials explained that under the Federal 1986 Money Laundering Control Act, financial institutions are required to report any single deposit of $10,000 or more to the IRS. The man then reduced the amount of the deposit to $8,000, so that the report need not be filed. Later that day, the same individual returned with a check for $4,000 from another financial institution and deposited it into the Napa Valley Mortgage account. These events led the bank officials to believe that the individual may have been attempting to circumvent the reporting law. They then called the IRS.

The rest, as they say, is history--a record seizure resulting from this tip. In addition to the drug seizure, at least six individuals have been arrested and over $1 million in cash, three vessels and real property, have been seized. I would like to take this opportunity to publicly thank the Bank of America and all of the financial institutions that are supporting the Treasury Department in its attack on the money that supports this insidious crime.

This is a stellar example of what can happen when financial institutions act in concert with law enforcement. Treasury actively encourages and depends on this type of cooperation. In order to facilitate this cooperation, within the next two weeks Treasury will be introducing, in conjunction with the Internal Revenue Service, a toll-free suspicious transaction number, 1-800-BSA-CTRS. Financial institutions will be able to call this number to report possible Bank Secrecy Act violations or money laundering violations, within the confines of the RFPA. A similar toll-free number for Customs, 1-800-BE ALERT, for reporting possible CMIR and other Customs law violations has been operational for some time.

Update on Treasury's Administration and Enforcement of the Bank Secrecy Act

Since last October, Treasury has reorganized the Office of Financial Enforcement to increase its ability to act expeditiously on civil penalty cases. The Office now has a new Director, Amy G. Rudnick, as well as a permanent Deputy Director, an Assistant

for International Affairs, an Assistant for Bank Secrecy Act Compliance on detail from the Office of the Comptroller of the Currency, a Compliance Research Analyst, and a Legal Intern. In addition, we have announced five additional permanent professional staff positions (one Bank Secrecy Act Compliance Supervisor, two Bank Secrecy Act Compliance Specialists and two Assistants for Legislation, Regulations, and Interpretations) to carry out the responsibilities of the Office. Treasury also has instituted a program where personnel from the various agencies with Bank Secrecy Act enforcement responsibility are working in the Office of Financial Enforcement on forty-five to one-hundred-eighty-day details. Currently, we have one detail from the Federal Reserve and one detail from IRS/Examination Division. The Federal Home Loan Bank System has committed a detail to begin on September 1, 1988. We believe that these details will be mutually beneficial to Treasury and the regulatory agencies.

In addition, Treasury has been engaged in an extended project, through the Bank Secrecy Act Working Group that Treasury heads, to revise and expand the guidelines that the bank supervisory agencies follow in referring possible violations of the Bank Secrecy Act to Treasury. These revised guidelines, which have been adopted by most of the bank supervisory agencies, address a broader range of factors that the supervisory agencies should consider in deciding whether to make referrals in particular cases. They also seek to streamline the referral process to minimize the time that it takes to forward a Bank Secrecy Act referral from the district office of a supervisory agency to Treasury.

Treasury also has taken a number of administrative actions to make the Treasury Financial Database, in which computerized data from the Bank Secrecy Act reports are stored, more readily accessible to law enforcement and supervisory agencies. The Office of Financial Enforcement has had "on-line" access to the Financial Database for some time, and is now finalizing arrangements with IRS to provide the bank supervisory agencies and the Securities and Exchange Commission with "on-line" access as well.

Treasury also has extensively revised the guidelines under which the U.S. Customs Service and the Internal Revenue Service may disseminate Bank Secrecy Act data to minimize procedural difficulties for other agencies and to make the data more readily available to Federal, State and foreign agencies.

In addition, Treasury has concluded an agreement with the Office of the Attorney General in California for transmission of magnetic tapes of Currency Transaction Reports that have been filed by California financial institutions. This agreement will allow the State of California to carry out its responsibilities under its own anti-money laundering law, without requiring California financial institutions to file duplicate copies of CTRs with the State.

Since last May, Treasury has had an unprecedented level of activity in improvements to the Bank Secrecy Act regulations. First, Treasury added the Postal Service to the list of institutions subject to the Bank Secrecy Act. We know of your special interest in the subject, because in 1986 a former "smurf" testified before your Committee on how he purchased Postal Service money orders to launder money. Law enforcement authorities in several major cities also observed that money launderers were purchasing Postal Service money orders with substantial amounts of cash. As you know, this problem prompted Congress, at the urging of this Committee, to add the Postal Service to the definition of "financial institution" in the Anti-Drug Abuse Act of 1986. Accordingly, Treasury amended the Bank Secrecy Act regulations on January 13, 1988, to include the Postal Service in the definition of the term "financial institutions."

We also have taken several other regulatory steps that would be of interest to your Committee:

- On June 26, 1987, we added a new Subpart to our regulations prescribing procedures for use of our administrative summons authority given to us in the Anti-Drug Abuse Act of 1986.

- On September 22, 1987, we amended 31 C.F.R. 103.43 to clarify our dissemination authority to governmental authorities of Bank Secrecy Act data and to provide for user fees for disclosures to State and local governmental authorities. The user fees would be used in the situations like the California agreement that I referred to earlier.

- On September 22, 1987, we added a new Subpart to our regulations establishing an administrative ruling system which I will discuss later in my testimony.

- On March 29, 1988, we amended 31 C.F.R. 103.25, the international "targeting" regulation, to permit reporting on retroactive transactions and to prohibit notification by the reporting financial institution of the existence of the reporting requirement to affected parties. These amendments will enable us to look at currency flows from the recent past, and will ensure that, when we do require reporting on a prospective basis, that the data will not be altered as a result of customers stopping their normal business patterns.

- We also have pending a Notice of Proposed Rulemaking, issued on April 7, 1988, proposing two amendments to the recordkeeping requirements for casinos. The comment period ended May 9, and we are in the process of drafting a final rule.

- We also have several regulatory projects pending. Of special interest to you might be a proposed definition of structuring that will be published as a Notice of Proposed Rulemaking in the next few weeks. In the near future, we also will be issuing a proposed regulation improving the CMIR provisions of the regulations. Finally, we soon will be publishing comprehensive revisions of the regulations applicable to casinos to address their unique compliance problems and capabilities.

- Finally, on March 11, 1988, Treasury published an Advanced Notice of Proposed Rulemaking to solicit the views of financial institutions, law enforcement agencies, and others on how financial institutions can best provide notice of the anti-structuring provisions of the Bank Secrecy Act to customers of financial institutions. We are in the process of evaluating the comments that we have received on this proposal.

Encouraging Compliance with the Bank Secrecy Act

Treasury has taken a number of steps to facilitate and assure full compliance by all types of financial institutions. Treasury also recognizes that many financial institutions have every interest in complying with the Act's requirements, but have legitimate questions about the requirements of the regulations and concerns about the costs associated with compliance. Treasury shares these concerns. To address these concerns, and to make the process of complying with the Act's requirements more efficient, Treasury has undertaken three significant projects.

First, Treasury, with the assistance of the IRS, has written a comprehensive handbook on how to properly exempt certain types of customer accounts and currency transactions from the CTR reporting requirements, as permitted by the regulations. Treasury and the IRS have written this handbook in response to their observation that many banks are over-reporting on exemptible customers, largely because of their concern that they may be penalized if they mistakenly place ineligible customers on their exemption lists. This practice has caused these banks to file many more CTRs that the regulations require. The Exemption Handbook, which is at the printers, should help to alleviate the banks' concerns about the proper use of the exemption provisions of the regulations, and minimize confusion about their proper application. In addition to the booklet, Treasury will be corresponding with the 50 largest banks that appear to be under-utilizing the exemption process.

Second, Treasury is about to issue formal administrative rulings on various provisions of the Bank Secrecy Act regulations. These rulings are being issued pursuant to a revision in the Bank Secrecy Act regulations, issued on September 22, 1987, that explains the process for seeking administrative rulings from

Treasury. As Treasury responds to various requests for rulings, or issues rulings on its own initiative, it will be able to develop an expanding range of interpretations of the regulations and provide the financial community with clearer guidance on the meaning of the regulations.

Third, on December 31, 1987, Treasury published a notice in the Federal Register that announced the establishment of a permanent program that permits financial institutions to file CTRs on magnetic tape with the IRS Data Center. An earlier pilot program confirmed the expected benefits of magnetic tape filing of CTRS, that is, an increase in the accuracy of data being reported (only 5% of CTRs filed by magnetic tape contained data inconsistencies or format errors); a reduction in processing costs (net savings to the government of $22 million over 10 years); and a reduction in the processing time, measured from date of transaction to date first available for agent review (from 45 days to 18 days, an overall reduction of 27 days). With the encouragement of Treasury, IRS, and the financial community, the program is growing, and we expect Chase Manhattan and Wells Fargo to begin filing by magnetic tape very soon.

Financial Enforcement Strategy

I now would like to turn to some of the broader law enforcement interests that influence Treasury's approach to Bank Secrecy Act enforcement. Treasury views the Bank Secrecy Act not as a discrete program that can be conducted without reference to the enforcement activities of other Federal agencies, but rather as an integral part of a coordinated approach to financial enforcement issues that Treasury, the Justice Department, and other Federal law enforcement agencies are now pursuing.

One of the most significant means for developing this coordinated approach is the Financial Enforcement Committee of the National Drug Policy Board, which is chaired by Treasury. The Committee has become increasingly active and visible as the overall coordinating body for government programs that attack the financial operations of drug traffickers.

Two of the Committee's more substantial projects deserve special mention. One is the development and coordination of an interagency Financial Enforcement Training Program that will include Federal, State, and local government training in financial investigation and prosecution techniques. This training program is meant to implement the financial investigations strategy that recognizes the importance of joint financial investigative task forces as a means of attacking the serious drug problem in this country. The strategy recognizes that, in addition to targeting known trafficking organizations, a strategy that follows the money flowing in and out of the trafficking organizations can uncover previously unknown trafficking groups and identify the upper echelons of the organization.

The other project is referred to by the Financial Enforcement Committee as the Money Flow Model Project. This project is designed to produce a computer simulation model of the money flow mechanisms of drug trafficking and other illegal enterprises. Such a model, in the Committee's view, is expected to provide the Policy Board with new analytical tools to aid in the investigation of the money flow that supports illegal activities, to assist in the analysis and development of financial policies to limit illegal activities that are supported by illegally obtained funds, to assist in the development of financial enforcement methods, and to improve the quantification of the total volume of illegal financial activity and its economic effects. The long-range objective of the project is to develop a computer simulation model that can be used by government agencies to plan appropriate action against the assets of major criminals and criminal organizations.

The Money Flow Model Project is being developed for the Financial Enforcement Committee by the Los Alamos National Laboratory. The initial phase of the project, the writing of the plan for the model, has been funded by joint contributions from the IRS, Customs, the FBI, and the DEA. The initial phase of the project began in April, 1988, and will run for ninety days.

In addition to these two projects, the Financial Enforcement Committee is overseeing a substantial number of other projects, including the cataloging of all financial enforcement training now being conducted, a program for cross-training of intelligence analysts involved in financial analysis, and a task force to explore more effective uses of financial information. All of these initiatives can be expected to yield substantial returns for the Federal Government in investigating, prosecuting, and seeking forfeiture of assets from leading drug traffickers and the money laundering on which they rely.

International Initiatives on Financial Enforcement

While the United States has taken significant steps to deal with the problem of money laundering, the Administration realizes that it must obtain the commitment and cooperation of foreign countries in order to effectively combat drug trafficking and other types of organized criminal enterprises. It is for these reasons that the Administration has raised the narcotics issue with our Summit partners. Narcotics will be discussed in Toronto because of the recognized urgent need for improved international cooperation on programs to counter all aspects of the problem, including its financing, production and trafficking.

The scope and complexity of these issues demand a cooperative international reaction and response. The United States plans to suggest that a special Summit country task force be convened that will include key enforcement, foreign affairs and financial

experts who are involved in the battle against narcotics. We will seek improved cooperation across a wide scale of activities and we will also suggest greater efforts in the United Nations and through bilateral treaties with both our Summit partners and other countries. This will be an ongoing process, elements of which are already in place.

In addition, Treasury has recently sent a series of letters to the chief executive officers of U.S.-based financial institutions with foreign branches. These letters set forth the risks associated with international money laundering, identify certain patterns of activity that should be considered suspicious, and encourage the foreign branches of these institutions to report any suspicious transactions to overseas representatives of the IRS and Customs in a manner that is consistent with foreign law. This initiative, which Treasury had promised to pursue in the foreign branches study, may well provide U.S. law enforcement authorities with additional leads in money laundering and Bank Secrecy Act cases, and should help to persuade leading U.S. financial institutions that expanded cooperation with Federal law enforcement authorities is in their interest and the interest of their legitimate customers.

Conclusion

In conclusion, we are fighting a war with many fronts in the battle against money laundering and the criminal enterprises it sustains, but our goals are clear. Treasury shares the goal of this Committee to close the doors of legitimate financial institutions to drug money launderers. We want financial institutions to be partners with Treasury in achieving this goal. In turn, we will act responsibly in balancing law enforcement needs with costs to financial institutions in exercising our regulatory authority. We also seek to maximize efficient and effective use of Bank Secrecy Act data through vigorous enforcement.

Finally, we want to facilitate good compliance by financial institutions through open communication with Treasury, education and guidance. Again, I want to commend this Committee for your continued interest in this most important mission.

I will be pleased to answer any questions that any member of the Committee may have.

TREASURY NEWS

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PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

SUBCOMMITTEE ON TRADE
of the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

June 9, 1988

The South African Sanctions Program and H.R. 1580

Thank you Mr. Chairman and Members of the Committee:

Good afternoon. My name is Richard Newcomb. I direct the Office of Foreign Assets Control at Treasury. It is a pleasure to testify before the Committee on the South African Sanctions Program currently in force and on H.R. 1580, the Comprehensive Anti-Apartheid Amendments of 1988, as reported by the Committees on Foreign Affairs and on Banking, Finance and Urban Affairs. The Treasury Department strongly opposes this Bill.

Foreign Assets Control ("FAC") is the office within Treasury responsible for implementing the import, financial, and new investment prohibitions of the Comprehensive Anti-Apartheid Act of 1986 (the "Act"). I would like to give you a brief overview of our implementation of certain of the Act's provisions, and then to comment on the impact Treasury believes H.R. 1580 would have on U.S. trade, finance, and on the U.S. economy as a whole.

The Department of Treasury is responsible for implementing the Act's import prohibitions on such things as South African gold coins, agricultural products and food, iron and steel, sugar, uranium ore, uranium oxide, coal, textiles, and products from parastatal organizations (i.e., organizations owned or controlled by the Government of South Africa), and the prohibitions against loans and new investment. FAC coordinates and oversees the activities of Treasury pursuant to the Act. In enforcing the Act's import prohibitions, FAC is supported by the U.S. Customs Service.

FAC's experience in sanctions enforcement dates back to the period prior to U.S. entry into World War II. Today, in addition to the South African sanctions program, we have eight other programs in place against North Korea (since 1950), Cuba (since 1963), Vietnam (since 1964), Kampuchea (since 1975), Nicaragua (since 1985), Libya (since 1986), Iran, first in 1979 and a second time in 1987, and now against Panama, pursuant to sanctions imposed by President Reagan on April 8.

The Act prohibitions on the importation of krugerrands and on lending to the South African Government closely followed those in the pre-existing Executive Order sanctions adopted in the autumn of 1985. The Act and its legislative history indicated that the Senate Foreign Relations Committee staff was guided by existing Treasury regulations and interpretations in drafting the krugerrand and government loan prohibitions of the Act and

directed that we continue existing practice where not inconsistent with the Act's language. Section 301 of the Act expanded the krugerrand ban to include all South African gold coins, in the event other gold coins are minted in the future. With that note, thus, FAC and Customs Service enforcement of the gold coin import prohibition was already in place on the Act's effective date. Similarly, the prohibition on new lending to the South African Government and its controlled entities had been fully implemented in 1985.

Enforcement of the current South African sanctions program as mandated by the Act is among the highest priorities of FAC and the Customs Service. Customs currently has 15 on-going investigations and has instituted several penalty actions against importers who have attempted to circumvent the South African import prohibitions.

We will continue to work with Customs in pursuing these cases both civilly and criminally, as appropriate, to the full extent of the law.

Upon passage of the Act, FAC, in cooperation with bank supervisory agencies, contacted all banks known to hold accounts of the South African Government and its controlled entities, to inform the banks of the prohibition on accepting or holding such accounts under section 308 of the Act. FAC implemented the exception permitting diplomatic and consular

accounts by issuing specific licenses to cover each such account in the United States.

Section 310 of the Act, which contains the prohibitions against loans and new investments, requires that "no national of the United States may directly or through another person, make any new investment in South Africa." (22 U.S.C. 5060). "New investment" is defined as "a commitment or contribution of funds or other assets" and "a loan or other extension of credit." (22 U.S.C. 5001). Under these provisions, a disinvesting U.S. parent corporation may not extend credit to corporations or individuals in South Africa (other than firms owned exclusively by black South Africans) to facilitate their purchase of its South African subsidiary nor contribute or lend working capital to its South African subsidiary unless it is necessary to enable it to operate in an economically sound manner without expanding its operations.

In order to monitor compliance with the prohibitions against loans and new investments, we have worked closely with all U.S. companies operating in South Africa and have advised them in writing of the Act's requirements. The Act does not require or encourage disinvestment from South Africa. Nonetheless, state and local procurement and investment laws and the Act have that effect.

Of the approximately 250 U.S. companies with which we have corresponded, approximately one-half have already disinvested or are in the process of disinvesting. The divestment strategies of the vast majority of companies clearly have not violated the Act; however, we are now examining a few transactions which have involved deferred payment or other extensions of credit in South Africa.

Although we consider it too early to determine the full impact of the Act, it has been clear from our communication with these companies that the Act's restrictions have forced those U.S. companies still present in South Africa to operate under serious financial constraint. As a result, many have been forced to disinvest, often under sales terms extremely unfavorable to the U.S. seller. Moreover, U.S. companies do not appear to be interested in making any new investments in South Africa even where it is permitted; not one registration for a new venture has been filed with our Office pursuant to the Act's exception for investment in firms owned by black South Africans.

We are also taking steps to insure that brokerage houses, stock exchanges, and U.S. securities dealers are on written notice about the Act's restrictions on investment in South African securities. Generally, only trading in preenactment (pre-October 2, 1986) securities, including American Depository Receipts evidencing preenactment issues, is permitted. We have

also advised banks of the Act's prohibitions on loans and other extensions of credit to the South African Government or its controlled entities (effective November 11, 1985 under sanctions which pre-dated the Act) or to any person or entity in South Africa. We are working with bank supervisory agencies to ensure compliance in this area.

Let me now turn to the provisions of H.R. 1580, as reported by the Committees on Foreign Affairs and Banking, Finance and Urban Affairs. The Treasury Department is strongly opposed to this Bill. Of particular concern to us are the provisions requiring, first, the embargoing of most trade transactions with South Africa; second, the forced divestiture of U.S. interests in South Africa; third, termination of any flexibility of U.S. banks in collecting on existing loans; and fourth, the extraterritorial extension of the import, export and investment prohibitions to foreign nationals outside the United States.

First, H.R. 1580 requires a virtual trade ban on South Africa. The loss of existing contracts to U.S. exporters and importers, and the immediate need to replace supply sources and export markets, might cause severe dislocations and bring higher prices in key U.S. economic sectors.

Treasury is concerned about the McCollum amendment adopted by the Committee on Banking and Finance. This amendment to the

Bill's import sanctions would prohibit importation of third-country products containing components of South African origin. Enforcement of this provision would be extremely cumbersome, requiring the Customs Service to determine whether South African content was included in virtually all imported items. Our trading partners, none of whom has adopted matching South African trade sanctions, will in all likelihood view the exclusion of their products under this provision as a nullification of benefits under the GATT, and retaliate against U.S. exports or seek compensation.

The exception to the H.R. 1580 import restriction for strategic minerals also raises difficult questions. In addition to existing certification requirements to authorize such imports, the Bill requires the President to certify that quantities of strategic minerals essential to the national economy and defense cannot be met in a timely manner by improved manufacturing processes, conservation, recycling, and economic substitution. On what basis is the President to determine whether essential economic and defense needs can be met on a timely basis without South African strategic minerals through improved manufacturing processes, conservation, recycling, and economic substitution? Is it intended that the President curtail the availability of strategic minerals from South Africa if U.S. business fails to adopt improved manufacturing processes, conservation, recycling, and economic substitution to end reliance on such minerals? What effect will such

curtailment have on the industrial concentration in the United States when firms financially unable to adopt expensive but feasible new technology are forced out of the market?

South Africa does not have to rely on U.S. exports given the foreign availability of the majority of goods traded by U.S. exporters. Thus, we believe the major direct impact of this sanction would fall on U.S. exporters, importers, and consumers, and on black employment in South African export industries. An indirect impact arises from the bill's proposed coverage of exports and reexports to South Africa from third-country producers that manufacture under U.S.-granted technology licenses. This provision will make the United States less attractive as a export trading partner, and is likely to reduce U.S. exports of goods and technology to third countries.

Second, the Bill requires U.S. nationals, within a period of six months, to divest themselves of any "investment in South Africa." "Investment in South Africa" is defined to include equity interests, capital contributions, loans made before April 20, 1988, and an undefined concept called "control of a South African entity" where no equity, loan, or capital interest is involved. It is unclear, but "control" may even cover such things as contracts for management services or trademark licenses essential to the success of a business. We are dealing here with a definition of "investment" that bears

no relationship to the normal use of that term in the business and financial communities.

The clear impact of the requirement for forced divestiture is the immediate and irreversible loss of value of assets held by U.S. investors and corporations. Treasury has in the past and will continue to oppose this proposal. Forced disinvestment runs counter to this Administration's policy that international capital markets and foreign investment remain free of controls. For U.S. investors holding South African securities, changing the rules established in the 1986 Act guarantees that the market value of their investments will plunge over the six-month grace period. Many American portfolio investors own pre-enactment shares in South African entities. These could involve investments of U.S. mutual funds. I cannot quantify the amount, but the value of these investments would also suffer as a result of the legislation.

On the corporate side, disinvestment will lead to a loss of job opportunities in South Africa, the possible demise of enlightened, non-discriminatory labor policies followed by U.S. companies as required by the Comprehensive Anti-Apartheid Act, and windfall gains for South African companies. American companies will be lucky to receive any reasonable offers for assets with a six-month deadline for divestiture. Why would South Africans or purchasers of any nationality pay fair value for assets when they know their would-be sellers must divest at

any price within weeks to comply with U.S. law? Further, South African exchange controls will create additional losses as U.S. companies convert their proceeds into U.S. dollars at the lower "financial rand" exchange rate. Such intended injury to the U.S. parent companies arising from forced divestiture may constitute a compensable taking of property under the Fifth Amendment to the Constitution.

What will be the practical impact of this move for the South African economy beyond a reduction in job opportunities? Perhaps black workers will be able to finance the purchase of their U.S.-controlled employers. However, past experience indicates that the more likely scenario is that businesses will be acquired by white South African interests on terms very advantageous to those investors. Unfortunately, the Bill's call for negotiations with worker representatives cannot arm the workers with sufficient economic power to finance purchases of U.S. assets in South Africa. Nor does the Bill continue even the limited exception in the present Act which authorizes investment in firms owned by black South Africans, so that acquisition loans to workers' representatives would not be possible. H.R. 1580 is, therefore, likely to lead to further concentration of economic power in white hands, and at firesale prices.

The second aspect of the disinvestment provision in H.R. 1580 I wish to address is the proposal to end U.S. lenders' ability to

reschedule loans made in South Africa prior to the 1986 Act. The present Act and its legislative history permits such rescheduling to avoid injury to U.S. lenders caught in the South African Government's 1985 debt moratorium measures, which limit the repatriation of hard currency loan proceeds, and which permit the South African Government to substitute itself for private sector borrowers on such loans.

The Bill would terminate this protection for U.S. lenders, and require that loans made under agreements reached prior to April 20, 1988, be repaid strictly in accordance with their existing terms. If not, the loans would be treated as prohibited investments in South Africa, and subject to the mandatory divestment provision. As noted, South African law permits the government to substitute itself as the borrower on existing hard currency loans. Such a substitution is treated as a rescheduling under the present Act, in accordance with its legislative history. This gives the South African Government the unilateral ability to trigger a divestiture requirement on outstanding U.S. loans. The loans would have to be either sold, probably at firesale prices, or otherwise divested.

Thus, U.S. banks, in effect, would be forced to provide debt relief to South Africa and subsidies to those who purchase the claims at the discounted price. They would lose all leverage in seeking repayment, without any corresponding damage to the South African borrower.

The losses to the banking community could be substantial and they would be concentrated in the nine money center banks. Although the level of exposure has been declining in recent years, it remains very substantial at $2.8B. Of that total, $2.2B is owed to the money center institutions or about 3.5% of their capital. As this Committee knows, there is strong regulatory and market pressure on these banks to increase capital. The proposed Bill would undercut that effort.

Finally, the extraterritorial application of the proposed disinvestment requirement will cause intense diplomatic friction, and potential third-country retaliation against the United States. This result would arise because the Bill enunciates a disinvestment policy for assets owned, not only by U.S. corporations, but by third-country entities that are owned or controlled by U.S. nationals. The breadth of this extraterritorial assertion of U.S. jurisdiction has previously been reserved for wartime conditions in sanctions programs adopted pursuant to the Trading with the Enemy Act. And even in wartime, the United States has not required its own nationals to divest themselves of foreign investments, but has focussed on the U.S. holdings of enemy countries.

To summarize Treasury's opposition to H.R. 1580, it would do more harm than good for U.S. interests whether viewed from an economic or foreign policy perspective. We believe the disinvestment requirement's main economic impact in South

Africa will fall on employment opportunities for black South Africans, while fostering greater concentration of economic power in the hands of white South Africans. The major effects on U.S. financial institutions will be to reduce their bargaining power vis a vis South African borrowers on existing loans, and force banks to incur substantial losses on their claims. The likely impact on the U.S. economy generally is a degree of economic dislocation for investors and for corporations with holdings in, or with service contracts, licensing or management agreements, or long-term import or export contracts with, South Africa. I will be pleased to respond to the Committee's questions.

TREASURY NEWS

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Remarks by M. Peter McPherson
Deputy Secretary
of
The U.S. Treasury Department
before
The World Food Conference
Des Moines, Iowa
June 6, 1988

The Case for Economic Policy Reform in Developing Countries

Thank you. It is a pleasure to be here today to offer you the Treasury Department's perspective regarding the importance of economic policy reform in fostering sustained economic growth in the developing world. In my remarks this afternoon, I will cover a number of financial and economic issues that are at the heart of third world development, including the international debt situation, needed structural reforms in developing countries, reform of public sector finances, financial sector liberalization, trade liberalization, and agricultural policy. Lastly, I will note the importance of these measures in solving the poverty conundrum.

The International Debt Strategy

As many of you are aware, Secretary Baker has taken a leading role in tackling one of the most nettlesome issues, the international debt situation. I believe it useful to review the guiding principles of the "Program for Sustained Growth," launched by Secretary Baker in October 1985 at the IMF/World Bank meetings in Seoul, Korea. These key tenets are also relevant to economic development generally.

- First, the central importance of economic growth and capital formation in easing the debt burden over time.
- Second, the need for market-oriented reforms in debtor nations to achieve such growth.
- Third, new debt and equity financing, and the return of capital flight, to help support such reforms.
- And fourth, a case-by-case approach to address the individual needs of each country.

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I firmly believe that these basic principles should continue to guide our approach in the period ahead. Developing nations need financial resources to grow, and require sustained, market-oriented reform of their economic structures. These adjustments will, in turn, promise stronger growth, higher standards of living and more productive and resilient economies with greater resources for educational, health, social and cultural programs.

Substantial progress is being made by debtor nations in putting into place policies to bring about the necessary financial stability and the structural foundations for stronger growth and external balance.

- According to World Bank data, 8 of the 15 major debtor countries grew at 4 - 5 percent or better last year, compared with only three countries in 1985.

- Debt service ratios for the group have fallen by one-fourth and interest service ratios by one-third since 1982.

- Aggregate current account deficits have been sharply reduced and are in a more manageable range.

- Export earnings have rebounded to near record highs, while imports this year should be the highest since 1982.

Despite concerns about the commercial bank component and delays in some instances, external financial support for these efforts by the major debtor nations has been provided in amounts that compare well with those needed to sustain the adjustment effort.

The support includes approximately $17 billion in new commercial bank loan commitments, over $220 billion in commercial bank reschedulings, $17 billion in Paris Club reschedulings, almost $14 billion in new World Bank loans, and $5 billion in temporary payments financing from the IMF since October 1985.

The international financial system is on a sounder footing, as commercial banks have increased capital relative to their loan portfolios, and enhanced reserves. Moreover, some debtor nations that experienced arrears are working to normalize relations with creditors. Indeed, there is now a deeper understanding of the negative repercussions of both unilateral moratoria and arrears that I believe is constructive.

While these are positive developments, we must all recognize that problems remain. A full return to creditworthiness by debtors is not a short-term process and will not be completed overnight. Additional efforts are still needed to reduce

fiscal and external deficits, control inflation, encourage new investment and savings, and unleash the creative potential of the private sector within debtor nations to help catalyze new loans, equity flows, and the return of flight capital. These are essential to improving and sustaining growth.

Within this context, our strategy is an evolutionary one. By emphasizing a diversity of options for commercial banks and innovative financing techniques, the "menu" approach to commercial bank support assists the return to creditworthiness. The development of such "menus" is an ongoing process. The options selected in individual cases are the result of voluntary choices developed and mutually agreed upon by the debtor governments and commercial creditors themselves.

For several countries, additional borrowing will be needed to support reforms, meet external obligations, and provide a stimulus to production and growth. Such flows, if used productively, can help to strengthen the debtors' own resources, and they can be fully consistent with the objective of restoring creditworthiness and reducing the real debt burden over time. Trade credits, project loans, and onlending for specific uses in the private sector all help to target resource flows for stronger growth. New money bonds which have some of the characteristics of a senior claim may also be attractive to some banks as a way of providing additional financing.

Debt conversion techniques have also been playing an increasingly important role in the debt strategy. They can shorten the debt workout period for some countries, or reduce current debt service burdens, or permit some banks to exit from the concerted lending process, thus streamlining procedures and accelerating the conclusion of new financing packages. Such debt conversion transactions may hold benefits for all parties and can supplement -- but not supplant -- the fundamental reform and financial support elements of the current strategy.

A number of such conversions have already been negotiated. Some $7.5 billion in debt/equity swaps have been consummated in 5 debtor countries in the past 3 years alone. Other countries are developing debt/equity swap mechanisms. There is a growing interest in debt/conservation and debt/charity swaps, as well. Through these swaps, debt instruments can be retired in exchange for local currency for important conservation or other social programs in the debtor country.

We are encouraging the World Bank to provide technical advice for debt/equity and debt/conservation swap programs. The U.S. has already taken steps in both the regulatory and tax areas to facilitate such conversions. Debt/equity conversions in particular have considerable untapped potential and should be given more attention by both debtors and creditors.

The recent Mexican debt exchange offer, whereby some $3.7 billion in bank claims were retired in exchange for $2.6 billion in new bonds with principal fully collateralized, is yet another innovative technique, which can increase flexibility for dealing with the current stock of debt. I expect that other creative financial market instruments of a similar nature will be developed in the period ahead.

To be successful, such efforts must be voluntary, privately financed, and developed within the market to benefit commercial banks and debtor nations alike. In contrast, we strongly oppose any approaches which are generalized, global, financed by creditor governments or mandatory in nature. This includes the creation of an international debt facility under the auspices of the IMF or World Bank aimed at providing a global "quick-fix" of the debt problem via debt purchases or securitization of commercial bank loans. Such plans merely shift the risk on private commercial bank debt to the international financial institutions themselves and their member governments -- which we certainly are not prepared to accept.

We would strongly discourage all from entertaining such notions. They would not support the adoption of necessary policy changes, but in fact would only delay needed adjustment and financing. Moreover, they would undermine the restoration of access to markets that some debtor nations are now achieving. In sum, such proposals could distract attention from the real work at hand: establishing a sound foundation for sustained growth.

In the effort to get developing countries back onto the growth path, the World Bank is one of the cornerstones of the debt strategy. The Bank is already committing 22-23 percent of its new lending towards "policy-based lending," i.e., lending that is conditional on the implementation of structural economic reforms. By encouraging sound economic policies in the debtor countries, policy-based lending also catalyzes private flows of capital.

The IMF also has a continuing and central role to play within the debt strategy. It must assist debtors in devising growth-oriented reform programs, support those programs with temporary balance of payments financing, and help catalyze private fianancial flows.

The Agenda for Policy Reform

Economic growth is not only the key to solving debt problems, it is also crucial to alleviating poverty. Growth means jobs and income. A bad economic structure is not sustainable forever and so the real choice is between prompt, orderly adjustment with the benefits of growth and jobs, or delayed or stop-go adjustment programs. Also, too often we forget that bad economic policies fall hardest on the weakest or poorest people in a society. For example, when politically powerful urban groups in developing

countries hold down prices farmers can receive, the impact often is to impose a type of tax on very poor people so that a somewhat better off urban population can have cheap food.

The action for reform lies first and foremost, of course, with the developing countries themselves. Many of these countries need to be more steadfast in their efforts to deal with economic reforms.

I will turn now to some of the critical elements of the development process.

Reform of Public Finance

The starting point for stabilization and orderly structural adjustment is usually reform of public finance. Large fiscal deficits, which ballooned in the late seventies and early eighties, were often harbingers of serious economic and financial problems in the major debtor countries: the ratio of public debt to GDP exploded, domestic savers responded to unsustainable fiscal deficits by sheltering their assets abroad, and real exchange rates rose excessively. These difficulties became especially acute in countries which had leveraged earlier windfalls from the commodity boom into excessive foreign borrowing to support dubious investment projects. When the boom ended, the resulting revenue contraction, combined with ongoing spending commitments, precipitated fiscal and external debt crises.

The subsequent (and necessary) preoccupation of the major debtor governments with stabilization has forced adoption of fiscal austerity programs. Fiscal austerity had two elements: spending cuts (fiscal policy) and improved revenue-raising capabilities (tax policy). In some of the initial attempts to cut back spending, however, fiscal austerity had the unfortunate effect of reducing spending for programs that help the truly poor. The challenge for structural adjustment in the areas of fiscal and tax policy has been to introduce reforms which reduce deficits, encourage sustained growth, minimize transitional costs, and establish a foundation for relaunching efforts to alleviate poverty.

The reform of fiscal policy has been central to the structural reform programs encouraged as part of the current debt strategy. A few generalizations have emerged on the elements of sound fiscal policy:

(1) Governments need to set spending priorities.

(2) Spending should be targeted to areas where government participation may be necessary for a well-functioning market, and economic growth, including primary education, and transportation infrastructure.

(3) Governments should avoid interfering where markets could be expected to operate effectively. Public investment in direct production or marketing of agricultural or industrial products is rarely justified.

(4) State-owned enterprises should be privatized where feasible, and, where full privatization is not yet possible, their claims on government financial resources should be reduced.

(5) Subsidy programs, particularly when they favor a particular sector or privileged group, must be reduced and eventually eliminated. Subsidy programs designed to promote exports, affect investment and production, or to control prices usually run counter to achieving sound, sustainable growth.

Structural reform must usually encompass substantial reform of the tax system. The effort to reduce large public deficits tempts policy makers to rely on significant increases in existing taxes. However, an increase in the rate of tax, particularly when the tax base is narrow, introduces disincentives and increases economic costs. Furthermore, developing country governments often rely on tariffs or taxes on exports because they generate revenue with limited administrative costs. However, trade taxes distort investment, production, and consumption decisions. Their impact is protectionist, often insulating particular sectors of the economy from foreign competition and creating an artificial privileged class within the economy.

To provide the proper foundation for growth-oriented policies, tax reform needs to focus on restructuring systems to increase the efficiency of tax collection, reduce distortions, and minimize the burden on the poor. In reforming tax systems, a few basic precepts come to mind:

(1) The tax base should be as broad as possible, so that the burden to raise additional revenue is spread equitably throughout the economy, rather than borne by a few sectors or groups.

(2) The structure of the tax system should avoid determining patterns of production, trade, consumption, saving, and investment.

(3) Developing countries should shift away from their reliance on trade taxes, whether in the form of export taxes or tariffs on foreign goods. Export taxes reduce the competitiveness of exports, discriminate against sectors with international competitive advantages, and are counterproductive to efforts to increase foreign exchange earnings. Tariffs protect inefficient local producers, and misallocate domestic resources.

(4) More emphasis should be placed on realistic user fees, so that those groups or individuals which receive particular services from the public sector pay for the cost of the services if possible.

(5) Tax systems should be simplified by reducing the number of different rates and the number of exemptions. Such reforms not only ease the collection burden but reduce the risk of circumvention by the priveleged.

Structural reform usually requires reform of the two major prongs of public finance, expenditures and taxation. Public finance can be a powerful tool for alleviating poverty. Structural reform is a necessary foundation for sustainable growth, the precondition for defeating poverty in both the medium-term and the long run. At the same time, an inordinate share of the transitional costs of adjustment may be borne by the poor. For this reason, the United States has been supportive of the World Bank's policy-based social sector loans, an innovative approach designed to ameliorate the social costs of adjustment and/or improve the efficiency of existing social programs to help the poor. Such lending can be effective as a bridge during the difficult adjustment process, provided it is well-targeted and used in an overall economic framework which promotes an improved policy environment.

Financial Sector Liberalization

Financial markets -- money, bond and equity markets, and non-bank financial institutions -- are with few exceptions still relatively undeveloped in many developing countries. A number of developing countries inadvertently disciminate against the development of these markets owing to distortions caused by interest rate controls and overvalued exchange rates, onerous tax policies, subsidized loan schemes and the practice of selling government bonds at below-market rates to captive holders.

The debt strategy that I outlined earlier helped deal with the need for domestic savings mobilization and on the crucial role of equity in the financial system, which can serve as a buffer against external shocks, such as lower commodity prices and export earings, as countries become less dependent upon external finance.

Measures to increase investment and develop domestic capital markets must be an integral part of any policy package that seeks to raise the rate of growth on a sustainable basis. The reduction in public sector deficits, as I detailed earlier, is likely to be an important component of the domestic resource mobilization effort. Private saving is also important, and can be promoted by allowing market forces to play a greater role in determining interest rates. Positive real rates of return on investment will also help to dampen consumption, and may help attract flight capital, which is the cheapest and most permanent form of investment.

With appropriate investment policies in place, much more foreign direct investment will accrue to developing countries. The benefits of foreign investment are manifold; it expands the pool of available financial resources, brings technical know-how, managerial and marketing expertise, and has advantages over bank borrowing in that an outward flow of earnings is unlikely to arise during stressful periods. I understand the political questions that are sometimes posed by foreign investment but the economic benefits are so great.

Trade Liberalization

The agenda for policy reform often must include the revamping of restrictive trade regimes.

In the fifties and sixties, many believed that developing countries could not open their markets to foreign competition and at the same time achieve rapid development. It is time to lay that myth to rest. We now know that trade liberalization improves rather than damages the performance of developing economies.

Trade barriers simply promote the development of uncompetitive industries that displace imports. These industries soak up resources in a wasteful manner that developing countries can ill afford. Often excessively capital intensive, these industries absorb too much of the capital that is scarce in developing countries and too little of what is abundant--labor. Since protected industries face minimal competition, they are frequently high-cost, low-quality producers which can only export if subsidized.

The result is chronic balance of payments problems for countries that adopt this inward-oriented development strategy, and chronic reliance on trade restrictions. A vicious cycle is created: protection leads to uncompetitiveness which leads to payments problems which leads to more protection.

In contrast, outward-oriented countries have performed markedly better. They have grown and developed substantially faster, while avoiding chronic balance of payments problems. They use resources more efficiently, as indicated by lower incremental capital-output ratios, and they adjust better to external shocks.

Importantly, this better performance does not just benefit a few owners of capital in the modern industrial sector. It also benefits workers and it benefits the agricultural sector. In a study of 41 developing countries, the World Bank found, for example, that manufacturing employment grew considerably faster in outward-oriented countries as a group than in inward-oriented countries. In addition, agricultural value added, as well as manufacturing value added, increased more rapidly in outward-oriented countries.

Income not only rises faster in countries with liberal trade policies, it is distributed more equitably. Rapidly growing exports in outward-oriented countries tend to be relatively labor intensive. This labor intensity increases the demand for labor and drives up wages over time. For countries like Hong Kong and Singapore, the share of income going to the poorest segments of the population increased in the sixties and seventies as the benefits of liberalized trade policies took effect.

Agriculture Policy Reform

The agricultural sectors in developing countries contribute about 20 percent to GDP and over 60 percent of total employment (WB data 1982-84). For the poorest countries, the agricultural shares are much larger. This is often an issue of how well people eat. Consequently, agricultural policies in these countries not only dictate performance in the agricultural sector, but they have major implications for their entire economies. Several countries have made considerable progress in raising agricultural productivity and food supplies. Others, however, have adopted policies which are biased against agriculture and frustrate the objectives of increased food supplies and incomes for their people.

In many cases, the agricultural policies in developing countries are the opposite of those in developed countries -- instead of supporting producer prices above world market levels they tax producers directly or indirectly to the point that prices received by farmers are below world levels. In other instances, governments provide substantial export subsidies for major export crops to generate foreign exchange earnings that can pay for high levels of imports. Because of these policies capital, land, and human resources are badly misallocated causing a severe drag on economic growth.

The first step for agricultural reform in developing countries is often to allow the farmer to receive market prices. This will give them incentives to raise production of those commodities in which they have a comparative advantage and to use available resources more efficiently. Sometimes this means more exports but usually the biggest impact is that the people in the country eat better.

Farmers' production and marketing opportunities often are much better over time if input subsidies to farmers and food subsidies to consumers are reduced, especially if combined with improved distribution systems. In addition, the government would save substantial amounts in budget expenditures.

Several people have pointed out that developing countries cannot be expected to undertake these steps to expose their farmers to the instability in world markets, often caused by industrial country policies that dump subsidized surpluses.

The United States agrees in principle and it has proposed multilateral agreements to eliminate policies that distort agricultural trade. Nevertheless, there are many policy reforms that can be implemented unilaterally to raise the efficiency of the agricultural and food sectors in poor countries. Then the distortionary border measures can be phased out later as part of the Uruguay Round commitments.

Removal of trade distorting measures by all countries should enhance the economic performance of LDCs in several ways. Reduced price instability in world markets should positively benefit both importing and exporting developing countries. The current system of highly insulated agricultural systems tends to exacerbate world price swings for those who depend on world markets for their income or their food. New market opportunities would open up for efficient producers as the less efficient redirected their resources to other products where they have a comparative advantage. Clearly, it is in the interest of developing countries to participate actively in agricultural reform and trade liberalization that will spur economic growth.

One estimate indicates that developing country liberalization for selected commodities could result in gains of nearly $30 billion to themselves. World prices of most commodities would rise along with world trade.

We recognize, however, that the collective advantages of reform may not extend immediately to developing countries individually, owing to their particular stage of development. For this reason, the United States in the present Uruguay Round of multilateral trade negotiations on agriculture acknowledges that consideration should be given in the trade liberalization process to the needs of countries whose adjustments to a freer trade environment would be a severe hardship. Also, some LDCs are not mature competitors in world agricultural trade and will be unable to undertake fully policy adjustments as called for by negotiated agreements among the leading world traders. Nevertheless, the enhanced economic opportunities of trade liberalization will be shared by all countries regardless of their relative standing in the world economy, and all will need to share in the reform effort.

The Effect of Adjustment on the Poorest

In summing up my remarks on the importance of structural reform, I believe it worthwhile to take a few moments to focus on the relationship between adjustment polcies and poverty. The implications of adjustment -- such as reduced consumption, import reductions, and shrinking resources for health, education and welfare -- can vitally influence the viability of adjustment programs.

Structural adjustment should incorporate positive steps to safeguard the long-term interests of the poor. For example,

financial reform can increase the supply of loanable funds available to the poor by raising foreign and domestic savings rates, and reducing the role in rationing in allocating credit. Programs could also support increased credit to agriculture. Other measures include removing price controls; the poor are often the hardest hit by high prices prevailing on black markets, since they typically lack access to goods at official prices. Depreciating the exchange rate can raise the real value of earnings of the poor engaged in export production. And shifting public expenditures that utilize the skills of the poor by expanding labor-intensive programs will also improve the position of the poorest.

Some countries may need to establish compensatory measures to protect the poor who suffer immediate adverse effects from policy measures aimed at restructuring production. Similarly, emergency employment schemes and changing the composition of social expenditures may be required.

Ideally, adjustment programs can act as a catalyst for governments to find more efficient and better targeted instruments to protect vulnerable groups.

Conclusion

A prime objective of the United States is to foster sustainable growth and development in the third world. In my view, major structural reform is the only viable approach for the developing countries to break out of the cycle of poverty that results from continued stagnation. In this regard, I am happy to say, sound economic attitudes and efforts are spreading across the developing world as countries increasingly recognize the importance of market-led growth. It is all the more incumbent on us in the industrialized countries, therefore, through our support of the multilateral development banks, as well as through bilateral efforts, to ensure that there are sufficient financial resources to support the meaningful structural reforms being undertaken by developing countries.

I look forward to discussing these issues with you today. Thank you.

TREASURY NEWS

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STATEMENT BY
DAVID MALPASS
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 10, 1988

Introduction

Mr. Chairman, I welcome the opportunity to discuss economic development in Central America. The bill before you, S. 2252, raises some timely questions.

In my testimony today, I would like to briefly describe an economic policy environment in which developing countries could prosper, relate that environment to the Central American democracies of Costa Rica, Guatemala, El Salvador, and Honduras, and provide some specific comments on S. 2252.

Toward strong economies

The primary economic development lesson of the 1980s is the importance of market-based economic systems. Some countries, such as the strong economies of southeast Asia, are well along in absorbing this approach, and are prospering. Others, such as China and perhaps the Soviet Union, have recognized this lesson and are testing its principles. In the developing world of Latin America, and, increasingly, of Africa, leaders are choosing market-based economic systems in order to successfully attract flight capital, external financing flows and foreign investment.

The political foundations for such systems are democracy, a respect for individual rights, and non-threatening neighbors. With these foundations, and the personal and national courage to undertake economic changes, we believe that the four democracies of Central America would have good prospects for sustained economic growth.

While I do not bring a blueprint for running sound economies, I believe that some politically difficult changes clearly need to be taken by the countries of Central America. This effort should obviously begin in Nicaragua, which is breaking all of the principles of sound economics and whose people are suffering as a result. But this hearing is on the democracies, so I would like to discuss two principles applicable to them.

An open economy is the starting point for economic progress. There are several key facets. First, the private sector must be allowed access to capital, including foreign exchange. Second, capital and goods must be allowed to flow easily into and out of the economy. Investment capital, and therefore jobs and growth, will shun an economy which places controls on it. Third, market-based prices must be the clearing mechanism for goods, foreign trade, the labor force and exchange rates. Fourth, an open economy requires a non-confiscatory tax system, one which leaves much of the profit with those who earned it.

Sound government macroeconomic policies are equally important. In addition to removing market restrictions which close the economy, governments must leave more resources and challenges to the non-government sector. Governments don't make profits, so it is crucial that spending by the governments and related parastatals be brought under control. Sound monetary policy has eluded Central America in recent years. Printing presses have been used to meet government payrolls, undermining currencies that were once stable. The resulting inflation has led to a severe misallocation of resources and of people's time and energy.

While these principles are generally accepted, perhaps even in the countries themselves, they are not being applied assiduously. I would like to review each of the economies, pointing to some of the key economic reforms which should be undertaken.

Costa Rica. In the early 1980's, Costa Rica was adversely affected by the rise in interest rates, deteriorating terms of trade, and collapse of regional markets. Although Costa Rica has introduced economic adjustment measures over the years, these efforts have surged and waned throughout the decade and have not had a lasting impact. Nonetheless, Costa Rica has made some commendable progress on economic reform on several fronts, leading to growth of over 4.5% in 1986 and 3% in 1987, respectively. The government has reduced the real value of the public sector wage bill and cut price supports for basic grains from the State's Agricultural Agency. Costa Rica also continues a flexible exchange rate policy with mini-devaluations of the colon and is making great strides towards becoming a member of the Generalized Agreement on Trade and Tariffs later this year.

The World Bank is working closely with the government of Costa Rica to support efforts to reform the financial sector. Costa Rica's National Development Corporation (CODESA) is working with the assistance of U.S.A.I.D. on a significant divestiture program. Although two major CODESA subsidiaries have been sold to the private sector in recent years, Costa Rica must make further progress on the nearly forty remaining CODESA enterprises.

Costa Rica's economy continues to be dependent on agricultural products such as coffee and bananas. Given its heavy debt burden and its vulnerability to agricultural export prices, Costa Rica needs to continue to develop and diversify its non-traditional exports. Some progress has already been made, but this must be supported by institutional reforms, such as simplifying the administrative procedures to enhance exports and to open the economy to foreign investment.

Internally, Costa Rica must concentrate on building confidence in its troubled financial sector so as to attract private deposits and support domestic investment. As a temporary measure, the Central Bank must tighten credit through ceilings on individual deposits to release resources for lending to troubled private commercial banks. Eventually, the government will have to place greater reliance on monetary instruments for such short-term adjustments. A deposit insurance scheme, recently announced by the Central Bank, should be implemented as soon as possible.

Guatemala. Vinicio Cerezo, the civilian president elected in 1986, inherited an economy characterized by uneven distribution of land and income, unemployment and underemployment affecting over 40% of the active population, stagnated foreign trade due to an unmanageable multiple exchange rate system, and depressed savings and investment. In his first year in office, Cerezo instituted a major economic stabilization program which reversed several years of economic decline. This set the stage for 2.5% real GDP growth in 1987 and possibly 3% in 1988.

The government is working on its diversification from agricultural products -- which account for 2/3 of its exports. Monetary reforms, including positive real interest rates and higher reserve requirements, have also been instituted. These policies lowered inflation from 40% in early 1986 to 10% in 1987. The government also simplified the exchange rate regime from more than thirty rates down to three.

However, several problems arose in 1987 which the government must now address. The country's principal focus must be fiscal discipline to allow room for increased private investment. The government could start by eliminating the foreign exchange subsidy to INDE, the power authority, either by unifying the three-tiered exchange rate which provides the subsidy or by bringing utility rates in line with the operating costs of the institution.

Honduras. During the 1984-86 period, the economy expanded at a moderate pace with low inflation. However, the fiscal and balance of payments situation continued to deteriorate. In 1987, Honduras initiated an economic program designed to assure continued growth and a strengthened balance of payments position, coupled with structural reforms. Real GDP grew by 4% and an inflation rate of 2.4% was the lowest in Latin America. But slippages in the program have caused a serious financial crisis. In 1987, the fiscal deficit came to more than 7% of GDP, the balance of payments current account deficit came to almost 8% of GDP, and external arrears increased, including arrears to the IMF, the World Bank, and the IDB -- Honduras' largest creditors.

Honduras is now working closely with the IMF and World Bank on a reform program. In February, the government took steps to curb the fiscal deficit by freezing government salaries and positions, limiting all current expenditures for goods and services to the 1987 level, and reducing transfer payments to parastatals and autonomous agencies. The first steps have already been taken to make the economy more competitive by reducing export taxes and expanding the scope of the parallel market.

Honduras must adopt a more market-oriented foreign exchange and trade system in order to diversify its export markets. The central government must strengthen its control over the hiring and pricing policies of state enterprises, and quicken the pace of divestment of these enterprises.

El Salvador. The economy has been burdened by a prolonged guerrilla war and the earthquake of October 1986.

The pace of economic recovery and reform has slipped. El Salvador has maintained negative real interest rates, high export taxes, an overvalued currency, extensive price controls, and low tariff rates on public utilities. These policies reinforced capital flight and discouraged exports. The 1988 Economic Plan will correct some of these distortions. Measures have been designed to improve fiscal performance, stimulate the growth of exports, and spur production. Price controls, import controls and subsidies have been significantly reduced. The freeze on public employment and wages has been continued. Some utility rates have already been raised. A tight monetary and credit policy will be used to keep the inflation rate below 20%.

Additional measures, however, are required. El Salvador needs positive real interest rates and a more flexible and unified foreign exchange system coupled with a reduction in export taxes. Strengthened management of state enterprises will also be imperative in order to reduce pressure on central government finances.

S.2252 and the Role of Securitization

I would now like to provide some comments on S. 2252 in the context of this economic overview. We profoundly share the purpose of the bill, promoting economic development in Central America. The bill proposes three steps to assist in this: securitization of debt, using U.S. government guaranteed bonds issued by these countries in exchange for their obligations to commercial banks; a reduction in the interest rates on U.S. government loans to those countries; and an increase in U.S. sugar quotas for the region, so as to boost their export earnings.

The current international debt strategy is built on a case-by-case, market-oriented approach based on sound economic reforms with external financial support. We cannot endorse either sweeping debt forgiveness or broad based guarantee proposals, and have been on the record many times with regard to this fundamental policy. Schemes which shift risk from commercial banks to the public sector run counter to the key tenets of the debt strategy, in that they would afford debtor countries little incentive to undertake needed reforms, and would likely choke off commercial bank flows for years to come. I would also note at this juncture that it is both unrealistic and unreasonable to ask the U.S. taxpayer to pick up the tab on an "exit" vehicle for foreign banks.

With regard to securitization of outstanding commercial bank claims, we are supportive of private, voluntary efforts to repackage sovereign loans, which can afford debtor nations debt relief and their commercial creditors better quality assets, as in the case of the recent Mexican debt-for-bond swap.

Such voluntary, market-driven securitization techniques may be attractive to both debtors and commercial banks, if appropriately designed. For example, the Mexican bond proposal, with collateralization of principal, attracted a wide range of bids from numerous banks. We expect to see more of these proposals in the period ahead. And the surest demarcation of a return to normal financial relations is access to international capital markets. We are beginning to see progress on this front -- Venezuela and Colombia have, within the past year, raised funds in the euromarkets, and Chile is planning to access the markets in the next few years, once the country begins to make principal repayments on its outstanding obligations.

As we interpret this legislation, all commercial banks, both foreign and domestic, could voluntarily tender their sovereign claims to the four countries at a discount, in exchange for a new security that is backed by the full faith and credit of the U.S. government. If the legislation were interpreted as mandatory and U.S. commercial banks were required by law to tender their claims, this would raise a host of additional concerns.

Again, as the legislation is drafted, the discount would be set by the secondary markets. While we strongly endorse letting the market value financial transactions -- as in the case of the two recent Brazil debt/equity auctions and the Mexican debt/bond offering -- this secondary market is not a valid proxy for the value of bank claims. The market is thin and supply outweighs demand. Thus, the process of ascertaining the fair value of these credits can be difficult and highly judgemental.

By way of background, well developed secondary markets have depth and breadth, and are usually supported by primary markets. In the usual sense of the term, the existence of a secondary market for any asset also implies that there is some homogeneity of obligors, terms, and legal underpinnings for the instruments traded. However, little of this infrastructure is found in the market for LDC debt. We believe that prices currently being quoted reflect the fact that it is still a very thin and imperfect market. Indicative prices published by Salomon Brothers, for example, have wide bid/offer spreads. A million-dollar deal can move the market. Thus, this secondary market is more like a bazaar, with individual buyers and sellers haggling over the terms of each transaction.

The proposal in S.2252 would politicize the debt work-out process in several ways. First, by offering a U.S. government guarantee of the newly-issued bonds, secondary market prices would rise in anticipation, increasing the contingent liability of the U.S. government. The U.S. would inevitably become enmeshed in the negotiation between the countries and their commercial banks in an effort to find a "fair" price for the transfer. Second, the bill itself makes a political value judgment, offering two countries the opportunity to transfer 100 percent of their debt, and the two others only a 40 percent opportunity. This is the type of dilemma the U.S. government would be in if this technique -- the selective offer of the full faith and credit of the United States -- were enacted. Furthermore, other countries may merit U.S. government support as much as these four, leading to a diplomatic nightmare and a lobbyist's dream.

In examining this proposal, we should keep in mind that U.S. government guarantees are not costless. The U.S already has a large national debt to finance, and, in this end, the provision of guarantees is likely to add to it.

The bill also suggests an initiative aimed at reducing the interest rates on claims owed to the Unites States government. If Congress legislated such an initiative, it would likewise have to appropriate funds to make up the interest rate differential, 4 percent in this case. Alternatively, the increased net outlay in the 150 account would have to be offset, which would reduce funds available for other debtor countries, including the poorest countries of Sub-Saharan Africa and the multilateral lending institutions. Reducing rates of interest on U.S. government loans to a select group of developing countries would also

establish a precedent for similar treatment of other U.S. government assets. Thus, the proposal would provide a relatively small savings to Central America at a large cost to the U.S. government.

I would like to conclude this section by returning to what I believe is a common objective between us -- securing strong economies in the region. I do not believe that the blanket debt guarantee proposed in this bill will lead to better economic systems in the region. Instead, it appears that it would perpetuate dependency on the U.S. and broaden it to a new area.

Sugar Import Quotas

U.S. quotas in general cause a tremendous loss of income to developing nations and to U.S. consumers. With respect to sugar quotas, the only permanent solution is the elimination of the disparity between domestic and world prices, by opening the U.S. market to domestic and foreign producers on a more competitive basis. We recognize that this goal would have to be achieved over several years and that the reform should be based on a multilateral agreement among sugar trading nations. The Administration currently supports pending legislation in the Congress (S.1948) with certain modifications, including authorization to lower the existing high price supports.

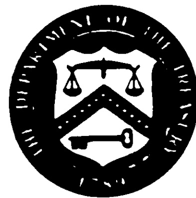
Conclusion

To conclude, I believe that the purpose of the bill is meritorious. Economic development in Central America is important to all of us and should be pursued.

However, the proposals in the bill would have consequences and costs far beyond Central America, and must be evaluated in that context. I look forward to a discussion here today on these issues.

Thank you, Mr. Chairman.

TREASURY NEWS



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PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

June 8, 1988

U.S. Government Embargo Programs

Chairman Bonker and Members of the Subcommittee:

My name is R. Richard Newcomb and I am the Director of the Office of Foreign Assets Control at the Department of the Treasury. I welcome the opportunity to appear before the Subcommittee today to discuss U.S. Government embargo programs administered by the Treasury Department and subsidiary trade with Cuba and to comment on H.R. 4692. This bill would provide an exemption from United States trade embargoes imposed in peacetime for exports of agricultural commodities produced in the United States.

The Office of Foreign Assets Control ("FAC") has primary responsibility for administering trade and financial sanctions imposed by the President against other countries under authority of the International Emergency Economic Powers Act ("IEEPA") Section 5(b) of the Trading with the Enemy Act ("TWEA"), and the International Security and Development Cooperation Act. The Office also has

B-1449

responsibility for administering the sanctions program against South Africa imposed by Congress under the Comprehensive Anti-Apartheid Act of 1986.

I will first describe Treasury's principal economic sanctions programs, including the embargo against Cuba. I will then describe the policy under which FAC issues licenses on a case-by-case basis for certain export and import transactions with Cuba by foreign subsidiaries owned or controlled by U.S. companies. I will then discuss the data Treasury has gathered since 1982 concerning licensed subsidiary trade with Cuba (tables providing this information are attached to the copies of my written statement provided to the Subcommittee). I should note that this information on subsidiary trade with Cuba is provided in response to a specific request, although the bill deals with exports from the United States rather than with trade by foreign subsidiaries. Finally, I will comment on issues raised by the proposed legislation which are of concern to the Treasury Department.

I should note that FAC lacks information concerning some of the points listed in the Chairman's May 22, 1988 letter to Secretary Baker. These areas, including the effectiveness of achieving foreign policy objectives of previous embargoes of American agricultural exports against certain nations; the economic impact of agricultural export restrictions on

American farmers and exporters; the effect of such embargoes on foreign perceptions of the U.S. as a reliable supplier of agricultural commodities and other goods; and an estimate of the global market share lost for American agricultural exports because of past and present embargoes, may be better addressed by the Departments of State, Commerce, or Agriculture.

I. THE PRINCIPAL TREASURY EMBARGO PROGRAMS

A. Descriptions of the Programs

1. Cuban Assets Control Regulations

The sanctions against Cuba include a freeze on Cuban assets in the U.S. and prohibitions on exports and imports, financial and transportation-related transactions, and certain travel transactions. They apply to any person subject to the jurisdiction of the U.S., including foreign branch offices and subsidiaries of U.S. firms, although exceptions are licensed on a case-by-case basis under certain circumstances for trade with Cuba by foreign subsidiaries of U.S. firms. The Cuban Assets Control Regulations are published at 31 C.F.R. Part 515 and are issued under the authority of Section 5(b) of the Trading With the Enemy Act, 50 U.S.C. App. Section 5(b).

2. Foreign Assets Control Regulations

The Foreign Assets Control Regulations impose sanctions against Vietnam, Cambodia and North Korea, including an assets freeze and export, import, financial and transportation prohibitions. These sanctions apply to any person subject to the jurisdiction of the U.S., including foreign branch offices and subsidiaries of U.S. firms. Unlike the Cuban Assets Control Regulations, no policy exists to permit the specific licensing of trade by foreign subsidiaries of U.S. firms with Vietnam, Cambodia, or North Korea. The Foreign Assets Control Regulations are published at 31 C.F.R. Part 500, and are issued under the authority of Section 5(b) of the Trading With the Enemy Act, 50 U.S.C. App. Section 5(b).

3. Nicaraguan Trade Control Regulations

The sanctions against Nicaragua include export, import and certain transportation prohibitions. They apply to exports and imports between the United States and Nicaragua, but not to trade in non-U.S.-origin goods between Nicaragua and foreign branch offices or subsidiaries of U.S. firms, or U.S. individuals located abroad. Thus U.S. nationals can broker or facilitate trade in non-U.S.-origin goods between the United States and Nicaragua. The sanctions against Nicaragua do not include an assets freeze or a prohibition

on financial transactions in general, such as direct loans, unlike the Cuban Assets Control Regulations or the Foreign Assets Control Regulations. However, financial transactions related to prohibited exports and imports (for example, trade financing) are not allowed. The Nicaraguan Trade Control Regulations are published at 31 C.F.R. Part 540 and are issued under the authority of the International Emergency Economic Powers Act, 50 U.S.C Sections 1701 - 1706.

4. Libyan Sanctions Regulations

The sanctions against Libya apply to any United States person, which includes foreign branch offices but not foreign subsidiaries of U.S. firms. The sanctions include an assets freeze and export, import, financial, transportation, and travel transaction prohibitions. The Libyan Sanctions Regulations are published at 31 C.F.R. Part 550 and are issued under the authority of the International Emergency Economic Powers Act, 50 U.S.C. Sections 1701 - 1706.

5. South African Transactions Regulations

The sanctions against South Africa include prohibitions on certain imports (including South African agricultural products) and certain exports (computer, military, and nuclear-related items). They prohibit certain financial

transactions, such as new investments in South Africa and loans to South Africa. The sanctions generally apply to any United States person, which includes foreign branch offices, but not foreign subsidiaries, of U.S. firms. The South African Transactions Regulations are published at 31 C.F.R. Part 545 and are issued under the authority of the Comprehensive Anti-Apartheid Act of 1986, 22 U.S.C. 5001 - 5116.

6. Iranian Transactions Regulations

These regulations prohibit importation into the United States of goods and services of Iranian origin. Unlike the Cuban Assets Control Regulations and the Foreign Assets Control Regulations, they do not freeze Iranian assets in the United States. They are published at 52 Fed. Reg. 44076 (Nov. 17, 1987) and are issued under the authority of Section 505 of the International Security and Development Cooperation Act of 1985, 22 U.S.C. Section 2349aa-9.

I should point out that formerly FAC administered a complete embargo on trade and financial transactions, as well as an assets freeze, with respect to Iran. This embargo, under the Iranian Assets Control Regulations, 31 C.F.R. Part 535, and the International Emergency Economic Powers Act, 50 U.S.C. Sections 1701 - 1706, was imposed in response to the taking of U.S. hostages by Iran in 1979. The embargo was

largely lifted in January 1981, pursuant to the Algiers Accords, which secured the release of the hostages. However, the basic framework of the Regulations has been kept in place in order to implement certain provisions of the Algiers Accords as an adjunct to the effective functioning of the Iran - U.S. Claims Tribunal at the Hague.

7. Panamanian Transactions Regulations

These sanctions block all U.S.-located assets of the Government of Panama and prohibit payments and financial transactions, with certain exceptions, with the Noriega/Solis regime emanating from the United States, or from U.S. persons and subsidiaries located in Panama. Exports from and to private parties are not prohibited. The regulations are published at 53 Fed. Reg. 20566 (June 3, 1988) and are issued under the authority of the International Emergency Economic Powers Act, 50 U.S.C. Sections 1701 - 1706.

B. Policy Objectives of the Programs

Treasury assets freezes and embargo regulations have a number of policy objectives. They impose economic pressure on specified foreign countries for purposes of implementing United States foreign policy objectives such as, formerly, pressuring Iran to release U.S. hostages or, currently,

influencing Cuba to end its adventurism in Central America. A major goal of Treasury's regulations is to deny target countries access to U.S. products. Treasury regulations also prevent the countries subject to them from earning foreign exchange from transactions with U.S. nationals or U.S. capital markets, as such foreign exchange could be used for purposes contrary to our national goals. In the case of Cuba, the embargo is particularly significant because of the proximity of the United States to Cuba. Such proximity would, absent the embargo, make the United States an obvious low-cost supplier of goods to Cuba and the natural market for Cuban goods.

Another important objective of the controls, common to the Foreign Assets Control and Cuban Assets Control Regulations, is to maintain the U.S.-located assets of the target countries in a blocked status as a bargaining chip for use in negotiating an eventual normalization of relations and claims settlement. The assets constitute important collateral for settlement of U.S. private property claims for expropriation, defaulted bank loans, unpaid U.S exports, and other claims.

II. SPECIFIC LICENSING OF SUBSIDIARY TRADE WITH CUBA

From the inception of the Cuban embargo in July 1963, until October 1975, the Cuban Assets Control Regulations

effectively prohibited virtually all trade transactions by foreign subsidiaries of U.S. firms with Cuba. However, in the mid-1970's, a South American subsidiary of a U.S. firm received a valuable order from Cuba for a shipment of trucks. Its application for a license to make the shipment was denied. This resulted in strong diplomatic protests, adding to existing pressures on the United States Government to modify provisions of the Cuban Assets Control Regulations affecting foreign subsidiaries of U.S. firms. At the same time, the Organization of the American States, which had formerly supported the embargo against Cuba, softened its stand with respect to trade with Cuba. In light of these pressures, Treasury published a regulation (31 C.F.R. section 515.559) setting forth terms and conditions under which specific licenses would be granted for certain kinds of foreign subsidiary trade with Cuba. The essential requirements of the policy are as follows:

(i) The transactions must be by a U.S. subsidiary, that is, a foreign-incorporated American-owned or controlled firm operating in a third country. If the foreign entity does not have a separate foreign legal personality but is merely a branch, office, or agency, trade transactions (and other transactions) involving Cuba can not be licensed.

(ii) Both imports from and exports to Cuba may be authorized. Service contracts can also be authorized.

(iii) Goods exported must be non-strategic. "Strategic goods" are defined as items designated with the letter "A" on the Commerce Department's Control List, signifying strategic or sensitive items, as well as items subject to State Department munitions controls, or to regulations relating to the export of nuclear energy facilities or materials.

(iv) No transfer of U.S.-origin technical data (other than maintenance, repair, and operations data) is authorized.

(v) Any U.S.-origin parts or components must be licensed by the Department of Commerce. Commerce will generally license re-export if the U.S.-origin components do not constitute more than 20% of the value of the finished product.

(vi) Generally speaking, no U.S dollar accounts or dollar financing may be involved.

(vii) No person within the the U.S. may be involved; the subsidiary must act on its own and conduct the transaction completely offshore. Involvement includes

assistance or participation by a U.S. parent firm, or any officer or employee thereof, in the negotiation or performance of a licensed transaction.

(viii) The subsidiary must be generally independent of the U.S.-based parent firm in the conduct of transactions of the type for which the license is being sought in such matters as decision-making, risk-taking, negotiation, financing, or performance.

(ix) The law or policy of the country in which the subsidiary is incorporated must require or favor trade with Cuba.

(x) Agricultural goods are subjected to the same licensing criteria as other products. Most applications for licenses of any type are granted.

III. VOLUME OF LICENSED SUBSIDIARY TRADE WITH CUBA

Between fiscal years 1982 and 1987, FAC received a total of 1,279 applications for licenses for subsidiaries to engage in trade with Cuba. This constituted an average of 213 applications per year, with the number of denials of licenses ranging from none in 1982 to two in 1984. Few licenses are denied, in large part due to self-selection prior to the filing of applications by persons not meeting

the above-mentioned criteria. During that time period, FAC compiled selected statistical information on the applications. FAC is currently in the process of entering the licensing records into its automated licensing tracking database.

The attached statistical summaries provide an analysis of licenses issued for fiscal years 1982 through 1987. Table I of the summaries lists the types of goods and commodities licensed for export to Cuba each year, broken down by consumable and non-consumable categories. From 1982 through 1986 a higher percentage of licensed exports in terms of dollar value were consumables, such as grain and wheat, while in 1987 the value of non-consumables exported was greater. The total value of licensed exports to Cuba each year ranged from a low of $87 million in 1983 to a high of $162 million in 1985. The average amount exported per year was $114 million.

As far as imports are concerned, Table I indicates that the two primary categories of commodities licensed for importation by foreign subsidiaries were sugar and naphtha. Relatively small amounts of molasses and tobacco were also licensed for importation during this period. The total value of licensed imports from Cuba to countries where foreign subsidiaries of U.S. firms are located ranged from a low of $55 million in 1983 to a high of $161 million in

1982. The average amount imported per year was $145 million.

The value of exports to Cuba exceeded that of imports from Cuba in four of the six years for which statistics are available. It should be noted that wide fluctuations have occurred in the total value of licensed exports and imports, which may be due to international shortages and surpluses of certain agricultural crops such as sugar and wheat. For example, 1986 experienced a 23 percent increase in total exports and imports over 1985, while 1987 experienced a 31 percent decline in total exports and imports from 1986.

In descending order of value, foreign subsidiaries in the United Kingdom, Switzerland, Canada, and Argentina have experienced the greatest dollar value of licensed trade with Cuba, as is indicated in Table II of the summaries. These countries, however, are not necessarily the source or the ultimate destination of the commodities, as the companies operating in them may merely be acting as brokers for goods originating from or destined to another location.

An attempt was made to compile data for fiscal years 1975-1980, but because of the manner in which the original data were maintained during those years, reliable data are not available.

IV. COMMENTS

Existing law already provides certain restrictions on the President's authority under the Export Administration Act of 1979, as amended, to impose embargoes for foreign policy or short supply reasons on agricultural products. The Treasury Department is opposed to any legislation that would tie the hands of the President by further restricting his ability to prohibit exports of agricultural products to embargoed nations during peacetime.

The ban on trade with Cuba limits the flow of goods to Cuba and helps isolate Cuba economically. Cuba, with Soviet political, economic and military assistance, has provided widespread support for armed violence and terrorism in this hemisphere. Cuba also provides and maintains troops in various countries in Africa and the Middle East, a factor that impedes political solutions to regional problems and furthers Soviet foreign policy interests. It is important to U.S. national security to counter Cuban efforts to advance Soviet strategic goals. The Cuban regulations, including the ban on export trade, inflict a clear and substantial cost on Cuba for its support for subversion and deny Cuba products and services that it could use to engage in activities inimical to U.S. national security interests. Trade embargoes against other nations, including Libya,

Vietnam, Cambodia, and North Korea fulfill similar goals with respect to those countries.

It should be noted that the licensing of subsidiary trade with Cuba is an unusual policy for trade embargoes under TWEA, brought about by specific foreign policy pressures. Trade embargoes under IEEPA or the International Security and Development Cooperation Act have not been applied to foreign subsidiaries of U.S. firms, and thus have not involved this issue. The fact that the United States Government was persuaded to institute such a policy in this instance should not play a role in determining whether the President should be forever precluded from using a ban on agricultural sales as a tool of foreign and economic policy. There may be countries in the future as to which a cut-off of agricultural exports would work serious economic harm. Similarly, there may be countries as to which the United States Government would feel it appropriate to ban agricultural exports based on actions taken by that government against United States interests. We believe that to place this tool out of the President's reach, in advance of unknown emergencies that may arise in the future, would be inappropriate and ill-advised.

Thank you, Mr. Chairman, I'll be pleased to respond to any questions.

U.S. FOREIGN SUBSIDIARY TRADE WITH CUBA

FISCAL YEARS 1982 - 1987

TABLE I
SUMMARY OF LICENSED U.S. FOREIGN SUBSIDIARY TRADE WITH CUBA

A. APPLICATIONS	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY1987
1. Applications approved	163	146	243	245	247	198
2. Applications denied	0	1	2	1	0	2
3. Applications not acted upon	7	6	5	10	2	1
TOTAL APPLICATIONS	170	153	250	256	249	201

B. EXPORTS TO CUBA IN MILLIONS OF U.S. DOLLARS* AND AS A PERCENTAGE OF TOTAL TRADE	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY1987
1. Grain, Wheat, and other consumables	$ 48 19 %	$ 55 39 %	$ 82 30 %	$ 109 38 %	$ 58 16 %	$ 54 22 %
2. Industrial and other non-consumables	$ 44 17 %	$ 32 23 %	$ 34 12 %	$ 53 18 %	$ 49 14 %	$ 75 31 %
Subtotal Exports	$ 92 36 %	$ 87 62 %	$ 116 42 %	$ 162 56 %	$ 99 30 %	$ 129 53 %

C. IMPORTS FROM CUBA IN MILLIONS OF U.S. DOLLARS* AND AS A PERCENTAGE OF TOTAL TRADE	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY1987
1. Naphtha	$ 54 21 %	$ 28 20 %	$ 120 44 %	$ 35 12 %	$ 65 18 %	$ 33 14 %
2. Sugar	$ 105 42 %	$ 26 18 %	$ 39 14 %	$ 91 32 %	$ 181 52 %	$ 81 33 %
3. Tobacco	$ 0.7 0.2%	$ 0.4 0.3%	$ 0.2 0.07%	$ 0.2 0 %	$ 0.3 0 %	$ 0.2 0 %
4. Molasses	$ 1 0.4%	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %
5. Others	$ 0 0 %	$ 0.7 0.5%	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %
Subtotal Imports	$ 161 64 %	$ 55 38 %	$ 159 58 %	$ 126 44 %	$ 254 70 %	$ 114 47 %

	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY1987
D. TOTAL EXPORTS & IMPORTS	$ 253	$ 142	$ 275	$ 288	$ 354	$ 243
PERCENT INCREASE (DECREASE)	21 %	(44) %	94 %	5 %	23 %	(31) %
E. EXPORT/IMPORT RATIO	36/64	62/38	42/58	56/44	30/70	53/47

SOURCE: U.S. TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY ~~1987~~ 1988

*=Numbers are rounded. Items may not add to totals due to rounding.

TABLE II

U.S. DOLLAR VALUES OF LICENSED U.S. SUBSIDIARY TRANSACTIONS WITH CUBA
(IN MILLIONS OF DOLLARS*)

COUNTRY	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FIVE YEAR TOTAL	FY87
Argentina	$22.00	$10.00	$12.00	$31.69	$22.35	$103.04	74.49
Australia	0.40	0	0	0	0	.40	0
Austria	0.10	0	0	2.39	0	2.49	0
Belgium	0.10	0.10	0.11	.36	.64	1.31	1.38
Bermuda	53.00	47.00	65.00	0	0	165.00	0
Brazil	0	0	0.02	0	0	.02	0
Canada	45.00	29.40	40.20	33.35	63.38	211.33	26.26
Costa Rica	0	0	0.02	1.35	0	1.37	0
Denmark	0	0.50	0	0	0	.50	0
France	18.00	0.03	0.20	1.29	5.06	24.58	10.03
Italy	0	0	0	0	.67	.67	0
Japan	0.10	0.10	0.09	0.08	.11	.48	0.15
Mexico	0	0.70	0.73	9.50	4.98	15.91	3.50
Netherlands	0.10	0.20	0.83	0.60	.87	2.60	0
Panama	1.00	0.50	25.00	0	0	26.50	0
Spain	6.00	4.00	5.00	7.59	10.93	22.59	9.42
Sweden	0.20	0.10	0.26	5.73	.09	6.38	0.21
Switzerland	0	17.00	82.03	63.30	76.34	238.77	56.93
United Kingdom	107.00	31.00	43.08	130.47	168.54	480.09	108.92
Venezuela	0	0.10	0	0	n	.10	14.56
West Germany	0.50	0.60	1.00	1.02	.17	3.29	0.91
TOTALS	$253.00	$142.00	$275.00	$288.72	$354.13	$1307.42	306.7

n = Negligible (less than $ 10,000)
* = Numbers are rounded, therefore totals may not add.

SOURCE: TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY ~~1987~~ 1988

TABLE III

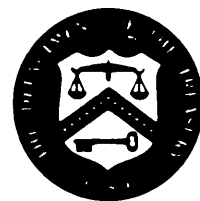
ITEMIZED U.S. DOLLAR VALUE* FOR LICENSED IMPORT/EXPORT TRANSACTIONS WITH CUBA BY U.S. SUBSIDIARIES
(In millions of dollars)

COUNTRY	FY 1982			FY 1983			FY 1984			FY 1985			FY 1986			FY 1987		
	Cuban Imports	Cuban Exports CON.	N-CON.	Cuban Imports	Cuban Exports CON.	N-CON.	Cuban Imports	Cuban Exports CON.	N-CON.	Cuban Imports	Cuban Exports CON.	N-CON.	Cuban Imports	Cuban Exports CON.	N-CON.	Imp	Exp. CON	N-C
Argentina	0	4.00	18.00	0	0	10.00	0	9.00	3.00	0	21.70	9.99	0	8.92	13.42	62.5	10.5	1.4
Australia	0	0	0.40	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Austria	0	0	0.10	0	0	0	0	0	0	0	0	2.39	0	0	0	0	0	0
Belgium	0	0	0.10	0	0	0.10	0	0	0.11	0	0.12	0.24	0	0.44	0.20	0	1.2	0.98
Bermuda	53.00	0	0	27.00	20.0	0	65.00	0	0	0	0	0	0	0	0	0	0	0
Brazil	0	0	0	0	0	0	0	0	0.02	0	0	0	0	0	0	0	0	0
Canada	1.00	29.00	15.00	0.40	16.0	13.00	0.20	21.00	19.00	0.16	15.60	17.40	16.23	37.00	10.15	0.2	14.5	11.3
Costa Rica	0	0	0	0	0	0	0	0	0.02	0	0	1.36	0	0	0	0	0	0
Denmark	0	0	0	0.50	0	0	0	0	0	0	0	0	0	0	0	0	0	0
France	0	17.00	1.00	0	0	0.03	0	0	0.20	0	0	1.20	0	0	5.06	0	0.29	9.7
Italy	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0.67	0	0	0
Japan	0	0	0.10	0	0	0.10	0	0	0.09	0	0	0.08	0	0	0.11	0	0	0.15
Mexico	0	0	0	0	0	0.70	0	0	0.73	0	0	9.50	0	0	4.98	0	0	3.5
Netherlands	0	0	0.10	0.20	0	0	0	0.10	0.03	0	0.29	0.30	0	0	0.07	0	0	0
Panama	1.00	0	0	0	0.5	0	0	25.00	0	0	0	0	0	0	0	0	0	0
Spain	0	0	6.00	0	0	4.00	0	0	5.00	0	2.46	5.12	0	0.02	10.91	0	0.26	8.5
Sweden	0	0	0.20	0	0	0.10	0	0	0.26	0	2.46	3.27	0	0	0.09	0	0	0.02
Switzerland	0	0	0	0	17.0	0	55.00	27.00	0.03	35.00	25.03	2.46	65.0	11.34	0	35.0	21.9	0
United Kingdom	105.00	0	2.00	26.00	2.0	3.00	39.00	0.08	4.00	91.36	37.06	1.23	165.36	0.60	2.57	78.0	5.5	25.3
Venezuela	0	0	0	0	0	0.10	0	0	0	0	0	0	0	0	0	0	0	14.6
West Germany	0	0	0.50	0	0	0.60	0	0	1.00	0	0	1.02	0	0	0.17	0	0	0.9

* = Numbers rounded. Items may not add to totals due to rounding.
CON. = Consumable goods
N-CON. = Non-Consumable goods
n = Negligible

SOURCE: TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY 1988

TREASURY NEWS



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202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,426 million of 13-week bills and for $6,405 million of 26-week bills, both to be issued on June 16, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 15, 1988			:	26-week bills maturing December 15, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.41%	6.60%	98.380	:	6.63% a/	6.96%	96.648
High	6.44%	6.64%	98.372	:	6.68%	7.01%	96.623
Average	6.44%	6.64%	98.372	:	6.67%	7.00%	96.628

a/ Excepting 1 tender of $310,000.

Tenders at the high discount rate for the 13-week bills were allotted 43%.
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	$ 36,955	$ 36,955	:	$ 30,225	$ 30,225
New York	22,540,535	5,521,410	:	21,172,950	5,714,900
Philadelphia	27,380	27,380	:	15,370	14,370
Cleveland	49,525	49,240	:	28,775	28,775
Richmond	66,880	66,880	:	25,805	25,805
Atlanta	30,640	30,640	:	25,120	25,120
Chicago	1,689,125	123,350	:	1,379,785	47,485
St. Louis	21,595	21,595	:	16,385	16,385
Minneapolis	11,715	8,865	:	16,845	11,995
Kansas City	26,155	26,155	:	33,915	33,915
Dallas	30,910	20,910	:	26,040	16,040
San Francisco	1,079,060	147,910	:	1,014,220	132,470
Treasury	344,720	344,720	:	307,815	307,815
TOTALS	$25,955,195	$6,426,010	:	$24,093,250	$6,405,300
Type					
Competitive	$22,134,225	$2,605,040	:	$19,543,530	$1,855,580
Noncompetitive	1,058,625	1,058,625	:	799,010	799,010
Subtotal, Public	$23,192,850	$3,663,665	:	$20,342,540	$2,654,590
Federal Reserve	2,339,955	2,339,955	:	1,950,000	1,950,000
Foreign Official Institutions	422,390	422,390	:	1,800,710	1,800,710
TOTALS	$25,955,195	$6,426,010	:	$24,093,250	$6,405,300

An additional $33,210 thousand of 13-week bills and an additional $197,990 thousand of 26-week bills will be issued to foreign official institutions for new cash.

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
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TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES
TUESDAY, JUNE 14, 1988

Good morning, Mr. Chairman and Members of the Committee. It is a pleasure for me to testify on the progress made by the President's Working Group on Financial Markets.

During the past two months, the principal members of the Working Group and our respective staffs have analyzed and discussed the extensive information and recommendations emanating from last October's market decline. Far from being a stalling device as some have criticized, the Working Group has moved forward, after much deliberation, on a number of critical issues to preserve the integrity, competitiveness, and efficiency of our nation's financial markets.

Our focus has been on positive actions that can be taken now -- immediately -- as contrasted with possible legislative restructuring that is subject to protracted debate and possible delay. Fortunately, the Working Group identified ways to act affirmatively, without legislation.

Collectively, the Working Group's action proposals address basic safety and soundness issues, should lessen the risk of systemic problems, and as a result, work to the benefit of all investors. The key issues -- identified by the Brady Commission, the General Accounting Office (GAO), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and others -- on which the Working Group has agreed unanimously and has taken constructive action include:

- an agreement on coordinated "circuit breakers" across markets to allow for cooling-off periods during times of extreme price declines;

- recommendations and conclusions on the credit, clearing, and payments system to ensure the necessary coordination of information and operations within and between markets and to avoid systems gridlock;

- agreement that current minimum margin requirements provide an adequate level of prudential protection to the financial system; and

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- o agreement on contingency planning, including the continuation of the Working Group, to ensure coordination and consultation in the event of future, rapid market disturbances.

I also am pleased to report that the securities, futures, and options industries already are making -- and should continue to make -- significant efforts to enhance operational capacity, to increase individual firm and clearinghouse capital, and to improve the fairness and quality of order executions for all investors, large and small.

THE NEED TO REDUCE SYSTEMIC PROBLEMS

The specific conclusions and recommendations are contained in the Working Group's interim report to the President, which has been sent to all members. It is essential, however, to understand the premise from which these conclusions evolved.

The Working Group views its primary mission as taking collective, safety and soundness actions which would substantially lessen possible systemic dangers to the U.S. financial system if we were again to encounter a severe stock market decline. Consequently, the Working Group -- acting on the most significant suggestions of the Brady Report and others -- views coordinated circuit breakers, prudential margins across markets, the proper functioning of credit, clearing, and payment systems, and contingency planning as key ingredients to prevent stock market declines from degenerating into self-feeding panics.

While markets will always react to changes in fundamental economic information, it is important to assure all investors as to the proper functioning of the financial system while such information is being digested in terms of market pricing. Indeed, reducing concerns over the viability of the mechanics and infrastructure of the system could mitigate the extent of market declines by reducing the risk premium inherent in those extreme situations where market participants worry about receiving full and timely payments. Hence, our emphasis on safety and soundness issues first during these past 60 days.

Daily Volatility Is Not A Systemic Threat

The issue of daily volatility, although an expressed public concern, is not in the category of systemic threat, in my opinion. However disconcerting such volatility can be on a short-term basis, it is important not to attempt cures that can do more harm than good. Markets must be allowed to adjust to new price levels without impediments to efficiency that in themselves

cause disruptive market action. Narrow price limits for circuit breakers, causing frequent market shut downs, would be an example of such self-defeating "cures".

Moreover, volatility is a subject which often has been treated publicly with more emotion than analysis. It must be noted that, with the exception of the period October 1987 through January 1988, there is no evidence of any increase in daily volatility. Volatility from 1983 through 1986, during which time the futures market was growing rapidly, was moderate to low as compared to similar prior periods. This is illustrated in Exhibit A. I should note that since February 1988, daily price volatility has returned to levels such as were seen in 1973, 1974, 1975, 1980, and 1982, and which are statistically indistinguishable from the norm for 1971 through 1986. In any case, we must be cautious in ascribing events of those few months of extraordinary volatility to changes which have been in place for some time or in extrapolating that those events will be the new norm in the future.

Some observers believe the individual investor has left the market because of a perception of increased volatility. It is equally possible that much of the retreat is in fact investors' collective views that the bull market has paused or that more attractive alternative investments are available. Individual investors have "left the market" in the wake of other major market declines (e.g., in the mid 1970s). Those individuals who want to own equities but are concerned about competing with large, sophisticated pools of capital can, if they wish, invest through them (e.g., mutual funds and pension funds) rather than trying to compete with them.

We must recognize that investor withdrawal during such bear markets is a fact of life, reaffirmed recently in a New York Times article which states in part:

> Investor disillusionment with the stock market is not a new phenomenon. Typically, investors withdraw each time there is a bear market -- contributing to the bleak mood. After the almost 50 percent drop in the value of stocks during the 1973-74 bear market, for instance, many individuals fled the market and stayed out until the bull market of the 1980's.
>
> The number of individual shareholders who owned stocks on the New York Stock Exchange fell to 25.2 million in 1975 from 30.8 million in 1970. The number of shareholders of mutual funds dropped to 7.8 million in 1980 from 8.4 million in 1970, according to estimates by the Investment Company Institute.

Numerous Factors Cause Markets to React More Quickly Today

There are numerous factors that have made markets react more quickly today to changes in the fundamental determinants of stock prices. First, the nature of stock ownership has changed substantially over the past twenty years, led by private and public pension funds. There have evolved very large individual aggregations of capital of a size unknown in an earlier period.1/ This, in turn, has led to changes in the techniques of managing such capital, often with an emphasis on the market as a whole (e.g., the S&P 500) rather than individual stocks. In the case of major broker/dealers, the need for trading liquidity by large bodies of capital has also increased the need for hedging techniques by corporate treasurers and money managers. Thus, the stock index futures markets have evolved as the lowest cost, most efficient response to these changed needs. "Trading the market" and hedging are not in and of themselves either good or bad -- they are economic facts that are not going to go away.2/

It is not the futures products themselves that are called into question; rather, it is the behavior of large institutional investors and large traders (e.g., Fortune 500 companies, union pension funds, mutual funds, etc.) that comes into play. I must admit, too, that I have some difficulty in my own mind when it comes to legislating behavior modifications of that magnitude.

Second, benefits of active futures markets are real: for example, they apply directly to the Treasury securities market. Treasury futures are used as hedging vehicles and as a cost-saving means to adjust positions in the underlying securities. These risk-reducing benefits of futures markets lead to a reduction of the risk premium investors require on the underlying Treasury securities and thus to lower interest costs for the Federal Government.

1/ At the end of 1987, U.S. private pension fund assets totalled almost $1.5 trillion and U.S. public pension fund assets were approximately another $500 billion. By comparison, total pension fund assets were approximately $820 billion at the end of 1980.

2/ 1987 statistics for the largest 200 pension funds show that a growing percentage of their assets (11.8%) is in stock index funds. A growing percentage of these pension funds (36%) also uses stock index futures.

For an excellent discussion of the increasingly significant role of derivative products -- particularly futures on stock indexes -- in the securities markets, members of the subcommittee really should review Chapter Three of the SEC's Staff Report "The Effects of Derivative Products" (<u>The October 1987 Market Break</u>) which I have attached as Exhibit B of my statement.

Third, with the index futures markets having exhibited greater volume in the underlying stocks than the cash market exchanges, it can be argued that the Chicago Mercantile Exchange (CME) has become a leader -- rather than a follower -- in price discovery of equity market value levels. Cash market prices are now often following, rather than leading, the so-called derivative market. The Brady Report and others have underscored the close economic linkage between these markets. Thus, the public debate over the role of index arbitrage is often misdirected. Index arbitrage only takes place when there is a difference of price level between the cash and futures markets, and such arbitrage, as in its age old role, helps equate those price levels.

Fourth, while it is true that index arbitrage can translate buying or selling pressure from one market to another, if those markets are truly economically linked and responding to the same fundamentals, then such arbitrage serves the useful purpose of quickly equalizing the price levels between the markets. It is worth noting in this context that the proposal of the New York Stock Exchange (NYSE) for trading baskets of stock on the NYSE would itself produce "index arbitrage" between the value of the basket and the underlying stocks -- but this arbitrage would be <u>within</u> the NYSE. What often is overlooked in discussions of arbitrage is that if there were no linkage of the markets, then more selling or buying could spill over into the cash markets directly. If the futures market were to disappear from this country, pressures on the stock market would only increase. The Brady Report takes note of such selling when the linkage broke down in October.

Much public criticism of index arbitrage is a classic case of wanting "to shoot the messenger" that brings the bad news of selling on the CME to the floor of the NYSE. If selling is going to take place to a degree that pushes prices down sharply, then cash markets will not be made immune by eliminating index arbitrage. The emphasis, therefore, should be on increasing the capacity of systems like the Designated Order Turnaround (DOT) system of the NYSE so that the public has fair and equal access to order transmission, rather than on restricting mechanical linkages between economically-linked markets.

Put another way, if there were no index futures market, then there would be no index arbitrage. But there is no evidence that such a condition would give the cash markets immunity from selling pressure generated by responses to fundamental events -- and no likelihood that having developed to meet a large and important investment need there will not be a viable index futures market, whether here or abroad.

Fifth, the volatility many people blame on index arbitrage could also be evident from direct selling in the cash market. In fact, pressures directly on cash markets are clear from history. Earlier in the postwar periods before the index futures markets came into existence in 1982, the Dow Jones Industrial Average (DJIA) had a number of significant declines as outlined in Exhibit C of my testimony. In fact, the 1973-74 bear market was worse than the 1987 decline; while it took longer, the end result was that price levels reacted to fundamental perceptions and adjusted accordingly. While individual share ownership is an important part of our financial system and should be encouraged, we cannot expect to be able to legislate normal human behavior -- any more than we should be expected to protect the revenues of brokerage firms by attacking symptoms rather than causes.

Sixth, the aggregation of capital is a factor in today's global markets, just as the phenomenon of rapid information dissemination also is important to recognize. The world now has the technological systems -- and therefore the ability --- for almost instantaneous response to any event. This provides another type of aggregation in the form of concerted buying or selling. While market liquidity has increased greatly in recent years, clearly some greater volatility can be intrinsic to concerted action. Eliminating information technology -- either by legislation or regulatory fiat -- hardly seems like a realistic reaction to concerns about volatility.

Finally, the Wall Street broker/dealer/specialist business has become increasingly capital-intensive. Since 1975, when fixed-rate commissions were ended, a notably larger percentage of revenues are now a function of capital returns rather than commission income. With capital risk thus less protected by a cushion of commission income, there is a tendency for block houses and specialists to become more risk averse in their bids during uncertain times. This, too, can lead to greater volatility.

Evolution in the Face of Change is Necessary

If I may be permitted a personal comment, I would like to point out that when I started in Wall Street in 1951, a million

shares traded on the NYSE in one day was a big event. Wall Street was like a private club, and a rather exclusionary club at that. No one worked too hard, competition was limited, individuals were as important as institutions, the U.S. economy was dominant, and the NYSE was <u>the</u> market of the world. There is more than a little nostalgia for those times that influences today's debates about how markets should function.

I would suggest, however, that the Wall Street of an earlier time also had its drawbacks and never could have accommodated the demands of a growing U.S. economy without itself changing. Those changes continue, particularly in an internationally competitive world. It would be a mistake to focus only on the fall-outs of those fundamental changes when attempting to determine whether structural modifications are needed for the markets themselves.

<u>Strong Agency and SRO Action Needed Against Frontrunning and Market Manipulation</u>

Before I turn to our recommendations, I want to take a minute to comment on an issue about which I feel strongly. Virtually all of the reports voiced concerns about customer protection, particularly in the areas of intermarket frontrunning and market manipulation. For example, the Brady Report recommended development of an extensive trading information system for the stock markets to better diagnose developing problems and uncover abuses. The CFTC staff urged establishment of standards for identifying potential intermarket frontrunning trading patterns and a mechanism -- perhaps the Intermarket Surveillance Group -- for the timely and effective communication of market surveillance data related to possible frontrunning activity among all exchanges with common self-regulatory interests. The SEC recommended strengthening current prohibitions and working with the CFTC and self-regulatory organizations (SROs) to ensure that adequate intermarket information is available to pursue such matters.

The Administration fully agrees that vigorous action against problems of intermarket frontrunning and market manipulation is essential. Along with the benefits of new products, technologies, and trading strategies have come increased opportunities for abuse by market professionals and insiders. These abuses have hidden economic costs in addition to their more obvious effect on smaller individual and institutional investors who come to believe that the rules are rigged against them. We deplore this situation and expect the regulators and SROs, who are in the best position to take affirmative action, to continue to do so. They already have made significant progress:

- The CME has just circulated a proposed definition of

frontrunning to futures industry representatives;

- The NYSE recently notified its members that trading futures based on knowledge of impending orders in the stock market is a violation of exchange rules. The NYSE plans to provide the futures exchanges with audit trail information on stock trading that would enable the Chicago futures markets to conduct ongoing surveillance for frontrunning; and

- The American Stock Exchange (Amex) has recently implemented systems to automatically monitor option trading for frontrunning, mini-manipulation, and pegging and capping. The Amex also is developing an expert system which uses artificial intelligence software to analyze potential insider trading market manipulation cases.

It is in the best interest of all investors concerned that the problems of frontrunning and market manipulation be resolved quickly and effectively by the agencies and SROs. Such action is crucial if we take seriously the charge that markets are rigged to the disadvantage of the small investor.

RECOMMENDATIONS

Let me now briefly summarize the Working Group's recommendations and conclusions. Our efforts have focused so far on six subjects which are described in more detail in our report to the President.

1. Continuing Coordination

The Working Group believes that its continuation is an excellent way to coordinate what should be an on-going process to address intermarket issues. The Brady Report and others have recommended that some additional regulatory mechanism be established to resolve these issues. Recognizing this concern for coordination, we believe cooperative efforts under the existing regulatory structure will continue to be effective, and in large measure, fulfill the intent of several legislative proposals. The very existence of this group has helped to keep the pressure on the various SROs and market participants to devise and implement necessary reforms on their own.

2. Circuit Breakers

In addressing coordinated trading halts and reopenings, so-called circuit breakers, the Working Group has focused on market events that are so dramatic as to trigger *ad hoc* closings of

equity markets and to pose potential systemic risks to our financial system. The Working Group has devised a cross-market mechanism to avoid ad hoc and destabilizing market breaks, recognizing that any disruption of trading is undesirable.

Our proposal is designed to substitute planned for unplanned, ad hoc trading halts, without increasing the overall frequency of such disruptions. Planned halts should allow time for the dissemination of information and consideration of decision to buy or sell in rare situations in which panic conditions threaten.

3. Prudential Margin Requirements

The Working Group reached agreement on several key points regarding prudential margins and concluded that:

- current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements, and that margins sufficient to cover all possible price movements would have unacceptable costs for the liquidity and efficiency of markets;

- there are additional protective cushions in place from capital requirements and surveillance for firms and clearinghouses; and

- given differences in price volatility of stocks and indexes and grace periods for settling margins, a consistent and harmonious margin regime among markets would produce significantly higher levels of margin for stocks than for futures.

The positions of the Working Group members on the need for margins in excess of the prudential level, and of the need for federal oversight, are set forth in the report to the President.

4. Credit, Clearing, and Settlement

As former Senator Nicholas Brady, who chaired the President's Task Force on Market Mechanisms, indicated recently, extreme stress on our clearing and credit systems came close to damaging our financial system last October. While a complicated and technical area, our financial system's network of clearing, credit, and settlement procedures truly is the nuts-and-bolts that allow hundreds of millions of transactions to be conducted and financed on a daily basis.

The Working Group has reviewed existing clearing, payments, and settlement systems to identify and set priorities for measures that they recommend be taken to reduce uncertainty, increase coordination, to assure confidence in the integrity of such systems, and to facilitate their smooth operation in volatile markets.

The Working Group endorses the view that the proper functioning of these systems is integral to the proper functioning of the financial markets as a whole and is pleased to report that significant progress has been made in this area. As more fully set forth in the report to the President, the Working Group is proposing an agenda of additional measures to be pursued to achieve the goal of more perfectly coordinated systems.

5. Contingency Planning

The Working Group believes that the purpose of contingency planning is to ensure that regulatory agencies and the SROs have in place systems which will allow them to identify emerging problems quickly and to react appropriately in the event of a market crisis. In an important sense, the Working Group recommendations for implementing circuit breakers, improving information flows, clarifying credit arrangements, and strengthening the clearing and settlement process can be viewed as a key part of contingency planning. By improving the market system's ability to withstand and react to shocks, these measures will enhance the system's first line of defense.

Going beyond this, the Working Group has given high priority to enhancing channels of communication among staffs of the respective regulatory agencies and the Treasury. In addition, staff of the three agencies are working jointly to improve information sharing across the agencies, with particular emphasis on a framework for coordinated monitoring of exposures and developments at major market participants. Finally, regarding international policy coordination, steps are being taken by the various agencies to strengthen existing contacts with their counterpart authorities in other major market centers to further improve this aspect of market surveillance.

6. Capital Adequacy and Systems Capacity Enhancement

Market participants, SROs, and regulatory agencies have taken or are planning a number of significant actions to enhance financial integrity and improve automated systems -- two of the issues the Working Group, the Brady Report, the GAO and others have identified as critical to the financial integrity and smooth functioning of the markets. Our report to the President cites

the many constructive steps already taken in these areas. The Working Group encourages these efforts and will continue to monitor developments to ensure that needed improvements are made.

CONCLUSIONS

In summary, Mr. Chairman and Members of the Committee, the Working Group has commenced action on a number of significant steps that collectively will work to reduce systemic threats to our financial markets. In so doing, we have pursued a sizeable portion of the agenda defined in large measure by the Presidential Task Force on Market Mechanisms,3/ the GAO, the SEC, the CFTC and other market observers. Indeed, Senator Brady concluded his recent public letter with a position that in fact has been the operating basis of the Working Group:

> We are not attempting to legislate against decline or interfere with the smooth functioning of the markets. The market will always seek its level ground; we are only trying to assure that it gets there safely.

The collective and coordinated actions recommended by the Working Group -- and corrective steps already taken by others -- help to assure that the market in fact does "get there safely" when it moves for whatever reasons.

We cannot legislate against market declines, regulatory dictates cannot eliminate volatility, and executive fiat is no more effective. Price controls and capital controls have never worked effectively in this country and no amount of government control can sway markets if underlying economic fundamentals -- or investor perceptions of those same fundamentals -- take the market one direction or another.

Moreover, it is unrealistic and ultimately counterproductive to attempt to roll back developments in financial markets brought about by advancements in telecommunication and computer technology and by changes in investment needs. We cannot go back to the days of the abacus or mechanical adding machines. If we did -- by trying to legislate against particular products or investor preferences or market strategies, for example -- then we would ultimately lose whatever competitive edge we now have to places like Toronto, Tokyo, or London.

3/ See, for example, the summary comparison of the recommendations in the Brady report and the actions taken by the Working Group in Exhibit D.

Mr. Chairman, I would be remiss if I did not commend the cooperative actions and constructive dialogue on the part of the Working Group members. We have spent considerable time and energy to arrive at our initial recommendations. The members of the Working Group have demonstrated that it is possible to address major, complex issues in a cooperative fashion -- even though we bring different perspectives and preferences to the table -- and in a reasonably short time frame. Disagreements on some matters have not blocked significant agreements that are apparent upon careful examination of the package we have presented to the President.

The public also has been well served by the Working Group's high caliber staff and their professional analyses, and I salute them.

We have made progress on basic elements that are essential to the safety and soundness agenda that we view as a priority. More work will be done, and we welcome the continuing challenge.

* * * * * * * * * * * * * *

Exhibit A

Volatility Measures, 1971-1988

Years	S&P 500	NYSE Composite
	Standard Deviations of Daily Price Changes (in Percentage Points)	
1971	0.640	0.645
1972	0.500	0.494
1973	0.997	1.007
1974	1.373	1.354
1975	0.967	0.949
1976	0.694	0.676
1977	0.570	0.539
1978	0.787	0.775
1979	0.682	0.682
1980	1.029	1.017
1981	0.843	0.825
1982	1.141	1.073
1983	0.868	0.781
1984	0.794	0.738
1985	0.632	0.589
1986	0.949	0.874
1987	2.120	1.972
1988 (Jan-Apr)	1.420	1.275
Inclusive Periods		
1971-1974	0.943	0.939
1975-1978	0.774	0.755
1979-1982	0.944	0.916
1983-1986	0.821	0.756
Jan-Sep 1987	0.984	0.905
Oct 1987-Jan 1988	3.538	3.290
Feb 1988-Apr 1988	1.073	0.960

Note: These standard deviations were calculated by the S.E.C. from daily data for the entire period indicated in the left column. Approximately two thirds of all daily price changes during a period will lie within one standard deviation of the average price change for the period. (About 95 percent of all changes will fall within two standard deviations and 99.75 percent within three standard deviations.)

Chapter Three

THE EFFECTS OF DERIVATIVE PRODUCTS

Derivative products, particularly futures on stock indexes, play an increasingly significant role in the securities markets. For example, the trading volume of stock index futures has grown spectacularly since their introduction in 1982. By the week preceding the October market break, trading in the Standard & Poor's ("S&P") 500 index futures contract ("SPZ") was averaging 106,400 contracts. 1/ This daily contract volume (based on the value of the S&P 500 index during the week preceding the market break) was the equivalent of approximately $16 billion worth of equity securities, and represented more than two times the average daily dollar volume of trading on the New York Stock Exchange ("NYSE") during September 1987. 2/ Similarly, options on stock indexes were the fastest growing segment of the options market in 1987 and, by October 1987, on average accounted for more than 43% of total options contract volume. 3/

The growth of derivative products reflects, in part, the trends toward greater institutionalization of the markets and of market basket trading, coupled with the changing nature of investment strategies. Analysis of these trends sheds light on the growing impact of futures trading in the securities markets.

A. Institutionalization

During the last ten years, institutional investors have held an increasingly large percentage of all outstanding equities. In particular, the growth of United States pension funds and mutual funds, and the accompanying changes in investment policy and asset allocation, primarily are responsible for the increasing institutionalization of the securities markets. 4/

At the end of 1975, institutions held 35.3% of the $685.1 billion total market value of all NYSE-listed stocks. At that time, pension funds held a total of $252 billion in assets, $113 billion of which were equity holdings. 5/ By the end of 1980, the market

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1/ See Divisions of Economic Analysis and Trading and Markets, Interim Report to the Commodity Futures Trading Commission ("CFTC") on Stock Index Futures and Cash Market Activity During October 1987, November 9, 1987, Table 2.

2/ See NYSE, Marketing Research Report (November 1987).

3/ Total volume for options contracts traded on all exchanges for the period from January to October 1987 was 276,570,000. The volume for index option contracts traded for the same period on all exchanges was 119,535,000 contracts. Index option contracts generally are one-fifth the size of index futures contracts.

4/ See Chart 3-1 (overview of pension fund growth and management trends).

5/ See J. Light & A. Perold, The Institutionalization of Wealth: Changing Patterns of Investment Decision Making, in Wall Street and Regulation 98 (1987, ed. S. Hayes).

value of all NYSE-listed stocks had increased to $1.2 trillion, while the institutional investors' share of that market value had remained constant, increasing only .1% to 35.4%. At that time, however, the total value of pension fund assets had increased to $485 billion, $220 billion of which were equity holdings, which accounted for 14% of all equities outstanding. 6/ By 1985, pension funds had more than doubled their 1980 level of equity investment, to almost $500 billion worth of stocks, which accounted for 22% of all equities outstanding. 7/

The 1980s have seen not only a substantial growth in the market value of institutional holdings, but also a surge in the percentage of the total trading volume on the NYSE accounted for by institutional investors. 8/ Large block transactions, 9/ a gauge of institutional participation in the stock market, have increased sharply since 1977. A total of 54,275 large blocks, accounting for 1.2 billion shares ($34 billion), were traded in 1977. 10/ These transactions accounted for 22.4% of the reported volume on the NYSE for that year. By 1983, these figures had more than doubled. In that year, 363,415 block transactions occurred, accounting for 9.8 billion shares ($346.92 billion), and representing 45.6% of reported volume on the NYSE. A record average of 2,631 daily block trades occurred in 1986, up from an average of 2,139 daily block trades in 1985, representing 49.9% of reported volume on the NYSE. Moreover, the total number of block transactions on the NYSE increased 23.5% in 1986 from the previous year. This represented a 25.2% increase in the number of shares accounted for by those trades. 11/ As further evidence of the rapid growth of these institutional transactions, on April 10, 1986, a new record was set when 48.8 million shares of Navistar International were traded, which was the largest block transaction in history as of that date. 12/ Prior to April 10, 1986, the largest block transactions in history had occurred on May 25, 1983, when 7.0 million shares of Ramada Inns were traded, and on November 30, 1983, when 6.35 million shares of AT&T changed hands. 13/

B. Market Basket Trading

The types of institutional transactions that occur and the investment decisions made by money managers also have changed as a result of evolving investment and trading strategies. Institutional money managers have made increasing use of passive

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6/ Id.

7/ Id.

8/ See Chart 3-2.

9/ Large block transactions are transactions of 10,000 or more shares.

10/ See Chart 3-2.

11/ See Chart 3-2: 539,039 block transactions occurred in 1985, accounting for 14.2 billion shares ($501.26 billion). In comparison, 665,587 block transactions occurred in 1986, accounting for 17.8 billion shares ($685.3 billion) traded.

12/ NYSE, Fact Book 12 (1987).

13/ Id.

asset management strategies. In 1980, money managers reported a total of $9 billion in indexed assets. 14/ This figure rose to $48.2 billion at the end of 1984. By 1985, index fund managers reported $81 billion in indexed assets, almost a 70% increase over the previous year's figure. As of May 31, 1987, the value of indexed assets for U.S. pension funds grew to $187.96 billion, $124.07 billion of which tracked U.S. equity indexes. 15/

As a result of the proliferation of index funds and the growth in indexed assets, along with investment tactics that require the simultaneous trades of large blocks of stocks, institutional investors increasingly have used program trades. Index fund managers began program trading in the mid-1970s. 16/ Currently, an estimated 25% of all institutional trading is accomplished by use of program trades. 17/ These trades include straight execution of multi-stock orders, as well as index arbitrage and substitution strategies, among others. The increase in this activity appears to have accelerated in 1987. For example, in January 1987, an average of 12.1 million shares per day was executed through the List Order Processing ("LIST") capability of the NYSE's Designated Order Turnaround ("DOT") system but by August 1987, that number had increased to an average of 16.6 million shares.

C. The Effects of Futures

The increasing institutionalization of the markets and the growth of passive investment strategies, such as indexing, 18/ have been accompanied by the increasing use by institutional investors of derivative products such as index options and financial futures. By 1984, only two years after the introduction of cash settled stock index options and futures, a number of institutional investors were using or actively considering using derivative markets to earn incremental returns on managed money, allocate assets to adjust for market risk, and manage various commercial and financial risks. 19/ Forty of the top 200 pension funds were using stock index futures at that time. Their use of derivative products, however, did not include dynamic hedging or portfolio insurance to any large extent. In 1984, only an estimated $200 million in

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14/ Christman, Indexed Assets up 70% in 1985, Pensions & Investment Age 6 (Dec. 23, 1985).

15/ Berkowitz, Indexed Assets Top $187 Billion, Pensions & Investment Age 3 (July 13, 1987).

16/ See, e.g., Investment Dealers' Digest 25 (March 2, 1987).

17/ Light & Perold, supra note 5, at 110.

18/ Indexing involves holding stocks in proportion to a widely followed index like the S&P 500.

19/ Board of Governors of the Federal Reserve System ("FRB"), Commodity Futures Trading Commission and the Securities and Exchange Commission ("SEC"), A Study of the Effects on the Economy of Trading in Futures and Options (Dec. 1984) ("Joint Study") at IV-17.

pension fund assets were dynamically hedged. 20/ This changed rapidly over the next three years as pension funds expanded their use of dynamic hedging or portfolio insurance strategies. In 1985, portfolio insurance was applied to an estimated $6 billion of pension fund assets. 21/

By 1986, the amount of pension fund assets committed to portfolio insurance strategies had increased to at least $8.5 billion, forty times greater than the value of pension fund assets that were dynamically hedged in 1984. 22/ By October 19, 1987, stock valued at more than $60 billion, mostly held by pension funds, was reported to be managed under portfolio insurance strategies. 23/

The Division of Market Regulation ("Division") has attempted to verify the total dollar value of portfolio assets that were subject to some type of portfolio insurance or protective hedging program during the October 1987 market break. Division staff spoke with the major vendors of portfolio insurance programs, with broker-dealers and banks that manage large portfolios, and with many corporate-pension plan managers. Based on these interviews, the staff has identified a minimum of approximately $55 billion in portfolio assets that were committed to some type of portfolio insurance strategy. This figure is a minimum estimate of portfolio assets subject to some type of portfolio insurance or protection plan. 24/ Moreover, staff interviews with market professionals indicate that a wider range of institutions actively use the futures markets. While these institutions do not employ the precise trading strategies dictated by portfolio insurance, they do employ the futures market to quickly adjust their relative equity holdings in a manner that can have effects on the market similar to portfolio insurance trading.

1. Benefits

As the staff has noted in prior analyses, the impact of index-related trading on the markets should be viewed in the context of the benefits provided by such trading. Various studies conducted before the October 1987 market break concluded that futures

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20/ Ring, Funds Watch as Others Try Program Trades, Pensions & Investment Age 1 (April 28, 1986).

21/ Ring, Dynamic Hedging Grows Despite Debate, Pensions and Investment Age 3 (April 14, 1986).

22/ Id.

23/ Ring, Execs Ponder Compatibility of Strategies, Pensions & Investment Age 15 (July 27, 1987).

24/ While this figure is smaller than estimates ranging from $60-$100 billion that have appeared in the press, we have attempted to the maximum extent possible not to double count portfolio assets. Various portfolio insurance programs are licensed by vendors. As a result, obtaining an accurate estimate of the amount of portfolio assets subject to some type of portfolio insurance strategy is difficult because information obtained from licensees also may have been provided by vendors.

and options on stock indexes offer significant benefits to today's capital markets. 25/ These studies found that the markets for these index products, especially the market for SPZ futures, add substantial liquidity and pricing efficiency to equity markets generally. Moreover, using these products, investors are able to control the risks in their portfolios in accordance with their particular needs. As a result, the markets perform their various economic roles more efficiently.

a. Liquidity Efficiencies

As described in Chapter One, an index option or future is a single instrument that can be used as a surrogate for many stocks. Substantial market making capital is concentrated in the more successful of these products, especially the SPZ future and the S&P 100 index option. In addition, market makers and hedgers are afforded favorable margin requirements, enabling them to effect transactions at lower cost. These factors contribute to the futures market's liquidity, allowing investors to execute large transactions with much smaller market effects than is possible in the separate stocks. 26/

b. Transactional and Hedging Efficiencies

The availability of derivative index products has substantially enhanced institutions' and other market professionals' hedging and market timing capabilities. Index futures and options also significantly reduce transaction costs when assets are reallocated among such as stocks, bonds and cash equivalents in a portfolio, or when additional funds are invested. 27/ Because commission rates, as well as execution costs, are lower for futures than for stocks, institutions changing the proportion of stocks in a portfolio can do so at lower cost by initially using the futures rather than the stocks themselves. For example, a debt portfolio can be converted rapidly to equity by simultaneously selling bond futures and buying stock index futures. In doing so, managers can increase their equity exposure without incurring the relatively higher transaction costs of the stock and bond markets. Thus, futures not only allow for the rapid reallocation of a portfolio, but create substantial savings in execution and

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25/ See, e.g., Joint Study, supra note 19, at IV-35; H. Stoll & R. Whaley, Expiration Day Effects of Index Options and Futures (1986) ("Stoll Study").

26/ A 1985 study by the investment firm of Kidder, Peabody & Co. estimated the difference in costs as follows: the cost of executing a $20 million stock trade in terms of the effect on the price of the stock would be 0.27%; for a similar futures trade, 0.04%. R. Wunsch, Stock Index Futures (Kidder Peabody & Co., April 23, 1985). More recently, Morgan Stanley estimated the market impact cost of a $120 million S&P 500 basket as 1.30 index points (or $520,000) in the stock market versus .05 index points (or $20,000) in the SPZ. R. Johnson, Program Trading Presentation (Morgan Stanley, July 9, 1987).

27/ Of course, the cost of executing a program has changed over time. According to Fredric A. Nelson of Bankers Trust, a $50 million S&P 500 program would have cost an investor $290,000 to execute in 1984, $165,000 to execute pre-October 1987, and $345,000 to execute after October 1987. F. Nelson, Trading Strategies and Execution Costs (Bankers Trust Company, December 3, 1987).

transaction costs. Of course, when and if the stock transactions take place, commission costs are incurred.

Moreover, as hedging vehicles, stock index products can offer investors substantial benefits. Through the sale of futures contracts, pension, endowment and other institutional investors can quickly, at relatively low cost, shift risk to those more willing to accept it.

2. **Price Impacts of Futures**

The existence of an active futures market in stock indexes has created, in effect, an alternative or "synthetic" stock market for the growing number of institutional investors who choose to trade passively by investing in funds tied to specific indexes or who are interested in buying and selling stocks in "baskets." The data set forth in the Market Chronology (Chapter Two) demonstrate the substantial impact this alternative stock market can have on the equity market, especially by increasing intra-day price volatility.

When futures on stock indexes were introduced, little attention was paid to the possible "price discovery" aspect of this new product or to its ability to displace the stock market as the preferred vehicle for trading baskets of stock. The primary emphasis was on the significant potential for hedging investment risk that was offered by a cash-settled future. Nevertheless, it is our view that, as a result of the increasing use of the futures market by institutional investors, including investors employing passive investment strategies and dynamic hedging techniques, 28/ the character of the market has changed to the point where the "price discovery" feature of the derivative market is leading, rather than following, price trends in the underlying equity markets. Moreover, through index arbitrage, the prices "discovered" in the futures pit are quickly transmitted to the floor of the NYSE where prices adjust to the general market sentiment expressed in the futures arena.

There are several reasons for the increased impact of futures. First, low transaction costs, low margin requirements, and normally high levels of liquidity, the very benefits cited by futures proponents, have made the futures market the "market of choice" for many active institutional traders. Many institutional traders who use futures reported to the staff that they did so because futures were a "cheaper" alternative to buying individual stocks. Some believed that they could increase or decrease market exposure virtually instantaneously, with little market or liquidity costs. For this reason, as noted above, the underlying market value of index futures traded daily generally exceeds the dollar volume on the NYSE. 29/ Accordingly, institution-led market movements are usually observed first in the futures markets.

28/ Dynamic hedging involves rebalancing a market portfolio to increase or decrease the proportion of equity exposure depending on market movements.

29/ The dollar value of SPZ 500 futures contracts traded daily has exceeded the dollar value of daily transactions on the NYSE since the last quarter of 1983. See N. Katzenbach, An Overview of Program Trading and Its Impact on Current Market Practices, 10 (December 21, 1987).

Second, the capital available for index arbitrage has increased substantially. In the early developmental stages of index arbitrage strategies, large broker-dealer firms trading for their own proprietary accounts dominated the business. These same firms continue to be the major players in index arbitrage, but today much of their business is as agent for institutional customers. Moreover, the availability of an efficient order routing system for baskets of stock (the NYSE LIST system) has decreased the time, and therefore the execution risk, involved in executing program trades. Efficient order routing also has increased the speed with which market movements in futures can be transmitted to the stock market.

Institutional investors also can make greater use of index arbitrage strategies than firms can trading for their own accounts. As noted below, the ability to initiate a so-called "short" arbitrage (i.e., buy futures, sell stocks "short") is limited by the Commission's and exchanges' short sale rules, which require that the "short stock" portion of the arbitrage be executed on "plus" ticks or "zero plus" ticks 30/ for each of the stocks comprising an arbitrageur's basket. Many institutional investors, particularly those who manage passive or index funds, already own the stocks underlying the index and, therefore, can initiate an arbitrage transaction involving stock selling without considering the short sale rule, because their sales would be "long" sales and not subject to the "tick" test provisions of the short sale rule. Moreover, because these institutions already own the securities comprising the index, the return they must receive on the arbitrage is less than would be required by other market participants. Accordingly, they are willing to effect arbitrage transactions with a smaller spread between the futures price and theoretical fair value.

The result of all these trends has been to increase the speed and frequency with which index futures price movements are transmitted to the stock market. There is, of course, nothing inherently wrong with index futures providing price discovery for the stock markets. Indeed, such close coordination of two related markets generally enhances pricing efficiency. The emergence of futures as a stock price leader, however, has had a significant impact on the stock market.

First, it increases the difficulty of enforcing marketmaking obligations imposed on specialists. As discussed in detail in Chapter Four, stock specialists are generally expected to buy or sell securities to offset temporary imbalances in supply and demand and to provide price continuity, depth, and liquidity, the general indicia of fair and orderly markets. Interviews with specialists confirm, however, that if the future is trading at a discount or premium to its theoretical value, specialists are unwilling to act aggressively to offset imbalances because the discount or premium indicates that more arbitrage selling or buying will enter the market. 31/ Other market participants may be equally reluctant to trade against pricing signals emanating from the futures market.

30/ A "plus tick" is a trade at a price greater than the immediately preceding transaction and a "zero-plus tick" is a trade at a price greater than the last transaction at a different price (e.g., a trade at 20 would be a plus tick if the prior trade was 19 7/8, and a zero-plus tick if the two prior trades were 19 7/8 and 20).

31/ See Chapter Four, infra for a discussion of specialist obligations and performance standards.

Second, the relatively low margins and absence of short sale restrictions in the futures market may encourage additional trading that might not occur if the derivative index products did not exist, in that large stock equivalent positions can be established or liquidated more quickly. The price movements caused by this increased trading velocity are then rapidly assimilated into the stock market through arbitrage, because arbitrage liquidations and index substitution activity again can occur consistent with short sale restrictions.

The staff believes that these two effects of futures price leadership (greater difficulty in maintaining orderly stock markets and an increase in the velocity of trading) have converged to contribute to increased intra-day volatility in the stock market. Indeed, recent studies have indicated that while, prior to 1987, inter-day stock price volatility was not out of line with prior periods, intra-day volatility was increasing. Moreover, by early 1987, inter-day volatility appeared to be increasing as well. 32/

This price impact does not appear to occur because of speculative activity in the index futures market. Neither our examinations of price volatility on September 11 and 12, 1986 and January 23, 1987 nor our analysis of futures trading during the October market break indicates that speculative activity in the futures market was predominant. Rather, as detailed in Chapter Two, institutions, not speculators, were the primary net sellers of futures on October 19, the day of the greatest market decline.

32/ See, e.g., Cowan, Whether Swings Will Continue is Uncertain, N.Y. Times, January 2, 1988, at 31, col. 3 ("It used to be that, on a given day the [DJIA] moved up or down by more than 2[%] only about once a month. Since May, such swings increased in frequency to almost once every three weeks, and by the fourth quarter of 1987, they occurred almost every other day on average"); N. Katzenbach, supra note 29, at 21-23; F. Edwards, Financial Futures and Cash Market Volatility: Stock, Index and Interest Rate Futures 18 (September 1987) ("Beginning in 1986, . . . volatility began to rise, and in 1987 increased even more. This pattern is evident for all measures of volatility, which show similar movements [footnote omitted]." According to Professor Edwards, from 1985 to 1986, the standard deviation of the high-low estimator for the S&P 500 increased from 0.3534 to 0.5832, while the mean of that indicator increased from 0.7809 to 1.1204. It should be noted, however, that Professor Edwards also stated: "It is doubtful that the rise in stock market volatility is due to anything associated with futures trading.")

We would note that some of the studies which have sought to measure market volatility before and after the introduction of stock index futures have done their comparisons using the Spring of 1982 as the relevant "event date" because that is when such futures were first introduced. However, such an "event date" does not accurately capture the full effects of futures trading. The dollar equivalent of stock trading via futures did not exceed NYSE trading volume until late 1983, proprietary index arbitrage did not become significant until Spring/Summer of 1984, index substitution programs only came into play during 1985-86, and dynamic hedging became considerably greater in 1986-87. Thus, whether such pre-/post-studies can ever "prove" that the market has been more or less volatile since the introduction of stock index futures, such studies should, at least, use a more finely textured "event date."

Exhibit C

Percentage Declines in Postwar Bear Markets, by Month-end Peaks and Bottoms in the Dow Jones Industrial Average

Dates	Closing DJIA	Duration	Percentage Drop
May 1946	212	5 months	20.3
Oct. 1946	169		
Dec. 1961	731	6 months	23.2
June 1962	561		
Dec. 1965	969	9 months	20.1
Sept. 1966	774		
Apr. 1969	950	14 months	28.1
June 1970	683		
Dec. 1972	1020	24 months	39.6
Dec. 1974	616		
Dec. 1976	1004	14 months	26.1
Feb. 1978	742		
March 1981	1003	16 months	19.4
July 1982	808		
Aug. 1987	2662	3 months	31.1
Nov. 1987	1833		

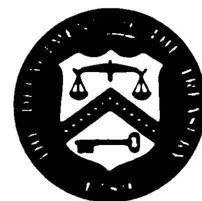
EXHIBIT D

SUMMARY COMPARISON OF BRADY RECOMMENDATIONS AND WGFM ACTIONS

	Brady Task Force Recommendations	WGFM Actions
1. Circuit breakers:	Recommends circuit breakers across markets.	Action: Circuit breakers across markets; followed five guidelines in recent letter by Senator Brady.
2. Clearing and Settlement Procedures:	Clearing systems should be unified to reduce financial risk; Senator Brady said flaws came close to damaging financial system in his recent letter.	Action: Numerous recommendations and proposals to increase coordination and facilitate smooth operation of market mechanisms; goal is a more perfectly coordinated system.
3. Intermarket Regulation:	One super-regulator, prefers FRB, but. Senator Brady recently stated that action on reform on other intermarket issues was more important than one regulator at this time.	Action: Consultation and coordination by WGFM will be on-going; important element of contingency planning.
4. Margins:	Should be consistent to control speculation and financial leverage, though not necessarily equal for futures and stocks; prefers to be set by FRB.	Action: Existing margins (which have been increased since October) are prudential and harmonious across markets to protect against trader or investor default; prudential margins appropriate for carrying stock should be significantly higher than those for a stock futures index contract; best left to SROs to regulate; additional cushions exist in capital requirements and surveillance.

4. <u>Margins</u>:	Should be consistent to control speculation and financial leverage, though not necessarily equal for futures and stocks; prefers to be set by FRB.	<u>Action</u>: Existing margins (which have been increased since October) are prudential and harmonious across markets to protect against trader or investor default; prudential margins appropriate for carrying stock should be significantly higher than those for a stock futures index contract; best left to SROs to regulate; additional cushions exist in capital requirements and surveillance.
5. <u>Information Systems</u>:	Monitor transactions and conditions in related markets (e.g., customer information behind each large trade).	<u>Action</u>: Numerous recommendations and proposals for improved inter-market information flows; SROs are exploring information for large stock traders; Administration favors strong action against front running and manipulation.

TREASURY NEWS



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

FOR IMMEDIATE RELEASE
June 14, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 12,800 million, to be issued June 23, 1988. This offering will result in a paydown for the Treasury of about $200 million, as the maturing bills are outstanding in the amount of $13,000 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 20, 1988. The two series offered are as follows:

91 -day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated March 24, 1988, and to mature September 22, 1988 (CUSIP No. 912794 QN 7), currently outstanding in the amount of $ 6,418 million, the additional and original bills to be freely interchangeable.

182 -day bills (to maturity date) for approximately $ 6,400 million, representing an additional amount of bills dated December 24, 1987, and to mature December 22, 1988 (CUSIP No. 912794 QD 9), currently outstanding in the amount of $ 9,275 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 23, 1988. 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 $1,719 million as agents for foreign and international monetary authorities, and $3,351 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

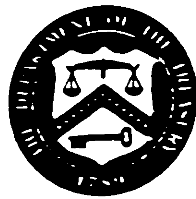
Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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

Text as Prepared
Embargoed Until Delivery
Expexcted at 9:30 A.M., E.D.S.T.

STATEMENT OF THE HONORABLE
JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
JUNE 15, 1988

Mr. Chairman and Members of the Committee:

I welcome this opportunity to discuss with you the Administration's legislative proposals for the Multilateral Development Banks (MDBs). I will begin by commenting on the Administration's legislative request for U.S. participation in the Fifth Replenishment of the African Development Fund and then turn to the general capital increase (GCI) for the World Bank and the issue of developing country external debt.

African Development Fund (AFDF)

Last November the Administration concluded negotiations with other donors on a $2.67 billion replenishment of the African Development Fund and agreed to seek Congressional authorization for U.S. participation. The proposed U.S. share is 11.8 percent or $105 million annually for three years. In the course of negotiating the replenishment, we succeeded in having a number of policy issues adopted on which Fund operations will focus. These include:

- promoting market-based incentive systems and appropriate pricing policies;
- meeting the primary needs of the poorest sections of the population in low income countries;
- fostering employment creation and increased incomes, with agriculture as the highest lending priority;
- eliciting or promoting the direct involvement of the ultimate beneficiaries, including women, in the design and implementation of projects and programs;
- contributing to the improvement of the environment; and

o developing country lending strategies, and coordinating lending programs with other donors.

The aspect of fostering market-based incentive systems is especially timely in view of the region's emerging commitment to strong economic systems. As you may know, I recently attended the annual meetings of the African Development Bank and Fund in Abidjan. I wanted to be the first Secretary of the Treasury to have done so. I had the opportunity to meet with President Diouf of Senegal, President Houphouet-Boigny of Cote D'Ivoire and Finance Ministers of many African countries. I am encouraged by the depth of their commitment to economic reform -- not only for the present but for the long term. My meetings in Abidjan reconfirmed this commitment.

The pursuit of such reforms requires a large measure of courage. For the poorest countries, the personal and national concessional financial support of the international community is a critical factor in the ability to succeed. The AFDF is an important source of such finance, and I urge you to support U.S. participation.

<u>The World Bank General Capital Increase</u>

The other important component of our legislative request is authorization for U.S. participation in the General Capital Increase (GCI) of the World Bank (IBRD).

After carefully reviewing the current and future demand for World Bank lending, we agreed with Bank President Barber Conable's assessment that a GCI was needed this year to insure that the Bank can continue to provide the necessary support for economic growth in the developing countries. The United States has an 18.75 percent share of the GCI, which implies a budget appropriation request of $70.1 million annually over a six year period. The callable capital program limitation would be $2.3 billion annually.

While the debt situation in developing countries is one factor in our decision to support the GCI -- and I will come back to that -- a healthy and vibrant World Bank will address broader economic, social, and environmental issues. The main role of the World Bank continues to be supporting economic development through sound project lending. At least 75 percent of World Bank lending is for projects to promote human and capital infrastructure in areas such as energy development, development finance corporations, agriculture and rural development, urban development, and transportation.

Energy is clearly essential to development, and becomes increasingly so as economies expand. But expansion of this sector can be very expensive, often requiring large-scale

investment. In its last fiscal year (1987) the World Bank made commitments of $3.5 billion for energy development projects, including support for the generation and distribution of electric power to households, schools, hospitals, and industry.

In contrast to direct support for large-scale projects, the World Bank also supports small and medium-scale productive enterprises through local development finance companies (DFCs). Most DFCs lend to manufacturing enterprises, though some also specialize in particular sectors or activities, such as tourism. In FY 1987 these financial intermediaries received IBRD commitments of $2.2 billion.

The reasons for World Bank lending to agriculture and rural development are compelling. Approximately six out of every ten people in developing countries depend on agriculture and related pursuits for their livelihood. Bank projects help developing countries expand irrigation systems, provide more effective extension services, make credit available to small farmers, adopt appropriate technology, increase storage, and improve marketing and distribution facilities. The Bank committed $1.9 billion of its resources to this sector last year.

Urban development was the fourth largest recipient of IBRD commitments in Bank fiscal year 1987, receiving $1.2 billion. Urban areas now contain nearly one-third of the total population in developing countries. Urban projects usually contain major components to upgrade slums and squatter development, or to create sites for additional low-income housing.

The transportation sector received the fifth largest amount of World Bank commitments last year, $1.1 billion. These projects support the construction of thousands of miles of main, secondary, feeder, and rural access roads; railway reconstruction; and expansion of seaports, riverports, and inland waterways.

Much of the Bank's lending program supports countries that are strategically important to the United States. Table 1 below compares last year's (FY87) World Bank commitments to U.S. bilateral economic assistance (Development Assistance, ESF, and PL-480). As an example, Turkey received commitments of $1.1 billion from the World Bank, compared to U.S. commitments of $100 million.

Even more striking is the level of World Bank support to countries who are very important to us but where there is the virtual absence of U.S. bilateral assistance. As an example, Argentina, Brazil and Mexico received $3.9 billion from the World Bank in 1987 and virtually nothing from the United States. In total, for all of the countries listed

in Table 1 below, World Bank commitments in 1987 amounted to $7.7 billion compared to $1.1 billion in U.S. commitments.

Table 1

Fiscal Year* 1987 Loan Commitments

Country	World Bank ($millions)	U.S. Bilateral ($millions)
Mexico	$1,678	**4
Brazil	1,262	**2
Argentina	965	---
Turkey	1,069	$100
Pakistan	397	325
Philippines	342	340
Morocco	577	87
Tunisia	334	84
Thailand	21	21
Indonesia	1,058	128
Totals	$7,703	$1,091

* U.S. and World Bank fiscal years differ by three months.
** Country share of regional development programs.

The U.S. portion of the paid-in capital (which is actual budget authority) that supported this $7.7 billion IBRD lending program was approximately $60 million as compared to the $1.1 billion dollar-for-dollar cost for the U.S. bilateral assistance.

These figures vividly illustrate how we cannot begin to duplicate bilaterally the amount the World Bank can lend as a multilateral institution. The cost would be prohibitive.

This funding has been put to good use:

- A $184 million loan will help Turkey improve environmental conditions in Izmir by promoting adequate water supply, sewerage, and sewage treatment facilities, as well as appropriate industrial waste-treatment policies and practices.

- A $22.3 million education loan to Morocco will improve the quality of vocational training and reduce its costs through improvements to instructor training.

- A $70 million loan will help Pakistan improve the efficiency of existing power stations, and add about 200 mega-watts of additional generating capacity.

- A $300 million loan will support Philippine economic-recovery efforts, including programs of tax reform, trade-policy rationalization, public-investment program restructuring, and rationalization of government financial institutions.

- In Brazil, an $84 million loan will benefit about 73,000 low-income farm families through construction of simple water-supply systems, construction of two fish hatcheries, provision of extension services, marketing support, funding for community subprojects, and demarcation and protection of a natural reserve.

An important aspect of our relationship with the Bank is the procurement contracts U.S. businesses receive from the IBRD. For FY 1987, the latest figures available, U.S. firms received $1.6 billion in disbursements from the IBRD for foreign procurement. In an effort to increase this amount, personnel from the Commerce Department, in conjunction with the U.S. Executive Director's office at the World Bank and Treasury staff, are working to increase the number of contracts on which U.S. firms bid.

Another important dimension of World Bank operations is the increasing effort to promote private sector development. Development finance companies, which I described earlier, channel considerable resources to the private sector. Bank projects in other areas often have specific elements to support the private sector. In Turkey, for example, Bank projects support joint ventures with the private sector for construction of power plants.

There is also support for the private sector through policy-based lending. Consultants financed through World Bank support are assisting governments in countries such as Kenya and the Philippines to formulate model agreements and revise legislation that affects petroleum in order to attract investment by foreign oil companies. Burkina Faso is being helped to revise mining sector tax and investment codes.

Policy Reform and International Debt

I will now turn to the essential role the World Bank plays in addressing the international debt problems of the developing countries. By encouraging growth-oriented structural reforms, providing both policy based and project loans to support stronger growth, and helping to catalyze private sector support for these nations, the World Bank is a key part of the cooperative international debt strategy. The strategy has broad international

support, recently reaffirmed at the spring IMF and World Bank meetings. At its heart is a firm belief that economic growth and capital formation are central to easing debt burdens over time, and that both market-oriented reforms and external financial support are essential to achieve those objectives.

The debt strategy provides a framework for addressing the individual needs of each debtor country on a case-by-case basis. However, it is dynamic in nature, supporting both innovation and evolution over time to keep pace with changing circumstances. Indeed, one of the great strengths of this approach is its adaptability.

I recognize that some of the members of this committee have questioned the extent of progress being made under this strategy, and advocate instead U.S. support for debt reduction through creation of a new international debt facility or other measures. I would like to address these two issues directly, because they are fundamental to where we go from here.

Progress

We must start from a recognition that the sheer magnitude of the external debt of the 15 major debtor nations (some $450 billion) and the exposure of U.S. and foreign commercial banks (approximately $290 billion) is such that "overnight" solutions are neither feasible nor practical. No one has the resources (or the political will) to purchase, guarantee, secure, or wipe out debt of this magnitude in a short timeframe: not the debtor nations, not the IMF, not the World Bank, and -- given current budgetary constraints in the U.S. and other industrial countries -- not our own taxpayers.

Moreover, total elimination of external debt isn't necessary. The objective is to work down total debt burdens over time, while improving the ability to service debt and enabling a return to creditworthiness. The question is how to best accomplish those objectives. The strategy we have been pursuing is a multi-faceted one, involving cooperative efforts to improve productivity, growth, and exports in debtor nations; to stretch out and reduce annual debt payments through reschedulings and other voluntary mechanisms; to provide interim financial support where needed; and to buttress the debtors' efforts through a supportive external environment.

While some countries such as Brazil or Peru have tried "shortcuts" to avoid needed policy reforms and conserve resources through unilateral debt moratoria, such policies have not worked -- indeed, they have been counterproductive and costly, as Brazilian officials have publicly recognized.

Admittedly there is fatigue among both debtor countries and commercial banks, but contrary to those who would argue that wholesale debt relief is the only solution, I believe the

present strategy is producing results and moving us toward resolution of this difficult problem. Allow me to draw your attention to the following facts:

- o According to World Bank data, 8 of the 15 major debtor countries grew at 4-5 percent or better last year, compared with only three countries in 1985. We should bear in mind that growth for the 15 countries was negative by 3% in 1983.

- o Debt service ratios for the group have fallen by one-fourth and interest service ratios by one-third in the past few years. This is largely due to the substantial decline in interest rates since 1982.

- o Aggregate current account deficits have been sharply reduced from a peak of $50 billion in 1982 to $15 billion in 1986, and $8 billion in 1987.

- o Export earnings rose by 13 percent to near record highs last year, while imports this year should be the highest since 1982.

- o The adoption of debt/equity swap mechanisms in some countries, as well as broader policy reforms, has encouraged the return of flight capital, while also helping to reduce debt and debt service burdens.

Perhaps the most important change during the past two years has been in the attitudes towards macroeconomic and structural policy reforms in the debtor nations. While some are doing better than others, virtually all of the major debtors accept the need to focus on market-led growth, restructuring their economies and removing impediments to trade and capital flows. Let me cite a few examples.

Mexico has liberalized its trade regime and continues its privatization of state enterprises. Through a market-based approach, the country has diversified its export base to the point where, for the past two years, non-oil exports have exceeded oil revenues. Foreign investment flows have also sharply increased. Mexico has recently adopted a special program to reduce inflation, although stronger efforts are still needed to bring its fiscal deficit under control.

Chile's comprehensive reform program, including a strong reliance on market mechanisms and a favorable business climate, has increased economic efficiency, kept inflationary pressures in check, attracted foreign direct investment and enabled strong growth. In the past two years Chile has also swapped $3.9 billion of its foreign debt into domestic equity and other investment, equivalent to approximately 30 percent of Chile's bank debt. If this could be accomplished in other countries, we would be well on our way to resolving debt problems.

Colombia has carried out a program of broad structural reforms supported by the World Bank and an "enhanced surveillance" arrangement with the IMF. Increased coffee revenues have been effectively utilized to finance development while avoiding inflationary pressures.

Uruguay has reversed the economic decline of the early 1980s through an export-based economic strategy and a competitive exchange rate. Its current account position is expected to improve this year and the inflation rate should continue to decline; growth prospects have also improved.

The Philippines has liberalized imports, is implementing a comprehensive tax reform program, and is instituting major agricultural reforms.

Finally, Bolivia has arguably produced the greatest measure of internal reform. It has also implemented an imaginative plan for accomplishing a substantial reduction in its stock of debt.

The World Bank has provided strong support for these reforms, through both fast-disbursing, policy-based loans to support structural reforms and project loans to enhance production and development. Its loans have also helped to catalyze additional private financial flows. Together, the IMF and the World Bank have provided approximately $17 billion in new loans for these countries since October 1985.

The commercial banks have also committed some $17 billion in new finance during this period, while rescheduling some $212 billion in outstanding debt, reducing spreads, and providing longer grace periods and maturities. Official creditors have also rescheduled some $18 billion in both principal and interest payments.

We have also taken the lead in advancing ideas for strengthening the debt strategy in a number of areas. These include my proposal last fall for the creation of a new IMF External Contingency Facility to help cushion the effect on IMF standby programs of unforeseen external developments, such as weaker commodity prices, natural disasters, or sustained higher interest rates that might force a performing country off its economic course. Our efforts to initiate these reforms resulted, in part, from discussions with debtor nations, who felt that longer programs with stronger structural reform content and greater recognition of unforeseen contingencies are essential to the long term resolution of the debt problem.

At the IMF Interim Committee on April 14, it was agreed in principle to establish a combined Compensatory and Contingency Financing Facility to address such external contingencies while retaining the essential features of the existing Compensatory Financing Facility and improving both its conditionality and its operation. We expect the new facility to expand potential

access for the fifteen major debtors by more than 25 percent, or, potentially, more than $12 billion, depending of course upon external developments. The Interim Committee also agreed to revitalize the IMF's Extended Fund Facility for use on a case-by-case basis to enhance the focus on structural reform. Here again there is potential for a significant increase in resources for selected countries.

Creditor countries have also taken a number of significant measures to assist low-income developing nations. For Africa, the IMF's new Enhanced Structural Adjustment Facility will provide concessional resources totalling SDR 6 billion to low-income countries facing protracted balance of payments problems that are engaged in economic and structural adjustment. Donor governments have pledged $6.4 billion of financing to be used in cooperation with the World Bank for low-income African countries with severe debt problems that have undertaken adjustment programs. Likewise, the Continuing Resolution passed by Congress in December gives the U.S. Agency for International Development (AID) additional funds for development assistance to Africa, and greater flexibility in allocating these funds.

In addition to these steps we recently indicated our willingness to support a differentiated approach for the poorest countries in future rescheduling of official debt in the Paris Club. This would permit creditor countries which are in a position to do so to provide concessional interest rates in debt reschedulings, in exchange for shorter repayments of their rescheduled debts. Those countries not able to provide concessional rates, such as the United States, would continue to reschedule the poorest countries' debts on longer terms.

Finally, as you all know, we have encouraged the development of a "menu" of alternative financing options to help meet the diverse interests of both debtor nations and the banking community in devising new financing packages. Financing innovations that are developed for the mutual advantage of banks and debtors are key to the resolution of the debt workout.

Such "menus" can provide a variety of options for new financing, including traditional balance of payments loans, trade credits, project loans, on-lending facilities, new money bonds, and even limited, voluntary interest capitalization. They can also include a range of new instruments, including debt/equity swaps, debt/conservation swaps, and "exit" bonds. Debt conversion instruments help to reduce both outstanding debt and debt service burdens. Banks would choose among these options in supporting debtor reform efforts, as in last-year's Argentine new money package and the pending Brazilian package.

The recent Mexican debt/bond exchange provides an example of an innovative, voluntary debt conversion technique worked out

between the debtor government and the commerical banks, with the principal amount of the new Mexican bonds in this case collateralized by the purchase of U.S. Treasury zero-coupon bonds. We believe the results of that exchange demonstrate that several commercial banks are interested in this kind of market-driven technique, but that most banks will only entertain such exchanges at rates well above thin secondary market values for such debt. We expect further market development of these kinds of debt conversion options in the period ahead.

Clearly, more still needs to be done. Nevertheless, the debtor countries are increasingly committed to reforms and are making progress toward sustained economic growth. We must continue to support these efforts, recognizing that a careful balance between reforms and new financing is essential to assure that debt does not increase at a faster pace than the debtor's ability to service it. While this is undoubtedly a difficult task, I believe the debt strategy now in place is the only viable approach to reach this goal.

Debt Facility Proposals

I recognize, of course, that a few critics urge another path -- the development of generalized debt forgiveness schemes, particularly through a variety of international debt facility proposals. The trade bill includes one option for such an approach. Some have offered other options. While each proposal varies in significant ways from the others, all have a number of common characteristics:

oo They provide for the new facility to either purchase commercial bank debt outright or swap new, discounted securities issued by the facilities (e.g., consols, preferred stock, or guaranteed bonds) for commercial bank claims.

oo Some portion of the discount would be passed on to the debtor nations, although the mechanisms for connecting this with economic reforms are not clear.

oo Creditor governments, and perhaps the IMF or World Bank, would back these transactions and assume the risk on the debt transferred to the new facility.

There are a number of technical details that differ from one proposal to the next. The trade legislation proposal would involve the outright purchase of debt from the banks, a "cashing out" for the banks, rather than an exchange for discounted securities, as in most other proposals. This approach is voluntary, but would involve an appreciable up-front cost,

depending upon the number of banks that want to sell their debt, presumably at a sufficiently attractive price.

On the other hand, other proposals would impose penalties on those banks that elect not to participate, through required reserves, writedowns, subordination of loans, or lower-value exit bonds. Such penalties to force participation and losses on loan portfolios could make it very unlikely that banks would provide any new credits to these countries for some time to come.

While treatment of interest on the new securities also varies, all of the proposals shift, to varying degress, the risk on both interest and principal to the international financial institutions or creditor governments.

All of these proposals pose serious problems:

oo First and foremost, these proposals would substitute new and generally very weak economic reform conditions as the basis for debt forgiveness by the new debt facility. This would contradict and confuse current IMF and World Bank conditionality.

oo These proposals would also politicize the debt problem, distracting creditors and debtors alike from the difficult but fundamental adjustment task. For example, debtor countries might purposefully attempt to capture a larger discount on their debt through debt repudiation or unsound economic policies. This could also exacerbate existing problems with flight of capital. Thus these proposals could well be counterproductive.

oo Furthermore, by consolidating debt in one international body, pressure to immediately pass on the "discount" of the debt swap or purchase would be intense, making it difficult to reward debtors' adjustment efforts with debt relief over time.

oo Likewise, debtors would likely seek equal treatment on any discount, forgiveness, terms, and conditionality. For example, Mexico, which has always serviced its debt on time, should not be put in the same category as Bolivia, whose debt banks were willing to buy back at 11¢ on the dollar. This example illustrates the importance of preserving the the case-by-case approach. Each country has unique economic circumstances and each country is at a different stage in the development process. Debt conversion and other financing techniques must recognize this fact.

oo Use of IMF or World Bank resources to back the facility would also affect the lending base of the IMF and credit-worthiness of the World Bank. There is some $290 billion of commercial bank debt to the 15 major debtors alone. The cost of repackaging this debt and guaranteeing new securities would be substantial.

oo It is inappropriate for governments unilaterally to force private financial institutions to sustain losses.

Neither government bail-outs, outright debt cancellation, nor debt repudiation offers permanent solutions; the only way to assure stronger growth and to resolve debt problems is for debtors to adjust structurally to strengthen growth and encourage the return of voluntary lending.

That is the essence of the debt strategy we are pursuing. Debt reduction techniques are voluntary options within this approach, depending upon commercial bank negotiations with the debtor nations. Through debt/equity swaps, some $7.5 billion in debt has already been converted into equity holdings in the major debtor countries since 1985. Debt/bond swaps and even debt restructurings, where agreed upon by banks, are also possible "menu" items -- without involving substantial up-front costs and contingent liabilities for creditor governments and their taxpayers. In the final analysis, the banks and debtor governments themselves must develop the options they are prepared to accept -- we can't force them into a single mold, nor should we try to do so.

Environmental Aspects of Lending Programs

The last issue of mutual interest I wish to address is the role of MDBs in the environment. One of our most important objectives in GCI negotiations has been to strengthen Bank policies and programs on a broad range of environmental issues. I have taken a personal interest in those issues. They are crucial to the protection and preservation of our natural resource base in all parts of the world. They are critical if we are to achieve successful and sustainable development and growth in developing countries over the longer term.

The report on the General Capital Increase, now adopted by the Bank's Board of Directors, calls for:

oo Additional emphasis on the need for better management of human and natural resources so that countries can achieve fully sustainable development.

oo Integration of environmental work into country development strategies, policies and programs.

oo Evaluation of the environmental costs of bank projects;

oo Mitigation or elimination of adverse effects of bank projects.

oo Support for national and regional programs to improve environmental management.

Getting this language into the Report on the General Capital Increase is an important step. It commits the institution's shareholders from both developed and developing countries, not just the President of the Bank, to an overall framework for environmental work over the next several years. Our job now is to see that this commitment is turned into a series of strategy papers, policy decisions, and lending programs that will have the impact that we seek.

During 1987, the World Bank carried out a major reorganization of its management and staff. One of its primary aims was strengthening the Bank's capacity to deal more effectively with environmental issues. A Central Environmental Department was created as well as environmental units in each of the Bank's four regional offices. Thus far, 45 full time permanent positions have been authorized for environmental purposes and provisions made for the equivalent of 18 man-years of consultant services.

In the Inter-American Development Bank, two senior environmental experts have been added to the Bank's permanent staff, an ecologist and an expert on rainforests. A three-day seminar on environmental issues was held last December for 40 members of the Bank's project analysis staff. Two additional seminars for other members of the Bank staff took place in May and a one-day briefing on environmental issues for the Bank's representatives in borrowing countries was held last week.

A start has also been made on promoting participation of non-governmental organizations in the project preparation cycle. The World Bank and the Inter-American Development Bank have held meetings with non-governmental organizations here in Washington to facilitate the exchange of information. The African Development Bank is making preparations for a similar meeting with African NGOs later this year in Abidjan. We will be reporting to you later this month on other aspects of NGO participation in multilateral development bank activities.

Within the U.S. Government we are working to improve the ability of the early warning system to monitor MDB projects with potential adverse effects. The Environmental Protection Agency is taking a more active role in both the early warning system and in our regular review of MDB projects. We are also taking a tougher stand against unsatisfactory loan proposals that reach the board, abstaining on environmental grounds on a number of loans over the past year.

We are also beginning more systematic consultations on environmental issues with other member countries. These include Development Committee discussions on environmental matters in April and an OECD Meeting in May to help develop an environmental checklist for decision-makers in multilateral and bilateral agencies. We expect to build on this checklist in meetings later this year and to develop more international support for environmental issues in general.

In sum, I think we are making appreciable progress toward our objectives. Obviously, we are not where we want to be, and we will need to put continuing emphasis on all of these issues. Our priority now should be to implement the provisions of legislation already in place. I look forward to working with you in that process in the upcoming months.

Conclusion

I believe we have a number of shared objectives. First, we must continue the work of the World Bank in supporting development and growth in developing countries. For the World Bank to effectively pursue this role, it needs increased resources. Second, the developing countries need to adopt market-oriented reforms in order to achieve stronger growth. Third, we must maintain a stable international financial system, while supporting increased flexibility and innovation in addressing debt problems.

The current debt strategy is working to address these objectives. I welcome the opportunity to discuss our perspective on these issues with you today, and hope that we can work together to achieve these common objectives.

Thank you, Mr. Chairman.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 15, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 4-YEAR NOTES TOTALING $15,250 MILLION

The Treasury will auction $8,500 million of 2-year notes and $6,750 million of 4-year notes to refund $16,294 million of securities maturing June 30, 1988, and to paydown about $1,050 million. The $16,294 million of maturing securities are those held by the public, including $2,202 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $15,250 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 prices of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $1,826 million of the maturing securities that may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

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

oOo

Attachment

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC OF 2-YEAR AND 4-YEAR NOTES TO BE ISSUED JUNE 30, 1988

June 15, 1988

Amount Offered to the Public ...	$8,500 million	$6,750 million
Description of Security:		
Term and type of security	2-year notes	4-year notes
Series and CUSIP designation ...	Series AC-1990 (CUSIP No. 912827 WH 1)	Series N-1992 (CUSIP No. 912827 WJ 7)
Maturity date	June 30, 1990	June 30, 1992
Interest Rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction
Interest payment dates	December 31 and June 30	December 31 and June 30
Minimum denomination available .	$5,000	$1,000
Terms of Sale:		
Method of sale	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%
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
Accrued interest payable by investor	None	None
Payment Terms:		
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ..	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Receipt of tenders	Wednesday, June 22, 1988, prior to 1:00 p.m., EDST	Thursday, June 23, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ..	Thursday, June 30, 1988	Thursday, June 30, 1988
b) readily-collectible check ...	Tuesday, June 28, 1988	Tuesday, June 28, 1988

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
Expected at 9:30 A.M., EDT
June 16, 1988

STATEMENT OF
DAVID R. MALPASS
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
U.S. DEPARTMENT OF TREASURY
BEFORE THE
SUBCOMMITTEE ON HAZARDOUS WASTES
AND TOXIC SUBSTANCES
COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS
UNITED STATES SENATE

THURSDAY, JUNE 16, 1988

Mr. Chairman:

I am pleased to participate in this review of environmental reforms in the multilateral development banks. We have had a clear and strong mandate from Congress that we should act through these Banks to promote environmentally sustainable economic growth and improved management of natural resources in borrowing countries. Treasury strongly supports these objectives. Let me begin by summarizing the principal points of that Congressional mandate and then discuss what we have done to implement it in managing U.S. participation in the multilateral development banks.

The first Congressional mandate for environmental action in the multilateral development banks, which include the World Bank and three regional banks for Asia, Africa, and Latin America, was included in the Continuing Resolution Act for 1987, Public Law 99-591. This legislation provided that the Secretary of the Treasury should instruct the U.S. Executive Directors in the Banks to promote a number of very specific and detailed reforms. These reforms included:

- addition of professionally-trained staff in the Banks.
- development of plans for systematic and thorough environmental review of projects.
- creation of line units to carry out such reviews.
- establishment of multidisciplinary planning processes.
- development of plans for rehabilitation and management of ecological resources.
- involvement of health and environmental ministers and non-governmental organizations in the project preparation cycle.
- increase in the proportion of environmentally-beneficial lending.

A report detailing progress in these areas was submitted to Congress in January, 1988. I will return in a few minutes to the subjects in that report and provide some details on the progress that is being made.

The second Congressional mandate on environmental reforms was included in the Continuing Resolution for FY 1988, Public Law 100-202. This legislation restated many of the reform objectives outlined in the previous year's Continuing Resolution and made them a part of the permanent authorization legislation. It also provided for a number of other initiatives including:

- an analysis of debt/conservation swaps.
- discussions with other donors regarding personnel and financial support for environmental programs in the regional development banks.
- discussions with other executive directors in the World Bank regarding establishment of a grassroots collaboration program.
- enhancement of the early-warning system for identifying problematic loans.
- report on a comprehensive strategy to address natural resource problems.

° discussions with other executive directors in the banks regarding integrated pest management.

This legislation took effect in December, 1987. We have already begun to implement some of these initiatives but action still remains to be taken in other cases.

It is clear even from this brief summary that a great deal of legislation is already in place. I want to assure you that we are making a conscientious effort to implement it. In fact, I believe we should make implementation our primary objective at this time and not seek the passage of new law on this subject.

Within Treasury, we are working hard to improve our oversight of environmental issues in the multilateral development banks. During 1987, we objected to six loans, citing concerns about adverse environmental effects. These loans included agricultural rehabilitation in the Sudan, electric power in Peru, a paper mill in Nepal, an abattoir in Botswana, livestock development in Benin, and agroforestry and livestock development in Mali. In February of this year, we objected to a loan to Burkino Faso for a road and water project because of serious environmental issues. On another occasion, a loan proposal adversely affecting tropical moist forests was withdrawn in the face of our objection. I am confident, however, that our influence on bank activities has been far broader than these figures suggest and that other projects have been modified before they reached the Board.

We are continuing close coordination with State and AID and with environmental groups in an effort to improve the early warning system for problematic projects. We are intervening more frequently and more effectively with MDB management to make our concerns clearer at an early stage and to seek improvements in project proposals. We have for example, visited the site of a major dam project in India to examine resettlement issues. We have also notified the World Bank of concerns about a hydro-power study in Nepal at the very earliest stage, the prefeasibility stage. We are taking an active role in international meetings on environmental issues, particularly those that affect projects and programs funded by the multilateral development banks.

We have had particularly strong support from a number of non-governmental organizations in gathering information and developing approaches to increase the effectiveness of our efforts. These organizations have assisted in the preparation of standards for evaluating projects that may adversely affect tropical moist forests. They have also helped us put in place standards for projects affecting open-range savannas of Sub-Saharan Africa and are now working with us on wetlands standards. The organizations have participated in the early warning system established by AID to identify projects that may adversely affect the environment. They have worked closely with us in analyzing problems associated with specific loan proposals or with projects that are being implemented.

To sum up, we have been getting involved at an earlier stage in the project cycle, trying to make specific changes in proposals before they come to the boards of the Banks. I might add that EPA is now becoming integrally involved both in early warning group meetings and in the final review of projects just before they come to the board.

Let me turn now to implementation of some of these legislative provisions, starting with those in Public Law 99-591.

Staffing and Training

During 1987, the World Bank carried out a major reorganization of its management and staff. One of its primary aims was to strengthen the Bank's capacity for addressing environmental issues. A central environmental department was established in the Policy, Planning and Research complex. Twenty-three positions have been authorized for the three divisions in the department. In addition, environmental units have been created in the technical departments of the Bank's four regional offices. Twenty-two positions have been authorized for these four units. The Bank has appointed a new director for the Environmental Department and a new advisor for scientific and environmental affairs. Both of these individuals appear to be well-qualified and capable, with extensive backgrounds in environmental matters. In addition to 45 permanent staff positions, the Bank has indicated that it expects to use the equivalent of 18 man-years in consultant services for environmental issues during its current fiscal year.

The regional development banks need to hire more environmental specialists and to assign more staff to environmental issues. We have been encouraging them to do that. The Inter-American Development Bank has recently hired two senior environmentalists for positions at the Bank's headquarters and a third expert has been assigned to the Bank's field office in Brazil. The Asian Development Bank has had five staff members working on environmental issues; however, the chief of their environmental section has recently been recruited for the World Bank's Asian Environmental Unit and a well-qualified replacement is needed to fill that position. The African Development Bank has said that it will increase its environmental staff from two to four and that a well-qualified African candidate will be sought as Chief of the Unit. The unit is currently headed by a Norweigan official seconded to the Bank.

Significant progress has been made on training. In the World Bank, an environmental training program has been introduced for Bank staff. The program is designed to raise awareness of environmental issues in development, to convey new techniques, and to introduce the latest developments in the field. The integration of environmental and economic work and the importance of policy intervention is to be included in the curriculum of the Economic Development Institute.

The Inter-American Development Bank has initiated a series of seminars on environmental issues. The first of these seminars took place over a three-day period in December, 1987, with forty members of the Bank's technical staff participating. Two other seminars were held in early May, one for projects analysis staff and one for loan officers. Similar seminars for other members of the staff are also planned. Just last week a seminar on environmental issues was held for the heads of the Bank's field offices in borrowing countries. The African Bank has sponsored a one-day seminar on the economic valuation of environmental impacts and a two-day seminar on environmental planning in project development. A third seminar focusing on grazing issues, which have been problematic in some Bank projects, is to be scheduled for later this year. In preparing for that seminar, we are encouraging the Bank to emphasize conservation and range management issues as well as productivity.

Management Line Units

Three of the Banks have established line units to provide for a systematic and thorough review of projects affecting the environment and natural resources. As I indicated earlier, the World Bank has set up four regional units. The Asian Development Bank and the African Development Bank have established smaller units that need to be strengthened. The Inter-American Development Bank decided to create an inter-departmental Committee instead of a line unit. It reviews projects in both the preparation and implementation phases an d is advised by a senior environmental specialist. We are encouraging the Bank to establish an environmental unit in the project analysis area.

Involvement of Health and Environmental Ministers and Participation of non-Governmental Organizations

The management of the banks report that they have taken steps to emphasize the involvement of health and environmental ministries. The Asian Development Bank provides special briefing materials to its country programming teams on environmental and natural resource development projects. The environmental unit at the bank is also in contact with environmental agencies in borrowing countries regarding specific projects in the pipeline that may need assessment. The African Development Bank has issued instructions to staff for expanding consultations with health and environmental ministers.

Participation of non-governmental organizations is also being encouraged in all of the banks. In the World Bank, the focal point for relations with non-governmental organizations has been shifted from Public Affairs to Policy, Planning and Research. This shift has facilitated the exchange of views and discussions on substantive issues. A number of initiatives are also going forward on the involvement of indigenous people and local community groups. We expect to report to the Congress on some of these initiatives over the next two weeks.

In May 1987, the Inter-American Development Bank sponsored a conference on environmental issues in Latin America and the Caribbean. There was extensive participation by regional and non-regional NGOs. There was also very broad representation from public agencies throughout the region, responsible for environmental protection and natural resource conservation. A second conference is now being planned to follow up on the results of the first conference. The African Development Bank is also making plans to hold a meeting for the African NGOs during the second half of this year. Non-governmental organizations from this country with our strong endorsement and support are helping the Bank to prepare for this meeting.

The Asian Development Bank has completed a working paper on cooperation with non-governmental organizations. The paper was based on consultation with a number of those organizations. A final report is expected shortly. All of the banks are seeking to involve NGOs in borrowing countries more actively in the project cycle and to see that local community groups and other organizations are fully informed of project planning at an early stage of the cycle. In agriculture, this has involved wider contacts with farmers organizations, water user associations and women's groups.

Multidisciplinary Planning in Land Uses and Rehabilitation and Management of Ecological Resources

All of these banks have sought to incorporate new technologies, including remote sensing techniques, into efforts to encourage more effective land use planning. The World Bank has begun preparation of comprehensive environmental action plans in a number of selected countries. It is also preparing terms of reference for consultants to identify areas where multidisciplinary support can help improve project preparation.

The multilateral development banks are providing funds for national and international agricultural research programs and for science and technology programs that support research into eco-system management. The World Bank is working with Harvard University and the Institute for International Environment and Development to assess alternative approaches to natural resource management. Task forces have also been organized within the World Bank to address desertification, deforestation, industrial accident risk avoidance, protection of critical eco-systems and mitigation of natural disasters in urban areas.

New Initiatives

We have begun a number of new initiatives as a result of the Continuing Resolution that was passed in December, 1987, Public Law 100-202.

On April 13, 1988, we submitted to the Congress a report that had been requested on debt for nature swaps. An Internal Revenue Service ruling that encourages participation in such swaps was released last December. The report recommends that the World Bank place additional emphasis on working with countries to establish priorities for conservation projects, possibly piggy-backing World Bank projects onto debt for nature programs. It also looks to the Bank to take a more active intermediary role in helping to arrange debt for nature swaps and to consider starting a pilot program in a country that has indicated that it is willing to establish one.

We have been in contact with other developed countries regarding the possibility of providing environmental experts to work in the regional development banks. Environmental experts from developed countries have already been seconded to the African Development Bank. Our executive directors in all three regional banks have talked with management about how this approach might be used to enhance effectiveness on environmental issues.

We have held a series of meetings with representatives of other donor countries regarding improvements in the environmental performance of the multilateral development banks. Environmental issues were an important point of discussion at the Development Committee meeting at the World Bank in April. In May, we participated in an OECD meeting in Paris seeking agreement on common criteria for decisionmakers in evaluating environmental issues in the multilateral development banks. I am pleased to say that EPA took part in the OECD meeting and that agreement was reached on a checklist for decisionmakers in both bilateral and multilateral agencies. We are hopeful of making further progresss on this issue in the months ahead.

We placed particular emphasis on environmental issues at the annual meeting of the Inter-American Development Bank in Venezuela in March, at the annual meeting of the Asian Development Bank in Manila in April and at the annual meeting of the African Development Bank in Abidjan earlier this month. All of these initiatives have been meant to involve the governments of other countries more effectively in our own efforts to improve environmental performance in the banks. I would like to provide for the record copies of the statements that we made at these meetings.

During the past year, we have worked closely with our colleagues at AID in implementing the early warning system for identifying problematic projects. We believe we can continue to enhance this system and become more influential in shaping the environmental aspects of individual loan proposals in the banks. I am hopeful that EPA participation will increase our effectiveness at this early stage of the project cycle. We are also cooperating with Greenpeace and other interested organizations in forming an informal working group to examine integrated pest management issues.

At the end of this month we will report to Congress on our discussions regarding establishment of a grassroots program to promote participation by indigenous people and local community groups in MDB project formulation. Later this Summer, we will collaborate with State and AID in analyzing more comprehensive strategies that can address natural resource problems through the multilateral development banks and in our bilateral aid program.

Application of NEPA Standards

It has been suggested that an amendment might be offered on the application of NEPA standards to multilateral development bank lending. As I understand the suggestions that have been made, they would require the preparation of environmental impact statements or environmental assessments. In the absence of such statements, it is my understanding that we would have to oppose any MDB loan that might come up for consideration.

I support strict environmental review of MDB projects. However, I would strongly oppose enacting the application of NEPA standards. We are most effective in the Banks when we have latitude and can work to enlist the support of other countries on specific issues. I believe the application of NEPA standards would paralyze our ability to act cooperatively and constructively with other member countries. It would reduce our effectiveness in promoting environmental reform in the banks and prevent us from making further progress toward environmental objectives set forth in the legislation. It could also set back some of the progress we have already made and that I outlined earlier.

NEPA is, in large part, a process designed to fit into the administrative and legal systems of the United States. It does not take account of legal and administrative differences between the United States, other countries, and international organizations. It does not consider the legal and administrative structures within which we operate in these organizations. It does not reflect the reality under which the United States has to conduct its relations with other countries and organizations.

The difficulty of applying NEPA standards to international activities was first recognized when Executive Order 12114 was signed by President Carter in 1979. This Executive Order specifically excluded from any form of NEPA standards "U.S. Government votes and other actions in international conferences and organizations." I believe that exemption should be continued.

U.S. voting power varies widely in the multilateral development banks. We have 18 percent in the World Bank, 34.5 percent in the IDB, 16.6 percent in the ADB; and 5.8 percent in the AFDB. I am particularly concerned about how NEPA dictated U.S. votes would be perceived in the AFDB, where our voting share is lowest.

Africa has the most pressing developmental problems in the world. Hundreds of thousands of its people perished in the famines of the the early 1980s. More than a million people are now thought to be at risk again. Africa also has very serious environmental problems: over-grazing, deforestation, desertification and threats to wildlife and their habitat.

Obviously, development and environment are linked very closely together. The focus of our efforts should be on finding the innovative and creative approaches that are needed to achieve substainable development objectives. A stream of automatic abstentions on environmental grounds would not help us in these efforts in the African Development Bank. Yet, the application of NEPA standards might well require blanket opposition to AFDB projects if data were not available or if a particular standard could not be met at a certain time.

I am not arguing against objecting to MDB loans on environmental grounds. As I said earlier, we have already done so on a number of occasions. Those actions were very helpful in focusing attention on specific environmental issues and in promoting positive changes. However, a stream of automatic U.S. abstentions because of failure to meet NEPA standards for environmental assessments would send a different message to the AFDB and its member countries and it would produce a different result. We would, in effect, be opting out of the action, not only on environmental issues but on other critical issues as well.

To sum up, Mr. Chairman, I am all in favor of strict environmental review, aimed at sustainable growth and development, for MDB projects in developing countries. That is what we have been trying to accomplish under existing legislation and I believe we have made substantial progress. The application of NEPA standards would not advance that progress. In my view, it could very likely set back the progress that has already been made.

There is extensive environmental legislation on the books. We have supported that legislation and made a strong effort to see that its provisions are implemented in the multilateral development banks. I believe we need to give that legislation a chance to work.

Our immediate objective is further progress on environmental reforms in the multilateral development banks. Beyond that, we look to strengthening the systems for environmental review in borrowing countries. A cooperative and constructive approach that gets support from other countries is the most productive way for us to proceed.

TREASURY NEWS

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Remarks by
Secretary of the Treasury
James A. Baker, III
To the U.S.I.A. International Council Briefing
Washington, D.C.
Thursday, June 16, 1988

Economic Policy Coordination and International Monetary Reform

The Development of Economic Policy Coordination

This year's Economic Summit begins in three days. As I am sure you know, there are really two economic summits, and both occur simultaneously.

The first Summit will take place in the meeting rooms where the heads of state and their finance ministers confer. Another may play out on the television screen, where reporters and commentators speculate on all the possibilities for conflict among the major actors.

I can't tell you what you can expect in this second, hypothetical summit. But I can offer you some insight as to what you can expect in the real Summit.

Much of the real Summit will focus on efforts to coordinate our economic policies in order to give our international economic system a better sense of direction and discipline.

Since the coordination process was initiated in 1985, we have gained some experience with it. I would like to discuss with you what has taken place over the last few years; touch briefly on how the process is doing; and tell you why I believe the coordination process (and not some more sweeping change) provides the best way to reform the international monetary system.

B-1456

Building the Process

The 1985 Plaza Agreement represented the first major step in the coordination effort. It involved an agreement by the G-5 on the direction national economic policies and exchange rates should take to facilitate growth and external adjustment. More fundamentally, it represented a commitment by the major industrial countries to work together more intensely to achieve global economic prosperity, and thereby enable each country to better achieve its own domestic objectives.

The success of the Plaza Agreement created momentum that led to further progress. At the Tokyo Summit, we developed a framework for multilateral surveillance of our economies using economic indicators.

At the Venice Summit last year, the coordination process was strengthened further by the adoption of arrangements involving the development of medium-term objectives and performance indicators to assess policies and performance.

Thus the major industrial countries have now developed a "political mechanism" to enhance their ability to coordinate economic policies. And although the process is still very young, there is already ample evidence that it is bearing fruit. Fiscal and monetary policies are being framed in an international as well as a domestic context. As a consequence, the United States has taken measures to reduce the budget deficit, to resist protectionism, and to improve competitiveness. The major surplus countries, Japan and Germany, have taken steps to improve domestic demand and reduce reliance on export-led growth. There have been coordinated interest rate actions. Cooperation in exchange markets has been intensified based on specific understandings.

As a result, the world economy is on a much more solid footing. Growth continues, but is now more balanced and is supportive of the adjustment process. Inflation remains low, and external imbalances are being reduced. The U.S. trade figures provide evidence that these imbalances are now declining in nominal as well as real terms. The April deficit was the lowest seasonally-adjusted monthly deficit since December 1984.

The coordination process was seriously tested last fall in the wake of the October stock market crash. It would have been easy for each of us to turn inward and focus on short-term measures to address immediate domestic needs. Instead, the G-7 pulled together to find a compatible and reinforcing set of policies to achieve common goals. These efforts demonstrate the resilience of the coordination process in the face of adversity. Since that time, strengthened underlying policy actions have been reflected in enhanced stability of exchange markets.

Strengthening Coordination and Reforming the System

As this process of coordination among the major industrial nations has been developing, questions continue to be raised about the need for "more fundamental monetary reform." This is natural. We certainly do not have a perfect monetary system -- nor total coordination of our policies. We cannot afford to rest on our laurels. We need further strengthening and reform of the system.

But what form and direction should this take? It is tempting to consider sweeping, revolutionary changes in the system -- particularly the exchange rate part of the system. But it is far from clear that such changes are desirable or practical.

While it may be difficult to recognize reform when it emerges gradually in a step-by-step fashion, I think that further strengthening of our process of coordination is the best means of achieving further reform of the monetary system.

So you ask -- what are the characteristics of this step-by-step or incremental approach to monetary reform which make it the best option available?

- First, it combines flexibility with greater commitment and obligation. At the same time, it involves no ceding of sovereignty.

- Second, it recognizes that reform of the system is not simply a matter of exchange rates or reserve assets, but must also involve appropriate fiscal, monetary and structural policies.

- Third, the system can encourage corrective policy action through the use of indicators and peer pressure without relying on automatic trigger devices.

- Fourth, the burden of adjustment is not biased toward or away from domestic policies or exchange rates, as was the case in the par value and early flexible rate regimes, respectively.

- Fifth, the coordination and indicator process contains symmetry by focusing on surplus as well as deficit countries.

- Sixth, evolutionary reform is more credible than attempts to impose a detailed set of formal constraints through broad structural changes which markets would consider overly ambitious and unsustainable.

The global economy is too dynamic -- and the forces of change too strong -- to be able to look ahead with great certainty and envision a highly defined international monetary structure that will fit the world economy of 1995, as well as that of 2005.

We must therefore move cautiously but steadily ahead, always alert to further improvements in the process and the system. In this connection, the major industrial countries agreed to adopt a commodity price indicator, including gold, to assist in assessing and reaching judgments about economic policies and performance. It will be used as an analytical tool in examining global price trends, not as an automatic trigger for policy action or an anchor for currencies.

We will need to continue to consider other measures, such as broadening the coordination process to cover structural reforms in such areas as tax reform, financial market liberalization, and deregulation of labor markets. We should also consider the use of "monitoring zones" for key indicators such as growth and trade balances to help in assessing an economy's performance.

Conclusion

So to conclude, I would submit that our process of international economic policy coordination has reformed and strengthened the international monetary system. We have created a political mechanism that has brought discipline and structure to international economic policy-making. And our approach has worked -- not perfectly of course. But I strongly suspect the world economy is better off today than we would have been had we not followed this course. And I think additional progress will be achieved in the future.

Many of those who earlier had doubted this process have seen its benefits. As a result, coordination now has broader support and momentum that should carry it into the future -- well beyond the terms of current administrations in the G-7 countries. We have come a long way in a few short years, and policy coordination should provide a sound framework for achieving meaningful and effective reform during the years ahead.

Thank you.

TREASURY NEWS

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FOR IMMEDIATE RELEASE
June 20, 1988

CONTACT: Office of Financin
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,408 million of 13-week bills and for $6,403 million of 26-week bills, both to be issued on June 23, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 22, 1988			:	26-week bills maturing December 22, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.48%	6.68%	98.362	:	6.79%	7.13%	96.567
High	6.52%	6.72%	98.352	:	6.84%	7.18%	96.542
Average	6.51%	6.71%	98.354	:	6.83%	7.17%	96.547

Tenders at the high discount rate for the 13-week bills were allotted 57%.
Tenders at the high discount rate for the 26-week bills were allotted 62%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

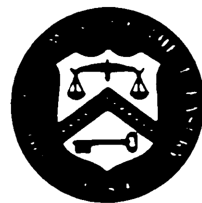
Location	Received	Accepted	:	Received	Accepted
Boston	$ 27,475	$ 27,475	:	$ 25,850	$ 25,850
New York	19,664,870	5,241,570	:	18,127,695	5,442,695
Philadelphia	16,625	16,625	:	18,170	17,490
Cleveland	23,160	23,160	:	23,125	23,125
Richmond	30,710	30,710	:	80,765	71,265
Atlanta	15,535	15,535	:	23,905	23,905
Chicago	2,159,840	516,590	:	1,587,920	188,420
St. Louis	17,730	17,730	:	18,090	18,090
Minneapolis	10,435	10,435	:	12,265	12,265
Kansas City	25,710	25,710	:	44,225	44,225
Dallas	28,540	18,540	:	26,395	16,395
San Francisco	1,306,830	335,600	:	1,334,650	280,650
Treasury	128,515	128,515	:	238,645	238,645
TOTALS	$23,455,975	$6,408,195	:	$21,561,700	$6,403,020
Type					
Competitive	$20,954,705	$3,906,925	:	$17,773,475	$2,614,795
Noncompetitive	601,395	601,395	:	676,720	676,720
Subtotal, Public	$21,556,100	$4,508,320	:	$18,450,195	$3,291,515
Federal Reserve	1,700,580	1,700,580	:	1,650,000	1,650,000
Foreign Official Institutions	199,295	199,295	:	1,461,505	1,461,505
TOTALS	$23,455,975	$6,408,195	:	$21,561,700	$6,403,020

An additional $38,905 thousand of 13-week bills and an additional $ 276,695 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1457

TREASURY NEWS



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

FOR RELEASE AT 4:00 P.M.
June 21, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 12,800 million, to be issued June 30, 1988. This offering will provide about $175 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $12,636 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 27, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 6,400 million, representing an additional amount of bills dated October 1, 1987, and to mature September 29, 1988 (CUSIP No. 912794 QA 5), currently outstanding in the amount of $15,917 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 6,400 million, to be dated June 30, 1988, and to mature December 29, 1988 (CUSIP No. 912794 QY 3).

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 30, 1988. 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 $ 1,975 million as agents for foreign and international monetary authorities, and $3,207 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1458

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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Remarks by
Secretary of the Treasury
James A. Baker, III
before the Canadian Importers and
Exporters Associations
Toronto, Canada
Wednesday, June 22, 1988

CANADA-U.S. FREE TRADE AGREEMENT: THE INTERNATIONAL PERSPECTIVE

I am pleased to join this distinguished group of business leaders in Canada. It is a special pleasure to see my good friend and colleague Mike Wilson. Mike has just played a central role in bringing the fourteenth Annual Economic Summit to a successful conclusion. Under the leadership of Prime Minister Mulroney, this Summit has demonstrated the effectiveness of cooperative efforts by the leaders of the major industrial countries. During this Summit, progress was achieved on a number of fronts, including the strengthening of our open multilateral trading system.

Today I would like to focus on another approach to strengthening the trading system, an approach that can reinforce and catalyze further multilateral progress. As you may have guessed, my remarks today are on the Canada U.S. Free Trade Agreement. Mike Wilson and I spent many hours working together on this Agreement and he deserves a lot of the credit for maintaining the momentum in the talks.

I know that all of you are here because you have both a financial stake and keen intellectual interest in Canadian and American trade policy. I mentioned that Mike Wilson deserves a lot of the credit for this agreement. But I suppose in a much more fundamental sense all of you share credit for the FTA. The agreement simply is a recognition by two governments of the underlying realities that have developed as a result of business transactions by thousands of businesses on both sides of the border.

Adventuresome international traders -- like yourselves, or Marco Polo, or de Champlain -- have always been way ahead of diplomats. And in fact, this agreement seeks to formally recognize what you have already created. Our countries already have a thriving trade, and it is time for the political system to step aside and allow this trade to flourish freely.

Realizing that many of you know the subject of U.S.-Canadian trade better than I, I'd like to focus on some international aspects of the agreement. You see, I believe Canada and the U.S. can take the lead in offering the world a model trade agreement. This agreement can serve not only as a pattern for future bilateral agreements, but also as a catalyst for action on the multilateral front.

A Perspective from the Past

The postwar achievements of multilateralism create an understandable caution about any bilateral trading agreement. But it's useful to recall that the multilateral GATT system grew out of a bilateral initiative to overcome destructive "unilateralism."

For much of the 19th and early 20th centuries, the "tariff question" was a major topic in international and domestic politics around the world. In the United States, comprehensive tariff bills were one of Congress' most important products. This Congressional direction of trade policy culminated in the infamous Smoot-Hawley bill, the Tariff Act of 1930, the last general tariff law enacted by Congress. Smoot-Hawley amended specific tariff schedules for over 20,000 items, establishing the United States' highest general tariff rate structure.

But only four years later, Secretary of State Cordell Hull persuaded Congress to enact a very different trade law, the Reciprocal Trade Agreements Act of 1934. This law authorized the President to negotiate and implement tariff reductions through bilateral agreements. In doing so, Congress moved from a rigid statutory tariff to a "bargaining tariff" that enabled the Executive to negotiate a cooperative trading system.

Secretary Hull certainly did bargain. During the next eleven years, the United States entered into 32 bilateral agreements with 27 nations. (I might add that the first agreement concluded under this act was with Canada.)

These bilateral achievements set a crucial precedent for the multilateral negotiations that followed World War II. Indeed, even the architects of GATT began with a bilateral model. They expected that the new trading structure would be built upon a U.S.-U.K. foundation, or later, a U.S.-European base.

The GATT system has enjoyed enormous success in lowering tariffs and reducing direct barriers to trade. GATT also has been relatively successful in defending these gains. Nevertheless, new forms of protectionism have arisen -- subsidies, restrictive government procurement rules, market-sharing schemes, voluntary export curbs, and discriminatory product standards, among others. The specialized, technical, and indirect nature of these barriers makes it harder to package reciprocal national concessions.

In the Tokyo Round, GATT responded with a "minilateral" solution: Some, but not all, GATT members agreed to special rules governing countervailing and antidumping duties, subsidies, government procurement, licensing, customs valuation, and product standards. These codes have helped create international standards -- which are effective as long as they are enforceable.

<u>The Present Challenge</u>

The success of the multilateral trading system has raised expectations -- and led to more difficult challenges. There are 5 major challenges that I would note.

First, the changing patterns and volatility of capital flows have had an enormous and sometimes destabilizing effect on trade. Both short- and long-term capital now move relatively easily around the globe to locations or securities offering more attractive mixes of risk and return. These flows affect currency values, which, in turn, influence the competitiveness of exports and imports.

Second, technology and industrial processes can now be transferred around the world with relative ease. As a result, there are many highly competitive newly industrialized nations. Unfortunately, some of the new titans of production have been slow to expand consumption commensurately, thus helping to create international imbalances.

Third, many of the successful exporting nations do not have a special affinity for the postwar liberal trading regime. Their "logic," labeled by some as the "New Mercantilism," is that exports are good and imports are bad. This perspective poses a serious threat to a trading system based on the presumption that expanded trade -- measured in terms of both imports and exports -- will increase world prosperity in a mutually satisfactory and sustainable fashion.

Fourth, the "rules" of the trading system do not adequately protect some sectors of growing importance -- services, investment, intellectual property, and high technology, among others. These sectors are areas of comparative advantage for some of the key sponsors and promoters of the multilateral system.

Fifth, domestic political support for the liberal trading system has been eroding in a number of nations. In the U.S., this political trend can be traced to stiffer foreign competition, caused in part by the inevitable rise of productive efficiency in reconstructed or developing nations.

There are some notable positive developments. The most prominent is the initiation of the Uruguay Round. These negotiations presage breakthroughs in the areas of services, intellectual property, agriculture, and trade-related investment. But many of these beneficial results, if they can be achieved, are years from full fruition. Moreover, the ultimate success of these negotiations depends on the creation of incentives for many nations to conform. In the meantime, we need examples of productive government activism that invigorate internationalists, reawaken businesses and consumers to the gains of open trade, and present possible models for arrangements with other nations.

Charting a Future Course

There is no assurance, however, that we will meet this present challenge with a constructive vision of the future.

As you are all well aware, many in the U.S. Congress are frustrated by the persistent trade imbalance and are trying to legislate the problem away. One of their approaches is to return to straightforward legislative protection for industries, for example, through direct restrictions on imports. Other nations are relying on similar barriers, frequently dressed up with local political justifications.

A second counterproductive approach, perhaps more popular, has been termed "process protectionism." This type of legislation tries to conceal itself as nothing more than seemingly modest adjustments in trade laws. But each tightening twist of law chokes off trade a little more, with little or no regard for GATT rules, international standards, or the likelihood of triggering retaliatory trade wars.

The United States is not the only nation contending with powerful internal factions advocating policies that will weaken the open trading system.

Some nations with large trade surpluses are disinclined to remove protection for politically powerful groups -- despite the obvious gains to their consumers and other businesses. Indeed, an odd Calvinist ethic of the trading system seems to inspire the belief in some of these nations (whether in Asia or Europe) that continuing surpluses are a sign of national superiority and a justification for inaction.

There is, however, an alternative approach to the future. This approach is idealistic in aim, but realistic and often incremental in method. It seeks to move nations toward a more open trading system through a strategy of consistent, complementary, and reinforcing actions on various international fronts, bilateral and multilateral. As some of these actions bear fruit, they should enhance domestic political support for other actions.

This is the approach embodied in the Canada/U.S. Free Trade Agreement. While the international trading system has been subject to increasing stress and strain, the Canadian-U.S. economic relationship has been growing and strengthening. Indeed, after over a century of failed efforts, our governments have a sterling opportunity to complete a North American Economic Accord.

This would cap a historical journey from hostility (based on two long-distant wars) to a high degree of economic interdependence and common purpose -- while maintaining national identities.

Given similar challenges of adjustment in the face of heightened international competition, businesses in both nations will profit from secure access to a home-base market of about 270 million people. Most economists expect the benefits of this open market to be greater for Canada because its opportunities for larger scale production will grow much more. By way of example, the 1965 Auto Pact produced a rationalization that led to fewer models, much greater volume, and a sizable boost in Canada's manufacturing trade, employment, and output. And the increased income generated from more efficient production on both sides of the border should prompt additional economic activity.

If both nations accept the final agreement, this achievement will grow in stature and importance over time. Its geopolitical potential is significant. A successful economic arrangement should enhance our ability to work together on other common problems. In the 20th century, we have maintained the longest peaceful border in the world and served with one another as allies in a common defense. In the 21st century, we will also need to work closely together to better address questions concerning the environment, wildlife, ocean borders, the Arctic, outer space, disease and medical science, terrorism, communications frequencies, bank and securities regulation, taxation, and immigration -- to name a few topics.

In addition, the accord accommodates and enhances future trade liberalization efforts in 6 ways.

First, the agreement respects GATT and is careful not to undermine the successes of the multilateral approach. Canada and the U.S. are lowering barriers between themselves, not raising barriers to others. We are seeking a healthy, dynamic linkage between bilateral and multilateral initiatives so as to prod and reinforce the GATT.

Second, the Canada-U.S. agreement extends the reach of an open, cooperative system by negotiating solutions in the areas of services, investment, and technology -- while respecting national sovereignty. (These arrangements demonstrate what can be achieved and offer conceptual approaches to which others may turn.)

Third, we have lowered the cost of initiating international liberalization in these new areas by breaking ground with only one nation at a time. When more nations are involved, it is often harder to arrange a satisfactory compromise.

Fourth, the rewards of this agreement offer an incentive to other governments. If possible, we hope this follow-up liberalization will occur in the Uruguay Round. If not, we might be willing to explore a "market liberalization club" approach, through minilateral arrangements or a series of bilateral agreements. In this fashion, North America can build steady momentum for more open and efficient markets.

Fifth, this agreement is also a lever to achieve more open trade. Other nations are forced to recognize that we will devise ways to expand trade -- with or without them. If they choose not to open their markets, they will not reap the benefits. By employing this lever together, the U.S. and Canada may be able to dislodge obstacles in special areas of common concern -- such as agriculture.

Sixth, this Canadian-U.S. accord could prove to be an attractive counterweight to protectionism in both our countries. It attracts those who want government to foster growth and opportunity by breaking down obstacles to achievement and fair competition, not by creating barriers to protect special interests.

Conclusion

Ladies and gentlemen -- as we know -- the Canada-U.S. FTA agreement is not yet law. In the weeks to come, there will be ample opportunities for naysayers to criticize the agreement. I hope they will be persuaded by logic and vision.

We need to enhance the resiliency of the trading system by promoting liberalization on a number of fronts. While we normally associate a liberal trading system with multilateralism -- bilateral or minilateral regimes may also help move the world toward a more open system.

Indeed, different agreements may be complementary, each fitting a special situation and together creating a liberalized network of mutually reinforcing systems. If activity on one frontier of trade negotiation slows, we may be able to maintain momentum and achieve solutions worthy of imitation through other agreements. If all nations are not ready to liberalize trade, we will begin with those that are and build on that success.

The Free Trade Agreement provides economic opportunities for both Americans and Canadians -- and could be the catalyst for a new trade policy strategy. The inquiries it already has elicited for similar agreements are encouraging. This interest gives both our countries an opportunity to set trade policy on a creative, positive, and pragmatic international course -- one that will benefit everyone associated with it.

Thank you.

File copy

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 22, 1988

CONTACT: LARRY BATDORF
(202) 566-2041

PROTOCOL TO U.S.-FRANCE INCOME TAX TREATY SIGNED

The Treasury Department today announced that a Protocol to amend the U.S.-France income tax treaty was signed in Paris on June 16, 1988. The Protocol will be subject to ratification in both countries and will enter into force upon exchange of instruments of ratification.

The Protocol will amend the treaty in several respects to conform the treaty rules to certain aspects of the Tax Reform Act of 1986. The present treaty provides for the imposition of a branch profits tax by France at a rate of 10 percent. The Protocol will add rules for the imposition of the U.S. branch tax, and will establish a reciprocal rate of tax on branch profits of 5 percent. The Protocol will amend the anti-treaty shopping rules of the present treaty to conform them with the new U.S. statutory rules by adding a "base erosion" test for entitlement to treaty benefits. The Protocol will make clear that deferred income of a permanent establishment may be taxed by the country where the permanent establishment is located, even if the income is received after the permanent establishment has ceased to exist. Finally, the Protocol will specify that the treaty applies to U.S. Federal income taxes imposed by the Internal Revenue Code of 1986.

The Protocol will provide, at the initiative of the French Government, that U.S. source investment income of U.S. citizens resident in France will be exempt from French income tax. Persons eligible for such benefits must demonstrate that they have complied with their U.S. income tax obligations, and must provide any certification of eligibility which may be required by the French tax authorities.

The Protocol will make a number of technical changes in the treaty to correct problems which have arisen in the application of the treaty in the United States or France.

The provisions relating to the exemption of U.S. citizens resident in France will have effect with respect to income derived on or after January 1, 1988. The branch tax provisions

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will have effect with respect to profits realized in any taxable year ending on or after the date of entry into force of the Protocol. Any changes in taxes withheld at source will have effect for amounts payable on or after the first day of the second month following entry into force. All other changes in the treaty made by the Protocol will have effect for taxable years beginning on or after the date of entry into force of the Protocol.

Copies of the Protocol are available in the Treasury Department Office of Public Affairs, room 2315 Main Treasury Building.

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PROTOCOL TO THE CONVENTION
BETWEEN THE FRENCH REPUBLIC AND THE UNITED
STATES OF AMERICA WITH RESPECT TO TAXES
ON INCOME AND PROPERTY OF JULY 28, 1967,
AS AMENDED BY THE PROTOCOLS OF OCTOBER 12, 1970,
NOVEMBER 24, 1978 and JANUARY 17, 1984

The Government of the French Republic and the Government of the United States of America, desiring to amend the Convention between the French Republic and the United States of America with respect to taxes on income and property of July 28, 1967, as amended by the Protocols of October 12, 1970, November 24, 1978, and January 17, 1984, have agreed upon the following provisions:

ARTICLE I

Article 1, paragraph 1(a) is amended as follows:

The phrase "the Federal income taxes imposed by the Internal Revenue Code" is replaced by the phrase "the Federal income taxes imposed by the Internal Revenue Code of 1986".

ARTICLE II

In Article 3:

- at the end of subparagraph 1(a) "and" is deleted; at the end of subparagraph 1(b) the period is replaced with ",and", and a new subparagraph 1(c) is added which reads as follows:

"(c) France or any of its local authorities."

- at the end of subparagraph 2(a) "and" is deleted; at the end of subparagraph 2(b) the period is replaced with ",and", and a new subparagraph 2(c) is added which reads as follows:

"(c) the United States or any of its political subdivisions or local authorities."

ARTICLE III

In Article 6:

- a new paragraph 3 is added which reads as follows:

3. For the implementation of paragraphs 1 and 2, any income or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where such permanent establishment is situated even if the payments are deferred until such permanent establishment has ceased to exist.

- Paragraphs 3 through 5 become respectively paragraphs 4 through 6.

- a new paragraph 7 is added which reads as follows:

7. When an insurance company of one of the Contracting States has a permanent establishment in the other Contracting State, the reinsurance premiums received shall be taken into account for the determination of taxable profits only in the Contracting State of which the company is a resident.

- Paragraph 6 becomes paragraph 8.

ARTICLE IV

In Article 9:

- paragraph 4 is replaced by a new paragraph which reads as follows:

4. Dividends paid by a corporation of one of the Contracting States shall be treated as income from sources within that Contracting State, and dividends paid by any other corporation shall be treated as income from sources outside that Contracting State.

- a new paragraph 7 is added which reads as follows:

7. The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders shares or other rights,

not being debt claims, participating in profits, as well as income treated as a distribution by the taxation laws of the Contracting State of which the company making the distribution is a resident.

ARTICLE V

In Article 10, at the end of paragraph 5, a sentence is added which reads as follows:

"In that case such interest shall be deemed to be paid by the permanent establishment or fixed base to the beneficial owner at the latest when it is taken into account as an expense of that permanent establishment or fixed base."

ARTICLE VI

In Article 11:

- paragraph 2 is deleted and replaced as follows:

2. Except as provided in paragraph 3, royalties may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax imposed on such royalties shall not exceed 5 percent of the gross amount paid.

- in paragraph 3 the phrase "and beneficially owned" is inserted before the phrase "by a resident".

- paragraph 6 is deleted and replaced as follows:

6. a) Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a local authority, a statutory body or a resident of that State.

b) Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such

permanent establishment or fixed base, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

c) Notwithstanding subparagraphs a) and b), royalties paid for the use of or the right to use property in the United States shall be deemed to arise therein.

- a new paragraph 8 is added which reads as follows:

8. For purposes of this Article, royalties shall be deemed to be paid to the beneficial owner at the latest when they are taken into account as expenses.

ARTICLE VII

In Article 12, a new paragraph 4 is added to read as follows:

"Paragraph (1) of this Article shall not apply in the case of gains described in paragraph (3) of Article 6."

ARTICLE VIII

In Article 13:

- paragraph 1 is deleted and replaced as follows:

1. a) A French corporation shall be exempt from the United States personal holding company tax in any taxable year if all of its stock is owned by one or more individual residents of France in their individual capacities for that entire year.

b) A French corporation shall be exempt from the United States accumulated earnings tax in any taxable year if it is a corporation described in paragraph 1 a) of Article 24 A.

- paragraph 2(a) is deleted and replaced as follows:

2. a) A corporation which is a resident of a Contracting State and which has a permanent establishment in the other Contracting State may be subject in that other Contracting State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed only on:

   i) in the case of the United States, that portion of the business profits of the corporation attributable to the permanent establishment which represents the "dividend equivalent amount" of those profits, in accordance with the provisions of the Internal Revenue Code; and

   ii) in the case of France, that portion of the business profits of the corporation which is attributable to the permanent establishment and which is included in the base of the French withholding tax in accordance with the provisions of French internal law.

b) The taxes referred to in subparagraph (a) shall apply to the portion of the business profits attributable to a trade or business conducted in one Contracting State through a partnership by a corporation resident of the other Contracting State which is a member of such partnership.

c) The taxes referred to in subparagraphs (a) and (b) shall not be imposed at a rate exceeding the rate specified in paragraph 2(b) of Article 9 (Dividends).

- paragraph 2(b) becomes paragraph 3.

ARTICLE IX

In Article 23:

In paragraph(2)(a)(ii), replace ";and" at the end of subparagraph(a) with "," and replace the period at the end of subparagraph (b) with ",".

- New subparagraphs (c), (d), and (e) are added to paragraph (2)(a)(ii) to read as follows:

(c) income consisting of dividends derived from sources within the United States (as described in paragraph (4) of Article 9), interest arising in the United States (as described in paragraph (5) of Article 10), or royalties derived from sources within the United States (as described in paragraph (6) of Article 11) which is beneficially owned by a resident of France and which is:

A) paid by the United States, any political subdivision or any authority thereof; or

B) paid by a United States legal entity the principal class of shares of or interests in which are substantially and regularly traded on a recognized stock exchange as defined in paragraph 3 of Article 24A; or

C) paid by a United States corporation other than one 10 percent or more of the outstanding shares of the voting stock of which the resident of France owned (either directly or indirectly) at all times during the part of such corporation's taxable year preceding the date of payment of the income to the owner of the income and during the prior taxable year (if any) of such corporation, provided that less than 50 percent of such stock is owned by residents of France during the same period; or

D) paid by a resident of the United States not more than 25 percent of the gross income of which for the prior taxable year (if any) consisted directly or indirectly of income derived from sources outside the United States,

d) capital gains derived from the sale or exchange of capital assets generating income as defined in subparagraph (c). However such sale or exchange shall remain taken into account for the determination of the threshold of taxation applicable in France to capital gains on movable property, and

e) profits or gains derived from transactions on a public United States options or futures market.

- The beginning of subparagraph (b) of paragraph 2 is amended to read as follows:

"b) As regards income or profits taxable in the United States under articles 9, 11, 13 or 15 A..." (the rest is not modified)

- A new subparagraph (e) is added at the end of paragraph 2 which reads as follows:

"e) The exemption provided by paragraph (2)(a)(ii) shall be granted:

i) only if the citizens of the United States who are residents of France demonstrate that they have complied with their United States income tax obligations, and

ii) upon receipt by the competent authority of France of such certification as may be prescribed by such authority or upon request to such authority for refund of tax withheld together with the presentation of any required certification."

ARTICLE X

- In Article 24, the last sentence of paragraph 2 is deleted and replaced as follows:

The provisions of this paragraph shall not be construed to prevent the application by either Contracting State of its tax on branch profits described in paragraph 2 of Article 13 (Branch Profits) of the Convention.

ARTICLE XI

Article 24 A is replaced by the following article:

ARTICLE 24 A

Limitation on Benefits

1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall not be entitled under this Convention to relief from taxation in that other Contracting State, nor to relief from double taxation in the first mentioned Contracting State, unless:

a) more that 50 percent of the beneficial interest in such person (or, in the case of a corporation, more than 50 percent of the number of shares of each class of the corporation's shares) is owned, directly or indirectly, by any combination of one or more of:

(i) individuals who are residents of the United States;

(ii) citizens of the United States;

(iii) individuals who are residents of France;

(iv) corporations in whose principal class of shares there is substantial and regular trading on a recognized stock exchange as defined in paragraph 3; and

(v) the Contracting States, their local authorities, or political subdivisions of the United States; and

b) not more than 50 percent of the gross income of such person is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of the Contracting States, one of the Contracting States or its local authorities, or political subdivisions of the United States or citizens of the United States.

2. The provisions of paragraph 1 shall not apply if the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the Convention.

3. The provisions of paragraph 1 shall not apply if the person deriving the income is a corporation which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

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

b) the French stock exchanges (Bourses de Valeurs); and

c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

ARTICLE XII

A new Article 25 A "Provisions for Implementation" is added which reads as follows:

The competent authorities of the Contracting States may prescribe rules and procedures, jointly or separately, to determine the mode of application of the provisions of this Convention.

ARTICLE XIII

1. Each party will notify the other upon the completion of the necessary constitutional procedures which concern it for entry into force of the present agreement which will take effect on the day of receipt of the last notification.

2. The provisions of this Protocol shall apply:

a) as regards taxes withheld at source, to amounts payable on the first day of the second month following the date of entry into force of this Protocol;

b) as regards taxes referred to in paragraph 2 of Article 13 of the Convention, as added by Article VIII of this Protocol, to profits realized in any taxable year ending on or after the date of entry into force of this Protocol;

c) as regards the new subparagraphs c), d) and e) of paragraph (2)(a)(ii) and the new subparagraph (c) of paragraph 2 of Article 23 of the Convention, as added by Article IX of this Protocol, to income described therein derived on or after January 1st 1988;

d) as regards all other modifications of the Convention made by this Protocol, for taxable years beginning on or after the date of entry into force of this Protocol.

ARTICLE XIV

This Protocol shall remain in force as long as the Convention of July 28, 1967, as amended by the Protocols of October 12, 1970, November 24, 1978 and January 17, 1984, remains in force.

IN WITNESS WHEREOF, the representatives of the governments, duly authorized thereto, have signed this Protocol.

Done at Paris this 16th day of June 1988, in duplicate, in the English and French languages, both texts being equally authoritative.

FOR THE GOVERNMENT OF THE FRENCH REPUBLIC:

/s/ Pierre Bérégovoy

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

/s/ Joe M. Rodgers

EMBASSY OF THE
UNITED STATES OF AMERICA

No. 181

Excellency:

I have the honor to refer to the Protocol, signed today, to the Convention between the United States of America and the French Republic with respect to Taxes on Income and Property of July 28, 1967, as amended by the Protocols of October 12, 1970, November 24, 1978, and January 17, 1984.

During the course of discussions leading to the development of the Protocol, the United States and French delegations agreed that nothing in paragraph 5 of Article 10 (Interest) of the Convention shall be understood to prevent or limit the application by a Contracting State of its internal law, or of its income tax treaty with a third State, with respect to interest paid by a permanent establishment located in the Contracting State to any resident of a third State. The provisions of internal law referred to in

His Excellency
Pierre Bérégovoy
Ministre d'Etat, Ministre de
l'Economie des Finances et du Budget

the preceding sentence are, in the case of the United States, those provisions of the Internal Revenue Code that impose a tax on interest described in Section 884(f)(1)(A) of such Code and, in the case of France, Article 119 bis and 125A of the Code Général des Impots.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

/s/ Joe M. Rodgers

Paris, June 16 1988

Dear Mr Ambassador,

I have the honor to acknowledge the receipt of your note of today's date which reads as follows :

"I have honor to refer to the Protocol, signed today, to the Convention between the United States of America and the French Republic with respect to Taxes on Income and Property of July 28, 1967, as amended by the Protocols of October 12, 1970, November 24, 1978, and January 17, 1984.

During the course of discussions leading to the development of the Protocol, the United States and French delegations agreed that nothing in paragraph 5 of Article 10 (Interest) of the Convention shall be understood to prevent or limit the application by a Contracting State of its internal law, or of its income tax treaty with a third State, with respect to interest paid by a permanent establishment located in the Contracting State to any resident of a third State.

The provisions of internal law referred to in the preceding sentence are, in the case of the United States, those provisions of the Internal Revenue Code that impose a tax on interest described in section 884 f (1) A of such Code, and in the case of France, articles 119 bis and 125 A of the Code Général des Impôts.

: Joe M. Rodgers
ıbassador of the United
:ates of America

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, dear Mr Minister, the renewed assurances of my highest consideration."

I have the honor to confirm to you that my Goverment is in agreement with the statements in your Note.

Accept, Dear Mr Ambassador, the renewed assurance of my highest consideration.

/s/ Pierre Bérégovoy

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 22, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $8,539 million of $29,177 million of tenders received from the public for the 2-year notes, Series AC-1990, auctioned today. The notes will be issued June 30, 1988, and mature June 30, 1990.

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

	Yield	Price
Low	8.04%	99.927
High	8.06%	99.891
Average	8.05%	99.909

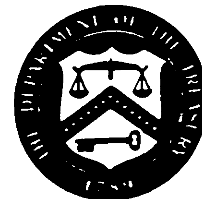
Tenders at the high yield were allotted 26%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 62,915	$ 62,915
New York	25,685,395	7,442,995
Philadelphia	46,495	45,495
Cleveland	66,250	66,050
Richmond	302,485	68,785
Atlanta	55,500	55,500
Chicago	1,571,595	437,495
St. Louis	93,840	74,470
Minneapolis	40,375	38,375
Kansas City	119,450	117,710
Dallas	19,530	19,515
San Francisco	1,101,615	97,875
Treasury	11,930	11,930
Totals	$29,177,375	$8,539,110

The $8,539 million of accepted tenders includes $1,173 million of noncompetitive tenders and $7,366 million of competitive tenders from the public.

In addition to the $8,539 million of tenders accepted in the auction process, $1,115 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,326 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.

TREASURY NEWS 

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

FOR IMMEDIATE RELEASE
June 23, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $6,753 million of $21,232 million of tenders received from the public for the 4-year notes, Series N-1992, auctioned today. The notes will be issued June 30, 1988, and mature June 30, 1992.

The interest rate on the notes will be 8-1/4%. The range of accepted competitive bids, and the corresponding prices at the 8-1/4% rate are as follows:

	Yield	Price
Low	8.35%	99.666
High	8.37%	99.599
Average	8.36%	99.632

Tenders at the high yield were allotted 79%.

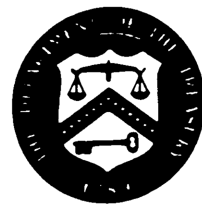
TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 27,452	$ 27,452
New York	18,780,599	6,272,773
Philadelphia	13,036	13,036
Cleveland	35,368	35,368
Richmond	127,724	22,678
Atlanta	25,305	25,305
Chicago	1,040,584	130,489
St. Louis	42,746	24,486
Minneapolis	18,146	18,146
Kansas City	44,112	44,102
Dallas	9,713	9,713
San Francisco	1,063,515	125,355
Treasury	4,123	4,123
Totals	$21,232,423	$6,753,026

The $6,753 million of accepted tenders includes $483 million of noncompetitive tenders and $6,270 million of competitive tenders from the public.

In addition to the $6,753 million of tenders accepted in the auction process, $405 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.

TREASURY NEWS



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

FOR IMMEDIATE RELEASE   June 24, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of May 1988.

As indicated in this table, U.S. reserve assets amounted to $41,949 million at the end of May, down from $42,730 million in April.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1988					
Apr.	42,730	11,063	9,589	11,275	10,803
May	41,949	11,063	9,543	10,912	10,431

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

B-1463

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
June 24, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $9,000 million of 364-day Treasury bills to be dated July 7, 1988, and to mature July 6, 1989 (CUSIP No. 912794 SH 8). This issue will result in a paydown for the Treasury of about $800 million, as the maturing 52-week bill is outstanding in the amount of $9,807 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, Thursday, June 30, 1988.

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 7, 1988. In addition to the maturing 52-week bills, there are $13,170 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 $2,522 million as agents for foreign and international monetary authorities, and $7,288 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 $115 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 5176-3.

B-1464

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 one-half hour prior to the closing time for receipt of tenders 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.

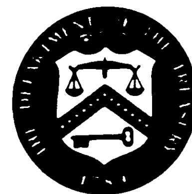
Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS 

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

FOR IMMEDIATE RELEASE
June 27, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,424 million of 13-week bills and for $6,413 million of 26-week bills, both to be issued on June 30, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 29, 1988			:	26-week bills maturing December 29, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.56%a/	6.76%	98.342	:	6.72%	7.05%	96.603
High	6.60%	6.80%	98.332	:	6.76%	7.10%	96.582
Average	6.59%	6.80%	98.334	:	6.75%	7.08%	96.588

a/ Excepting 1 tender of $685,000.

Tenders at the high discount rate for the 13-week bills were allotted 36%.
Tenders at the high discount rate for the 26-week bills were allotted 87%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 30,355	$ 30,355	:	$ 40,525	$ 40,525
New York	20,421,135	5,165,015	:	21,260,390	5,196,490
Philadelphia	19,035	19,035	:	16,750	16,750
Cleveland	57,940	57,940	:	24,030	24,030
Richmond	28,710	28,710	:	31,180	31,180
Atlanta	26,690	26,690	:	33,480	33,480
Chicago	2,062,715	341,715	:	1,736,435	535,420
St. Louis	19,995	19,355	:	28,700	24,700
Minneapolis	8,020	8,020	:	9,050	9,050
Kansas City	33,430	33,430	:	34,815	34,815
Dallas	18,710	18,710	:	19,130	19,130
San Francisco	1,259,095	359,455	:	1,251,030	159,230
Treasury	316,040	316,040	:	287,840	287,840
TOTALS	$24,301,870	$6,424,470	:	$24,773,355	$6,412,640
Type					
Competitive	$21,576,440	$3,699,040	:	$20,808,185	$2,447,470
Noncompetitive	868,565	868,565	:	746,425	746,425
Subtotal, Public	$22,445,005	$4,567,605	:	$21,554,610	$3,193,895
Federal Reserve	1,707,410	1,707,410	:	1,500,000	1,500,000
Foreign Official Institutions	149,455	149,455	:	1,718,745	1,718,745
TOTALS	$24,301,870	$6,424,470	:	$24,773,355	$6,412,640

An additional $16,745 thousand of 13-week bills and an additional $327,055 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1465

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 A.M.
June 28, 1988

STATEMENT OF
ADELBERT L. SPITZER
SPECIAL ASSISTANT TO THE ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the Treasury Department's views concerning the question of competition between tax-exempt organizations and taxable businesses, particularly small businesses.

As you know, the issue of "unfair competition" between tax-exempt organizations and taxable businesses has been the subject of considerable debate during the past several years and is currently being considered by the Oversight Subcommittee of the House Ways and Means Committee in its review of the unrelated business income tax ("UBIT") that applies to tax-exempt organizations. The Treasury Department has testified before the Oversight Subcommittee twice on this subject during the past year. On June 22, 1987, we testified with respect to general issues raised by the UBIT and on May 9, 1988, we commented on a list of "discussion options" prepared by the Subcommittee.

We believe this Committee's consideration of the issue of competition between tax-exempt organizations and taxable businesses is an important part of the current debate. Although federal income tax exemption is, of course, a significant benefit enjoyed by tax-exempt organizations, it is by no means the only governmental subsidy provided to such organizations. An analysis of the effect on competition of tax exemption is incomplete unless it also considers both the other benefits granted by the federal government (such as reduced postal rates and the ability to issue tax-exempt bonds) and those granted by state and local governments (such as real estate tax exemption). In addition, although changes to the federal income tax law undoubtedly would affect the competitive balance between taxable and exempt firms,

there are a variety of other means of affecting this balance -- not all of which would involve legislation. This Committee is well situated to undertake a broad review of this important subject and to effectuate significant beneficial changes.

My testimony will focus primarily on the UBIT, the rationale for income tax exemption, and the effect on competition of income tax exemption and other governmental subsidies. I will begin by describing the overall dimensions of the tax-exempt sector of our economy. Second, I will describe the structure of the UBIT, together with the historical developments that led to the enactment of the tax in 1950. Third, I will outline the tax policy considerations that are relevant to a review of the UBIT. Fourth, I will summarize briefly Treasury's recommendations with respect to the UBIT. Finally, I will offer several suggestions as to how the interests and expertise of this Committee can best be used to address the issue of competition between taxable and tax-exempt firms.

I. Dimensions of the Tax-Exempt Sector

A. General Description of Tax-Exempt Organizations

It is important to note that there is a distinction between nonprofit organizations and tax-exempt organizations. A nonprofit organization is an organization that is prohibited, generally by its organizational documents or state law, from distributing profits or net earnings to individuals who exercise control over it, such as its directors, officers or members. A nonprofit organization is not prohibited from earning a profit but, rather, is prohibited from distributing its profits to individuals in their private capacity.

Although most nonprofit organizations are exempt from federal income tax, the Internal Revenue Code (the "Code") does not by its terms grant tax-exempt status to all nonprofit organizations. Instead, the Code exempts from tax a diverse group of organizations, including religious, charitable, scientific and educational organizations; social welfare organizations; labor and agricultural organizations; business leagues; social clubs and many others. (see Figure 1.) Certain of these organizations -- primarily religious, charitable, scientific and educational organizations described in section 501(c)(3) of the Code -- are not only exempt from tax, but also are eligible to receive tax deductible contributions.

The Code does not prohibit tax-exempt organizations (other than private foundations) from engaging in business activities for profit. If such business activities are substantially related to the tax-exempt purpose of the organization, such as the operation of a dining hall or a dormitory by a college, any profit from the business is exempt from tax. If a business is unrelated to the exempt purpose of the organization, however,

such as the operation of a manufacturing facility by a university, any profits from the unrelated business are subject to income tax, generally to the same extent as the profits of a taxable business. The fact that an organization is required to pay tax on its unrelated business income does not, in general, affect the organization's tax-exempt status. Nonetheless, if the operation of unrelated businesses becomes the primary purpose of a tax-exempt organization, and thus its exempt function becomes a secondary purpose, the organization will cease to qualify for tax exemption under the Code.

B. Size of Exempt Sector

Tax-exempt organizations make up a large, diverse and growing sector of the U.S. economy. Currently, there are approximately 1.2 million exempt organizations, including 340,000 churches exempt under section 501(c)(3); nearly 390,000 educational, charitable, scientific, and religious organizations (other than churches) also exempt under section 501(c)(3); 130,000 civic leagues and social welfare organizations exempt under section 501(c)(4); and 355,000 mutual benefit organizations such as labor unions, chambers of commerce, mutual insurance companies, organizations of war veterans, and cemetery companies, also exempt under section 501(c).

In the last 20 years, there has been substantial growth in the nonprofit sector. During this period, the number of active tax-exempt organizations included in the Internal Revenue Service Master File ("IRS Master File")1/ more than doubled, from about 410,000 in 1968 to about 866,000 currently.

C. Economic Activity

A significant portion of U.S. economic activity occurs in the exempt sector. The Bureau of Economic Analysis estimated that current operating expenditures of nonprofit organizations totaled $239 billion in 1985, or six percent of GNP. In 1984, employees of nonprofit organizations (both paid and volunteer) accounted for ten percent of total hours worked in the U.S. economy, and paid employees of nonprofit organizations accounted for six percent of total hours worked by paid employees.

1/ The IRS Master File of Tax-Exempt Organizations is a compilation of all organizations which have applied for and received recognition of tax-exempt status from the Internal Revenue Service. Since churches are not required to apply for tax exemption, most do not do so, and very few are listed on the IRS Master File. Of the 1.2 million estimated tax-exempt organizations referred to in the text, 866,000 are active tax-exempt organizations reported on the IRS Master File and 340,000 are churches that are not reported on the IRS Master File.

Much of the economic activity of the nonprofit sector is made up of public charities and social welfare organizations that provide health, education or research services. In 1984, 47 percent of current operating expenditures of nonprofits were accounted for by health service organizations, and 22 percent by educational and research organizations. In turn, hospitals accounted for the bulk of economic activity in the nonprofit health service sector, and private elementary and secondary schools and private colleges and universities accounted for the bulk of economic activity in the nonprofit education and research sector. In contrast, the broad range of mutual benefit organizations exempt under provisions other than section 501(c)(3) and section 501(c)(4) accounted for only 10 percent of current operating expenditures of all nonprofits in 1984.

D. Funding for the Nonprofit Sector

Nonprofit organizations finance their activities through a number of sources: government grants, private donations, fees for services, operation of businesses, and investments yielding income such as interest, dividends, rents, or royalties. The relative reliance on these different revenue sources differs greatly among subsectors of the nonprofit community. For example, while religious organizations rely mainly on private contributions, health service organizations rely on fees and charges for most of their funding, and social service organizations rely most heavily on government grants. (See Table 1.)

The proportion of revenue derived from various sources also varies with the size of nonprofit organizations. Data for 1983 indicate that with respect to "public charities" (section 501(c)(3) organizations that are not private foundations), the greater the asset size of the organization, the lesser its reliance on government grants or private contributions, and the greater its reliance on fees and charges and other revenue sources. (See Table 2.)

There is some evidence that nonprofits have increased their reliance on income-producing or commercial activities in recent years. IRS Master File data show that, in 1946, organizations exempt under section 501(c)(3) obtained 59 percent of their support from business receipts, interest, dividends, rents, royalties, sales of assets and miscellaneous sources other than government grants, private contributions, dues and assessments; 71 percent from such sources in 1975; and 78 percent in 1983.2/

2/ Survey data from organizations such as the Urban Institute, Partners for Livable Places, the Rockefeller Brothers Fund, and the National Assembly provide supporting evidence of a trend toward increasing commercial activity by nonprofits.

For a number of reasons, however, the available IRS data do not give a definitive picture of nonprofit funding trends. First, requirements for filing Form 990, the information return filed by tax-exempt organizations, have changed over time, and the form has been subject to reporting and coding problems. Specifically, because Form 990 is an information return that does not result in tax liability, improper and erroneous information is reported more frequently than on forms that require computation of tax liability. Coding problems result from the lack of detailed statistical tests to check for reporting accuracy. Second, unrelated business income is reported on a separate form (Form 990-T), income from for-profit subsidiaries of nonprofit organizations is reported on the corporate income tax return (Form 1120), and income from partnerships is reported on the partnership return (Form 1065). Each of these forms would need to be matched with the Form 990 of the tax-exempt entity in order to obtain a comprehensive picture of the organization's commercial activity.

E. The Unrelated Business Income Tax (UBIT)

As noted above, tax-exempt organizations are required to pay income tax on their unrelated business income. In fiscal year 1985, approximately three percent of all tax-exempt organizations on the IRS Master File of Exempt Organizations filed Form 990-T in order to report unrelated business income. The amount of unrelated business tax revenue has increased sharply during the past several years, from about $30 million in fiscal year 1985 to $53 million in fiscal year 1986 to $120 million in 1987. Preliminary data suggest another sharp increase for 1988. (During this same period, the number of Forms 990-T processed increased each year by only approximately 15 percent.) This rapid rise in the UBIT revenue has likely resulted from a combination of increased compliance and increased unrelated activity.

Data for 1984 indicate that most unrelated businesses have a small amount of gross unrelated business income. Only 18 of the roughly 25,000 nonprofits filing in 1984 reported unrelated business income over $3 million, 56 reported unrelated business income between $1 million and $3 million, and 1,412 reported unrelated business income between $100,000 and $1 million. In addition, fewer than one third of the 25,000 nonprofits reporting unrelated business income had positive taxable income, and were therefore subject to tax.

The amount of tax reported on Form 990-T, however, does not present a complete picture of tax paid by exempt organizations on unrelated businesses. As noted above, many exempt organizations operate unrelated businesses in taxable subsidiaries that file corporate income tax returns. Under current reporting requirements, it is not possible to identify the returns of taxable corporations owned by exempt organizations or to correlate such returns with those of their parents. Thus, no data are available with respect to the amount of tax paid by subsidiaries of exempt organizations.

II. Current Law

A. Historical Development

Prior to 1950, the law was unclear as to the taxation of unrelated business activities of tax-exempt organizations. Under the "destination of income" rule described below, the majority of courts had held that a tax-exempt organization did not lose its tax exemption by virtue of the conduct of an unrelated business so long as the profits from the business were dedicated to charitable purposes. In fact, a "feeder" organization that engaged exclusively in commercial, non-exempt activities was treated as exempt from tax so long as all the profits from the organization were distributed to an affiliated charitable organization. The majority view was thus that the destination of income, not its source, was the appropriate test for tax exemption. Because of the liberality of the destination of income rule, prior to 1950 a number of charitable organizations carried on unrelated businesses -- businesses that often competed directly with taxable companies.

In 1950, Congress responded to the operation of unrelated businesses by exempt organizations by enacting a tax on such organizations' unrelated business income. The legislative history of the Revenue Act of 1950 indicates that Congress was primarily concerned with the issue of "unfair competition." Both the House and Senate reports state:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.

As part of the Revenue Act of 1950, Congress also enacted a Code provision pertaining to "feeder organizations," which provides that an organization carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to another exempt organization.

In addition to directly operating a commercial enterprise, some tax-exempt organizations engaged in transactions which became popular during the late 1940s -- the "sale and lease-back" of a taxable business to an exempt organization. In such transactions, a charitable organization would acquire a property (such as real estate) from a business, often borrowing to finance the entire acquisition, and would then lease the property back to the seller under a long-term lease. The result of the transaction was that the seller received capital for use in its

business, the seller's taxable income was substantially reduced by the deductible rent, and the charity received the difference between the rental payments and its loan amortization payments, with little or no money down.

The House and Senate reports identified three principal objections to sale and lease-back arrangements. First, the tax-exempt organization was trading on its exemption because the only contribution it made to the sale and lease-back was its tax exemption. Second, the lease-back transactions, if unchecked, would result in tax-exempt entities owning the bulk of the commercial and industrial real estate in the country. Third, the exempt organization that entered into the sale and lease-back and either paid an above-market price for the property, or charged below-market rent for the use of the property, had in effect sold part of its tax exemption. In response to these objections, Congress imposed the UBIT on income from the long-term rental of debt-financed real property and personal property leased in connection with it.

Notwithstanding the changes made by the Revenue Act of 1950, many tax-exempt organizations continued to engage in unrelated commercial activities. Such activities were permissible under the law because, first, a number of tax-exempt organizations such as churches, social clubs, and fraternal beneficiary societies were not subject to the tax on unrelated business income and, second, because the tax on rental income from debt-financed real property did not apply to leases of five years or less. The tax on debt-financed real property was avoided by so-called Clay Brown transactions -- "bootstrap acquisitions" similar to the sale and lease-back transactions described earlier.3/

In response to the continued involvement of charitable organizations in unrelated businesses, Congress in 1969 revisited this area of the law and made several significant changes. First, the rules regarding debt-financed property were expanded to include all debt-financed property unrelated to the exempt purpose of the organization, with no exception for short-term leases. Second, the tax on unrelated business income was expanded to apply to all exempt organizations, except certain U.S. instrumentalities created and expressly granted tax-exemption by a specific act of Congress. Third, the investment income of social clubs and voluntary employees' beneficiary associations was subjected to tax, based on the rationale that an exemption for investment income constituted an unwarranted subsidy of recreational or personal activities. Fourth, any rent, interest or royalties paid by an 80-percent controlled subsidiary to a tax-exempt parent was included in unrelated business taxable income of the parent in an amount

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3/ The transactions were named after the Supreme Court case that refused to recharacterize the transaction at issue and upheld the taxpayer's claimed tax benefits. Clay Brown v. U.S., 380 U.S. 563 (1965).

reflecting the portion of the subsidiary's income that would be unrelated business income if earned directly by the tax-exempt parent organization. The controlled subsidiary rule was imposed to discourage charitable organizations from "renting" part of their physical plants to taxable subsidiaries, thereby reducing or eliminating the taxable income of the subsidiaries. And fifth, Congress clarified the definition of the term "trade or business" to include activities carried on within a larger aggregate of similar activities. Thus, the sale of advertising in a magazine published by an exempt organization could be treated as an unrelated business, even though publication of the magazine was the organization's exempt function.

Each of the changes made by the Tax Reform Act of 1969 had the effect of tightening the rules with respect to the unrelated business activities of charitable organizations, helping to ensure that such organizations paid tax on income from business activities unrelated to the purpose for which they were granted tax exemption.

During the early 1980s, a number of charitable organizations again became involved in leasing transactions with taxable entities, although with a different twist from the sale and lease-back transactions described earlier. Due to the investment tax credit and accelerated depreciation, certain types of property were effectively subject to a negative rate of tax, generating credits or losses that would offset income from the other investments. Because tax-exempt organizations could not benefit from these tax incentives directly, a number of exempt organizations, including schools, city governments, federal agencies, and foreign governments, sold part of their assets to taxable businesses that could make use of the tax incentives and would then lease the property back on a long-term basis. As part of the Tax Reform Act of 1984, Congress sought to discourage such transactions by providing that property used by a tax-exempt entity (including foreign and domestic governments) is not eligible for tax incentives such as the investment tax credit and accelerated depreciation.

Subsequent to the 1969 Act, exceptions were created to the debt-financed property rule for certain real estate investments. In 1980, with respect to pension trusts, in 1984 with respect to educational institutions, and in 1986 with respect to real property title holding companies, the general rule was modified to exclude from the debt-financed property rules the acquisition of real estate with debt so long as certain requirements were met.

B. Structure of the Unrelated Business Income Tax

In general, the UBIT is imposed on the unrelated business taxable income of organizations that are otherwise exempt from tax under Code section 501(a). Tax-exempt trusts are taxed at individual tax rates and all other exempt organizations are taxed at corporate rates.

The term "unrelated trade or business" means any trade or business that is regularly carried on and is not substantially related, aside from the need of the organization for funds, to the performance of the purpose for which the organization was granted exempt status.

Specifically excluded from the term "unrelated trade or business" is any trade or business (1) in which substantially all the work is performed by volunteers; (2) which is carried on by a section 501(c)(3) organization or a state or city college or university primarily for the convenience of its members, students, patients, officers, or employees (the "convenience exception"); or (3) which is the selling of donated merchandise. Certain trade show and similar activities are also specifically excluded, as are services furnished by certain cooperative hospital service organizations, the rental of telephone poles by cooperative telephone or electric companies, the rental of mailing lists to certain other exempt organizations, and the distribution of low-cost articles incidental to soliciting charitable contributions. Conducting bingo games is also specifically excluded so long as bingo is legal under state law and is not ordinarily conducted on a commercial basis.

The term "unrelated business taxable income" is defined as the gross income derived from any unrelated trade or business less deductions directly connected with the carrying on of such trade or business, subject to certain modifications. Among the most significant of the modifications are the following:

1. All dividends, interest, payments with respect to loans of securities, and annuities are excluded.

2. Royalties (including overriding royalties), whether measured by production or by gross or taxable income, are excluded.

3. Rent from real property, and rents from personal property leased with real property if the rents attributable to the personal property are only an incidental amount of the total rents received or accrued under the lease, are excluded. If more than 50 percent of the rent under a lease is attributable to personal property, then none of the rent, whether attributable to the real property or the personal property, qualifies for the exclusion. In addition, rent does not qualify for the exclusion if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage of receipts or sales).

4. All gains or losses from the sale, exchange or other disposition of property, other than the sale of property of a kind properly includable in inventory and property held primarily for sale to customers in the ordinary course of a trade or business, are excluded. Thus, for

example, gain on commodity futures contracts ordinarily would be excluded. Also excluded are all gains on the lapse or termination of options to buy or sell securities written by the organization in connection with its investment activities.

5. Income from various research activities also is excluded. All income from research performed for the United States, a state, or a political subdivision of a state is excluded. In the case of a college, university, hospital, or organization operating primarily for the purpose of carrying on fundamental research that makes the results of its research freely available to the public, all income derived from research is excluded, regardless of for whom it is performed.

6. A "specific deduction" of $1,000 is allowed from unrelated business taxable income for all tax-exempt organizations, thus preventing the imposition of tax when the profit from an unrelated business activity is very small.

As noted earlier, the modifications for interest, royalties, annuities and rents do not apply to an 80-percent controlled subsidiary to the extent it is engaged in a trade or business unrelated to the exempt purpose of the parent organization.

Special rules apply in computing the unrelated business taxable income of social clubs, voluntary employees' beneficiary associations, supplemental unemployment benefit trusts and group legal services organizations. In general, all income of these organizations other than "exempt function income" is deemed to be unrelated. Exempt function income is income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members (or their dependents or guests) goods, facilities or services in furtherance of the organization's exempt purpose, and income set aside for charitable purposes or for certain defined benefits. In the case of voluntary employees' beneficiary associations, supplemental unemployment benefit trusts, and group legal services organizations, there are in addition various limits on the extent to which such set aside income is treated as exempt function income. The primary effect of these rules is to tax the investment income of the organizations subject to the rules.

The provisions of section 514, pertaining to "unrelated debt-financed income," also represent a set of special rules in that a charitable organization can have unrelated business taxable income under this section regardless of whether it is engaged in a trade or business. The section provides that to the extent any property held for the production of income is debt-financed, the income from the property is subject to tax.

There are a number of exclusions from the definition of debt-financed property, including the following: (1) property the use of which is substantially related to the exempt purpose of the organization, (2) property used for research activities, the income from which is specifically excluded from tax under section 512, and (3) property used in certain other trades or businesses, the income from which is excluded under section 513, namely, businesses run by volunteers, businesses run for the convenience of members, students, etc., and businesses involving the sale of donated property.

A final, and very significant, exception to the debt-financed income rules is an exception, added in 1980 and subsequently amended, for the acquisition of real estate by "qualified organizations," namely, educational institutions, pension trusts, and real property title holding companies exempt under section 501(c)(25). Section 514(c)(9) provides that the term "acquisition indebtedness" does not include debt incurred by a qualified organization to purchase real property so long as certain conditions are met. These conditions include: (1) the purchase price is a fixed amount; (2) the amount of any indebtedness, and the time for payment of such indebtedness, is not contingent on revenue, income, or profits derived from the real property; (3) the real property is not leased back to the seller or a party related to the seller; (4) the real property, if purchased by a pension trust, is neither purchased from, nor leased to, certain disqualified persons; (5) neither the seller nor a related party or certain disqualified persons (in the case of a pension trust) provides financing in connection with the real property; and (6) if the real property is held by a partnership and one or more of the partners is not a qualified organization, then allocations to the partners must be "qualified allocations" (i.e., must not vary over time) or must follow a special rule allowing certain variations from qualified allocations. The elaborate requirements of section 514(c)(9) were designed, in part, to prevent charitable organizations from entering into the type of "bootstrap" acquisitions that were common prior to the Tax Reform Act of 1969.

III. Tax Policy Considerations

A. Rationale for Tax Exemption of Nonprofit Organizations

The exemption of charitable, religious, and educational organizations from tax has been a part of federal law since 1894 when the first federal act imposing a general tax on the income and profits of corporations was enacted. Many other tax exemption provisions, including those for labor unions, trade associations, and social clubs, were enacted over seventy years ago. Despite, or perhaps because of, the long history of tax exemptions in the federal income tax law, there is little guidance in the legislative record as to the rationale for exempting particular organizations from tax. At the time of the early income tax statutes, however, most exempt organizations

were supported primarily by donations. Notions of taxable income were not easily applicable to their activities, distinguishing them from the for-profit businesses that Congress intended to tax. Certain other organizations, such as labor unions or trade associations, were (and continue to be) funded principally by membership dues and could appropriately have been viewed as mutual benefit organizations that function, in part, as conduits for their members.

Over the years, the exempt sector has grown enormously in both size and diversity. Moreover, many exempt organizations have come gradually to derive much or all of their income from sources other than donations. These changes have not only increased the importance of tax exemption to the exempt sector, but have also tended to blur the historical differences in activities and funding between exempt and taxable organizations. The broadest segment of the exempt sector, for example, including in particular those organizations exempt under section 501(c)(3) engaged in educational and health activities, draw substantial revenues from sources that could, at least in concept, be subject to income tax. Tax exemption for these organizations may, in part, reflect historical circumstances, but is more importantly based on the same tax policy principles that support an income tax deduction for charitable contributions. Taxes are imposed to fund the activities of government, and represent a removal of resources from private hands to support the broad, public purposes served by government. Although public charities are privately operated and controlled, their exempt activities are restricted to those deemed to serve the general public interest. An organization that provides food and shelter for the poor, or that encourages education, the arts or humanities, is serving the same general purposes with which government itself is concerned. Thus, resources dedicated to the activities of such organizations may be viewed as similar to funds transferred to and used for the general purposes of government. For this reason, income transferred through a charitable contribution or earned directly by a public charity may appropriately be exempted from tax.

Although the above rationale for exempting public charities and their activities from taxation remains as strong today as when the income tax was first enacted, limits on the scope of such tax exemption are appropriate and necessary. This nation has prospered through its reliance on a private, market-based economy to supply necessary goods and services. The role of government generally has been restricted to those socially important activities not adequately supported by the private sector. The role of the quasi-governmental, not-for-profit sector should similarly be restricted to that of supplementing, and not supplanting, the activities of for-profit businesses. Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is inadequate, or the distribution of those goods or services undesirable.

B. The Problem of Competition

As described above, Congress adopted the unrelated business income tax primarily because of its concern with "unfair" competition between tax-exempt organizations and taxable businesses. Some competition between tax-exempt and taxable activities is inevitable, however, and could not be eliminated without repealing altogether the tax exemption for many nonprofit organizations. A nonprofit hospital will compete with for-profit hospitals for patients, and, in providing its patients with food, drugs or medical devices, will compete with taxable businesses offering the same products. Similarly, in maintaining student dormitories and dining halls, an exempt university will compete with local businesses offering housing and meals. Because the hospital and university are not subject to tax, they may be able to provide goods or services at a lower cost than their taxable competitors or to expand more rapidly to attract additional students or patients. Although this may leave the exempt organization with a competitive advantage over its taxable counterpart, this advantage is an intended consequence of the societal decision to encourage the exempt functions performed by these organizations.

Competition between taxable and tax-exempt organizations becomes of greater concern, however when the good or service provided by the tax-exempt organization is further removed from the organization's core purposes. We may not be concerned that a state university's tax exemption extends to sales of textbooks through the student bookstore, since the product is essential to the school's educational function and may be irregularly or incompletely supplied by private businesses. If the same student bookstore, however, also sells clothes, appliances and other consumer goods, the activity moves further from the university's educational function, and involves products which in general are amply supplied by the private sector. Extending the university's tax exemption to sales of these products may only displace taxable businesses in an area where private markets are working effectively.

There is little empirical evidence regarding either the behavior of exempt organizations in competition with taxable businesses or the response of taxable businesses to such competition. Even though tax exemption allows a nonprofit organization to earn a higher rate of return than a taxable company within a particular activity, some have argued that this does not necessarily create an adverse effect on the taxable business. Because the nonprofit organization enjoys a similarly higher rate of return on other uses of its capital, including passive investments, the relative "opportunity cost" of entering a particular business (which includes the revenue lost from forgoing alternative investments) can be equivalent for taxable and exempt organizations. As a result, taxable and exempt businesses may be in the same relative position with respect to the decision whether or not to enter a particular business. Thus, following this analysis, if income tax exemption were the

sole benefit granted to nonprofit organizations, nonprofit and taxable organizations might well co-exist in the same business, just as such organizations co-exist in the stock and bond markets.

Nonetheless, when tax exemption is combined with other governmental subsidies -- such as the ability of some exempt organizations to issue tax-exempt bonds, access to lower postal rates, exemption from certain federal excise taxes, and exemption from certain state and local taxes -- an exempt organization's cost of producing goods and services for sale is further reduced. Hence, its profit is increased without a corresponding increase in the return available from alternative passive investments. Consequently, there exists an additional incentive to produce such goods or services as opposed to making a passive investment.

In addition, as a result of their various cost-saving benefits, it is possible that tax-exempt organizations would reduce their prices in an attempt to drive out non-exempt competitors. Engaging in this type of "predatory" pricing leads firms to forego profits in the short run, in the hope that future profits will be large enough to overcome the near-term losses. There is little agreement, however, among economists about whether such pricing is common or whether it is likely to be successful. A further complicating factor with respect to the pricing behavior of exempt organizations is that they will often be motivated primarily by the desire to maximize the output of their exempt product, not by the desire to maximize profits. This could result in prices of such exempt products that are lower than the prices of the goods and services sold by taxable competitors and that give rise to no taxable income. Although a taxable competitor might well view this as predatory pricing, the tax-exempt organization might in fact have no desire to ultimately raise its prices to capture a monopoly profit. The desire to maximize exempt output would depend, of course, on whether the organization views those items as part of its primary exempt function, rather than as part of an ancillary, profit-seeking function.

Thus, although the precise consequences are not perfectly understood, the combination of tax exemption with other governmental subsidies will in some cases create a competitive advantage for tax-exempt organizations. Such advantage could be sufficient in certain cases to discourage taxable firms from entering an industry or could encourage existing taxable firms to leave the industry. This result is of particular concern if exempt organizations impinge on activities previously carried on principally by taxable businesses. In such a situation, the taxable businesses would not have anticipated competition from tax-exempt organizations and would have made economic decisions ignoring this possibility.

C. Economic Efficiency

In addition to limiting unfair competition, the unrelated business income tax serves the goal of economic efficiency by helping to ensure that the subsidy of tax exemption is used in the manner that provides the greatest social benefit.

The effect of the UBIT on economic efficiency can best be seen by considering the impact of a system that exempts from tax all unrelated business income. Such a tax system would encourage equally the pursuit of exempt and unrelated activities by non-profit organizations. This would be an inefficient use of the grant of tax exemption, in that a subsidy is not needed to assure production of appropriate amounts of most commercial goods and services.

Tax exemption for unrelated business income would also act as an indirect subsidy to the primary exempt function of a nonprofit organization because the organization would direct some or all of its unrelated business income towards its exempt function. Subsidizing the primary exempt function of nonprofit organizations by means of a tax exemption for unrelated income, however, would simply reward those organizations that are most successful in pursuing commercial ventures. Such a system would be unlikely to provide the greatest reward to the most deserving organizations; i.e., those that provide the greatest social benefit.

Our current tax system does not, of course, exempt all nonprofit income from taxation. Nevertheless, the criterion of economic efficiency can be applied to those particular areas in which nonprofit commercial activities do, in fact, escape taxation in order to help determine whether such activities should remain exempt.

D. Accountability

As indicated above, the privilege of tax-exempt status affords substantial benefits and, at least with respect to public charities, may be justified because of the public, quasi-governmental purposes served by their activities. Because nonprofit organizations are privately controlled, however, their activities are not subject to the public review or scrutiny that applies to the actions of government. It is thus necessary that the tax system ensure that nonprofit organizations are operated for the purposes that support their exemption.

At present, the responsibility for ensuring that nonprofit organizations are accountable for the benefits of tax exemption rests in large part on the enforcement activities of the Internal Revenue Service. Through the return and audit process, the Internal Revenue Service is in a position to review the activities of nonprofit organizations and the purposes for which their funds are spent.

In addition to focusing on an exempt organization's use of funds, however, the tax system may improve accountability by encouraging particular sources of funding. Thus, rules limiting the scope of tax exemption may appropriately encourage an exempt organization to concentrate on activities and investments that do not distract from its exempt function. This chanelling function may be served by the current law rules subjecting nonprofit organizations to tax on their unrelated business activities. Although the earnings from an unrelated business activity may go equally to serve the organization's exempt purposes, the unrelated activity may divert management resources or otherwise cause the organization to lose sight of its exempt function. In the same vein, the current law rules exempting passive investment income, whether or not related to a nonprofit organization's exempt function, effectively encourage investments that will not directly engage the organization in purely commercial activity.

There are, of course, limits on the extent to which the tax laws can be used to ensure accountability of tax-exempt organizations. For example, the role of determining whether contributed funds are used wisely and efficiently is not a function of the tax law, but is performed to some degree by donors who support exempt organizations. If an organization is able to sustain itself to an increasing extent by commercial activity, however, it becomes less dependent on the scrutiny of such private donors. Hence the UBIT helps ensure that exempt organizations remain, at least to some degree, accountable to third-party donors. The ability of donors to perform this oversight function would also be aided by fuller public disclosure required by federal or state law.

IV. Analysis of Current Law

In our testimony before the Oversight Subcommittee on June 22, 1987, we described a number of aspects of the UBIT as warranting Congressional attention. Our recommendations, in summary, were as follows:

1. With respect to business activities of exempt organizations, the Treasury Department believes the current standard of a substantial relationship to an organization's exempt purpose has conceptual merit as the basis for granting exemption from tax. We are concerned, however, with administrative and interpretative problems this standard has created. Although we do not propose changes in the "substantially related" standard, we do recommend more detailed reporting as a means of improving enforcement and compliance and of providing a basis for further review of the adequacy of the standard.

2. With respect to the existing exceptions from the "substantially related" standard, we suggest that the scope of the exemptions for businesses operated by volunteers or for the convenience of students, patients

and others should be reexamined. We are concerned that these provisions may extend to activities not meriting exemption and, at least in their current form, cannot be justified on grounds of administrative convenience. Although similar conceptual questions might be raised about the provision exempting sales of donated property, in practice, we believe the exception operates appropriately.

3. With respect to the computation of the tax on unrelated business income, we suggest that the rules for allocation of expenses be clarified to reflect the appropriate relationship between an organization's exempt functions and unrelated activities. In addition, we support retention of the "fragmentation rule" and an increase in the specific deduction from unrelated business income from $1,000 to $5,000.

4. For purposes of characterizing otherwise tax-exempt passive income from subsidiaries as taxable, we suggest that the definition of a controlled subsidiary be broadened to include subsidiaries in which an exempt organization has more than a 50 percent interest in stock value or voting power. In addition, for purposes of determining whether the primary purpose of an organization is the conduct of an exempt function, we suggest that consideration be given to aggregating the activities of an exempt organization and its subsidiaries in appropriate cases.

5. With respect to passive investment income, we suggest that such income should continue to be exempt in the case of public charities, but should be taxable to social welfare organizations unless permanently set aside for charitable purposes. The treatment of passive income of labor unions and trade associations requires further study. In addition, we suggest that the exclusion for royalties should be narrowed to prevent avoidance of the tax on unrelated business income in certain circumstances.

6. With respect to the exclusions from tax for income derived from certain research activities, we believe additional attention should be given to the definition of research and to requirements for public dissemination of the results of research.

7. With respect to joint venture activities of exempt organizations, we are concerned that current restrictions on partnership allocations between taxable and tax-exempt partners may not be adequate to prevent abuse. In addition, we have serious reservations whether current law is adequate to deal with issues raised by partnerships formed to conduct exempt activities of tax-exempt organizations.

In our testimony before the Oversight Subcommittee on May 9, 1988, we commented on a group of "discussion options" released by the Subcommittee. We testified in support of a number of these discussion options, some with certain modifications. In general, the discussion options we supported would:

1. Retain the "substantially related" standard.

2. Provide special rules that override the "substantially related" standard in several particular areas, providing instead a "bright line" test for taxability. These areas include: retail stores, medical equipment sales, fitness facilities, travel and tour services, some food sales, veterinary services, hotels, routine testing, affinity credit cards, advertising, and amusement parks.

3. Repeal the convenience exception.

4. Modify the taxation of royalties in order to distinguish active from passive royalties.

5. Increase the specific deduction to $5,000.

6. Modify the definition of a "controlled subsidiary" and the rules applicable to such subsidiaries.

7. Aggregate the activities of exempt organizations and certain controlled subsidiaries for purposes of applying the primary purpose test.

8. Revise the rules for allocating expenses between exempt and taxable uses of property.

9. Expand reporting to the IRS and mandate certain studies.

In addition to supporting these relatively discrete changes to the UBIT being considered by the Oversight Subcommittee, the Treasury Department believes that Congress should undertake a broad review of the rationale for tax exemption in order to ensure that the substantial benefits of tax exemption are appropriately limited. Such a review would enable Congress to determine whether the current categories of exempt organizations, and the basic rules regarding unrelated business taxable income, are appropriate when applied to the tax-exempt sector of our modern economy -- a sector that is undeniably much changed since the earliest rules regarding tax exemption were adopted by Congress. This kind of comprehensive review would require the collection of improved data regarding the scope of commercial activities being conducted by exempt organizations and the effect of those activities on taxable competitors. Hence Treasury believes that a Congressional mandate to expand the reporting requirements of exempt organizations, with appropriate exceptions for small organizations, is particularly important.

V. Other Options for Addressing Issue of Unfair Competition.

The debate during recent years with respect to competition between taxable businesses and tax-exempt organizations has focused on the grant of federal income tax exemption and the operation of the unrelated business income tax. Although these are important issues and warrant careful consideration by Congress, tax exemption is only one component of the overall governmental effort to encourage and subsidize the activities of certain non-profit organizations. Much work remains to be done in analyzing these additional subsidies and helping to coordinate the efforts of the federal government, together with state and local governments, to provide incentives in the most economically efficient and equitable manner. Such incentives should be designed to encourage the increased production of undersupplied goods and services by the tax-exempt sector while at the same time not discouraging the taxable sector from providing these same goods and services.

We believe the Committee on Small Business has an important role in the analysis and resolution of the issues noted above. In particular, we recommend that the Committee consider undertaking the following three initiatives.

1. Coordination of federal, state and local actions.

The question of the appropriate scope of tax exemption and other governmental subsidies has been sporadically reviewed at the federal, state and local levels. Several localities, for example, have recently challenged the real estate tax exemption of non-profit hospitals. It would be helpful if a more coordinated review were undertaken. In particular, it would be useful to know where and how state criteria for exemption have come to differ from federal criteria and why. As a first step, an effort should be made to quantify, in a systematic manner, the types and amounts of governmental subsidies provided to various categories of tax-exempt organizations. For example, it would be useful to know which organizations that are exempt from federal income tax are also exempt from local real estate tax. A second step would be to analyze whether those subsidies are being allocated in an economically efficient manner -- *i.e.*, whether those organizations providing the greatest social benefit also receive the largest subsidies.

2. Further analysis of "unfair competition".

As noted above, there is little conclusive evidence regarding the competitive effects of tax exemption and other governmental subsidies. This issue should be studied in greater detail, utilizing improved data that the Internal Revenue Service intends to collect as well as data collected by other governmental agencies and private organizations. It would be helpful, for example, to analyze particular industries in which the balance between taxable and exempt firms has changed over time. More generally, it would be useful for research to address basic

questions regarding the behavior of non-profit organizations to determine, for example, whether they are likely to engage in predatory pricing and whether they tend to produce higher or lower quality output *vis a vis* taxable competitors. Because current policy analysis is based largely on anecdotal evidence, it is difficult to reach broad conclusions with respect to these important issues.

In addition, it would be beneficial to undertake a broad analysis of the interrelatedness of exempt organizations and taxable businesses; in particular, whether exempt organization activities may in some cases assist the growth of taxable businesses. For the most part, representatives of particular businesses (such as travel agencies or fitness clubs) have raised concerns about exempt organizations that directly compete in those businesses. Although such concerns are entirely appropriate, these businesses may not have considered whether the presence of exempt organizations may at times encourage other kinds of taxable businesses. A number of exempt organizations have asserted, for example, that their income-producing activities often create substantial opportunities for taxable businesses. Examples cited have included universities producing new technology that is developed by the taxable sector or organizations whose activities draw tourists to a particular area and thus create opportunities for restaurants, hotels, etc. To the extent that these increased opportunities represent new economic activity, rather than simply replacement of such activity elsewhere, they provide economic benefits to all.

3. Improved cooperation between taxable and exempt entities.

In many instances the problem of unfair competition could be reduced by increased cooperation between taxable and exempt competitors. Tax-exempt organizations generally do not have an interest in developing and managing active businesses and thus drawing attention away from their charitable, educational, etc. pursuits. Concerns with funding for their exempt functions will often mandate that an organization vigorously pursue every revenue source, however, and exempt organizations should not be expected to allow facilities or assets capable of producing income to lie idle. Instead, taxable businesses should be encouraged to work with exempt organizations in order to bring these available facilities and other assets into the marketplace in a manner that maximizes passive income for the exempt organization and active business income for the taxable company. We believe this Committee is well situated to encourage this form of mutually beneficial cooperation.

The Committee on Small Business serves an invaluable function in providing a forum for the concerns of small businesses. Such concerns are of the utmost importance to those of us involved in the formulation and administration of the unrelated business income tax. We welcome your assistance in identifying problems and formulating solutions in this important and difficult area.

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

Figure 1 Description, General Nature of Activities, Example, and Number of Tax-Exempt Organizations, By Internal Revenue Code Section

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(1)*	Corporations organized under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States	Federal Deposit Insurance Corp.	24
501(c)(2)	Title holding corporation for exempt organization	Holding title to property of an exempt organization.	Naugatuck Masonic Building Corp.	5,712
501(c)(3)*	Religious, educational, charitable, scientific, literary. Testing for public safety, fostering certain national or international amateur sports competitions, or prevention of cruelty to children or animals organizations. Includes private foundations and nonexempt charitable trusts	Activities of nature implied by description of class or organization.	American Heart Association, Inc., Ford Foundation	386,987
501(c)(4)	Civil leagues, social welfare organizations, and local associations of employees	Promotion of community welfare, charitable, educational, or recreational.	Lions Clubs	129,423
501(c)(5)	Labor, agricultural, and horticultural organizations	To improve conditions of work and to improve products and efficiency.	AFL-CIO	71,182
501(c)(6)	Business leagues, chambers of commerce, real estate boards, etc.	Improvement of business conditions of one or more lines of business.	Chamber of Commerce National Football League	56,336
501(c)(7)	Social and recreational clubs	Pleasure, recreation, social activities.	Ocean Ski Club, Inc.	56,216
501(c)(8)	Fraternal beneficiary societies and associations	Lodge providing for payment of life, sickness, accident, or other benefits to members.	Knights of Columbus	86,255

Figure 1 continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(9)	Voluntary employees' beneficiary associations (including federal employees' voluntary beneficiary associations formerly covered by section 501(c)(10))	Providing for payment of life, sickness, accident, or other benefits to members.	Warren Fire-fighers Fund Assoc.	10,481
501(c)(10)	Domestic fraternal societies and associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members.	Knights Templar of the US 33 Natick Commandery	16,953
501(c)(11)	Teachers' retirement fund associations	Teachers' association for payment of retirement benefits.		9
501(c)(12)	Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, etc.	Activities of a nature similar to those implied by the descriptions of class of organization beneficial to members.	Salem Rural Water Corp.	5,345
501(c)(13)*	Cemetery companies	Burials and incidential activities for members.	Williamson Cemetery Assoc.	7,704
501(c)(14)	State chartered credit unions, mutual reserve funds	Loans to members. (Exemption for building and loan associations and cooperative banks repealed by Revenue Act of 1951, affecting all years after 1951).	Williamson County Catholic Credit Union	6,189
501(c)(15)	Mutual insurance companies or associations	Providing insurance to members substantially at cost (limited to organizations with gross income of $150,000 or less).	Sand-Clay Mutual Burial Assoc.	910

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(16)	Cooperative organizations to finance crop operations	Financing crop operations in conjunction with activities of a marketing or purchasing association.		18
501(c)(17)	Supplemental unemployment benefit trust	Payment of supplemental unemployment compensation benefits.	Dayton Malleable Iron Company, Ohio Malleable Div.	702
501(c)(18)	Employee funded pension trust	Payment of benefits under a pension plan funded by employees (created before June 25, 1959).		5
501(c)(19)*	Post or organization of war veterans	Activities implied by nature of organization.	American Legion Posts	24,815
501(c)(20)	Trusts for prepaid group legal services	Forms part of a qualified group legal service plan or plans. (Applicable to taxable years beginning after December 31, 1976).		202
501(c)(21)	Black Lung Trusts	Satisfies claims for compensation under Black Lung Acts. (Generally, applicable to taxable years beginning after December 31, 1977).		21
501(c)(22)	Pension Trust	Pension plan withdrawal liability trust created to provide funds to meet payments under section 4223(i) or (j) of ERISA.		0
501(c)(23)	Veterans' insurance associations	Provide insurance and other benefits to member veterans.		0
501(c)(24)	Trusts	Described in ERISA section 4049		0
501(c)(25)	Title holding companies	Those with 35 or fewer entities exempt under IRC section 401 and 501(c)(3) and governmental units.		0

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(d)	Religious and apostolic associations	Regular business activities; communal religious community.		84
501(e)*	Cooperative hospital service organizations	Enumerated cooperative services for hospitals.		79
501(f)*	Cooperative service organizations of operating educational organizations	Collective investment services for educational organizations.		1
			TOTAL	865,653

* Generally, contributions under this Code subsection are tax deductible. Other organizations not asterisked could establish trusts under Code subsection 501(c)(3) which may receive tax deductible contributions.

NOTE: Examples are not shown for organizations tax-exempt under Code subsections 501(c)(11), (16), (18), (20), (21), 501(d), 501(e), and 501(f) because there is very little activity.

NOTE: Number of organizations is a count of the number of active entities on the IRS Exempt Organization/Business Master File as of April 30, 1987.

Table 1

Sources of Nonprofit Support by Subsector, 1984

Type of Nonprofit Organization	Total Revenues	Private Contributions 1/	Government	Dues, Fees & Charges	Endowment & Other
Health					
$ billion	$125.7	$17.4	$44.5	$60.8	$3.0
percent	100%	13.8%	35.4%	48.4%	2.4%
Education & Research					
$ billion	$57.1	$11.8	$9.7	$30.5	$5.0
percent	100%	20.7%	17.0%	53.4%	8.8%
Religious Organizations					
$ billion	$28.8	$24.8	-	-	$4.0
percent	100%	86.1%	0%	0%	13.9%
Social Service 2/					
$ billion	$21.8	$8.3	$9.6	$2.8	$1.1
percent	100%	38.1%	44.0%	12.8%	5.0%
Civic, Social and Fraternal					
$ billion	$7.0	$2.2	$3.5	$0.9	$0.4
percent	100%	$31.4%	50.0%	12.9%	5.7%
Arts and Culture					
$ billion	$6.9	$4.6	$0.9	$0.7	$0.7
percent	100%	66.7%	13.0%	10.1%	10.1%

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Office of Tax Analysis

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Source: Dimensions of the Independent Sector, 1986, Table 4.1.

1/ Including contributions from churches.
2/ Including legal services.

Note: Foundations are excluded.

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

Table 2

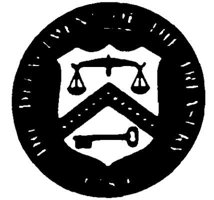
Nonprofit Charitable Organizations

Components of Revenue as Percent of Total Revenue by Asset Size, 1983

Asset Size	Private Contributions	Government Grants	Dues & Assessments	Program Service Revenue	Other
Under $100,000	23.2	42.0	6.4	20.6	7.8
$100,000--$499,999	18.7	34.4	5.2	34.3	7.4
$500,000--$999,999	22.8	40.8	2.0	26.7	7.7
$1,000,000--$9,999,999	17.0	13.2	2.0	55.4	12.4
$10,000,000--$49,999,999	11.0	4.5	1.2	72.9	10.4
$50,000,000 or More	6.5	5.9	0.7	73.0	13.9

Department of the Treasury
Office of Tax Analysis

June 19, 1987

TREASURY NEWS


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FOR RELEASE AT 4:00 P.M.
June 28, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,200 million, to be issued July 7, 1988. This offering will provide about $25 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,170 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 5, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,600 million, representing an additional amount of bills dated April 7, 1988, and to mature October 6, 1988 (CUSIP No. 912794 QP 2), currently outstanding in the amount of $7,086 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,600 million, to be dated July 7, 1988, and to mature January 5, 1989 (CUSIP No. 912794 QZ 0).

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 7, 1988. In addition to the maturing 13-week and 26-week bills, there are $9,807 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 $1,993 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $2,108 million as agents for foreign and international monetary authorities, and $7,288 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

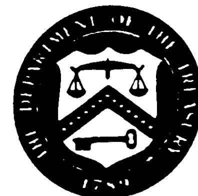
Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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
June 30, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,036 million of 52-week bills to be issued July 7, 1988, and to mature July 6, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.04% a/	7.54%	92.882
High -	7.04%	7.54%	92.882
Average -	7.04%	7.54%	92.882

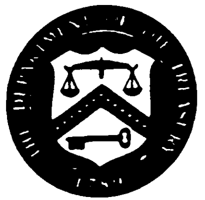
a/ Excepting 1 tender of $20,000.
Tenders at the high discount rate were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 24,270	$ 19,270
New York	30,443,110	8,657,255
Philadelphia	11,700	11,700
Cleveland	18,345	18,345
Richmond	22,685	22,685
Atlanta	16,685	15,685
Chicago	1,240,420	36,320
St. Louis	20,945	14,945
Minneapolis	10,230	10,230
Kansas City	24,660	24,660
Dallas	10,415	10,415
San Francisco	1,230,245	35,245
Treasury	159,440	159,440
TOTALS	$33,233,150	$9,036,195
Type		
Competitive	$29,713,655	$5,516,700
Noncompetitive	504,495	504,495
Subtotal, Public	$30,218,150	$6,021,195
Federal Reserve	2,900,000	2,900,000
Foreign Official Institutions	115,000	115,000
TOTALS	$33,233,150	$9,036,195

An additional $176,800 thousand of the bills will be issued to foreign official institutions for new cash.

B-1468

// TREASURY NEWS 
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July 5, 1988

MARTOCHE ASSUMES OFFICE OF THE
ASSISTANT TREASURY SECRETARY FOR ENFORCEMENT

Salvatore R. Martoche, Assistant Secretary of Labor (Office of Labor Management Standards) has assumed the duties of the Office of Assistant Secretary of the Treasury (Enforcement) at the direction of the President.

In his new position, Mr. Martoche will take a leading role in the nation's war against illegal drugs and money laundering. He will coordinate Treasury-wide enforcement policy and supervise the following Treasury Bureaus: the U.S. Customs Service; the U.S. Secret Service; the Bureau of Alcohol, Tobacco and Firearms; and the Federal Law Enforcement Training Center. He also will oversee the Office of Foreign Assets Control.

Mr. Martoche was appointed Assistant Secretary of Labor in 1986. He served as United States Attorney for the Western District of New York from 1982 to 1986. From 1969 to 1982 he was in private law practice. His practice included administrative proceedings and civil and criminal litigation.

Mr. Martoche is a 1962 graduate of Canisius College in Buffalo, New York, and a 1967 graduate of the University of North Dakota Law School. He is married to the former Mary Dee Benesh, who is also an attorney. They have three children: Amy, 17, Claire, 15, and Christopher, 13.

B-1469

TREASURY NEWS

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

Statement of
Stephen J. Entin
Deputy Assistant Secretary for Economic Policy
Department of the Treasury
before the
Subcommittee on Social Security and Family Policy
Committee on Finance
United States Senate
June 30, 1988

The Chairman and the Subcommittee are to be greatly commended for the close attention they are giving to the condition of the Social Security System and its economic influence. This is an important and complex subject which is too often ignored except when a crisis is imminent. This hearing into the long run outlook for the System is unusual in that it is being held at a time of healthy trust fund balances and rising annual surpluses, and is focusing on fundamental long term budget and growth questions which are not, and probably cannot be, addressed in the ordinary budget process.

In the last several years, the Trustees and the Social Security Administration have been working together to make more information available in the annual reports, and to present it in more useful form. Recent improvements to the Reports include provision of two intermediate scenarios, II-A and II-B; clearer presentation of the pattern of surpluses and deficits over 25 year subperiods, supplemented by the use of graphs; Appendix E, which shows the combined condition of OASI, DI and HI in terms of percents of taxable payroll; Appendix F, which shows the combined system in terms of percents of GNP; and Appendix G, which shows the long range estimates of Social Security Trust Fund operations in dollars. The material in Appendix G has been published since 1983 as a separate Actuarial Note, and was moved into the Trustees Report this year for the first time. It seems to have attracted some interest.

We shall continue to work to improve the Reports, in the hope of making them as useful as possible to the Congress, the financial community and the public. Any comments on the content and presentation of the Reports, or suggestions for additional material for inclusion, would be greatly appreciated.

I should also like to recommend to the Subcommittee a pair of just-released studies of the trust fund build-up and its possible economic and budgetary consequences. These very timely

studies were proposed, commissioned and supervised by the two Public Trustees, Suzanne D. Jaffe and Mary Falvey Fuller, with the assistance of the Department of Health and Human Services. The studies were prepared by the Brookings Institution and by Lewin-ICF, Inc.[1/] I understand that the Subcommittee has received copies. I shall draw heavily on their discussion and conclusions in this presentation, and I have appended the final chapters of each study to my statement. Chapters 2 and 5 of the full Lewin-ICF study are particularly good at conceptualizing the relevant issues and spelling out the key assumptions about fiscal choices and the reactions of the public that must be made in analyzing the problem.

Components of Social Security

Social Security comprises the major set of programs affecting the elderly. There are four parts to Social Security, each with its own trust fund. The payroll tax is used to finance three of the four parts: Old-Age and Survivors Insurance (OASI), Disability Insurance (DI), and Hospital Insurance (HI, or Medicare Part A). The fourth part, Supplemental Medical Insurance (SMI, Medicare Part B), covers physician's fees and office visits, and is financed roughly three-quarters by general revenues and one-quarter by premiums; it needs only a small trust fund, as it has a direct claim on general revenues and the premiums are adjusted annually. OASI and DI are managed by the Social Security Administration (SSA), and are frequently referred to jointly as OASDI. HI and SMI are managed by the Health Care Finance Administration (HCFA). The three programs funded by the payroll tax are often referred to jointly as OASDHI. The 1983 Social Security Amendments mandated that OASI, DI and HI (but not SMI) be moved off-budget in 1993. The Gramm-Rudman-Hollings Act accelerated the shift of OASI and DI off-budget to 1986. Consequently, OASI and DI are currently reported off-budget, HI and SMI are currently reported on-budget, and HI will be moved off-budget in 1993.

Sudden awareness of the projected trust fund build-up has led in recent weeks to considerable discussion among interested parties. Some regard it as an unexpected solution to the budget deficit problem. Others fear that that is exactly what the trust fund surplus will be used for, financing other government spending rather than preparing for the retirement of the baby boom generation. Others fear that the trust funds will swallow up the whole national debt, removing the entire supply of Treasury bonds from the financial markets, complicating monetary

1/ "Final Report to Social Security Administration, U.S. Department of Health and Human Services on Contract No. 600-87-0072 to Brookings Institution", and "Study of the Potential Economic and Fiscal Effects of Investment of the Assets of the Social Security Old-Age and Survivors Insurance and Disability Insurance Trust Funds."

policy and portfolio decisions. Some fear an even more massive build-up which could require extensive trust fund investment in, and control of, large portions of the U.S. private sector.

Before proceeding to discuss these concerns, it would be helpful to put some of these figures in perspective.

The Magnitude of the Trust Fund Build-up

Table 1, derived from Table G-1 in Appendix G of the OASDI Trustees Report, shows income, outgo, near term trust fund surpluses and subsequent deficits in both current and real 1988 dollars. It shows that the OASDI trust funds will peak at just under $12 trillion shortly after 2030 under Alternative II-B assumptions. This current dollar figure is not adjusted for inflation. Alternative II-B assumes an average of 4 percent inflation over the next 75 years. As shown in Graph 1 and Table 1, the OASDI trust fund peaks in real terms shortly after 2020 at nearly $2.6 trillion in terms of real 1988 dollars. Alternative II-B projects that nominal GNP in 2030 will be nearly $55 trillion. Real GNP in 2020 will be about $8.9 trillion in real 1988 dollars.

Looking only at the off-budget OASDI trust funds neglects HI. HI is currently in surplus, but it will begin running deficits in 1993 under Alternative II-B assumptions. Its trust fund will be exhausted by 2005. The combined OASDHI trust fund build-up is much smaller than that of OASDI. Graph 2 compares in real terms the OASDI and combined OASDHI trust funds. In real 1988 dollars, the OASDI funds peak at $2.6 trillion in 2022, while the combined OASDHI trust fund peaks at $1.7 trillion in 2016, six years earlier.

Another perspective can be gained by looking at the source of the trust fund build-up. Table 1 shows that over half of the annual surpluses of the OASDI system after 2005 are due to interest from the general fund. Between 2015 and 2020, OASDI tax income, excluding interest, falls below outlays, and more than 100 percent of the build-up of the trust fund from $9 trillion to $12 trillion is due to the interest transfer from general revenues. (See also Table 3.) Table 2 shows the same pattern emerging earlier for the combined OASDHI system. The interest element of these surpluses, and this interest-related build-up, are an intra-government transfer. They do not contribute to a surplus for the unified budget, and are not part of the net impact of the OASDI system on the financing needs of the government or on the credit markets.

The unified budget impacts of OASDI and OASDHI are shown in Table 3 in current and real 1988 dollars, and in Table 4 in terms of percent of taxable payroll and GNP. It is the unified budget impact of OASDI, income excluding interest less outlays, which measures the impact of OASDI on the credit markets. As OASDI's outlays begin to exceed its tax revenues between 2015 and 2020,

OASDI will be increasing rather than reducing the Federal Government's borrowing from the credit markets. HI begins to run deficits on this basis in 1993. For the OASDHI system, the annual deficits excluding interest begin between 2010 and 2015.

Thus, the trust fund build-up overstates the net contribution of OASDI and OASDHI toward financing the unified budget deficit. Tables 3 and 4 show that the OASDI surpluses excluding interest never exceed $75 billion in real 1988 dollars and 1.1 percent of GNP. The more distant OASDI deficits are roughly 1.4 percent of GNP. The peak OASDHI surplus occurs in the next few years at about 0.85 percent of GNP, and the outyear combined deficits are slightly over 3 percent of GNP.

Macroeconomic Impact

The Brookings and the Lewin-ICF papers reach broadly similar conclusions concerning the key elements of the macroeconomic impact of a trust fund build-up. Some of these are straightforward; others are quite surprising. One of the most interesting points is that the impact of the trust fund build-up has little to do with Social Security, and is instead primarily dependent on how other elements of the economy act or react.

One commonly hears that the trust fund build-up is designed to pay for the retirement benefits of the large baby-boom generation. Of course, the trust funds themselves do not represent real goods and services to be consumed by future retirees. What is meant by the statement is that the OASDI surplus is expected to increase government saving, which in turn is expected to increase national saving, investment, productivity and real output. Under such conditions, future real benefits would be paid out of the increased real output of the economy, without lowering the real income of future workers. Whether this scenario plays out as stated, however, depends on many factors, which are analyzed in depth by Brookings and ICF.

Government Saving.

Both studies conclude that the effect of the OASDI Trust Fund build-up on the economy depends heavily on the overall fiscal behavior of the government. ICF states:

> The accumulation of Treasury obligations by the OASDI trust funds, in itself, will not provide real resources to pay future benefits nor directly affect the economy. If the current and projected OASDI surpluses are used to finance other government spending, and there is no increase in net government savings, the surpluses will not contribute to the accumulation of real resources that could be used to fund future social security outlays.

Because of the demographic configuration, major increases in both OASDI and Medicare expenditures will be required in the 21st century. The burden of those expenditures must be born by the working population at that time. If those future workers are to be endowed with increased resources to help them bear that burden, current savings and capital accumulation must be increased.

ICF and Brookings ran scenarios in which the OASDI surpluses financed portions of other government spending for the next 25 to 30 years, followed by a period in which OASDI deficits were financed by non-OASDI surpluses. This yielded results only slightly better than the baseline Alternative II-B projections for GNP, productivity and wages.

Both studies then ran other scenarios in which the non-OASDI budget balance was stabilized so that movements in OASDI trust fund surpluses and deficits were reflected dollar for dollar in changes in government saving. (Brookings assumed that policy changes would reduce the non-OASDI budget deficit to 1.5 percent of GNP in the 1990s and stabilize it at that level. ICF assumed the non-OASDI budget would be balanced.) In other words, both scenarios assumed that the trust fund build-up would be allowed to increase government saving through about 2030, after which the trust fund drawdown would reduce government saving.

National Saving.

Net changes in government saving have the potential to affect GNP. However, both studies point out that an increase in government saving might not translate into increased capital formation, due to reduced private saving. ICF suggests that a complementary set of policies to promote saving and investment would be required to ensure the desired outcome.

It is widely accepted that movements in government saving are commonly offset to some greater or lesser degree by counter-movements in private sector saving, thereby reducing the effect on national saving. The studies give several reasons.

- Higher taxes may reduce disposable income and saving directly.
- A reduced budget deficit, if it has adverse demand effects on the economy, may reduce growth, income and saving.
- Higher capital formation, if it occurs, may reduce the rate of return on capital, lower interest rates, and reduce saving insofar as saving is interest sensitive.
- A lower rate of return on capital domestically might result in some additional saving being diverted abroad, reducing the domestic capital build-up.

- o Taxpayers may see the drop in the Government deficit as relief from the prospect of higher future taxes. This would increase perceived "permanent income" and lead to greater private consumption (the Barro effect).

A recent study (The Impact of Government Deficits on Personal and National Saving Rates) by Darby, Gillingham and Greenlees of the Office of Economic Policy, U.S. Treasury, supports this concern. The study also notes that the degree to which a reduction in the Federal deficit is offset by lower private saving is sensitive to the method of deficit reduction, at least in the short term.

- o The study found that after one year, a $1 increase in taxes, holding government spending constant, leads to roughly a $0.20 increase in national saving because the $1 increase in government saving (decrease in the government deficit) is offset by an $0.80 decline in private saving. In other words, national saving increases as a result of a tax increase by only the 20-cents-on-the-dollar consumer expenditure cut which it induces.

- o In contrast, a $1 decrease in government spending, holding taxes constant, would cause a much larger $0.80 increase in national saving. Specifically, after one year, the spending decrease increases government saving by $1 which would be offset by only a $0.20 increase in consumption and decline in private saving, thus increasing national saving by $0.80.

- o Although these two fiscal actions have the same impact on the budget deficit, a spending decrease has approximately four times the short-run impact on national savings of a tax increase.

Higher Investment and Capital Formation.

Assuming no adverse saving offset, the Brookings and Lewin-ICF studies went on to demonstrate that if national capital accumulation were increased by an amount equal to the OASDI Trust Fund accumulation, the productivity, output, and income of the economy would increase. According to ICF,

> If additional capital investment matches the trust fund accumulation during this period, GNP could be increased by two to four percent, compared to what it would be with no additional investment. The greater capital stock and national output could help fund the greater outlays that will be required after 2020 by (1) permitting a greater level of consumption out of current income, and (2) permitting an increase in consumption at the cost of a reduction in capital

accumulation during the period when the trust fund is being drawn down to finance outlays.

Longer Term Consequences.

Both studies make the surprising point that, under these assumptions, OASDI Trust Fund accumulation and increased national capital accumulation will not significantly help the long term OASDI financing problem, if existing tax and benefit provisions are not changed.

ICF states, "Increased capital accumulation would increase national output and income and increase the level of real resources that can be used to pay the increased OASDI outlays. However, under existing OASDI tax and benefit provisions, increased national income generated by domestic investment will not improve the long term OASDI financial imbalances."

This non-intuitive result, emphasized both by Brookings and ICF, comes from a peculiar feature of the tax and benefit provisions of the OASDI System. Both tax revenues and benefit levels earned by newly retired workers are linked to wages. (The benefit formula is described in Appendix D of the OASDI Report.) As higher saving and investment rates improve productivity, real wages will rise. Higher wages result in higher tax receipts very quickly, improving the OASDI balance. However, the higher wages result in higher benefit levels, in the same proportion, about 15 to 20 years later. Because benefits exceed income under current assumptions, an equal percent increase in wages, revenues and benefits ultimately would raise the OASDI deficit. Furthermore, the assumed lower interest rates accompanying the higher capital stock will reduce OASDI interest earnings and trust fund balances over the period relative to the baseline, resulting in an even greater degree of dissaving toward the end of the period, and a faster trust fund drawdown.

Both papers indicate that a faster trust fund drawdown, and larger national dissaving, should they materialize mechanically in this fashion, could ultimately depress the capital stock and GNP below the baseline projections. Consequently, the improvements in the economy would be temporary. This conclusion is based on the admittedly unrealistic assumption built into the presentations for expositional purposes that Congress would permit the trust funds to become exhausted in this fashion, and permit the unified budget to deteriorate. It also assumes that the improvement in the rest of the budget due to faster growth and lower interest outlays would automatically be spent.

- An illustration of the link between wages and benefits is provided in Table 7. The wage-linked benefit formula provides a nearly constant replacement rate (benefits as a percent of preretirement income) over the next 75 years for retired workers who earned the average wage. There will be some adjustments to upper income replacement rates

due to the sharp increase in the maximum covered wage in the 1977 Amendments, resulting in an increase in upper income replacement rates through 2015. Thereafter, upper income replacement rates will stabilize.

- Between 1988 and 2065, the real wage of the average wage worker in the year prior to age 65 retirement will rise 175 percent in real terms, from $18,553 for the 1988 retiree to $50,934 for the 2065 retiree (all in real 1988 dollars). The benefit upon first retiring, assuming the worker had always earned the average wage and worked full time, will rise 169 percent (closely matching the 175 percent rise in real wages), from $7,534 for the 1988 retiree to $20,303 for the 2065 retiree (in real 1988 dollars). For a married worker with a spouse receiving spousal benefits, these figures would be 50 percent larger, or $11,301 in 1988 and $30,455 in 2065 (in real 1988 dollars).

- A single worker who has always earned the maximum covered wage would have real wages in the year before age 65 retirement of $45,508 for the 1988 retiree and $120,233 for the 2065 retiree (all in 1988 dollars), up 164 percent, and benefits of $10,095 in 1988 versus $31,990 in 2065 (in 1988 dollars), a difference of 217 percent in real terms. For a couple with spousal benefit, the benefits in real 1988 dollars would be $15,143 in 1988 and $47,985 in 2065.

- Faster real wage growth than assumed in Alternative II-B would push real benefits up proportionally, and widen projected long run deficits.

Uncertainty.

It should be emphasized that the Brookings and ICF projections of a weaker GNP 50 to 75 years from now are subject to great uncertainty. They depend heavily on the assumption that an accelerated trust fund drawdown will be permitted to reduce national saving in the distant future below the baseline projection. However, it is unlikely that the non-OASDI deficit will be held strictly to the paths assumed in the two studies, and it is certain that Congress will act to restore solvency to the trust funds before they are exhausted. Thus, there are steps that could be taken to preserve the stronger economy and prevent the projected trust fund drawdown from depressing saving and per capita GNP. The non-OASDI budget could be allowed to move into greater surplus, boosted by the stronger assumed GNP and lower interest rates, as the OASDI program begins to run deficits in the outyears, or the OASDI balance could be improved through tax changes, alteration of the benefit formula, or changes in retirement age or other parameters of the program.

Investing the Trust Funds

Under current law, OASDI receipts in excess of amounts needed for benefit payments are invested in U.S. Government securities. For the most part, these are special, non-marketable Treasury securities which are sold only to the trust funds, and which by law pay interest at the average rate on marketable Treasury securities outstanding with four years or more to maturity. Unlike ordinary securities, these special securities may always be redeemed at par. This provision shelters the trust funds from the risk of price fluctuations in the event that market interest rates change. The funds may also invest in ordinary marketable Treasury securities, or other securities guaranteed as to principle and interest by the United States.

During the period of trust fund build-up, the OASDI trust funds have the potential to absorb most or all of the outstanding and projected Treasury obligations held by the public. Other things equal, this debt would then be reissued to the public as the trust funds were drawn down during subsequent periods of deficit.

If the non-OASDI portion of the budget were to run deficits averaging 1.5 to 2.0 percent of GNP over the next 40 years (roughly equal to the post World War II average of 1.7 percent), the share of Treasury obligations in the hands of the public would be greatly diminished, but the public's holdings would probably not be eliminated entirely. If the non-OASDI budget were balanced, or brought close to balance, then the trust fund build-up could eliminate holdings of Treasury securities by the public for some period of time.

A sharp reduction in Treasury debt held by the public could result in some reduction in interest rates paid on Treasury debt. However, there is a wide range of securities which are reasonably close substitutes for one another, and it is unlikely that a sharp skewing of interest rates would occur. The financial markets could cope with a markedly lower share of Treasury securities in the total pool of financial instruments. Lewin-ICF points out that the share of Treasuries in total credit market paper has fluctuated widely over the last 40 years with little impact on interest rates.

Nonetheless, ICF recommends that Treasury securities should not be eliminated entirely, because of their useful characteristics of low risk, liquidity and diversity of maturities, traits of particular importance to many fiduciary institutions. ICF suggests that, if the need should arise, the trust funds might obtain securities of other Federal agencies, or that additional special assets could be created for the trust funds without eliminating all marketable Treasury securities. Both Brookings and ICF point to the rising volume of government guaranteed mortgage instruments, such as GNMA securities, as possible investment alternatives for the trust funds. These securities

will expand in volume as the economy grows, and could provide a large pool of safe securities should the trust funds show signs of absorbing an excessive share of Treasury obligations.

A substantial portion of Treasury securities is held by the Federal Reserve. The Fed manages monetary policy by injecting or withdrawing bank reserves by buying or selling these securities. The Fed prefers to deal in a very liquid market where its activities create the minimum disruption, and finds the Treasury bill market ideal. Nonetheless, the Fed has the authority to deal in a wide range of securities, and would not face insurmountable obstacles in the event of a sharp reduction in the supply of Treasury obligations.

Neither Brookings nor Lewin-ICF sees much economic impact from alternative investment strategies for the trust funds. Certainly, barring substantial improvement in the rest of the budget, such a shift would be of limited economic impact. If the trust funds were to lend to private sector borrowers instead of the Treasury, more of the Treasury debt would have to be held by the public. The trust funds would hold some of the non-Treasury securities the public would otherwise hold. Total debt, saving and capital formation would be unaffected. The public's portfolio would be somewhat less risky, the trust fund's portfolio somewhat more risky.

Aggressive movement of the funds into equities and other private securities would entail higher risk of loss or default than Treasury obligations, a risk unsuitable to the social policy goal of the programs. If ownership of equities or private sector bonds were contemplated, significant problems would arise as to potential federal control of corporations, the allocation of investment resources, and the conduct of business. We recommend against such involvement.

Conclusion

The OASDI trust fund build-up should be put into perspective with respect to GNP, inflation and projected deficits in other parts of the Social Security System and the rest of the budget, and the projected outyear deficits of OASDI.

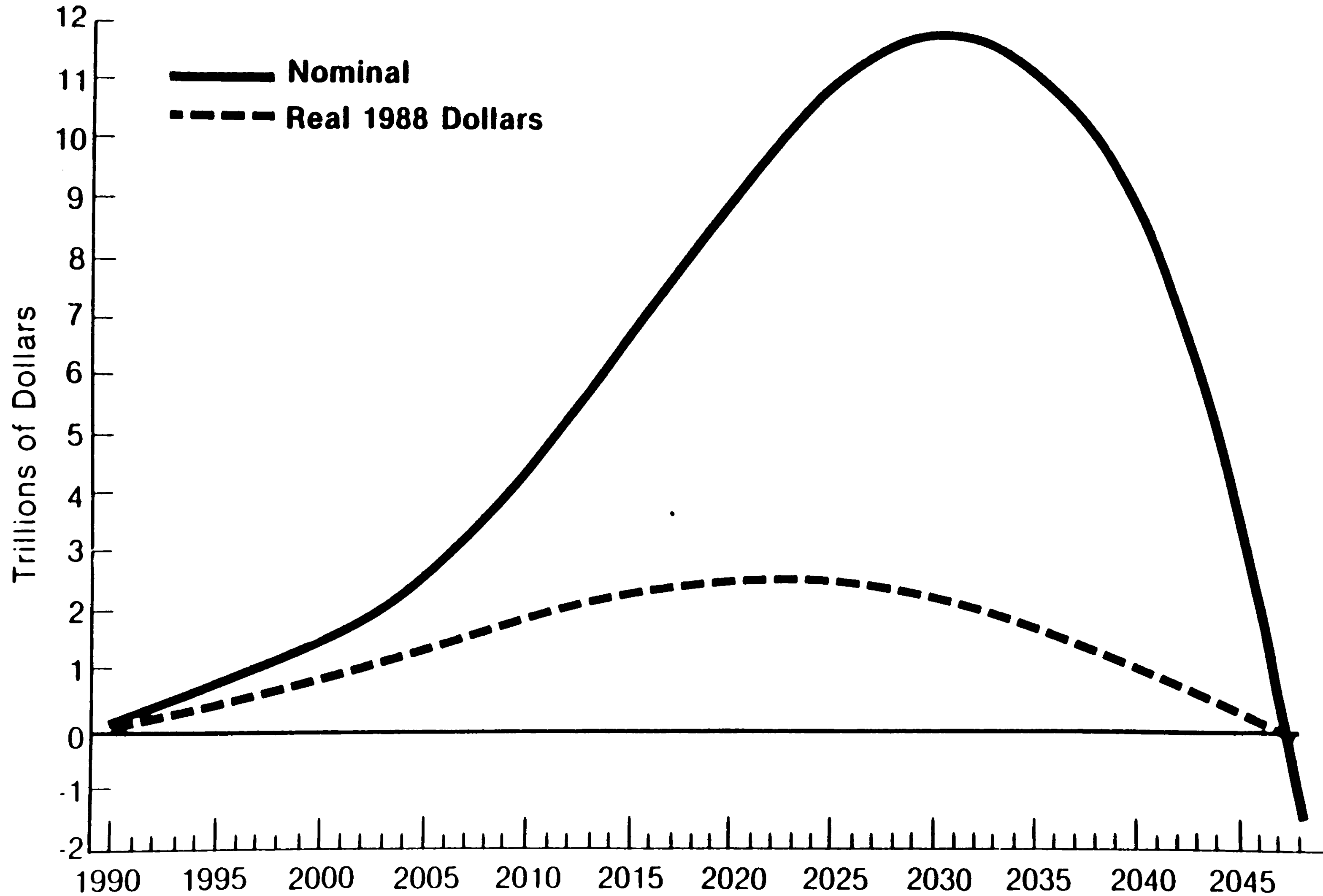
The economic impact of the trust fund surpluses will depend on what happens to the rest of the budget. According to studies by Brookings and Lewin-ICF, if the OASDI surpluses are used to finance other government outlays, little additional capital formation will occur. If the rest of the budget moves close to balance, and if the trust fund surpluses and subsequent deficits were translated into domestic saving and investment, they would first raise and then lower GNP, wages, and real output. Output could be 2 to 4 percent higher than otherwise in real terms prior to the drawdown of the trust funds in the 2030s and 2040s.

This projection could be muted by a number of factors. The changes in government saving could be largely offset by counter-movements in private saving with little change in national saving. Even if national saving did rise prior to 2030, domestic capital formation would not be assured in the absence of improved tax treatment; saving might move abroad rather than raise investment in the U.S. Beyond 2030, the beneficial effects of the build-up eventually could be more than reversed by greater dissaving, and the balance of OASDI would be worsened. The earlier gains in real wages would raise real OASDI benefits via the wage-linked benefit formula, leading to higher OASDI deficits and a reduced government saving rate. This result is dependent on the assumption of a fixed deficit path in the rest of the budget, and could be altered by assuming rising surpluses in the rest of the budget, or changes in the tax rate, benefit formula, retirement age or other features of the OASDI system.

The trust fund build-up may reduce or eliminate publicly held Treasury debt, depending on what one assumes regarding the deficit of the rest of the budget. This debt would be reissued in later years of OASDI deficit. Credit markets should be able to cope with such shifts as they have in the past without major changes in interest rates. Alternatively, other investment options, such as federally backed mortgage instruments, would be a secure investment option. There is ample time to explore this issue, which may never arise in practice.

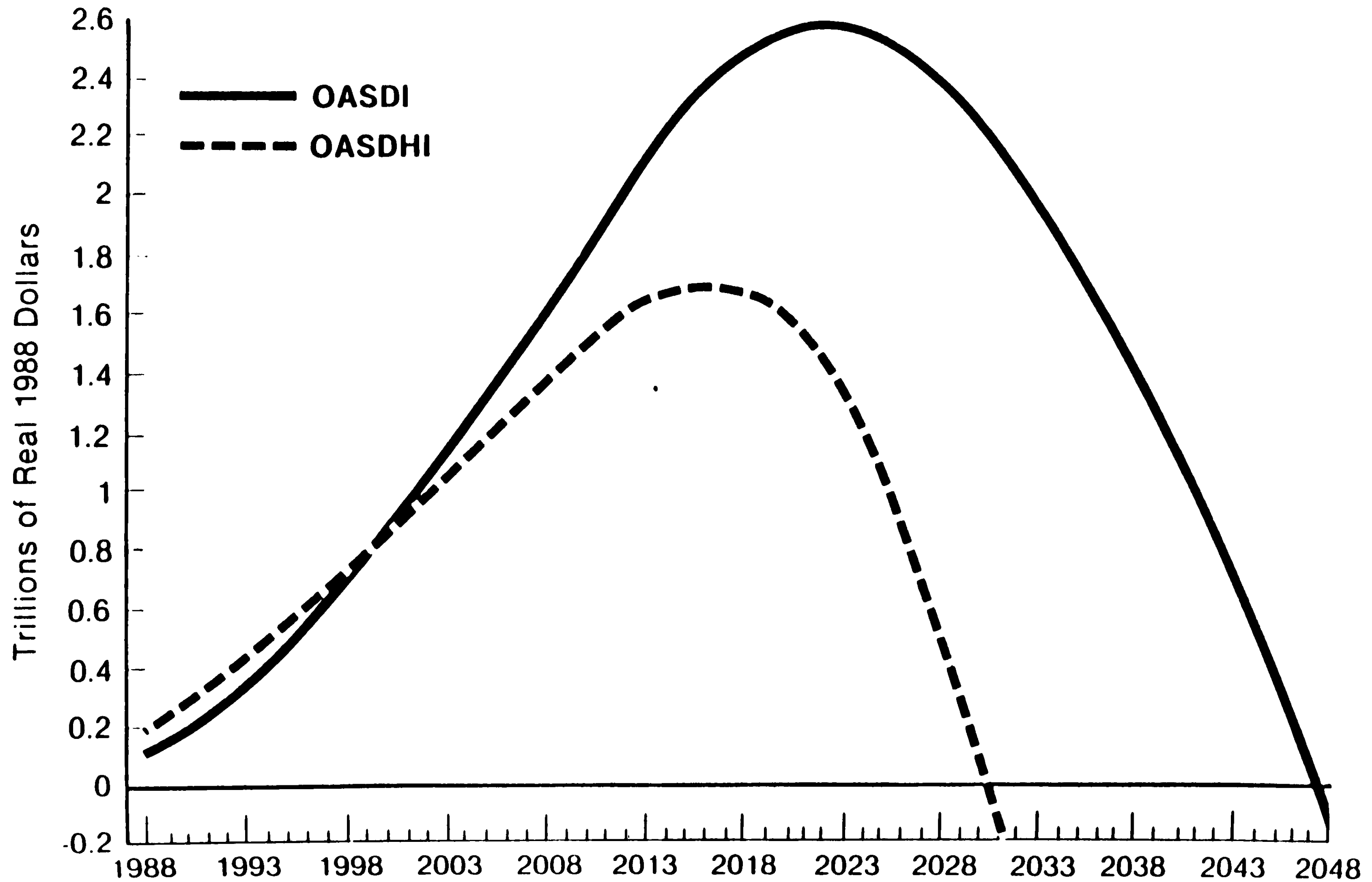
Graph 1

END OF YEAR OASDI TRUST FUND ASSETS ALT IIB, 1988 TRUSTEES REPORT



Graph 2

REAL END OF YEAR TRUST FUND ASSETS ALT IIB, 1988 TRUSTEES REPORT



Graph 3

OASDI and OASDHI Income and Outgo Under Present Law, 1988 Alternative II-B

(Percent of Taxable Payroll)

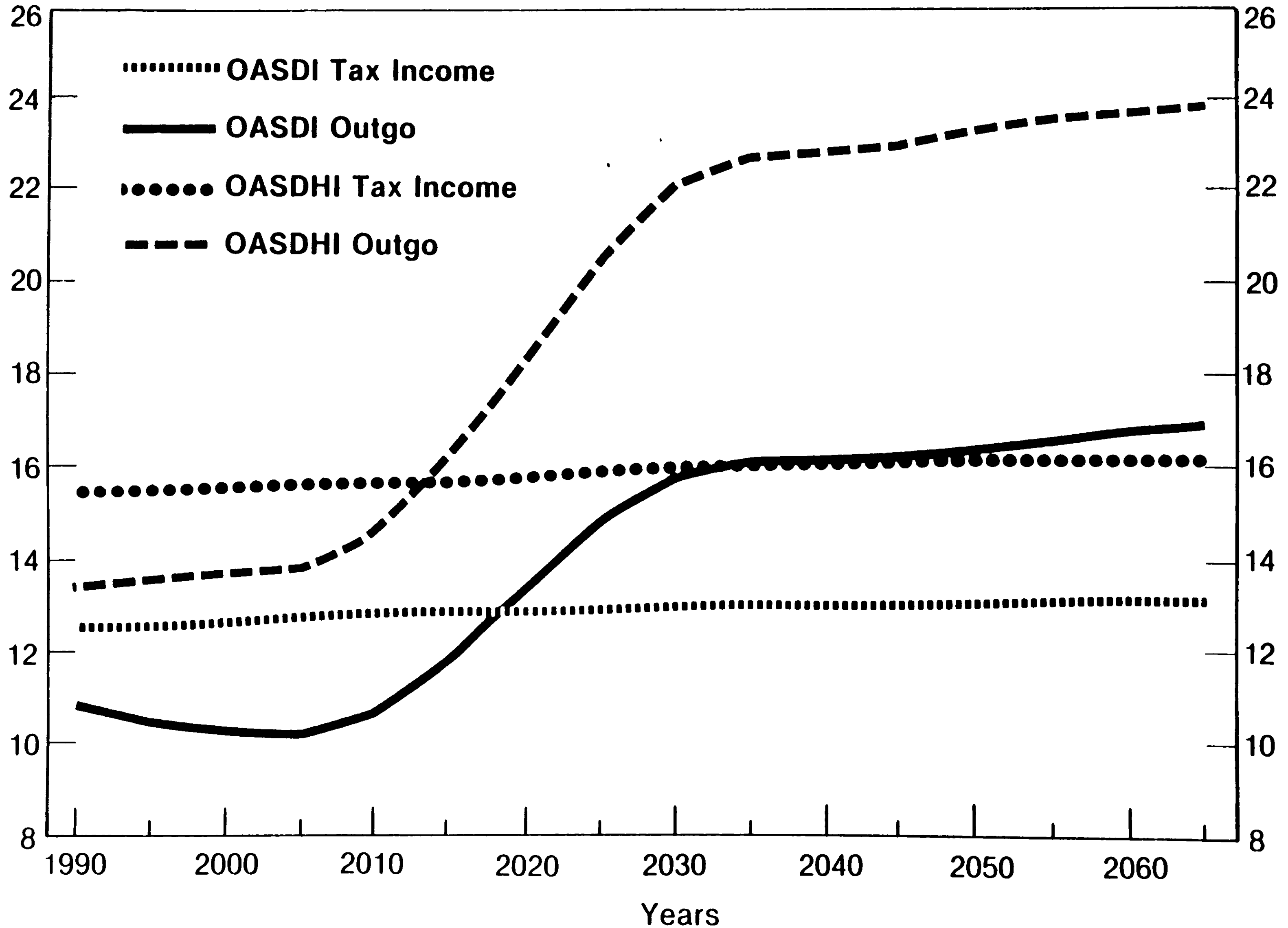


Table 1

Estimated Operations of the OASI and DI Trust Funds
(billions of dollars)

Calendar Year	Income Excluding Interest	Interest	Total Income	Total Outgo	Assets at End of Year
		Current Dollars			
1988	254.7	8.0	262.7	222.4	109.1
1990	293.3	16.3	309.5	252.2	211.9
1995	403.2	44.8	447.9	338.3	645.5
2000	547.9	83.6	631.5	446.8	1,409.4
2005	739.9	146.4	886.3	595.1	2,632.5
2010	987.4	250.5	1,237.9	825.8	4,460.6
2015	1,302.6	383.7	1,686.3	1,203.7	6,763.0
2020	1,703.0	523.2	2,226.2	1,775.4	9,124.3
2025	2,220.3	636.7	2,857.0	2,549.4	10,996.2
2030	2,898.7	692.0	3,590.7	3,524.5	11,837.5
2035	3,788.2	664.4	4,452.6	4,703.2	11,240.0
2040	4,937.8	532.8	5,470.6	6,121.7	8,840.4
2045	6,422.5	251.8	6,674.3	7,966.8	3,799.4
2050	8,349.6	-282.2	8,067.4	10,464.9	-5,744.6
2055	10,867.1	-1,238.2	9,628.9	13,797.0	-22,752.8
2060	14,159.3	-2,836.9	11,322.4	18,109.0	-51,053.9
2065	18,443.8	-5,374.2	13,069.6	23,662.1	-95,828.2
		Real (1988) Dollars			
1988	254.7	8.0	262.7	222.4	109.1
1990	268.9	14.9	283.8	231.3	193.5
1995	303.3	33.7	336.9	254.5	485.6
2000	338.7	51.7	390.4	276.2	871.3
2005	376.0	74.4	450.3	302.4	1,337.6
2010	412.4	104.6	517.0	344.9	1,863.0
2015	447.1	131.7	578.9	413.2	2,321.6
2020	480.5	147.6	628.1	500.9	2,574.4
2025	514.9	147.6	662.5	591.2	2,550.1
2030	552.5	131.9	684.4	671.8	2,256.3
2035	593.5	104.1	697.6	736.8	1,760.9
2040	635.8	68.6	704.4	788.3	1,138.4
2045	679.7	26.6	706.4	843.2	402.1
2050	726.3	-24.5	701.8	910.4	-499.7
2055	777.0	-88.5	688.5	986.5	-1,626.8
2060	832.1	-166.7	665.4	1,064.2	-3,000.3
2065	890.9	-259.6	631.3	1,143.0	-4,628.8

The top panel is from Table G1 of the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds; the lower panel is derived from the upper panel using the adjusted CPI in Table G2 of the Report.

Table 2

Estimated Operations of the OASDI and HI Trust Funds
(billions of dollars)

Calendar Year	Income Excluding Interest	Interest	Total Income	Total Outgo	Assets at end of year
		Current Dollars			
1988	317.1	15.7	332.8	276.7	200.3
1990	363.5	26.0	389.5	317.9	318.2
1995	499.6	53.2	552.8	441.5	750.0
2000	678.4	84.6	763.0	600.9	1,405.5
2005	915.4	131.5	1046.9	817.5	2,340.5
2010	1221.3	204.2	1,425.5	1,145.1	3,613.9
2015	1,609.4	283.4	1,892.8	1,662.4	4,970.0
2020	2,101.3	330.8	2,432.1	2,448.4	5,715.6
2025	2,736.4	283.2	3,019.5	3,540.6	4,745.1
2030	2,569.5	56.2	3,625.6	4,949.4	596.9
2035	4,663.0	-431.0	4,232.1	6,675.9	-8,103.9
2040	6,077.6	-1,282.5	4,795.1	8,765.7	-2,3149.3
2045	7,904.4	-2,642.5	5,261.9	11,448.3	-47,072.0
2050	10,274.5	-4,751.0	5,523.4	15,036.1	-84,118.1
2055	13,369.6	-7,725.6	5,644.0	19,805.5	-136,392.1
2060	17,417.6	-12,497.9	4,919.7	26,022.2	-220,101.4
2065	22,686.6	-19,559.8	3,126.8	34,014.5	-343,818.1
		Real (1988) Dollars			
1988	317.1	15.7	332.8	276.7	200.3
1990	333.3	23.8	357.1	291.5	291.8
1995	375.8	40.0	415.8	332.1	564.1
2000	419.4	52.3	471.7	371.1	868.9
2005	465.1	66.8	532.0	415.4	1,189.3
2010	510.1	85.3	595.4	478.3	1,509.3
2015	552.5	97.3	649.8	570.7	1,706.1
2020	592.9	93.3	686.2	690.8	1,612.6
2025	634.6	65.7	700.2	821.1	1,100.4
2030	680.4	10.7	691.1	943.4	113.8
2035	730.5	-67.5	663.0	1,045.9	-1,269.6
2040	782.6	-165.1	617.5	1,128.7	-2,980.9
2045	836.6	-279.7	556.9	1,211.7	-4,982.0
2050	893.8	-413.3	480.5	1,308.0	-7,317.5
2055	955.4	-570.4	385.6	1,416.1	-10,064.8
2060	1,023.6	-754.0	269.6	1,529.3	-13,274.8
2065	1,095.8	-966.0	129.8	1,643.0	-16,976.9

Treasury estimates derived from data underlying the 1988 Trustees Report.

Table 3

Unified Budget Impact of Projected OASDI and HI Surpluses and Deficits (Excludes Interest) in Current and Constant Dollars (Alternative II-B) (billions of dollars)

	Current Dollars			Real (1988) Dollars		
YEAR	OASDI	HI	TOTAL	OASDI	HI	TOTAL
1988	32.30	8.10	40.40	32.30	8.10	40.40
1990	41.00	4.50	45.50	37.59	4.13	41.72
1995	64.90	-6.80	58.10	48.82	-5.11	43.71
2000	101.10	-23.60	77.50	62.50	-14.59	47.91
2005	144.80	-46.90	97.90	73.58	-23.83	49.75
2010	161.60	-85.40	76.20	67.49	-35.67	31.82
2015	98.90	-151.90	-53.00	33.95	-52.14	-18.19
2020	-72.40	-274.70	-347.10	-20.43	-77.50	-97.93
2025	-329.10	-475.10	-804.20	-76.32	-110.18	-186.50
2030	-625.80	-754.10	-1379.90	-119.28	-143.74	-263.02
2035	-915.00	-1097.80	-2012.80	-143.35	171.99	-315.34
2040	-1183.90	-1504.10	-2688.00	-152.45	-193.68	-346.13
2045	-1544.30	-1999.60	-3543.90	-163.44	-211.63	-375.07
2050	-2115.30	-2646.30	-4761.60	-184.01	-230.20	-414.21
2055	-2929.90	-3506.00	-6435.90	-209.49	-250.68	-460.17
2060	-3949.70	-4654.80	-8604.50	-232.12	-273.55	-505.67
2065	-5218.30	-6109.60	-11327.90	-252.06	-295.11	-547.17

SOURCE: These figures have been derived from numbers presented in the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Tables G2 and G3; for 2065, additional information was provided by the Social Security Administration.

Table 4

Unified Budget Impact of Projected OASDI and HI Surpluses and Deficits (Excludes Interest) as Percent of Taxable Payroll and Percent of GNP (Alternative II-B)

	Percent of Payroll			Percent of GNP		
YEAR	OASDI	HI	TOTAL	OASDI	HI	TOTAL
1988	1.56	0.38	1.94	0.68	0.17	0.85
1990	1.79	0.19	1.98	0.76	0.08	0.85
1995	2.07	-0.21	1.86	0.88	-0.09	0.78
2000	2.37	-0.52	1.85	1.01	-0.23	0.77
2005	2.53	-0.78	1.75	1.07	-0.34	0.72
2010	2.53	-1.06	1.07	0.89	-0.47	0.42
2015	1.02	-1.44	-0.42	0.41	-0.63	-0.22
2020	-0.51	-2.00	-2.51	-0.23	-0.87	-1.10
2025	-1.89	-2.67	-4.56	-0.80	-1.15	-1.95
2030	-2.78	-3.26	-6.04	-1.16	-1.39	-2.55
2035	-3.12	-3.64	-6.76	-1.28	-1.54	-2.83
2040	-3.10	-3.83	-6.92	-1.26	-1.61	-2.87
2045	-3.11	-3.91	-7.02	-1.26	-1.63	-2.88
2050	-3.28	-3.99	-7.27	-1.31	-1.64	-2.95
2055	-3.50	-4.06	-7.56	-1.38	-1.66	-3.04
2060	-3.62	-4.14	-7.77	-1.42	-1.67	-3.09
2065	-3.68	-4.18	-7.85	-1.43	-1.67	-3.10

SOURCE: OASDI and HI percentages were obtained from the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Tables 26 and E3; respectively. Additional information, for 2065, was provided by the Social Security Administration.

Table 5

CONTRIBUTION RATES FOR THE OASDI AND HI PROGRAMS

Calendar years	Contribution rates (percent)					
	Employees and employers, combined			Self-employed		
	OASDI	HI	Total	OASDI	HI	Total
1966	7.70	0.70	8.40	5.80	0.35	6.15
1967	7.80	1.00	8.80	5.90	0.50	6.40
1968	7.60	1.20	8.80	5.80	0.60	6.40
1969-70	8.40	1.20	9.60	6.30	0.60	6.90
1971-72	9.20	1.20	10.40	6.90	0.60	7.50
1973	9.70	2.00	11.70	7.00	1.00	8.00
1974-77	9.90	1.80	11.70	7.00	0.90	7.90
1978	10.10	2.00	12.10	7.10	1.00	8.10
1979-80	10.16	2.10	12.26	7.05	1.05	8.10
1981	10.70	2.60	13.30	8.00	1.30	9.30
1982-1983	10.80	2.60	13.40	8.05	1.30	9.35
1984[1]	11.40	2.60	14.00	11.40	2.60	14.00
1985[1]	11.40	2.70	14.10	11.40	2.70	14.10
1986-1987[1]	11.40	2.90	14.30	11.40	2.90	14.30
1988-89[1]	12.12	2.90	15.02	12.12	2.90	15.02
1990 and later	12.40	2.90	15.30	12.40	2.90	15.30

[1]See section entitled "Nature of the Trust Funds", OASDI Trustees Report, for description of tax credits allowed against the combined OASDI and HI taxes on net earnings from self-employment in 1984-89.

TABLE 6—COMPARISON OF ESTIMATED TOTAL INCOME RATES AND COST RATES FOR THE OASI, DI, AND HI PROGRAMS, BY ALTERNATIVE, CALENDAR YEARS 1988-2060
(As a percentage of taxable payroll[1])

Calendar year	Total income rate	Cost rate: OASI	DI	HI[2]	Total	Balance[3]
Alternative I						
1988	15.19	9.58	1.06	2.50	13.13	2.06
1989	15.20	9.46	1.04	2.51	13.01	2.19
1990	15.48	9.39	1.01	2.59	13.00	2.48
1991	15.50	9.27	.99	2.63	12.89	2.61
1992	15.50	9.15	.98	2.66	12.78	2.72
1993	15.50	9.01	.97	2.68	12.65	2.85
1994	15.50	8.87	.96	2.70	12.53	2.97
1995	15.50	8.75	.97	2.72	12.44	3.06
1996	15.50	8.63	.97	2.74	12.34	3.15
1997	15.50	8.53	.98	2.74	12.25	3.24
2000	15.54	8.17	1.01	2.75	11.92	3.61
2005	15.59	7.76	1.09	2.70	11.56	4.02
2010	15.63	7.90	1.22	2.67	11.79	3.84
2015	15.69	8.75	1.29	2.67	12.71	2.98
2020	15.76	9.93	1.33	2.78	14.04	1.72
2025	15.81	10.82	1.38	2.98	15.18	.63
2030	15.84	11.27	1.35	3.17	15.79	.05
2035	15.85	11.23	1.31	3.31	15.85	.00
2040	15.84	10.87	1.30	3.40	15.57	.27
2045	15.83	10.55	1.32	3.44	15.32	.51
2050	15.83	10.42	1.33	3.48	15.23	.60
2055	15.83	10.37	1.32	3.52	15.21	.62
2060	15.83	10.29	1.31	3.56	15.16	.67
Alternative II-A						
1988	15.19	9.61	1.08	2.51	13.21	1.98
1989	15.20	9.55	1.07	2.56	13.18	2.03
1990	15.48	9.57	1.05	2.68	13.30	2.19
1991	15.50	9.49	1.04	2.75	13.29	2.22
1992	15.51	9.40	1.03	2.82	13.25	2.26
1993	15.51	9.31	1.03	2.89	13.24	2.27
1994	15.51	9.23	1.04	2.96	13.23	2.28
1995	15.51	9.15	1.05	3.03	13.22	2.28
1996	15.51	9.06	1.06	3.10	13.22	2.29
1997	15.51	8.99	1.08	3.15	13.22	2.29
2000	15.56	8.73	1.12	3.31	13.17	2.39
2005	15.62	8.44	1.26	3.53	13.23	2.39
2010	15.68	8.68	1.44	3.77	13.90	1.78
2015	15.74	9.72	1.55	4.12	15.38	.36
2020	15.83	11.18	1.60	4.66	17.44	-1.62
2025	15.90	12.45	1.69	5.29	19.44	-3.53
2030	15.95	13.32	1.68	5.85	20.85	-4.90
2035	15.98	13.65	1.65	6.22	21.51	-5.53
2040	15.98	13.60	1.65	6.40	21.65	-5.66
2045	15.99	13.54	1.71	6.48	21.74	-5.75
2050	16.00	13.70	1.74	6.55	22.00	-6.00
2055	16.02	13.93	1.73	6.63	22.29	-6.27
2060	16.02	14.07	1.72	6.70	22.49	-6.46
Alternative II-B						
1988	15.19	9.65	1.08	2.52	13.25	1.94
1989	15.20	9.65	1.08	2.58	13.30	1.90
1990	15.50	9.74	1.07	2.71	13.52	1.98
1991	15.51	9.73	1.07	2.80	13.60	1.91
1992	15.52	9.68	1.06	2.88	13.62	1.89
1993	15.52	9.62	1.06	2.95	13.63	1.89
1994	15.52	9.54	1.07	3.03	13.64	1.88
1995	15.52	9.47	1.07	3.11	13.65	1.86
1996	15.52	9.40	1.09	3.18	13.66	1.86
1997	15.52	9.33	1.10	3.23	13.66	1.85
2000	15.57	9.14	1.16	3.42	13.72	1.85
2005	15.65	8.91	1.31	3.68	13.89	1.75
2010	15.71	9.18	1.49	3.96	14.63	1.07
2015	15.78	10.26	1.60	4.34	16.20	-.42
2020	15.87	11.81	1.66	4.90	18.37	-2.51
2025	15.94	13.18	1.76	5.57	20.50	-4.56
2030	16.00	14.14	1.74	6.16	22.04	-6.04
2035	16.03	14.54	1.71	6.54	22.79	-6.76
2040	16.03	14.52	1.71	6.73	22.96	-6.92
2045	16.04	14.47	1.78	6.81	23.06	-7.02
2050	16.05	14.63	1.80	6.89	23.32	-7.27
2055	16.06	14.86	1.80	6.96	23.62	-7.56
2060	16.07	15.02	1.78	7.04	23.84	-7.77
Alternative III						
1988	15.19	9.80	1.13	2.56	13.48	1.71
1989	15.21	10.02	1.16	2.67	13.86	1.35
1990	15.53	10.19	1.17	2.85	14.21	1.32
1991	15.52	10.33	1.19	2.99	14.50	1.02
1992	15.54	10.69	1.24	3.16	15.09	.45
1993	15.54	10.60	1.25	3.28	15.13	.41
1994	15.54	10.52	1.27	3.43	15.22	.32
1995	15.54	10.43	1.28	3.57	15.29	.25
1996	15.54	10.37	1.31	3.71	15.40	.14
1997	15.54	10.32	1.34	3.85	15.51	.03
2000	15.61	10.18	1.40	4.31	15.89	-.28
2005	15.70	10.00	1.59	5.07	16.65	-.95
2010	15.77	10.35	1.84	5.98	18.17	-2.40
2015	15.85	11.66	2.00	7.18	20.85	-4.99
2020	15.97	13.63	2.10	8.79	24.52	-8.56
2025	16.07	15.58	2.25	10.60	28.43	-12.36
2030	16.17	17.30	2.26	12.17	31.73	-15.57
2035	16.23	18.48	2.26	13.14	33.88	-17.62
2040	16.27	19.16	2.30	13.53	34.99	-18.72
2045	16.31	19.80	2.43	13.71	35.94	-19.63
2050	16.36	20.72	2.51	13.86	37.08	-20.72
2055	16.42	21.74	2.51	14.01	38.26	-21.84
2060	16.46	22.57	2.48	14.17	39.22	-22.76

[1]The taxable payroll for HI is somewhat larger than the taxable payroll for OASDI, because HI covers all Federal civilian employees, including those hired before 1984, all State and local government employees hired after April 1, 1986, and railroad employees. This difference is relatively small and does not significantly affect the comparisons.

[2]Cost rates for HI exclude amounts required for trust fund maintenance.

[3]The balance is the total income rate minus the combined OASDI and HI cost rate. Negative balances are deficits.

Table 7

Projected Initial Real Benefits for Single Retirees
Age 65 with Average and Maximum Covered Earnings (Alternative II-B)

Retire-ment Year	Annual Benefits					
	Current Dollars		Constant 1988 Dollars		Replacement Rate	
	Average	Maximum	Average	Maximum	Average	Maximum
1988	7,534	10,095	7,534	10,095	42.2	23.0
1990	8,621	11,690	7,905	10,719	44.0	25.1
1995	10,558	14,691	7,941	11,050	41.4	24.4
2000	13,762	19,891	8,508	12,297	41.4	25.3
2005	17,907	26,827	9,099	13,632	41.4	26.2
2010	23,291	35,931	9,727	15,006	41.4	27.1
2015	30,297	47,635	10,400	16,352	41.4	27.6
2020	39,415	62,214	11,121	17,553	41.4	27.7
2025	51,277	80,942	11,891	18,771	41.5	27.7
2030	66,704	105,292	12,714	20,069	41.5	27.7
2035	86,769	136,776	13,594	21,428	41.5	27.7
2040	112,866	177,910	14,534	22,909	41.5	27.7
2045	146,811	231,374	15,538	24,488	41.5	27.7
2050	190,964	300,899	16,612	26,175	41.5	27.7
2055	248,410	391,411	17,761	27,986	41.5	27.7
2060	323,127	509,142	18,989	29,921	41.5	27.7
2065	420,320	662,284	20,303	31,990	41.5	27.7

Assumes retirement at age 65. Beneficiaries are assumed to have been full time workers earning the average wage in covered employment, or the maximum covered wage throughout their working lives. Married couples with a spousal benefit would receive 150 percent of the amounts shown in the table. Data were provided by the Social Security Administration.

STUDY OF THE POTENTIAL ECONOMIC AND FISCAL EFFECTS OF INVESTMENT OF THE ASSETS OF THE SOCIAL SECURITY OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS

FINAL REPORT

Submitted to:
U.S. Department of Health and Human Services
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May 1988

CHAPTER SIX

CONCLUSIONS

This chapter summarizes several of the major conclusions of the study.

1. **The Effect of OASDI Trust Fund Accumulation on the Economy and on the Ability of the OASDI System to Fund Future Benefits Depends on the Overall Fiscal Behavior of the Government.**

The accumulation of Treasury obligations by the OASDI trust funds, in itself, will not provide real resources to pay future benefits nor directly affect the economy. If the current and projected OASDI surpluses are used to finance other government spending, and there is no increase in net government savings, the surpluses will not contribute to the accumulation of real resources that could be used to fund future social security outlays.

Because of the demographic configuration, major increases in both OASDI and Medicare expenditures will be required in the 21st century. The burden of those expenditures must be born by the working population at that time. If those future workers are to be endowed with increased resources to help them bear that burden, current savings and capital accumulation must be increased.

Increasing real government savings will require significant changes in non-OASDI taxes and expenditures. The changes required to balance non-OASDI federal accounts are illustrated by comparing Scenario 1 described in Chapter 3 with Scenarios 4 or 7. In Scenario 4, for example, non-OASDI taxes are increased by 1.4 percent of GNP, non-OASDI outlays are reduced by 1.4 percent of GNP, the Medicare HI payroll tax is increased to 3.9 percent of payroll, and HI outlays are reduced by 20 percent. These major changes are phased in over the period 1991-1995 in order to balance the federal budget by 1997.

2. Even if Federal Deficits Are Reduced Significantly and Federal Government Savings Are Increased, Private Capital Accumulation Is Not Assured.

Increased government savings could be offset by increased private consumption. If the accumulation of large OASDI trust funds, and the corresponding government savings, is to help fund future OASDI outlays, a complementary set of policies to promote -- or at least to avoid penalizing -- private savings and investment is required. The large requirements for retirement income and for health care that will be associated with the significant increases in the elderly population that will occur in the next century mandates the current importance of these issues.

3. If National Capital Accumulation Is Increased by an Amount Equal to the OASDI Trust Fund Accumulation, the Productivity, Output, and Income of the Economy Would Increase.

The size of the OASDI trust fund is projected to be greater than 25 percent of GNP during the period 2012-2026. If additional capital investment matches the trust fund accumulation during this period, GNP could be increased by two to four percent, compared to what it would be with no additional investment. (Alternative macroeconomic model estimates are presented in Table 4-1 and Table 4-11 in Chapter 4.) The greater capital stock and national output could help fund the greater OASDI outlays that will be required after 2020 by (1) permitting a greater level of consumption out of current income, and (2) permitting an increase in consumption at the cost of a reduction in capital accumulation during the period when the trust fund is being drawn down to finance outlays.

4. **OASDI Trust Fund Accumulation and Increased National Capital Accumulation Will Not Significantly Help the Long Term OASDI Financing Problem if Existing Tax and Benefit Provisions Are Not Changed.**

Increased capital accumulation would increase national output and income and increase the level of real resources that can be used to pay the increased OASDI outlays. However, under existing OASDI tax and benefit provisions, increased national income generated by domestic investment will not improve the long term OASDI financial imbalances. Two factors are at work. (1) Increased domestic investment will increase average wages. Increased wages will increase tax revenues immediately but will increase benefits equally, after a short lag. At first the projected OASDI surpluses will be increased, but after about 2025 the projected deficits will be increased. Ultimately, benefit payments will be increased more than tax revenues. (2) The increased capital intensity of the economy will reduce the rate of return to capital and will reduce the interest earned on the trust fund balances. Interest rates could be reduced by five to six percent during the period 2015-2025 when the trust fund is greatest. Both the increase in wages and the reduction in interest rates reflect the increased income and productivity of the economy, and hence an increase in economic well-being. Nevertheless, under the current OASDI financing and benefit calculation provisions, they hurt the long run financial balance of the system.

5. **Finding an Alternative to Treasury Securities for Investment of the OASDI Trust Funds Is Not a High Priority, Especially for the Next Two Decades.**

The possibility that the OASDI trust funds could acquire all marketable Treasury securities is of interest, but is not a current concern. First, it will not happen soon, if at all. The earliest that outstanding marketable

federal debt could be eliminated, under our most severe fiscal scenario, is 2008. Second, a significant reduction in the proportion of total financial assets accounted for by Treasury securities is unlikely to affect significantly the functioning of financial markets, interest rates, or the conduct of monetary policy. The share of financial assets accounted for by Treasury securities has varied greatly over the past forty years with no apparent effect on interest rates (as shown in Figures 5-1 and 5-2 of Chapter 5). Third, in the unlikely case that the federal government maintains budget surpluses long enough to eliminate net government debt, other assets could be created (or existing federal agency assets could be increased) for the Treasury or the OASDI trust funds to hold, without disrupting financial markets.

6. Because of the Useful Role They Play in Financial Markets, Treasury Securities Should Not Be Eliminated.

Treasury securities have unique features, in terms of risk, liquidity, diversity of maturities; they are widely held; and they play an important role in world financial markets. Consequently, they should not be eliminated. Other assets should be created for the Treasury or the OASDI trust funds to hold, rather than eliminating all marketable Treasury securities. These assets could be designed to provide for the trust funds the desirable features that Treasury securities provide.

7. There Are No Alternatives to Current OASDI Trust Fund Investment Policy that Would Provide a Meaningful Improvement in Investment Performance.

No alternative assets would provide an obvious improvement in the risk-return characteristics of the OASDI trust funds, nor should that be the focus of social security trust fund investment policy. The social security

system represents a major social commitment and a major element of social policy, and it plays a major role in the economy. The focus of social security investment policy should be (1) the overall long term productivity of the economy, and (2) intergenerational and intragenerational equity. The OASDI system may affect the long term productivity of the economy through influencing the savings-consumption mix. This mix should be consistent with accepted views of intergenerational equity.

An increased return on a portfolio of investments can be achieved only by increasing the risk. A key issue is who bears the risk of the social security system. Historically, beneficiaries have not born the risk. The risk that revenues will not match what is expected or required to pay promised benefits has been born by all taxpayers, through the federal budget. If the risk is born by all citizens, the best investment policy for the social security system is to seek to maximize the aggregate rate of return to capital and therefore the productivity of the economy. The focus of OASDI trust fund investment policy should be the long term productivity of the economy. It may be that assets could be acquired by the OASDI trust fund which have a greater expected return, in exchange for bearing greater risk. Such a policy would simply redistribute the composition of assets and risk in the economy. It would not change the overall productivity of the economy or the aggregate rate of return.

FINAL REPORT

TO

SOCIAL SECURITY ADMINISTRATION
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

ON

CONTRACT NO. 600-87-0072

TO

THE BROOKINGS INSTITUTION

Principal Investigators

Henry J. Aaron
Barry P. Bosworth
Gary T. Burtless

LESSONS TO BE LEARNED

The major lessons of this study can be summarized briefly.

[1] Growth of total factor productivity in the nonfarm business sector must be quite high by historical standards if real wages are to grow at the rate assumed in the IIB projections. From 1947 through 1973, total factor productivity in the nonfarm business sector grew 14 percent per decade. This rate slumped to just 7 percent between 1975 and 1985. Under our assumptions about the growth of productivity on farms and in the government and institutional sectors and about sectoral shifts, total factor productivity within nonfarm business must grow 13 to 16 percent per decade to meet the IIB assumption about real wage growth over the next 75 years.

[2] To replicate the detailed IIB projection of future trust fund balances, we are forced to accept the Social Security Administration's exact projection of future interest rates on federal Treasury debt. The interest rates projected by the Social Security Administration are not entirely consistent with our neoclassical growth model. The rise in worker productivity over the projection period arises partly from capital deepening--that is, a growing level of investment in capital per worker. As capital per worker rises, and with it the ratio of capital stock to nonfarm output, we would expect a decline in the rate of return on capital and a corresponding drop in the rate of return on financial

assets--such as Treasury debt. This decline should persist long after 1995, the year in which the IIB projection assumes the real return on the trust fund will stabilize. On the other hand, the IIB projections are based on the assumption that the real rate of interest (adjusted for inflation) will fall sharply from its current level of 5 percent to a constant 2 percent over the last 65 years of the projection period.

[3] <u>The projections of future trust fund balances and solvency are highly sensitive to the assumed rate of interest</u>. If the real rate of return on the trust fund is just one percentage point higher than assumed in the IIB projections, the reserve position in 2060 is changed from a deficit equal to 9.7 percent of GNP in that year to a surplus equal to 4.3 percent of GNP. Because projections are so acutely sensitive to the interest rate, our simulation results depend on how we assume the interest rate on the trust fund moves when the rate of return on capital changes. We assume that a proportional change in the real, after-corporate-tax rate of return on reproducible capital causes a proportional change in the real interest rate on the trust fund balance. (The real, after-corporate-tax rate of return is measured as a ten-year moving average, so the interest rate on the trust fund responds with a lag to changes in the real return on capital.) In our baseline simulation we assume that the IIB projection of interest rates on the trust fund is exactly correct.

[4] When a shift in policy changes the capital stock from the baseline projection, productivity and the real wage change immediately. The rise in wages will be proportionately smaller than the rise in the size of the capital stock, but the effect on wages is nonetheless immediate. The rise in wages leads to an instantaneous and equal proportional rise in social security payroll taxes.

[5] Because of the social security indexing formula, a rise in real wages is followed in 15-20 years by a proportionately equal rise in benefits. Until this 15-20 year interval has elapsed, payroll tax revenues will have risen by proportionately more than benefit outlays, so the balance of [Taxes - Benefit Outlays] has probably improved. If the interest rate earned on the trust fund were unchanged, the trust fund reserve at the end of this period would therefore be increased, because the social security surplus in each year over the period is larger or the deficit is smaller.

[6] Twenty years after an increase in real wages, benefits and tax revenues will have risen by equal proportionate amounts. The change in the annual net balance of social security (revenues minus outlays) depends upon the baseline position of this net balance. If taxes exceed benefits in the baseline, a proportionate increase in both improves the balance. However, in periods when baseline benefits exceed taxes, a proportionate increase in both only worsens the annual balance.

[7] Any federal fiscal policy that raises national saving and leads to a deepening of the domestic capital stock will tend to reduce the real rate of return on nonfarm business investment. A drop in real rates of return will tend to reduce the real interest rate on federal Treasury debt and, hence, on the trust fund reserve. A policy that reduces real interest on the trust fund without affecting the year-to-year balance of [Taxes - Benefit Outlays] must harm the long-term solvency of the system.

[8] If a nonOASDI fiscal policy is adopted that permits swings in the social security surplus to be fully reflected as swings in national saving and domestic investment, domestic investment will initially rise but ultimately fall below the level it would otherwise have been. Because the social security surplus is large and positive through the year 2030, investment will be raised through that year; because the surplus disappears in subsequent years, investment will be lowered thereafter.

[9] The policy just mentioned will first raise the capital stock, worker productivity, wages, and social security taxes above the level they would otherwise have been. But by the end of the projection period, the capital stock, productivity, wages, and social security revenues will be lower than they would have been under a policy that fixed the overall federal deficit as a constant share of GNP. (The capital stock must ultimately be reduced because over the entire 75-year pro-

jection period the trust fund faces a small deficit.) This pattern implies that the solvency of the social security system itself will be harmed by a fiscal policy that first raises but ultimately reduces the rate of national saving and domestic investment.

[10] The effect of the social security surplus on financial markets and the economy depends critically on the budget policy of the remainder of the federal government. If the deficit in the general fund account is small enough, national saving and investment could rise well above the levels projected in our baseline, with obvious effects on productivity, real wages, and social security benefits. However, these gains to the real economy result in only temporary gains to the social security system itself. Ultimately, benefits rise by a greater absolute amount than tax revenues, leading to a larger long-run deficit under current assumptions about the real interest rate earned on the trust fund.

[11] International investment reduces growth of the domestic capital stock, output, wages, and social security tax revenues. Because some national saving is invested abroad rather than at home, the capital stock and worker productivity fail to rise as fast as they would if all saving were invested domestically.

[12] Given the trust fund build-up indicated by the IIB projections, the burden of social security on the economy will be reduced. The near-term social security surplus will be smaller than it would be

if all saving is invested at home. On the other hand, the rate of return earned on the trust fund will be higher, because the smaller domestic capital stock (in our model) leads to a higher domestic interest rate. Ultimately, social security benefits absorb a smaller percentage of net and gross national income, because the investment of the social security surplus abroad does not raise domestic productivity and wages, and hence does not increase social security benefits.

[13] <u>If one believes that the aggregate saving rate will vary with changes in the age-composition of the population, the private saving rate should rise over the next three decades because of a decline in the proportion of the population in the age bracket that dissaves--young adults under age 35.</u> Depending upon our assumption about the saving rate among people over age 65, the aggregate saving rate over the entire projection period will remain above the rate of the last decade. Hence, the private saving rate should be higher than the rate we assume in our baseline projection. A higher private saving rate would tend to reinforce the effects of short- or long-term changes in the government saving rate. This conclusion follows from the fact that a given percentage change in gross national product resulting from a change in fiscal policy will cause a bigger swing in private saving, leading in turn to larger proportional effect on investment, the capital stock or foreign investment, and worker productivity or national income earned on foreign assets.

[14] <u>If private saving rises with the real interest rate, the real economic effects of any given change in fiscal policy or social security investment policy will be smaller than they would be if private saving did not respond to changes in the rate of interest</u>.

[15] <u>The assumption of a lower elasticity of substitution of capital for labor does not produce interesting (or convincing) results</u>.

[16] Contrary to the fears of some analysts, we find that available financial assets--Treasury debt, corporate bonds, residential mortgages, state and local bonds--are close substitutes for one another. The relative interest rates on these assets have fluctuated within narrow bounds in spite of the wide variation over time in the market availability of different types of assets. <u>Hence, we doubt that a sharp decline in the availability of Treasury debt will substantially affect the functioning of financial markets</u>.

[17] For several reasons it would be convenient to maintain a market in short-term and highly liquid Treasury securities. Such a market would be precluded if all Treasury debt were held by the social security trust fund. <u>Should this contingency arise--and given current fiscal policy, it seems highly unlikely it will--we suggest a policy of investing social security surpluses in federally backed securities, such as mortgage backed securities of the Government National Mortgage Associa-</u>

tion. This type of investment does not require the OASDI Trustees to become involved in issues of corporate management.

[18] The expected yield of the trust fund would rise under this alternative policy, but the risk exposure of the fund would rise as well. The increase in risk would not be large; neither would be the expected gains. The primary issues surrounding investment in such assets would be whether such a policy would increase the likelihood that social security reserves would actually be allowed to accumulate and to add to public saving.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.

July 5, 1988

Contact: Office of Financing
202/376-4350

TREASURY TO AUCTION $6,500 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $6,500 million of 7-year notes to refund $3,382 million of 7-year notes maturing July 15, 1988, and to raise about $3,125 million new cash. The public holds $3,382 million of the maturing 7-year notes, including $305 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $6,500 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 $87 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.

oOo

Attachment

B-1471

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED JULY 15, 1988

July 5, 1988

Amount Offered:

To the public .... $6,500 million

Description of Security:

Term and type of security .... 7-year notes
Series and CUSIP designation G-1995
(CUSIP No. 912827 WK 4)
Maturity date .... July 15, 1995
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 15 and July 15
Minimum denomination available .. $1,000

Terms of Sale:

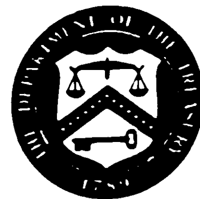
Method of sale .... Yield auction
Competitive tenders .... Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders .... Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor .... None

Payment Terms:

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 .... Tuesday, July 12, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):
a) funds immediately available to the Treasury .. Friday, July 15, 1988
b) readily-collectible check .. Wednesday, July 13, 1988

TREASURY NEWS 

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

FOR RELEASE AT 4:00 P.M.
July 5, 1988

Contact: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,200 million, to be issued July 14, 1988. This offering will result in a paydown for the Treasury of about $375 million, as the maturing bills are outstanding in the amount of $13,578 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 11, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,600 million, representing an additional amount of bills dated April 14, 1988, and to mature October 13, 1988 (CUSIP No. 912794 QQ 0), currently outstanding in the amount of $6,583 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,600 million, to be dated July 14, 1988, and to mature January 12, 1989 (CUSIP No. 912794 RA 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 July 14, 1988. 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 $1,718 million as agents for foreign and international monetary authorities, and $3,553 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1472

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 one-half hour prior to the closing time for receipt of tenders 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, 27-76, and 2-86, as applicable, 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.

6/87

TREASURY NEWS

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

FOR IMMEDIATE RELEASE July 5, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,639 million of 13-week bills and for $6,601 million of 26-week bills, both to be issued on July 7, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 6, 1988			26-week bills maturing January 5, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.56%	6.76%	98.342	6.68%	7.01%	96.623
High	6.57%	6.77%	98.339	6.71%	7.04%	96.608
Average	6.57%	6.77%	98.339	6.71%	7.04%	96.608

Tenders at the high discount rate for the 13-week bills were allotted 26%.
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	$ 40,470	$ 40,470	$ 36,365	$ 36,365
New York	33,677,350	5,853,905	23,512,540	5,755,805
Philadelphia	26,405	26,405	23,245	22,245
Cleveland	43,205	40,500	35,820	35,820
Richmond	44,090	44,090	40,115	40,115
Atlanta	45,660	35,410	42,120	42,120
Chicago	1,946,090	43,090	1,494,500	59,450
St. Louis	36,585	36,085	31,450	31,450
Minneapolis	7,240	7,240	15,460	15,460
Kansas City	39,735	39,735	50,795	50,795
Dallas	26,595	26,595	17,910	17,910
San Francisco	1,250,620	74,550	1,362,150	68,150
Treasury	371,380	371,380	425,160	425,160
TOTALS	$37,555,425	$6,639,455	$27,087,630	$6,600,845
Type				
Competitive	$33,886,940	$2,970,970	$22,269,320	$1,782,535
Noncompetitive	1,090,920	1,090,920	1,108,940	1,108,940
Subtotal, Public	$34,977,860	$4,061,890	$23,378,260	$2,891,475
Federal Reserve	2,387,635	2,387,635	2,000,000	2,000,000
Foreign Official Institutions	189,930	189,930	1,709,370	1,709,370
TOTALS	$37,555,425	$6,639,455	$27,087,630	$6,600,845

An additional $96,970 thousand of 13-week bills and an additional $803,930 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1473

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

FOR IMMEDIATE RELEASE REVISED
July 13, 1988

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Acting Secretary, Federal Financing Bank (FFB), announced the following activity for the month of December 1987.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $152.4 billion on December 31, 1987, posting a decrease of $4,432.8 million from the level on November 30, 1987. This net change was the result of an increase in holdings of agency debt of $1,024.3 million, and decreases in holdings of agency-guaranteed debt of $26.8 million and in agency assets of $5,430.3 million. FFB made 126 disbursements during December.

Attached to this release are tables presenting FFB December loan activity and FFB holdings as of December 31, 1987.

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B-1474

FEDERAL FINANCING BANK

December 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #456	12/7	$ 70,000,000.00	3/1/88	5.565%	
Note #457	12/29	3,750,000.00	3/29/88	6.065%	
TENNESSEE VALLEY AUTHORITY					
Advance #824	12/4	225,000,000.00	12/10/87	5.645%	
Advance #825	12/7	295,000,000.00	12/17/87	5.715%	
Advance #826	12/10	100,000,000.00	12/14/87	6.145%	
Advance #827	12/10	35,000,000.00	12/16/87	6.145%	
Advance #828	12/10	106,000,000.00	12/17/87	6.145%	
Advance #829	12/14	102,000,000.00	12/17/87	6.165%	
Advance #830	12/17	100,000,000.00	12/21/87	6.255%	
Advance #831	12/17	395,000,000.00	12/23/87	6.255%	
Advance #832	12/21	83,000,000.00	12/30/87	6.175%	
Advance #833	12/23	20,000,000.00	12/31/87	6.245%	
Advance #834	12/23	375,000,000.00	1/1/88	6.245%	
Advance #835	12/30	27,000,000.00	1/4/88	6.155%	
Advance #836	12/30	49,000,000.00	1/6/88	6.155%	
Advance #837	12/31	133,000,000.00	1/8/88	6.015%	
U.S. POSTAL SERVICE					
Note #14	12/1	1,500,000,000.00	5/31/12	9.074%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Philippines 11	12/1	93,676.60	9/12/96	8.105%	
Kenya 10	12/2	60,034.84	5/5/94	8.745%	
Greece 16	12/2	6,724,153.63	9/1/13	9.218%	
Turkey 18	12/2	951,560.42	3/12/14	9.265%	
Turkey 18	12/2	1,230,059.51	3/12/14	9.305%	
Morocco 13	12/2	652,134.70	5/31/96	8.505%	
Morocco 13	12/2	182,891.13	9/8/95	8.995%	
Turkey 18	12/3	176,769.93	9/12/96	8.135%	
Morocco 13	12/4	24,643.54	5/31/96	8.505%	
Columbia 7	12/4	12,149.20	9/5/91	8.325%	
Turkey 18	12/8	731,142.00	3/12/14	9.335%	
Peru 10	12/8	104,061.73	4/10/96	9.075%	
Greece 17	12/8	568,294.73	8/25/14	9.195%	
Turkey 18	12/14	797,941.24	3/12/14	9.555%	
Turkey 18	12/17	962,881.79	3/12/14	9.255%	
Greece 16	12/29	156,485.94	9/1/13	9.105%	
Greece 17	12/29	62,356,100.37	8/25/14	9.061%	

+rollover

FEDERAL FINANCING BANK

December 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Harrisburg, PA	12/1	$ 1,474,951.00	12/1/93	8.745%	8.936% ann.
*St. Petersburg, FL	12/7	2,365,000.00	12/1/95	8.727%	8.917% ann.
*St. Petersburg, FL	12/7	1,474,951.00	12/1/95	8.727%	8.917% ann.
San Juan, PR	12/10	301,471.83	10/1/88	7.165%	7.264% ann.
Toa Baja, PR	12/10	79,450.90	5/2/88	6.635%	
Florence, SC	12/14	49,990.00	7/1/88	6.995%	7.020% ann.
Rochester, NY	12/15	90,000.00	8/31/88	7.185%	7.261% ann.
Lincoln, NE	12/15	5,000.00	10/3/88	7.265%	7.364% ann.
Montgomery Co. Dev. Corp.	12/17	210,717.00	5/16/88	6.705%	
Indianapolis, IN	12/29	893,517.00	3/1/88	5.995%	
RURAL ELECTRIFICATION ADMINISTRATION					
*Corn Belt Power #55	12/2	125,000.00	12/31/15	9.209%	9.105% qtr.
*Corn Belt Power #138	12/2	162,000.00	12/4/89	7.895%	7.819% qtr.
Kamo Electric #209	12/3	4,941,000.00	12/4/89	7.895%	7.819% qtr.
Kamo Electric #209	12/3	1,136,000.00	12/4/89	7.915%	7.838% qtr.
*United Power #67A	12/4	1,300,000.00	1/2/90	7.905%	7.828% qtr.
*United Power #129A	12/4	3,000,000.00	1/2/90	7.907%	7.830% qtr.
Deseret General #315	12/4	2,303,000.00	1/3/17	9.154%	9.052% qtr.
*Colorado Ute Electric #152	12/9	1,045,000.00	12/31/15	9.315%	9.209% qtr.
*Upper Missouri Electric #172	12/9	345,000.00	12/31/15	9.315%	9.209% qtr.
*East River Electric #117	12/10	2,000,000.00	12/31/14	9.266%	9.161% qtr.
*Allegheny Electric #175A	12/10	3,366,000.00	1/2/90	8.014%	7.935% qtr.
*Allegheny Electric #175A	12/10	5,668,000.00	1/2/90	8.014%	7.935% qtr.
Old Dominion Electric #267	12/14	1,203,000.00	1/2/90	8.153%	8.072% qtr.
*Wabash Valley Power #104	12/14	5,302,000.00	12/31/15	9.500%	9.390% qtr.
*Wabash Valley Power #206	12/14	8,313,000.00	12/14/89	8.155%	8.074% qtr.
*Colorado Ute Electric #203	12/16	993,000.00	12/12/89	8.045%	7.966% qtr.
*Continental Telephone #254	12/16	2,400,000.00	1/2/18	9.315%	9.209% qtr.
*Continental Telephone #115	12/16	100,000.00	1/2/18	9.315%	9.209% qtr.
Sho-Me Power #324	12/16	500,000.00	1/2/90	8.023%	7.944% qtr.
*Colorado Ute Electric #96	12/21	3,720,000.00	12/31/15	7.945%	7.868% qtr.
*Wabash Valley Power #252	12/22	450,000.00	12/22/89	7.965%	7.887% qtr.
*Wabash Valley Power #252	12/23	350,000.00	12/26/89	8.045%	7.966% qtr.
*Wabash Valley Power #206	12/23	748,000.00	12/31/15	9.132%	9.030% qtr.
*Brazos Electric #108	12/28	40,000.00	12/31/18	8.999%	8.900% qtr.
*Brazos Electric #230	12/28	8,228,000.00	12/31/18	8.999%	8.900% qtr.
*W. Virginia Telephone #17	12/30	718,000.00	12/31/15	9.028%	8.928% qtr.
*Corn Belt Power #138	12/30	117,000.00	12/30/89	7.985%	7.907% qtr.
*Colorado Ute Electric #198A	12/30	8,565,000.00	1/2/90	7.975%	7.897% qtr.
*Colorado Ute Electric #152A	12/30	22,335,000.00	1/2/90	7.975%	7.897% qtr.
*Colorado Ute Electric #168A	12/30	418,323.00	1/2/90	7.975%	7.897% qtr.
*Colorado Ute Electric #198A	12/30	2,690,000.00	1/2/90	7.975%	7.897% qtr.

*maturity extension

FEDERAL FINANCING BANK

December 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
*Old Dominion Electric #267	12/31	$ 43,816,484.90	1/2/90	7.875%	7.799% qtr.
*Wolverine Power #138A	12/31	21,772,000.00	1/2/90	7.880%	7.804% qtr.
*Wolverine Power #182A	12/31	14,946,000.00	1/2/90	7.880%	7.804% qtr.
*Wolverine Power #100A	12/31	1,489,711.12	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	1,247,000.00	12/31/87	7.874%	7.798% qtr.
*Wolverine Power #100A	12/31	1,031,044.48	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	1,880,533.36	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	1,593,866.64	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	1,245,088.88	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	461,533.36	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	363,111.17	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	47,777.76	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	210,222.24	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #101A	12/31	200,666.64	1/2/90	7.874%	7.798% qtr.
*Wolverine Power #274	12/31	656,603.84	1/2/90	7.876%	7.800% qtr.
*Corn Belt Power #292	12/31	390,743.81	1/2/90	7.869%	7.793% qtr.
*Corn Belt Power #292	12/31	474,049.59	1/2/90	7.869%	7.793% qtr.
*Sunflower Electric #174	12/31	15,000,000.00	12/31/15	8.971%	8.873% qtr.
*Colorado Ute Electric #78A	12/31	835,714.32	1/2/90	7.876%	7.800% qtr.
*Colorado Ute Electric #297	12/31	8,350,975.62	1/2/90	7.876%	7.800% qtr.
*Colorado Ute Electric #276	12/31	5,045,378.78	1/2/90	7.876%	7.800% qtr.
*Colorado Ute Electric #78A	12/31	3,514,333.28	1/2/90	7.866%	7.790% qtr.
*Kamo Electric #266	12/31	7,484,235.29	1/2/90	7.868%	7.792% qtr.
*Tri State Electric #89A	12/31	23,176,640.00	1/2/90	7.875%	7.799% qtr.
*Tri State Electric #89A	12/31	4,943,080.24	1/2/90	7.875%	7.799% qtr.
*Tri State Electric #89A	12/31	6,026,652.40	1/2/90	7.875%	7.799% qtr.
*Tri State Electric #89A	12/31	4,791,360.00	1/2/90	7.875%	7.799% qtr.
*Cugach Electric #257	12/31	12,645,000.00	12/31/19	8.996%	8.897% qtr.
*Kansas Electric #216	12/31	907,000.00	1/2/90	7.885%	7.809% qtr.
*Kansas Electric #216	12/31	1,140,000.00	1/2/90	7.885%	7.809% qtr.
*Kansas Electric #216	12/31	825,000.00	1/2/90	7.885%	7.809% qtr.
*Kansas Electric #216	12/31	575,000.00	1/2/90	7.885%	7.809% qtr.
*Kansas Electric #216	12/31	1,065,000.00	1/2/90	7.885%	7.809% qtr.
*Kansas Electric #216	12/31	1,245,000.00	1/2/90	7.885%	7.809% qtr.
*Cajun Electric #263	12/31	45,224,242.43	1/2/90	7.876%	7.800% qtr.
*Cajun Electric #263	12/31	61,060,606.07	1/2/90	7.876%	7.800% qtr.
*Cajun Electric #263	12/31	32,184,848.47	1/2/90	7.876%	7.800% qtr.
*Kamo Electric #209	12/31	3,842,000.00	1/2/90	7.885%	7.809% qtr.
*Upper Missouri Electric #283	12/31	1,624,257.44	12/31/15	8.934%	8.836% qtr.
*New Hampshire Electric #270	12/31	2,706,000.00	1/2/18	8.984%	8.885% qtr.

*maturity extension

FEDERAL FINANCING BANK

December 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Forward Development Corp.	12/9	$ 141,000.00	12/1/02	9.111%	
Alabama Community Dev. Corp.	12/9	286,000.00	12/1/02	9.111%	
Mid City Pioneer Corp.	12/9	349,000.00	12/1/07	9.201%	
Evergreen Comm. Dev. Assoc.	12/9	416,000.00	12/1/07	9.201%	
Tulare County Ec. Dev. Corp.	12/9	500,000.00	12/1/07	9.201%	
S. Eastern Ec. Dev. Corp.	12/9	146,000.00	12/1/12	9.258%	
Minneapolis Ec. Dev. Corp.	12/9	149,000.00	12/1/12	9.258%	
HEDCO Local Dev. Corp.	12/9	359,000.00	12/1/12	9.258%	
Metro. Growth & Dev. Corp.	12/9	500,000.00	12/1/12	9.258%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-03	12/31	618,915,323.15	3/31/88	6.155%	
DEPARTMENT OF TRANSPORTATION					
Section 511					
Missouri-Kansas-Texas #7	12/7	1,000,000.00	9/14/99	9.076%	8.975% qtr.

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	December 31, 1987	November 30, 1987	Net Change 12/1/87-12/31/87	FY '88 Net Change 10/1/87-12/31/87
Agency Debt:				
Export-Import Bank	$ 11,971.5	$ 12,463.5	$ -492.0	$ -492.0
NCUA-Central Liquidity Facility	118.0	122.8	-4.8	6.6
Tennessee Valley Authority	16,709.0	16,688.0	21.0	323.0
U.S. Postal Service	5,853.4	4,353.4	1,500.0	1,500.0
U.S. Railway Association +	-0-	-0-	-0-	-0-
sub-total*	34,651.9	33,627.6	1,024.3	1,337.6
Agency Assets:				
Farmers Home Administration	59,674.0	64,934.0	-5,260.0	-5,335.0
DHHS-Health Maintenance Org.	84.0	84.0	-0-	-0-
DHHS-Medical Facilities	102.2	102.2	-0-	-0-
Overseas Private Investment Corp.	0.7	0.7	-0-	-0-
Rural Electrification Admin.-CBO	4,071.2	4,241.2	-170.0	-170.0
Small Business Administration	18.5	19.0	-0.3	-1.1
sub-total*	63,950.5	69,380.9	-5,430.3	-5,506.1
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,354.0	18,358.2	-4.2	-810.0
DEd.-Student Loan Marketing Assn.	4,940.0	4,970.0	-0-	-0-
DHUD-Community Dev. Block Grant	323.4	325.1	-1.7	-0.8
DHUD-New Communities	30.4	30.6	-0.2	-0.2
DHUD-Public Housing Notes +	2,034.9	2,034.9	-0-	-39.2
General Services Administration +	391.6	394.6	-3.0	-4.0
DOI-Guam Power Authority	33.2	33.2	-0-	-0-
DOI-Virgin Islands	26.7	27.2	-0.4	-0.4
NASA-Space Communications Co. +	949.4	949.4	-0-	140.8
DON-Ship Lease Financing	1,788.3	1,788.3	-0-	-0-
DON-Defense Production Act	-0-	-0-	-0-	-0-
Rural Electrification Administration	21,191.2	21,214.8	-23.5	-5.7
SBA-Small Business Investment Cos.	726.3	732.3	-6.0	-14.3
SBA-State/Local Development Cos.	897.4	899.0	-1.6	-2.4
TVA-Seven States Energy Corp.	1,896.7	1,883.9	12.8	73.0
DOT-Section 511	53.8	52.8	1.0	-1.6
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	53,814.4	53,841.2	-26.8	-664.8
grand total*	$ 152,416.8	$ 156,849.7	$-4,432.8	$-4,833.3

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 11, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,608 million of 13-week bills and for $ 6,608 million of 26-week bills, both to be issued on July 14, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 13, 1988			:	26-week bills maturing January 12, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.69% a/	6.90%	98.309	:	6.97%	7.33%	96.476
High	6.73%	6.94%	98.299	:	7.00%	7.36%	96.461
Average	6.72%	6.93%	98.301	:	6.99%	7.35%	96.466

a/ Excepting 1 tender of $17,000,000.

Tenders at the high discount rate for the 13-week bills were allotted 86%.
Tenders at the high discount rate for the 26-week bills were allotted 2%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,010	$ 36,010	:	$ 40,625	$ 40,625
New York	21,852,110	4,988,110	:	21,874,955	5,556,495
Philadelphia	26,170	26,170	:	23,185	21,185
Cleveland	43,970	43,970	:	34,025	34,025
Richmond	43,790	43,790	:	40,555	40,555
Atlanta	49,090	49,020	:	33,425	33,425
Chicago	1,164,860	525,860	:	830,820	156,820
St. Louis	29,075	26,935	:	34,740	30,740
Minneapolis	6,600	6,600	:	21,505	16,605
Kansas City	48,345	48,345	:	69,495	69,495
Dallas	36,040	36,040	:	27,395	27,395
San Francisco	1,510,360	379,520	:	1,514,520	100,640
Treasury	397,815	397,815	:	479,915	479,915
TOTALS	$25,244,235	$6,608,185	:	$25,025,160	$6,607,920
Type					
Competitive	$22,235,155	$3,599,105	:	$20,448,265	$2,031,025
Noncompetitive	1,142,200	1,142,200	:	1,174,845	1,174,845
Subtotal, Public	$23,377,355	$4,741,305	:	$21,623,110	$3,205,870
Federal Reserve	1,800,130	1,800,130	:	1,800,000	1,800,000
Foreign Official Institutions	66,750	66,750	:	1,602,050	1,602,050
TOTALS	$25,244,235	$6,608,185	:	$25,025,160	$6,607,920

An additional $20,650 thousand of 13-week bills and an additional $370,050 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1475

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 a.m., E.S.T.
July 12, 1988

STATEMENT OF
DENNIS E. ROSS
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON
TAXATION AND DEBT MANAGEMENT

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here to present the views of the Treasury Department regarding the miscellaneous bills that are the subject of this hearing: S.2484 (extension and modification of research credit); H.R.1961 (portability of pension benefits); S.2078 and S.2291 (employee approval of the establishment of employee stock ownership plans); H.R.2792 (tax treatment of Indian fishing rights); S.1239 (treatment of certain short-term obligations in the hands of certain taxpayers); S.2611 (provision of certain tax return information to the Veterans Administration); and S.1821 (exclusion of certain seafood processors from the definition of employee).

RESEARCH CREDIT

Let me turn first to S.2484, the Research and Experimental Credit and Extension Act of 1988, introduced by Senate Finance Committee members John C. Danforth and Max Baucus. Because research spending is essential to fostering technological innovation, which is a major source of growth in productivity, the Administration is committed to encouraging continued growth of private, domestic research activities. To this end, the Administration strongly favors a permanent R&E credit, and supports the efforts of those, such as Senator Danforth and Senator Baucus, who are attempting to improve the effectiveness of the credit.

B-1476

A. Background: Description of Current Law and S.2484

1. Current Law

The 1981 Economic Recovery Tax Act adopted a 25 percent incremental R&E tax credit "in order to encourage enlarged research efforts by companies which already may be engaged in some research activities." The R&E credit was originally scheduled to expire on December 31, 1985, and it was intended that Congress "have an opportunity to evaluate the operation and efficacy of the credit" before any extension. The 1986 Tax Reform Act (the "1986 Act") extended the credit to December 31, 1988, lowered the rate of credit to 20 percent, restricted the definition of eligible expenditures, and included the credit in the general business credit limitation.

Under section 41 of the current Code, a 20 percent tax credit is allowed for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the excess of the current year's qualified research expenses over the base amount. The base amount is the average annual amount of qualified R&E expenditures over the prior three years (or if the firm is not in existence for three years, the average of the expenditures for its years in existence). This base, however, is subject to the limitation that it never be less than 50 percent of current qualified expenditures.

The 1986 Act also established a separate 20 percent tax credit ("the University Basic Research Credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The University Basic Research Credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, adjusted for inflation.

In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Restrictions adopted in the 1986 Act further limit the credit to expenditures for research that is technological in nature and that will be useful in developing a new or improved business component. In addition, certain research is specifically excluded from the credit, including research performed outside the United States, research relating to style, taste, cosmetic, or seasonal design factors, research conducted after the beginning of commercial production, research in the social sciences, arts, or humanities, and research funded by a person other than the taxpayer.

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception, relating to certain research joint ventures, the "trade or business test" for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. As a result, new corporations and corporations entering a new line of business cannot claim the credit for qualifying R&E expenses because the expenses do not relate to an ongoing trade or business.

The R&E credit is aggregated with certain other business credits and subject to a limitation based on tax liability. The sum of these credits may reduce the first $25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back three years and forward fifteen.

The Ways and Means Committee has tentatively agreed to extend the present-law credit for two years. Thus, the credit would apply to qualified research costs paid or incurred on or before December 31, 1990. To offset some of the revenue cost of the two-year extension, the Committee also agreed to reduce deductions under section 174 by the amount of the taxpayer's section 41 credit allowed for the taxable year.

2. Description of S.2484

S.2484 is designed to increase the R&E credit's incentive effect and to increase the number of taxpayers that are eligible for the credit. S.2484 would retain the incremental feature of the present credit and its 20 percent rate, but would make the credit permanent and modify calculation of the base amount. The new base would be a fixed historical base equal to the average of the firm's qualified R&E expenditures for 1983-1987 and would be indexed annually by the average increase in gross national product (GNP). In addition, in 1989 the base would receive a one-time upward adjustment of seven percent (in order to make the base revenue-neutral with respect to earlier proposals with a three-year base). Firms also would have the option of a separate seven percent credit for expenditures over 75 percent of the base amount. As with current law, all firms would be subject to a 50 percent base limitation.

Under the proposal, the "trade or business" test would be made less stringent so that new firms and firms entering new lines of business could claim the credit without regard to the trade or business test if the taxpayer intended to use the results of the research in the active conduct of a present or future trade or business. The credit would not be available, however, for research undertaken for investment rather than business purposes. Thus, research intended solely to be licensed to unrelated parties for use in their businesses would not be eligible for the credit. In addition, the liberalized trade or

business rules would apply only to in-house research and not to research contracted out to unrelated parties. S.2484 also contains special rules for calculating the base for start-up firms.

B. Evaluation of the Danforth-Baucus Bill (S.2484)

1. Summary Evaluation

Prior Treasury testimony before this Subcommittee has described certain weaknesses in the structure of the current R&E credit. While continuing to believe that the R&E credit is an important stimulant for economic growth and productivity, we have also studied ways to restructure the credit so as to increase its incentive effect. The Danforth-Baucus proposal is consistent with our own views regarding the optimal credit structure, and we believe it can have a significant effect in encouraging R&E. Accordingly, the Treasury strongly supports the basic structure and design of the credit proposed in S.2484.

The President has proposed a permanent R&E credit in his 1989 budget at a revenue cost equal to an extension of the current credit. Although the Administration's first priority is to prevent expiration of the credit, we would support an R&E credit as modified in the Danforth-Baucus bill if the proposal were made revenue-neutral to an extension of current law. As I will discuss later, we believe the revenue cost of the Danforth-Baucus bill can be reduced while maintaining the bill's important structural improvements to the credit.

The R&E credit proposed in the Danforth-Baucus bill has several advantages: (1) it greatly increases the incentive of the R&E credit both in absolute terms and per dollar of credit; (2) it increases the percentage of R&E-performing firms that are eligible for the credit; (3) it eliminates the relationship between the availability of the credit and the rate of inflation; (4) it extends to new firms R&E incentives which had previously been available only to established firms; and (5) it makes the credit permanent. I will discuss each of these advantages in turn.

2. Incentive Effects

The most important feature of the Danforth-Baucus credit is the replacement of the current credit's moving-base with a fixed-base structure. We believe the fixed-base structure results in a five-fold increase in the credit's incentive effect per dollar of revenue cost.

It is now widely acknowledged that an incremental credit with a base equal to a moving average of previous expenditures l[illegible] to an effective rate of credit which is only a fraction of the statutory rate. A credit's effective rate is the effective

reduction in price of the last or marginal expenditure undertaken by any firm and is a measure of the credit's incentive effect. Treasury analyses, as well as other studies, indicate that the average effective rate of the current R&E credit is about two percent. Thus, the credit on average provides the same incentive as a two percent price reduction on R&E expenditures. This relatively small effect is again primarily attributable to the moving base, since additional R&E in one year increases the base and effectively decreases the credit in subsequent years. Thus, R&E generating a dollar credit in the first year will cause a 33.3 cent reduction in credit in each of the following three years, so that the credit's only benefit to a firm is a deferral rather than a reduction in taxes.

In some situations the moving base can actually turn the effective rate of credit negative, so that the credit encourages a firm to reduce R&E expenditures. This occurs both when a firm is growing slowly and current R&E expenditures are below base and when a firm is growing quickly and is subject to the 50 percent base limitation. For firms below base, negative effective rates of credit result because marginal increases in R&E yield no credit but reduce credits in future years. For firms subject to the base limitation, negative effective rates of credit result because each 50 cents of credit earned in the current year is followed by 33.3 cents less of credit in each of the following three years.

The Danforth-Baucus bill would address both the low and negative incentive problems by adopting a base equal to an average of 1983 through 1987 expenditures, adjusted upward by seven percent, and (to maintain relatively even revenue costs over time) indexed to nominal GNP. The critical feature of this so-called "fixed" base is that a firm's current spending will have no effect on future credits. Thus, unlike the current credit, a dollar of credit earned in the current year does not reduce credits in the following year. Under the Danforth-Baucus bill, firms eligible for a 20 percent credit on average receive the incentive equivalent to nearly a 20 percent reduction in price. Taxable high-growth firms facing the 50-percent base limitation have an effective rate of credit equal to 10 percent. Even low-growth firms on the alternative seven percent credit receive twice the incentive of that provided by current law.

3. Growth and Eligibility for the Credit

The Danforth-Baucus bill would also significantly increase the percentage of R&E-performing firms eligible for the credit. This increase is achieved through the design of the primary and alternative bases, which results in a larger number of firms with R&E expenditures above base.

The limited availability of the current credit to firms performing R&E is too often overlooked. High rates of R&E growth

in the early 1980s (due both to real growth and to inflation) minimized the problem because inflation kept many slow-growing firms from falling below base. A slowdown in R&E growth in the late 1980s, however, has made it increasingly apparent that an increase in availability of the credit would improve its effectiveness.

The goal of a tax credit for R&E is to encourage a firm to invest in R&E at a level higher than it would absent the credit. In economists' jargon, the credit is designed to increase marginal expenditures. In the absence of a credit, all firms determine their optimal amounts of R&E spending by weighing costs against potential benefits. If it were known that each firm would spend $X in the absence of a credit, the most efficient credit would provide a tax reduction <u>to all firms</u> for expenditures above their respective $X amounts. Although there has been much debate about how the credit should be distributed among firms with high, low or negative growth in R&E, the credit is most effective if it encourages all firms, regardless of whether their $X amount is declining or increasing, to increase R&E investments.

Unfortunately, the $X amount for every firm cannot be accurately determined and in designing a credit base some judgment must be made about the behavior of firms with respect to R&E expenditures. The three-year moving base of the current R&E credit assumes that firms steadily increase R&E investment over time, so that their $X amount is always in excess of prior years' expenditures. Although this model may reflect the usual behavior of larger firms, which tend to show steady growth in R&E, smaller firms have more varied spending patterns. Small firms may have only one or two research projects for which optimal expenditures may increase or decrease greatly, depending on the particular phase of the research cycle that is faced in the current year. Both Treasury studies and a recent General Accounting Office study indicate that the moving-base of the current credit result in approximately one-third of all R&E-performing firms being ineligible for the credit in any one year.

There are, of course, some trade-offs involved in designing a credit base so as to improve the availability of the credit. Lowering the credit base so as to increase the credit's availability comes at the price of increasing the amount of credit to <u>all</u> firms or lowering the rate of credit. At one extreme, the base could be set at zero and all firms would be eligible for the credit; but such a credit at a 20 percent rate would be extremely expensive. Increases in the base save revenue, but, of course, decrease availability. Although no credit base can achieve optimal levels of availability at acceptable revenue costs, the two-tiered credit of the Danforth-Baucus bill significantly increases the credit's availability without substantially expanding the credit's revenue cost.

4. Inflation

Under S.2484 the credit base is indexed to GNP. As a result, the amount of the credit allowable to any firm and the cost of the credit to the government no longer depends on the rate of inflation. In this way, the credit is provided only for real increases in R&E spending. By contrast, under the current credit structure, the availability of the credit, the amount of credit, and the revenue loss from the credit are positively related to the rate of inflation. This is undesirable as a matter both of tax and economic policy.

From a tax policy standpoint, the incentive effects of the credit are diminished since the amount of the credit available to the taxpayer depends on the variable of inflation. There is similarly uncertainty as to the credit's total cost to the government.

The effect of inflation on the credit also has a perverse macroeconomic effect. Since inflation is usually associated with strong aggregate demand, the incremental credit has the opposite effect of an automatic stabilizer: it encourages increased business spending during economic expansions and decreased spending during recessions.

As noted above, the Danforth-Baucus proposal provides a credit insulated from the effects of inflation. Because the base is indexed to nominal GNP growth (which includes inflationary as well as real growth), firms are not unduly rewarded for growth in qualified expenditures due to inflation nor are they penalized for slowdowns in the rate of inflation. The revenue costs of the Danforth-Baucus proposal are therefore much less dependent upon the rate of inflation than the current credit. Furthermore, because the amount and availability of the credit is much more certain, its incentive effect per dollar of revenue cost is larger.

5. Entry into New Markets and Eligibility for the Credit

S.2484 greatly expands the number of firms eligible for the credit by allowing new firms and firms beginning a new line of business to claim the credit for qualifying R&E expenses that relate to the active conduct of a present or future trade or business. Under current law, a new firm or a firm entering a new line of business may not earn credits until qualified expenses are incurred "in carrying on" a trade or business. Since it may be several years between initial research expenditures and the sale of products resulting from such expenditures, the tax system puts start-up firms at a competitive disadvantage vis-a-vis established firms who are already "carrying on" a trade or business.

The Danforth-Baucus proposal would allow expenditures of new firms and firms entering new lines of business to claim the credit without regard to the trade or business test if the taxpayer intends to use the results of the research in the active conduct of a present or future trade or business. Thus, a firm that intends merely to lease or license the results of research would continue to be ineligible for the credit.

6. Permanency of the Credit

S.2484 makes the credit permanent, which we strongly support. The ability of the credit to induce additional R&E expenditures depends directly on its availability at the time firms are planning R&E projects and projecting costs. R&E activity, by its nature, is long-term, and taxpayers should be able to plan their research activity with certainty that the credit will be available. Thus, if the credit is to have the intended incentive effect, the R&E credit must be made permanent.

7. The University Basic Research Tax Credit

We also support the provision in S.2484 that extends the University Basic Research Credit along with a general R&E credit. This provision was first available to taxpayers as a result of the 1986 Act, and its structure should be reviewed for possible modification once tax return data and other evidence is available. At this time, however, it appears that the University Basic Research Credit provides an important incentive to basic R&E activities that are critical to this country's economic future.

8. Suggested Modifications to the Danforth-Baucus Proposal

As I stated earlier, we strongly support the structural changes in the R&E credit proposed in the Danforth-Baucus bill. Our full support for the legislation, however, would require that its revenue cost be limited to that of the current R&E credit. We believe that this revenue objective can be obtained without sacrificing the bill's structural improvements to the R&E credit.

In our view, the best way to limit the revenue cost of the Danforth-Baucus credit is to reduce a taxpayer's section 174 research deductions by the amount of credit taken. Such a reduction of deductible expenses currently exists for the rehabilitation tax credit and the targeted jobs credit. Similarly, a reduction of depreciable basis equal to 50 percent of the investment tax credit existed before it was repealed by the Tax Reform Act of 1986.

Disallowing a deduction for R&E expenses to the extent of R&E credits would treat all sources of Federal support for R&E similarly for tax purposes. The Federal government supports research indirectly through grants and tax credits. Although a tax credit is economically equivalent to a grant (but administered through the tax system), tax credits and grants have different tax treatment. Research costs funded through grants are not deductible while research costs offset by credits are fully deductible. Disallowing the deduction of expenses attributable to credits would rationalize the current budget accounting for alternative funding sources for research by measuring both direct subsidies and tax expenditures for R&E in pre-tax dollars.

For example, Firm A conducts $100 in qualifying research and receives $20 from the government as a 20-percent matching grant. Under current law, Firm A is entitled to deduct only the $80 R&E expenses it actually incurred. By contrast, Firm B conducts $100 of research and receives $20 of tax credit rather than a $20 grant. Under current law, Firm B is entitled to deduct the entire $100 of R&E expense even though the $20 tax credit to Firm B is equivalent to $20 grant received by Firm A.

I should emphasize that our support for disallowance of R&E expenses by the amount of the R&E credit is tied to adoption of the balance of the Danforth-Baucus bill. Although this deduction disallowance has a sound tax policy basis, as a practical matter it is a reduction in the statutory rate of the credit.1/ As part of the Danforth-Baucus proposal, this reduction is more than offset by other improvements in the credit. We would not support it, however, were it proposed as part of an extension of the existing R&E credit.

To further improve the distribution of the credit while maintaining revenue neutrality with respect to extension of the current credit, the Treasury also recommends replacing the seven percent upward adjustment of the fixed base with a two percent adjustment. The revenue cost, incentive effect, and percentage of firms eligible for credit under the Danforth-Baucus proposal with Treasury's suggested revenue-preserving modifications are shown in Table 1.

1/ The deduction disallowance effectively reduces the credit by the tax rate, 34 percent, resulting in an effective credit rate of approximately 13.2 percent.

TABLE 1

Summary of R&E Credit Stuctures with Permanent Extension

Proposal	Revenue Cost Over Fiscal Years 1989 Through 1993	Incentive: Increase in R&E Per Dollar of Revenue Loss	Availability: Percentage of Firms Earning Credit
(1) Ways and Means Credit	$ 3,162 mil.	$ 0.20	67.5 %
(2) Extension of Current Law	$ 4,791 mil.	$ 0.20	67.5 %
(3) Danforth-Baucus R&E Credit	$ 6,459 mil.	$ 1.21	74.9 %
(4) Proposed Treasury R&E Credit	$ 4,865 mil.	$ 1.11	77.8 %

TABLE 2

Revenue Cost of R&E Credit Proposals Under Two-Year, Three-Year, and Permanent Extensions

Proposal	Revenue Cost (millions of dollars) 1989	1990	1991	1992	1993	5-Year Total
	(fiscal years)					
(1) Ways and Means Proposal						
(a) Two-year Extension	265	538	361	139	93	1395
(b) Three-year Extension	265	538	675	438	191	2107
(c) Permament Extension	265	538	675	789	896	3162
(2) Extension of Current Law						
(a) Two-year Extension	401	815	547	211	140	2114
(b) Three-year Extension	401	815	1023	664	290	3193
(c) Permament Extension	401	815	1023	1195	1357	4791
(3) Danforth-Baucus Credit						
(a) Two-year Extension	510	1059	713	276	182	2740
(b) Three-year Extension	510	1059	1357	886	385	4196
(c) Permament Extension	510	1059	1357	1627	1906	6549
(4) Treasury R&E Credit						
(a) Two-year Extension	390	809	544	210	139	2092
(b) Three-year Extension	390	809	1028	667	291	3184
(c) Permament Extension	390	809	1028	1220	1418	4865

PENSION PORTABILITY: H.R.1961

A. Background

The issue of pension portability is a complex one, which warrants serious and in-depth study by Congress, the Treasury Department, the Department of Labor and other policymakers. Prior to addressing H.R.1961, therefore, I would like to discuss the issue in general terms, in order to identify the basic sources of qualified plan benefit losses attributable to employees changing employers, the difficulties associated with increasing portability and the portability effects of some of the recent, major legislative changes in the pension area.

1. Portability Under the Current Retirement Plan System

The issue of pension portability has often been viewed narrowly as whether employees can "take" their full vested benefits with them when they leave employers and invest them in other plans or individual retirement accounts (IRAs). This view of portability is often referred to as portability of assets or cash values. Other common views of pension portability have included portability of benefits and portability of service. Portability of benefits refers primarily to vesting and other eligibility conditions (e.g., age and service conditions applicable to early retirement subsidies) that may cause mobile employees to lose pension benefits when they lose jobs. Finally, portability of service refers generally to the recognition under a defined benefit plan, for participation, vesting, and benefit accrual purposes, of an employee's service for employers other than the employer maintaining the plan. More recently, commentators have begun to believe that while the concept of portability includes these particular issues, it actually may be a much broader concept that touches on many of the basic features of our voluntary, employer-based private pension system.

Viewed more broadly, pension portability refers to the differential between the total pension benefit that a short-term, mobile employee receives for a working lifetime with many employers and the total pension benefit that a long-term employee receives for the same working lifetime with a single employer. This benefit differential is often referred to as a portability loss. Because many workers do not remain with a single employer for their entire working lifetimes, or in many cases even for their last 15 working years, portability actually reflects a concern about whether sufficient numbers of this nation's workers receive meaningful retirement benefits under the private pension system. Also, portability reflects a concern about whether the tax benefits associated with the private system are fairly distributed among various groups of workers--for example, mobile

and long-term employees, young and old employees, highly compensated and non-highly compensated employees, and women and men.

Under current law, two employees may start out at equal jobs, do an equal amount of work, and receive the same amount of cash pay, but, under the voluntary, employer-based pension system, they may receive very different levels of pension benefits for the same amount of work. If women shift employment more often than men, for instance, they will receive smaller total pensions at retirement for the same number of years of work. The extent of these portability losses will depend upon many factors, including, for example, the future rate of inflation.

The issue of portability centers broadly on what is considered a "fair" differential of lifetime pension benefits between mobile and less-mobile workers. If one tries to determine what is "fair" by examining the pension rules established by Congress, it is difficult to come to a conclusion. For example, under the typical defined contribution plan, fairness generally is determined by providing employees with contributions that are an equal proportion of current pay. Under a typical defined benefit plan, however, "fairness" is often based on the provision of an equal replacement rate on a service and pay base approximating final salary or salary in the employee's peak earning years.

While these defined contribution and defined benefit formulas might sound similar in concept, in practical terms they can have enormously different impacts on mobile employees relative to long-term employees. Defined benefit formulas often result in little or no real accrual of benefits to the mobile employee, especially in their young and middle years. Moreover, these formulas produce benefits that are much more subject to the vagaries of such factors as inflation. For example, although the typical defined benefit formulas may at low inflation rates strike an appropriate balance between mobile and long-term workers, at higher inflation rates these formulas may excessively favor the long-term workers.

In evaluating portability issues and proposals, one should recognize that pension benefit differentials between mobile and long-term employees do not always reflect market failures or imply that certain groups of employees are being treated unfairly in the larger perspective. Such benefit differentials may to an extent be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and of appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

For example, employers requiring specially skilled workers may well prefer to link pension benefits to length of service,

such as through deferred vesting or deferred benefit accruals, in order to retain such skilled workers. Other employers requiring employees with more general skills, however, may have less incentive to reward employees to stay for longer periods of time. Similarly, for a variety of reasons (e.g., need for cash income or other benefits), employees may appropriately select jobs offering different levels of pension benefits. Also, to gain the greater benefit security offered by properly funded and PBGC-insured defined benefit plans relative to defined contribution plans, employees may favor employment providing defined benefit plan coverage over employment with an employer that maintains only a defined contribution plan.

In this setting, it is important that employees have a better understanding of their benefit entitlements and rights under defined benefit plans and defined contribution plans. Informed employees should be better able to make employment decisions and bargain more effectively over the desired mix of cash compensation and pension benefits.

The following discussion surveys the basic features of the voluntary, employer-based private pension system that may contribute to pension portability losses for mobile workers.

a. Gaps in Pension Coverage

Differentials of pension benefits between long-term workers and mobile workers may first occur because not all employers maintain qualified plans and those employers that do maintain plans do not necessarily cover all of their employees. Thus, many mobile employees are likely not be covered under qualified plans for some portion of their working lifetimes.

Gaps in pension coverage generally are more common among lower-paid workers in part because such workers may value retirement benefits relative to cash compensation less than do higher-paid workers. Nondiscrimination rules for qualified plans, however, for broad social and tax equity reasons, require employers to provide a portion of their lower-paid employees with comparable pension benefits. Nevertheless, some disparity of pension coverage is allowed to exist in favor of higher-paid employees. For example, under current law, an employer that provides pension benefits to 100 percent of its highly compensated employees (generally, employees who have at least a five percent ownership interest in the employer and employees who earn over $50,000) need provide comparable pension benefits to only 70 percent of the employer's non-highly compensated employees.

Furthermore, it is common even for employers that maintain broad-based qualified plans to exclude newly hired employees from plan coverage until the employees have performed at least one year of service for the employer. Thus, to the extent mobile employees fail to stay with employers for at least one year, they commonly do not earn any pension benefit. Thus,

their total working years commonly will exceed the total years of pension coverage by at least the total number of jobs.

In the 1986 Act, the pension coverage rules were modified to increase the extent to which an employer's low- and middle-income employees must be provided comparable qualified plan benefits. For example, under the pre-1986 Act rules, a pension plan could qualify for tax-favored status if it covered a reasonable classification of employees. While there is always doubt whether a coverage classification is reasonable, in certain circumstances a classification including 100 percent of an employer's highly compensated employees and only 20 percent of the non-highly compensated employees could qualify as reasonable. Under the 1986 Act rules, not only must a pension plan cover at least a reasonable classification of the employer's employees, but also all of the non-highly compensated employees of the employer must receive, on average, pension benefits that are at least 70 percent of the average pension benefits received by the employer's highly compensated employees.

While gaps in pension coverage have contributed to mobile employees' portability losses, research to date has not indicated the frequency with which such gaps lead to major benefit differentials between mobile and long-term employees. Also, the extent to which the coverage changes adopted in the 1986 Act will affect portability losses is as yet uncertain as the new rules only go into effect in 1989.

b. Disparities in Benefit Levels

Even if a mobile employee is covered under an employer's qualified plan, portability losses for mobile workers may occur because employers do not all maintain qualified plans that provide comparable levels of benefits. For example, one employer may provide its employees with coverage under a defined contribution plan that provides an annual contribution of five percent of current compensation, while another employer maintains a 10 percent defined contribution plan or a defined benefit plan that provides a retirement benefit of 1.25 percent times years of service times the employee's final pay. In the voluntary, employer-based private pension system, there are numerous differences in the benefit levels provided under the various types of qualified plans. Indeed, one of the premises of our voluntary pension system is that an employer should have the flexibility to set an affordable and appropriate level of benefits for its workforce.

In fact, while these disparities in benefit levels contribute to differences in benefits among employees, it is not clear that this factor per se would create a greater likelihood that a mobile employee would incur a portability loss.

c. Deferred Vesting

Even if a mobile employee earns a meaningful level of pension benefits under a qualified plan, the plan may require that the employee perform a minimum number of years of service before vesting in his benefit. Beginning in 1989, the tax law permits a plan to defer an employee's vesting in his earned benefits until he has performed at least five years of service (ten years in the case of a collectively bargained, multiemployer plan). Obviously, mobile employees will more often fail to stay with employers for the period necessary to vest in their pension benefits and thus will more frequently suffer portability losses due to deferred vesting.

In many cases, deferred vesting may also work to the disadvantage of the lower-paid employees. To the extent that low- and middle-income workers change jobs more frequently than higher-paid employees, the lower-paid mobile workers are more likely to lose accrued benefits due to inadequate vesting service, just as they are more likely not to accrue benefits due to gaps in pension coverage and lower levels of benefits.

In the 1986 Act, the pension vesting rules were modified generally to reduce the number of years of service that a plan could require an employee to complete before vesting. Before the 1986 Act, for example, a plan could defer vesting until an employee had performed ten years of service. The 1986 Act reduced the years of service that a plan could require for full vesting from ten to five years (except that multiemployer plans still may require ten years of service).

It is difficult at this time to assess fully the effect of the 1986 Act vesting changes on portability since these changes are not effective until 1989. However, it is clear that fewer employees will incur portability losses under the 1986 Act rules. While five-year vesting will still contribute to some employees' benefit losses, existing evidence does not indicate that it is a major factor in causing significant portability losses among mobile employees.

d. Deferral of Pension Benefit Accruals

Portability losses for mobile workers typically occur under those pension plans that use contribution or benefit formulas based, in whole or in part, on an employee's years of service or final pay with the employer. Under such formulas, as an employee accumulates additional years of service and approaches retirement age, the employee earns pension benefits representing increasing percentages of the employee's final pay immediately preceding retirement. Thus, by producing a pattern of deferred benefit accrual over an employee's working lifetime, these formulas provide longer service employees and employees closer to retirement with larger benefit accruals than short service, more mobile, and younger employees.

For example, assume that a mobile employee earns 40 years of pension benefits with four employers (ten years with each employer) under identical defined benefit plans that base benefits on the employee's final pay with the employer. The total pension benefit earned by this employee will be significantly smaller than the total benefit earned by an employee who earns all 40 years of benefits under an identical defined benefit plan with a single employer. This is because none of the plans base their benefits on the employee's years of service with prior employers or on the employee's compensation with subsequent employers. Indeed, very few of the defined benefit plans in the private system (other than collectively bargained, multiemployer plans) grant credit for service or pay with other employers.

Service- and final-pay-based benefit formulas are most common among defined benefit plans. Indeed, even defined benefit plans with career average pay benefit formulas generally defer benefit accruals because benefits under such plans are often regularly improved or updated to reflect employees' pay as of the update. However, some defined contribution plans, such as target benefit plans and plans that allocate greater contributions to employees with additional years of service, exhibit the same pattern of deferred benefit accrual.

In addition to the deferred benefit accrual that naturally occurs under service- and final-pay-based benefit formulas, some defined benefit plans also permit long-service employees who retire at an early retirement age (often, age 55) to receive an additional generous pension benefit. Thus, for example, a defined benefit plan may provide that an employee who retires with at least 25 years of service at age 55 will receive the same annual benefit that he had earned for commencement at age 65. In effect, this early retirement benefit can be a very valuable, deferred benefit for employees who retire at age 55 with at least 25 years of service.

The portability effect of deferred accruals, then, is similar to the effect of deferred vesting. The value of the lost benefits due to deferred benefit accruals, however, is generally much greater than the value of the lost benefits attributable to an employee's first few years of service. Thus, deferred accruals may cause long-service and older employees to receive significantly greater pension benefits than the more mobile, younger employees. Also, the extent of the significant benefit differential resulting from deferred accruals is dependent on the level of inflation, and does not depend solely on real wage growth. Finally, to the extent that lower-paid workers turn over more rapidly than higher-paid employees, deferred accruals result in the lower-paid employees accruing less than comparable pension benefits than long-service employees over the same working lifetime.

e. Pre-Retirement Benefit Erosion

Some commentators argue that the issue of portability involves not only differences in vested pension benefits earned by mobile and long-term workers, but also differences in the pension benefits ultimately received at retirement. That is, portability problems can result not only from a mobile employee's failure to accrue a benefit, but also from the failure to preserve an accrued benefit as a retirement benefit.

Defined benefit plans generally may not make benefit distributions available to an employee before the employee either terminates employment with the employer or attains retirement age under the plan. Mobile workers will have more opportunities to receive pre-retirement benefit distributions than will long-term employees. Research indicates that, particularly for younger employees, high percentages of pre-retirement distributions are used for nonretirement purposes, rather than rolled over to IRA or other plans. Thus, mobile employees generally incur greater reductions in their ultimate pension benefits through pre-retirement benefit distributions. Note, however, that except for foregone tax advantages, this factor does not imply that mobile employees receive less compensation from employers, only that they consume their pension benefits earlier.

The 1986 Act adopted various rules designed to reduce the extent to which pension benefits are consumed before retirement. The Act applied a 10 percent early distribution tax, eliminated special ten-year averaging for pre-retirement lump-sum distributions, and adopted a pro rata basis recovery rule for qualified plans. These changes are likely to reduce the level of pre-retirement benefit erosion by encouraging mobile employees who do receive pre-retirement distributions to preserve their benefits in IRAs and other plans for retirement.

2. General Problems with Portability Proposals

No matter how attractive the portability label may be, proposals intended to promote portability must be carefully evaluated in light of several important objectives: increasing savings; promoting an efficient allocation of resources; distributing fairly the significant tax benefits associated with private pension plans; and providing meaningful private pension benefits to low- and middle-income employees. As discussed above, in evaluating portability proposals, one should remember that pension benefit differentials between mobile and long-term employees may be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

Features of the voluntary, employer-based, tax-qualified pension system that contribute to portability losses may also provide important benefits more consistent with the objectives set forth above. For example, it is difficult to expand coverage or improve benefit levels without also either creating disincentives for employers to maintain qualified plans by increasing employer costs or threatening the voluntary nature of the system (e.g., mandating employer-provided pensions). Also, some employers and employees may have non-tax and non-pension preferences that may justify some benefit differentials. Finally, proposals to encourage the maintenance of additional qualified plans that provide more meaningful levels of retirement benefits within the context of the voluntary system are likely either to have revenue costs or to affect adversely benefit funding or discrimination.

a. Benefit Indexing

Those who criticize the portability effects of deferred benefit accruals often suggest indexing an employee's benefit for years between pre-retirement termination of employment and the employee's retirement age. Such indexing could be based on price or wage growth and is aimed at giving an employee credit for future pay increases with subsequent employers. However, indexing either would substantially increase the cost of maintaining defined benefit plans or result in reductions in the ultimate pension benefits for long-service employees and employees who commence employment fewer than ten or fifteen years before retirement.

b. Mandating Prior Service Credit

Another approach to addressing the portability losses of deferred benefit accruals is to mandate that defined benefit plans credit an employee's years of service with all prior employers and then to permit such plans to offset employees' pension benefits by the benefits provided by the prior employers. This approach would impose significant costs on employers that maintain defined benefit plans and thus would likely encourage employers to stop providing defined benefit plan coverage. In many ways, this approach would be impractical given the wide differences among the types of plans and could significantly deter employers from hiring older employees.

c. Deferred Accruals May Benefit Mobile Employees

To further complicate the analysis regarding the portability effects of deferred benefit accruals is the view that plans providing deferred accruals actually may be beneficial to mobile employees. By working the last ten or fifteen working years under a plan that defers employees' benefit accruals to the years approaching retirement age, a mobile employee is able to earn a significant portion of the pension benefits he would have

earned if he had stayed with a single employer. Under the voluntary, employer-based private pension system in an economy where mobility is common, many workers will earn no or very small pension benefits for at least some of their years of employment. Indeed, during certain periods of their lives, some employees will opt for employment that maximizes their cash compensation in lieu of pension benefits. The availability of plans that defer benefit accruals to the years approaching retirement thus gives many employees the opportunity to "catch up" on earning pension benefits at the end of their working lifetimes.

Thus, one must balance the adverse portability effects of deferred benefit accruals with other important economic, tax, and retirement objectives. Given the ability of final pay defined benefit plans to produce a meaningful retirement benefit for an employee, including a low- or middle-income employee, over his last ten or fifteen working years, there is no single factor by which to determine when an appropriate balance has been achieved.

d. Other Portability Proposals

Other proposals have been made to address pension portability. For example, as discussed, minimum coverage and vesting requirements for qualified plans may have some effect on portability losses. Some proposals would facilitate or encourage tax-free benefit rollovers and transfers among IRAs and retirement plans (e.g., increases in the early distribution tax), while others at least would permit employees who have made after-tax employee contributions to plans to transfer such contributions to IRAs and other retirement plans. Of course, there are significant questions about the extent to which these proposals meaningfully would improve pension portability. Also, these and other proposals must be evaluated not only in light of their purported portability effects, but also in light of the important economic, tax, and retirement objectives outlined above.

3. Description of H.R.1961--Pension Portability Act of 1988

H.R.1961, the Pension Portability Act of 1988, proposes to make various changes to the qualified plan and IRA rules in an attempt to promote the portability of pension benefits. In general, H.R.1961 would provide that (i) in certain circumstances, a plan would be required to make the direct transfer of an employee's pension benefits to an IRA the primary form of benefit distribution; (ii) the Secretary of the Treasury could permit employees to roll over to IRAs their after-tax employee contributions to qualified plans; (iii) IRA amounts transferred from qualified plans would be subject to the spousal protections applicable to defined contribution plans; (iv) IRA trustees would be required to make IRA-to-IRA transfers within 10 days of receipt by the trustee of the IRS owner's transfer request; and (v) employers that do not maintain pension plans

would be able to maintain an alternative salary reduction form of simplified employee pension (SEP). These changes would not become effective until 1992.

B. Discussion

In our view, the major feature of the bill likely to facilitate portability is the rule permitting plan-to-IRA transfers of after-tax employee contributions. Under current law, because after-tax employee contributions may not be rolled over or transferred from qualified plans to IRAs, in many cases employees are not able to preserve these amounts in tax-favored retirement vehicles.

Most of the other features appear to be intended to provide employers with greater authority to move the qualified plan benefits of employees who have terminated employment to IRAs without employee consent. At best, these features would be neutral with respect to portability issues. In fact, some of these features would merely relieve employers of administrative burdens at the risk of reducing some of the rights and benefits that employees and their spouses would otherwise enjoy if their benefits remained in the employer's plan.

The alternative salary reduction SEP generally is a SEP design that many employers could adopt on their own under the salary reduction SEP rules currently in effect. But H.R.1961 makes the salary reduction SEP available to employers of all sizes--current law limits salary reduction SEPs to employers with fewer than 25 employees--so long as the employers do not maintain other qualified pension plans. However, it appears that H.R.1961 attempts to expand pension coverage through salary reduction SEPs, in part, by applying nondiscrimination rules that are more relaxed than the rules applicable to similar tax-favored arrangements, such as cash or deferred arrangements under section 401(k). In our view, employers should not be able to avoid the generally applicable nondiscrimination rules simply by providing tax-favored pension benefits through a particular form of plan, such as SEPs; tax-qualified retirement plans should be subject to a consistent set of nondiscrimination rules.

We recognize that, despite recent legislative changes, portability remains a very important issue that affects millions of Americans and that the current pension system could be improved to reduce portability losses. In this connection, we believe that many of the legislative proposals under consideration, including H.R.1961, make important contributions to the continuing dialogue on portability. However, they must be evaluated in light of the important economic, tax, and retirement objectives previously discussed. Also, in recent years, the private retirement system has been the subject of several significant, positive legislative changes which many employers and benefit advisors have yet to fully digest. Time is needed to properly assess the portability effects of these recent changes to the pension law, many of which only become effective in 1989.

EMPLOYEE APPROVAL OF THE ESTABLISHMENT OF EMPLOYEE STOCK OWNERSHIP PLANS: S.2078 and S.2291

A. Background

An employee stock ownership plan ("ESOP") is a qualified pension plan designed to invest primarily in employer securities. An ESOP is a "defined contribution" type of qualified plan. In a defined contribution plan, an employee's benefit is equal to the value of the contributions and other amounts allocated to the employee's account under the plan, adjusted for investments gains and losses. Assets of a defined contribution plan are generally invested by the plan trustee either in a diversified portfolio of investments or according to participants' directions. Because employees' benefits are directly dependent on the value of the plan's assets, employees bear the risk of investment experience. Under an ESOP, employees' benefits are directly dependent upon the success and profitability of their employer because the assets of an ESOP are primarily invested in employer securities. Thus, the investment risk borne by ESOP participants is greater than the risk borne by participants in other types of defined contribution plans.

Significant tax preferences are available for ESOPs and transactions involving ESOPs. All of the tax preferences available for defined contribution plans are available for ESOPs. This is so even though ESOPs are not solely retirement plans and the tax preferences exist to encourage employers to provide employees retirement income benefits. These tax preferences permit a corporation maintaining an ESOP to receive a current deduction for its ESOP contributions and provide that plan participants are not taxed on their benefits until they are distributed. Many additional tax preferences are available, some of which simply increase the preferences available generally to defined contribution plans and others which reflect the nonretirement features of ESOPs. One often stated justification for these additional preferences is that ESOPs provide employees an equity ownership interest in their employers and, thus, increase employee productivity and company profitability.

The increased tax preferences available for ESOPs are larger permissible deductions for contributions and greater annual allocations to accounts than are permitted for other defined contribution plans. Generally, an employer may deduct the amount of its contribution to a defined contribution plan up to 15% of the compensation paid to plan participants. If an ESOP borrows to purchase employer securities, the maximum deduction permitted is increased to 25% of participants' compensation, to the extent the compensation is used to repay principal on the loan. Moreover, any contribution used to pay interest on the loan is fully deductible. The maximum amount that may be allocated annually to a participant's account in a defined contribution

plan is the lesser of $30,000 and 25% of the participant's compensation. In the case of an ESOP satisfying certain nondiscrimination requirements, the maximum dollar allocation is increased to $60,000.

In addition, other special tax preferences are available for ESOPs and transactions involving ESOPs. First, an employer may deduct dividends paid on employer securities held by an ESOP. Second, banks and certain other financial institutions may exclude from income 50% of the interest received on an ESOP loan. Third, persons who sell employer securities to an ESOP may defer taxation on the gain from the sale if the proceeds of the sale are reinvested in domestic companies and certain other requirements are met. Fourth, an ESOP may assume the estate tax liability of the deceased owner of the employer. Fifth, certain estates may deduct up to 50% of the proceeds from certain sales of employer securities to ESOPs. Sixth, early distributions from ESOPs are exempted from the 10% excise tax on early distributions from qualified plans. Finally, if a reversion from a defined benefit plan is transferred to an ESOP, the reversion is not subject to income tax and the 10% excise tax applicable to reversions. This exception from taxation for reversions does not apply to reversions transferred to ESOPs pursuant to plan terminations occurring after December 31, 1988. Treasury testified before the Subcommittee on Taxation and Debt Management of the Committee on Finance on March 28, 1988 in opposition to any extension of this expiring exemption from taxation for transfers of reversions to ESOPs.

Senate bills S.2078 and S.2291 require a majority of the employees of an employer establishing an ESOP to approve establishment of the plan pursuant to an election conducted by secret ballot. The employer is required to notify its employees of all of the material facts concerning the plan, including (i) the terms of the ESOP, (ii) whether assets from another plan will be transferred to the ESOP and, if so, the terms of the other plan and (iii) whether the ESOP would replace a plan of the employer.

The bills also permit the Secretary of the Treasury to provide that a participant's voting rights required under section 409(e) of the Internal Revenue Code are not satisfied unless the participant's voting rights with respect to securities allocated to the participant's account are substantially similar to the voting rights of holders of the same or similar class of securities.

B. Discussion

The Treasury Department supports the underlying purpose of S.2078 and S.2291, which is to provide ESOP participants with the same stock ownership rights as other holders of similar classes of stock. As I indicated earlier, current law provides significant tax incentives for ESOPs. Although Treasury does not believe this Committee should now reexamine the appropriateness of these incentives, there are questions about whether the existing ESOP rules provide employees with a degree of control consistent with full ownership of their stock.

The bills' requirement of majority approval of employees for the establishment of an ESOP does not directly provide ESOP participants with more substantial stock ownership rights. It is possible that the requirement may have the effect of inducing employers to provide more substantial stock ownership rights so that a majority of the employees will approve the plan. Although we would be sympathetic with this result, it is not clear that employees would exercise their voting rights to secure additional stock ownership rights. Moreover, we are concerned about interfering with the historically voluntary decisions of employers to establish compensation levels or employee benefit plans.

A second more targeted effect of S.2078 and S.2291 is to require ESOPs of closely held corporations to permit participants to vote the shares allocated to their accounts on all matters for which other shareholders of the same class of securities may vote. The bills would have no effect on the voting rights of participants in ESOPs which hold publicly traded employer securities, because equal voting rights are already required in such cases.

Under current tax law, employer securities contributed to an ESOP must be either (i) common stock which is readily tradeable on an established securities market or (ii) where there is no class of stock which is so readily tradeable, common stock which has combined voting power and dividend rights equal to or in excess of the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights. Additionally, if the securities of the employer are required to be registered with the Securities and Exchange Commission, the ESOP must permit participants to vote the securities allocated to their accounts. If the securities are not required to be registered, participants only have the right to vote in corporate mergers, consolidations, recapitalizations, liquidations and similar transactions.

It is apparent from Senator Armstrong's floor statement given when S.2078 was introduced that the equal voting right provision was intended to override an ESOP trustee's ability to vote shares irrespective of the voting directions it receives from

participants. Since this is an issue of fiduciary responsibility governed under Title I of the Employee Retirement Income Security Act of 1974, it is under the jurisdiction of the Department of Labor, which is the proper agency to consider its merits. We understand that the Department of Labor intends to file a written statement for the record on this issue.

INDIAN FISHING RIGHTS INCOME: H.R.2792

A. Background

There is no provision in the Internal Revenue Code that exempts a person from payment of Federal income tax on the grounds that the person is an Indian. Thus, in their "ordinary affairs," Indians are generally subject to Federal income tax to the same extent as other persons. Any exemption from Federal income tax must be derived from treaties or agreements with Indian Tribes, from the Federal tax statutes, or from some other Act of Congress.

Prior to 1871, when the Congress prohibited treaty making with Indian tribes, several Indian tribes entered into treaties with the United States Government and several territorial governments reserving various fishing rights to the Indians. Since then, additional Indian fishing rights have been established by statute, executive order, or agreement later approved by an Act of Congress. Fishing rights secured by various treaties, Acts of Congress, and executive orders have been held to include the right to fish for commercial purposes as well as the right to fish for subsistence purposes. *Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 676 (1979). In three different cases, the courts have held that income derived by an Indian from the exercise of fishing rights reserved under a treaty was not exempt from Federal income tax, on the grounds that there was no express language in the treaty providing that income from such fishing rights was to be tax-exempt. *Peterson Estate v. Commissioner*, 90 T.C. No. 18 (Feb. 11, 1988); *Earl v. Commissioner*, 78 T.C. 1014 (1982); *Strom v. Commissioner*, 6 T.C. 621 (1946), *aff'd per curiam* 158 F.2d 520 (9th Cir. 1947).

H.R. 2792 would amend the Internal Revenue Code to exempt from tax income derived by a member of an Indian tribe from the exercise of fishing rights of the tribe that are protected by treaty. The exemption would also apply to income derived from the exercise of protected fishing rights by certain Indian-owned corporations and other business entities, referred to by the bill as "qualified Indian entities". Income derived by an individual member of a tribe from the exercise of protected fishing rights would be exempt, whether such income is in the form of earnings from self-employment, wages paid by another member of the tribe, wages paid by a qualified Indian entity, or dividends or other distributions from a qualified Indian entity. Income exempted under the bill from Federal taxation would also be exempted from State taxation.

The bill would exempt income derived from protected fishing rights not only from income taxes, but also from employment taxes, including social security (FICA), and unemployment

compensation (FUTA) taxes. The bill would amend the Social Security Act to provide that exempt income is not taken into account in determining social security benefits. The bill would be effective for all taxable years, and thus would resolve all current disputes between the Internal Revenue Service and taxpayers involving prior years, and would apply to requests or actions for refunds that are not time-barred. The bill would also provide the sole basis for exempting fishing rights income from tax; it would prevent treaties and other laws from being construed to provide a tax exemption for such income.

B. Discussion

The Treasury Department recognizes that the issue of taxation of income derived by Indians from exercise of fishing rights protected by treaty is of great concern to Indian tribes throughout the country, and particularly in the Northwest and Great Lakes areas. As previous testimony from the Department of the Interior has indicated, at the time these treaties were signed, many tribes reserved the right to fish in perpetuity. Statement of Ross O. Swimmer, Assistant Secretary for Indian Affairs, Department of the Interior, Hearings of the Select Committee on Indian Affairs, United States Senate, on S. 727, a Bill "To Clarify Indian Treaties and Executive Orders with Respect to Fishing Rights," March 27, 1987. The Indians who were parties to the treaties understood that they would be able to fish (and trade fish) on the same basis as before the treaties, when they were neither required to pay taxes nor turn over any portion of their catch to the Federal Government. H.R.2792 would embody that understanding in law by providing a tax exemption for fishing rights income even though no express exemption is provided by treaty or other authority.

The Administration supports H.R.2792, while also believing that it should not serve as a precedent for conferring tax-free status on all income derived by Indians from resources covered by treaties. Moreover, we understand that fishing serves a number of unique and important functions in Indian cultural and religious life, and thus may be distinguished from other types of activities engaged in by Indians that would remain fully taxable under H.R.2792.

TREATMENT OF CERTAIN SHORT-TERM OBLIGATIONS IN THE HANDS OF CERTAIN TAXPAYERS: S.1239

A. Background

Section 1281 requires certain taxpayers to accrue interest income on short-term obligations (obligations with a fixed maturity of not more than 1 year). Section 1281 applies to, among others, accrual-basis taxpayers, dealers, banks and regulated investment companies. With respect to taxpayers not subject to section 1281, section 1282 requires the deferral of interest expense on leveraged purchases of short-term discount obligations. Both sections are effective for obligations acquired after July 18, 1984.

Section 1803(a)(8)(A) of the 1986 Act added section 1281(a)(2) in order to clarify that the accrual rule of section 1281 applies to both acquisition discount and accrued, but unpaid, coupon interest on short-term obligations. This amendment to section 1281 under the 1986 Act is effective for obligations acquired after September 25, 1985. Section 118(c)(1) of the Technical Corrections Act of 1988 would make the amendment effective for obligations acquired after December 31, 1985.

S.1239 would exempt banks not otherwise using an accrual method of accounting from both sections 1281 and 1282 with respect to loans made in the ordinary course of the banks' trade or business. Accordingly, such banks would not be required to accrue interest with respect to such loans and, also, would not be required to defer interest expense incurred in producing such deferred interest income. The provision would be effective for obligations acquired after July 18, 1984.

Moreover, with respect to taxpayers to whom section 1281 still applied, S.1239 would change the effective date of the provision which requires accrual of coupon interest on short-term obligations under section 1281 to obligations acquired after October 22, 1986.

B. Discussion

The Treasury Department opposes S.1239.

In general, the accrual method of accounting is preferable to the cash method of accounting because the accrual method provides a more accurate method of determining taxable income. Under the accrual method of accounting, items of income are recognized as they are economically incurred, as opposed to when they are paid. Accordingly, it is generally appropriate to use the accrual method except where the additional complexities created by the use of such method outweigh the improvement in income measurement that the method provides.

As part of the 1984 Act, Congress decided that in the case of certain taxpayers, including banks, it was appropriate to require accrual of acquisition discount on short-term obligations. Banks, including small banks, were included under the requirement because they are generally sophisticated taxpayers with respect to both the financial systems which they maintain and the financial instruments in which they regularly deal. Furthermore, banks generally determine their income from short-term obligations on an accrual basis for regulatory accounting purposes. Thus, applying the provisions of section 1281 to banks was not viewed as imposing unreasonable administrative burdens on the affected taxpayers.

Moreover, in addition to the general superiority of accrual tax accounting, there are other strong policy reasons for continuing to apply section 1281 to small banks. An exception for small banks would effectively permit small banks to use the interest expense incurred in carrying such obligations to shelter other unrelated income, leading to a distortion of income and a mismatching of income and expense.

With respect to the provision in the 1986 Act clarifying that taxpayers affected by section 1281 must accrue coupon interest, the Treasury Department has no objection to the provision in the Technical Corrections Bill which would change the effective date of the clarification from September 25, 1985 to December 31, 1985. Such a change would have the effect of simplifying the application of the provision for many taxpayers who report income on a calendar-year basis. Changing the effective date to October 22, 1986, however, would provide an unwarranted benefit to the affected banks and would unfairly reward the taxpayers who have failed to comply with the law.

DISCLOSURE OF TAX INFORMATION TO THE VETERANS ADMINISTRATION: S.2611

A. Background

Under section 6103 of the Code, the IRS is required to disclose tax return information upon request to a variety of agencies or individuals, including federal and state tax administrators, certain other government agencies, and certain interested persons such as a taxpayer's spouse or attorney. The IRS is not currently required to disclose tax return information to the Veterans Administration. The bill would require the IRS to disclose tax return information to assist the VA in its administration of its benefit programs.

B. Discussion

The Office of Management and Budget has advised that the Administration's position on this bill is under development. Consequently, my testimony today represents solely the Treasury Department's views on this issue.

Although the Treasury Department is sympathetic to the needs of the VA for information, it opposes this bill on the ground that it is the type of ad hoc modification to section 6103 which tends to undermine the confidentiality of tax returns and has the potential to damage the voluntary compliance system. In this respect, S.2611 resembles other similar modifications, which have been made or proposed.

Section 6103 was completely revised in 1976. The revision was due in large part to concerns regarding the unwarranted disclosure and inappropriate use of tax returns, in some cases for political purposes. The general rule adopted at that time and contained in section 6103 is that tax returns are confidential and are not subject to disclosure except in particular circumstances specified by statute. During the 1980's there has been a steady expansion in the exceptions to the general rule of confidentiality. The largest expansion came in 1984, when Congress required the IRS to commence disclosure of return information to federal, state, or local agencies administering certain benefit programs (AFDC, Medicare etc.). Currently, 55 separate agencies participate in this program. In 1986-87, the IRS made 27.2 million disclosures to these agencies.

GAO has estimated that returns or return information of 80 million taxpayers now are subject to disclosure under section 6103. The bill under consideration would increase the number of taxpayers whose returns are subject to disclosure by 1.6 million.

It is argued that permitting the VA access to tax returns would increase federal receipts. It is possible that receipts

may, in fact, be increased, at least in the short term, but we believe that focusing on increased receipts in this context is a shortsighted approach.

Allowing the Veterans Adminstration access to taxpayer return information will encourage other agencies to seek similar access. Typically, as in the current case, a federal agency seeking access to tax returns would be able to present data showing that federal receipts would be enhanced. In each case, the argument would also be made that it would not result in a significant increase in the number of taxpayers subject to disclosure. Thus, in any particular case an agency will be able to make the same arguments that are made today. If we grant the VA access to tax records, it will be difficult to deny access to other agencies in the future. The eventual result will be that confidentiality of tax returns will have become a hollow promise.

We believe that taxpayers have a right to expect that their tax returns will remain confidential. Furthermore, it is possible that permitting increased access to tax returns may actually result in a reduction in voluntary compliance. Any reduction in voluntary compliance would lose far more in federal revenue that would be gained by permitting agency access to tax records. (The IRS has estimated that a 1% drop in voluntary compliance would cause federal revenues to drop by $3.8 billion.) Admittedly, at this time we do not know for certain that weakening confidentiality will reduce compliance. The IRS has begun a study of this issue, and we believe that any further expansion of the exceptions to return confidentiality, even where an increase in federal receipts can be predicated, should await the outcome of the study. Furthermore, we believe that amendment of section 6103 should not be handled on a piecemeal basis in response to requests from specific agencies. Certainly any federal agency would prefer to have the power to order the IRS to disclose tax information, especially if other agencies are being granted that power. Because of the important principles involved, amendment of section 6103 should be handled on a comprehensive basis; if there are good reasons to allow the Veterans Administration access to return information, then it should be handled as part of a general rule allowing federal agencies access in certain cases.

In summary, we believe that Congress should not amend section 6103 to permit additional disclosure of tax return information until the completion of the study on confidentiality and taxpayer compliance. If, after the study is completed, amendment of section 6103 appears in order, then section 6103 should be revised by means of a thoughtful, comprehensive approach.

EXCLUSION FOR CERTAIN SEAFOOD PROCESSORS FROM THE DEFINITION OF EMPLOYEE: S.1821

A. Background

An employer is required to withhold from its employees' wages Federal income tax and the employee's share of Federal Insurance Contributions Act (FICA) tax and to pay Federal Unemployment Tax Act (FUTA) tax and its portion of the FICA tax. These taxes only apply with respect to employees. S.1821 excludes certain seafood processors from the definition of "employee" and, thus, such seafood processors would be treated as self-employed individuals.

B. Discussion

The Treasury Department opposes S.1821 because it treats seafood processors who are in fact employees as self-employed individuals for Federal tax purposes. This treatment is both unfair and burdensome to seafood processors and detrimental to the Federal tax system. If seafood processors are treated as self-employed individuals, they would be required to pay taxes under the Self-Employment Tax Act (SECA) in an amount approximately equal to the sum of the employer's and employee's portions of the FICA tax. The employers of the seafood processors would pay no FICA or SECA taxes for these employees. Seafood processors who are not operating their own businesses and who are unaccustomed to keeping business records would be required to file additional tax forms and remit therewith Federal income and SECA taxes. Such a system of collecting taxes is not as effective as the withholding system and, thus, S.1821 has the effect of losing revenue.

CONCLUSION

This concludes my prepared remarks. I would be pleased to address any questions which you might have.

TREASURY NEWS

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STATEMENT OF
C. EUGENE STEUERLE
DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

Thank you, Mr. Chairman, for the opportunity today to discuss some of the Administration's current views on pension portability. Let me begin by congratulating you on holding this hearing. Pension portability is a subject that warrants serious and in-depth examination by Congress and other policy-makers, and I am sure that today's hearing will make a significant contribution to that important dialogue.

WHAT IS PENSION PORTABILITY

The issue of pension portability has often been viewed narrowly as whether employees can "take" their full vested benefits with them when they leave employers and invest them in other plans or individual retirement accounts (IRAs). This view of portability is often referred to as portability of assets or cash values. Other common views of pension portability have included portability of benefits and portability of service. Portability of benefits refers primarily to vesting and other eligibility conditions (e.g., age and service conditions applicable to early retirement subsidies) that may cause mobile employees to lose pension benefits when they lose jobs. Finally, portability of service refers generally to the recognition under a defined benefit plan, for participation, vesting, and benefit accrual purposes, of an employee's service for employers other than the employer maintaining the plan.

More recently, commentators have begun to believe that while the concept of portability includes these particular issues, it actually may be a much broader concept that touches on many of the basic features of our voluntary, employer-based private pension system.

Viewed more broadly, pension portability refers to the differential between the total pension benefit that a short-term, mobile employee receives for a working lifetime with many employers and the total pension benefit that a long-term employee receives for the same working lifetime with a single employer. This benefit differential is often referred to as a portability loss. Because many workers do not remain with a single employer for their entire working lifetimes, or in many cases even for their last 15 working years, portability actually reflects a concern about whether sufficient numbers of this nation's workers receive meaningful retirement benefits under the private pension system. Also, portability reflects a concern about whether the tax benefits associated with the private system are fairly distributed among various groups of workers--for example, mobile and long-term employees, young and old employees, highly compensated and non-highly compensated employees, and women and men.

Under current law, two employees may start out at equal jobs, do an equal amount of work, and receive the same amount of cash pay. However, under the voluntary, employer-based pension system, they may receive very different levels of pension benefits for the same amount of work. If women shift employment more often than men, for instance, they will receive smaller total pensions at retirement for the same number of years of work. The extent of these portability losses will depend upon many factors, including, for example, the future rate of inflation.

The issue of portability centers broadly on what is considered a "fair" differential of lifetime pension benefits between mobile and less-mobile workers. If one tries to determine what is "fair" by examining the pension rules established by Congress, it is difficult to come to a conclusion. For example, under the typical defined contribution plan, fairness generally is determined by providing employees with contributions that are an equal proportion of current pay. Under a typical defined benefit plan, however, "fairness" is often based on the provision of an equal replacement rate on a service and pay base approximating final salary or salary in the employee's peak earning years.

While these defined contribution and defined benefit formulas might sound similar in concept, in practical terms they can have enormously different impacts on mobile employees relative to long-term employees. Defined benefit formulas often result in little or no real accrual of benefits to the mobile employee, especially in their young and middle years. Moreover, these formulas produce benefits that are much more subject to the vagaries of such factors as inflation. For example, although the typical defined benefit formulas may at low inflation rates strike an appropriate balance between mobile and long-term workers, at higher inflation rates these formulas may excessively favor the long-term workers.

In evaluating portability issues and proposals, one should recognize that pension benefit differentials between mobile and long-term employees do not always reflect market failures or imply that certain groups of employees are being treated unfairly in the larger perspective. Such benefit differentials may to an extent be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and of appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

For example, employers requiring specially skilled workers may well prefer to link pension benefits to length of service, such as through deferred vesting or deferred benefit accruals, in order to retain such skilled workers. Other employers requiring employees with more general skills, however, may have less incentive to reward employees to stay for longer periods of time. Similarly, for a variety of reasons (e.g., need for cash income or other benefits), employees may appropriately select jobs offering different levels of pension benefits. Also, to gain the greater benefit security offered by properly funded and PBGC-insured defined benefit plans relative to defined contribution plans, employees may favor employment providing defined benefit plan coverage over employment with an employer that maintains only a defined contribution plan.

Consistent with this, it is important that employees have a better understanding of their benefit entitlements and rights under defined benefit plans and defined contribution plans. Informed employees should be better able to make employment decisions and bargain more effectively over the desired mix of cash compensation and pension benefits.

The following discussion surveys the basic features of the voluntary, employer-based private pension system that may contribute to pension portability losses for mobile workers.

GAPS IN PENSION COVERAGE

Differentials of pension benefits between long-term workers and mobile workers may first occur because not all employers maintain qualified plans and those employers that do maintain plans do not necessarily cover all of their employees. Thus, many mobile employees are likely not be covered under qualified plans for some portion of their working lifetimes.

Gaps in pension coverage generally are more common among lower-paid workers in part because such workers may value retirement benefits relative to cash compensation less than do higher-paid workers. Nondiscrimination rules for qualified plans, for broad social and tax equity reasons, nonetheless require employers to provide a portion of their lower-paid employees with comparable pension benefits. Still, some disparity of pension coverage is allowed to exist in favor of higher-paid employees. For example, under current law, an employer that provides pension benefits to 100 percent of its highly compensated employees (generally, employees who have at least a 5 percent ownership interest in the employer and employees who earn over $50,000) need provide comparable pension benefits to only 70 percent of the employer's non-highly compensated employees.

Furthermore, it is common even for employers that maintain broad-based qualified plans to exclude newly hired employees from plan coverage until the employees have performed at least one year of service for the employer. Thus, to the extent mobile employees fail to stay with employers for at least one year, they commonly fail to earn any pension benefit. Thus, their total working years commonly will exceed the total years of pension coverage by at least the total number of jobs.

In the Tax Reform Act of 1986 (the 1986 Act), the pension coverage rules were modified to increase the extent to which an employer's low- and middle-income employees must be provided comparable qualified plan benefits. For example, under the pre-1986 Act rules, a pension plan could qualify for tax-favored status if it covered a reasonable classification of employees. While there is always doubt whether a coverage classification is reasonable, in certain circumstances a classification including 100 percent of an employer's highly compensated employees and only 20 percent of the non-highly compensated employees could qualify as reasonable. Under the 1986 Act rules, not only must a pension plan cover at least a reasonable classification of the employer's employees, but also all of the non-highly compensated employees of the employer must receive, on average, pension benefits that are at least 70 percent of the average pension benefits received by the employer's highly compensated employees.

While gaps in pension coverage have contributed to mobile employees' portability losses, research to date has not indicated the frequency with which such gaps lead to major benefit differentials between mobile and long-term employees. Also, the extent to which the coverage changes adopted in the 1986 Act will affect portability losses is as yet uncertain as the new rules only go into effect in 1989.

DISPARITIES IN BENEFIT LEVELS

Even if a mobile employee is covered under an employer's qualified plan, portability losses for mobile workers may occur because employers do not all maintain qualified plans that provide comparable levels of benefits. For example, one employer may provide its employees with coverage under a defined contribution plan that provides an annual contribution of five percent of current compensation, while another employer maintains a 10 percent defined contribution plan or a defined benefit plan that provides a retirement benefit of 1.25 percent times years of service times the employee's final pay. In the voluntary, employer-based private pension system, there are numerous differences in the benefit levels provided under the various types of qualified plans. Indeed, one of the premises of our voluntary pension system is that an employer should have the flexibility to set an affordable and appropriate level of benefits for its workforce.

In fact, while these disparities in benefit levels contribute to differences in benefits among employees, it is not clear that this factor per se would create a greater likelihood that a mobile employee would incur a portability loss.

DEFERRED VESTING

Even if a mobile employee earns a meaningful level of pension benefits under a qualified plan, the plan may require that the employee perform a minimum number of years of service before vesting in his benefit. Beginning in 1989, the tax law permits a plan to defer an employee's vesting in his earned benefits until he has performed at least five years of service (ten years in the case of a collectively bargained, multiemployer plan). Obviously, mobile employees will more often fail to stay with employers for the period necessary to vest in their pension benefits and thus will more frequently suffer portability losses due to deferred vesting.

In many cases, deferred vesting may also work to the disadvantage of the lower-paid employees. To the extent that low- and middle-income workers change jobs more frequently than higher-paid employees, the lower-paid mobile workers are more likely to lose accrued benefits due to inadequate vesting service, just as they are more likely not to accrue benefits due to gaps in pension coverage and lower levels of benefits.

In the 1986 Act, the pension vesting rules were modified generally to reduce the number of years of service that a plan could require an employee to complete before vesting. Before the 1986 Act, for example, a plan could defer vesting until an employee had performed ten years of service. The 1986 Act reduced the years of service that a plan could require for full vesting from ten to five years (except that multiemployer plans still may require ten years of service).

It is difficult at this time to assess fully the effect of the 1986 Act vesting changes on portability since these changes are not effective until 1989. However, it is clear that fewer employees will incur portability losses under the 1986 Act rules. While five-year vesting will still contribute to some employees' benefit losses, existing evidence does not indicate that it is a major factor in causing significant portability losses among mobile employees.

DEFERRAL OF PENSION BENEFIT ACCRUALS

Portability losses for mobile workers typically occur under those pension plans that use contribution or benefit formulas based, in whole or in part, on an employee's years of service or final pay with the employer. Under such formulas, as an employee accumulates additional years of service and approaches retirement age, the employee earns pension benefits representing increasing percentages of the employee's final pay immediately preceding retirement. Thus, by producing a pattern of deferred benefit accrual over an employee's working lifetime, these formulas provide longer service employees and employees closer to retirement with larger benefit accruals than short service, more mobile, and younger employees.

The attached Table 1 demonstrates how the value of an employee's accrued pension benefit for a year varies by age and inflation for continuing with an employer for one additional year under a simple defined benefit plan. These results can be contrasted with a typical defined contribution plan that provides approximately the same level of accrued pension benefits for employees of all ages earning the same amount of compensation. At even zero percent inflation, a defined benefit plan provides increasing levels of benefits as age increases. Note, in particular, how the value of benefits varies enormously by inflation. In effect, when there is an unindexed plan, the combination of real wage growth and inflation erode enormously the value of accrued benefits for an employee leaving employment before normal retirement age.

This pattern of accrual has a significant effect on the benefits ultimately received by a mobile employee. For example, assume that a mobile employee earns 40 years of pension benefits

with four employers (ten years with each employer) under identical defined benefit plans that base benefits on the employee's final pay with the employer. The total pension benefit earned by this employee will be significantly smaller than the total benefit earned by an employee who earns all 40 years of benefits under an identical defined benefit plan with a single employer. This is because none of the plans base their benefits on the employee's years of service with prior employers or on the employee's compensation with subsequent employers. Indeed, very few of the defined benefit plans in the private system (other than collectively bargained, multiemployer plans) grant credit for service or pay with other employers.

Service- and final-pay-based benefit formulas are most common among defined benefit plans. Indeed, even defined benefit plans with career average pay benefit formulas generally defer benefit accruals because benefits under such plans are often regularly improved or updated to reflect employees' pay as of the update. However, some defined contribution plans, such as target benefit plans and plans that allocate greater contributions to employees with additional years of service, exhibit some of the same pattern of deferred benefit accrual.

In addition to the deferred benefit accrual that naturally occurs under service- and final-pay-based benefit formulas, some defined benefit plans also permit long-service employees who retire at an early retirement age (often, age 55) to receive an additional generous pension benefit. Thus, for example, a defined benefit plan may provide that an employee who retires with at least 25 years of service at age 55 will receive the same annual benefit that he had earned for commencement at age 65. In effect, this early retirement benefit can be a very valuable, deferred benefit for employees who retire at age 55 with at least 25 years of service.

The portability effect of deferred accruals then is similar to the effect of deferred vesting. The value of the lost benefits due to deferred benefit accruals, however, is generally much greater than the value of the lost benefits attributable to an employee's first few years of service. Thus, deferred accruals may cause long-service and older employees to receive significantly greater pension benefits than the more mobile, younger employees. Also, the extent of the significant benefit differential resulting from deferred accruals is dependent on the level of inflation, and does not depend solely on real wage growth. Finally, to the extent that lower-paid workers turn over more rapidly than higher-paid employees, deferred accruals result in the lower-paid employees accruing less than comparable pension benefits than long-service employees over the same working lifetime.

PRE-RETIREMENT BENEFIT EROSION

Some commentators argue that the issue of portability involves not only differences in vested pension benefits earned by mobile and long-term workers, but also differences in the pension benefits ultimately received at retirement. That is, portability problems can result not only from a mobile employee's failure to accrue a benefit, but also from the failure to preserve an accrued benefit as a retirement benefit.

Defined benefit plans generally may not make benefit distributions available to an employee before the employee either terminates employment with the employer or attains retirement age under the plan. Mobile workers will have more opportunities to receive pre-retirement benefit distributions than will long-term employees. Research indicates that, particularly for younger employees, high percentages of pre-retirement distributions are used for nonretirement purposes, rather than rolled over to IRA or other plans. Thus, mobile employees generally incur greater reductions in their ultimate pension benefits through pre-retirement benefit distributions. Note, however, that except for foregone tax advantages, this factor does not imply that mobile employees receive less compensation from employers, only that they consume their pension benefits earlier.

The 1986 Act adopted various rules designed to reduce the extent to which pension benefits are consumed before retirement. The Act applied a 10 percent early distribution tax, eliminated special ten-year averaging for pre-retirement lump-sum distributions, and adopted a pro rata basis recovery rule for qualified plans. These changes are likely to reduce the level of pre-retirement benefit erosion by encouraging mobile employees who do receive pre-retirement distributions to preserve their benefits in IRAs and other plans for retirement.

DISCUSSION

No matter how attractive the portability label may be, proposals intended to promote portability must be carefully evaluated in light of several important objectives: increasing savings; promoting an efficient allocation of resources; distributing fairly the significant tax benefits associated with private pension plans; and providing meaningful private pension benefits to low- and middle-income employees. As discussed above, in evaluating portability proposals, one should remember that pension benefit differentials between mobile and long-term employees may be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

Features of the voluntary, employer-based, tax-qualified pension system that contribute to portability losses may also provide important benefits more consistent with the objectives set forth above. For example, it is difficult to expand coverage or improve benefit levels without also either creating disincentives for employers to maintain qualified plans by increasing employer costs or threatening the voluntary nature of the system (e.g., mandating employer-provided pensions). Also, some employers and employees may have non-tax and non-pension preferences that may justify some benefit differentials. Finally, proposals to encourage the maintenance of additional qualified plans that provide more meaningful levels of retirement benefits within the context of the voluntary system are likely either to have revenue costs or to affect adversely benefit funding or discrimination.

Benefit indexing. Those who criticize the portability effects of deferred benefit accruals often suggest indexing an employee's benefit for years between pre-retirement termination of employment and the employee's retirement age. Such indexing could be based on price or wage growth and is aimed at giving an employee credit for future pay increases with subsequent employers. However, indexing either would substantially increase the cost of maintaining defined benefit plans or result in reductions in the ultimate pension benefits for long-service employees and employees who commence employment fewer than ten or fifteen years before retirement.

Mandating prior service credit. Another approach to addressing the portability losses of deferred benefit accruals is to mandate that defined benefit plans credit an employee's years of service with all prior employers and then to permit such plans to offset employees' pension benefits by the benefits provided by the prior employers. This approach would impose significant costs on employers that maintain defined benefit plans and thus would likely encourage employers to stop providing defined benefit plan coverage. In many ways, this approach would be impractical given the wide differences among the types of plans and could significantly deter employers from hiring older employees.

Deferred accruals may benefit mobile employees. To further complicate the analysis regarding the portability effects of deferred benefit accruals is the view that plans providing deferred accruals actually may be beneficial to mobile employees. By working the last ten or fifteen working years under a plan that defers employees' benefit accruals to the years approaching retirement age, a mobile employee is able to earn a significant portion of the pension benefits he would have earned if he had stayed with a single employer. Under the voluntary, employer-based private pension system in an economy where

mobility is common, many workers will earn no or very small pension benefits for at least some of their years of employment. Indeed, during certain periods of their lives, some employees will opt for employment that maximizes their cash compensation in lieu of pension benefits. The availability of plans that defer benefit accruals to the years approaching retirement thus gives many employees the opportunity to "catch up" on earning pension benefits at the end of their working lifetimes.

Thus, one must balance the adverse portability effects of the manner in which many plans provide deferred benefit accruals with other important economic, tax, and retirement objectives. Given the ability of final pay defined benefit plans to produce a meaningful retirement benefit for an employee, including a low- or middle-income employee, over his last ten or fifteen working years, there is no single factor by which to determine when an appropriate balance has been achieved.

Other portability proposals. Other proposals have been made to address pension portability. For example, as discussed, minimum coverage and vesting requirements for qualified plans may have some effect on portability losses. Some proposals would facilitate or encourage tax-free benefit rollovers and transfers among IRAs and retirement plans (e.g., increases in the early distribution tax), while others at least would permit employees who have made after-tax employee contributions to plans to transfer such contributions to IRAs and other retirement plans. Of course, there are significant questions about the extent to which these proposals meaningfully would improve pension portability. Also, these and other proposals must be evaluated not only in light of their purported portability effects, but also in light of the important economic, tax, and retirement objectives outlined above.

CONCLUSION

Many believe that the current voluntary, employer-based pension system is flawed from a portability perspective. We recognize that, despite recent legislative changes, portability remains a very important issue that affects millions of Americans and that the current pension system could be improved to reduce portability losses.

As we have suggested, the issue of pension portability is at its core the issue of whether the existing system is "fair" as between mobile and long-term employees. Even if Congress were to come to an agreement about how fairness should be measured and to conclude that some existing plans are unfair by that measure, the preceding discussion indicates that it will be difficult to identify the policy prescription that might succeed in achieving greater fairness.

In this connection, many of the legislative proposals under consideration make important contributions to the continuing dialogue on portability. However, they must be evaluated in light of the important economic, tax, and retirement objectives previously discussed. For example, mandating greater levels of coverage or benefits for mobile workers could also result in fewer pension plans. Also, in recent years, the private retirement system has been the subject of several significant, positive legislative changes which many employers and benefit advisors have yet to fully digest. Time is needed to properly assess the portability effects of these recent changes to the pension law, many of which only become effective in 1989.

Thank you again for giving me the opportunity to present some of the Administration's views on pension portability. I would be happy to answer any questions that you might have.

TABLE 1

THE EFFECT OF INFLATION AND PLAN TYPE ON THE CHANGE
in the
PRESENT VALUE OF PENSION BENEFITS
if the
WORKER REMAINS ON THE JOB AN ADDITIONAL YEAR

Age of Employee	Years with Employer	Defined Contribution Plan	Defined Benefit Plan Inflation Rate 0%	4%	8%
25	1	$2559	$2559	$ 442	$ 84
35	10	3119	3731	1238	414
45	20	3802	5294	3019	1586
55	30	4635	7362	6843	5442
65	40	5650	10082	14826	17556

Department of the Treasury
Office of Tax Analysis

July 11, 1988

Notes: Assumes employee works for employer continuously from age 25. Initial salary is $20,000, rising to $44,160 in real terms at age 65. Pension benefits are based on high salary times 2% times years of service. Real economy is assumed to grow at 2% annually. Defined contribution plan assumes 12.795% of salary contributed.

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 12, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $6,505 million of $17,934 million of tenders received from the public for the 7-year notes, Series G-1995, auctioned today. The notes will be issued July 15, 1988, and mature July 15, 1995.

The interest rate on the notes will be 8-7/8%. The range of accepted competitive bids, and the corresponding prices at the 8-7/8% interest rate are as follows:

	Yield	Price
Low	8.90%*	99.872
High	8.92%	99.769
Average	8.91%	99.821

*Excepting 2 tenders totaling $11,000.
Tenders at the high yield were allotted 80%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 9,916	$ 9,916
New York	15,875,466	5,982,266
Philadelphia	7,550	7,550
Cleveland	11,655	11,655
Richmond	21,726	19,726
Atlanta	9,920	9,920
Chicago	1,076,551	203,751
St. Louis	12,061	8,861
Minneapolis	8,284	8,184
Kansas City	13,551	13,551
Dallas	9,151	4,151
San Francisco	875,746	222,746
Treasury	2,331	2,331
Totals	$17,933,908	$6,504,608

The $6,505 million of accepted tenders includes $331 million of noncompetitive tenders and $6,174 million of competitive tenders from the public.

In addition to the $6,505 million of tenders accepted in the auction process, $200 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $87 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.

TREASURY NEWS

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

Release Upon Delivery
Expected at 9:30 a.m., E.D.T.
July 13, 1988

STATEMENT OF
O. DONALDSON CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to be here this morning on behalf of the Administration to express our views on certain provisions contained in H.R. 4333, the Technical Corrections Act of 1988, as tentatively marked up by the House Ways and Means Committee. In keeping with the purposes of this hearing, my testimony will focus primarily on provisions in the Ways and Means bill that have not previously been considered by this Committee and certain other provisions of the bill which the Committee has determined to cover in this hearing.

Before proceeding to the specific proposals in the Ways and Means bill, I would like to describe for the Committee our view of the constraints that should limit this Committee's consideration of substantive provisions that go beyond technical corrections to the Tax Reform Act of 1986 ("the 1986 Act") and the Omnibus Budget Reconciliation Act of 1987 ("the 1987 Act"). First, it is imperative that Congress pass technical corrections legislation this year. Such action is necessary to alleviate taxpayer uncertainty and to ensure that the intent of Congress in enacting the 1986 and 1987 tax legislation is carried out. The addition of numerous substantive provisions to the technical corrections bill jeopardizes the prospects for enacting such a bill this year.

Second, we are still not very far down the road from the 1986 Act, which substantially overhauled the federal tax system. As all interested parties have recognized, the system needs a reasonable amount of time to assimilate these changes. Consequently, no major changes in the tax laws are presently in order.

Finally, the President remains firmly opposed to any new taxes, and will not support revenue-raising provisions adopted merely to fund tax relief for some particular group or interest. We hope this Committee will support the President in his determination not to raise taxes on business or working Americans.

The President's budget does propose the extension of Medicare insurance coverage to state and local government employees who began work before April 1, 1986. This is the only major group of employees in the United States who are not participating fully in Medicare. The proposal would eliminate the drain on the Medicare trust fund caused by the fact that most state and local employees are covered by Medicare even though they are not subject to the payroll tax. It would also ensure Medicare benefits to the 25 percent of state and local employees who do not currently receive these benefits.

Although we have proposed extension of Medicare coverage as an appropriate reform of the Medicare system, the proposal also has a positive revenue effect. As I will discuss below, we could recommend to the President certain of the revenue measures marked up by the Ways and Means Committee, where those measures have a sound policy basis and are not designed merely to raise revenue. I should again emphasize, however, that the President's tolerance for revenue measures is very limited, and we will not recommend and do not expect him to support provisions beyond those I will discuss here today.

Given that the legitimate revenue sources available to this Committee will be very limited, it will be necessary for the Committee to carefully limit possible revenue-losing provisions. Our own priorities in this regard are generally reflected in the budget. We believe it is essential that we continue to stimulate research activities in this country. The encouragement of such activities through an R&E credit and R&E allocation rules plays a strategic role in our country's commitment to technological and competitive leadership in the international community. The budget also proposes a permanent extension of the one-year deferral of the application of the 2-percent floor on miscellaneous itemized deductions to mutual fund shareholders. The President's budget also proposes remedying the so-called "triple tax" problem faced by foreign corporations with both a U.S. branch and U.S. shareholders, and we support recent efforts to develop a domestic election procedure for solving that problem.

Since the budget was prepared, we have become increasingly aware of the burdens imposed by recent changes in the rules relating to the collection of the excise tax on diesel fuel. These burdens are especially pronounced in the case of farmers,

who are now experiencing what may be the worst drought since the "Dust Bowl" days of the 1930's. We are pleased to see that the Ways and Means Committee has essentially adopted the relief provision that this Committee adopted in March of this year. We strongly support this relief provision.

We also believe this Committee should give careful consideration to extending the expiring relief provisions for troubled thrifts. As recent months have made clear, the financial problems facing the savings and loan industry and the FSLIC have not diminished. Allowing the relief provisions for troubled thrifts to expire would only complicate the task of restoring the thrift industry to fiscal health.

REDUCE DIVIDENDS RECEIVED DEDUCTION

Background

Under present law, dividends received by domestic corporations from other domestic corporations generally are entitled to complete or partial relief from taxation. The extent of the relief depends upon a number of circumstances, including the relationship between the corporations paying and receiving the dividend. Complete relief generally is allowed for dividends between members of the same affiliated group. In the case of an affiliated group that files a consolidated return, this is accomplished by excluding intra-group dividends from the income of the recipient. In the case of an affiliated (but nonconsolidated) group, intra-group dividends generally are eligible for a 100-percent dividends received deduction ("DRD"). In the case of nonaffiliated corporations, relief from tax on dividend income is not complete. A recipient corporation with so-called "direct" holdings (i.e., ownership of 20 percent or more by vote and value of the stock of the distributing corporation) is allowed an 80-percent DRD. A recipient corporation with so-called "portfolio" holdings (i.e., ownership of lesser amounts of the distributing corporation's stock) is allowed a 70-percent DRD.

A number of special rules limit the benefit of the DRD in certain situations in which allowance of the full DRD is viewed as inappropriate. For example, the ability of recipient corporations to utilize the DRD to avoid paying any tax is limited by section 246(b) and the alternative minimum tax rules. The ability of recipient corporations to gain an "arbitrage" benefit by deducting interest or similar amounts used to finance dividend-paying stock is limited by the debt-financed portfolio stock rules of section 246A and the proration rules applicable to insurance companies. The ability of recipient corporations to

manipulate the character of income to take advantage of the differing treatment of dividend income and gain or loss from the sale of stock is limited by the holding period rules of section 246(c) and the extraordinary dividend rules of section 1059.

Proposal

The Ways and Means bill would reduce the DRD available with respect to portfolio holdings of stock from 70 percent to 55 percent for dividends received in 1989, 51.5 percent for dividends received in 1990, and 50 percent for dividends received in 1991 and subsequent calendar years.1/ No transition relief would be provided for existing stock holdings.

Discussion

Decisions regarding the appropriate level of the DRD address a central issue of corporate taxation -- to what extent will income earned indirectly by an individual through one or more corporations be taxed differently than income earned directly by the individual. Under our tax system, income earned through a corporation is taxed at both the corporate level and the individual level. As a matter of ideal tax policy, the imposition of two levels of tax on income earned through corporations may be questioned. Economists and academicians have argued that the corporate and individual tax systems should be integrated to produce only a single level of tax, and many of our major trading partners provide some degree of integration of their corporate and individual tax systems. In recognition of the tax policy merits of providing relief from double taxation of corporate income, the President's 1985 tax reform proposals to the Congress proposed to allow corporations a partial dividends paid deduction. This tax reform proposal was not enacted, however, and we recognize that, for the foreseeable future, income earned through corporations will continue to be subject to two levels of tax.

1/ The Ways and Means bill would also revise the threshold for distinguishing between "direct" and "portfolio" holdings of stock. It would provide that the 80-percent DRD is available only with respect to dividends received by a corporation owning more than 20 percent (rather than 20 percent or more) of the distributing corporation. The principal effect of this change would be to preclude any corporation that is a member of an affiliated group from paying dividends qualifying for the 80-percent DRD to any corporation that is not a member of the affiliated group.

Although our tax system fails to provide relief from the double taxation of income earned through corporations, the system has since its inception provided relief from multiple taxation of the same income within the corporate sector. The first federal tax based on corporate income, the Payne-Aldrich Tariff Act of 1909, allowed corporations a 100-percent DRD on the ground that "there is no reason in the world why a corporation that owns stock in another company should pay a double tax on those holdings...." 44 Cong. Rec. 4696 (1909) (remarks of Rep. Payne). Although a DRD was not contained in the Revenue Act of 1913, a 100-percent DRD was reinstituted by the Revenue Act of 1917.

Since that time, the DRD has been retained with only minor changes. The DRD was reduced from 100 percent to 90 percent by the Revenue Act of 1935, and to 85 percent by the Revenue Act of 1936. These changes were intended to offset an anticipated incentive for businesses to divide their income among several corporations to avoid a newly-enacted surtax on income above a certain level and to discourage the formation of holding companies and other complicated corporate structures. Both of these concerns have since been dealt with more directly and effectively.2/ In connection with the limitation of the benefits of multiple surtax exemptions for affiliated corporations, the Revenue Act of 1964 increased the DRD for affiliated corporations not utilizing multiple surtax exemptions from 85 percent to 100 percent. The DRD for dividends between nonaffiliated corporations remained at 85 percent. The 1986 Act reduced the DRD for nonaffiliated corporations to 80 percent to prevent the 1986 Act's reduction in corporate tax rates from producing a significant reduction in the effective tax rate on intercorporate dividends.

Thus, prior to the 1987 Act, dividends between nonaffiliated corporations had been treated consistently for over fifty years, since the Revenue Act of 1935. The House version of the 1987 Act would have reduced the DRD to 75 percent for all nonaffiliated corporations. The report accompanying the House bill stated that

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2/ Holding companies were regulated by the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940. Multiple surtax exemptions for affiliated corporations were limited by the Revenue Act of 1964 and eliminated by the Tax Reform Act of 1969. Finally, the ability of nonaffiliated corporations to take advantage of multiple surtax exemptions was limited by the Tax Reform Act of 1984, which phased out the benefit of the graduated tax rates for corporations with taxable incomes exceeding $1,000,000, and by the 1986 Act, which reduced this threshold to $100,000.

the 80-percent DRD was "too generous for corporations that are not eligible to be treated as the alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation." H.R. Rep. No. 391, 100th Cong., 2d Sess. 1094 (1987). This proposed reduction in the DRD for dividends between nonaffiliated corporations would have represented a significant change in the historical treatment of intercorporate dividends. The 1987 Act, as enacted, however, made an even more significant change in the treatment of intercorporate dividends by introducing a distinction between "direct" and "portfolio" holdings of stock for purposes of the DRD.

The taxation under current law of dividends between nonaffiliated corporations diverges to a minor degree from the pure corporate-solution model of taxation inherent in allowance of a DRD. The further reduction in the DRD proposed in the Ways and Means bill would substantially increase that divergence. The stated rationale of the new House proposal to further reduce the DRD for portfolio holdings is the same as that given by the House in connection with its 1987 proposal to reduce the DRD to 75 percent for all nonaffiliated corporations -- the supposed undue generosity of the current DRD for corporations that are not alter egos. Description of Possible Committee Amendment Proposed By Chairman Rostenkowski to H.R. 4333, prepared by the Staff of the Joint Committee on Taxation, June 21, 1988 at 85. This second reduction of the DRD in two years, and the "alter ego" theory that is said to justify the reduction, augurs future erosion -- even the complete elimination -- of the DRD for portfolio stock.

Although the "alter ego" theory has in the past justified a higher DRD for dividends between affiliates than for dividends between nonaffiliates, we believe that it does not justify further substantially reducing the DRD for nonaffiliate dividends and discarding the long-standing policy that the same stream of corporate income should not be subject to tax at the corporate level more than once. The combined effect of the 1987 Act reduction and the proposed reduction in the DRD for portfolio stock would be to increase the maximum effective tax rate on intercorporate dividends from 6.8 percent (20 percent of the dividend taxed at the maximum rate of 34 percent) to 17 percent (50 percent of the dividend taxed at the maximum rate of 34 percent). This change would increase the aggregate corporate level tax on this income from 38.49 percent to 45.22 percent. Complete elimination of the DRD for portfolio stock would increase the aggregate corporate level tax to 56.44 percent.

Although the erosion of the DRD for portfolio stock would thus represent a substantial change in a basic tenet of our system of corporate taxation, it appears that this proposal (and the change made by the 1987 Act) were made without consideration of its financial and economic impact. Indeed, revenue

considerations seem to be the only force driving this proposal. We strongly believe that a change of this type in a basic principle of corporate taxation should be made only after careful consideration has been given to all its financial and economic effects.

Any further erosion of the DRD for nonaffiliate dividends may have a number of significant consequences. First, by further encouraging corporations to rely on debt, it will likely alter dramatically the existing balance between equity and debt financing, a balance that arguably already favors debt to too great a degree. This is particularly true, because this change, coming on the heels of last year's legislation, could rationally be taken to indicate that the deduction will soon be completely eliminated.

Further reliance on debt capital may increase the vulnerability of corporations, and the economy as a whole, both to the risks of bankruptcy and to cyclical changes in the economy. Moreover, corporations like banks and financial institutions and utilities that have traditionally relied on corporate shareholders as a source of capital will be affected disproportionately by a reduction in the DRD.

One study shows that of the over $27 billion dollars of preferred stock issued in the years in 1984-1987, approximately 21.7 percent was issued by utilities, 17.5 percent by banks, 14.9 percent by industrials, 7.6 percent by insurance companies and the remaining 38.7 percent by other financial institutions including thrifts. In the case of many of these heavy issuers of preferred stock, the equity raised by preferred stock serves crucial business and financial objectives. For example, banks are required by both national and international regulatory bodies to satisfy minimum capital requirements. <u>See</u> "Banks New Minimum Capital Rules Add to International Banks' Worries," <u>Wall Street Journal</u>, July 12, 1988, p. 17. One study has indicated that in the three year period 1985-87, the U.S. banking industry raised $3.5 billion of equity capital through preferred stock, representing 42 percent of the total equity raised by the banking industry. The manner in which banks currently meet regulatory requirements may thus be significantly altered by the proposed legislation.

Similarly, utilities, which generally have very high capital requirements, historically have relied on preferred stock as an important source of equity. One study has indicated that, in 1987, a group of 100 investor-owned utilities had $27.8 billion of preferred stock outstanding.

The proposed reduction in the DRD would therefore likely increase significantly the cost of equity capital of corporations in these and other industries which have historically relied heavily on preferred stock financing. As a consequence, corporations in these industries will find it more difficult to meet regulatory requirements, or to the extent not constrained by regulatory requirements, will be induced to increase their debt load and, potentially, the financial vulnerability of their capital structures.

In addition, the proposed decrease in the DRD will likely decrease substantially the market value of existing corporate stock because it will reduce the after-tax return realized by corporate investors. This effect will be especially large where, as in the case of most preferred stock, a large proportion of the stock is held by other corporations. The revenue generated by a reduction in the DRD, then, will come largely from current corporate holders of portfolio stock. In addition, the rate at which any reduction in the DRD is phased in may affect the extent of any decrease in the market value of stock. The rate of the phase-in contained in the House proposal, however, appears to have been dictated by revenue considerations and not by concerns regarding the potential market impact of a reduction in the DRD, a market impact that is likely to be a substantial one as is indicated by the reaction of the market since the proposed reduction was first announced in early June.

We recognize the concerns of some that, in certain circumstances, the DRD may serve not merely to provide relief from multiple levels of corporate taxation, but rather to provide unwarranted tax benefits. It is certainly appropriate to study and address these issues, and general reduction in the DRD with respect to portfolio holdings may, indirectly, be responsive to these policy issues. The proposed reduction in the DRD would, however, affect <u>all</u> corporations that issue or hold portfolio stock, whether <u>or not</u> allowance of the DRD had any effect other than providing relief from multiple taxation. If Congress ultimately determines that the existing restrictions on the use of the DRD are not adequate, it should consider more targeted measures to strengthen those restrictions.

In conclusion, we believe that the House proposal to reduce the DRD for portfolio stock should not be adopted. Proposed without careful consideration of the consequences, this measure would reverse long-standing and fundamental principles of corporate taxation solely as a revenue-raising measure. We question whether a change of this magnitude can be justified as part of technical corrections legislation and without the foundation of a comprehensive study of its policy merits and financial and economic impact.

REPEAL OF THE COMPLETED CONTRACT METHOD

Background

Pursuant to changes made by the 1986 Act, taxpayers producing property under a long-term contract generally 3/ are required to use either of two methods of accounting: the percentage of completion method or the percentage of completion-capitalized cost method. I.R.C. §460.

Under the percentage of completion method the taxpayer is required to include in gross income in each year of the contract a portion of the contract price based on the percentage of the contract completed by the end of the taxable year. This percentage is determined under the "cost-to-cost" method, and generally is based on the ratio of all contract costs incurred through the end of the year to total expected contract costs.4/ Under the percentage of completion method the taxpayer also deducts contract costs in the taxable year in which they are incurred.

Upon completion of the contract, a "look-back" rule requires the taxpayer to redetermine contract income for each year of the contract based on actual price and costs. The taxpayer is entitled to receive, or required to pay, interest for each year of the contract based on the difference between contract income as originally reported and contract income as redetermined.

The percentage of completion-capitalized cost method is a hybrid method under which the taxpayer is required to report a portion of the contract price and costs using the percentage of completion method. The remaining portion of contract price and costs may be reported using the completed contract method, if

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3/ The 1986 Act generally does not apply to any construction contract of a taxpayer with average annual gross receipts not exceeding $10 million, if the taxpayer estimates that the contract will be completed within two years. See §460(e).

4/ The Internal Revenue Service has permitted taxpayers to use a simplified method of determining the degree of contract completion under which only certain costs are taken into account. See Notice 87-61, 1987-2 C.B. 370, 373.

that is the taxpayer's "normal method of accounting". Under the completed contract method no amount is includable in gross income, and no contract costs are deductible, until the contract is completed.

The 1986 Act required that 40 percent of contract income and costs be accounted for under the percentage of completion method, and limited the use of the completed contract method to the remaining 60 percent. The 1987 Act raised the percentage of contract income and costs required to be taken into account under the percentage of completion method from 40 percent to 70 percent, and reduced the percentage allowed to be taken into account under the completed contract method from 60 percent to 30 percent.

In addition to requiring that a portion of income and costs from any long-term contract be taken into account under the percentage of completion method, the 1986 Act also provided new rules for allocating costs to long-term contracts. The general effect of these rules is to require that more costs be allocated to long-term contracts, and therefore to reduce the amount of taxable income that can be deferred under what is left of the completed contract method of accounting.

Under the 1986 Act, all costs, including indirect costs such as administrative expenses, that directly benefit or are incurred by reason of long-term contracts must be allocated to such contracts. This rule effectively applies the cost allocation rules provided by the Tax Equity and Fiscal Responsibility Act of 1982 for extended period long-term contracts to all long-term contracts. In addition, the 1986 Act requires that all costs identified as contract costs under a cost-plus contract or a contract with the Federal Government be allocated to the contract. Finally, the 1986 Act requires that interest costs be allocated to long-term contracts, and therefore deferred to the extent that the taxpayer uses the completed contract method.

Proposal

The Ways and Means bill would, by requiring use of the percentage of completion method for all long-term contracts, fully repeal the completed contract method. This provision generally would apply to all long-term contracts entered into on or after June 21, 1988. The provision would not apply to contracts of small construction companies exempted by the 1986 Act, or to certain ship construction contracts exempted by the 1987 Act.

Discussion

The Administration opposes repeal of the completed contract method. This proposal would again reopen a compromise reached in 1986 in the context of tax reform, and do so solely to raise revenues, rather than for reasons of tax policy. This revenue increase would come at the expense of certain industries that already have experienced an increase in their relative tax burdens as a result of the 1986 Act.

During the process that led to passage of the 1986 Act, the relative merits of the completed contract and percentage of completion methods of accounting for long-term contracts, as well as the need for new cost allocation rules, were thoroughly considered by both the Administration and the Congress. The Administration did not propose repeal of the completed contract method, but instead proposed to limit the potential for deferral of income under the method through expanded cost allocation rules.5/ The tax reform bill passed by the Senate in 1986 would have retained the completed contract method, while providing such expanded cost allocation rules. The tax reform bill passed by the House, in contrast, would have repealed the completed contract method and required use of the percentage of completion method, except for certain construction contracts of small taxpayers.6/ Recognizing that significant policy arguments can be made for and against each method, the Congress arrived at a compromise between the percentage of completion and completed contract methods, which was embodied in the 1986 Act. In order to raise revenues, the 1987 Act reopened this compromise and further restricted use of the completed contract method. The Administration did not support this action.

We believe that any change in current rules governing accounting for long-term contracts should be based on tax policy rather than revenue considerations. Such a change should take place only after a thorough reexamination of this area, including a reexamination not only of the relative merits of the completed contract and cost-to-cost percentage of completion methods, but also of alternatives to these two methods.

5/ The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 198-207 (May, 1988).

6/ See H.R. Rep. No. 841, 99th Cong., 2d Sess. II-310-11 (1986).

SPEED UP CORPORATE ESTIMATED TAXES

Background

Corporations are subject to a penalty with respect to underpayments of estimated income tax liability. I.R.C. §6655. In general, estimated tax payments must equal 90 percent of the tax shown on the return for the taxable year to avoid imposition of the penalty. Under a safe-harbor (not available to large corporations), no penalty is imposed if the estimated tax payments equal 100 percent of the tax shown on the corporation's return for the preceding taxable year.

An additional safe-harbor, available to all corporations, permits the amount of any quarterly estimated tax payment to be based on an annualization of the corporation's year-to-date income. This annualization safe-harbor is intended to allow corporations to estimate their tax liability by reference to events that have occurred prior to the due date of a required payment.

Under current law, any reduction in a quarterly estimated tax payment that results from using the annualization safe-harbor must be partially made up in the next estimated tax payment for the taxable year if the corporation does not continue to use the annualization method in computing the subsequent payment. In such cases, the corporation must increase the amount of the subsequent payment by 90 percent of the shortfall resulting from the prior use of the annualization method to avoid the penalty.

To illustrate the effect of this "recapture" rule, assume that a corporation with a seasonal business has relatively little income during the first part of its taxable year and substantially higher income in the latter part of the year. Assume further that under the general rule, which requires that estimated tax payments equal 90 percent of the tax liability shown on the return for the taxable year, each of the quarterly estimated tax payments would have to be $88,000. Under the annualization safe-harbor, however, the required payments for the first and second quarter would be, say, only $27,000 each. If the corporation did not continue to use the annualization method in its third quarter, its required estimated tax payment of $88,000 for the third quarter would be increased by $110,000 (90 percent of the excess of $176,000 over $54,000). Thus, an underpayment penalty can be avoided if the corporation pays estimated taxes of $198,000 ($88,000 + $110,000) for the third quarter.

Proposal

The Ways and Means bill would require corporations to increase quarterly estimated tax payments by 100 percent (rather than 90 percent) of the reduction in a prior payment that results from using the annualization safe-harbor.

Discussion

The recapture rule under current law, and under the proposal, applies only if a corporation computes at least one quarterly estimated tax payment using the annualization safe-harbor and does not continue to use the same approach for the remainder of the taxable year. If the taxable income of a corporation is recognized uniformly throughout the taxable year, or if the level of taxable income consistently declines throughout the taxable year, none of the estimated tax payments due will be based on the annualization method. In contrast, if the level of taxable income recognition consistently increases throughout the taxable year, all of the estimated tax payments due will be based on the annualization safe-harbor. Thus, in these circumstances, no recapture is required under current law or under the proposal.

If, however, taxable income recognition levels fluctuate during the taxable year, the recapture rule may increase the amount of an estimated tax payment. This is likely to occur, for example, when taxable income recognition levels start out relatively low, peak during the middle of the year, and decline towards the end of the year. In these circumstances, the first and second quarterly estimated tax payments are likely to be determined under the annualization safe-harbor, while the payments for the third and fourth quarters would be determined under the general rule (i.e., 90 percent of tax liability shown on the return for the year).

Without a recapture rule, a corporation with fluctuating taxable income would be required to pay less estimated tax than a corporation that recognizes its income uniformly throughout the year. This discrepancy is substantially reduced by the 90-percent recapture rule under current law and would be eliminated entirely by the 100-percent recapture rule under the proposal. We see no reason why a corporation that uses the annualization method for only part of the year should not be required to make up any shortfall completely when it ceases to use that method.

REPEAL RULES PERMITTING LOSS TRANSFERS BY ALASKA NATIVE CORPORATIONS

Background

Under present law, Alaska Native Corporations ("ANCs") are exempt from several rules that limit the ability of loss corporations to sell or otherwise transfer their losses to other corporations. These exemptions began with the Tax Reform Act of 1984, which amended Code section 1504(a) to tighten the definition of affiliated groups eligible to file consolidated returns, but which also delayed the effective date of this change until taxable years beginning after 1991 in the case of affiliations with ANCs.

The 1986 Act further liberalized the requirements for affiliation with an ANC (or with a wholly-owned subsidiary of an ANC) for any taxable year beginning after 1984 and before 1992. In particular, the 1986 Act made it clear that no provision of the Code (e.g., sections 269 and 482) or principle of law (e.g., the assignment of income doctrine) may be applied to deny the benefit or use of losses or credits of an ANC which is the common parent of an affiliated group, or of a wholly-owned subsidiary of such an ANC, to the group. Thus, as so liberalized, affiliation with an ANC is to be determined solely according to the provisions expressly contained in section 1504(a) of the Code as it existed before the amendments made by the 1984 Act.

Proposal

The Ways and Means Committee proposal would terminate the exemption of ANCs from the generally applicable current law rules for losses and credits of an ANC (1) arising after April 26, 1988, or (2) arising on or before April 26, 1988 to the extent such losses and credits are used to offset income assigned (or attributable to property contributed) after that date. This proposal is identical to H.R. 4475 as introduced by Chairman Rostenkowski on April 27, 1988.

Discussion

The exemption of ANCs from the general rules applicable to loss corporations was intended to provide special relief to ANCs with large net operating losses and numerous business credits that they would not otherwise have been able to use. This relief was designed to allow losses and credits of an ANC and its wholly-owned subsidiaries to be used on a consolidated return against the income and tax liability of profitable corporations and to allow the ANC group to share in the resulting economic benefits. It was hoped that the resulting infusion of capital would help improve the financial condition of ANCs and that resulting relationships with other corporations would permit ANCs to acquire new business expertise.

As a tax policy matter, these special provisions have always been controversial, and the tension between this provision and sound tax policy has increased over the last several years. Recent tax legislation has severely curtailed the ability of one corporation to transfer its losses and credits to another. In particular, transfers between corporations have been restricted by (i) the amendments relating to the definition of an "affiliated group" in section 1504 of the Code, (ii) the revised limitations on net operating losses and certain built-in losses following an ownership change in section 382, and (iii) the limitation on the use of preacquisition losses to offset built-in gains in section 384. In light of these changes, the continuation of special rules that permit certain taxpayers to sell losses and credits without regard to any provision of the Code or principle of law that would otherwise restrict such a transfer is unjustifiable.

Although it appears that there may have been some success in achieving the goals underlying this relief provision, it also appears that the losses and credits available to be transferred, and that have been transferred, far exceed the estimates made at the time these special relief provisions were adopted. Now that it is clear that the associated revenue costs greatly exceed Congress's expectations, it is appropriate to terminate this relief.

The proposal would, in effect, prevent ANCs from engaging in any transactions after April 26, 1988 that would have the effect of transferring their losses or credits, whether such losses or credits arose before or after such date, to another corporation (except to the extent permitted by the generally applicable rules). In addition, this proposal would affect certain transactions entered into before such date if the losses or credits "arise" after such date. It is unclear, however, whether a loss arises for purposes of this proposal when it is realized and recognized for tax purposes or when it is economically incurred. For this reason, the time at which losses are deemed to arise under the proposal should be clarified.

This proposal would also prevent ANCs from transferring losses or credits arising on or before April 26, 1988 to the extent such losses or credits are used to offset income assigned (or attributable to property contributed) after that date. It apparently would not prohibit transfers of such losses and credits to the extent they are used to offset income which is actually earned after that date as long as the income was assigned (or the property to which it is attributable was contributed) before April 26, 1988. This "grandfathering" of transactions involving income actually earned after April 26, 1988 may result in further revenue losses. It may also be

perceived as unfairly benefiting those ANCs that had already completed transactions transferring their losses and credits as opposed to those that had not yet completed such transfers. For these reasons, consideration should be given to expanding the proposal to apply to all income earned after April 26, 1988.

NONDISCRIMINATION RULES FOR HEALTH AND OTHER EMPLOYEE BENEFIT PLANS

Background

As part of the 1986 Act, with Administration support, Congress adopted rules limiting the extent to which employer-provided health, group-term life insurance, and certain other employee benefit plans may discriminate in favor of an employer's highly compensated employees. Satisfaction of these new nondiscrimination rules, which are contained in section 89 of the Code, is a precondition to the exclusion by the employer's highly compensated employees of such tax-favored benefits from income. The requirements of section 89 are not yet in effect; they will be effective for taxable years beginning after the earlier of (i) the date that is three months after Treasury issues certain regulations, or (ii) December 31, 1988.

Section 89 requires not only that the health and other benefits be available to employees on a nondiscriminatory basis, but also that actual receipt of benefits be nondiscriminatory. In general, an employer's health and other benefit plans are nondiscriminatory if (i) at least 90 percent of the employer's nonhighly compensated employees have benefits available that are at least 50 percent as valuable as the benefits available to the highly compensated employee with the most valuable benefit available, and (ii) the per capita average value of the benefits actually provided to the nonhighly compensated employees is at least 75 percent of the analogous per capita average for the highly compensated employees. Application of the section 89 rules requires that the benefit coverages provided by an employer be valued and that data on the family status of employees and the actual coverage received by employees and their families be collected and analyzed.

Proposal

In response to many of the concerns raised by employers about the difficulty of proving compliance with the section 89 rules, the Ways and Means bill would make numerous changes to section 89.

Discussion

In our view, any changes to the section 89 rules should be consistent with the nondiscrimination policy reflected in the original rules and should address specific administrative concerns raised by employers within the structure of the existing rules; changes that would create new testing approaches or otherwise add additional administrative complexity for employers or the IRS should be avoided. In addition, any changes that affect not only section 89, but also the nondiscrimination rules applicable to qualified retirement plans (e.g., changes to the highly compensated employee definition) must be carefully scrutinized to assure that pension policy objectives are not being frustrated. In certain circumstances, it may be appropriate to provide that such changes apply only for purposes of section 89.

We believe that the proposed changes generally satisfy these guidelines, and we generally support them. In fact, we have been considering many similar changes in developing administrative guidance on the new rules.

Among the most significant of the proposed changes is the transition valuation rule permitting employers to use any reasonable method of health coverage valuation (including employer cost) until the later of January 1, 1991 or 6 months after the IRS issues valuation rules. The existing statute directs employers to determine the value of health coverage in accordance with guidelines and tables issued by the IRS. However, developing generic value guidelines and tables has proven to be a difficult task that we are not likely to complete within the next 12 months. Thus, this change will enable employers to prove compliance with the nondiscrimination rules by using value or cost information that will in most cases be accessable with little difficulty.

Another very significant change is the rule permitting employers to prove compliance with the nondiscrimination rules by testing the benefits available and provided on a single day of the year, subject to appropriate anti-manipulation rules, instead of tracking benefit availability and coverage for each day of the year. By also permitting employers to prove compliance on the basis of a statistically valid sample of employees and coverages, rather than on the basis of data collected on all employees and coverages, the proposed changes eliminate what may have been the gravest administrative concern raised by employers--the difficulty and cost of collecting and analyzing employee and benefit data for each employee for each and every day of the year.

Finally, we would like to mention one particular issue that is not directly addressed in the Ways and Means bill, but that we are aware is a matter of some concern to employers. The issue relates to the extent to which employers will be able to apply section 89 on a separate line of business or operating unit basis (section 414(r)). Employers evidently are concerned that the line of business regulations we are developing will not permit sufficient disaggregation of an employer into separate units based on geographical areas.

We are aware that special concerns relating to health benefits argue strongly for permitting the disaggregation of an employer into small, geographically based units for section 89 testing purposes (e.g., health plans and costs vary significantly by geographical area and the health nondiscrimination rules apply on a per capita, rather than a percentage of compensation, basis). Consistent with these concerns, we intend to provide early guidance under section 89 that will specifically address the extent to which employers may separately apply the new rules with respect to separate geographical sites. This guidance will generally permit disaggregation beyond that permitted under section 414(r). Also, an employer will be able to apply these special section 89 disaggregation rules even before section 414(r) guidance is issued.

EXTENSION FOR ONE YEAR OF THE LOW-INCOME HOUSING TAX CREDIT

Background

The 1986 Act created a low-income housing tax credit which may be claimed by owners of residential rental property used for low-income housing. I.R.C. §42. The credit is intended to encourage investment in rental housing for individuals near the poverty level. The credit is set to expire on December 31, 1989.

New construction and qualified rehabilitation expenditures for non-federally subsidized low-income housing units are eligible for a tax credit of up to 70 percent of the initial low-income housing investment. The owner of a qualified project receives a portion of the credit each year over a 10-year period, and the amount of each annual credit is grossed-up so that the sum of the credits received equals 70 percent of the investment on a present value basis. If tax-exempt bond financing or certain other government subsidies are used to finance the project, then a 30 percent credit rate applies. Purchases of existing units that were last placed in service more than 10 years ago are also eligible for a 30 percent credit.

The credit is available only for units rented to households near or below the poverty level. In general, a project owner can choose one of two minimum qualifying criteria: (1) 40 percent of units must be rented to households whose incomes do not exceed 60 percent of area median income, or (2) 20 percent of the units must be rented to households whose incomes do not exceed 50 percent of area median income. In addition, the amount of rent charged for the low-income units is subject to certain limitations.

Designated state agencies authorize credits to qualifying projects subject to an overall cap of $1.25 per capita of new annual credit authority per year. In 1987, the total credit authority was approximately $300 million. States generally may not carry over unused credit authority. A limited exception is provided for buildings placed in service in 1990, if expenditures equal to 10 percent or more of total project costs are incurred before January 1, 1989. Credit authority for such property may be carried over from the 1989 credit allocation for the credit agency.

A full or partial recapture of the credit is applicable with respect to any project that (i) fails to provide the agreed upon percentage of low-income housing units, (ii) exceeds qualifying rent limits, or (iii) is transferred without the posting of a suitable bond. For projects that fail to comply in the first 11 years, one-third of the credit is recaptured with interest. The recapture fraction phases out between years 12 through 15.

The technical correction bills in both the Senate (S. 2238) and the House (H.R. 4333) contain the same technical corrections provisions relating to the low-income housing credit. These changes are primarily technical in nature and are needed to make the credit more effective and easier to use. Treasury generally supports the entire package of technical corrections to the credit proposed by both the House and the Senate. Passage of a technical corrections bill is an important step to ensure proper utilization of the credit.

Proposal

In addition to the numerous technical corrections provisions, the Ways and Means Committee has agreed to extend the credit for one year to December 31, 1990. The extension of the credit this year is intended to help ensure the continued use of this housing subsidy while Congress has an opportunity to gather more information on its operation and relative efficiency before deciding to continue, modify, or eliminate the credit. No changes to the credit have been proposed by the Ways and Means Committee to offset the revenue cost of a one-year extension of the credit.

Discussion

The Administration is opposed to extending the low-income housing credit for one year. The credit does not expire until the end of 1989, and it is thus premature to enact a one-year extension of the credit this year. Developers can continue to plan low-income projects with the assurance that credits will be available so long as the project is (i) placed in service before the end of 1989, or (ii) placed in service in 1990 and 10 percent or more of total project costs are incurred before January 1, 1989. Thus, we believe that development and construction of low-income projects will continue this year without an extension of the credit.

More importantly, we believe that it is critical that the relative efficiency of the current credit and alternative housing subsidies be fully analyzed before any decision is made to extend the credit. Even a one-year extension of the credit is an expensive proposition because credits are allowed in each of the next ten years. Thus, a one-year extension means a significant revenue cost each year for ten years. While the current revenue cost of the low-income housing tax credit is estimated to be $60 million in calendar year 1987, the cost grows to around $800 million in fiscal year 1991 as a result of increased usage of the credit and the continued payment of credits for 10 years on earlier projects. We estimate that the cost of a one-year extension of the credit would be $.8 billion over 5 years.

While the low-income housing credit is a clear improvement over prior tax incentives for low-income housing, we have serious concerns about the efficiency and equity of the credit that require a further examination of the credit before it is extended. First, would some subsidized units simply replace units that would have been available in the absence of federal assistance? If so, the credit may not result in a significant long-run increase in housing supply. Second, the credit includes no incentive for maintenance. If units receiving the credit rent at below market levels, will landlords allow the projects to deteriorate without losing tenants? In addition, without additional subsidies, will project owners have any economic incentive to continue to rent to low-income tenants after the compliance period elapses? Finally, will households substantially below the poverty level benefit from the credit?

Another source of inefficiency of the credit is that it may not result in housing of a quality or location that is appropriate for or desired by low-income renters. Thus, even if the full value of the credit were passed along to low-income tenants, the value to the renter would be less than the amount of the subsidy.

The Administration has addressed many of these concerns by reemphasizing its commitment to rental housing vouchers in the 1989 budget. Vouchers avoid many of the inefficiencies discussed above. The budget proposes to provide 135,500 additional vouchers to needy households. In light of the relative efficiency of vouchers, we oppose making the low-income housing credit the dominant mechanism for assisting low-income housing. In this regard, we look forward to working with Congress to determine the best method of providing housing assistance to poor families.

ESTATE FREEZES

Background

The 1987 Act added section 2036(c) to the Code in an effort to remove the tax advantages of various techniques designed to "freeze" the value of an estate for federal estate tax purposes. These techniques involve a transfer of the right to appreciation in an asset with the owner retaining an income interest in the asset or rights to control the asset. A typical "estate freeze" consists of parents transferring common stock in the family business to their children while retaining control of the corporation, and a right to the corporation's income, through ownership of preferred stock. The effect of section 2036(c), where it applies, is to treat the owner as retaining the transferred interest and to include that interest in the owner's estate.

Section 2036(c) applies to any transfer occurring after December 17, 1987, if the transferor holds a substantial interest in an "enterprise" and in effect transfers property having a disproportionately large share of the potential appreciation in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise. The Conference Report describes an "enterprise" as including any business or other property which may produce income or gain. A person holds a "substantial interest" in an enterprise if he or she owns, directly or indirectly, 10 percent or more of the voting power or income stream, or both, in the enterprise. An individual is treated as owning an interest in an enterprise which is directly or indirectly owned by any member of an individual's family.

Section 2036(c) excludes from the decedent's gross estate an interest that is transferred in a bona fide sale for full and adequate consideration. However, this exception is not applicable to a transfer between family members if the transfer otherwise satisfies the criteria of section 2036(c). In addition, section 2036(c)(4) provides that if a transferor disposes of his retained interest within three years of his death, the previously transferred interest will be included in his estate for Federal estate tax purposes.

Under the current statute, a transferred interest is includible in the transferor's estate (and valued as of the time of the transferor's death) regardless of whether the transferee transfers his interest in the enterprise (or whether proportionality is restored) before the death of the transferor. However, if the transferor disposes of his retained interest more than three years before his death, or it is otherwise terminated before that time, section 2036(c) does not apply.

The technical corrections bills in both the House (H.R. 4333) and the Senate (S. 2238) contain identical rules imposing a gift tax when the original transferor transfers the retained interest, or the original transferee transfers the transferred property, to a person who is not a member of the original transferor's family. Under this proposed technical correction, the amount that would have been included in the transferor's estate with respect to the transferred property if the transferor had died at that time would be treated as a current gift by the transferor ("the deemed gift rule"). Section 2036(c) would then no longer apply to that transferred property for estate tax purposes. If the transferor or transferee transfers only a portion of the retained or transferred interest, respectively, a proportionate amount of the interest would be treated as a deemed gift under this rule.

Proposal

In addition to the proposed technical corrections in H.R. 4333 and S. 2238, the Ways and Means Committee has tentatively adopted additional technical corrections which further clarify and broaden both the original statute and the first set of proposed technical corrections. For example, the Ways and Means bill provides that for purposes of the deemed gift rule described above, terminations, lapses and other changes in any interest in property of the transferor or transferee are treated as transfers. The bill also confers upon the transferor a right of contribution similar to that of section 2207A 7/ and provides the Treasury Department with authority to describe circumstances in which an individual and such individual's spouse will not be treated as one person.8/

7/ Under section 2207A, a surviving spouse's estate is granted a right to recover from the recipients of certain property the estate taxes paid as a result of the inclusion of the property in the spouse's estate.

8/ This rule is intended to prevent the inclusion of interests in property under section 2036(c) in both spouses' estates where there is a transfer of the retained interest between spouses.

The Ways and Means bill includes safe harbors for certain common business transactions that otherwise might be reached by section 2036(c). For example, the bill provides that section 2036(c) will not apply solely because the transferor receives or retains certain debt of the enterprise. Further, the statute would not apply solely because the transferor enters into an agreement for the sale or lease of goods or other property to be used in the enterprise, or the providing of services, if the agreement is an arms-length agreement for fair market value and does not otherwise involve any change in interests in the enterprise. Finally, the bill provides that section 2036(c) will not apply merely because the owner has granted an option to sell property at fair market value as of the time the option is exercised.

Discussion

Section 2036(c) is designed to remedy the perceived unfair estate tax advantage resulting from the creation and transfer of fractional interests in an enterprise with different rights to income, voting control and appreciation. The creation and transfer of such interests may arguably result in the transfer of wealth outside the transfer tax system in certain situations.

In general, the purpose of the proposed "deemed gift" technical correction in the first set of technical corrections is twofold. First, it is designed to impose the tax on the value of the transferred interest at the time that the transferee disposes of the transferred property or the transferor disposes of the retained property (or when proportionality is restored). Second, it is designed to prevent the complete avoidance of the consequences of section 2036(c) by subsequent transfers more than three years before death.

Both sets of technical corrections to section 2036(c) are very broad in scope. While some of the technical corrections are necessary to clarify the statute and provide safe harbors to taxpayers who might otherwise be affected by section 2036(c), we are concerned that they are considerably broader than the perceived abuse would require.

We are also concerned whether further tightening of these rules which has the effect of increasing taxes on estates is warranted without further study. The Treasury Department is interested in exploring whether additional safe harbors or further guidance can or should be provided either by legislative or administrative action. In this regard, we look forward to working with this Committee to improve this provision and provide needed guidance as soon as possible.

There is one other provision in the House bill -- the so-called "residual treaty override" -- which is of such far-reaching and fundamental significance to our tax policy and tax law that I must ask for forebearance for a few moments in order to comment on it here, even though I have testified on the treaty override provision before.

RESIDUAL TREATY OVERRIDE

Background

In my statement before the Subcommittee on Taxation and Debt Management last July 22 on the then-pending technical corrections bill, I explained that the Administration strongly opposes the provision in the technical corrections bill that purports to "clarify" the relationship between income tax treaties and provisions in the 1986 Act. This provision, section 112(aa)(2)(C) of the Technical Corrections Act of 1988 introduced in the Senate and the House of Representatives on March 31, 1988, remains in the bill tentatively approved by the House Ways and Means Committee. I am not asking now, as I did before, that the Committee eliminate this provision altogether. Instead, I would strongly urge the Committee to consider modifying this provision so that it addresses the concerns that Congress and the Administration share regarding the relationship between treaties and tax legislation, but does so in a manner that does not needlessly and gratuitously undermine the standing and credibility of the United States as a treaty partner.

Description of Section 112(aa)(2)(C) of H.R. 4333.

Section 112(aa) of the technical corrections bill attempts to provide definitive rules for the coordination of provisions in the 1986 and 1987 tax legislation and pre-existing treaties. The approach taken is to identify provisions in the recent tax legislation that are thought to conflict with one or more income tax treaties and to specify those provisions that would not apply to the extent inconsistent with pre-existing treaties and those that would override U.S. treaty obligations. In addition, section 112(aa)(2)(C) provides that, in any other cases of conflict between the two recent tax Acts and treaties, the Acts' provisions are to apply notwithstanding any treaty obligation of the United States.

Discussion

During Congress's consideration of the 1986 Act, the Administration made clear its opposition to the several treaty overrides contained in that legislation. Our view then, and now, is that treaty overrides are neither necessary nor appropriate. Today, however, I do not want to restate old arguments, but rather to focus solely on the residual override in section 112(aa)(2)(C).

In the 15 months since a residual override was first proposed by congressional staff, we have regularly discussed with your staffs the importance of treaties and the importance of ensuring that treaties and tax legislation are interpreted in a manner that is consistent with the intent behind both the legislation and treaties. Significantly, there is agreement on many important points:

-- There is agreement that courts generally have done a good job of reconciling statutes and treaties by applying canons of construction developed in the process of two centuries of judicial decisionmaking.

-- There is agreement that courts do and should seek to avoid finding a conflict between statutes and treaties whenever possible, so that effect can be given to both.

-- There is agreement that, in interpreting statutes and treaties, courts do and should consider the intent of Congress and the Administration in enacting the legislation and entering into the treaty.

-- There is agreement that taxpayers should not be permitted to use treaties in ways not intended by the treaty partners to prevent application of general tax provisions enacted by Congress.

Regrettably, the residual override -- as currently drafted -- would make it more difficult for courts to reconcile statutes and treaties in a manner that gives effect to the purposes of both. In the case of presently unidentified conflicts between statutes and treaties, the residual override expresses a congressional intent that the legislation be given effect over pre-existing treaties in every case. Courts are simply instructed to make the treaty yield to the later-enacted statute.

As I stated in my testimony last year, we believe that for the non-judicial branches of government to insist that courts blindly apply the later-in-time doctrine reflects a lack of confidence in courts and a lack of regard for treaties. It also

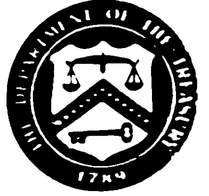
denies both the United States and its treaty partners the benefit of case-by-case consideration of how purported conflicts should be resolved on their merits, in light of the respective purposes and policies intended to be served by the treaties and the relevant legislation.

Although the Administration strongly opposes the residual override as it is currently drafted, we believe the attention that has been given to the interaction of statutes and treaties can lead to productive change. We recognize and share the concerns expressed by congressional staffs that taxpayers not be permitted to misinterpret or misapply treaties in a manner that prevents appropriate application of the many important tax changes included in the recent tax legislation. We agree with congressional staffs that misuse of treaties, if permitted, can undermine the respect for treaties that is essential to an effective treaty network. At the same time, we sense broad agreement in Congress that income tax treaties are an important benefit for our multinational taxpayers and for the U.S. economy and thus should be preserved and strengthened.

Accordingly, we are now in the process of discussing with your staffs and the staff of the Joint Committee on Taxation an alternative to the residual treaty override that would give appropriate weight to treaties but would also ensure that treaties are not misused to undermine congressional intent in enacting tax legislation.

I urge you to reconsider the residual treaty override of section 112(aa)(2)(C) and amend the provision appropriately. We -- Congress and the Administration -- are presented with a significant opportunity. Deleting the residual override as it is currently drafted and substituting a suitable alternative will reaffirm to treaty partners that the United States takes its treaty commitments seriously and values its treaty network. It will deter our treaty partners, many of whom are undergoing their own tax reform following the United States' lead, from unilaterally overriding our tax treaties to the detriment of United States taxpayers and interests. It will remove a significant impediment in our international relations that has adversely affected our tax treaty program and has even spilled over into international relationships on other issues. In addition, appropriate amendment to this provision will strengthen the Executive Branch's ability to carry out the responsibility given it by Congress to implement in our tax treaties the many important changes in tax law and policy established by the 1986 and 1987 Acts.

TREASURY NEWS



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

FOR IMMEDIATE RELEASE
July 14, 1988

CONTACT: LARRY BATDORF
(202) 566-2041

RECIPROCAL TAX EXEMPTIONS OF SHIPPING AND AIRCRAFT INCOME

The Treasury Department today announced further agreements with Finland, Greece and Taiwan for the reciprocal tax exemption of income from international shipping and aviation. The exchanges of notes are in accordance with sections 872 and 883 of the Internal Revenue Code. In each case the exemption applies for taxable years beginning on or after January 1, 1987. Earlier such agreements with thirteen countries were announced in Treasury News Releases B-1294 of February 24, 1988 and B-1411 of May 17, 1988.

Copies of the notes with Finland and Greece are available from the Office of Public Affairs, room 2315, Department of the Treasury, Washington, D.C. 20220. The notes with Taiwan will be released when they arrive in Washington and have been processed by the Department of State.

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B-1481

No. 60

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of Finland and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with Sections 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from tax gross income derived by an enterprise of Finland from the international operation of ships or aircraft. For this purpose, an "enterprise of Finland" means an enterprise carried on by individuals who are residents of Finland (other than United States citizens) or by corporations organized in Finland. This exemption is granted on the basis of equivalent exemptions granted by Finland to enterprises of the United States.

In the case of a Finnish corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Finland or of another country which grants a reciprocal exemption to United States citizens and corporations; or,

(2) The corporation's stock is primarily and regularly traded on an established securities market in Finland, or is wholly owned by a corporation whose stock is so traded and which is also organized in Finland.

For purposes of subparagraph (1), the Government of Finland will be treated as an individual resident of Finland. For purposes of applying the 50-percent test to a foreign corporation, if the foreign corporation is a United States controlled foreign corporation, as defined in Section 957(A) of the Internal Revenue Code, the United States shareholders of the foreign corporation are treated as residents of the foreign country in which the corporation is organized. For purposes of subparagraph (1), stock of a corporation owned by another corporation, partnership, trust or estate shall be treated as owned proportionately by the beneficial owners.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Embassy of the United States of America considers that this note, together with the Ministry's reply note confirming that the Government of Finland agrees to these terms, constitutes an agreement between two governments. An enterprise of Finland which derives income from the international operation of ships or aircraft may choose to apply to such income either the provisions of this agreement or of the convention between the United States of America and the Republic of Finland with respect to taxes on income and property, signed on March 6, 1970, or of any similar convention subsequently entered into between the two countries. This agreement shall enter into force on the date of the Ministry's reply note

and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs the assurances of its highest consideration.

Embassy of the United States of America,

Helsinki, April 8, 1988

This is a true copy of the original Diplomatic Note No. 60., attested by

Lawrence E. Butler
Economic Officer

William Kiehl
A/DCM

OF FINLAND

12856

The Ministry for Foreign Affairs present their compliments to the Embassy of the United States of America and has the honor to acknowledge receipt of the Embassy's note of 8 April 1988 containing a proposal for the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Finland agrees to exempt from tax gross income derived from the international operation of ships or aircraft by an enterprise of the United States. For this purpose, the term "enterprise of the United States" means an enterprise carried on by U.S. citizens (who are not residents of Finland) or by corporations organized in the United States.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(1) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are citizens of the United States or are residents of another country which grants a reciprocal exemption to Finnish residents and corporations; or

(2) The corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

To
the Embassy of the United States of America
H e l s i n k i

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Ministry for Foreign Affairs is pleased to confirm that the Embassy's Note and this Reply Note constitute an agreement between the two governments. An enterprise of the United States which derives income from the international operation of ships or aircraft may choose to apply to such income either the provisions of this agreement or of the Convention between the United States of America and the Republic of Finland with respect to taxes on income and property, signed on 6 March 1970, or of any similar convention subsequently entered into between the two countries. This agreement shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after 1 January 1987.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry for Foreign Affairs take this opportunity to renew to the Embassy of the United States of America the assurance of their highest consideration.

Helsinki, 22 April 1988

The Department of State proposes to the Embassy of Greece that the Government of the United States of America and the Government of Greece conclude an agreement to exempt from income tax, on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Greece (other than U.S. citizens) and corporations organized in Greece. This exemption is granted on the basis of equivalent exemptions granted by Greece to citizens of the United States (who are not residents of Greece) and to corporations organized in the United States (which are not subject to tax by Greece on the basis of residence).

In the case of a Greek corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. domestic law. In the case of a corporation incorporated in a third country which grants an

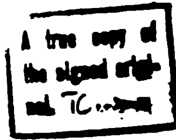
corporations, section 883(c) of the Internal Revenue Code will not apply if more than 50 percent of the value of the stock of the corporation is owned by individuals who are residents of Greece.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Department of State considers that this note, together with the Embassy's reply note confirming that the Government of Greece agrees to these terms, constitutes an agreement between the two Governments which shall enter into force on the date of the Embassy's reply note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

A resident or corporation of Greece which derives income from the international operation of ships or aircraft may choose to apply to such income either the provisions of the agreement or of the tax treaty between the United States and Greece signed on February 20, 1950.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.



Department of State,

Washington, June 10, 1988

EMBASSY OF GREECE
WASHINGTON, D. C.

Ref. No. 1069.1/AS872

The Embassy of Greece presents its compliments to the Department of State and has the honor to acknowledge receipt of the Department's note dated June 10, 1988 proposing the terms of a reciprocal exemption from income tax of income derived from the international operation of ships and aircraft.

The Government of Greece in accordance with its relevant legislation, agrees to exempt from income tax on a reciprocal basis gross income derived from the international operation of ships or aircraft by U.S. citizens (who are not residents of Greece) and corporations organized in the United States (other than corporations which are subject to tax by Greece on the basis of residence).

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of Greece's domestic law.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from rental on a bareboat basis of ships and aircraft used for international transport.

The Embassy is pleased to confirm that the Department of State's note and this reply note constitute an agreement between the two Governments, which shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

A resident or corporation of the United States which derives income from the international operation of ships or aircrafts may choose to apply to such income either the provisions of this agreement or of the tax treaty between the United States and Greece signed on February 20. 1950.

Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of Greece avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.

June 10, 1988

TREASURY NEWS

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

CONTACT: OFFICE OF FINANCING
(202) 376-4350

FOR IMMEDIATE RELEASE
July 18, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,671 million of 13-week bills and for $ 6,627 million of 26-week bills, both to be issued on July 21, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 20, 1988			:	26-week bills maturing January 19, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.75%	6.96%	98.294	:	7.07%	7.43%	96.426
High	6.77%	6.98%	98.289	:	7.09%	7.45%	96.416
Average	6.76%	6.97%	98.291	:	7.09%	7.45%	96.416

Tenders at the high discount rate for the 13-week bills were allotted 6%.
Tenders at the high discount rate for the 26-week bills were allotted 69%.

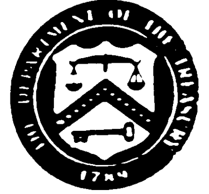
TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,025	$ 36,025	:	$ 37,615	$ 37,115
New York	30,044,130	6,099,200	:	21,333,275	6,017,110
Philadelphia	24,145	24,145	:	23,830	21,830
Cleveland	29,805	29,710	:	50,880	40,415
Richmond	40,160	40,160	:	36,695	36,695
Atlanta	35,550	35,550	:	47,100	44,750
Chicago	1,265,820	51,620	:	906,695	56,695
St. Louis	27,220	23,220	:	38,375	30,915
Minneapolis	17,005	7,005	:	13,510	8,510
Kansas City	32,595	27,655	:	48,635	44,255
Dallas	19,135	19,135	:	24,235	24,235
San Francisco	1,119,810	71,810	:	1,288,325	108,825
Treasury	206,205	206,205	:	155,585	155,585
TOTALS	$32,897,605	$6,671,440	:	$24,004,755	$6,626,935
Type					
Competitive	$29,426,685	$3,200,520	:	$19,376,500	$1,998,680
Noncompetitive	896,120	896,120	:	858,955	858,955
Subtotal, Public	$30,322,805	$4,096,640	:	$20,235,455	$2,857,635
Federal Reserve	2,030,200	2,030,200	:	1,750,000	1,750,000
Foreign Official Institutions	544,600	544,600	:	2,019,300	2,019,300
TOTALS	$32,897,605	$6,671,440	:	$24,004,755	$6,626,935

1/ Equivalent coupon-issue yield.

B-1482

TREASURY NEWS



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Text as Prepared
For Release Upon Delivery
Expected at 11:30 a.m. DST

Remarks by Thomas J. Berger
Deputy Assistant Secretary For International Monetary Affairs
U.S. Department of the Treasury

before the
Institute for International Research Conference
on
Penetrating Japanese Markets
Washington, D.C.
July 18, 1988

Structural Adjustment in the Land of the Rising Sun: Japan's Next Great Challenge

Introduction

Good morning, ladies and gentlemen. It is a pleasure for me to address this conference regarding current economic trends in Japan and their impact on American companies doing business in the Land of the Rising Sun. In talking about the "Japanese economy" we must be careful to recognize that there are, in fact, two Japanese economies. One is the international, free-market oriented, manufacturing economy that is one of the most productive in serving the world's demand for high-quality, technologically sophisticated goods. The other is Japan's internal economy that serves its domestic markets rather less well, presenting Japanese consumers and investors with relatively high-cost goods and services, even in the face of import competition; this economy is held back by a vast network of regulations, tradition and institutional barriers. It is in need of wide-ranging structural reforms in order to achieve its full potential.

This morning I would like to briefly discuss with you (1) Japan's two economies, (2) where changes are occurring domestically, (3) what further reforms are needed and (4) what the implications are for U.S. companies.

Japan's External Economy

From reading the newspaper headlines, you might believe that recent developments in Japan make it the ultimate success story. In the first quarter of 1988, real GNP increased at an annual rate of 11.3 percent -- over three times the U.S. GNP growth rate for the same period; consumer prices actually fell at an annual rate of 0.8 percent and unemployment averaged only 2.7 percent. Perhaps the most headline-grabbing bit of news was that Japan's per capita GNP in 1987, at $19,200, surpassed the figure of $18,200 for the United States.

The first quarter 1988 real GNP growth rate I just mentioned was the highest quarterly figure for Japan in over ten years. Indeed, if real GNP growth were to cease for the rest of the year, Japan would still achieve a growth rate of at least 5 percent on a year-average basis for 1988. This is certainly a strong indication that Japan has weathered well the almost 100 percent appreciation of the yen against the dollar since early 1985.

Adjustment of the external accounts in Japan has also been progressing, even if somewhat more slowly. The 1987 current account surplus rose slightly in dollar terms, but measured in yen, it declined by about 14 percent from 1986 levels. Import and export volume changes in 1987 were in the right direction with imports increasing by 9.3 percent and exports registering an upward movement of only 0.3 percent.

Both the Japanese inflation and unemployment rates are low and expected to remain so, especially relative to the United States. Consumer prices rose 0.1 percent in 1987 -- compared to a 3.7 percent increase in the United States -- and should rise no more than 1.0 percent in 1988. Japan's fiscal policy should not fan inflationary expectations anytime in the near future. The central government budget deficit should drop to around 2 percent of GNP in 1988. If you were to count the balance on social security, as we do in the United States, the Japanese government budget balance would be in surplus, albeit a small one, in 1988.

Japan's Internal Economy

Ironically, Japan's spectacular success in international trade and commerce is not reflected fully in its domestic economy. Although the unemployment rate is low, there is a widespread redundancy of workers -- so-called "underemployment". For example, the inefficient retail and farming sectors are allowed to survive in order to accommodate workers that elsewhere would be either let go or retired early.

Although the inflation rate is almost zero, price levels are quite high -- paying $50 for a melon and $70,000 per square foot of land in Tokyo's business district are but two examples. In fact, after taking into account such different relative price

levels, Japan's real per capita GNP as measured by the OECD on a purchasing power parity basis becomes just $13,100, well below the $18,200 figure for the U.S. I mentioned earlier.

Why is it that Japan's internal or "second" economy is less of a success story than its external counterpart? An important reason for this is that while old-fashioned, free-market principles are respected and revered in Japan's international manufacturing economy, there is much less of this orientation in the Japanese domestic market. Instead, there exists a multitude of government regulations and structural impediments that seem designed to protect the status quo. These include inefficient distribution systems, quantitative import restrictions, administrative actions, cartel-like behavior and certification requirements, among others. The end result is a higher price structure, reduced economic activity and a lower level of imports.

A practical example of how these restrictions slow the demand for imports is the difficulty U.S. and other foreign firms have in introducing new products to the Japanese market. U.S. firms typically use special premiums and other promotional devices to introduce a new product or to spark new demand. However, in Japan, the Japan Fair Trade Commission works together with groups of domestic manufacturers to design market standards. Such standards, including restrictions on the use of sales promotion techniques, sometimes serve to inhibit foreign products from gaining access to Japanese markets. Until recently, in one industry the maximum promotional premium allowable was just 2-3 percent of the retail price -- not much of an incentive to either the retailer or consumer they are directed at.

Turning to the farming sector, food prices in Japan are kept well above international levels by using various laws that regulate price and distribution. Japan imports 86 percent of its wheat. Yet, despite the substantial yen appreciation since 1985 that would normally be expected to lower the price of imports, wheat prices have remained almost constant since 1984. Sugar and milk prices are also kept artificially high and, as a result, products made from these staples, such as bread and cookies, are also expensive. On the other hand, poultry, eggs and other foods that are marketed based on supply and demand are relatively inexpensive.

Another example of how structural impediments in the domestic economy blunt the demand for imports (despite substantial exchange rate changes) is the institutional resistance to price reductions. Recent Bank of Japan statistics show that while the prices of imported goods entering Japanese markets have fallen 23 percent since 1985, the prices of competing domestic products have dropped by only half that amount. In the case of consumer products, the prices of the competing domestic products have fallen by only a third as much. In most other economies such a divergence in prices between imports and exports would bring forth a flood of imports. Why hasn't this happened in Japan?

Part of the answer lies in the inability of certain lower-priced foreign goods to actually reach final consumers at those lower prices. In theory, international arbitrage -- the purchase of a good in the lower-price market and sale of the same good in the higher-price market -- should remove major price differences so that only transportation and other delivery costs would be reflected. However, as a practical matter, arbitrage has been prevented or slowed in a number of Japanese domestic markets. The prices of certain foreign goods, once inside the Japanese domestic economy, are raised by means of long-term supplier relationships which limit opportunities for new entrants, distribution systems that sometimes prevent foreign goods from reaching the consumer, government price controls and other factors. In such circumstances, the competitive pressure in the tradeable goods sector is diminished and consumers and investors have less effective purchasing power.

The mechanism of Japan's marketing and distribution systems, whether it be for food, durable goods, home appliances, electronics, autos or leisure goods, overwhelmingly favor the interests of the producer and not the consumer. Products controlled by oligopolies, such as automobiles and electrical appliances, have closed distribution channels. Legislation protects other distribution networks through, for example, the Alcoholic Beverage Approval Law, the Food Control Law and the Large-Scale Retailing Law.

We often hear that the reason for the high cost of land in Japan is the country's population density. Actually, Japan's population density is below that of New Jersey where I grew up and roughly the same as Massachusetts where I went to college. And the Tokyo region is only slightly more densely populated than New York City. In fact, various land-use regulations that interfere with the efficient functioning of the free market are more to blame for the high prices. Examples include tax breaks for farm land, rent-control laws that make redevelopment difficult and a system that levies taxes on old houses and apartment buildings based on their value in their current form rather than on their much greater value as building sites.

It is because of the need for structural reform in Japan, and in other industrial countries, that at the Toronto Economic Summit last month the United States pushed for structural adjustment objectives to be adopted as a regular part of the Group of Seven (G-7) economic policy coordination process. The G-7 countries recognized and stated in the Toronto Economic Declaration that: "international cooperation involves more than coordination of macroeconomic policies." Accordingly, the G-7 countries agreed to "continue to pursue structural reforms by removing barriers, unnecessary controls and regulations; increasing competition, while mitigating adverse effects on social groups or regions; removing all disincentives to work, save and invest, such as through tax reform; and by improving education and training."

The specific priorities for each country were outlined in an annex to the Summit Declaration.

How Japan Is Changing

Respected Japanese authorities -- such as the Maekawa Committee, the central bank and noted private research groups -- recognize the need for removing structural rigidities. Earlier this year, the Bank of Japan stated: "It is of vital importance... to continue to make every effort to open up Japan's markets further by reforming the institutional framework and traditional practices...." The Japanese government's new Five-Year Economic Plan, presented in May, recommitted the government to push for structural adjustment measures put forward in other fora.

Some changes recommended in the 1986 Maekawa Report have already taken place. One aim was to stimulate domestic demand, and, with the aid of the 1987 Economic Stimulus Package, domestic demand has definitely been given a significant boost. What is not yet clear is how much of that will translate into increased domestic demand for imports, which is the ultimate goal. More specifically, the Maekawa Report also called for tax reductions to increase disposable income. Under the first stage of tax reform legislated in the fall of 1987, the top marginal tax rate was cut from 70 to 60 percent. In the second stage, due to be considered by the Diet this month, another reduction in the top rate to 50 percent will be discussed. The introduction of an indirect tax similar to Europe's VAT is planned to help finance these reductions in direct taxes. This will be coupled with the removal of the current complicated maze of individual excise taxes.

Another recommendation from the Maekawa Report was the removal of the preferential tax treatment for savings. The tax exemption for interest on small-denomination savings was largely abolished as part of the fall 1987 tax legislation, and went into effect in April of this year. In response to the new tax on interest, individual savers have been diverting a significant portion of their funds to the equity market. To prevent the growing disintermediation of funds from harming the banking system, it is essential that the financial authorities quickly liberalize interest rates on small deposits to make these alternatives more attractive to investors.

Over recent years, the Japanese financial markets, also highlighted in the Maekawa Report, have been experiencing the winds of change. As you may be aware, the U.S. Treasury has been engaged in a series of negotiations with the Japanese Ministry of Finance, known as the "Yen/Dollar Talks," which have focused on needed financial market changes. The most impressive progress has been in the internationalization of the yen. This process has been fostered through the development of a Euroyen market, which has helped the yen to reflect more fully Japan's position as the world's second largest economy. Starting with just $1 billion in Euroyen bond issues in 1984, volume reached $23 billion at the end of last year, making it one of the largest Euromarkets after the

dollar sector. Progress has also been made in improving the access of foreign financial institutions to the Japanese market. Foreign firms first joined the Tokyo Stock Exchange in 1986 and now hold 22 out of a total of 114 seats. Foreign commercial banks have been granted licenses to do trust banking and to indirectly enter the securities business. In general, the degree of access and transparency has improved considerably in the last few years, although significant problems remain.

Meanwhile, as a result of greater consumer sophistication and exchange rate movements that have produced a higher yen, cracks are beginning to appear in Japan's traditional distribution channels. The existing structure is certainly not collapsing, but bargain hunters and some non-traditional retailers now pose a perceptible, if limited, challenge to traditional networks of distribution. A growing stream of relatively inexpensive manufactured imports from Asia -- mainly textiles and food products, but including increasing amounts of consumer electronics, appliances and leisure goods -- are reaching the Japanese market. Discount stores are growing in popularity. Japanese entrepreneurs have lately begun to exploit the price differences between similar products available abroad and domestically in Japan through the re-import of Japanese goods previously exported. For example, a discounter in Japan recently re-imported cordless telephones and sold them for the equivalent of $75 as opposed to the $646 price on similar domestic models. Unfortunately, the volume of these changes is not yet sufficient to have a profound effect on our trade balance, nor is there necessarily a Japanese "consensus" to encourage them.

Where Further Changes Are Needed

In Japan, an official report or study is often the first step toward change. A case in point was the 1986 Maekawa Report which was meant to be a blueprint for restructuring the Japanese economy. Although some of the Maekawa Report's recommendations in the macroeconomic area have been carried through -- including stimulating domestic demand and partial tax reform -- most of the microeconomic recommendations have not been implemented. Needed measures that have not been acted on include streamlining the distribution system, further reducing working hours, strictly enforcing the Anti-Monopoly Law, overhauling outdated building and development codes, and further financial market liberalization.

Indeed, significant additional progress needs to be made in the financial sector before it can be considered truly open, market-driven and competitive. For example, the small-denomination bank deposit that the average Japanese family might hold currently returns only one-half of one percent because of Ministry of Finance regulations. Access to the Japanese 10-year government bond market, essentially 90 percent of all traded bonds in Japan, is restricted through a tightly regulated syndicate system in which all foreign firms together are allowed only 2.5 percent of newly-issued bonds. In comparison, under the auction

system in the United States, any one firm, foreign or domestic, can take up to 35 percent of any one issue, and any three firms, foreign or domestic, could conceivably take an entire issue.

Radical changes are also needed in the crucial areas of land use patterns. Subsidies and taxes that keep land in urban areas employed in farming should be eliminated.

Other structural rigidities that need to be addressed include some obstacles that are relatively intangible such as the long-term supplier relationships I mentioned earlier that put foreign producers at a disadvantage; cartel-like behavior by domestic firms; tightly organized business associations; and the cultivated perception of poor quality in foreign-produced goods.

There are other obstacles and rigidities that have not yet fully emerged, but which the Japanese government will have to contend with in the near future. These include the strains caused by an aging population and the growing presence of women in a traditionally male-dominated labor force.

Can Japan Change?

In evaluating the steps taken so far by Japan to remove structural rigidities, the question is often asked whether Japan will persevere. Can Japan continue to change and meet its next greatest challenge?

One thing is clear. Meeting the challenge of successful structural reform will take more than traveling abroad, buying foreign goods and appearing at international meetings.

Although it is true that old habits are hard to shake off, anyone who has traveled in Japan and spent time with these remarkable people must be optimistic that change will come. Their hard work, self-discipline, dedication and deep belief in the worth of their country are an inspiration to us all. Let us hope that these same qualities that have led to Japan's international economic success will eventually force a more efficient and more consumer-oriented domestic economic system.

If Japan is able to persevere and effect meaningful structural reform, the implications are clear. For U.S. companies doing business in Japan, it will mean a larger, more competitive and more open market with an increased potential for profit. For Japan, the removal of structural barriers will result in a more robust domestic economy, higher productivity, lower prices and a higher quality of everyday life. More generally, it will lead to a faster reduction in existing trade imbalances between the U.S. and Japan. This in turn will contribute to stable foreign exchange and financial markets. These are certainly goals worth striving for.

Thank you very much.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
July 19, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,200 million, to be issued July 28, 1988. This offering will provide about $250 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $12,960 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 25, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,600 million, representing an additional amount of bills dated October 29, 1987 and to mature October 27, 1988 (CUSIP No. 912794 QB 3), currently outstanding in the amount of $15,709 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,600 million, to be dated July 28, 1988, and to mature January 26, 1989 (CUSIP No. 912794 RD 8).

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 28, 1988. 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 $1,436 million as agents for foreign and international monetary authorities, and $3,240 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1484

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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 19, 1988

Contact; Bob Levine
566-2041

TREASURY STATEMENT ON BRAZILIAN BRIDGE LOAN

The U.S. Department of Treasury announced today that it has agreed to participate in a multilateral bridge arrangement to provide Brazil with approximately $500 million in short-term financing. The Bank for International Settlements (BIS) is also participating in this bridge, supported by a number of central banks. United States participation in this multilateral effort indicates our strong support for Brazil's economic reform efforts and financing plan for 1988/89 in cooperation with the international financial community, including a stand-by arrangement with the International Monetary Fund.

B-1485

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
July 20, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $8,750 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $8,750 million of 2-year notes to refund $10,403 million of 2-year notes maturing July 31, 1988, and to paydown about $1,650 million. The public holds $10,403 million of the maturing 2-year notes, including $1,064 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $8,750 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 $1,478 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

B-1487

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED AUGUST 1, 1988

July 20, 1988

Amount Offered:

To the public	$8,750 million

Description of Security:

Term and type of security	2-year notes
Series and CUSIP designation	AD-1990 (CUSIP No. 912827 WL 2)
Maturity date	July 31, 1990
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 Terms:

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 27, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, August 1, 1988
b) readily-collectible check ..	Thursday, July 28, 1988

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
July 22, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $ 9,000 million of 364-day Treasury bills to be dated August 4, 1988, and to mature August 3, 1989 (CUSIP No. 912794 SJ 4). This issue will result in a paydown for the Treasury of about $ 575 million, as the maturing 52-week bill is outstanding in the amount of $ 9,574 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, Thursday, July 28, 1988.

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 August 4, 1988. In addition to the maturing 52-week bills, there are $ 13,160 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 $ 1,745 million as agents for foreign and international monetary authorities, and $ 6,271 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 $150 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 5176-3.

B-1488

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 one-half hour prior to the closing time for receipt of tenders 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 tende: 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

// TREASURY NEWS

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

FOR IMMEDIATE RELEASE

July 25, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of June 1988.

As indicated in this table, U.S. reserve assets amounted to $41,028 million at the end of June, down from $41,949 million in May.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1988					
May	41,949	11,063	9,543	10,912	10,431
June	41,028	11,063	9,180	10,793	9,992

1/ Valued at $42.2222 per fine troy ounce.

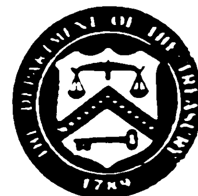
2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

B-1489

TREASURY NEWS



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

FOR IMMEDIATE RELEASE
July 25, 1988

CONTACT: LARRY BATDORF
(202) 566-2041

UNITED STATES AND INDONESIA SIGN INCOME TAX TREATY

The Treasury Department announced today that the United States and Indonesia have signed a treaty for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, together with a related protocol and exchange of notes. The proposed treaty, protocol and notes were signed in Jakarta on July 11, 1988 by Secretary of State George Shultz and Indonesian Minister of Foreign Affairs Ali Alatas. They will enter into force on the exchange of instruments of ratification.

The proposed treaty is the first such treaty signed by the two countries. It is based on the model draft treaties published by the United States, the Organization for Economic Cooperation and Development, and the United Nations. It also takes into account recent tax law changes in both countries. In recognition of Indonesia's status as a developing country, the proposed treaty permits higher taxation at source than is permitted in U.S. tax treaties with other industrial countries. For example, the maximum rate of withholding tax at source on dividends, interest and royalties is generally 15 percent, with an exemption for interest paid to instrumentalities of the other government and a 10 percent maximum rate on payments for the leasing of certain equipment. It also provides lower thresholds (120 days) for the taxation of certain business and employment income than many U.S. income tax treaties.

The accompanying protocol and exchange of notes set forth certain understandings with respect to specific provisions of the treaty.

The proposed treaty, together with the protocol and notes, will be transmitted to the Senate for its advice and consent to ratification. They will enter into force on the exchange of instruments of ratification. The provisions with respect to withholding taxes on dividends will take effect for amounts paid or credited on or after the first day of the second month following its entry into force. The provisions with respect to other taxes take effect for taxable years beginning on or after January 1 of the year of entry into force.

A copy of the proposed treaty and the accompanying exchange of notes may be obtained from the Office of Public Affairs, U.S. Treasury Department, room 2315, Washington, D.C. 20220.

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B-1490

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 25, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,611 million of 13-week bills and for $6,606 million of 26-week bills, both to be issued on July 28, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 27, 1988			:	26-week bills maturing January 26, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.83% a/	7.04%	98.274	:	7.07% b/	7.43%	96.426
High	6.90%	7.12%	98.256	:	7.11%	7.48%	96.406
Average	6.88%	7.10%	98.261	:	7.09%	7.45%	96.416

a/ Excepting 2 tenders totaling $7,225,000
b/ Excepting 1 tender of $500,000.
Tenders at the high discount rate for the 13-week bills were allotted 13%.
Tenders at the high discount rate for the 26-week bills were allotted 14%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 28,670	$ 28,670	:	$ 34,660	$ 34,660
New York	18,366,375	5,363,625	:	17,766,895	5,627,895
Philadelphia	34,660	34,660	:	20,140	20,140
Cleveland	32,985	32,985	:	40,465	40,465
Richmond	48,555	48,555	:	50,440	50,440
Atlanta	27,855	27,855	:	24,050	24,050
Chicago	889,900	372,400	:	815,190	100,690
St. Louis	22,455	22,455	:	23,795	23,795
Minneapolis	5,260	5,260	:	10,320	10,320
Kansas City	32,720	32,720	:	36,310	36,310
Dallas	31,285	21,935	:	30,990	25,990
San Francisco	1,233,110	236,740	:	1,268,375	124,075
Treasury	383,475	383,475	:	487,620	487,620
TOTALS	$21,137,305	$6,611,335	:	$20,609,250	$6,606,450
Type					
Competitive	$18,314,060	$3,788,090	:	$16,688,330	$2,685,530
Noncompetitive	1,003,865	1,003,865	:	1,064,340	1,064,340
Subtotal, Public	$19,317,925	$4,791,955	:	$17,752,670	$3,749,870
Federal Reserve	1,690,160	1,690,160	:	1,550,000	1,550,000
Foreign Official Institutions	129,220	129,220	:	1,306,580	1,306,580
TOTALS	$21,137,305	$6,611,335	:	$20,609,250	$6,606,450

An additional $57,080 thousand of 13-week bills and an additional $647,420 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1491

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
July 26, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,600 million, to be issued August 4, 1988. This offering will provide about $450 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,160 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, August 1, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,800 million, representing an additional amount of bills dated May 5, 1988, and to mature November 3, 1988 (CUSIP No. 912794 QS 6), currently outstanding in the amount of $6,910 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,800 million, to be dated August 4, 1988, and to mature February 2, 1989 (CUSIP No. 912794 RE 6).

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 August 4, 1988. In addition to the maturing 13-week and 26-week bills, there are $9,574 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 $1,455 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,605 million as agents for foreign and international monetary authorities, and $6,271 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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 IMMEDIATE RELEASE
July 27, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $ 8,782 million of $ 23,516 million of tenders received from the public for the 2-year notes, Series AD-1990, auctioned today. The notes will be issued August 1, 1988, and mature July 31, 1990.

The interest rate on the notes will be 8-3/8%. The range of accepted competitive bids, and the corresponding prices at the 8-3/8% rate are as follows:

	Yield	Price
Low	8.40%*	99.955
High	8.42%	99.919
Average	8.41%	99.937

*Excepting 3 tenders totaling $100,000.
Tenders at the high yield were allotted 67%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 75,345	$ 75,345
New York	20,004,785	7,283,615
Philadelphia	55,045	54,055
Cleveland	83,440	83,440
Richmond	114,435	89,145
Atlanta	54,590	53,260
Chicago	1,582,515	537,115
St. Louis	86,375	82,550
Minneapolis	43,455	42,465
Kansas City	156,030	156,030
Dallas	29,410	24,410
San Francisco	1,214,955	284,555
Treasury	15,715	15,715
Totals	$23,516,095	$8,781,700

The $ 8,782 million of accepted tenders includes $ 1,366 million of noncompetitive tenders and $ 7,416 million of competitive tenders from the public.

In addition to the $ 8,782 million of tenders accepted in the auction process, $605 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,478 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.

B-1493

TREASURY NEWS

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

July 28, 1988

Robert B. Zoellick to Leave Treasury

Secretary James A. Baker, III announced today the resignation of Robert B. Zoellick, Counselor to the Secretary and Executive Secretary. Mr. Zoellick is leaving to become the Campaign Issues Director of Vice President Bush's Campaign for President. In that post, he will supervise all issues and policy development for the campaign.

Robert Zoellick joined the Treasury Department in July, 1985, as the Special Assistant to Deputy Secretary Richard G. Darman. Shortly thereafter, he became Deputy Assistant Secretary for Financial Institutions Policy, working for Under Secretary George D. Gould and Assistant Secretary Charles O. Sethness.

In August, 1986, Zoellick began working directly for Secretary Baker as Executive Secretary and Special Advisor to the Secretary. In January of 1988, he was promoted to the Assistant Secretary-level rank of Counselor to Secretary Baker, while retaining his other responsibilities.

Secretary Baker noted that "Bob has been of great aid to me in helping to develop and implement the Department's international and domestic priorities since 1986. I appreciate in particular his work on the U.S.-Canada Free Trade Agreement, the omnibus trade bill, and the budget and reconciliation packages. Bob has played a key role for me and for the Department during his three years of service here. He is a first-rate public servant, and we will miss him."

Under Secretary Gould added that Zoellick played an important role in efforts to design and secure enactment of Treasury's plan to recapitalize the FSLIC fund. "In the face of considerable opposition, Bob's perservance proved a crucial contribution at a critical time." Gould also noted that Zoellick's work with the Farm Credit System helped save taxpayers billions of dollars while ensuring the System's continued viability.

Immediately before coming to the Treasury Department, Zoellick served as Vice President and Assistant to the Chairman and CEO of Fannie Mae. He is a *Phi Beta Kappa* graduate of Swarthmore College, and earned a J.D. *magna cum laude* from Harvard Law School and an M.P.P. from Harvard's Kennedy School of Government.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
July 28, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,021 million of 52-week bills to be issued August 4, 1988, and to mature August 3, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.39%	7.94%	92.528
High -	7.41%	7.96%	92.508
Average -	7.40%	7.95%	92.518

Tenders at the high discount rate were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 15,255	$ 15,255
New York	28,659,565	8,296,855
Philadelphia	10,925	10,925
Cleveland	20,195	20,195
Richmond	23,920	18,920
Atlanta	14,560	14,560
Chicago	1,194,600	108,000
St. Louis	10,495	10,495
Minneapolis	4,870	4,870
Kansas City	21,945	21,915
Dallas	17,480	7,480
San Francisco	1,361,975	330,375
Treasury	160,705	160,705
TOTALS	$31,516,490	$9,020,550
Type		
Competitive	$28,401,080	$5,905,140
Noncompetitive	465,410	465,410
Subtotal, Public	$28,866,490	$6,370,550
Federal Reserve	2,500,000	2,500,000
Foreign Official Institutions	150,000	150,000
TOTALS	$31,516,490	$9,020,550

An additional $245,000 thousand of the bills will be issued to foreign official institutions for new cash.

B-1495

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
Friday, July 29, 1988

Contact: Charley Powers
566-8773

TREASURY DEPARTMENT ASSESSES FIRST CIVIL PENALTY
AGAINST A CURRENCY EXCHANGE HOUSE

Salvatore R. Martoche, Acting Assistant Secretary of Treasury for Enforcement, today announced civil penalties totalling $3.01 million against Oscar's Money Exchange of Hildago, Texas, its owner Oscar Ortiz Alvarez, and Antonio Franco, for violations of the Bank Secrecy Act. This is the first time that Treasury has imposed a civil penalty against a currency exchange house. It reflects increased efforts by Treasury to detect and deter money laundering being conducted through the use of currency dealers and exchangers.

The Bank Secrecy Act requires that persons who transport currency or currency equivalent monetary instruments in excess of $10,000 into or out of the United States to file a report with the United States Customs Service. The purpose of requiring these reports under the Bank Secrecy Act is to assist Government efforts in criminal, tax and regulatory investigations and proceedings.

This case originated through an investigation by the North Central and Gulf Coast Organized Crime Drug Enforcement Task Forces (OCDETF). This OCDETF is comprised of special agents and police officers from the U.S. Customs Service, Internal Revenue Service, Federal Bureau of Investigation, Bureau of Alcohol, Tobacco and Firearms, Drug Enforcement Administration, Texas Department of Public Safety and the U.S. Marshals Service.

Antonio Franco is currently serving 35 years in a federal prison for his participation in a massive drug smuggling and distribution ring. This organization laundered $5.56 million through Oscar's Money Exchange. In June 1987, Federal agents seized $2.55 million after executing a search warrant at Oscar's Money Exchange. The remaining $3.01 million was transported to Mexico by Alvarez and others without filing the necessary Customs forms.

Oscar Ortiz Alvarez was arrested in McAllen, Texas on July 25, 1988, on money laundering charges, filed in the U.S. District Court for the Southern District of Texas.

Acting Assistant Secretary Martoche commends the OCDETF members for their outstanding work in this case.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 1, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,800 million of 13-week bills and for $6,816 million of 26-week bills, both to be issued on August 4, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 3, 1988			:	26-week bills maturing February 2, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.86%	7.08%	98.266	:	7.14%	7.51%	96.390
High	6.90%	7.12%	98.256	:	7.16%	7.53%	96.380
Average	6.89%	7.11%	98.258	:	7.15%	7.52%	96.385

Tenders at the high discount rate for the 13-week bills were allotted 14%.
Tenders at the high discount rate for the 26-week bills were allotted 35%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 33,840	$ 33,840	:	$ 39,460	$ 39,460
New York	20,093,915	5,211,855	:	20,670,040	5,766,190
Philadelphia	34,340	34,340	:	27,065	25,765
Cleveland	49,025	49,025	:	41,805	41,805
Richmond	40,135	40,135	:	206,265	102,815
Atlanta	23,795	23,795	:	29,630	29,630
Chicago	1,396,340	441,740	:	1,116,050	144,800
St. Louis	42,730	41,870	:	36,340	32,340
Minneapolis	10,460	10,460	:	11,970	11,970
Kansas City	50,130	50,130	:	56,910	56,910
Dallas	36,015	26,015	:	31,385	21,385
San Francisco	1,327,885	447,285	:	1,317,895	81,895
Treasury	389,940	389,940	:	461,085	461,085
TOTALS	$23,528,550	$6,800,430	:	$24,045,900	$6,816,050
Type					
Competitive	$20,256,615	$3,528,495	:	$19,765,395	$2,535,545
Noncompetitive	1,170,650	1,170,650	:	1,159,365	1,159,365
Subtotal, Public	$21,427,265	$4.699,145	:	$20,924,760	$3,694,910
Federal Reserve	1,970,625	1,970,625	:	1,800,000	1,800,000
Foreign Official Institutions	130,660	130,660	:	1,321,140	1,321,140
TOTALS	$23,528,550	$6,800,430	:	$24,045,900	$6,816,050

An additional $59,940 thousand of 13-week bills and an additional $518,260 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1497

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:00 A.M.
AUGUST 2, 1988

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
TUESDAY, AUGUST 2, 1988

Mr. Chairman, Senator Garn, and Members of the Committee, I appreciate this opportunity to return again today to testify on the condition of the Federal Savings and Loan Insurance Corporation (FSLIC). Specifically, I will comment on why, from the Administration's perspective, it is unnecessary to transfer resources from the American taxpayer to FSLIC so FSLIC in turn can close -- or warehouse -- insolvent savings institutions in this country.

I. The Administration's Three-Prong Strategy

First, a bit of history is in order.

When I first testified in front of this Committee on March 4, 1986, I presented the Administration's three-pronged strategy to revitalize the thrift industry and FSLIC. That strategy is as valid today as it was when we first proposed it. The challenge for Congress in the future will be to follow through and ensure that it is fully implemented.

To summarize briefly, our three-pronged strategy was -- and still is -- as follows:

- First, the thrift industry as a whole had to be strengthened: capital had to be increased and the growth of problem institutions had to be halted through improved supervision;

B-1498

- Second, FSLIC's resources had to be augmented to permit it to resolve a greater number of insolvent institutions; and
- Third, the franchise value of ailing thrifts particularly had to be enhanced to lower FSLIC's resolution costs: new entrants into the industry can increase its overall capital base and long-term health.

For a more complete description of our triad approach, I refer you to my March 4, 1986, testimony. It was our opinion, however, that without the additional capital, the FSLIC would be forced to continue deferring the resolutions of many insolvent thrifts. With the appropriate financial and organizational resources, the Federal Home Loan Bank Board (FHLBB) and the FSLIC could set more ambitious targets and resolve more cases, more quickly -- and in a more cost effective manner. The attractive interest rate environment then prevailing provided the ideal window of opportunity to move ahead to resolve ailing thrift institutions.

At that time, the Administration believed an immediate recapitalization of the fund would reaffirm depositor confidence in the health and stability of the thrift industry and the viability of the deposit insurance funds. Furthermore, prompt handling of the most debilitated thrifts would help healthy thrifts by lowering their cost of deposits, which had been bid up by feeble institutions calling for funds virtually at any price.

We still believe that these three inter-related segments of our plan -- if fully implemented and when finally in place -- will strengthen the savings industry and allow it to continue to provide competitive housing finance into the next century. Federal Home Loan Bank Board Chairman Dan Wall recently testified before the Committee on the steps the Board is taking to aggressively implement this strategy, and in the interest of time, I will not repeat that description. New capital regulations are in place, institutions without adequate capital are supervised and regulated more closely, examination forces are being upgraded, new entrants and acquirors are more actively pursued, and problem cases are being resolved within the limits of existing resources and market capacities -- both financial and, as importantly, managerial.

II. The Treasury/FHLBB FSLIC Recapitalization Plan

The Treasury Department, working in conjunction with former Chairman Ed Gray and the Federal Home Loan Bank System, was directly involved with developing the financing prong of the

strategy. In devising our plan to recapitalize FSLIC, two simple requirements were upper-most in our minds.

First, the time-tested notion of self-help was vital. The taxpayer was not to be called upon to bail-out an industry that with some measure of sacrifice over time could substantially help itself. After all, many thrift owners and managers have profited greatly from their franchise and they presumptively were paying too small an insurance premium in the past. In addition, by structuring our recapitalization plan as a balance of the financing burden of the recapitalization of the fund between the Federal Home Loan Banks and the thrifts, a negative budgetary effect was avoided.

Second, the recapitalization plan needed to make substantial resources available up front to reduce the growth of insolvent institutions as quickly as possible. To this end, we devised a unique industry-based plan that would enable the FSLIC to devote about $25 to $30 billion over 5 years to handling its sizeable load of problem cases, while in all likelihood being able to phase-out the special premium assessment over the same period.

Let me stress that our proposal, by providing a $15 billion recapitalization which would have supplied up to $25 to $30 billion to FSLIC over 5 to 6 years, was adequate to cover even the then most pessimistic estimates of the costs involved.

You will recall that I testified in support of our FSLIC recapitalization plan on May 8, 1986. Based on our conversations at that time, Congress seemed to recognize the seriousness of the problems confronting both FSLIC and the thrift industry. I must confess that initially I had high hopes that Congress would act expeditiously to approve an industry self-help plan -- that involved no appropriation from the U.S. taxpayer -- so that FSLIC could go about its business of closing down hopelessly insolvent thrifts. But 1986 wore on, and we were faced with numerous false starts in Congress and -- to put it bluntly -- industry-induced delays, which the General Accounting Office (GAO) testified cost FSLIC $6 million per day or over $2 billion per year. We obviously were distressed by these delays since the resolution costs for FSLIC were accumulating at a time when FSLIC (assuming the proper resources) should have been aggressively acting to resolve its caseload of problem institutions. The situation was particularly disturbing since ours was the <u>only</u> plan on the table.

Not only did active industry opposition slow the legislative pace, but in the final days of the 99th Congress, controversial and extraneous amendments began to materialize in both the House and Senate -- amendments which had absolutely nothing to do with

enhancing FSLIC's resources or protecting depositors. Only in the final days of the session were attempts made to bounce a loaded-down FSLIC recapitalization plan back and forth between the two houses of Congress. Meanwhile, sick, insolvent thrifts grew sicker.

In 1987, we were faced with three general problems left over from the previous year:

- industry attempts to reduce the amount of their contribution to revitalizing their insurance fund;

- the addition of more controversial, and extraneous amendments that had nothing to do with helping FSLIC or protecting depositors; and

- new, significant obstacles to FSLIC's operation, both in terms of its ability to properly supervise and, when necessary, close problem institutions, and to attract outside capital and potential acquirors for troubled thrifts.

Throughout this period, Treasury Secretary Baker, others in the Administration, and I repeatedly urged Congress to act to bolster FSLIC's resources. In the end, only after the threat of a Presidential veto did we get two-thirds of the financing we originally proposed -- and this only after the House of Representatives voted overwhelmingly for only one-third, with the Senate going as far as one-half the financing. Even then we ended up with new restrictions on the Board's ability to supervise and resolve problem institutions (the so-called "forbearance" provisions) and numerous disincentives to enhance the acquisition of troubled thrifts.

III. Current Cries for a Taxpayer Bail Out

Less than a year later and after waiting more than fifteen months for Congress to act, we now hear cries from some quarters of the industry for a taxpayer bailout of massive, unprecedented proportions. These bleatings are predicated on the dubious assertion that the Government caused the thrifts' problems and, therefore, it is time for the Government to ante up to solve the problem. To my way of thinking, that is tantamount to a thrift executive saying that the Government made me take out my charter and then engage in housing finance for my livelihood -- all under the protection of FSLIC's shield on my front door. Let me offer my observations on the two most frequently heard refrains in this regard.

First, it is argued by some in the thrift industry that the Government prematurely deregulated interest rates ceilings on time and savings accounts in depository institutions (Regulation Q) and this in turn caused the industry's problems. It is true that after years of simply extending Regulation Q, Congress finally created the Depository Institutions Deregulation Committee in 1980 to remove ceilings on savings accounts and phase-out the differential that existed between commercial banks and savings institutions. Obviously, there were those in the industry who didn't like the move to market-determined rates -- and who would after years of protection by the Federal Government.

However, beginning in the late 1970s and extending into 1980, double digit inflation and high interest rates were making it next to impossible for thrifts to compete for deposits because of the unprecedented disintermediation occurring in the marketplace. Savers' funds were flowing into new products such as money market mutual funds. Simply put, had the Government not acted in a responsible manner to deregulate interest rates ceilings imposed by Congress, thrifts would have been disintermediated into the mist.

Second, others in the industry have said that either inadequate or too liberal investment opportunities caused the problems. I believe the increased asset powers authorized for thrifts by the Garn-St Germain Depository Institutions Act of 1982 were neither inadequate nor too liberal. Among other powers, the Act authorized thrifts to offer checking accounts to their commercial customers, permitted commercial loans in an amount equal to up to 10 percent of assets, and expanded consumer lending authority from 20 percent of assets to 30 percent of assets.

Was it the Garn-St Germain Act that caused Vernon Savings and Loan Association in Texas to fail -- with 94% nonperforming loans? Did that Act cause the problems of the American Savings and Loan Association in California? Did this limited deregulation at the federal level cause the failure of numerous state-chartered institutions? A review of the facts will show that the answer to these questions is: no.

It is true that a number of states have granted their state-chartered institutions broader asset powers than federal thrifts enjoy and that this has contributed to pressure on FSLIC. As I testified more than two years ago, we need to reconcile States' authority to grant new thrift powers with FSLIC's financial responsibility to pick up the pieces when these state-chartered institutions fail. The Administration has supported achieving a better balance by placing additional state-

approved activities in holding company subsidiaries -- if the Bank Board determines that this extra degree of protection for FSLIC is required. State-chartered thrift institutions could still engage in new business opportunities -- properly supervised -- but with an important new distinction. Instead of operating with the backing of a federal deposit insurance fund, those managers who wanted to engage in new activities would have to do so with their own capital at risk -- up front in a separately capitalized subsidiary -- instead of with FSLIC-insured funds.

The most forceful defense the government has against these industry allegations of premature deregulation is that 85 percent of the FSLIC-insured institutions with 84 percent of the assets are solvent under GAAP accounting today. This great majority of the industry has been able to handle changes that the general economy and competition from other providers of financial services have been forcing on them over the past 10 years.

Now, in a surprising and abrupt change of view, a vocal part of the industry is now saying that the problem is larger than the $5 billion in FSLIC assistance it advocated just last year, and that its problems have grown beyond its capacity to handle by itself. Therefore, you undoubtedly can expect this portion of the industry to continue to step up its calls for general assistance from taxpayers.

The industry's spokesmen have not bothered, however, to tell the taxpayers of this country how much of their -- our -- money may be needed. A draft "Plan for Economic Revival," which was advanced, floated, and then withdrawn this past spring by one association gives an idea of the kind of assistance they feel is necessary -- the establishment of four new federal corporations and a massive amount of resources transferred from taxpayers to FSLIC. This is the same group that last year brought you a much heralded, but soon forgotten "Pay-As-You-Go Plan" that never quite managed to make it into legislative form. If we follow this course, we'll be headed for a "We-Pay-As-They-Go Plan."

One of these proposed corporations was a new Recapitalization Finance Corporation (RFC) based on the concept of the RFC established in the 1930s. The new RFC would purchase preferred stock and or subordinated debt, thus increasing the capital of well managed but poorly capitalized institutions; e.g., those that qualify for capital forbearance under the Competitive Equality Banking Act (CEBA). Interest-bearing RFC notes would be used to purchase the preferred stock which then would be paid off by receiving institutions as they recovered. The plan would have the RFC capitalized by periodic infusions of capital from both the Federal Deposit Insurance Corporation (FDIC) and FSLIC sufficient to buy zero-coupon Treasury

securities in an amount that would guarantee and eventually pay off the principal of the notes. The Treasury would pay the interest on the notes and the Federal Reserve would be expected to accept the notes as collateral for borrowing.

We believe that establishing such an RFC would be an unnecessary and extremely expensive way to give assistance, especially if the only institutions that qualify for the assistance are the same ones already given capital forbearance under CEBA. Also, it seems unlikely that the FSLIC and the FDIC could provide the necessary periodic capital infusions. Furthermore, the FSLIC already has the authority to issue income capital certificates, which serve the same purpose that the proposed preferred stock and/or subordinated debt would serve: that is, increasing capital in troubled institutions.

The Plan for Economic Revival also would have established asset holding corporations (AHCs) -- one for delinquent home mortgage loans and one for non-mortgage loans. These AHCs would purchase troubled assets from institutions and then hold them -- and the underlying properties -- off the market.

At the request of Congress, the FHLBB published a study last February attempting to determine the feasibility of establishing an AHC. The report concluded that in light of the estimated organizational problems and huge costs of such an organization, it would be preferable -- and more cost effective -- to assist private institutions holding these troubled assets. The private sector is usually able to manage such assets at a considerably lower cost than a bureaucracy engaged in central planning. Before anyone contemplates starting down the road of creating new federal agencies, stop and ask yourself: does Washington do a better job of managing properties and assessing local economic conditions and markets?

I also am struck by the number of academics and consultants who are quick to jump to a taxpayer remedy as the solution to FSLIC's problems. I have seen figures that range from $64 billion upwards to $100 billion -- two and three times what the GAO estimates, for example. I'm not sure what their assumptions are -- or who their clients are for that matter -- but I am amazed at how quick some observers are to give up hope of resolving the problem by existing means and to rush to use someone else's money -- yours and mine.

As I stated in my 1986 testimony to this Committee:

> "Anyone's estimate of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially

> attributable to important variables -- such as interest rates and regional real estate conditions -- that may affect significantly the health of many institutions over time."

It is my understanding that Federal Reserve Board Chairman Alan Greenspan took a similar position during his recent appearance here. Rather than focus on numbers in the future that no one really knows, we should instead focus on numbers for which we can account. We know, for example, that over the next three years FSLIC will have about $19 billion to close insolvent institutions -- as much as it says it can handle efficiently -- and Chairman Wall has testified that $42 billion is available over ten years for that same purpose.

Before we rush to a transfer of funds from taxpayers through FSLIC to insolvent institutions, we really ought to exhaust all other available resources. I should think that all Committee Members would be on their guard against a general taxpayer bailout for managers of failing and failed institutions, particularly since any such bailout would be charged to the Committee's annual budget allocation and force harder choices among other programs under the Committee's jurisdiction that already compete for limited resources from the Federal Government.

IV. Actions Congress Can Take to Avoid Tapping Taxpayers Resources

As I indicated at the beginning of my statement, the challenge for Congress in the future will be to fully implement the three-pronged strategy we proposed two and one half years ago. Given FSLIC's considerable resources over the next several years (together with those of the Federal Home Loan Bank System), it is unnecessary to act hastily or to release the industry from obligations established fairly less than a year ago.

If Congress wants to take further steps to put the Administration's inter-related triad in place, I can suggest the following steps to help both FSLIC and the thrift industry before you call on the American taxpayer. Let me list these for you briefly:

- More Recapitalization Financing

The structure of the Administration's recapitalization plan is now in place, it works as we indicated, and it is flexible in the event that additional funds are needed. This structure could be expanded, if necessary, using various sources (the industry or

the Federal Home Loan Banks, for example) both for the capital to buy zero coupon Treasuries to guarantee the defeasance of the principal and for the money to cover interest payments on the bonds issued.

- <u>Thrift Charter Enhancement</u>

Thrift charter enhancement provides a vital means of expanding the capital base of the industry. In general, we favor efforts that will attract outside capital while maintaining the safety and soundness of the industry.

On April 27 of this year, Assistant Secretary for Domestic Finance Charles Sethness testified before this Committee on "The Thrift Charter Enhancement Act of 1988" (S. 2073), introduced by Senator Karnes. We are pleased that the Committee recently reported a revised bill to meet a number of our concerns. We still would urge you to take an extra step and repeal the counter productive cross-marketing restrictions contained in the Competitive Equality Banking Act.

- <u>Facilitate Acquisitions</u>

The resolution costs for FSLIC can be reduced, not only by enhancing the franchise value, but also by facilitating acquisitions. As I have testified previously, inter-industry acquisitions are a touchy subject, but the acquisition logic is straightforward and undeniable.

Insolvent institutions have imposed real costs on healthy thrifts as well as FSLIC. Since the Administration -- and hopefully Congress -- is not in the mood for a budget busting bailout, all non-expenditure solutions should be explored. This includes removal of the cumbersome bidding priorities for emergency acquisitions of failing thrifts under Sec. 408(m)(3)(B) of the National Housing Act.

- <u>Use Private Capital to Back Additional State-Chartered Authorities Instead of FSLIC-Insured Funds.</u>

As I indicated in 1986 and again this morning, Congress should reconcile states' authority to structure new thrift products and services with FSLIC's responsibilities, especially now given its limited resources. Use of a separately capitalized subsidiary of a holding company -- with private capital as the line of defense, rather than FSLIC -- is our preferred approach.

o <u>Strengthened Enforcement Authority</u>

The Administration generally supports the strengthened enforcement provisions in the Proxmire Financial Modernization Act (S. 1886) that is now pending before the House Banking Committee. Many of these authorities were requested by former Chairman Ed Gray four years ago and have been endorsed by Chairman Wall. For example, the regulators would be empowered to issue temporary cease and desist orders where an institution's records were in disarray or not available. For whatever reasons, Congress has delayed in giving the federal regulators the tools they have long requested to carry out their supervisory responsibilities.

o <u>Extend Expiring Tax Provisions</u>

Extension of the tax provisions that affect the FSLIC's ability to arrange for assisted acquisitions of troubled thrift institutions also should be considered by the Congress. These provisions, which under current law will expire at the end of 1988, maximize the value of FSLIC assistance. One such provision provides that assistance paid by the FSLIC in connection with an assisted acquisition will not be considered taxable income. The other provisions clarify that a FSLIC-supervised merger or acquisition can quality as a tax-free reorganization, such that the net operating and built-in tax losses of troubled institutions can be utilized fully by a subsequent acquiring institution. The extension of these provisions would allow FSLIC to resolve a greater number of cases and to resolve them more quickly than it could if the provisions were allowed to expire.

VI. <u>Conclusion</u>

In closing, I urge this Committee in the strongest possible terms to resist mounting pleas for an unnecessary, budget busting bailout of FSLIC. The precious resources of our taxpayers should not be tapped until the existing plan has had a chance to work and all other reasonably available resources have been used. In any case, no single change in existing mechanisms should be made without re-evaluating the full array of institutional arrangements.

Congress passed the recapitalization legislation less than 12 months ago. The FHLBB has a plan in place to close approximately 100 institutions in Texas and 100 additional institution in FSLIC's current caseload by the end of 1988. In

addition, they expect by the end of 1989 to have resolved all 259 institutions in FSLIC's caseload as of December 1987. The Bank Board believes that the financial resources available to them will cover the costs of this ambitious plan.

In other words, important strides have been made in all three areas of the Administration's 1986 plan, although there is still more to do. Programs now in place should be given time to work (and a better data base assembled) before taxpayer money is thrown at the problem. All existing resources, including those of the Federal Home Loan Bank System, should be utilized first and all non-expenditure solutions should be implemented. Obviously, more steps along the line I have suggested can and should be taken.

If additional resources become necessary at a later date, then the Bank Board, the Administration and the Congress will have time -- and the obligation -- to carefully reconsider the full range of inter-related policy issues with respect to our regulatory and deposit insurance structure.

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TREASURY NEWS

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

August 2, 1988

Charles O. Sethness to Leave Treasury

Charles O. Sethness, Assistant Secretary for Domestic Finance since October 1985, has resigned effective September 2, 1988. Mr. Sethness will become the Director of the Capital Markets Department of the International Finance Corporation (IFC).

In announcing Mr. Sethness' pending departure, Secretary Baker noted that "Chuck has done an excellent job on a very wide range of extremely complicated issues. We will miss his ability to master substantive issues, work effectively to develop consensus in the Administration and be an effective advocate with affected constituencies and the Congress, which have been invaluable to the Department, the Administration and the country." Baker added that "Chuck's leadership role in achieving a viable solution to the Farm Credit System crisis saved billions of dollars of taxpayer money while protecting credit access for farmers. He has made contributions of similar import to the recapitalization of the FSLIC fund, the Administration's loan asset sales and credit reform initiatives, the protection of the integrity of the Federal Financing Bank, and the progress we have sought to make in improving the competitiveness of our financial services industry."

At Treasury, Mr. Sethness has been responsible for the management of the government debt, the Federal Financing Bank, government credit program policy, policy development for the financial services industry and the capital markets, policy direction for the government securities markets, the fulfillment of the government's responsibilities on the projects taken over from the U.S. Synthetic Fuels Corporation in 1986, and the Office of Revenue Sharing until its termination in 1987.

Under Secretary George D. Gould, for whom Mr. Sethness worked directly, added that "Chuck's energy, loyalty, support, integrity, professionalism and effectiveness have been a superb example of public service at its best. He did a remarkable job with Treasury's regulatory role under the Government Securities Act of 1986; with the difficulties of REA and Foreign Military Sales borrowers' prepayments of FFB loans; with our overall coordination and liaison role with the financial institution regulators and our involvement with the Securities Investor Protection Corporation, the Pension Benefit Guaranty Corporation, the Farm Credit System Assistance Board; with a host of credit program and agency borrower issues; and served with notable distinction and insight as the chief of staff of the President's Working Group on Financial Markets. All of us who had the real pleasure of knowing and working with him during the past three years will feel his absence."

Before joining the Treasury Department Mr. Sethness spent four years as the Associate Dean for External Relations at the Harvard Business School. Prior to that he was a Managing Director of Morgan Stanley, Inc. He served as the U.S. Executive Director on the board of the World Bank from 1973 to 1975.

Mr. Sethness graduated from Princeton University in 1963, and earned his MBA with High Distinction in 1966 from Harvard Business School as a Baker Scholar.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 2, 1988

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,600 million, to be issued August 11, 1988. This offering will provide about $100 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,506 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, August 8, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,800 million, representing an additional amount of bills dated May 12, 1988, and to mature November 10, 1988 (CUSIP No. 912794 QT 4), currently outstanding in the amount of $6,423 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,800 million, to be dated August 11, 1988, and to mature February 9, 1989 (CUSIP No. 912794 RF 3).

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 August 11, 1988. 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 $1,575 million as agents for foreign and international monetary authorities, and $4,067 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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

August 3, 1988

Deputy Assistant Secretary Stephen J. Entin to Leave Treasury

The Treasury Department today announced that Stephen J. Entin, Deputy Assistant Secretary for Economic Policy, has resigned his position, effective August 15. Mr. Entin is to accept the post of resident scholar at the Institute for Research on the Economics of Taxation. IRET is headed by Dr. Norman B. Ture, former Under Secretary of the Treasury for Tax and Economic Policy.

In announcing Mr. Entin's pending departure from government service, Secretary Baker noted that "The Administration has benefited for more than seven years from Steve's economic advice and I have often relied on his counsel and expertise. He has been a valuable asset to the Department and will be sorely missed."

Mr. Entin joined the Treasury in 1981 with the incoming Reagan Administration after serving for several years on the staff of the Congressional Joint Economic Committee, where he worked in the areas of tax policy, capital formation and labor and savings incentives.

At Treasury, Mr. Entin was instrumental in developing the tax indexing provision of the 1981 Economic Recovery Tax Act. He assisted in the preparation of Administration macroeconomic analysis, budget forecasts and the annual Trustees Reports of the Social Security System. He was a member of numerous interagency working groups covering a wide range of issues, including health care, research and development, competitiveness, the steel and auto industries, space commercialization, the defense industrial base, welfare reform and the family.

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE August 3, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY AUGUST QUARTERLY FINANCING

The Treasury will raise about $14,250 million of new cash and refund $14,756 million of securities maturing August 15, 1988, by issuing $11,000 million of 3-year notes, $11,000 million of 10-year notes, and $7,000 million of 248-day cash management bills. The $14,756 million of maturing securities are those held by the public, including $2,501 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $29,000 million are 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.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $1,955 million of the maturing securities that may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

The 10-year note being offered today will be eligible for the STRIPS program.

Details about each of the notes are given in the attached highlights of the offering and in the official offering circulars. Details about the cash management bills are given in a separate announcement.

oOo

Attachment

B-1502

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
AUGUST 1988 QUARTERLY FINANCING

August 3, 1988

Amount Offered to the Public.....	$11,000 million	$11,000 million	$7,000 million
Description of Security:			
Term and type of security........	3-year notes	10-year notes	248-day cash management bills
Series and CUSIP designation.....	Series T-1991 (CUSIP No. 912827 WM 0)	Series C-1998 (CUSIP No. 912827 WN 8)	
CUSIP Nos. for STRIPS Components.	Not applicable	Listed in Attachment A of offering circular	(see separate announcement for details)
Issue date	August 15, 1988	August 15, 1988	
Maturity date....................	August 15, 1991	August 15, 1998	
Interest rate....................	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	
Investment yield.................	To be determined at auction	To be determined at auction	
Premium or discount..............	To be determined after auction	To be determined after auction	
Interest payment dates...........	February 15 and August 15	February 15 and August 15	
Minimum denomination available...	$5,000	$1,000	
Amount required for STRIPS.......	Not applicable	To be determined after auction	
Terms of Sale:			
Method of sale...................	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%	
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	
Accrued interest payable by investor..............	None	None	
Payment Terms:			
Payment by non-institutional investors.......................	Full payment to be submitted with tender	Full payment to be submitted with tender	
Payment through Treasury Tax and Loan (TT&L) Note Accounts....	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries	
Deposit guarantee by designated institutions..........	Acceptable	Acceptable	
Key Dates:			
Receipt of tenders...............	Tuesday, August 9, 1988, prior to 1:00 p.m., EDST	Wednesday, August 10, 1988, prior to 1:00 p.m., EDST	
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury.....	Monday, August 15, 1988	Monday, August 15, 1988	
b) readily-collectible check.....	Thursday, August 11, 1988	Thursday, August 11, 1988	

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
August 3, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $7,000 MILLION OF 248-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $7,000 million of 248-day Treasury bills to be dated August 15, 1988, and to mature April 20, 1989 (CUSIP No. 912794 RU 0).

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, Thursday, August 11, 1988. 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 of the Federal Reserve Banks and Branches. Tenders will not be accepted for bills to be maintained on the book-entry records of the Department of the Treasury (TREASURY DIRECT).

Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

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, futures, and forward transactions. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

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.

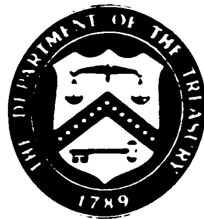
No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment 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. Those submitting competitive tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Monday, August 15, 1988. 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

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

TREASURY NEWS



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

For Release Upon Delivery
Expected at 10:30 A.M.
August 4, 1988

STATEMENT OF
WILLIAM M. PAUL
ACTING DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SELECT COMMITTEE ON HUNGER
AND THE
WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES

Messrs. Chairmen and Members of the Committees:

I am pleased to have this opportunity to present the Treasury Department's views concerning H.R. 81, which, if enacted, would allow taxpayers entitled to income tax refunds to direct that all or part of their refunds be contributed to a trust fund for the relief of domestic and international hunger. H.R. 81 would also establish a commission to oversee the distribution of such contributed amounts. With me today are two assistant commissioners of the Internal Revenue Service - John Johnson, Assistant Commissioner (Planning, Finance and Research), and Robert Brauer, Assistant Commissioner (Employee Plans and Exempt Organizations).

Background

Before turning to the Treasury Department's views on H.R. 81, I would like to provide the Committees with background information regarding two existing programs that are, to a greater or lesser degree, analogous to the funding mechanism proposed in H.R. 81: the Presidential Election Campaign Fund check-off, and California's program permitting voluntary contributions on its state income tax returns.

Presidential Election Campaign Fund. Since 1973, individuals whose Federal income tax liability is at least one dollar have been able to designate one dollar of their tax to the Presidential Election Campaign Fund. In Fiscal Year 1987, 22 percent of the total individual income tax returns, or 22.4 million returns, designated a total of $33.2 million to this Fund. The main costs of administering this provision consist of labor costs to transcribe data at the IRS service centers when the returns are processed. The Internal Revenue Service estimates that the cost of administering this provision in Fiscal Year 1984 was approximately $400,000. We would point out that this program differs from the proposal in H.R. 81 in that taxpayers simply check a box designating a dollar of their tax to

go to the Campaign Fund, which in no way increases their tax or reduces their refund. Under H.R. 81, taxpayers would have to specify a dollar amount of their refund to be contributed to the proposed trust fund.

California Check-off Program. Since 1982 California has allowed taxpayers to make voluntary contributions to the California Election Campaign Fund on their state income tax returns. In 1983, the California legislature expanded this program by adding four additional funds, and two more funds were added in 1987. Thus, California's individual tax return forms currently permit individuals to make voluntary contributions to seven different funds: the Alzheimer's Disease/Related Disorders Fund; the California Fund for Senior Citizens; the Rare and Endangered Species Preservation Program; the State Children's Trust Fund for the Prevention of Child Abuse; the United States Olympic Committee Fund; the Vietnam Veterans Memorial Fund; and the California Election Campaign Fund. The California legislature is currently considering proposals to add yet two more funds: the California Fire Foundation Fund and the State Emergency Family Needs and Assistance Fund.1/

With respect to the 1987 tax year, the seven funds listed on the California returns received roughly 700,000 contributions out of 12,000,000 tax returns. Contributions totaled approximately $3,400,000 at an estimated cost of 7 cents per contribution. The implementation of the California program has required the addition of ten lines to the California forms and requires taxpayers to make approximately eight additional decisions and two additional calculations.

Discussion

The Treasury Department agrees that domestic and international hunger is a serious problem. Nevertheless, we have consistently opposed proposals such as H.R. 81 that would use federal tax returns and the federal tax collection system for goals that are wholly unrelated to the raising of tax revenues. It is our view that federal tax returns and the federal tax collection system should not be used as a vehicle for voluntary contributions to any charity or cause, however meritorious. In this regard, the Committees should note that we have in the past opposed proposals to add tax return "check-offs" for such worthwhile causes as a U.S. Olympic Committee fund, a National Organ Transplant fund, the National Endowment for the Arts, the

1/ According to information compiled by the Federation of Tax Administrators, a total of 37 states have check-off programs that allow taxpayers to designate a portion of their tax or refund for at least one specified purpose.

National Endowment for the Humanities, and a fund for the reduction of the public debt.[2] In addition, as part of The President's Tax Proposals to the Congress for Fairness, Growth & Simplicity (1985), the President proposed the repeal of the presidential election campaign check-off.

Our opposition to such proposals stems not from any disagreement with the underlying purposes of the proposals, but rather from our concerns regarding the confusion, complexity and administrative burdens that such well-intentioned and seemingly innocent proposals would create. These concerns are heightened by the fact that, as the California experience illustrates, the adoption of H.R. 81 would invite other charitable causes to seek similar treatment. It would indeed be difficult to argue that certain charitable goals, such as the fight against world hunger, should have a check-off, but that others, such as the prevention of child abuse, or aid for the handicapped, the elderly or the homeless, should not.[3]

Moreover, any check-off system would further complicate tax returns and instructions. At least one and probably two additional lines would have to be added to all affected forms. This Administration is committed to reducing the paperwork burden and complexity of the tax forms and has already made significant progress in this area. Proposals such as this one are inconsistent with these goals.

Several other problems are presented by the proposed check-off system. First, the legislation under consideration would, if enacted, place an administrative burden on the Internal Revenue Service at a time when the Service is facing budgetary

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2/ Since 1983, IRS publications have carried a message inviting taxpayers to make voluntary contributions to reduce the public debt when they file their tax returns. The instructions for income tax returns have advised taxpayers that they could make such contributions to the IRS in the form of a separate check made out to the Bureau of the Public Debt. In Fiscal Year 1987, there were 723 such contributions totaling $159,000. For the five years since the Service has been publicizing this program, there have been 10,382 contributions for a total of $1.5 million.

3/ The experience of other states also illustrates the difficulty of resisting efforts to add additional check-offs for other worthy causes. According to the Federation of Tax Administrators, 31 new designated check-offs were added to state tax returns during the past four years. Check-offs were added for political campaigns (four states), protection of wildlife (three states), child abuse and related causes (ten states), olympic funding (two states), funding for the arts (one state) and other miscellaneous causes (eleven states).

constraints. Were the Service required to reallocate resources to implement this proposal, its traditional functions would suffer. If the tax check-off system were extended to other charities, which we believe would be a real possibility if H.R. 81 were enacted, the result would create further administrative problems for the Service.

Second, we believe such a system would be confusing to taxpayers. The fact that it would operate differently from the current check-off for the presidential campaign fund, which is made out of a taxpayer's tax liability and does not affect the amount of any refund the taxpayer may receive, would itself cause confusion. Further, voluntary contributions by taxpayers who itemize would qualify as deductible contributions for the taxable year in which they were made. Thus, a designation or check-off in one year (e.g., on a 1989 return filed in 1990) would give rise to a deduction on the next year's return (e.g., the 1990 return filed in 1991). Because the taxpayer might be making yet another designation or check-off on the subsequent year's return, there is significant potential for taxpayer confusion and error.

Third, if a taxpayer were to designate a portion of a refund for contribution that turns out to exceed the refund to which the taxpayer is actually entitled, either because the taxpayer's tax liability is adjusted due to a mathematical error or substantive change or because the refund is "intercepted" under the refund offset program, the Service would presumably have to inquire whether the taxpayer still wished to make the contribution. If the transfer to the proposed trust fund were already made, a request for reimbursement to the Treasury - either by the taxpayer or the trust fund - might be necessary.

Another serious concern we have with the bill is that it gives the Hunger Commission the authority to direct the Secretary of the Treasury to revoke an organization's tax-exempt status if the organization is found by the Commission to have committed certain "prohibited acts." This concept of granting the authority to revoke tax-exempt status to an agency other than the IRS is unprecedented. In effect, it establishes an entirely new system of administering the laws pertaining to tax-exempt status for a certain class of tax-exempt organizations. Furthermore, the Hunger Commission staff presumably will have no experience in auditing exempt organizations, and we do not know the standards that would be applied in determining if tax-exempt status should be revoked. Granting this authority to the Hunger Commission would open a Pandora's box of administrative and legal problems.

While we sympathize greatly with the underlying goals of H.R. 81, we oppose the bill primarily because of the precedent it would establish and because of the administrative problems its enactment would create.

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

TREASURY NEWS

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

TEXT AS PREPARED
Embargoed for Release
Until Delivery
Expected at 12:30 p.m., EDT

Remarks by
M. Peter McPherson
Deputy Secretary of the Treasury
To the Institute for International Economics
Washington, DC
Thursday, August 4, 1988

The European Community's Internal Market Program: An American Perspective

Good Afternoon:

I am pleased to have this opportunity to speak to you today about the European Community's ongoing efforts to create a single integrated market. This is an ambitious effort to free the movement of goods, services, capital, and people throughout the 12 member states of the EC by the end of 1992.

A unified internal market presents new opportunities for Europeans and it presents new challenges for the rest of the world. The United States has supported the goal of European integration from its inception. We are concerned, however, by statements from Brussels that suggest the EC may try to exclude others as it liberalizes internal barriers. The creation of a single market that reserves "Europe for Europeans" would be bad for Europe, for the United States, and for the multilateral economic system.

Today I would like to comment, as an enthusiastic and interested observer, on our hopes and concerns about the shape of Europe that emerges after 1992.

I offer these remarks in a constructive spirit, with the hope that we and the EC can have a mutually helpful process of candid, open discussion about the implications of 1992 for countries that are outside the Community. After a brief description of the rationale of 1992, I will focus my remarks:

B-1505

The completion of the internal market will have implications for the multilateral economic system. In my judgment, we are poised at a critical juncture in the evolution of the international economy. Economic interdependence has brought great benefits to those nations which participate fully in the global economy. But the pressures that often accompany the expansion of trade among nations have also tested support within many countries for the open, multilateral trading system. Mercantilist attitudes have become more common. Adherence to the principles and disciplines of the GATT has eroded. And areas of critical importance to the U.S., such as financial and other services, investment, and intellectual property, are not adequately protected.

The Uruguay Round of multilateral trade negotiations is an effort to deal with these strains on the international trading system. How the EC approaches its effort at internal liberalization will have an important influence on the success of those negotiations and on the future direction of the global economy. In essence, Europe faces two opposing choices.

-- The EC may liberalize barriers internally, yet try to protect newly integrated markets from certain foreign competition. If this path is taken the EC would critically undermine the open, multilateral economic system.

-- Alternatively, the EC can make integration within Europe a genuinely free-market exercise and have an open policy toward the rest of the world as it opens its markets within. The industrial countries reaffirmed this goal at the recent Toronto Economic Summit.

All countries have a stake in this process.

-- We would all benefit from access to a dynamic, integrated European market. And we would suffer if Europe closed its doors and turned in on itself. Clearly, Europe would also suffer without the stimulus of world competition.

-- A stronger, more unified Europe would strengthen the economic underpinnings of the Atlantic Alliance. And a protected, isolated Europe would weaken the industrial base of the Community and undermine the economic strength of Europe.

Yes, we see compelling promise in the program, but the process of internal liberalization itself will generate pressures for greater external protection. Some feel that the pressure of greater competition within Europe should be mitigated by limiting competition from the rest of the world. This is the sentiment behind suggestions, such as that made by one prominent industrialist, that a "protective curtain" be erected around the internal market.

We find this reciprocity issue particularly troubling. I would like to take a few moments here to explain why reciprocity is unacceptable and why we expect the Community to grant national treatment to branches and subsidiaries of U.S. institutions in the EC.

The notion of reciprocity enjoys considerable simplistic appeal, because it suggests fair and equitable treatment. The Commission's proposal, however, could require countries to mirror the laws and regulations of the EC in order to have equal access to the internal market. The danger of this approach is that legitimate differences in national regulatory regimes could be used to justify discrimination against foreign firms. In the financial area, differences in organizational structures, the scope of permitted operations, regulatory and prudential frameworks, market instruments, clearance and settlement procedures, and methods of financing public debt will always exist.

To illustrate from our side of the Atlantic:

-- We allow financial institutions in the United States -- foreign and domestic -- to offer a greater range of financial instruments than is permitted in some EC countries. I ask you: Should we demand reciprocity and deny banks of the EC access to U.S. financial markets until their own countries adopt policies identical to our own?

Because of these differences, reciprocity that seeks to achieve identical commercial privileges in countries with different regulatory regimes will almost inevitably result in discrimination. In short, reciprocity that seeks identical treatment in different countries is a retreat back to protectionism.

In fact, the variety of financial environments around the world and the scale of our presence in each other's markets makes it impossible to provide reciprocal treatment for foreign firms without creating a huge regulatory bureaucracy and also severely limiting the flexibility of the market and the range of opportunities for foreign firms. I should point out that, at the end of 1987, there were over 660 foreign bank operating entities in the United States, representing 260 foreign bank families from more than 60 countries, with total U.S. assets of over $594 billion. And 147 U.S. banks have a total of 873 branches in 70 foreign countries.

We welcome the opportunity to talk with the member states and the Commission about the implications of 1992. We believe it is important for the EC to be open, in a timely way, with others about the external dimensions of the internal market program. Greater information about the actual intentions of the EC would help alleviate concerns generated by statements made in domestic political contexts. Early consultations that respect the rights and interests of others would surely be best for countries on both sides of the Atlantic.

In conclusion, I would like to express once again genuine admiration for the historic effort underway in Europe today. The United States is enthusiastic about the potential contribution of the completion of the internal market to a stronger, more dynamic Europe.

The international economic system is at a critical and in some ways vulnerable point in its evolution. This makes it particularly important that the 1992 effort support, not undermine, our shared objectives in moving toward a more open international trading and financial system. Regional efforts at liberalization can contribute to this goal, but only if accomplished without raising barriers to others.

We have expressed our hopes and concerns about 1992, not to challenge the program but to head off potential conflicts. Countries outside Europe have a natural interest in the process. And Europeans have a natural interest in preserving the support of other countries for the multilateral economic system.

We share the excitement in Europe. And we look forward to discussions with Brussels and the member states.

Thank you.

TREASURY NEWS

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

August 4, 1988

Contact: Bob Levine
566-2041

TREASURY STATEMENT ON PROPOSED SHORT-TERM FINANCING FOR ARGENTINA

The U.S. Department of Treasury announced today that it is working with the Government of Argentina to arrange short-term financing of up to $500 million. These funds would become available when Argentina meets the requirements for additional flows under the World Bank's policy-based sector lending program. United States willingness to participate in this effort reflects support for Argentina's economic reform efforts and the determination of the government of Argentina to address its international financial relations in a constructive manner. These efforts will be fully supported by the World Bank and we expect that they will be supported as well by the international financial community, including a new stand-by arrangement with the International Monetary Fund. The United States believes that renewed Argentine efforts should help stabilize its economy and promote sustained growth. This bridge is being formulated with the B. I. S. representing other creditor governments.

B-1506

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

FOR IMMEDIATE RELEASE August 8, 1988

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Acting Secretary, Federal Financing Bank (FFB), announced the following activity for the month of January 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $152.1 billion on January 31, 1988, posting a decrease of $318.2 million from the level on December 31, 1987. This net change was the result of decreases in holdings of agency debt of $258.6 million, in holdings of agency-guaranteed debt of $59.3 million and in holdings of agency assets of $0.3 million. FFB made 64 disbursements during January.

Attached to this release are tables presenting FFB January loan activity and FFB holdings as of January 31, 1988.

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B-1507

FEDERAL FINANCING BANK

January 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other th semi-annu
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
Note #458	1/7	$ 16,400,000.00	4/7/88	6.155%	
TENNESSEE VALLEY AUTHORITY					
Advance #838	1/6	92,000,000.00	1/11/88	6.245%	
Advance #839	1/8	144,000,000.00	1/15/88	6.085%	
Advance #840	1/11	72,000,000.00	1/18/88	6.175%	
Advance #841	1/15	22,000,000.00	1/19/88	6.195%	
Advance #842	1/15	98,000,000.00	1/20/88	6.195%	
Advance #843	1/18	96,000,000.00	1/25/88	6.185%	
Advance #844	1/20	56,000,000.00	1/28/88	6.275%	
Advance #845	1/25	23,000,000.00	2/1/88	6.115%	
Advance #846	1/25	67,000,000.00	2/3/88	6.115%	
Advance #847	1/28	45,000,000.00	2/2/88	6.045%	
Advance #848	1/28	26,000,000.00	2/3/88	6.045%	
Advance #849	1/29	27,000,000.00	2/5/88	5.985%	
Advance #850	1/31	137,000,000.00	2/8/88	5.935%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 17	1/4	660,000.00	8/25/14	8.975%	
Greece 17	1/8	34,151,545.00	8/25/14	8.988%	
Kenya 10	1/11	186,135.02	5/5/94	8.725%	
Colombia 7	1/12	37,632.00	9/15/91	8.315%	
Turkey 18	1/13	1,506,736.91	3/12/14	9.215%	
Niger 3	1/19	155,738.21	5/15/95	8.310%	
Greece 17	1/20	1,246,100.37	8/25/14	8.815%	
Greece 15	1/20	1,495,290.58	6/15/12	8.915%	
Turkey 18	1/20	916,656.71	3/12/14	8.925%	
Turkey 18	1/25	609,646.51	3/12/14	8.785%	
Phillipines 11	1/26	35,101.94	9/12/96	7.775%	

FEDERAL FINANCING BANK

January 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Baltimore, MD	1/4	$ 1,333,000.00	1/2/93	8.455%	8.634% ann.
Ponce, PR	1/14	118,931.20	10/3/88	7.005%	7.079% ann.
San Juan, PR	1/14	441,230.61	10/3/88	7.005%	7.079% ann.
Montgomery Co. Dev. Corp.	1/25	245,854.00	5/15/88	6.295%	
Florence, SC	1/25	31,552.81	7/1/88	6.555%	
Long Beach, CA	1/25	400,000.00	8/1/88	6.635%	6.643% ann.
Ponce, PR	1/25	21,100.00	10/3/88	6.745%	6.806% ann.
Rochester, NY	1/28	200,000.00	8/31/04	8.475%	8.655% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
*Wabash Valley Power #206	1/4	12,306,000.00	1/4/90	7.895%	7.819% qtr.
*Wabash Valley Power #104	1/4	6,327,000.00	12/31/15	9.024%	8.924% qtr.
*Wabash Valley Power #206	1/6	29,911,000.00	1/3/17	8.966%	8.868% qtr.
*Northwest Elec Power Co #176	1/6	775,000.00	1/8/90	7.885%	7.809% qtr.
*Corn Belt Power #166	1/6	77,000.00	1/3/17	8.966%	8.868% qtr.
*Corn Belt Power #94	1/6	423,000.00	1/3/17	8.966%	8.868% qtr.
*San Miguel Electric Co. #110	1/7	6,218,000.00	12/31/15	9.030%	8.930% qtr.
Central Electric Power #248	1/11	5,000.00	1/3/23	9.224%	9.120% qtr.
*Allegheny Electric #175	1/12	1,708,000.00	4/2/90	7.976%	7.898% qtr.
*Allegheny Electric #255	1/12	5,893,000.00	4/2/90	7.985%	7.907% qtr.
*Wabash Valley Power #206	1/13	11,896,000.00	1/16/90	7.925%	7.848% qtr.
*Wabash Valley Power #104	1/13	3,453,000.00	1/3/17	9.163%	9.060% qtr.
*Wabash Valley Power #206	1/13	2,292,000.00	1/3/17	9.163%	9.060% qtr.
*Wolverine Power #183A	1/13	583,000.00	1/2/90	7.909%	7.832% qtr.
Brazos Electric Power #332	1/15	752,000.00	12/31/19	9.127%	9.025% qtr.
*Wolverine Power #183A	1/22	232,000.00	1/2/90	7.628%	7.557% qtr.
Tex-La Electric #329	1/22	10,997,000.00	1/3/22	8.792%	8.697% qtr.
Sunflower Electric #174	1/25	6,000,000.00	1/3/17	8.729%	8.636% qtr.
*Colorado-Ute-Electric #96A	1/25	1,145,000.00	4/20/90	7.675%	7.603% qtr.
Sho-Me Power #324	1/25	500,000.00	4/2/90	7.682%	7.610% qtr.
Blue Ridge Electric #307	1/25	987,000.00	4/2/90	7.670%	7.598% qtr.
Central Iowa Power #295	1/27	2,200,000.00	1/2/18	8.783%	8.689% qtr.
*Colorado-Ute-Electric #198A	1/27	1,810,000.00	4/2/90	7.725%	7.652% qtr.
*San Miguel Electric Co. #110	1/28	8,152,000.00	12/31/15	8.607%	8.516% qtr.

*maturity extension

FEDERAL FINANCING BANK

January 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Alabama Community Dev. Corp.	1/6	$ 114,000.00	11/1/03	8.877%	
Comm. SB Dev. Corp.	1/6	121,000.00	11/1/03	8.877%	
Mid-Atlantic CDC	1/6	245,000.00	11/1/03	8.877%	
E. Central Michigan Dev. Corp.	1/6	126,000.00	11/1/08	8.953%	
Long Island Development Corp.	1/6	184,000.00	11/1/08	8.953%	
Massachusetts CDC	1/6	260,000.00	11/1/08	8.953%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-04	1/29	663,569,912.25	4/29/88	6.055%	

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	January 31, 1988	December 31, 1987	Net Change 1/1/88-1/31/88	FY '88 Net Change 10/1/87-1/31/88
Agency Debt:				
Export-Import Bank	$ 11,971.5	$ 11,971.5	$ -0-	$ -492.0
NCUA-Central Liquidity Facility	118.4	118.0	0.4	7.0
Tennessee Valley Authority	16,450.0	16,709.0	-259.0	64.0
U.S. Postal Service	5,853.4	5,853.4	-0-	1,500.0
U.S. Railway Association +	-0-	-0-	-0-	-0-
sub-total*	34,393.3	34,651.9	-258.6	1,079.0
Agency Assets:				
Farmers Home Administration	59,674.0	59,674.0	-0-	-5,335.0
DHHS-Health Maintenance Org.	84.0	84.0	-0-	-0-
DHHS-Medical Facilities	102.2	102.2	-0-	-0-
Overseas Private Investment Corp.	0.7	0.7	-0-	-0-
Rural Electrification Admin.-CBO	4,071.2	4,071.2	-0-	-170.0
Small Business Administration	18.2	18.5	-0.3	-1.4
sub-total*	63,950.2	63,950.5	-0.3	-5,506.4
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,322.4	18,354.0	-31.5	-841.5
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DHUD-Community Dev. Block Grant	323.7	323.4	0.2	-0.6
DHUD-New Communities	29.1	30.4	-1.3	-1.5
DHUD-Public Housing Notes +	2,034.9	2,034.9	-0-	-39.5
General Services Administration +	391.6	391.6	-0-	-3.8
DOI-Guam Power Authority	33.2	33.2	-0-	-0-
DOI-Virgin Islands	26.7	26.7	-0-	-0.4
NASA-Space Communications Co. +	949.4	949.4	-0-	140.8
DON-Ship Lease Financing	1,758.9	1,788.3	-29.4	-29.4
Rural Electrification Administration	21,187.4	21,191.2	-3.9	-9.6
SBA-Small Business Investment Cos.	718.0	726.3	-8.3	-22.6
SBA-State/Local Development Cos.	896.0	897.4	-1.4	-3.8
TVA-Seven States Energy Corp.	1,913.0	1,896.7	16.3	89.3
DOT-Section 511	53.8	53.8	-0-	-1.6
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	53,755.1	53,814.4	-59.3	-724.1
grand total*	$ 152,098.6	$ 152,416.8	$ -318.2	$-5,151.5

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 8, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,814 million of 13-week bills and for $6,805 million of 26-week bills, both to be issued on August 11, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 10, 1988			:	26-week bills maturing February 9, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.92%	7.14%	98.251	:	7.26%	7.64%	96.330
High	6.94%	7.16%	98.246	:	7.27%	7.65%	96.325
Average	6.94%	7.16%	98.246	:	7.26%	7.64%	96.330

Tenders at the high discount rate for the 13-week bills were allotted 94%.
Tenders at the high discount rate for the 26-week bills were allotted 03%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 44,190	$ 44,190	:	$ 41,795	$ 41,795
New York	21,064,540	5,412,740	:	20,343,935	5,912,765
Philadelphia	26,020	26,020	:	26,095	24,155
Cleveland	34,525	34,525	:	32,760	32,760
Richmond	50,535	50,535	:	47,320	47,320
Atlanta	27,890	27,890	:	37,435	37,435
Chicago	1,324,610	374,310	:	1,245,135	47,985
St. Louis	36,060	33,000	:	32,290	26,835
Minneapolis	14,120	9,120	:	19,775	14,925
Kansas City	36,330	36,330	:	53,200	53,200
Dallas	34,670	24,670	:	35,525	25,525
San Francisco	1,758,180	345,210	:	1,261,415	68,215
Treasury	395,005	395,005	:	472,315	472,315
TOTALS	$24,846,675	$6,813,545	:	$23,648,995	$6,805,230
Type					
Competitive	$21,604,855	$3,571,725	:	$19,133,910	$2,290,145
Noncompetitive	1,086,890	1,086,890	:	1,134,600	1,134,600
Subtotal, Public	$22,691,745	$4,658,615	:	$20,268,510	$3,424,745
Federal Reserve	2,066,815	2,066,815	:	2,000,000	2,000,000
Foreign Official Institutions	88,115	88,115	:	1,380,485	1,380,485
TOTALS	$24,846,675	$6,813,545	:	$23,648,995	$6,805,230

An additional $28,585 thousand of 13-week bills and an additional $460,815 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1508

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
August 9, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,600 million, to be issued August 18, 1988. This offering will not provide new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,590 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, August 15, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 6,800 million, representing an additional amount of bills dated May 19, 1988, and to mature November 17, 1988 (CUSIP No. 912794 QU 1), currently outstanding in the amount of $ 6,900 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 6,800 million, representing an additional amount of bills dated February 18, 1988, and to mature February 16, 1989 (CUSIP No. 912794 RG 1), currently outstanding in the amount of $ 9,907 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 August 18, 1988. 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 $ 1,590 million as agents for foreign and international monetary authorities, and $ 4,629 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M.
August 9, 1988

STATEMENT OF
THE HONORABLE O. DONALDSON CHAPOTON
ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today in support of protocols to our existing income tax treaties with France and Belgium. We appreciate the willingness of the Committee to consider the protocols. Prompt action by the Senate consenting to the ratification of the protocols is important to our tax treaty program and to the U.S. economy, which will benefit from these agreements.

Because this is the Treasury Department's first opportunity to appear before this Committee since tax reform, I want to describe briefly the purpose of tax treaties and the special significance of these two protocols, which are the first fruits of our efforts to amend our tax treaties to reflect the important tax law changes enacted by the Tax Reform Act of 1986.

The principal purpose of income tax treaties is to minimize international double taxation and thereby promote the free flow of capital, labor and technology unconstrained by tax impediments. Tax treaties help create a "level playing field" by minimizing the extent to which the decision to locate an investment in the home country of the investor or a foreign country depends upon tax considerations. By reducing barriers to efficient investment, tax treaties help foster international competitiveness and economic growth, to the benefit of all countries.

Barriers to international investment in the form of double taxation can occur, for example, when a corporation in one country receives dividends from a corporation in another country. Both countries may tax the income. A treaty may relieve the double taxation, as our treaties typically do, by obligating the source country where the income was earned to reduce its rate of tax on the dividends and by requiring the country of the

recipient's residence to grant a credit against its tax for the tax actually paid to the source country.

Tax treaties also aid international tax administration, thereby reducing tax evasion and helping to ensure fairness for taxpayers subject to more than one tax regime. Our treaties typically provide for the exchange of tax information and establish a mutual agreement procedure to address problems affecting specific taxpayers or classes of taxpayers.

The importance and utility of tax treaties is evidenced, in part, by the growing network of treaties that link various countries. The United States now has 37 bilateral income tax treaties in effect; many other countries, particularly in Europe, have treaties with as many as 50 or 60 nations. The U.S. treaty network is continuing to grow. In early July, we signed our first agreement with Indonesia, which we plan to bring before this Committee in the near future. We are in various stages of negotiation with perhaps a half-dozen other countries with which we do not presently have treaties, in addition to continuing our efforts to amend or renegotiate existing treaties.

I am particularly pleased to be speaking in support of the two protocols that are before the Committee today because they are the first examples of our efforts to amend or renegotiate our treaties to reflect the changes in U.S. tax law enacted by the Tax Reform Act of 1986. As I will discuss in more detail later, the French protocol includes several changes that conform it with the 1986 Act; the Belgian protocol has less sweeping changes, because we are in the process of renegotiating the entire treaty, but the protocol does include an important provision to prevent "treaty shopping" in the manner Congress indicated was appropriate in the 1986 Act.

Significantly, we were able to reach agreement on these protocols reflecting the 1986 Act with remarkable speed, as far as tax law is concerned. Congress, as you are aware, is still engaged in the process of enacting technical corrections to the 1986 Act; Treasury and the Internal Revenue Service are still engaged in the process of providing taxpayers with the guidance needed to comply with the Act. Yet we already have two protocols with major trading partners that reflect tax law changes in the Act ready for your consideration, and we have several more protocols and new treaties that do so nearing the final stages of completion. These include an important new treaty with Germany, which we expect to conclude in the next few months.

We take some pride in this evidence of our ability to conform tax treaties to changes in the U.S. tax laws. During consideration of the 1986 Act and the pending technical corrections bill, considerable attention has been focused on the appropriate relationship between tax treaties and tax statutes. The "inflexibility" of treaties has sometimes been cited as a reason to justify Congress overriding treaties unilaterally, in

order to ensure that tax law changes will be applied to all taxpayers. In candor, amending tax treaties through bilateral renegotiation is not always an easy process. But there is evidence that our treaty partners, many of which have followed the United States' lead in pursuing comprehensive tax reform, are often as interested as we are in expeditiously revising treaties on a bilateral basis to accommodate important changes in domestic tax law and policy as these affect the expanding economic relations between us. Some of that evidence is before you today -- in the form of these two protocols -- and we expect to make continuing progress in demonstrating that treaties can be promptly and successfully renegotiated to reflect important changes in domestic tax law and policy.

Before turning to the details of the two protocols, I want to note for the Committee that there is one tax policy concern that will require the negotiation of further changes to our treaties with Belgium and France, as well as with other countries, in the near future. We are in the process of considering the appropriate tax treatment under treaties of foreign shareholders in U.S. regulated investment companies (RICs) and real estate investment trusts (REITs), which are pass-through corporate entities that do not pay tax if they distribute most of their income annually to shareholders. Because of the special nature of these entities, we believe that foreign shareholders in such entities should not qualify for the low "direct investment" dividend withholding rates available in many of our treaties to principal (usually 10 percent or greater) shareholders; in addition, it is possible that certain foreign shareholders of REITs should not qualify for the reduced withholding rate on portfolio dividends. We are continuing to examine this issue and to discuss the matter with the staff of the Joint Committee on Taxation.

We have already begun discussing this issue with several of our treaty partners, including France, some of whom have expressed analogous concerns regarding the eligibility of such dividends for the treaty exemption applicable to direct investment dividends. It is the Treasury Department's intention to discuss these and other issues with France in the near future with the objective of resolving such issues in a separate protocol. We also intend to address this issue in our renegotiation of the Belgian treaty.

In accordance with our usual procedure, I would like to submit, for the record, the Treasury Department's technical explanations of the protocols. I will now point out the most important features of the protocols.

FRANCE

Our income tax treaty with France was signed in 1967 and amended by protocols in 1970, 1978, and 1984. As mentioned above, the protocol was prompted by the need to reflect in the

treaty certain key changes to the Internal Revenue Code ("the Code") made by the Tax Reform Act of 1986 ("the Act").

One of the most significant provisions of the protocol strengthens the so-called "anti-treaty shopping" rules of the treaty. All of our recent tax treaties have a provision, a limitation on benefits article, whose purpose is to prevent residents of third countries from deriving benefits from the treaty ("treaty shopping"). If, for example, a resident of Portugal, with which we currently do not have an income tax treaty, could invest in the United States through a French corporation rather than directly and reduce the U.S. tax burden on U.S. source income by claiming certain benefits under the United States-France treaty, Portugal would have less of an incentive to negotiate a treaty with the United States. Even when the ultimate investor is resident in another treaty country, the absence of a limitation on benefits article in the residence country treaty creates a disincentive to renegotiate the third country treaty and thus makes more difficult the objective of ensuring that each of our treaties is responsive to important changes in the law and policy of both countries.

The existing treaty with France generally provides that a person (other than an individual) who is a resident of one of the Contracting States is not entitled to treaty benefits unless more than 50 percent of the beneficial interest in the person is owned by residents of a Contracting State, the States themselves or local authorities thereof, U.S. citizens, or corporations in whose principal class of shares there is substantial and regular trading on a recognized stock exchange ("qualifying persons").

This "stock ownership" requirement alone may not be a sufficient safeguard against treaty-shopping in all cases. A French corporation could, for example, have all French individual owners but largely eliminate its French tax by making deductible interest payments to residents of third countries. Any reduction in U.S. tax on the French corporation pursuant to the treaty would indirectly inure to the benefit of the interest recipients.

Like some of our more recent treaties, the protocol consequently provides that, in order to claim benefits, a person must satisfy both stock ownership and "base erosion" requirements. Under this latter requirement, not more than 50 percent of the gross income of the person may be used to meet liabilities to persons who are not qualifying persons. It should be noted that the addition of this "base erosion" requirement makes the French limitation on benefits article consistent with Congress' view of a proper limitation, as expressed in the statutory limitation on benefits provision relating to the branch profits tax, as added by the Act.

Similarly, several other provisions of the protocol amend the treaty to make it more consistent with the Code as amended by the Act. The Act added to the Code a "branch profits tax" on deemed

remittances from a U.S. branch of a foreign corporation to the home office of the corporation. The tax is intended as a counterpart to the withholding tax on dividends paid by a U.S. subsidiary to its foreign parent corporation and functions to equalize the tax treatment of these two forms of foreign corporate investment in the United States. Although the present treaty permits both the United States and France to impose branch taxes within certain limitations, the treaty provision was designed with the French branch tax, which has existed for many years, in mind.

The protocol replaces this provision with one which permits both countries to impose their branch taxes in accordance with their internal law, subject to two limitations. First, only earnings attributable to a permanent establishment are subject to the tax, just as only the business profits earned by a resident of one treaty partner which are attributable to a permanent establishment maintained in the other treaty partner are taxable by such other treaty partner. Second, the maximum rate for the branch profits tax of both countries is fixed at 5 percent, the same rate that applies to dividends paid by a subsidiary organized in one of the treaty partners to its parent corporation organized in the other. The protocol also clarifies that the branch profits taxes (as well as other taxes added by the Act, such as the alternative minimum tax) are creditable taxes under the treaty.

In connection with the Act's narrowing of the Code exemption for income earned by foreign governments, the legislative history of the Act provided that for treaty purposes a foreign government is to be treated as a resident of its country eligible for treaty benefits unless it denies treaty benefits to the United States. The protocol accordingly provides that the United States, France, their local authorities, and the political subdivisions of the United States qualify as residents of the respective countries. Thus, if any of these governmental entities derive income from the other Contracting State which is subject to tax by such State, it is entitled to whatever benefits the treaty provides with respect to such income.

In the French treaty, as in most of our tax treaties, only business profits earned by a resident of one treaty partner which are attributable to a permanent establishment in the other treaty partner are taxable by such other treaty partner. The Act amended the Code to provide that income attributable to a business that a foreign person conducted in the United States which is received after the business ceases to exist is taxable by the United States. The protocol clarifies that this provision may be applied consistently with the treaty, so long as the income when earned was attributable to a permanent establishment under the treaty's principles. The protocol allows France to tax similarly income earned by a U.S. person that had a permanent establishment in France to which the income is attributable.

There is one provision of the protocol which is not related to the 1986 Act but which provides substantial benefits to U.S. citizens resident in France. Under this change, France will exempt certain U.S. source investment income of U.S. citizens resident in France. These individuals now pay tax to France on this income at a maximum rate of 54 percent. The Act cut the maximum U.S. tax rate on individuals to 28 percent. U.S. citizens, like U.S. corporations, can claim foreign taxes as credits against U.S. tax, but only up to the U.S. rate on the foreign source income subject to foreign tax (the "foreign tax credit limitation"). U.S. citizens resident in France, by virtue of a prior protocol provision permitting foreign source treatment of certain of their U.S. source income, could claim their French tax as a credit and thereby reduce their U.S. tax on their U.S. source investment income, but one consequence of the Act's rate reduction is that such individuals are now paying substantial French tax in excess of (and thus not creditable against) their U.S. tax.

Foreign taxes which are not creditable because of the foreign tax credit limitation, known as "excess credits," have become a much more serious problem for U.S. taxpayers as a result of the Act's rate reduction, since the foreign tax credit limitation declines as the U.S. rate declines. Without the protocol U.S. citizens resident in France would not benefit at all from the U.S. rate reduction (by contrast to U.S. citizens resident in the United States) since, as before the Act, they would continue to pay French tax at a 54 percent rate, a large portion of which would result in excess credits.

The protocol accordingly exempts from French tax U.S. source dividends, interest, and royalties earned by such individuals which are paid by (a) the United States or a political subdivision thereof, (b) a U.S. legal entity the principal class of shares of or interests in which are substantially and regularly traded on a recognized stock exchange, (c) a U.S. corporation in which the individual has less than a 10 percent interest, or (d) a U.S. resident which earns not more than 25 percent of its gross income from non-U.S. sources. Capital gains from the sale of assets giving rise to this income also qualify for the exemption. The exemption is available only if the individual who realizes the income demonstrates to France that he has complied with his U.S. tax obligations.

We believe this is an important illustration of how the treaty process can respond to changes in U.S. law by providing tax benefits to Americans without any cost to the U.S. Treasury. Without this protocol Americans living in France would be seriously disadvantaged as compared with Americans living in the United States and U.S. firms would find it more difficult to attract Americans to work for them in France, with concomitant damage to the competitiveness of such firms abroad.

The remainder of the protocol principally consists of minor changes to the dividends, interest, and royalties articles of the treaty requested by France. All these changes are discussed in the technical explanation.

BELGIUM

Our income tax treaty with Belgium, which was signed in 1970, is currently under renegotiation, in part to have the treaty reflect changes in the Code made by the Act. Both the United States and Belgium are committed to the prompt completion of a new treaty, and a round of negotiations will likely be held in the next six months.

The Act's reduction of the maximum U.S. corporate tax rate from 46 to 34 percent has had such a large impact on U.S. corporations operating in Belgium through Belgian subsidiaries, however, that both countries believe that one issue needs to be resolved immediately. As discussed above, one effect of the U.S. rate reduction is that U.S. taxpayers are now paying substantial taxes to foreign governments which are in excess of their U.S. tax liability. The combined Belgian tax rate on corporate earnings and dividends out of those earnings paid to a foreign parent corporation is more than 51 percent. With the U.S. corporate rate now at 34 percent, U.S. corporations operating in Belgium through Belgian subsidiaries are now generating large amounts of excess credits on their dividend payments to the U.S. parent corporation.

Under the existing treaty the withholding tax rate on dividends paid by a Belgian subsidiary to its U.S. parent is 15 percent, the rate on all dividends which qualify for a rate reduction under the treaty. To ameliorate the excess credit problem, the protocol drops the rate to 5 percent in the case of dividends paid by a resident of one of the treaty partners to a corporate shareholder which is a resident of the other partner and which owns at least 10 percent of the voting stock of the payor company. The rate on all other dividends derived from sources within one of the treaty partners and paid to a resident of the other partner remains 15 percent. The treaty, as amended by the protocol, has the same rates as the U.S. Treasury Department Model Treaty.

The present treaty does not have a limitation on benefits article. The protocol adds such an article to the treaty. It serves to deny treaty benefits with respect to withholding taxes on dividends, interest and royalties unless certain requirements, similar to those in the French treaty, as amended by the protocol, are met. The Belgian protocol generally provides that the owner of the income must satisfy stock ownership and base erosion requirements essentially identical to those in the French protocol. These requirements, however, are deemed to be met if one of two alternative requirements is satisfied. The first alternative is satisfied if the income derived from one

Contracting State for which the treaty benefit is claimed is derived in connection with, or is incidental to, the active conduct of a business by the owner of such income in the other Contracting State. The second alternative is satisfied if the owner of the income is a corporation whose principal class of shares is substantially and regularly traded on a recognized stock exchange. These alternatives are consistent with recent U.S. tax treaty policy and with the statutory limitation on benefits provision applicable to the branch profits tax.

As mentioned above, the United States and Belgium are continuing negotiations on a full new income tax treaty. We recognize, however, that some people may be concerned that the changes made by the protocol may decrease the incentive of both the United States and Belgium to conclude a new treaty that fully reflects the Act's changes to the Code. To allay this potential concern, the protocol permits either partner to terminate the protocol after it has been in force for five years. If this option is exercised, the treaty will be effective as if the protocol had never entered into force so that, for example, the withholding rate on dividends paid by a Belgian subsidiary to its U.S. parent would increase to 15 percent.

* * *

In conclusion, I want to state again my appreciation for the willingness of the Committee to consider these two important protocols. The Constitution directs us, the Executive Branch and the Legislative Branch, to act together as partners in the treaty-making process. In the context of tax treaties, this partnership extends not only to the process of Senate advice and consent to ratification, by which a signed treaty is brought into force, but also to each and every phase of cooperative effort by which the relevant features of our tax law and policy are brought into force in a new protocol or treaty, from initial consultations with the Joint Committee on Taxation and of the Senate and House tax-writing committees and their staffs, through negotiations with our treaty partners, to follow-up consultations and finalization of the treaty documents. We take very seriously this partnership and the obligations it imposes on us, as the two protocols before you today -- the most recent fruits of this partnership -- attest. We believe the partnership is in vigorous health and operating in a manner most faithful to the spirit with which it was created. I urge the Committee to take prompt action in support of these two protocols.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 9, 1988

CONTACT: Felice Pelosi
202/566-2843

SUSANNE H. HOWARD APPOINTED
DEPUTY TREASURER OF THE UNITED STATES

Treasury Secretary James A. Baker, III today announced the appointment of Susanne Hinson Howard to be Deputy Treasurer of the United States. She has been serving as the Press Secretary to the Treasurer, Katherine D. Ortega.

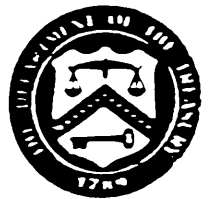
Mrs. Howard, who has an extensive background in public relations and public affairs, came to the Department of Treasury from the U.S. Small Business Administration, where she served as the Conference Coordinator for President Reagan's Women's Business Ownership National Initiative Conferences. From 1981-1983 she served as Special Assistant to the Administrator of the Economic Regulatory Administration, Department of Energy.

Prior to joining the Reagan Administration, Mrs. Howard was a consultant to the Electric Council of New England, directing the design and management of a collegiate energy education program. She organized energy workshops in California, while serving on the board of the Energy Advocacy Conference. She is also co-author of "Getting Started," a primer on pro-energy citizen action.

Mrs. Howard, from El Centro, California, received her Bachelor of Science degree from Brigham Young University. She is married to Captain H. Wyman Howard, Jr., USN. They have three children, Midshipman 2/c H. Wyman Howard, III, Anne-Marie Evans Howard and Kent Hinson Howard.

B-1511

TREASURY NEWS



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

August 5, 1988

MARGARET TUTWILER TO LEAVE TREASURY

Margaret DeB. Tutwiler, Assistant Secretary of the Treasury for Public Affairs and Public Liaison, will leave the Treasury Department on August 17, 1988 to join Vice President Bush's Campaign for President as the Deputy to the Chairman.

In announcing Miss Tutwiler's upcoming departure, Secretary Baker noted that "Margaret's tireless efforts in support of this Administration, both at Treasury and the White House, are the result of her relentless and consistent commitment to its objectives. She has been a valued advisor for many years and I am delighted that she has decided to dedicate her efforts toward the Bush Campaign."

At Treasury, Miss Tutwiler serves as the principal spokesperson for the Secretary. She oversees the Department's communications, press activities, and scheduling on a daily basis and for all major events. She is responsible for promoting understanding of Treasury policy through her work with the press corps, business and consumer groups.

Before coming to Treasury in February 1985, Miss Tutwiler served as a member of President Reagan's senior staff at the White House, first as Special Assistant to the President and Executive Assistant to the Chief of Staff (1980-1984) and later as Deputy Assistant to the President for Political Affairs (1984-1985). From 1978-1980, Miss Tutwiler was Director of Scheduling for George Bush's Presidential and Vice Presidential campaigns.

Miss Tutwiler became Public Affairs Representative for the National Association of Manufacturers in Alabama and Mississippi after having worked for the Alabama Republican Party in 1974 and having served in President Gerald Ford's re-election campaign from 1975-1976.

In July 1985, Miss Tutwiler was a member of the official U.S. delegation to the 1985 World Conference to Review and Appraise the Achievement of the United Nations Decade for Women in Nairobi, Kenya.

A native of Birmingham, Alabama, Miss Tutwiler graduated from the University of Alabama. She resides in Washington, D.C.

B-1512

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 9, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $11,097 million of $32,819 million of tenders received from the public for the 3-year notes, Series T-1991, auctioned today. The notes will be issued August 15, 1988, and mature August 15, 1991.

The interest rate on the notes will be 8-3/4%. The range of accepted competitive bids, and the corresponding prices at the 8-3/4% rate are as follows:

	Yield	Price
Low	8.76%*	99.974
High	8.77%	99.948
Average	8.77%	99.948

*Excepting 2 tenders totaling $2,005,000.

Tenders at the high yield were allotted 95%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 53,990	$ 53,980
New York	29,849,935	10,048,210
Philadelphia	35,010	33,960
Cleveland	95,650	82,350
Richmond	91,780	53,240
Atlanta	42,560	40,560
Chicago	1,352,685	185,685
St. Louis	89,180	74,855
Minneapolis	41,670	40,670
Kansas City	123,695	121,695
Dallas	30,820	24,820
San Francisco	1,004,185	329,035
Treasury	8,035	8,035
Totals	$32,819,195	$11,097,095

The $11,097 million of accepted tenders includes $1,186 million of noncompetitive tenders and $9,911 million of competitive tenders from the public.

In addition to the $11,097 million of tenders accepted in the auction process, $635 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,630 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.

B-1513

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 A.M.
August 10, 1988

STATEMENT OF
DANA L. TRIER
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department regarding several bills designed to revitalize the uranium industry of the United States, to provide for the cleanup of various mining sites, and to modify the enrichment program currently run by the Department of Energy. As you know there have been three separate bills introduced in the House to achieve the above purposes. Two of these bills, H.R.4934 and H.R.4975 are nearly identical. I will begin my testimony with the third bill, H.R.4489.

H.R.4489

The Treasury Department opposes H.R.4489. Title I of the bill would impose a fee on the use of foreign uranium by civilian nuclear reactors. This provision would violate the pending Free Trade Agreement between the United States and Canada, as well as the General Agreement on Trade and Tariffs ("GATT"). Robert Reinstein of the Office of the United States Trade Representative stated in testimony on June 28, 1988 before the Subcommittee on Energy and the Environment of the Committee on Interior and Insular Affairs that "the provisions of Title I would be inconsistent with the [Free Trade] Agreement, as well as with Article III of the GATT, and that the President's senior advisors would recommend a veto of any bill containing this provision." Thus, the Administration and the Treasury Department oppose H.R.4489.

B-1514

H.R.4934 and H.R.4975

I would like to now turn to H.R.4934 and H.R.4975. These two bills, which are for all practical purposes identical, would enact the Uranium Revitalization, Tailings Reclamation and Enrichment Act of 1988 (the "Act"). I will refer to these bills collectively as the "Act."

The Administration supports this proposed legislation, with certain modifications, as a reasonable compromise of the competing interests involved. These modifications include provision of the proposed government corporation with a private sector-type board of directors, expanded authority to borrow from the public for its project financings and independence and flexibility to market its product effectively; subjection of the corporation to NRC, EPA, and OSHA regulations; application of apportionment to both the Uranium Revitalization Fund and the proposed corporation; and elimination of legislative bypass authority.

Moreover, the Treasury Department believes that, from a tax policy perspective, the Act represents a far sounder approach to implementing the significant compromises it embodies than that taken by H.R.4489. However, we also believe it is appropriate for Congress to consider clarifying several ancillary tax issues raised by the proposed legislation.

Background

As the Committee is aware, among the purposes of the Act is the resolution of two major disputes that have arisen among miners and users of uranium and the United States government. One of these disputes concerns the relative liability and responsibility of uranium miners, the utility industry, and the federal government for cleanup and reclamation of uranium mining sites across the country. The other major dispute concerns the liability of the utility industry for unrecovered costs of the uranium enrichment program run by the federal government.

The Act would establish a Uranium Revitalization Trust Fund (the "Fund" or "Uranium Fund") to achieve a number of goals, including funding a program for the purchase of domestic uranium and the mine tailings cleanup effort. The uranium and utility industries would both make contributions to the Fund, as discussed further below.

In addition the Act would also establish the United States Enrichment Corporation, which would be a government-owned corporation. The Corporation would take over the uranium enrichment program from the Department of Energy, and would also support the Uranium Fund. The Department of Energy would transfer most of its existing uranium enrichment facilities to the Corporation. The Corporation would issue capital stock to the United States representing an equity investment equal to the book value of the assets transferred to the Corporation. The

Corporation would pay dividends on its capital stock out of earnings, unless there is an "overriding need" to retain those funds for corporate purposes. The Corporation would have an "initial debt" to the United States of $364 million dollars, required to be repaid over twenty years. However, this debt will be reduced by $300 million of the payments made by the Corporation to the Uranium Fund over the next five years, so that the initial debt will be reduced to $64 million. The United States would be prohibited from selling the stock of the Corporation without further legislation. Nonetheless, we understand that the eventual privatization of the Corporation is a goal of the legislation.

My testimony here today will focus on the tax policy implications of the proposed legislation. The Administration supports this proposed legislation with the modifications described above. I will not, however, discuss the diverse liability, energy, and environmental issues addressed by the Act, which are being fully discussed in the testimony of the Department of Energy. I will instead focus on four aspects of the proposed legislation: the reliance on user fees; collection of the taxes; the application of the Trust Fund Act; and certain potential tax interpretation issues.

User Fees

From a tax policy perspective, the most attractive feature of the Act is that the proposed Uranium Fund would be funded by what might be appropriately termed "user fees," rather than taxes levied on the general public. There are to be two major sources of private contributions to the Fund: the mining industry and the utility industry. Moreover, through the United States Enrichment Corporation, the federal government will provide additional support. In addition, states in which mining sites are located are permitted to make voluntary contributions to the Fund, although it is possible that few, if any, such voluntary contributions will be made.

The largest component of the funding is to be $1 billion contributed by the utility industry. Licensees for civilian nuclear power reactors would contribute to the Fund by means of a fee of $72 per kilogram of uranium contained in fuel assemblies initially loaded into each civilian nuclear reactor during each year, commencing January 1, 1988. The fee applies to the use of either foreign or domestic uranium. The fee will continue to be payable until the $1 billion figure is reached. It is anticipated that it will take five or six years for the fees to accumulate $1 billion. No specific cutoff date for the contributions is provided, so that if the $1 billion figure is not reached as quickly as anticipated, utilities will continue to pay until it is reached. Because utilities using the nuclear fuel are direct beneficiaries of the programs supported by the Fund, it is appropriate that they should bear financial responsibility under the Act in proportion to their use of nuclear fuel.

Mining companies are required to contribute to the Fund only if they elect to participate in the cleanup program under the Act with respect to active mining sites listed in the Act. If they do so elect, contributions are to be $2,000,000 per active site, $1,000,000 of which is to be contributed by January 31, 1990, and $1,000,000 of which is to be contributed by January 31, 1991. Mining companies are also to contribute $.50 by January 31, 1992 and $.50 by January 31, 1993 per dry ton of tailings produced by mining activities prior to the effective date of the Act. Total contributions by the mining industry are estimated at $300,000,000. It is also appropriate that producers of uranium should assist in financing the Uranium Fund if they benefit through participation in the cleanup program, and that the contributions of participating producers are to be measured by the number of their active sites and the amount of tailings at each active site.

The United States Enrichment Corporation established by the Act will also provide $450,000,000 in support to the uranium Fund. This contribution is to be made through $90,000,000 payments each December 15 from 1989 through 1993. $60,000,000 of each $90,000,000 installment is to be credited against the "initial debt" of the Corporation to the United States Treasury. Furthermore, since the United States will be the sole stockholder of the Corporation, any payments made by the Corporation reduce the value of the federal government's equity in the Corporation.

Collection By the Internal Revenue Service

Although the Administration supports this proposed legislation, we also believe that it is appropriate to clarify that the fees to be charged under the Act would most appropriately be collected by the Department of Energy rather than the Internal Revenue Service. The Act does not currently specify which agency would be responsible for collection. Certain types of user fees or excise taxes are collected by the Service because collection would be impractical for an agency not generally involved with tax collection. An example would be excise taxes on trucks or tires; it would not make sense for the Department of Transportation to collect such taxes. In this case, however, the involvement of the Department of Energy in the enrichment of uranium and the supply of nuclear fuel to civilian reactors would indicate that the Department will be able to effectively carry out collection of the fees due pursuant to the Act. It may not be necessary to have a specific provision in the Act concerning the role of the Service in collecting the fees, but some type of indication of Congressional intent on this point would be helpful.

Establishment Under the Trust Fund Code

The Fund would in some respects resemble other federal trust funds that have been set up for various purposes, such as the Hazardous Substance Superfund, the Leaking Underground Storage

Tank Trust Fund, and the Vaccine Injury Compensation Trust Fund. Unlike these other funds, however, the Uranium Fund is not established under the Trust Fund Code, a subtitle of the Internal Revenue Code. Although the Fund may not have been intentionally excluded from the Trust Fund Code, under the Act it would be codified as part of the Atomic Energy Act, not the Internal Revenue Code. Thus, the Fund would apparently be excluded from the coverage of the Trust Fund Code. Since the Fund is to be "established in the Treasury of the United States", we believe it would be appropriate to consider establishing the Uranium Fund under the Trust Fund Code.

In this regard, we note that some of the Act's provisions would be inconsistent with provisions of the Trust Fund Code. First, The Trust Fund Code requires that "the amounts appropriated... to any Trust Fund shall be transferred at least monthly from the general fund of the Treasury." Code section 9601(a). This rule would not be satisfied with respect to the Uranium Fund as contemplated under the Act, which would require payments to the Fund to be made annually by each of the parties required to pay into the Fund. It would seem that if the purposes of the Uranium Fund are better served by annual payments, there is no overriding reason to impose monthly payments. Thus, if the Fund were to be established under the Trust Fund Code there would need to be a modification of the rules of section 9601(a) for purposes of the Uranium Fund.

Second, the Act provides that moneys in the Fund would be invested in a manner differing from the investment program applicable to other funds under the Trust Fund Code. Code section 9602 provides that it shall be the duty of the Secretary of the Treasury to invest the portion of any trust fund that is not, in the Secretary's judgment, necessary for current withdrawals. The Act would grant the authority to determine the amount of the Uranium Fund to be invested in any particular year to the Secretary of Energy. It is not clear why this particular fund should be handled differently from those funds pursuant to the Trust Fund Code. If it is appropriate for the Secretary of the Treasury to determine the amount to be invested under the Vaccine Injury Compensation Fund, the Oil Spill Liability Trust Fund, or the Black Lung Disability Trust Fund, then it would seem that it would be appropriate that the Secretary of the Treasury should manage the investments of the Uranium Fund to a like degree.

The Act also provides additional specific rules concerning the investment of moneys in the Uranium Fund which differ slightly from the general trust fund rules. Section 9602 provides that investments under the Trust Fund Code may only be made in interest bearing obligations of the United States. The Act likewise provides that the investments of the Uranium Fund can be made only in interest-bearing U.S. obligations, but investments will be restricted to those that the Secretary had determined to be of appropriate maturity for the needs of the Fund. The Act also provides that the interest rate on the U.S.

obligations in which moneys of the Fund are invested "shall not exceed the average rate applicable to existing borrowings." It is not clear exactly what this restriction means. The phrase "existing borrowings" is nowhere defined. It apparently could refer to borrowings of the Fund, or to borrowings of the U.S. government. It may be that the purpose of the restriction is to restrict the profit the Fund earns at the expense of the U.S. government. In any event, the restriction might well hamper proper fiscal management of the Fund, and we therefore believe that consideration should be given to deleting it.

In summary, we do not see compelling reasons for having different investment rules for the Uranium Fund than for other federal trust funds. Thus, it appears appropriate that if enacted the Act should establish the Uranium Fund under the Trust Fund Code.

Potential Tax Issues

We should also note that there are several collateral tax issues potentially raised by the proposed legislation. First, we note that the tax treatment of the fees paid is not entirely clear. The Act provides that the fees paid by licensees of civilian nuclear reactors are to be considered "as a component of fuel cost for accounting and regulatory purposes." It is not clear if this provision is also meant to require that the fees be treated as part of fuel cost for federal tax purposes as well. Although the language does not specify the tax treatment of the fees, the broad language might be interpreted to require this result. We would oppose such an interpretation. The purpose of the fee is not to pay for the acquisition of fuel but to compensate the U.S. government for unrecovered costs of prior enrichment activities and to fund cleanup of the tailings resulting from the mining of fuel used in prior years.

We believe it is appropriate for the tax treatment of the fee to be determined through the normal process of determining the federal tax treatment of any other payment; that is, through regulations or by means of private or public rulings that address the issue in a specific factual context. We believe that the same logic applies to the determination of the federal tax treatment of contributors to the Fund by the mining industry.

Second, it appears that the Corporation would be subject to federal income tax, although this is not explicitly stated in the bill. Under the Internal Revenue Code, federal instrumentalities formed by an act of Congress after 1984 are exempt from federal income taxation only if the exemption is specifically provided under the Internal Revenue Code. Therefore, the Corporation would be subject to federal income tax, and it might be wise to have the Act or legislative history clarify this point.

Finally, several state tax issues are raised by the Act. Under the Act the Corporation would be exempt from state and local taxes of any sort. The Act does provide, however, that the Corporation is to make payments in lieu of taxes to state and local authorities.

This provision raises a number of issues. The payments in lieu of taxes are intended to approximate the amount that would be payable by private industrial firms owning similar facilities and engaged in similar activities, except that no payments are to be made in lieu of taxes imposed on net income. Some jurisdictions impose gross receipts type taxes. It is not clear why the Corporation should make payments in lieu of a gross receipts tax but not of an income tax. The Act would also provide that in no event would the payment in lieu of taxes be less than the amount payable as actual taxes calculated as if the transfer of properties had not occurred. Despite this mandatory minimum, the Act provides that the Corporation will have absolute discretion to determine the amount of tax payable. It is arguably inconsistent to have absolute discretion coupled with the mandatory minimum.

Finally, I would like to note the possible ramifications of a provision that includes certain contractors within the scope of the state tax exemption. In providing the Corporation's exemption, it is stated that "the activities of the Corporation for this purpose shall include the activities of organizations pursuant to cost-type contracts with the Corporation to manage, operate, and maintain its facilities." The proposed legislation goes on to provide that this exemption is not intended to exclude income of the Corporation's contractors from state or local income taxes. This provision appears to be aimed at cases which have held that federal contractors may not rely on the federal government's exclusion from state and local taxes. In United States v. New Mexico, 455 U.S. 720 (1981), the Supreme Court held that, despite the use of cost-type contracts, Atomic Energy Commission contractors were liable for gross receipts and sales taxes imposed by the state of New Mexico. The Court held that constitutional immunity from state or local taxes exists only where the contractors are "so closely connected to the government that that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned." Id. at 735. The Court found that the use of cost-type contracts did not result in such an inseparable relationship. Numerous other cases have considered the liability of federal contractors for state and local taxes.

The extension of federal tax immunity to the Corporation's contractors must be considered in light of this background. It may be appropriate in certain cases for federal contractors to be treated as instrumentalities of the federal government for purposes of state and local taxes, and it may be that Congress will determine that the Corporation's contractors should be so treated. However, it is important that the background and possible collateral consequences of such a provision be understood and considered before such a provision is enacted.

CONCLUSION

The Treasury Department supports the legislation proposed in H.R.4934 and H.R.4975, with the modifications described previously. Although a number of collateral issues are raised by the bills, we believe that on balance the bills represent a reasonable approach to the issues intended to be resolved by the legislation.

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

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 10, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 10-YEAR NOTES

The Department of the Treasury has accepted $11,001 million of $ 20,354 million of tenders received from the public for the 10-year notes, Series C-1998, auctioned today. The notes will be issued August 15, 1988, and mature August 15, 1998.

The interest rate on the notes will be 9-1/4%. 1/ The range of accepted competitive bids, and the corresponding prices at the 9-1/4% interest rate are as follows:

	Yield	Price
Low	9.24%*	100.064
High	9.29%	99.743
Average	9.27%	99.871

*Excepting 1 tender of $50,000.

Tenders at the high yield were allotted 17%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 15,479	$ 13,479
New York	19,013,840	10,359,600
Philadelphia	7,684	7,684
Cleveland	15,227	15,227
Richmond	12,766	12,766
Atlanta	15,217	15,207
Chicago	792,899	361,239
St. Louis	28,566	12,566
Minneapolis	11,100	11,100
Kansas City	20,039	20,039
Dallas	6,225	6,225
San Francisco	412,338	162,585
Treasury	2,936	2,936
Totals	$20,354,316	$11,000,653

The $11,001 million of accepted tenders includes $ 495 million of noncompetitive tenders and $10,506 million of competitive tenders from the public.

In addition to the $11,001 million of tenders accepted in the auction process, $325 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/ The minimum par amount required for STRIPS is $ 800,000. Larger amounts must be in multiples of that amount.

B-1515

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

FOR IMMEDIATE RELEASE August 11, 1988

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Acting Secretary, Federal Financing Bank (FFB), announced the following activity for the month of February 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $150.2 billion on February 29, 1988, posting a decrease of $1.9 billion from the level on January 31, 1988. This net change was the result of an increase in holdings of agency debt of $91.7 million, and decreases in holdings of agency-guaranteed debt of $2,011.7 million and in agency assets of $0.9 million. FFB made 59 disbursements during February.

Attached to this release are tables presenting FFB February loan activity and FFB holdings as of February 29, 1988.

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B-1516

FEDERAL FINANCING BANK

February 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #459	2/3	$ 9,570,000.00	5/4/88	6.015%	
Note #460	2/18	13,400,000.00	5/19/88	6.045%	
TENNESSEE VALLEY AUTHORITY					
Advance #851	2/3	115,000,000.00	2/12/88	6.015%	
Advance #852	2/5	46,000,000.00	2/12/88	5.955%	
Advance #853	2/8	143,000,000.00	2/15/88	5.935%	
Advance #854	2/12	69,000,000.00	2/16/88	5.935%	
Advance #855	2/12	33,000,000.00	2/17/88	5.935%	
Advance #856	2/12	70,000,000.00	2/19/88	5.935%	
Advance #857	2/15	173,000,000.00	2/22/88	6.055%	
Advance #858	2/19	25,000,000.00	2/23/88	5.995%	
Advance #859	2/19	54,000,000.00	2/26/88	5.995%	
Advance #860	2/22	151,000,000.00	2/26/88	5.985%	
Advance #861	2/26	34,000,000.00	3/2/88	5.935%	
Advance #862	2/26	62,000,000.00	3/3/88	5.935%	
Advance #863	2/26	132,000,000.00	3/4/88	5.935%	
Advance #864	2/28	42,000,000.00	3/7/88	5.885%	
Advance #865	2/29	152,000,000.00	3/7/88	5.885%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Peru 10	2/1	69,617.70	4/10/96	8.215%	
Morocco 13	2/1	18,950.00	5/31/96	7.805%	
Phillipines 11	2/1	231,671.96	9/12/96	7.535%	
Greece 15	2/1	2,000,000.00	6/15/12	8.535%	
Turkey 18	2/1	738,508.68	3/12/14	8.545%	
Morocco 11	2/1	6,020.50	12/8/95	8.205%	
Turkey 18	2/3	2,804,512.02	3/14/12	8.435%	
Turkey 18	2/4	297,284.86	3/14/12	8.505%	
Peru 10	2/4	148,105.27	4/10/96	8.195%	
Turkey 18	2/10	649,533.81	3/12/14	8.505%	
Gabon 6	2/16	1,404,710.00	2/15/90	7.029%	
Gabon 5	2/16	1,000,000.00	3/20/89	6.582%	
Niger 3	2/16	73,132.76	5/15/95	8.085%	
Turkey 18	2/16	479,460.13	3/12/14	8.605%	
Phillipines 11	2/17	108,633.44	9/12/96	7.495%	
Phillipines 11	2/22	9,452.01	9/12/96	7.435%	
Greece 17	2/22	1,246,100.41	8/25/14	8.455%	
Greece 15	2/25	1,138,636.29	6/15/12	8.515%	
Gabon 4	2/26	536,290.00	7/15/88	6.068%	

+rollover

FEDERAL FINANCING BANK

February 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Toa Baja, PR	2/16	$ 300,000.00	5/2/88	6.055%	
*Ponce, PR	2/16	32,078.50	10/1/88	6.555%	6.598% ann.
*Rochester, NY	2/19	20,000.00	8/31/88	6.425%	6.436% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
*Wabash Valley Power #206	2/1	134,000.00	1/3/17	8.489%	8.401% qtr.
*Allegheny Electric #175A	2/1	7,042,000.00	4/2/90	7.396%	7.329% qtr.
*Wolverine Power #182A	2/1	459,000.00	1/2/90	7.299%	7.234% qtr.
United Power #222	2/5	950,000.00	5/2/90	7.365%	7.298% qtr.
Brazos Electric #333	2/9	3,000,000.00	1/3/22	8.491%	8.403% qtr.
*Wabash Valley Power #206	2/10	821,000.00	2/12/90	7.245%	7.181% qtr.
*Wabash Valley Power #206	2/10	1,981,000.00	1/3/17	8.433%	8.346% qtr.
*Wabash Valley Power #104	2/10	4,062,000.00	1/3/17	8.433%	8.346% qtr.
*Wolverine Power #183A	2/10	1,101,000.00	1/2/90	7.220%	7.156% qtr.
*Wolverine Power #182A	2/10	858,000.00	1/2/90	7.220%	7.156% qtr.
*Colorado Ute Electric #198A	2/18	540,000.00	4/2/90	7.388%	7.321% qtr.
Oglethorpe Electric #320	2/18	5,184,000.00	4/2/90	7.395%	7.328% qtr.
*New Hampshire Electric #192	2/18	970,000.00	12/31/18	8.605%	8.514% qtr.
*Colorado Ute Electric #168A	2/22	873,000.00	4/2/90	7.347%	7.281% qtr.
*Colorado Ute Electric 168A	2/24	1,290,057.00	4/2/90	7.296%	7.231% qtr.
*Colorado Ute Electric #96A	2/24	745,000.00	4/2/90	7.296%	7.231% qtr.
*Colorado Ute Electric #203A	2/24	1,505,000.00	4/2/90	7.297%	7.232% qtr.
Tex-La Electric Coop #329	2/24	1,637,290.67	1/3/22	8.480%	8.392% qtr.
Cooperative Power Assoc. #156	2/29	2,396,000.00	3/1/90	7.285%	7.220% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
West Tennessee Invest Corp.	2/10	93,000.00	2/1/08	8.345%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note #A-88-05	2/29	644,553,689.96	5/31/88	5.945%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	February 29, 1988	January 31, 1988	Net Change 2/1/88-2/29/88	FY '88 Net Change 10/1/87-2/29/88
Agency Debt:				
Export-Import Bank	$ 11,971.5	$ 11,971.5	$ -0-	$ -492.0
NCUA-Central Liquidity Facility	113.1	118.4	-5.3	1.7
Tennessee Valley Authority	16,547.0	16,450.0	97.0	161.0
U.S. Postal Service	5,853.4	5,853.4	-0-	1,500.0
U.S. Railway Association +	-0-	-0-	-0-	-0-
sub-total*	34,485.0	34,393.3	91.7	1,170.7
Agency Assets:				
Farmers Home Administration	59,674.0	59,674.0	-0-	-5,335.0
DHHS-Health Maintenance Org.	84.0	84.0	-0-	-0-
DHHS-Medical Facilities	102.2	102.2	-0-	-0-
Overseas Private Investment Corp.	-0-	0.7	-0.7	-0.7
Rural Electrification Admin.-CBO	4,071.2	4,071.2	-0-	-170.0
Small Business Administration	17.9	18.2	-0.3	-1.7
sub-total*	63,949.3	63,950.2	-0.9	-5,507.3
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,303.0	18,322.4	-19.4	-860.9
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DHUD-Community Dev. Block Grant	316.5	323.7	-7.1	-7.7
DHUD-New Communities	29.1	29.1	-0-	-1.5
DHUD-Public Housing Notes +	2,034.9	2,034.9	-0-	-39.5
General Services Administration +	391.6	391.6	-0-	-3.8
DOI-Guam Power Authority	33.1	33.2	-0-	-0-
DOI-Virgin Islands	26.7	26.7	-0-	-0-
NASA-Space Communications Co. +	949.4	949.4	-0-	140.8
DON-Ship Lease Financing	1,758.9	1,758.9	-0-	-29.4
DON-Defense Production Act	-0-	-0-	-0-	-0-
Rural Electrification Administration	19,192.9	21,187.4	-1,994.4	-2,004.0
SBA-Small Business Investment Cos.	716.4	718.0	-1.6	-24.2
SBA-State/Local Development Cos.	893.1	896.0	-2.9	-6.7
TVA-Seven States Energy Corp.	1,927.0	1,913.0	14.0	103.4
DOT-Section 511	53.5	53.8	-0.2	-1.8
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	51,743.4	53,755.1	-2,011.7	-2,735.3
grand total*	$ 150,177.7	$ 152,098.6	$ -1,920.9	$ -7,072.3

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 11, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S AUCTION OF 248-DAY CASH MANAGEMENT BILLS

Tenders for $7,021 million of 248-day Treasury bills to be issued on August 15, 1988, and to mature April 20, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	7.71%*	8.17%	94.689
High	7.74%	8.20%	94.668
Average	7.73%	8.19%	94.675

*Excepting 1 tender of $200,000.

Tenders at the high discount rate were allotted 63%.

TOTAL TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 200	$ 200
New York	23,319,040	6,142,565
Philadelphia	1,800	1,800
Cleveland	13,310	12,200
Richmond	250	250
Atlanta	170	170
Chicago	1,236,315	654,165
St. Louis	5,055	3,055
Minneapolis	--	--
Kansas City	3,745	3,005
Dallas	16,100	6,100
San Francisco	1,076,120	197,620
Treasury	--	--
TOTALS	$25,672,105	$7,021,130

The $7,021 million of accepted tenders includes $13 million of noncompetitive tenders and $7,008 million of competitive tenders from the public.

B-1517

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 15, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,807 million of 13-week bills and for $6,811 million of 26-week bills, both to be issued on August 18, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 17, 1988			:	26-week bills maturing February 16, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.02%	7.24%	98.226	:	7.48%	7.88%	96.218
High	7.06%	7.29%	98.215	:	7.52%	7.93%	96.198
Average	7.05%	7.28%	98.218	:	7.51%	7.92%	96.203

Tenders at the high discount rate for the 13-week bills were allotted 82%.
Tenders at the high discount rate for the 26-week bills were allotted 22%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,140	$ 36,140	:	$ 38,985	$ 38,985
New York	21,632,865	5,907,150	:	20,040,620	5,839,320
Philadelphia	24,295	24,295	:	23,155	23,155
Cleveland	51,910	51,605	:	44,200	44,200
Richmond	39,625	39,625	:	44,060	44,060
Atlanta	36,275	36,275	:	33,210	31,675
Chicago	1,145,450	65,950	:	1,010,300	152,500
St. Louis	30,605	26,605	:	37,985	34,205
Minneapolis	7,010	7,010	:	10,575	10,575
Kansas City	35,985	35,985	:	57,380	57,380
Dallas	35,860	25,860	:	31,950	21,950
San Francisco	1,125,725	169,355	:	1,199,150	79,550
Treasury	380,910	380,910	:	433,005	433,005
TOTALS	$24,582,655	$6,806,765	:	$23,004,575	$6,810,560
Type					
Competitive	$20,893,265	$3,117,375	:	$18,334,175	$2,140,160
Noncompetitive	1,105,985	1,105,985	:	1,137,395	1,137,395
Subtotal, Public	$21,999,250	$4,223,360	:	$19,471,570	$3,277,555
Federal Reserve	2,479,310	2,479,310	:	2,150,000	2,150,000
Foreign Official Institutions	104,095	104,095	:	1,383,005	1,383,005
TOTALS	$24,582,655	$6,806,765	:	$23,004,575	$6,810,560

An additional $41,105 thousand of 13-week bills and an additional $526,195 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1518

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
August 16, 1988

CONTACT: Office of Financing
202/376-4350

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 August 25, 1988. This offering will provide about $1,125 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $12,884 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, August 22, 1988. The two series offered are as follows:

92-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated November 27, 1987, and to mature November 25, 1988 (CUSIP No. 912794 QC 1), currently outstanding in the amount of $15,819 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated August 25, 1988, and to mature February 23, 1989 (CUSIP No. 912794 RJ 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 August 25, 1988. 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 $1,817 million as agents for foreign and international monetary authorities, and $4,647 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.
August 17, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR 2-MONTH NOTES
TOTALING $16,000 MILLION

The Treasury will raise about $5,425 million of new cash by issuing $8,750 million of 2-year notes and $7,250 million of 5-year 2-month notes. This offering will also refund $10,572 million of 2-year notes maturing August 31, 1988. The $10,572 million of maturing 2-year notes are those held by the public, including $1,263 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $16,000 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 price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $863 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 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-1521

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR 2-MONTH NOTES

August 17, 1988

<u>Amount Offered to the Public</u> ...	$8,750 million	$7,250 million
<u>Description of Security</u>:		
Term and type of security	2-year notes	5-year 2-month notes
Series and CUSIP designation ...	Series AE-1990 (CUSIP No. 912827 WP 3)	Series M-1993 (CUSIP No. 912827 WQ 1)
Issue date	August 31, 1988	September 1, 1988
Maturity date	August 31, 1990	November 15, 1993
Interest rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction
Interest payment dates	February 28 and August 31	May 15 and November 15 (first payment on May 15, 1989)
Minimum denomination available .	$5,000	$1,000
<u>Terms of Sale</u>:		
Method of sale	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%
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
Accrued interest payable by investor	None	None
<u>Payment Terms</u>:		
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ..	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable	Acceptable
<u>Key Dates</u>:		
Receipt of tenders	Tuesday, August 23, 1988, prior to 1:00 p.m., EDST	Wednesday, August 24, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Wednesday, August 31, 1988	Thursday, September 1, 1988
b) readily-collectible check ...	Monday, August 29, 1988	Tuesday, August 30, 1988

TREASURY NEWS

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

FOR IMMEDIATE RELEASE August 18, 1988

M. Peter McPherson, Deputy Secretary of the Treasury since August 6, 1987, is Acting Secretary of the Treasury effective August 18, 1988.

Before joining the Treasury, Mr. McPherson served as Administrator, Agency for International Development.

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B-1522

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
August 19, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $9,000 million of 364-day Treasury bills to be dated September 1, 1988, and to mature August 31, 1989 (CUSIP No. 912794 SK 1). This issue will result in a paydown for the Treasury of about $525 million, as the maturing 52-week bill is outstanding in the amount of $9,524 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, Thursday, August 25, 1988.

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 September 1, 1988. In addition to the maturing 52-week bills, there are $13,647 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 $2,128 million as agents for foreign and international monetary authorities, and $7,379 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 $100 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 5176-3.

B-1523

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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 August 22, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of July 1988.

As indicated in this table, U.S. reserve assets amounted to $43,876 million at the end of July, up from $41,028 million in June.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1988					
June	41,028	11,063	9,180	10,793	9,992
July	43,876	11,063	8,984	14,056	9,773

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

B-1524

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 22, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,002 million of 13-week bills and for $7,009 million of 26-week bills, both to be issued on August 25, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 25, 1988			:	26-week bills maturing February 23, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.15%	7.38%	98.173	:	7.49%	7.89%	96.213
High	7.18%	7.42%	98.165	:	7.52%	7.93%	96.198
Average	7.18%	7.42%	98.165	:	7.51%	7.92%	96.203

Tenders at the high discount rate for the 13-week bills were allotted 81%.
Tenders at the high discount rate for the 26-week bills were allotted 25%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,720	$ 36,720	:	$ 38,430	$ 38,430
New York	21,798,715	6,029,345	:	22,309,400	6,051,900
Philadelphia	20,100	20,100	:	21,965	20,965
Cleveland	38,980	38,980	:	38,310	38,310
Richmond	43,505	43,505	:	44,360	44,360
Atlanta	28,585	28,585	:	30,820	30,820
Chicago	1,017,665	62,915	:	899,510	104,510
St. Louis	27,555	23,555	:	30,360	26,360
Minneapolis	6,265	6,265	:	9,730	9,730
Kansas City	33,875	33,875	:	44,020	44,020
Dallas	36,295	26,295	:	26,830	16,830
San Francisco	1,208,395	296,395	:	1,382,695	141,195
Treasury	355,010	355,010	:	441,890	441,890
TOTALS	$24,651,665	$7,001,545	:	$25,318,320	$7,009,320
Type					
Competitive	$21,103,405	$3,453,285	:	$20,366,315	$2,057,315
Noncompetitive	992,635	992,635	:	1,043,745	1,043,745
Subtotal, Public	$22,096,040	$4,445,920	:	$21,410,060	$3,101,060
Federal Reserve	2,446,585	2,446,585	:	2,200,000	2,200,000
Foreign Official Institutions	109,040	109,040	:	1,708,260	1,708,260
TOTALS	$24,651,665	$7,001,545	:	$25,318,320	$7,009,320

An additional $11,160 thousand of 13-week bills and an additional $349,540 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1525

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 23, 1988

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $8,779 million of $35,272 million of tenders received from the public for the 2-year notes, Series AE-1990, auctioned today. The notes will be issued August 31, 1988, and mature August 31, 1990.

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

	Yield	Price
Low	8.72%*	99.829
High	8.72%	99.829
Average	8.72%	99.829

*Excepting 2 tenders totaling $60,000.

Tenders at the high yield were allotted 74%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 56,995	$ 56,995
New York	31,352,165	7,895,245
Philadelphia	32,375	32,375
Cleveland	91,555	71,555
Richmond	102,640	63,600
Atlanta	61,600	40,600
Chicago	1,429,750	172,750
St. Louis	102,510	81,970
Minneapolis	39,150	39,150
Kansas City	137,410	132,410
Dallas	35,460	29,160
San Francisco	1,733,785	66,785
Treasury	96,525	96,525
Totals	$35,271,920	$8,779,120

The $8,779 million of accepted tenders includes $1,224 million of noncompetitive tenders and $7,555 million of competitive tenders from the public.

In addition to the $8,779 million of tenders accepted in the auction process, $820 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $863 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.

B-1526

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 23, 1988

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 September 1, 1988. This offering will provide about $ 350 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,647 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, August 29, 1988. 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 June 2, 1988, and to mature December 1, 1988 (CUSIP No. 912794 QV9), currently outstanding in the amount of $ 7,268 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,000 million, to be dated September 1, 1988, and to mature March 2, 1989 (CUSIP No. 912794 RK2).

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 September 1, 1988. In addition to the maturing 13-week and 26-week bills, there are $ 9,524 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 $ 1,946 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 2,046 million as agents for foreign and international monetary authorities, and $ 7,379 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 24, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $7,268 million of $21,568 million of tenders received from the public for the 5-year 2-month notes, Series M-1993, auctioned today. The notes will be issued September 1, 1988, and mature November 15, 1993.

The interest rate on the notes will be 9 %. The range of accepted competitive bids, and the corresponding prices at the 9 % rate are as follows:

	Yield	Price
Low	9.03%	99.800
High	9.04%	99.759
Average	9.04%	99.759

Tenders at the high yield were allotted 82%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 28,123	$ 28,123
New York	19,248,860	6,592,900
Philadelphia	18,334	18,334
Cleveland	54,715	42,735
Richmond	32,852	31,952
Atlanta	23,228	23,228
Chicago	1,024,356	323,296
St. Louis	44,302	28,302
Minneapolis	25,287	25,287
Kansas City	46,968	46,958
Dallas	16,289	12,289
San Francisco	1,002,753	92,853
Treasury	1,889	1,889
Totals	$21,567,956	$7,268,146

The $7,268 million of accepted tenders includes $600 million of noncompetitive tenders and $6,668 million of competitive tenders from the public.

In addition to the $7,268 million of tenders accepted in the auction process, $180 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

B-1528

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
August 24, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $10,000 MILLION
OF 20-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $10,000 million of 20-day Treasury bills to be issued September 2, 1988, representing an additional amount of bills dated March 24, 1988, maturing September 22, 1988 (CUSIP No. 912794 QN 7).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, August 30, 1988. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders from the public will not be accepted. Tenders will not be received at the Department of the Treasury, Washington.

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches. Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

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, 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.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. 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. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Friday, September 2, 1988. 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

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

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 25, 1988

Contact: Charlie Powers
566-8773

ALL BANKS REQUIRED TO REPORT LARGE CURRENCY TRANSACTIONS WITH CASINOS

The Treasury Department announced today that it is revoking all existing exemptions granted to banks from reporting currency transactions by casinos under the Bank Secrecy Act. The Bank Secrecy Act generally requires banks and other financial institutions to report all cash transactions in excess of $10,000. Treasury's regulations under the Bank Secrecy Act allow banks to exempt the transactions of certain businesses from reporting and to request special exemptions for other types of businesses from Treasury. Since April 8, 1987, the regulations provide that banks may not request special exemptions for transactions with any other nonbank financial institutions such as casinos (with gross annual gaming revenues exceed $1,000,000). Nevertheless, many exemptions granted by Treasury for casinos predating the regulatory change remain in force and necessitate this revocation action.

Casinos with gross annual gaming revenues of less then $1,000,000 are not considered nonbank financial institutions under the Bank Secrecy Act regulations. However, Treasury is revoking existing exemptions for these smaller casinos and has decided, as a matter of policy, that no exemptions for those casinos will be granted in the future by Treasury.

Banks must remove all casinos from exemption lists and begin reporting all transactions with them in excess of $10,000 on IRS Form 4789, the Currency Transaction Report, no later than September 30, 1988. The September 30, 1988, effective date is being provided to enable banks to implement this requirement more easily.

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B-1530

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 25, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,004 million of 52-week bills to be issued September 1, 1988, and to mature August 31, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.72%	8.32%	92.194
High -	7.73%	8.33%	92.184
Average -	7.72%	8.32%	92.194

Tenders at the high discount rate were allotted 6%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 18,200	$ 18,200
New York	28,899,975	8,545,955
Philadelphia	12,540	12,540
Cleveland	16,050	16,050
Richmond	24,045	20,165
Atlanta	13,635	13,635
Chicago	1,469,030	115,990
St. Louis	20,200	16,200
Minneapolis	9,970	9,970
Kansas City	27,270	25,270
Dallas	21,525	11,525
San Francisco	1,689,885	43,385
Treasury	154,665	154,665
TOTALS	$32,376,990	$9,003,550
Type		
Competitive	$28,914,300	$5,540,860
Noncompetitive	462,690	462,690
Subtotal, Public	$29,376,990	$6,003,550
Federal Reserve	2,900,000	2,900,000
Foreign Official Institutions	100,000	100,000
TOTALS	$32,376,990	$9,003,550

An additional $180,000 thousand of the bills will be issued to foreign official institutions for new cash.

B-1531

TREASURY NEWS

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

Text as Prepared
For Release Upon Delivery
Expected at 11:00 a.m. DST

Opening Remarks by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
during the
American Institute in Taiwan -
Taiwan Coordination Council for North American Affairs
Financial Services Talks
Washington, D.C.
August 29, 1988

The talks we are embarking on today are indeed timely. The winds of change are blowing in international financial markets as never before. Interdependence between national economies is increasing. Modern technology is making closer neighbors of us all. It is a time of tremendous opportunity and also of heightened risk. Those who can take advantage of the prevailing winds will move ahead; their financial markets will be broadened, deepened and made more prosperous. Efficiency will increase and as a result the cost of providing services to consumers will be reduced.

Financial deregulation is occurring around the globe and pointing the way to an exciting future. The United Kingdom and Canada with their "big" and "little" bangs have led the way. There is a wave of financial liberalization and deregulation in other European countries. Japan has shown steady progress in creating more competitive and efficient capital markets.

In the United States, significant deregulation took place several years ago, but the Congress is now rethinking the law and the powers that separate our banking and securities business. The Senate has passed a bill and the House is considering legislation that would substantially revise the Glass-Steagall Act. This Administration strongly supports Glass-Steagall reform as the proper next step in modernizing the U.S. financial system.

B-1532

In this broad context, I offer praise to the CCNAA delegation for those efforts being made in Taiwan towards greater financial liberalization and internationalization. We are both aware that over-regulation in any market results in inefficiencies, market distortions, high-cost services and a weak competitive situation. An obvious result is lower growth and a weaker financial infrastructure than would otherwise be the case.

We are pleased that there is movement in Taiwan towards liberalizing the foreign exchange, securities and banking laws. The Taiwan authorities deserve praise and credit for these initiatives. In my role as Chairman of the discussions on banking and securities, I assure you that I give full credit to your good intentions. But good intentions need to be translated into concrete acts and accomplishments. The United States seeks nothing less than full national treatment -- equality of competitive opportunity -- for U.S. financial firms in Taiwan. We realize this cannot be achieved overnight or in a single act. What we do seek from you is an outline or model -- call it a timetable if you will -- that will give an indication not only of your intentions, but also of the stages by which you intend to translate them into actual fact.

The progress we seek must benefit both of us. A steady movement towards national treatment is in your own long-term best interests as well as those of your financial partners. When foreign firms enter your market to establish branches or subsidiaries or to offer new instruments and services, they are making a significant statement: they have decided to enter a long-term inter-dependent and mutually beneficial relationship. Taiwan has a highly intelligent and well-educated population. Therefore, technology transfer and an increase in the skills of the local population are certain to take place as well. U.S. firms are second to none in their willingness to recognize and reward local managers.

As we enter into these financial services discussions, each side needs to approach the talks with perspective, flexibility, and understanding. Accordingly, as we continue to work together, I can think of no better words to keep in mind than those of President Eisenhower to Speaker of the House Sam Rayburn some 33 years ago: "We shall have much to do together; I am sure we shall get it done, and that we shall do it in harmony and with goodwill."

Thank you very much.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 29, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,014 million of 13-week bills and for $7,038 million of 26-week bills, both to be issued on September 1, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 1, 1988			:	26-week bills maturing March 2, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.21%	7.45%	98.177	:	7.47%	7.87%	96.224
High	7.28%	7.52%	98.160	:	7.50%	7.90%	96.208
Average	7.26%	7.50%	98.165	:	7.50%	7.90%	96.208

Tenders at the high discount rate for the 13-week bills were allotted 11%.
Tenders at the high discount rate for the 26-week bills were allotted 58%.

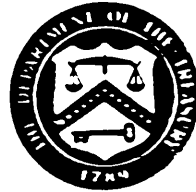
TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 37,070	$ 37,070	:	$ 39,110	$ 39,110
New York	20,162,200	5,452,700	:	22,259,995	6,015,830
Philadelphia	24,300	24,300	:	27,015	26,595
Cleveland	41,940	41,210	:	38,230	38,230
Richmond	40,530	40,530	:	42,380	37,380
Atlanta	35,225	35,225	:	30,435	30,435
Chicago	1,180,880	402,880	:	1,676,410	237,010
St. Louis	27,445	24,555	:	33,710	29,710
Minneapolis	15,535	10,535	:	6,345	6,345
Kansas City	57,455	57,455	:	39,480	39,480
Dallas	34,950	29,950	:	29,750	19,750
San Francisco	1,306,080	509,130	:	1,543,735	79,735
Treasury	348,355	348,355	:	438,680	438,680
TOTALS	$23,311,965	$7,013,895	:	$26,205,275	$7,038,290
Type					
Competitive	$19,741,130	$3,443,060	:	$21,434,500	$2,267,515
Noncompetitive	1,030,030	1,030,030	:	1,038,780	1,038,780
Subtotal, Public	$20,771,160	$4,473,090	:	$22,473,280	$3,306,295
Federal Reserve	2,379,400	2,379,400	:	2,100,000	2,100,000
Foreign Official Institutions	161,405	161,405	:	1,631,995	1,631,995
TOTALS	$23,311,965	$7,013,895	:	$26,205,275	$7,038,290

An additional $19,895 thousand of 13-week bills and an additional $276,805 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1533

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

FOR IMMEDIATE RELEASE
August 29, 1988

CONTACT: Felice Pelosi
202/566-2843

PETER H. DALY APPOINTED
DIRECTOR, BUREAU OF ENGRAVING & PRINTING

Acting Secretary M. Peter McPherson today announced the appointment of Peter Hughes Daly to be the Director of the Bureau of Engraving and Printing (BEP). He has been the Acting Director since April, 1988.

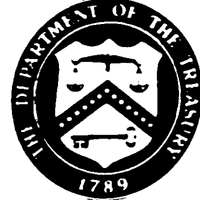
Mr. Daly, who began his career in the Federal Government in 1965 as a Management Intern, joined the BEP in 1968 as Assistant Head, Labor Relations and Wages Branch, in the Office of Industrial Relations. In 1974 he was promoted to Manager, Human Resource Development Division, and in 1976 was selected as Assistant to the Bureau Director. He was appointed Chief of the Office of Planning and Policy Development in 1980 and in 1982 became Deputy Executive Director of the U.S. Savings Bonds Division. In 1983 he returned to the BEP as Deputy Director and in 1986 served in the dual capacities of the BEP Deputy Director and Executive Director of the U.S. Savings Bonds Division for a six month period.

Mr. Daly has been recognized by many awards and honors during his tenure at Treasury. He holds a degree in Economics from Villanova University and has done graduate work with honors standing at Rutgers, George Washington, and American Universities. He has published articles and studies in the fields of economics and management.

He resides in Washington, D.C. and has two daughters, Jill and Mary Megan.

B-1534

TREASURY NEWS



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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 30, 1988

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 September 8, 1988. This offering will provide about $300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,699 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, September 6, 1988. 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 June 9, 1988, and to mature December 8, 1988 (CUSIP No. 912794 QW 7), currently outstanding in the amount of $6,429 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated September 8, 1988, and to mature March 9, 1989 (CUSIP No. 912794 RL 0).

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 September 8, 1988. 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 $1,599 million as agents for foreign and international monetary authorities, and $4,664 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1535

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 30, 1988

RESULTS OF TREASURY'S AUCTION OF 20-DAY CASH MANAGEMENT BILLS

Tenders for $10,052 million of 20-day Treasury bills to be issued on September 2, 1988, and to mature September 22, 1988, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	7.90%	8.05%	99.561
High	7.94%	8.08%	99.559
Average	7.93%	8.08%	99.559

Tenders at the high discount rate were allotted 37%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	37,531,000	9,753,190
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	--	--
Chicago	1,535,000	188,700
St. Louis	4,000	1,000
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	1,500,000	109,200
TOTALS	$40,570,000	$10,052,090

B-1536

TREASURY NEWS

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

Text as Prepared

Statement by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
at the Conclusion of the
American Institute in Taiwan -
Taiwan Coordination Council for North American Affairs
Financial Services Talks
Washington, D.C.
August 31, 1988

Mr. See-Ming Chen, representing the Taiwan authorities, and I have just concluded a meeting to discuss financial services in the banking and securities sectors.

During the meeting, I noted the progress made by Taiwan over the past few years. Important steps have been taken to liberalize outward capital movements and deregulate interest rates. With respect to the banking sector, Taiwan authorities have raised the ceiling on commercial paper guarantees, allowed foreign banks to buy and sell gold coins, permitted foreign banks to set up a second branch, and have permitted foreign bank branches to participate in the automated teller machine network. In the securities sector, foreign firms are now able to participate in new joint venture securities firms, and foreign investors are able to invest in the domestic securities market by way of mutual funds issued abroad.

These measures represent an important first step in the development of Taiwan as a financial center. Building on this progress, at our meeting over the past several days, Taiwan agreed to raise the limit on loans to a single customer to NT$500 million, and facilitate the inward remittance of capital by foreign institutions to execute guarantees and to boost branch capital. The Taiwan authorities also agreed to permit U.S. insurance companies greater flexibility in making investments in New Taiwan Dollars through the ability to buy and sell Taiwan public sector debt instruments.

I also took note of the Taiwan authorities' intention to move substantially toward national treatment in the revision of their banking law with respect to both savings and trust

activities with a view to allowing U.S. firms to engage in and receive national treatment in a substantial number of new activities. In addition, the Taiwan authorities noted that they are studying the potential design of a Taiwan Depository Receipt which would foster domestic investment in foreign securities. In this regard, we offered to supply technical assistance should the Taiwan authorities request it.

The U.S. supports Taiwan's desire to become a major Asian financial center within the next decade. Although I am encouraged by the actions taken to date, it is important that progress toward national treatment continue and that financial market liberalization and development move forward without delay. This would be encouraged by relaxing entry restrictions for foreign banks (including additional branches), liberalizing further foreign exchange controls, allowing movement toward wholly-owned foreign securities branches and subsidiaries and revising onerous capital requirements for foreign bank branches. In this context, a timetable for future action is essential.

TREASURY NEWS

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

Text as Prepared

"Iowa Exports to the World"

M. Peter McPherson

Deputy Secretary of the Treasury
Iowa International Trade Symposium

Des Moines, Iowa

September 1, 1988

Greeting

Excellencies, Governor, Senator, distinguished guests, I am pleased to be here in Des Moines. I want to thank Senator Grassley for inviting me here to be with you, and for asking me to be a part of this year's Iowa International Trade Symposium.

Introduction

I'm delighted that this year's symposium has been such a success. You have truly brought the world to Iowa. But it's every bit as important to bring Iowa to the world. This evening I want to talk about some of the things the United States government does to help bring Iowa -- and other American exporters -- to the world.

To start, I'd like to discuss how international economic policy coordination creates the stable, certain business atmosphere that fosters international trade and has improved the prospects for American exporters.

Then I'd like to discuss our efforts to create a level playing field for American exporters who want to bring their products to the world.

-- We are trying to eliminate trade barriers that close overseas markets to our exports.

-- We are trying to reform the world trade system. We want strong new trade rules, based on free market principles. We want the most efficient producer to be the most competitive supplier.

-- We also provide support for U.S. exporters, particularly agricultural exporters who must compete against subsidies as well as the weather.

Finally I'd like to talk a little about the opportunities that Iowa has to bring itself and its products to the world.

Macroeconomic Policies

The process of coordinting international economic cooperation is crucial to our competitiveness. The major industrial nations have sought to improve global growth, thus expanding markets for U.S. exports, both in developed and developing countries. We have also been working to achieve exchange rate relationships that more fully reflect competitive realities. actions on these fronts are an antidote to protectionism which closes markets and export opportunities.

The major countries have made significant progress in achieving these objectives. The United states is reducing its budget deficit and restoring competitiveness. Japan and Germany have taken major steps to improve growth prospects. The depreciation of the dollar has increased the competitiveness of U.S. exports. Efforts to deal with international debt problems through the debt strategy are helping debtor nations to adopt market-oriented reforms and promote sustained growth. All of these efforts are bearing fruit. U.S. exports have grown over 30 percent in the last year and real net exports now account for well over one-half of U.S. growth.

There is little question that the decline in exchange rates since 1985 has helped U.S. agricultural exports. In FY 1987, exports were $28 billion, compared to $26 billion in FY 1986, and for FY 1988, USDA is forecasting $34 billion.

Eliminating Trade Barriers

An immediate goal of the Administration effort to help Americans export is to increase our access to foreign markets. That often means aggressively pursuing the elimination of foreign trade barriers.

No Administration has worked harder than this one against subsidized competition and trade barriers abroad. And that work has paid off. The President has rolled back barriers in Europe and Japan, among other places.

Recently, we resolved a number of long-standing disputes with the Japanese over processed foods. Japan agreed to reduce barriers for eleven broad categories -- from fruits, juices, and dairy products, to peanuts, peas, beans, breakfast cereals, and soup. Imports of these products had been severely restricted, in some cases prohibited, for over 20 years. Under the three-year settlement, Japan will eliminate many of its import quotas and reduce a number of tariffs.

Earlier this year we reached a similar agreement with Japan that reduced barriers to the sale of U.S. beef and citrus products. Japan agreed to phase out beef import quotas. Tariffs were initially increased but they will be phased down.

We have also fought hard against EC proposals aimed at restricting imports of meat from animals treated with growth hormones. We viewed these measures as a blatant maneuver to impose trade barriers under the guise of health regulations. In December 1987, the President authorized retaliation against the measures. As a result, the EC agreed to suspend the application to imports of the proposed regulations until 1989. In the meantime, EC member states have continued to permit imports of our meats.

We have made it clear to the Community that we need a permanent solution to the problem. We will retaliate again, if necessary, to defend the interests of our meat exporters.

We have also insisted that the EC eliminate illegal subsidies for oilseed processors. These subsidies have nullified the advantages of the tariff rates for soybeans that we obtained in earlier negotiations. We continue to press the EC on this issue. We are actively pursuing this matter in the GATT.

We have also conveyed to the European Community our concerns that their efforts to create a single European market by 1992 do not create new barriers to U.S. agricultural exports.

Nor are we concentrating solely on Europe and Japan. We are pressing the Koreans to remove an import ban on beef and wine; they have already removed restrictions on cigarettes. We have also concluded an agreement with India to relax restrictions on almonds.

Our willingness to retaliate in cases where we face discrimination in foreign markets has put other nations on notice: We will defend the interests of U.S. exporters.

Negotiating New Trade Rules

The ultimate objective of our trade policy is to negotiate new trade rules, based on free trade principles, that will prohibit trade barriers and trade distorting subsidies. We have taken some large steps in the direction of free trade. The Free Trade Agreement with Canada is one. As I told Senator Grassley during the negotiations with Canada, the agreement particularly benefits Iowans by providing access to Canadian gas and oil, roughly equivalent as that of Canadians. We all remember the seventies. Everyone benefits from this agreement -- consumers who drive cars or who need heat; businessmen who use gas and oil; or farmers with tractors or who use petroleum-based farm inputs like fertilizer and pesticides. At the same time, it benefits Canadians by encouraging new investment and employment there.

We also have an agreement with Mexico that establishes principles for mutually beneficial trade and investment. These agreements are a good start, but we must begin to address all of these problems in a more comprehensive way.

The United States believes the time is right for a sweeping reform of the world trade system. We believe the current Uruguay Round of GATT trade negotiations gives us that opportunity.

Our main Uruguay Round objectives are to eliminate barriers to agricultural trade and to establish rules in services, investment, and intellectual property.

World Agricultural Trade

Agriculture is an area that requires particular attention. As you know, world agricultural trade is plagued by trade barriers and export subsidies that divert trade, smother market signals, and burden government budgets. These distortions eliminate the competitive advantage of the most efficient farmers, make it more expensive to feed families, and empty taxpayer wallets.

Agricultural trade is in such a state that American farmers, the planet's most productive farmers, need billions of dollars in government support every year to compete against foreign subsidies.

Such subsidy programs can have strange results. For example:

-- In the European Community, surplus butter is being used for animal feed.

-- In Japan, consumers pay nearly six times more for domestic rice than the world market price.

-- In the Common Market, the export subsidy on feed wheat is more than two times the world sales price of $73 per ton.

-- We can also find examples here at home.

If there is one bright spot in this dismal picture, it is that the problem has become so bad that agricultural producing nations are being forced to consider change. No country, particularly not the United States, is willing to "unilaterally disarm" and leave its farmers unprotected from subsidized competition. The only way we can get rid of the problem is through cooperation between ourselves and our trading partners.

What is the U.S government doing about this situation?

In the past, governments have been reluctant to develop more disciplined agricultural trade policies. Now, however, we are committed to going beyond the limitations of past negotiations in order to truly reform the trading system for agriculture. That reform will eventually provide the level playing field that will work to the advantage of efficient farmers -- like Iowa farmers.

Providing a Level Playing Field

Another goal of the Administration program is to provide a level playing field for American producers. We will protect our exporters, particularly our farmers, from subsidized competitors until we can eliminate trade barriers. Our goal is to allow our producers to compete with other efficient producers for the world market. Until that time, however, we are not willing to leave our farmers exposed to unfair competition from foreign farmers who can tap their government treasuries. Frankly, we have worked hard to expand our export programs. That's the only way we can protect our share of the world market from the encroachment of other governments. We are prepared to continue such policies, despite their expense, until we can get an international agreement to stop the subsidy spiral.

The 1985 Food Security Act has helped U.S. farmers recapture a larger share of world agricultural markets. One provision of the Act, The Export Enhancement Program (EEP), provides assistance to U.S. exporters competing against subsidized exports from other nations. The EEP program has not only enabled us to compete against subsidies, it has underscored our commitment to even the terms of competition for our farmers. This in turn has focused attention on the problems in world agricultural trade, and focused attention on our proposals to reform the agriculture trade system. By demonstrating our seriousness, the EEP program has helped bring our trading partners to the negotiating table.

The Targeted Export Assistance Program (TEA) helps U.S. agricultural exporters counter the effects of unfair trade practices. It does that by providing cash or commodities to help underwrite the development of promotions in targeted markets. After one year of promotion under TEA, the average increase in sales for 21 important products in target markets was over 48 percent.

I have strongly insisted here tonight that other countries open their markets to us, but as we ask that of others, we must continue to fight to keep our own country open to imports. Such a policy benefits not just others but us.

Commitment to the Farm Community

These measures demonstrate our commitment to protect the American farm community from today's distorted world trade situation. More recently, the drought relief bill will provide direct payments to farmers who have suffered catastrophic losses and provide relief to hard-hit livestock producers as well. That too demonstrates our commitment.

This bill provides a wide range of assistance to producers affected by the drought but stays within necessary budget limitations. The bill will provide an estimated $3.9 billion to farmers in FY 1989.

The key provisions of the bill are:

- Feed assistance to livestock, dairy, and poultry producers who normally grow their own feed and have a loss in feed production on their farm.
- Payments to producers with production shortfalls of greater than 35 percent for both program and non-program crops. Lost tree seedlings, pasture, forage, and cover crops may be reestablished with cost-share payments.
- No reduction in the dairy price support level on January 1, 1989 and a 50-cent per cwt. increase for the period April - June 1989.
- Emergency low interest loans to producers with losses in eligible counties regardless of whether they had Federal crop insurance.
- FHA guarantees for loans refinanced by farmers unable to repay due to drought and guarantees for loans for rural businesses weakened by the drought.

As President Reagan said, "This bill isn't as good as rain but it'll tide you over until normal weather and your own skills permit you to return to your accustomed role of being the most productive farmers in the world."

Outlook

Even with all the problems we face -- drought, subsidized competition, and markets distorted by trade barriers -- our ability to sell in overseas markets continues to improve.

A week ago the trade numbers came out for the 2nd quarter. In April, May, and June, American exports were the highest they've been in our history. That, along with falling imports, gave us our best international trade balance in 3 years, the lowest deficit since the 2nd quarter of 1985. Rising manufacturing exports and rising agricultural exports are two big reasons for this strong showing, which covered trade with almost every region of the world. Although our imports are still high, we are now exporting more than we ever have before.

We expect the improvement in our trade balance to continue. In particular, we are expecting another good year for U.S. farm exports:

-- For fiscal year '88, the volume of U.S. agricultural exports is expected to climb to about 146 million tons -- up thirteen percent.

-- The value of agricultural exports is projected to rise to about $34 billion -- a 22 percent increase.

-- Our 1988 agriculture trade surplus should reach $12.5 billion, up by more than $5 billion from last year.

-- These increases come on top of our strong export recovery in 1987, when sales volume and dollar values were up significantly.

We have succeeded in gradually opening and reopening foreign markets to U.S. exports. What's more, our efforts to change the system are showing greater promise. U.S. manufacturers and farmers now have a better chance to compete.

<u>What Iowa Offers the World</u>

How does Iowa best take advantage of that chance to compete? Let me tell you what I see. I grew up on a farm in a part of Michigan that is very much like rural Iowa. Our community possessed the same strengths that I see here:

-- natural agricultural resources,

-- a superb educational system, and

-- the work ethic and the high productivity of the Iowa people.

These basic strengths make Iowa very competitive. I know this state well. I have been here many, many times over the years. I have visited Iowa State and the University of Iowa. I have talked to your farmers and businessmen.

The rich farmland here provides a solid underpinning for the Iowa economy. The outstanding educational system -- fine public schools, great Universities, a network of community colleges -- make it easy for Iowa to move into research and technology-based enterprise and to build on an Iowa tradition of quality production of a whole range of products. Last but certainly not least, the qualities of the Iowa people make Iowa an attractive place for firms to do business and for people to live.

University research in Iowa is spawning new industry, just as it has in North Carolina's Research Triangle. For example, Edge Technologies is a high-tech firm in Ames that does metals research. It grew out of the new industrial natural research done at Iowa State. The University of Iowa's Laser Center fosters applications of that flexible technology. Iowa's State's Biotech Center combines both technological and agricultural know-how.

The quality of Iowa's work force, its work ethic and high productivity, the efforts of both Governor Branstad and the Iowa Congressional delegation, are attracting business. Eastman Kodak has a new facility in Cedar Rapids. NYPRO from Massachusetts has set up a joint venture with a Japanese firm in Mt. Pleasant, and General Foods has a new processed food plant in Mason.

This year's drought on top of the high interest rates of eight years ago brought difficult times to Iowa. Basic strengths, however, have brought the future to Iowa, a future that Iowa can export to the world.

Thank you.

TREASURY NEWS

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

For Immediate Release
September 6, 1988

Statement by
The Honorable David C. Mulford
Assistant Secretary for International Affairs
U.S. Department of the Treasury
with respect to the
Announcement by the Japanese Ministry of Finance
regarding
New Issuance Procedures for 10-Year
Japanese Government Bonds

The U.S. Treasury welcomes the announcement today by the Japanese Ministry of Finance of a major change in its issuance procedures for 10-year Japanese government bonds. Under the new procedures 40 percent of the monthly issues of these bonds will be sold by auction starting in April of 1989. In addition, the share of U.S. financial institutions in the Underwriters Syndicate will be increased effective next month.

We believe that these two steps, coupled with certain other measures described in the Finance Ministry's announcement, should significantly improve the competitive opportunities for U.S. financial institutions in the Japanese government bond market when fully implemented.

Although we are encouraged by these recent actions, it is important that movement toward financial market liberalization in Japan continue, building on the progress made over the past several years.

B-1539

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 6, 1988

CONTACT: Robert Levine
202/566-2041

Wetlands Standards Approved for Multilateral Development Bank Loans

Acting Secretary M. Peter McPherson today announced approval of standards for U.S. evaluation of multilateral development bank loans that may adversely affect wetlands areas in developing countries.

The standards were developed by Treasury with the cooperation of an informal working group on international wetlands, chaired by Malcolm Baldwin, former Acting Chairman of the Council on Environmental Quality. The working group is composed of experts from government and environmental organizations. It focuses on the conservation of wetlands worldwide. The standards are the third in a series of standards being prepared for the development of projects that may affect various eco-systems in developing countries. Other standards already developed by Treasury and the working group are those for tropical moist forests and Sub-Saharan savannas.

In announcing approval of the wetlands standards, McPherson emphasized the multilateral character of the development banks and the importance of working cooperatively and constructively with other member countries in order to bring about the reforms that are being sought. He said, "The United States has been in the forefront of an international effort to encourage greater emphasis on environmental issues in the banks and in the borrowing countries. How successful we are over the longer term will depend on our ability to build support for our ideas among other member countries."

Earlier this year, Treasury participated in a meeting of experts under the auspices of the Organization for Economic Cooperation and Development and sought to encourage wider use of standards among both bilateral and multilateral donors. The next meeting of the experts is expected to take place in Paris in December and Treasury will seek acceptance of the wetlands standards at that time.

B-1540

As McPherson noted, Treasury's work on the standards has been one part of a more comprehensive effort to encourage a broad array of environmental reforms in the multilateral development banks. That effort has involved cooperation with a number of environmental groups as well as work with the management of the banks and with governments of other member countries. Environmental reform was a key element of the agreement negotiated last year to increase the capital of the World Bank.

Copies of these standards have been forwarded to U.S. Executive Directors at the World Bank, the Inter-American Development Bank, the Asian Development Bank and the African Development Bank. They will also be used by Treasury and other agencies as part of the U.S. Government's internal review of multilateral development bank loans.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 6, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,008 million of 13-week bills and for $7,016 million of 26-week bills, both to be issued on September 8, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 8, 1988			:	26-week bills maturing March 9, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.22% a/	7.46%	98.175	:	7.37%	7.76%	96.274
High	7.28%	7.52%	98.160	:	7.40%	7.79%	96.259
Average	7.26%	7.50%	98.165	:	7.40%	7.79%	96.259

a/ Excepting 1 tender of $200,000.

Tenders at the high discount rate for the 13-week bills were allotted 11%.
Tenders at the high discount rate for the 26-week bills were allotted 97%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,630	$ 32,630	:	$ 36,430	$ 36,430
New York	20,445,650	5,819,650	:	20,408,245	5,939,345
Philadelphia	18,455	18,455	:	13,120	12,120
Cleveland	38,950	38,950	:	32,140	32,140
Richmond	39,380	39,380	:	34,260	34,260
Atlanta	31,480	31,480	:	29,710	29,710
Chicago	986,685	303,185	:	860,945	206,195
St. Louis	31,970	29,080	:	33,325	29,325
Minneapolis	12,785	12,785	:	16,675	16,525
Kansas City	28,100	28,100	:	35,670	35,670
Dallas	37,260	32,260	:	27,085	21,935
San Francisco	1,310,575	253,735	:	1,294,490	171,480
Treasury	368,140	368,140	:	451,020	451,020
TOTALS	$23,382,060	$7,007,830	:	$23,273,115	$7,016,155
Type					
Competitive	$19,801,105	$3,426,875	:	$18,589,130	$2,332,170
Noncompetitive	1,009,035	1,009,035	:	993,375	993,375
Subtotal, Public	$20,810,140	$4,435,910	:	$19,582,505	$3,325,545
Federal Reserve	2,364,130	2,364,130	:	2,300,000	2,300,000
Foreign Official Institutions	207,790	207,790	:	1,390,610	1,390,610
TOTALS	$23,382,060	$7,007,830	:	$23,273,115	$7,016,155

An additional $87,010 thousand of 13-week bills and an additional $562,490 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1541

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.

September 6, 1988

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 September 15, 1988. This offering will provide about $ 625 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,363 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, September 12, 1988. 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 June 16, 1988, and to mature December 15, 1988 (CUSIP No. 912794 QX 5), currently outstanding in the amount of $ 6,625 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 March 17, 1988 and to mature March 16, 1989 (CUSIP No. 912794 RM 8), currently outstanding in the amount of $ 9,200 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 September 15, 1988. 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 $ 1,987 million as agents for foreign and international monetary authorities, and $ 4,445 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 7, 1988

CONTACT: Mark Beams
(202) 566-8275

TREASURY DEPARTMENT ANNOUNCES RULING WITH RESPECT TO SECTION 1.863-3(b) OF THE INCOME TAX REGULATIONS

The Treasury Department today announced the issuance of Rev. Rul. 88-73, which interprets section 1.863-3(b) of the Income Tax Regulations to require the use of the independent factory or production price ("IFP"), where such a price exists, to determine the division between domestic and foreign sources of income from sales outside the United States of inventory (as defined in section 865(h)(1)) produced (in whole or in part) within the United States. Rev. Rul. 88-73 was issued in order to resolve uncertainty concerning whether the IFP method set forth in Example (1) of section 1.863-3(b) is elective with taxpayers, such that the so-called "50/50 method" set forth in Example (2) of that section is available in circumstances where an IFP can be shown to exist. The result reached in Rev. Rul. 88-73, which denies taxpayers use of the 50/50 method where an IFP exists, reflects the language and purposes of the regulations, and is consistent with express language describing present law in each of the Committee Reports relating to the Tax Reform Act of 1986. See H. Rep. No. 426, 99th Cong. 1st Sess. 359 (1985); S. Rep. No. 313, 99th Cong. 2d Sess. 329 (1986); and H. Rep. No. 841, 99th Cong. 2d Sess. II-595 (1986).

The 1986 legislation preserved the existing rules for allocating income from export sales of inventory between foreign and domestic sources. Citing concerns over possible adverse trade effects, Congress rejected proposals imposing more restrictive allocation rules and directed instead that Treasury study the relevant trade and tax policy issues. H. Rep. No. 841, 99th Cong. 2d Sess. II-596 (1986). Although the Committee Reports to the 1986 Act indicate that present law requires use of the IFP method where an IFP exists, they also indicate that under present law the 50/50 method "generally" will be available. H. Rep. No. 426, 99th Cong. 1st Sess. 359 (1985). It follows that an interpretation of the regulations under which the 50/50 method would cease to be "generally" available would be inconsistent with the intent of Congress in preserving existing law.

Treasury does not intend to change the current regulations, but is studying how the operative terms of those regulations, including the term "independent factory or production price," should be interpreted, giving due regard to Congress' understanding that the division between domestic and foreign sources of income from sales outside the United States of inventory produced within the United States "generally" is made under the 50/50 method. Treasury will issue appropriate guidance on this issue in the near future and invites comments on the issue from all interested persons. Comments should be sent to Leonard B. Terr, International Tax Counsel, Room 3064, Department of Treasury, Washington, D.C. 20220. Because of the need to resolve this matter expeditiously, comments should be sent by September 19, 1988, or as soon as possible thereafter.

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Part I

Section 863.--Allocation Methods for Income from Sources Partly Within and Partly Without the United States

26 CFR 1.863-3: Use of an independent factory or production price.

Rev. Rul. 88-73

ISSUE

If a taxpayer that produces and sells inventory within the United States and also sells the inventory outside the United States makes certain sales which establish an independent factory or production price for such inventory, must such price be used for purposes of determining the division between domestic and foreign sources of income from sales of the inventory outside the United States, including sales to foreign subsidiaries of the taxpayer?

FACTS

Corporation X, a domestic corporation, is engaged in the production and sale of product A in the United States and the sale of such product outside the United States, including sales

to its foreign subsidiaries. Product A is inventory, within the meaning of section 865(h)(1) of the Internal Revenue Code of 1986, in X's hands. Certain sales by X to unrelated distributors establish an independent factory or production price, as described in section 1.863-3(b) of the income tax regulations, for sales of product A outside the United States.

LAW AND ANALYSIS

Under section 863(b) of the Code, income from the sale of inventory (within the meaning of section 865(h)(1)) which is produced (in whole or in part) in the United States and sold in a different country is treated as derived from sources partly within and partly without the United States. That section gives the Secretary of the Treasury the authority to prescribe processes or formulas of general apportionment to determine the division of income between domestic and foreign sources in such cases.

The processes or formulas of general apportionment to be used under section 863(b) of the Code are prescribed through three examples contained in section 1.863-3(b) of the regulations. Example (1) of these regulations provides as follows:

> Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price -- or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established -- unaffected by considerations of tax liability and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States <u>shall</u> be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year. (Emphasis added.)

Example (1) requires a taxpayer to use an independent factory or production price, if such a price exists, to determine the division between domestic and foreign sources of income from sales outside the United States of inventory produced (in whole or in part) within the United States. The priority of Example (1) over the other methods of apportionment described in section 1.863-3(b) of the regulations is confirmed by language contained in the legislative history of the Tax Reform Act of 1986. In the House Ways and Means Committee, Senate Finance Committee, and Conference Committee Reports, the description of current law provides that the division of income must be made on the basis of an independent factory or production price if such a price exists. H.R. Rep. No. 841 (Conf. Rep.), 99th Cong., 2d

Sess. II-595 (1986), 1986-3 (Vol.4) C.B. 1, 595; S. Rep. No. 313, 99th Cong., 2d Sess. 329 (1986), 1986-3 (Vol.3) C.B. 1, 329; H.R. Rep. No. 426, 99th Cong., 1st Sess. 359 (1985), 1986-3 (Vol.2) C.B. 1, 359.

HOLDING

Corporation X must use the independent factory or production price for purposes of determining the division between domestic and foreign sources of income from sales of product A outside the United States, including sales to its foreign subsidiaries.

TREASURY NEWS

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

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
SEPTEMBER 8, 1988

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
THURSDAY, SEPTEMBER 8, 1988

Mr. Chairman and Members of the Committee, I appreciate this opportunity to testify before you today on your questions regarding the Federal Savings and Loan Insurance Corporation (FSLIC). Given the misinformation I have heard and read recently about FSLIC notes, these hearings should provide a useful, educational forum to explain to the American people that the Federal Government stands behind the obligations of the FSLIC and the Federal Deposit Insurance Corporation (FDIC).

In my testimony this morning, I will first address your specific questions and then discuss the related issue of the cries for taxpayer assistance for the FSLIC.

Full Faith and Credit of FSLIC Notes

Your first question asks the Administration's position on the need for the full faith and credit of the United States behind the notes issued by the FSLIC. As you know, both the FSLIC and the FDIC issue notes, in addition to using cash resources, to satisfy their obligations to protect depositors at insured thrifts and banks.

First, a brief refresher course in government budget accounting is in order.

The Office of Management and Budget (OMB) scores these notes as federal outlays when they are issued, just like payments of other obligations are scored, such as those for certain housing programs or export commitments.

When either the FSLIC or the FDIC issues a note to meet its obligations, the OMB's budget scoring rules state that four simultaneous transactions occur, all equal to the principal value of the note:

- o the explicit recognition of a budgetary obligation;
- o satisfaction (or payment) of that obligation (an outlay);
- o budget authority to borrow; and
- o an increase in the federal debt.

Attached to my testimony are two appendices which are helpful to further understand the budget treatment of these notes. Appendix I, for example, is a May 20, 1988, OMB letter to the Senate Budget Committee on this issue. Appendix II is from the President's February budget for FY 1989 and indicates that the FSLIC and FDIC notes -- special instruments instead of cash -- are recorded as budget outlays (just as cash payments) because, like cash, they satisfy the respective agency obligations and carry the presumption of payment in cash when the notes mature. These FSLIC and FDIC notes are classified by OMB as budgetary obligations, spending (outlays) and debt.

I also want to point out to the Committee and others that the Congressional Budget Office (CBO) concurs in OMB's scoring of these notes. This conforms to the budget treatment that OMB has been giving the Federal Housing Administration (FHA) debentures that are used to pay default claims on FHA-insured mortgages.

Investors, accountants, and others -- who take the time to understand the budget treatment of these notes -- will recognize the severe consequences that would result if the insurance agencies defaulted on their obligations. Therefore, they should not need the extra comfort of a resolution stating that the full faith and credit of the United States backs the notes.

FSLIC's Use of the Notes

Your second question asks for the Administration's analysis of the manner and purpose for which the notes are being utilized by the FSLIC in assistance transactions.

The FSLIC has been using case resolution techniques that depend on FSLIC notes and other obligations which are supported in part by the Financing Corporation's (FICO) borrowing authority, made available through the Competitive Equality Banking Act of 1987 (CEBA). The FSLIC has decided to use these

techniques instead of relying only on the FICO funding authority because the resulting cost to the FSLIC may be roughly 300 basis points less than the cost of using cash raised through the FICO obligations. Because the shorter-term, tax-exempt FSLIC notes have a lower interest cost, more of the FSLIC's premium income can be used to resolve problem institutions instead of using the premium income to pay the interest on the FICO bonds.

Also, more resources are available up front to resolve cases because of the current restrictions on FICO borrowings. To the extent that the FSLIC's problems are related to cyclical real estate, energy, and/or agricultural problems, the use of short-term notes aids in determining the scope of such cyclicality before incurring the costs of longer-term FICO borrowings. If the problems turn out to be cyclical in nature for specific institutions, the shorter-term assistance will be all that is needed, and the industry will not have to pay the interest expense on the FICO bonds for the thirty year period.

The Administration strongly supported the industry self-help FICO borrowing plan, adopted by Congress over a year ago, which provides assistance to the FSLIC in a budget neutral manner. (The funds raised through the FICO authority offset the assistance payments; this contrasts with the use of FSLIC notes which are scored as budget outlays). However, if the FICO authority can be used to leverage the funds that are available to FSLIC so more insolvent thrifts can be resolved more expeditiously, then the Treasury has no objection to the use of notes with one very important proviso; that is, that the FSLIC continues to limit use of the notes to the resources available for the ultimate redemption of the notes.

As you know, the 1987 CEBA (Sec. 505) removed the President's authority to exercise oversight over the aggregate level of budgetary obligations incurred by the deposit insurance agencies. With this in mind, we fully appreciate the concerns expressed by members of this Committee and others about the actual and contingent liabilities which are accruing as a result of FSLIC (and FDIC) operations. Both Congress and the Executive Branch have a need to be kept well informed of potential future liabilities of these agencies, with as much advance notification as is realistically possible.

In the absence of formal Congressional or Executive Branch approval of aggregate levels of FSLIC budgetary obligations, Chairman Wall publicly -- and correctly, in my opinion -- has set self-imposed limits on projected FSLIC obligations at a level which the FSLIC believes can be completely covered by non-taxpayer funds (including the use of Financing Corporation proceeds) over a 10-year period.

Policies Toward the Issuance of Full Faith and Credit

Your third question asks about the Administration's policies concerning the full faith and credit commitments by individual agencies of the Federal Government.

As I indicated earlier, FSLIC and FDIC notes are treated as budgetary obligations, spending (outlays), and debt under government accounting standards. To do otherwise would erode the public's confidence in the obligations of the government agency in question and, by extension, of all government obligations. The end-result would be an increase in the overall cost of government borrowing. Most agencies, however, are required to stay within the spending and borrowing limits set by the Congress through the appropriations process. The Office of Management and Budget has oversight authority to ensure that agencies do stay within their spending limits. Since OMB does not have oversight over the budgetary obligations of the deposit insurance agencies, your hearings today and in the future can serve a useful oversight purpose.

Treatment of Notes in the Federal Budget

Your fourth question asks for an analysis of the treatment of the notes in the federal budget and whether the full faith and credit backing will change the budget treatment in any manner.

In light of some of the misstatements I have seen and read recently, I have rechecked the proper accounting principles that should apply. The Office of Management and Budget has assured me -- and CBO concurs -- that the budget treatment of the FSLIC notes, which I explained in my answer to your first question, will not change in any manner if a full faith and credit resolution is passed.

Issues of new notes would continue to be scored as outlays, which in turn satisfy the FSLIC's obligations and increase the budget deficit.

Limits on FSLIC Notes

Another question asks whether there is a need to place limits on the FSLIC's use of promissory notes and other financial assistance agreements consistent with the FSLIC's available cash resource projections.

Unchecked spending authority, whether in government, private industry, or a family, usually erodes financial discipline and ultimately increases costs. For this reason, the Administration did not support the provisions in the CEBA which exempted the

Federal depository institution insurance agencies from the apportionment of funds provisions that apply to other government agencies. Furthermore, the CEBA provisions, which removed the Administration's oversight of the spending of these agencies, did not assign the oversight responsibility to any other independent party.

However, Chairman Wall and the other two members of the Bank Board have repeatedly given public assurances that the FSLIC will not issue notes in excess of the premium income, FICO borrowing authority and other resources available to it. The FSLIC cash flow projections through 1998 demonstrate that it has the resources to repay the FSLIC notes that it expects to issue.

As long as the FSLIC abides by this self-imposed restriction on the amount of notes outstanding, we would prefer that Congress not set a statutory limit on the amount of notes that can be issued. Any such limit could reduce the FSLIC's flexibility to resolve problems in a timely manner and erode public confidence in Federal deposit insurance.

We would strongly urge Congress to continue to hold regular oversight hearings to ensure that the FSLIC is adhering to its self-imposed and financially responsible policy for the issuance of notes. As contemplated in CEBA, it is entirely appropriate that this Committee conduct such hearings to monitor the use of the FSLIC's available resources.

Limits on Insolvent Thrifts

Your last question asks for comments on the merits of any provision that would require the Bank Board to limit any new loans or investments on the part of insolvent thrift institutions, the deposits of which are insured by the FSLIC, as well as on limiting the asset growth rate of insolvent institutions.

The Administration supports limiting the asset growth rate of insolvent institutions so they do not take on high risk assets that will raise the FSLIC's ultimate resolution costs. However, legislation or a sense of the Congress resolution should not be necessary given the FHLBB's past and on-going actions.

Currently, the FHLBB's supervisory policy directive (SP-62) limits not only the growth of thrifts that are insolvent, but also the growth of thrifts that fail to meet the 3 percent minimum net worth requirement. The directive states that, as a general rule, institutions failing to meet their net worth requirement should not be permitted liability growth in excess of that amount implied by interest credited (currently, the average

interest paid on deposits is about 7 to 8 percent per year), except insofar as it is necessary to meet loans-in-process obligations or legal commitments binding at the time that the supervisory action is taken.

In the near future, the FHLBB is expected to approve an amendment to its supervisory directive which would place a ban on new lending by insolvent thrifts unless a thrift's supervisory agent gives prior approval for new loans and investments. This is another case where Congressional interest and guidance has had its intended results without the need for rigid statutory restrictions that could work at cross-purposes with protecting depositors.

Current Cries for a Taxpayer Bailout of FSLIC

Mr. Chairman, I would be remiss if I did not take this opportunity to comment briefly on a topic that is closely related to my testimony today.

Less than a year after the passage of part of the Administration's FSLIC recapitalization plan and after waiting more than fifteen months for Congress to act, we now hear cries from some quarters for a taxpayer bailout of massive, unprecedented proportions. These outcries are predicated on the dubious assertion that the Government caused the thrifts' problems and, therefore, it is time for the Government to ante up to solve the problems. To my way of thinking, that is tantamount to a thrift executive saying that the Government made me take out my charter and then engage in housing finance for my livelihood -- all under the protection of FSLIC's shield on my front door.

Now, in a surprising and abrupt change of view a vocal part of the industry is saying that the problem is larger than the $5 billion in FSLIC assistance it advocated just last year, and that its problems have grown beyond its capacity to handle by itself. Therefore, you undoubtedly can expect this portion of the industry to continue to step up its calls for general assistance from taxpayers.

Before anyone rushes into a transfer of funds from the American taxpayer through FSLIC to insolvent institutions, we really ought to exhaust all other available resources -- both financial and nonfinancial. I should think that all Committee Members would be on their guard against a general taxpayer bailout for managers of failed institutions, particularly since any such bailout probably would be charged to the Committee's annual budget allocation and force difficult choices among other programs under the Committee's jurisdiction which compete for limited resources.

TREASURY NEWS

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Remarks by
M. Peter McPherson
Acting Secretary of the Treasury
to the
Bankers' Association for Foreign Trade
Washington, D.C.
Thursday, September 8, 1988

Europe in 1992; the Outlook for Banking and Financial Services

I am very pleased to have this opportunity to discuss with you the European Community's efforts to create a single integrated market. It is an ambitious effort to free the movement of goods, services, capital, and people throughout the 12 member states by the end of 1992. The focus of my remarks will be on financial services, especially banking.

A unified internal market presents new opportunities for Europeans. It presents new challenges for the rest of the world. The United States has supported the goal of European integration from its inception. As we look ahead, however, we are concerned by statements from Brussels that suggest the EC may try to selectively exclude others as it liberalizes internal barriers. The creation of a single market either for goods or financial services that reserves "Europe for Europeans" would be bad for Europe, for the United States, and for the multilateral interdependent system in which you and I function.

Let me stress that I am commenting as an enthusiastic and interested observer. I offer my remarks in a constructive spirit. I sincerely hope that the United States and the EC can have mutually candid, open discussions about the implications of 1992 for countries that are outside the Community. In this process, I certainly hope the Treasury Department can benefit from the views and observations of the members of the Bankers' Association for Foreign Trade, including both your U.S. and foreign members.

After a brief description of the rationale of 1992, I will focus my remarks:

-- First, on the implications of the single EC market for the international financial community.

-- And, second, on specific areas of U.S. concern.

With progress toward a single market, European financial and industrial firms will be able to achieve greater economies of scale. Specialization along the lines of what individual countries do best will increase efficiency in the allocation of resources. The demands of competition should spur mergers, rationalization of activities, technological innovation and greater productivity. The program can help stimulate growth and employment, reduce consumer prices, and raise standards of living throughout Europe. It should also result in a single EC capital market largely free of restrictions. The liberalization of internal barriers will make an important contribution to removing the remaining structural rigidities in European financial markets.

Let me state clearly that the comments I am making about the need for and benefits of an open, liberal market also apply at home. As we urge others to liberalize, we in the United States have an obligation to keep our markets open. This Administration pledges to continue to fight this battle. This point must be understood. Thus, all countries have a stake in this process and in its successful implementation.

-- We would all benefit from access to a dynamic, integrated European financial market. We would suffer if Europe closed its doors and turned in on itself. Clearly, Europe also would suffer without the stimulus of world-class competition in financial services.

The United States Government is, of course, sensitive to the political pressures that may arise from internal liberalization, but we would find unacceptable measures that would limit market access for third countries and discriminate against foreign companies already established or that wish to establish in the Community.

-- You perhaps are aware that Commission officials have proposed using "reciprocity" as a standard for granting third countries access to newly liberalized sectors in Europe in those areas not covered by the GATT. Specifically, the proposed banking and investment services directives state that the reciprocal treatment afforded an EC financial institution in a third-country market may determine whether firms from that third country will be permitted access to an integrated European market for financial services.

-- Those directives require an automatic referral of applications to the EC Commission for a determination of reciprocal treatment. This process could delay applications for months and, in and of itself, result in significant delays in approvals for non-EC financial institutions.

If applied on a narrow or mirror image basis, this standard of reciprocity could discriminate against firms in the United States seeking entry to the EC and against U.S.-owned firms already operating in Europe. It would undermine the principle of national treatment and the decades-long effort by the OECD to liberalize capital movements.

We find this reciprocity concept particularly troubling. I would like to take a few moments to explain our reasons and why we expect the Community to grant national treatment to branches and subsidiaries of U.S. institutions in the EC.

The notion of reciprocity enjoys considerable simplistic appeal, because it suggests fair and equitable treatment. You may do in my market only what I can do in yours. Strictly applied, the Commission's proposal could require third countries to mirror the laws and regulations of the EC in order to have equal access to the internal market. The danger of this approach is that legitimate differences in national regulatory regimes, the size of markets, or the instruments available in them are not recognized and could be used to justify discrimination against foreign firms. In the financial area, differences in organizational structures, the scope of permitted operations, regulatory and prudential frameworks, market instruments, clearance and settlement procedures, and methods of financing public debt are likely to always exist.

Modern financial services are in a broad sense a single industry. But, from a different perspective, financial services are many, many different businesses that continue to change with new ones coming into existence. Of course, a mirror image approach is not going to work.

To illustrate from our side of the Atlantic:

-- We allow financial institutions in the United States--foreign and domestic--to offer a greater range of financial instruments than is permitted in some EC countries. I ask you: Should we demand reciprocity and deny banks and securities firms of the EC access to U.S. financial markets until their own countries adopt policies or financial instruments identical to our own?

Because of these national differences, reciprocity that seeks to achieve identical commercial privileges in countries with different market structures and regulatory regimes will almost inevitably result in discrimination. In short, reciprocity that seeks identical treatment in different countries is a retreat back to protectionism.

In fact, the variety of financial environments around the world and the scale of our presence in each other's markets makes it impossible to provide reciprocal treatment for foreign firms without creating a huge regulatory bureaucracy and also severely limiting the flexibility of the market and the range of opportunities for foreign firms. I should point out that, at the end of 1987, there were over 660 foreign bank operating entities

in the United States, representing 260 foreign bank families from more than 60 countries, with total U.S. assets of over $594 billion. And 147 U.S. banks have a total of 873 branches in 70 foreign countries. I would not want to have to build a matrix to measure "reciprocity."

Instead of reciprocity, we consider national treatment the most effective way to avoid discrimination and preserve free and open financial markets. This principle is embodied in the codes and instruments of the OECD and in U.S. federal law. It seeks to ensure that foreign firms are treated the same way domestic firms are treated. By allowing domestic and foreign firms to compete on an equal footing in each market, national treatment accommodates national differences in regulatory regimes and supports the objectives of free access and non-discriminatory treatment.

Overall, we allow foreign firms, including banks, access to the U.S. market and we grant them national treatment within our market. We expect the Community to extend to U.S. firms access to newly integrated markets in Europe and to provide national treatment to U.S. companies and their subsidiaries operating within the EC.

There is much in the EC integrated financial market plan that deserves praise:

-- The EC's two agreed directives on liberalization of capital movements (in 1986 and 1988) eliminate barriers to capital flows within the Community. The deadline for compliance for most member states is July 1, 1990.

-- The agreed directive on coordination of laws, regulations and administrative provisions governing mutual funds (known in EC jargon as UCITS - Undertakings of Collective Investment in Transferable Securities). This liberalizes somewhat the prudential restrictions imposed on portfolio managers.

-- The draft proposed directive on investment services would allow EC-based investment firms (brokers, dealers and portfolio managers) the freedom to establish branches and provide cross- border services within the European Community. This would entail home-country authorization and home-country supervision for prudential purposes.

-- The proposed second banking directive introduces the concept of a single banking license (or passport), under which a bank incorporated under the laws of one member state would have the automatic right to establish branches or supply cross-border services in any other member-state while remaining under the control of home country supervisory authorities.

-- A prerequisite for this notion of home country control is the mutual recognition of prudential standards in the area of capital requirements, larger exposures and deposit guarantee schemes.

-- The EC plan also includes a definition of banking that is modeled after the universal banking system in several EC countries.

Given this range of potential activity, we welcome the public commitments of the European Heads of State, most recently at the Hannover Summit, to keep the EC open to third countries and to honor their obligations under the GATT.

I mention these commitments because we consider it essential that the single financial market be accomplished in a way:

1. that is consistent with the Friendship, Commerce and Navigation treaties, OECD obligations, and the GATT;

2. that provides national treatment to U.S. firms and their subsidiaries.

3. that supports the objectives of the Uruguay Round and honors the EC's commitments in the Punta del Este Declaration; and

4. that avoids damage to the trade, financial, and investment interests of those outside the Community.

These points are critical. If barriers against foreign-owned firms are raised in the context of completing the internal market, the EC will undermine support in the United States--and elsewhere--for multilateral efforts toward a more open international financial and trading system. Indeed, as I have said elsewhere, the intensification of protectionism in Europe would certainly evoke a response from the U.S. Government.

Within the Treasury and throughout the U.S. Government, we are ensuring that our counterparts in European Governments and at the EC Commission are aware of our views and concerns. We believe it is important for the EC to communicate, in a timely way, with others about the external dimensions of the internal market program. Greater information exchange about the actual intentions of the EC would help alleviate concerns generated by statements made in domestic political contexts. There are questions, and early consultations that respect the rights and interests of others would surely be best for countries on both sides of the Atlantic.

-- Treasury is also making its voice heard in multilateral fora, such as the OECD. We have made clear our position that the benefits of EC liberalization should be extended to all OECD members. The reciprocity provisions in the EC plan would be inconsistent with the obligations of OECD members under the Capital Movements Code.

-- I would ask you as U.S. bank representatives and this organization to institute a two-way information exchange with us, so that we may help keep each other up to date on developments.

-- In this overall context, you should also know that Treasury is required under the new trade bill to report to Congress by December 1, 1990 and at least every four years thereafter on our efforts to achieve national treatment. Due to the importance of the EC plan, we are sure to include a chapter on the issues involved and our efforts to resolve them. While mentioning the National Treatment Study, I must also express Treasury's ongoing appreciation to BAFT and its very competent staff for their help. Ms. Condeelis and Mr. Romaniak deserve a pat on the back from Treasury as well as from you.

In conclusion, I want to express once again genuine admiration for the historic effort underway in Europe today. Our shared objective should be in moving towards a more open international trading and financial system. Regional efforts at liberalization can contribute to this goal, but only if accomplished without raising barriers to others. If things go well, all potential participants will have an opportunity to gain. If the construction of a European financial market results in discriminatory activities, we all stand to lose. I have expressed our hopes and concerns about 1992, not to challenge the program, but in an attempt to head off potential conflicts. Countries outside Europe have a natural interest in the process. And the EC has a natural interest in preserving the support of other countries as its members move to construct a world-class integrated financial market.

Thank you.

TREASURY NEWS

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FOR IMMEDIATE RELEASE
September 9, 1988

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RECIPROCAL TAX EXEMPTIONS OF SHIPPING AND AIRCRAFT INCOME

The Treasury Department today announced agreements with Cyprus and Singapore for the reciprocal tax exemption of income from international shipping and aviation. The Cyprus note is in addition to the provision in the U.S.-Cyprus income tax treaty. The Singapore note expands the note of March 24, 1988 to include income from shipping as well as aircraft. The exchanges of notes are in accordance with sections 872 and 883 of the Internal Revenue Code. In each case the exemption applies for taxable years beginning on or after January 1, 1987. Earlier such agreements were announced in Treasury News Releases B-1294 of February 24, 1988, B-1411 of May 17, 1988, and B-1481 of July 14, 1988.

Copies of the notes with Cyprus are available from the Office of Public Affairs, room 2315, Department of the Treasury, Washington, D.C. 20220. The notes with Singapore will be released when they arrive in Washington and have been processed by the Department of State; the only change from the March 24 notes is the extension to include income from shipping.

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B-1546

EMBASSY OF THE
UNITED STATES OF AMERICA

No. 189

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs and has the honor to propose that the two Governments conclude an Agreement to exempt from income tax on a reciprocal basis, income derived by residents of the other country from the international operation of ships and aircraft. The terms of the Agreement are as follows:

-- The Government of the United States of America, in accordance with Section 872(B) and 883(A) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships and aircraft by individuals who are residents of Cyprus (other than U.S. citizens) and by corporations organized in Cyprus. This exemption is granted on the basis of equivalent exemptions granted by Cyprus to citizens of the United States (who are not residents of Cyprus) and to corporations organized in the United States (and not taxed by Cyprus on the basis of residence).

-- In the case of a Cyprus corporation, the exemption shall apply only if the corporation meets either of the following conditions:

1) More than fifty percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Cyprus or of another

country which grants a reciprocal exemption to U.S. citizens and corporations; or

2) The corporation's stock is primarily and regularly traded on an established securities market in Cyprus, or is wholly owned by a corporation whose stock is so traded and which is also organized in Cyprus.

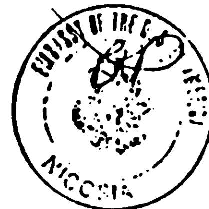
For purposes of sub-paragraph one, the Government of Cyprus will be treated as an individual resident of Cyprus. For purposes of applying the fifty percent test to a Cyprus corporation, if the corporation is a U.S. controlled foreign corporation, as defined in Section 957(A) of the Internal Revenue Code, the U.S. shareholders are treated as residents of Cyprus. For purposes of sub-paragraph one, stock of a corporation owned by another corporation, partnership, trust or estate shall be treated as owned proportionately by the beneficial owners.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Embassy considers that this Note, together with the Ministry's reply Note confirming that the Government of Cyprus agrees to these terms, constitutes an Agreement between the two Governments. A resident of Cyprus who derives income from the international operation of ships or aircraft may choose to apply to such income either the provisions of this agreement or of the Convention between the United States of America and the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on March 19, 1984. This Agreement shall enter into force on the date of the Ministry's reply Note and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either Government may terminate this Agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs of the Republic of Cyprus the assurances of its highest consideration.



Embassy of the United States of America

Nicosia, June 21, 1988

REPUBLIC OF CYPRUS

MINISTRY OF FOREIGN AFFAIRS

No............................

418/87

850/69

NOTE VERBALE

The Ministry of Foreign Affairs of the Republic of Cyprus presents its compliments to the Embassy of the United States of America and has the honour to acknowledge receipt of the latter's Note Verbale No. 189 of June 21, 1988 proposing the terms of a reciprocal exemption from income tax derived from the international operation of ships and aircraft.

The Government of the Republic of Cyprus agrees to exempt from tax gross income derived from the international operations of ships or aircraft by U.S. citizens (who are not residents of Cyprus) and by corporations organized in the United States (which are not taxed by Cyprus on the basis of residence).

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

1. More than fifty percent of the value of a corporation's stock is owned, directly or indirectly, by individuals who are

.../2

citizens of the United States or are residents of another country which grants a reciprocal exemption to Cyprus residents and corporations; or

2. The corporation's stock is primarily and regularly traded on an established securities market in the United States, or is wholly owned by a corporation whose stock is so traded and which is also organized in the United States.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Ministry of Foreign Affairs of the Republic of Cyprus is pleased to confirm that the Embassy's Note and this reply Note constitute an Agreement between the two Governments. A U.S. citizen or corporation which derives income from the international operation of ships and aircraft may choose to apply to such income either the provisions of this Agreement or of the Convention between the United States of America and the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and

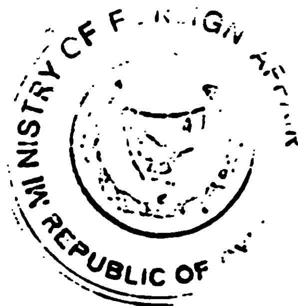
.../3

Property, signed on March 19, 1984. This Agreement shall enter into force on today's date and shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Republic of Cyprus avails itself of this opportunity to renew to the Embassy of the United States of America the assurances of its highest consideration.

S.L. Nicosia, 8 July, 1988.



To the
Embassy of the
United States of America,
Nicosia.

TREASURY NEWS

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

September 8, 1988

Deputy Assistant Secretary Dallas S. Batten to Leave Treasury

The Treasury Department today announced that Dallas Sanford Batten, Deputy Assistant Secretary for Economic Policy Coordination, has resigned his position, effective September 9. Mr. Batten is to join the Financial Relations Division of the International Monetary Fund.

Commenting on Mr. Batten's departure, Dr. Michael Darby, Assistant Secretary for Economic Policy, remarked, "The Administration has benefited greatly from Sandy's understanding of international finance, open economy macroeconomics, and applied econometrics. The Department's loss is decidedly the IMF's gain. He joins the Fund at a time when his expertise can make a particularly constructive contribution to their important efforts at policy coordination."

Mr. Batten joined the Treasury Department in 1987, after extensive service with the Federal Reserve Bank of St. Louis. He also served as Senior Staff Economist for the President's Council of Economic Advisers.

A former member of the faculty at both Denison University and Muskingum College, Mr. Batten earned a Ph.D in economics at Ohio State University in 1980. He is also the recipient of an M.A. from that institution (1974), and holds a B.A. (magna cum laude) from the University of Richmond (1973), where he was elected to Phi Beta Kappa.

The author of numerous articles, monographs, and book reviews, Mr. Batten also serves as a referee for a number of scholarly economic journals. He resides in Chantilly, Virginia, with his wife and two children.

B-1547

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 12, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,021 million of 13-week bills and for $7,027 million of 26-week bills, both to be issued on September 15, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 15, 1988			:	26-week bills maturing March 16, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.20%	7.44%	98.180	:	7.40%	7.79%	96.259
High	7.22%	7.46%	98.175	:	7.42%	7.82%	96.249
Average	7.21%	7.45%	98.177	:	7.41%	7.80%	96.254

Tenders at the high discount rate for the 13-week bills were allotted 19%.
Tenders at the high discount rate for the 26-week bills were allotted 5%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,035	$ 32,035	:	$ 36,785	$ 36,785
New York	26,047,840	6,209,080	:	24,084,005	6,102,855
Philadelphia	28,805	28,805	:	23,485	21,485
Cleveland	42,630	40,775	:	31,385	31,385
Richmond	115,720	40,720	:	75,355	71,460
Atlanta	27,415	27,415	:	28,610	27,350
Chicago	1,299,895	43,895	:	1,195,970	89,220
St. Louis	27,235	23,225	:	32,390	28,390
Minneapolis	11,405	6,405	:	12,750	7,720
Kansas City	25,860	25,860	:	42,965	42,965
Dallas	33,055	23,055	:	31,115	21,115
San Francisco	1,358,175	83,175	:	1,295,425	172,675
Treasury	436,950	436,950	:	373,695	373,695
TOTALS	$29,487,020	$7,021,395	:	$27,263,935	$7,027,100
Type					
Competitive	$25,790,375	$3,324,750	:	$22,431,810	$2,194,975
Noncompetitive	1,122,005	1,122,005	:	974,410	974,410
Subtotal, Public	$26,912,380	$4,446,755	:	$23,406,220	$3,169,385
Federal Reserve	2,395,855	2,395,855	:	2,050,000	2,050,000
Foreign Official Institutions	178,785	178,785	:	1,807,715	1,807,715
TOTALS	$29,487,020	$7,021,395	:	$27,263,935	$7,027,100

An additional $59,315 thousand of 13-week bills and an additional $500,685 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1548

TREASURY NEWS

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

Text as Prepared
For Release Upon Delivery
Expected at 1:00 p.m. DST

Remarks by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury

before the
Brookings Institution Conference
on
U.S. Governmental Institutions and U.S.-European Relations
Washington, D.C.
September 12, 1988

Preparing for 1992: A Yankee View on Europe's Internal Market Program

Introduction

I welcome this opportunity to address this distinguished European audience on a topic of interest to both Europeans and Americans. The year 1992 will indeed be a big one. We in the U.S., of course, will be celebrating the 500th anniversary of Columbus' discovery of America. You in Europe have set 1992 as the completion date for an historical necessity -- the formation of a single, integrated market within the European Community (EC). It is an ambitious effort to free the movement of goods, services, capital and people throughout the 12 member states.

I hope you will not consider me immodest if I suggest that I may be able to bring a unique perspective to "Europe 1992." As the popular song by Bruce Springsteen annunciates, I was "born in the U.S.A." In addition, I have served proudly as a U.S. Government official for almost three years. However, it is also true that both my parents were born in Europe and that I spoke a European language before I learned the American tongue. In my remarks today I will attempt to draw on this diverse background to offer you an objective and balanced view of the EC's internal market program.

A unified market presents new opportunities for Europeans. It is our hope that it will be a crucible for innovation and deregulation. It also presents new challenges for the rest of the world. The United States has supported the goal of European integration from its inception. As we look ahead, however, we are concerned by statements from Brussels that suggest the EC may

try to selectively exclude others as it liberalizes internal barriers. The creation of a single market either for goods or services that reserves "Europe for Europeans" would be bad for Europe, for the United States, and for the multilateral trading system in which we function.

Today I would like to comment as a sympathetic and enthusiastic observer. I offer my remarks in a constructive spirit. I sincerely hope that the United States and the EC can have mutually candid, open discussions about the implications of 1992 for countries that are outside the Community.

If you will allow me, I would like to focus my remarks this afternoon on two areas: First, on the implications of creating a single EC market and, second, on specific areas of U.S. concern. Because I have spent the bulk of my professional life in the private sector as a banker, my comments will have a special emphasis on financial services.

1992: An Historical Imperative

With progress toward a single market, European financial and industrial firms will be able to achieve greater economies of scale. Specialization along the lines of what individual countries do best will increase efficiency in the allocation of resources. The demands of competition should spur mergers, rationalization of activities, technological innovation and greater productivity. The program can help stimulate growth and employment, reduce consumer prices, and raise standards of living throughout Europe. It should also result in a single EC capital market largely free of restrictions. The liberalization of internal barriers will make an important contribution to removing the remaining structural rigidities in European financial markets.

Concerns of the U.S.

The U.S. Government is, of course, sensitive to the political pressures that may arise from internal liberalization, but we would find unacceptable measures that would limit market access for third countries and discriminate against foreign companies already established or that wish to establish in the EC.

You perhaps are aware that Commission officials have proposed using "reciprocity" as a standard for granting third countries access to newly liberalized sectors in Europe in those areas not covered by the GATT. Specifically, the proposed banking and investment services directives state that the reciprocal treatment afforded an EC financial institution in a third-country market may determine whether firms from that third country will be permitted access to an integrated European market for financial services.

Those directives require an automatic referral of applications to the EC Commission for a determination of reciprocal treatment. This process could delay applications for months and, in and of itself, result in significant delays in approvals for non-EC financial institutions. Such a procedure is overly bureaucratic and impracticable and, ironically, is precisely the type of process "Project 1992" is meant to eliminate in the march to greater efficiency.

If applied on a narrow or mirror-image basis, this standard of reciprocity could discriminate against firms in the United States seeking entry to the EC and against U.S.-owned firms already operating in Europe. It would undermine the principle of national treatment and the decades-long effort by the OECD to liberalize capital movements.

We find this reciprocity concept particularly troubling. I would like to take a few moments to explain our reasons and why we expect the Community to grant national treatment to branches and subsidiaries of U.S. institutions in the EC.

Reciprocity versus National Treatment

The notion of reciprocity enjoys considerable emotional and simplistic appeal. It suggests that, "You may do in my market only what I can do in yours." Strictly applied, the Commission's proposal could require third countries to mirror the laws and regulations of the EC in order to have equal access to the internal market. The danger of this approach is that legitimate differences, for example, in national regulatory regimes, are not recognized and could be used to justify discrimination against foreign firms. In the financial area, differences in organizational structures, the scope of permitted operations, regulatory and prudential frameworks, market instruments, clearance and settlement procedures, and methods of financing public debt will always exist.

To illustrate from our side of the Atlantic, we allow financial institutions in the United States -- foreign and domestic -- to offer a greater range of financial instruments than is permitted in some EC countries. I ask you: Should the U.S. demand reciprocity and deny banks and securities firms of the EC access to U.S. financial markets until their own countries adopt policies or financial instruments identical to our own?

Because of these national differences, reciprocity that seeks to achieve identical commercial privileges in countries with different market structures and regulatory regimes will almost inevitably result in discrimination. In short, reciprocity that seeks identical treatment in different countries is a retreat to protectionism.

In fact, the variety of financial environments around the world and the scale of our presence in each other's markets makes

it impossible to provide reciprocal treatment for foreign firms without creating a huge regulatory bureaucracy and a market with limited flexibility. I should point out that, at the end of 1987, there were over 660 foreign bank operating entities in the United States, representing 260 foreign bank families from more than 60 countries, with total U.S. assets of over $594 billion. And 147 U.S. banks have a total of 873 branches in 70 foreign countries. I would not want to have to build a matrix to measure "reciprocity."

Instead of reciprocity, we consider national treatment the most effective way to avoid discrimination and preserve free and open financial markets. The principle of nondiscrimination is embodied in the OECD Code of Liberalization of Capital Movements, and national treatment is, of course, central to the National Treatment Instrument of the OECD, as well as an important principle in Friendship, Commerce and Navigation Treaties between the United States and a number of EC member countries. The national treatment approach seeks to ensure that, in a given market, foreign firms are treated in the same way as domestic firms. By allowing domestic and foreign firms to compete on an equal footing in each market, national treatment accommodates national differences in regulatory regimes and supports the objectives of free access and non-discriminatory treatment.

Overall, we in the U.S. allow foreign firms, including banks, free access to our market. And, once here, we grant them national treatment. We consider it essential that the single EC financial market be accomplished in a way that:

(1) extends access and provides national treatment to U.S. firms and their subsidiaries;

(2) is consistent with the Friendship, Commerce and Navigation Treaties, OECD obligations, and the GATT;

(3) supports the objectives of the Uruguay Round and honors the EC's commitments in the Punta del Este Declaration; and

(4) avoids damage to the trade, financial, and investment interests of those outside the Community.

These points are critical, for if barriers against foreign-owned firms are raised in the context of completing the internal market, either directly or as the result of the application of a standard of reciprocity, the EC will undermine support in the United States -- and elsewhere -- for multilateral efforts toward a more open international financial and trading system. Indeed, the intensification of protectionism in Europe would certainly evoke a response from the U.S. Government.

The Need for a Constructive Dialogue

Within the Treasury and throughout the U.S. Government, we are ensuring that our counterparts in European Governments and at the EC Commission are aware of our views and concerns. We believe it is important for the EC to communicate, in a timely way, with others about the external dimensions of the internal market program. Greater information exchange about the actual intentions of the EC would help alleviate concerns generated by statements made in domestic political contexts. There are questions, and early consultations that respect the rights and interests of others would surely be best for countries on both sides of the Atlantic.

Treasury is also making its voice heard in multilateral fora, such as the OECD. We have made clear our position that the benefits of EC liberalization should be extended to all OECD members. The reciprocity provisions in the EC plan would be inconsistent with the obligations of OECD members under the Capital Movements Code.

In this overall context, you should also know that Treasury is required under the Omnibus Trade Bill to report to Congress by December 1, 1990 and periodically thereafter on our efforts to achieve national treatment. Due to the importance of the EC plan, we plan to include a chapter on the issues involved and our efforts to resolve them.

Conclusion

In conclusion, I want to express once again genuine admiration for the historic effort underway in Europe today. Our shared objective should be to move toward a more open international trading and financial system. Regional efforts at liberalization can contribute to this goal, but only if accomplished without raising barriers to others. If things go well, all potential participants will have an opportunity to gain. If the construction of a European financial market results in discriminatory activities, we all stand to lose. I have expressed our hopes and concerns about 1992, not to challenge the program, but in an attempt to head off potential conflicts. Countries outside Europe have a natural interest in the process. And the EC has a natural interest in preserving the support of other countries as its members move to construct a world-class integrated financial market.

Thank you very much.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
September 13, 1988

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 September 22, 1988. This offering will result in a paydown for the Treasury of about $8,925 million, as the maturing bills total $22,929 million (including the 20-day cash management bills issued September 2, 1988, in the amount of $10,052 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, September 19, 1988. 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 December 24, 1987, and to mature December 22, 1988 (CUSIP No. 912794 QD 9), currently outstanding in the amount of $15,965 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated September 22, 1988, and to mature March 23, 1989 (CUSIP No. 912794 RP 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 September 22, 1988. 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 $4,367 million as agents for foreign and international monetary authorities, and $3,328 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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

TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY
EXPECTED AT 10:00 A.M. EDT

REMARKS BY M. PETER McPHERSON
ACTING SECRETARY OF THE TREASURY
BEFORE
THE AMERICAN ENTERPRISE INSTITUTE
WASHINGTON, D.C.
SEPTEMBER 14, 1988

IT'S TIME TO RETHINK THE ROLE OF GATT IN ECONOMIC DEVELOPMENT STRATEGIES

Thank you. I appreciate the opportunity to speak to you today, and I would like to give special thanks to the American Enterprise Institute for hosting this occasion.

Today, I want to share with you views on some problems with the treatment of developing countries in the General Agreement on Tariffs and Trade, otherwise known as the GATT. The GATT provides what is called "special and differential treatment" for developing countries.

Special and differential treatment actually embodies a number of concepts. Those that I want to talk about today are those that discourage developing countries from opening their markets and adopting liberal trade policies. I'm not talking about GSP or other trade preferences for imports into developing countries. I am concerned about the provisions that allow LDCs to except themselves from normal GATT rules in order to pursue import substitution, which is contrary to GATT's basic free trade principles. The original justification for these exceptions was the mistaken belief that import substitution was the way to promote economic development.

Import substitution encouraged by inward-looking policies is no longer considered sound development policy -- the World Bank certainly takes that view. During the six and one-half years I was Administrator of AID, we encouraged trade liberalization among developing countries -- not import substitution. Sound development policy means an open economy -- open to trade, open

to investment, open to services. Economic development is not promoted by inward-looking policies or protectionism.

Since coming to Treasury and becoming directly involved in trade policy, I've reaffirmed my view that the GATT, by allowing exceptions to its general principles for developing countries, sanctions the use of trade restrictive measures by these countries, hindering both trade liberalization and development. These exceptions not only encourage bad development policies, they are used as cover for protectionism that has nothing to do with development. What's more, LDC ability to avoid GATT obligations weakens the political formula of reciprocal concessions and undercuts trade-liberalizing negotiations.

My message today is straightforward: If we know that excepting developing countries from GATT rules hurts development and the trading system, then it's time for a new, more constructive, approach, one consistent with current economic thinking, the interests of developing countries, and the good of all.

Inward-Looking Development Strategy: Whence It Came

In the 1950s, the conventional belief was that developing countries could best industrialize behind high walls of trade protection. Only by turning inward and protecting infant industries, it was thought, could developing countries one day be able to compete on even terms with industrialized nations. This development strategy was commonly called import substitution.

The belief that development was encouraged by import substitution and trade protection had a profound impact on the development of the GATT. GATT was set up to encourage more open trade among countries, yet development supposedly required trade protection. Out of this contradiction arose the principle of allowing developing countries to except themselves from GATT rules. Under this principle, GATT's prohibitions against restrictive trade measures, and requirements for reciprocity, can be suspended or weakened for developing countries. GATT rules were thus made consistent with the supposed requirements for development.

I appreciate the conditions which gave rise to the import substitution movement, because I've witnessed these same conditions in many developing countries today. While at AID, I visited about 50 developing countries, met with their leaders, visited town and country, and spoke with their people. I know that people everywhere will work for a better life and many are succeeding. I am proud of the work we do at AID in food production, health and safety, and many other areas. Still, too many people in the LDCs are mired in the poverty of their fathers and grandfathers.

For many of these countries, the same dependence on primary

products which existed in the 1950s exists today, along with the same pessimism. Increased import substitution has built up a powerful constituency for continued protection, regardless of the economics. It is understandable, then, why import substitution still has political support in some developing countries, and why, therefore, provisions in GATT allowing developing countries to use trade restrictive measures are considered important by some in the developing world.

Development Strategies: What Works, What Doesn't

We have to acknowledge that developing countries face very significant constraints on their development. Development is not an easy thing. It's not like following a recipe. But after 30 years, we know much more about what helps and what hurts development.

George Bernard Shaw is reputed to have said that if all economists were laid end to end, they wouldn't reach a conclusion. Shaw was wrong. They would, in fact, reach conflicting conclusions. On the broad conditions necessary for economic development, however, there is now an emerging consensus among economists. Most now agree that in order to promote development a country should train and educate people, build critical institutional capabilities, obtain or create needed technology, and construct vital infrastructure. Moreover, of great importance, countries should pursue sound monetary and fiscal policies, avoid overvalued exchange rates, encourage domestic and foreign investment, and reduce structural rigidities which prevent efficient allocation of resources.

Economists also recognize that trade policy characterized by outward orientation is an important complement to these other policies in promoting development.

Countries reap a number of economic benefits from outward-oriented trade policies, including:

- Efficiency gains from production based on comparative advantage;
- Economies of scale resulting from production for expanded markets;
- Lower inflation, given imports of lower-priced goods;
- More efficient investment, which frees capital savings for other investment;
- Higher savings ratios;
- Increased employment of labor, higher wages, and more equitable income distribution;

- o Increased technological innovation; and

- o Higher growth rates.

Let me cite a few examples of economies that have followed outward-oriented trade policies and have realized some of these benefits. Hong Kong and Singapore are two well-known examples of newly-industrializing economies that have followed outward-oriented trade policies and prospered. But what are some lesser known examples?

In the late 1970s, Turkey's trade policies were highly protectionist and inward-oriented. Between 1965 and 1980, Turkey's annual export growth averaged 5.5 percent. Turkey then reversed course and began to liberalize trade. Since 1980, its exports have increased almost 20 percent per year. No economy, not even Taiwan, has performed better. And Turkey has diversified its exports. Manufactured goods accounted for just 2 percent of exports in 1965, but today account for 56 percent.

In recent years, Mexico has done a virtual about-face in trade policy. It has made a serious commitment to outward-oriented policies to diversify its exports and increase the competitiveness of its import-competing sector. In conjunction with its accession to the GATT and several Trade Policy Loans from the World Bank, Mexico has cut tariffs sharply and greatly reduced reliance on quantitative restrictions.

Mexico's non-oil export producers have been quick to respond to this more favorable environment. Last year, Mexico's non-oil exports surged 24 percent. In the first half of this year, growth has continued at a healthy rate of 19 percent. Oil exports now account for only a third of total export revenues, down from three-quarters at the beginning of this decade. Mexico has laid the foundation of recovery by implementing sound trade policies coupled with improved monetary and fiscal measures.

In contrast, the potential gains from trade are sacrificed by countries practicing an import substitution or inward-looking strategy. Over the medium-to-long term, import substitution reduces export capacity, exacerbates balance-of-payments problems, depresses wages, worsens income distribution, and inhibits economic growth. Rather than a strategy for economic development, import substitution is a strategy for economic decline.

Import Subtitution is Built on False Assumptions

The import substitution strategy is built on several false assumptions, including the ideas: (1) that external factors totally control developing-country economies; (2) that export

prospects for developing countries are poor; and (3) that market principles don't work in developing countries.

External conditions are not the sole determinants of LDC economic performance. More specifically, a country's own policies -- including macroeconomic, exchange rate, structural, and trade policies -- are among basic determinants of its economic prospects. External demand is not destiny. To believe that it is, ignores the importance of the supply side and the role of policies which can improve the efficiency of markets and increase productive capacity.

Those who advocate import substitution believe dependence on primary exports dooms developing countries to poverty. Their theory can only hold if developing countries completely specialize in primary production for export. If they ever did, most don't now. Most (66 percent) of the non-fuel exports of developing countries now consist of manufactured goods.

Pessimists say that even if developing countries produce more manufactured and other non-traditional goods for export, industrialized countries won't absorb them. Well, even during the dampened growth years of the 1980s, a time of growing protectionism, developing countries increased the volume of their exports of manufactured goods to developed countries by over 9 percent per year. Their share of total developed-country consumption of manufactured goods is still under 3 percent. In addition, the newly industrializing economies will provide growing markets for exports of developing countries.

Market principles work in LDCs just as they do in developed countries. Producers in developing countries respond to relative price incentives. They are capable of exploiting comparative cost advantages to compete in international markets. Witness the export success of the newly industrializing economies.

Special Treatment for Developing Countries in GATT

The import substitution approach to economic development induced developing countries to seek exemptions from basic GATT obligations. These special arrangements for developing countries were accepted by the developed-country members of GATT in stages, but one result is that they permit trade protection as a development tool.

A key amendment of GATT rules came in 1955, with the addition of a special balance-of-payments waiver for LDCs to impose quantitative trade restrictions. The waiver should be a temporary one -- used only long enough to allow macroeconomic adjustment policies to work.

In reality, the BOP waiver, in effect, has allowed indefinite trade restrictions under a BOP cover. The rationale is BOP correction, but the restrictions actually serve to protect

domestic industries, even if that was not the original intent. Fully 85 percent of LDC import quotas notified to GATT by LDCs are justified under the BOP waiver. Some of these quotas have been in place for decades.

The distinction between trade restriction to address temporary BOP problems and restriction to protect specific industries has been obscured -- obscured to the point where there is no practical difference. The BOP waiver is used to provide lasting cover for import substitution policies. This exacerbates BOP problems, because prolonged use of import quotas and so forth create a bias against exporting which ultimately reduces the export base. Instead of exporting more to correct a BOP problem, the LDC ends up importing less.

Another critical facet to the special treatment provided LDCs involves the concept of non-reciprocity. Under non-reciprocity, developing countries are not expected to reciprocate developed-country trade concessions in trade negotiations if such contributions are inconsistent with the development, financial, and trade needs of developing countries.

LDCs often view opening markets in exchange for better access to foreign markets as bad for development. Reciprocity could work for LDCs as well as it did for the developed countries recovering from the war.

The cumulation of special exemptions and arrangements for developing countries through GATT's history has effectively removed LDCs from obligations under GATT's first principles -- nondiscrimination, transparency, and reciprocity. Developing countries are members of GATT, but, for many, their membership is without substance.

GATT's Special Treatment Works Against Trade Liberalization

Not only is import substitution built on false assumptions, but the special treatment in GATT which complements it weakens the trade liberalization movement. Developed countries have little incentive to offer permanent trade concessions to developing countries in exchange for greater access to LDC markets, because LDC markets can be readily closed again under provisions permitting exceptions to GATT principles, such as those related to the balance-of-payments waiver and infant industry protection.

Within developing countries, GATT's basic political formula of reciprocal trade liberalization cannot be "sold" as necessary to obtain the opening of developed-country markets. Many developing countries are currently receiving the benefits of past trade rounds without having had to pay for those benefits in terms of adhering to GATT obligations. Without special exemptions from GATT obligations, LDC governments sincerely wishing to liberalize trade would be better able to mobilize

domestic support for doing so, as well as improve their negotiating leverage with the industrial countries.

Developing countries have negotiated as special pleaders and therefore not as equals. They have fought for rules that permit trade protection and preferences. They won, but the victory appears Pyhrric. Trade protection hurts development and makes developing-country less efficient and less competitive.

Further, extended special treatment for developing countries weakens the integrity of the GATT system. It creates two contradictory sets of GATT rules which act as a drag on worldwide trade. It's rather like having two sets of traffic rules for large and small cars -- large cars go on green, but small cars stop or go as they wish. Traffic would be snarled when it's to everyone's benefit that it flow smoothly.

Finally, special treatment for developing countries is self-applied and self-enforced. No rules govern eligibility. The freedom to impose trade restriction otherwise prohibited under GATT is available to those who wish to use trade protection for its own sake, and not necessarily to develop, say, infant industries.

A New Approach to S and D

The old theory that trade protection promotes development is bankrupt. But GATT still echoes this theory. It is time for a new approach, one that recognizes the role of trade liberalization and outward orientation in promoting development. Is it possible to marry outward-oriented development with special treatment for developing countries? I think so. The key is to differentiate between that special and differential treatment that encourages liberalization and that which discourages liberalization.

Limited, short-term departures from GATT obligations can help ease the short-term economic costs and difficult political decisions that accompany trade liberalization. A new, more constructive, approach to GATT's rules for developing countries can accelerate trade liberalizaton. The old approach merely encourages trade protection. We need to recognize the problems inherent in prolonged use of trade restrictions, and support economic development strategies that remove market disincentives to export and that facilitate the adoption of liberal trade policies.

Measures consistent with this new approach include:

1. Technical assistance provided to LDCs by the GATT Secretariat, developed countries, and the World Bank. Technical assistance includes advice on technical import regulations and certification procedures. It also includes GATT Secretariat technical support for dispute settlement.

2. Realistic phase-in periods for GATT disciplines. These can help ease the short-term economic costs and difficult political decisions that accompany trade liberalization.

3. The Generalized System of Preferences and other such trade preference programs. The improved access to developed markets provided by GSP has certainly helped many LDCs. Such preferences can be constructive if time-limited and if they encourage trade liberalization by the recipients.

Current GATT practices that need reform include the following:

1. Balance of Payments: The rules that permit quotas justified for balance of payments reasons. GATT should allow such restrictions only in true crisis situations and encourage countries to adopt sound, effective adjustment policies instead of relying on import restrictions.

2. Non-reciprocity. The concept that LDCs should <u>not</u> offer to reduce their own barriers in exchange for better access to export markets. As I said earlier, this concept undercuts trade liberalizing negotiations.

One last note on the new approach. As we develop rules in the Uruguay Round for the new trade areas -- services, intellectual property, and investment -- we should not repeat the mistakes of the past. In efforts to ensure that LDCs are included in the negotiations and covered by GATT rules, we should not turn to special treatment that would delay their participation in the trading system or damage their prospects for economic growth.

<u>Concluding Remarks</u>

In conclusion, the principle of special treatment for developing countries to support inward-looking economic development strategies as currently applied in GATT is premised on the belief that trade protection promotes development. Experience has thoroughly discredited this premise. It is time for GATT to operate in a way consistent with current economic thinking, the development interests of LDCs, and the interest of the trading community at large. A new approach to the economic development needs of developing countries would justify departures from GATT rules when such departures create conditions for more liberal trade policies and ultimately greater compliance with GATT obligations. This approach is something on which we can build.

We have an opportunity through the Uruguay Round of trade negotiations to strengthen GATT rules to the benefit of the entire trading community. In this Round, for our LDC trading partners to insist reflexively that special and differential treatment, as currently understood, applies to all areas of

negotiation will, I fear, diminish the Round's promise.

The United States accepts the broad parameters for the negotiations which the Punta del Este Declaration laid down, including the statement that special and differential treatment shall apply to the negotiations. However, I think it's useful to remind ourselves of the major negotiating objectives set out in the declaration:

- To reverse protectionism;
- To preserve the basic principles of GATT; and
- To develop a more open and durable trading system, in the belief that such actions promote growth and development.

These actions will promote growth and development. And that's our mission.

It is not in the interest of developing countries to emphasize their desire for exceptions to GATT obligations to the detriment of these broad objectives of the Uruguay Round. Indeed, LDCs would, as I've stated, be better off in the longer run to abandon their claim to exceptions to GATT rules.

Clearly, special treatment for LDCs has political and legal relevance to the trade negotiations. But one must separate this political and legal relevance from its economic relevance. Economically, the payoff from heavy LDC investment in exceptions to GATT principles has been dubious. My sense is that LDCs can gain much more by negotiating as true trade partners in the Uruguay Round than as special pleaders. Tough bargaining on their part, given their increased commercial leverage, will likely pay off in vastly improved market access.

The trading system confronts some very major problems. Their solution lies within a strong multilateral trading system under GATT. The strength of GATT is its first principles: nondiscrimination, transparency, and reciprocity. There is common ground in GATT's first principles on which the interests of both developed and developing countries can more effectively coalesce. All GATT members should renew their commitment to these first principles.

For developed countries, this means fulfilling their obligation to adhere to principles of an open, multilateral trading system and to raise LDC stakes in the system by increasing access to developed-country markets. Developed countries must not only resist new protectionism but more seriously challenge the old. For developing countries, it means a greater willingness to share in GATT's obligations as equals.

TREASURY NEWS

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FOR RELEASE AT 12:00 NOON
September 16, 1988

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $ 9,000 million of 364-day Treasury bills to be dated September 29, 1988, and to mature September 28, 1989 (CUSIP No. 912794 SL 9). This issue will result in a paydown for the Treasury of about $ 275 million, as the maturing 52-week bill is outstanding in the amount of $ 9,281 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, Thursday, September 22, 1988.

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 September 29, 1988. In addition to the maturing 52-week bills, there are $ 13,097 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 $ 2,307 million as agents for foreign and international monetary authorities, and $ 5,495 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 $100 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 5176-3.

B-1552

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

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