U.S. DEPT. OF THE TREASURY

PRESS RELEASES

TREASURY NEWS

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

September 16, 1988

Edith E. Holiday Joins Treasury

Secretary of the Treasury Nicholas F. Brady today announced that Edith E. Holiday has joined the Department of the Treasury. Ms. Holiday will oversee matters pertaining to public affairs and public liaison and will act as counselor to the Secretary.

Prior to joining the Department, Ms. Holiday was Chief Counsel and National Financial and Operations Director for the Bush-Quayle '88 Presidential Campaign. Previously she served as Director of Operations for George Bush for President and Special Counsel for the Fund for America's Future.

In 1984 and 1985, Ms. Holiday was Executive Director for the Commission on Executive, Legislative and Judicial Salaries. She practiced law with the firm of Dow Lohnes & Albertson in 1983 and 1984 and with the firm of Reed Smith Shaw & McClay from 1977 to 1983. Ms. Holiday also served as Legislative Director for then U.S. Senator Nicholas F. Brady.

Ms. Holiday received her B.S. and her J.D. degrees from the University of Florida, Gainesville. A native of Georgia, Ms. Holiday is married to Terrence B. Adamson.

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TREASURY NEWS

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September 19, 1988

Appointment of Bruce R. Bartlett
As Deputy Assistant Secretary for Policy Analysis

Bruce R. Bartlett has been appointed Deputy Assistant Secretary of the U.S. Treasury for Policy Analysis, in the office of Economic Policy, effective September 18, 1988.

Until his appointment, Mr. Bartlett was Senior Policy Analyst in the Office of Policy Development at the White House, where he specialized in economic analysis.

Before joining the Reagan Administration, Mr. Bartlett was a senior fellow at the Heritage Foundation from 1985 to 1987. He previously had been Vice President of Polyconomics, an economic consulting firm, and Executive Director of the Joint Economic Committee of the U. S. Congress. He also served on the staffs of Senator Roger Jepsen, Congressman Jack Kemp, and Congressman Ron Paul.

Mr. Bartlett is the author of The Supply-Side Solution (1983) and Reaganomics: Supply-Side Economics in Action (1981). He has been a contributor to the Wall Street Journal, the New York Times, the Washington Post, and many other business and news publications.

Born in Ann Arbor, Michigan, in 1951 and educated at Rutgers University (B.A., 1973) and Georgetown University (M.A., 1976), Mr. Bartlett currently resides in Alexandria, Virginia.

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 19, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,047 million of 13-week bills and for $7,007 million of 26-week bills, both to be issued on September 22, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 22, 1988			:	26-week bills maturing March 23, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.16% a/	7.39%	98.190	:	7.31%	7.70%	96.304
High	7.18%	7.41%	98.185	:	7.34%	7.73%	96.289
Average	7.17%	7.40%	98.188	:	7.34%	7.73%	96.289

a/ Excepting 1 tender of $10,000.

Tenders at the high discount rate for the 13-week bills were allotted 25%.
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	$ 32,610	$ 32,610	:	$ 30,310	$ 30,310
New York	26,311,575	6,314,025	:	21,467,390	6,322,640
Philadelphia	16,575	16,575	:	14,200	12,200
Cleveland	29,710	29,710	:	19,130	19,130
Richmond	47,785	27,785	:	26,035	26,035
Atlanta	16,265	16,265	:	19,105	19,065
Chicago	1,331,170	155,420	:	1,010,520	149,270
St. Louis	24,665	20,655	:	24,195	21,145
Minneapolis	4,650	4,650	:	6,460	6,460
Kansas City	24,150	24,150	:	25,165	25,165
Dallas	32,885	24,135	:	22,165	12,165
San Francisco	1,275,010	225,510	:	1,320,930	256,680
Treasury	155,030	155,030	:	107,080	107,080
TOTALS	$29,302,080	$7,046,520	:	$24,092,685	$7,007,345
Type					
Competitive	$26,675,845	$4,420,285	:	$19,559,365	$2,474,025
Noncompetitive	679,855	679,855	:	529,020	529,020
Subtotal, Public	$27,355,700	$5,100,140	:	$20,088,385	$3,003,045
Federal Reserve	1,678,180	1,678,180	:	1,650,000	1,650,000
Foreign Official Institutions	268,200	268,200	:	2,354,300	2,354,300
TOTALS	$29,302,080	$7,046,520	:	$24,092,685	$7,007,345

1/ Equivalent coupon-issue yield.

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TREASURY NEWS
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TEXT AS PREPARED
Expected at 1:15 P.M., EDT

REVISED

Remarks by M. Peter McPherson
Deputy Secretary
of
The U.S. Treasury Department
before
New York Financial Writers' Association
New York, New York
September 19, 1988

Third World Development in the Information Age

Good afternoon. Thanks for inviting me to speak to you.

You all rely on high technology to assemble information from all over the world -- to analyze, synthesize, and dispatch it to a wide audience. For this reason, I think my chosen topic for today -- Third World Development in the Information Age -- will be of particular interest to you.

My message today is straight forward. The new information age makes it imperative that LDCs open themselves up to advancing technology for their own self interest. This means liberalizing investment regimes, protecting intellectual property rights, and not restricting trade in services. LDCs have essentially two options as they face the current round of GATT negotiations: they can either join in the efforts to liberalize the world economy and to ensure equal access to markets, or they can shut themselves off from the benefits of this new age. If LDCs fail to make needed policy changes, the information age will pass them by and leave them even further behind economically. There is a separate speech on why such LDC policy changes are important for the U.S., but today I will focus on how important the changes are to the LDCs.

LDCs need help to take advantage of the new information age, and more assistance should come from the World Bank. Better public policies alone will not solve the problem. LDCs need help to train their people, build institutions and infrastructure, and prepare themselves for continuing technological advancement. This is especially true for LDCs that are not NICs. The World Bank has made some efforts in this area but should be more active in encouraging and assisting LDCs along this path.

The latest technological revolution -- commonly called the information age -- must be distinguished from the earlier agricultural and industrial technologies.

First, agricultural implements and industrial machines both substitute mechanical power for muscle power. Information technology leverages brain power. Leveraging brain power isn't new. The abacus has been with us for 26 centuries. What is different is the quantum, almost infinite leap in leveraging afforded by information technology.

Second, the speed at which this technology is spreading and developing can be thought of in terms of months and days compared to the thousands of years that the agricultural and industrial revolutions required, respectively, to take seed and grow. Indeed, within a matter of decades government and commerce in the industrialized world have become dependent on the rapidly changing computer and the new forms of telecommunications -- satellite transmissions and optic-fiber cables -- that link computers.

The uses of information technology are ubiquitous and well known to you, so at this point in my presentation I will simply list some of them: the control of inventories, costs, finance, or marketing; transportation planning; computer controlled electric service grids; industrial robots; computer controlled machine tools; and research. In fact, it is hard to imagine end uses that cannot benefit from information technology -- many of which depend primarily on developing a computer capacity.

In brief, information technology is revolutionizing and is critical for LDCs.

To further set the stage for my argument, I want to reflect for a moment on the key, reasons for economic growth and development -- not just in the third world today, but historically.

Development is a process particular to each country, and each must establish its own needs, methods, and pace. However, a country's strategy and policies must also be sensitive to the external environment. Indeed, I think most would agree that development has been and continues to be driven by the combined force of good economic policies and the advance of technology.

This relationship is reflected both in history and in recent trends. Policies can constrain or promote economic development. For instance, there is growing recognition of the economic development value of policies that allow the productive property of society to be owned by private parties and used for private gain. Look at the impact of the changes in China in recent years. Also, the Soviet Union is now in the throes of altering past policies to produce greater productivity -- for example, by leasing land to individual farmers for up to 50 years.

To further make the point, changes in trade policy in Turkey since the late 1970's have had a tremendous impact on economic growth. From highly protectionist and inward-oriented policies in the late 1970's, Turkey has reversed course and begun a major trade liberalization. As a result, export growth, which averaged 5.5 percent between 1965 and 1980, has registered almost 20 percent per year since 1980.

Recent changes in the U.S. tax code have also revealed an important link between policy and economic development. The dramatic reduction in marginal tax rates begun in 1981 has boosted the incentive to productive activity and deserves an important share of the credit for the vast increase in new jobs created by the U.S. economy -- 17.8 million since November 1982.

Certainly government policies have helped and burdened economic progress, and, as I will discuss later, many LDCs must come to terms with the fact that their current policies hinder development in today's information age.

History also shows the importance of <u>technology</u> in driving economic development. The invention of the plow ushered in productive agriculture and altered the human lifestyle in a way that fostered further invention. James Watt in the 1770's made a number of innovations to improve the efficiency of steam powered engines and produced a practical power plant that contributed immeasurably to the Industrial Revolution. The perfection of the internal combustion gas engine about a century later made possible cars, trucks, and the airplane, all of which have radically transformed human lifestyles. And a critical stimulus to economic growth since WWII has been the computer -- which has joined with related technical breakthroughs to generate the new technological age now driving economic progress at a fast pace.

It is instructive at this point to look at the record of developing countries in incorporating technology in their pursuit of economic development.

First, it must be noted that the circumstances of international competition and economic advancement have changed for LDCs as technology has advanced.

Advanced technology has brought on a gradual decline in some of LDCs' traditional comparative advantages. Peter Drucker has pointed out that LDC comparative advantages in low labor costs and raw material exports have begun to erode. For example, because of increased flexibility and an extended life-cycle of manufacturing processes in more developed countries, low labor costs no longer ensure that LDCs will produce textiles more cheaply and effectively than highly automated mills in the Carolinas. Similarly, technological advancements have often displaced traditional raw materials. For instance, the prevalence and quality of fiberoptic products have diminished the importance of copper as an input for production.

Advanced information technology has also altered the very nature of international market economic activity. Competition to provide inputs, services, and final products has been heightened by the minimization of distance and the ease of establishing and changing relations between providers and utilizers. Manufacturers will quickly switch their source of parts and services to the cheapest provider of an input to production. Countries must as a result maintain their comparative advantage and competitive prices or they lose. In some ways all countries, certainly all LDCs, are competing against all other countries. Open economies will tend to get the technology and win; closed economies will usually stagnate. And while competition has intensified, developing countries are also increasingly expected by developed countries -- as reflected in the new U.S. trade bill -- to carry their own weight by operating on an even plane in the world economy.

Even though circumstances have been changing to make information technology central to operation in the international market, many LDCs do not have a good record of incorporating this modern technology into their economies.

Indeed, the process of adopting appropriate policies and allowing technology to lead the way to development has been inhibited by bad policies in many of the developing countries.

I would like to review the background to this situation.

When low rates of technology transfer in the modern sectors of many less developed countries became apparent, commentators quickly concluded that technology designed for conditions in developed countries -- relatively cheap capital and expensive, skilled labor -- often was not appropriate for the LDCs. Their solution to the alleged incompatibility of advanced technology with LDC conditions was to transfer or develop "appropriate technology" -- e.g., improved plows or ovens that would be directly applicable to the a developing country.

The concept itself is sensible. However, we now know that appropriate technology for developing countries need not exclude advanced technology, even if designed principally with the developed world in mind. Many new technologies are flexible enough to be adjusted to the needs and capabilities of a developing country, if accompanied by proper training.

Information technology is "appropriate" for mechanization of the financial sector of most any country; it can also be invaluable in agricultural research, health services, and other traditional development activities. Furthermore, employment of these technologies can help control the high costs of development: microelectronics can, for instance, help countries make more efficient and limited use of electric power, thus limiting capital costs. And by allowing separation of the provider from the utilizer of inputs, information technology opens up new potential for developing countries to expand non-traditional exports, e.g. data processing in the Caribbean for a U.S. client.

Information technology is also crucial to countries that would like to prepare themselves to be more receptive to higher levels of technology. Computers are useful tools of education and training. Through what is called computer-assisted instruction, or interactive instruction, a student sitting at a computer terminal can work through a series of "frames" that teach and test understanding. Limited application of computer technology can also improve the electric power and telephone systems in LDCs, making them better able to support more extensive use of information technology in business and industry. And there are other applications through which computers and other information technology can help speed up the development process. As advancements continue to be made -- e.g. making desktop computers more affordable and other information technology more accessible -- information age technology should become more appropriate in the development process. The returns on investments in technology transfers will grow as such technology is incorporated more broadly and effectively.

How can LDCs better take advantage of these benefits of the information age and keep from being left behind in the world economy?

Because of the unique nature of information technology and the significance of its incorporation in economic development, LDCs must plan carefully their strategies and policies for becoming part of the information age.

The establishment of appropriate and stable macroeconomic policies that encourage private enterprise and a healthy economy is a preliminary and critical step. There are also a series of important policy changes which many developing countries must make.

Investment must be encouraged. In a speech on interdependence, top Canadian government official and GATT negotiator Sylvia Ostry pointed out that

> the trend to increasing international integration that is inherent in the information revolution is likely, at least for a time, to enhance the role of the multinational enterprise as a carrier of leading-edge technology. Access to this new generic technology and the flows of capital by which it will in considerable part be transferred will become a prime determinant of growth and development around the world.[1]

Thus LDCs must come to realize the importance for their advancement of allowing foreign investment to enter their markets.

Many LDCs have policies that impede such foreign-owned establishments. They often require foreign firms to enter into uneconomical partnership with LDC governments or private enterprises and impose other costly conditions on the entry of a multilateral corporation into their market. Because the operation of multinational firms in developing countries is a primary mechanism for the transfer of information technology, such restrictive policies are counterproductive for LDCs. Although LDCs can certainly purchase, for example, off-the-shelf personal computers as their trade regime allows, direct investment often facilitates transfer of capital, management expertise, and an ongoing stream of technological know-how that is otherwise very difficult to secure.

Foreign investors must also keep their end of the bargain by being good "citizens" in developing countries. Such investors should provide lasting and useful training to nationals; they should take advantage of local contributions and strengths and not isolate their operations. By carrying their business and technology to developing countries, foreign investors are also creating new demand for their goods and services. They should accordingly maintain a balanced long-term perspective on their involvement in these countries.

Another pivotal policy area is protection of intellectual property rights. Such policies are an important determinant of a multinational firm's willingness to enter an LDC and to carry advanced technology there. The widespread, unauthorized copying of software and the cloning of hardware undercut the markets and profits of those that bear development costs and marketing expenses. Software publishers -- whether in developed or developing countries -- may be particularly wary of circulating their product in an area where it might be copied and distributed without means of legal recourse. I am told often of corporate decisions to go to one country as opposed to another because of concerns with intellectual property protection. Also, for example, Brazil has already burdened its whole industrial base by sharply cutting back critical informative technology from outside the country.

Policies for the protection of intellectual property rights should not afford multinationals undue advantages, such as a mechanism for establishing a monopoly they might have lost in the developed world because of the expiration of a patent. At the same time, stronger agreements might encourage not only the distribution of equipment and software by multinational firms in LDCs, but also the development of systems and programs targeted more precisely to their needs.

In addition, policies governing <u>trade in services</u> help determine the ability and inclination of firms to engage in technology transfer. Many LDCs have significant non-tariff barriers that impede the sale of international border services. They impose restrictions on the import of, for example, computer data and information and other value-added services. Such restrictions inhibit the incorporation of established technology into a developing country's economy, despite market demand for such technology. They can also work against LDCs that establish export potential in services.

In designing a strategy for the information age, developing countries must also address the relative weakness of their physical and human resource bases. Well-trained workers and efficient institutional infrastructures are vital to securing and utilizing the mechanisms of advanced technology. Those countries that want to join the current acceleration of technology must concentrate on improving their capacity for education and training. The indigenous private sector -- which benefits from private development of highly profitable sectors such as telecommunications -- can be expected to provide some training, and for this reason domestic private enterprise should be encouraged. The potential of multinationals to contribute to training and education is also extremely high.

Yet these countries need more than just more skilled labor. The proper institutional structure to train and carry out other functions is key. The importance and difficulty of building such institutions must not be minimized.

In sum, appropriate policies and enthusiastic initiatives to attract technology and encourage its development are crucial to LDCs who want to continue to advance in the world economy. Information technology can help these countries become more competitive producers of goods and services. It can also help them to update their traditional modes of production and perhaps conserve some of the comparative advantages afforded them by their own national characteristics.

It is my thesis that those countries that prepare themselves for the advance of information technology will prosper, while those that choose not to do so will stagnate. As the leading development institution, the World Bank has a crucial role to play in helping these countries adapt to the information age.

What has the Bank been doing in this area? The recent advent of microcomputers and improvements in memory technology and portability have contributed to increased Bank involvement in transfer of information technology. Bank spending on information technology has grown at roughly 30 percent annually in the past six years, compared to 15 percent in the previous five years.

- The Bank gives support to projects involving a variety of levels of technology, ranging from a few microcomputers for a health and nutrition project to large mainframe computers for a petroleum exploration project.

- The Bank has also made use of information technology to assist member countries in automating statistical and economic data bases and developing reliable management systems.

- The IFC has recently established, on an interim and experimental basis, a Technology Service Program which will serve as a technology broker, matching demand in the private sectors of developing countries with appropriate suppliers.

Yet with one exception, the Bank has only supported information technology as a small component of other projects. And the cost of information technology as a percentage of total project cost is usually very small, five percent or less. There is some indication, then, that the World Bank's lending program is still oriented to an industrial age mindset and requires adjustment to an information age focus.

The Bank has a critical role to play in helping developing countries to gain access to and become more receptive to information technology. It must make a significant additional effort to support transfer of information technology in all aspects of its work.

Sector loans, which are traditionally conditioned to the adoption of proper policies, are an important tool here. Just as the Bank has sought to promote improved trade policies and more open trade regimes in developing nations, it could more broadly utilize sector loans to encourage policies which better protect intellectual property rights, liberalize trade in services, and open up investment regimes. Also, additional project loans could be supported to improve telecommunications and other support systems for information technology. Massive amounts of training are, of course, critical. Technical assistance could be enhanced with the target of making transfer of information technology a component of most World Bank activity in developing countries.

The Bank should consider how it might best focus its efforts on encouraging integration of information technology in the development process.

The information age is still accelerating. Many developing countries are at a crossroads where they must decide whether to participate by opening up their economies and attaining a higher standard of living for their people, or, alternatively, to stagnate and fall further behind. Self interest should compel the LDCs to work in GATT to open up their economies by liberalizing investment regimes, providing better protection for intellectual property rights, and reducing restrictions on trade in services.

Because of the enormous importance of the information age for the economies of LDCs, we have an obligation through the World Bank to train people and help build institutions and infrastructure. And of course the Bank, through its sectoral loan program, should help bring about the changes critical to LDCs' joining in the industrial age.

Ladies and Gentlemen, I thank you for your attention, and I will be delighted to take questions.

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1. Ostry, Sylvia, "Interdependence: Vulnerability and Opportunity," 1987 Per Jacobsson Lecture.

TREASURY NEWS

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September 19, 1988

Charles H. Dallara
Senior Advisor for Policy to the Secretary of the Treasury

Secretary of the Treasury Nicholas F. Brady today announced that Charles H. Dallara will serve as Senior Advisor for Policy to the Secretary of the Treasury. Mr. Dallara continues to serve as the U.S. Executive Director to the International Monetary Fund (IMF).

As Senior Advisor for Policy to the Secretary, Mr. Dallara will support the Secretary and Deputy Secretary in the monitoring and development of policies covering the full range of the Department's activities. He will also be responsible for the oversight of the Executive Secretary and the related functions.

Mr. Dallara has served in his current positions at the IMF and the Treasury since 1984. Prior to that, he held a variety of other positions at the Treasury, and served as the U.S. Alternate Executive Director at the IMF.

Mr. Dallara received his Ph.D., M.A., and M.A.L.D. from the Fletcher School of Law & Diplomacy, Tufts University, and a B.A. in economics from the University of South Carolina. He also served as an officer in the U.S. Navy from 1970-1974.

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TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 10:30 A.M. EDT

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Acceptance Ceremony for the
Lockheed P-3 Aircraft by the Customs Service
Hangar #6, Federal Aviation Administration
Washington National Airport
Tuesday, September 20, 1988

Thank you, Commissioner von Raab, and good morning, ladies and gentlemen. I took office just last Friday and this is my first formal event as Secretary of the Treasury. Nothing could suit me more, as it underlines the importance with which we in the Treasury view the War on Drugs. Ensuring a drug-free America is a high priority for all of us.

I am joining the efforts of a group of men and women I greatly respect. We are all grateful for the leadership of the President, our First Lady, Nancy Reagan, and Vice President George Bush.

Attorney General Dick Thornburgh and I have worked together in the past. I am looking forward to working with him again. Since he became Attorney-General, Dick has again shown us his gift for leadership by galvanizing our coordinated efforts.

The members of Congress here today (Senator Pete Domenici, Senator Dennis DeConcini, Senator Phil Gramm and Congressman Glenn English) show by their presence that same strength of purpose.

And when it comes to people like Willy von Raab and Commandant Paul Yost and the men and women of the Customs Service and the Coast Guard, we all express our appreciation and admiration for their level of commitment and dedication. But we do know that the American people understand both the importance and the frustrations in the fight against drugs.

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The Administration's continuity of drug enforcement efforts IS paying off. However, the pace of our progress will never be fast enough until illegal drugs are no longer available on American streets and all agree much work needs to be done.

The Treasury Department has done its part in the crackdown on drugs on at least three separate fronts. We are working hard to reduce the flow of drugs across our borders and having the P-3 as part of the Customs Service fleet marks a red-letter day in that effort. It gives Customs a new dimension for its interdiction efforts. Furthermore, this plane is a tangible result of what can happen when the Administration and Congress work together toward a worthwhile goal.

Second, we're working to close the doors on the places that the money-laundering drug kingpins hide their profits derived from poisoning our young people.

Third, Treasury agents have fanned out across the United States to seek out and prosecute the criminals who make a career of running the illegal drug network.

Drug abuse is a problem that doesn't respect national boundaries. But it can become a minor chapter in our history if we continue to stand together.

We must close down the sources, cut off the shipments, vigorously enforce the laws, wipe out the demand, and firmly but compassionately treat the addicted. This Blue Eagle Aircraft symbolizes our commitment to use every resource at our command to make sure that this happens.

Thank you.

TREASURY NEWS

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FOR RELEASE AT 4:00 P.M.
September 20, 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 September 29, 1988. This offering will provide about $900 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,097 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 26, 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 30, 1988, and to mature December 29, 1988 (CUSIP No. 912794 QY 3), currently outstanding in the amount of $6,766 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,000 million, to be dated September 29, 1988, and to mature March 30, 1989 (CUSIP No. 912794 RQ 9).

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

The bills will be issued for cash and in exchange for Treasury bills maturing September 29, 1988. In addition to the maturing 13-week and 26-week bills, there are $9,281 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 $1,964 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $2,064 million as agents for foreign and international monetary authorities, and $5,660 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).

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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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TREASURY NEWS

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

September 21, 1988

Contact: Art Siddon
566-5252

Secretary of the Treasury Brady Requests Treasury FSLIC Study

Secretary of the Treasury Secretary Nicholas F. Brady today directed the Treasury Department to review the position of the Federal Savings and Loan Insurance Corporation (FSLIC) in light of the variety of methodologies being used to arrive at potentially higher case resolution cost estimates.

The Treasury study will be headed by Under Secretary for Finance George D. Gould, who oversees Treasury's monitoring of the thrift industry. Mr. Gould will report his findings and recommendations directly to Secretary Brady.

Background

Under Secretary Gould recently testified before both the Senate and House Banking Committees on additional steps Congress should take before considering any taxpayer bailout of FSLIC. Those steps include:

- authorizing the remaining $5 billion in nontaxpayer recapitalization resources the Administration requested in 1986;
- utilizing the flexibility of the current FSLIC recapitalization plan to provide additional resources, if necessary, for both principal and interest payments on FSLIC's Financing Corporation bonds;
- enhancing the charter for a savings and loan association to attract more private capital to the industry;

- protecting insured depositors by using separately capitalized affiliates of a holding company to engage in state-chartered activities not permitted for federal S&Ls, if FSLIC determines such action is necessary;
- strengthening enforcement and supervisory authority; and
- extending expiring tax provisions on a temporary basis.

One of Mr. Gould's first assignments at Treasury was to devise the Administration's plan to recapitalize FSLIC with $15 billion of nontaxpayer funds in March 1986. This plan, together with FSLIC's normal resources, would have produced $25-30 billion to begin resolving insolvent savings and loan associations two and a half years ago. Congress approved a restricted $10 billion recapitalization in August 1987.

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

September 21, 1988

NICHOLAS F. BRADY
SECRETARY OF THE TREASURY

Nicholas F. Brady became the 68th Secretary of the Treasury on September 15, 1988.

Secretary Brady served in the United States Senate from April 20, 1982 through December 27, 1982. During that time he was a member of the Armed Services Committee and the Banking, Housing and Urban Affairs Committee.

In 1984 President Reagan appointed Secretary Brady Chairman of the President's Commission on Executive, Legislative and Judicial Salaries. He has also served on the President's Commission on Strategic Forces (1983), the National Bipartisan Commission on Central America (1983), the Commission on Security and Economic Assistance (1983), and the Blue Ribbon Commission on Defense Management (1985). Most recently, Secretary Brady chaired the Presidential Task Force on Market Mechanisms (1987).

Secretary Brady's career in the banking industry spans 34 years. He joined Dillon, Read & Co. Inc. in New York in 1954, rising to Chairman of the Board. He has been a Director of the NCR Corporation, the MITRE Corporation, and the H. J. Heinz Company, among others.

He has also served as a trustee of Rockefeller University and a member of the Board of The Economic Club of New York. He is a member of the Council on Foreign Relations, Inc. He is a former trustee of the Boys' Club of Newark.

Mr. Brady was born April 11, 1930 in New York City. He was educated at Yale University (B.A., 1952) and Harvard University (M.B.A., 1954). He and his wife, Katherine, have four children.

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TREASURY NEWS

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

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

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 4-YEAR NOTES TOTALING $15,750 MILLION

The Treasury will auction $8,750 million of 2-year notes and $7,000 million of 4-year notes to refund $17,473 million of securities maturing September 30, 1988, and to paydown about $1,725 million. The $17,473 million of maturing securities are those held by the public, including $2,210 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $15,750 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 prices of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $1,646 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 SEPTEMBER 30, 1988

September 21, 1988

Amount Offered to the Public ...	$8,750 million	$7,000 million
Description of Security:		
Term and type of security	2-year notes	4-year notes
Series and CUSIP designation ...	Series AF-1990 (CUSIP No. 912827 WR 9)	Series P-1992 (CUSIP No. 912827 WS 7)
Maturity date	September 30, 1990	September 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	March 31 and September 30	March 31 and September 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	Tuesday, September 27, 1988, prior to 1:00 p.m., EDST	Wednesday, September 28, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Friday, September 30, 1988	Friday, September 30, 1988
b) readily-collectible check ...	Wednesday, September 28, 1988	Wednesday, September 28, 1988

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

FOR IMMEDIATE RELEASE

September 22, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of August 1988.

As indicated in this table, U.S. reserve assets amounted to $47,778 million at the end of August, up from $43,876 million in July.

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					
July	43,876	11,063	8,984	14,056	9,773
Aug.	47,778	11,061	9,058	18,017	9,642

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.

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

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 10:45 A.M. EDT

Testimony of the Honorable
M. Peter McPherson
Deputy Secretary of the Treasury
before the
Legislation and National Security Subcommittee
of the
House Committee on Government Operations
September 22, 1988

Good morning, Mr. Chairman, and Members of the Committee. I appreciate the opportunity to comment on the proposed Financial Management Improvement Act.

While this Administration has made significant progress in improving Federal financial management in the areas of cash management, credit management/debt collection, accounting, financial reporting and internal controls, there is still much to do. Thus, we support the Comptroller General's legislation in order to continue the progress and improvement made over the last several years.

In my testimony today, I would like to share Treasury's specific positions with respect to the four key elements of the legislation. While I recognize the Chief Financial Officer issue is raised first in the draft legislation, I would like to address that issue last.

I. Financial Statements

Treasury supports the second key element of the proposed legislation--development of integrated financial statements. Financial statements measure the results of agency and governmentwide asset and liability management and also provide "early warnings" of emerging concerns before they become major problems.

We share your belief, Mr. Chairman, that the financial statements must accurately portray the Government's financial position and be understandable to users. Further, the statements must present financial results objectively, on a consistent basis, and take into account the unique character of the Federal Government.

While there are still some accounting issues that need to be resolved, none are insurmountable or need cause delay.

II. Audit Requirements

Second, the legislation would require annual audits of the financial statements. While Treasury recognizes the need for audits and supports the concept, Treasury opposes annual auditing because it is not practical at this time. In the Department alone, there are over 21 accounting systems and approximately 100 other miscellaneous fund accounts. Performing annual audits on all these systems and accounts would drain most audit resources away from contract and program audits, which are high-priority activities helping to ensure the integrity of Treasury's operations. Treasury recommends a cyclical audit schedule established by the CFO in coordination with the Inspectors General in order to best allocate scarce audit resources.

III. Agency Controllers

Third, Treasury supports the proposed provision that would legislatively establish agency controllers. While agencies currently have designated financial officers, the legislation will place a more appropriate level of importance on the function.

IV. Chief Financial Officer

And now I return to the CFO issue. The Administration strongly supports the concept of a Chief Financial Officer (or CFO) for the Federal Government. In July 1987, Jim Miller established a CFO administratively to provide the leadership and organization to rectify the widely recognized deficiencies in Federal financial management. A statutory CFO would further strengthen the efforts underway by mandating a governmentwide financial structure that could provide the needed organization, direction, and guidance.

The organizational location of the CFO, however, is an issue still open to debate. There are pros and cons to locating the CFO in OMB, and pros and cons to locating the CFO in Treasury, as proposed by this legislation.

The arguments for keeping the CFO at OMB are:

- OMB is in the Executive Office of the President, and has a leadership role;
- OMB oversees the budget process and approves funding for financial management systems; and
- During this Administration, OMB has provided strong leadership which, in partnership with Treasury, has led to significant progress in improving Federal financial management.

(As an aside, I would like to note that the strong leadership from OMB in this area can largely be attributed to Joe Wright and his eight year personal commitment to improving management in the Federal Government. It is rare for a senior government official to dedicate himself to a long-term view of "good government," and even rarer for someone to make as great a difference as Joe has.)

The arguments against are:

- Of the 33 functions of a CFO, OMB currently provides policy direction and shares responsibility--with Treasury--for ten other functions. In contrast, Treasury is involved in 31 of the 33 functions.

- OMB institutionally focuses most of its efforts on the budget process, and, more specifically, on program funding decisions; by necessity, other matters traditionally receive less attention and priority at OMB.

- OMB currently does not have the staff or the in-depth technical expertise to implement the full range of CFO functions.

The arguments for placing the CFO in Treasury are:

- Treasury is already performing most CFO-type responsibilities. Of 33 typical CFO functions, Treasury performs 18 independently, and is a key player in 13 others.

- The CFO function is a logical extension of Treasury's responsibilities. Treasury is already the Federal Government's cash manager, debt manager, central operating accountant, the central source for governmentwide financial reports, manager of central financial systems, and the financial operational link for all government agencies.

- Treasury also collects most of the Government's revenue and disburses most of its payments.

- Moreover, Treasury already has an organization and staff in place that could quickly be adapted to support a statutory CFO.

For example, the Financial Management Service within the Treasury has:

- 212 professional accountants,
- 209 computer professionals,
- 76 financial specialists, and
- 2,000 operations personnel.

- o Finally, a Treasury-located CFO could draw upon the wealth of financial and economic expertise that already exists within the Treasury.

The primary argument against a Treasury-located CFO is that:

- o The Treasury Department is not in the Executive Office of the President and does not control the agency budgets. The budget process has been an important tool in bringing about changes in the process.

Overall, I want to stress that I strongly support a statutory CFO, regardless of its ultimate location.

I would like to add two technical points here relating to the CFO provision. If the legislation ultimately placed the CFO in Treasury, we would urge that the CFO functions be assigned to the Secretary of the Treasury, thus preserving the Secretary's management prerogatives, although we would not object to establishing an additional Under Secretary position. In addition, Treasury believes that a standard Presidential appointment of an Under Secretary would be more appropriate than the proposed eight-year term, because it limits necessary Secretarial and Presidential management prerogatives.

* * *

In conclusion, Mr. Chairman, Treasury supports the proposed legislation and recommends the specific modifications I addressed. The time is right for moving forward because it is the logical next step in our joint and continued efforts to improve Federal financial management.

Mr. Chairman, I thank you for the opportunity to appear before the Subcommittee and I am available to answer any questions.

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

September 22, 1988

Contact: Art Siddon
566-5252

ADMINISTRATION OPPOSES ENERGY AND COMMERCE COMMITTEE AMENDMENTS

Under Secretary of the Treasury for Finance George D. Gould today expressed the Administration's strong opposition to the controversial amendments reported by the House Energy and Commerce Committee. The amendments were to the Depository Institution Act of 1988 already reported by the House Banking Committee on a 31-20 vote on July 28, 1988.

"For years, we have encouraged Congress to step forward and make the hard decisions to modernize outdated statutes in ways that promote greater competition, benefit consumers, and equalize regulatory burdens of financial services providers. The Energy and Commerce action today, on top of earlier action by the House Banking Committee, demonstrates that the House of Representatives is not prepared to move forward into the modern financial world. Their collective action is two steps backwards, retreating into a protectionist, anti-competitive regime left over from the 1930s," Gould said.

"If Congress wants to do something in the public interest before it adjourns and accommodate innovation in the future, it should simply pass those provisions in the Senate bill repealing the Glass-Steagall Act and building new firewalls to ensure the safety and soundness of our financial system," Mr. Gould declared.

"In light of today's rapidly evolving financial world, it is critical for the United States to act in a positive fashion, particularly because of the increasing global competition that we face from our major trading partners in the delivery of financial services."

The Administration supports much of the Financial Modernization Act, which passed the Senate by a 94-2 vote on March 30, 1988. It repeals parts of the Glass-Steagall Act and re-writes the Bank Holding Company Act in ways that would bring new capital and new competition to investment banking. Bank holding companies could establish separately capitalized

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 22, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,029 million of 52-week bills to be issued September 29, 1988, and to mature September 28, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.47%	8.03%	92.447
High -	7.48%	8.04%	92.437
Average -	7.48%	8.04%	92.437

Tenders at the high discount rate were allotted 82%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 13,415	$ 13,415
New York	25,058,465	8,202,130
Philadelphia	9,710	9,710
Cleveland	12,505	12,505
Richmond	76,730	24,930
Atlanta	12,875	12,875
Chicago	1,196,905	115,105
St. Louis	14,965	10,965
Minneapolis	12,975	7,975
Kansas City	23,565	23,565
Dallas	20,235	10,235
San Francisco	1,507,045	432,545
Treasury	152,850	152,850
TOTALS	$28,112,240	$9,028,805
Type		
Competitive	$25,388,750	$6,305,315
Noncompetitive	423,490	423,490
Subtotal, Public	$25,812,240	$6,728,805
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	100,000	100,000
TOTALS	$28,112,240	$9,028,805

An additional $372,300 thousand of the bills will be issued to foreign official institutions for new cash.

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TREASURY NEWS

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CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 26, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,019 million of 13-week bills and for $ 7,004 million of 26-week bills, both to be issued on September 29, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 29, 1988			26-week bills maturing March 30, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.19% a/	7.42%	98.183	7.41%	7.80%	96.254
High	7.25%	7.49%	98.167	7.49%	7.89%	96.213
Average	7.23%	7.47%	98.172	7.48%	7.88%	96.218

a/ Excepting 2 tenders totaling $2,650,000.

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 44%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 27,940	$ 27,940	$ 26,375	$ 26,375
New York	19,743,650	5,738,650	20,249,925	5,864,925
Philadelphia	18,275	18,275	20,840	20,840
Cleveland	53,610	53,610	30,200	30,200
Richmond	36,430	36,430	40,885	40,885
Atlanta	30,495	30,495	26,725	26,725
Chicago	903,795	135,295	731,805	71,205
St. Louis	22,520	22,520	37,665	33,665
Minneapolis	5,435	5,435	10,290	10,290
Kansas City	24,370	24,370	51,620	51,620
Dallas	31,055	31,055	32,240	24,440
San Francisco	1,137,895	562,035	1,082,470	290,470
Treasury	333,075	333,075	512,460	512,460
TOTALS	$22,368,545	$7,019,185	$22,853,500	$7,004,100
Type				
Competitive	$19,451,380	$4,102,020	$18,583,690	$2,734,290
Noncompetitive	890,955	890,955	1,050,310	1,050,310
Subtotal, Public	$20,342,335	$4,992,975	$19,634,000	$3,784,600
Federal Reserve	1,828,510	1,828,510	1,650,000	1,650,000
Foreign Official Institutions	197,700	197,700	1,569,500	1,569,500
TOTALS	$22,368,545	$7,019,185	$22,853,500	$7,004,100

1/ Equivalent coupon-issue yield.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 10:00 a.m. EST
September 27, 1988

STATEMENT OF
THOMAS S. NEUBIG
DIRECTOR AND CHIEF ECONOMIST
OFFICE OF TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss the results of the Treasury Department's Interim Report to the Congress on Life Insurance Company Taxation. The Deficit Reduction Act of 1984 (the "1984 Act") substantially altered the tax treatment of life insurance companies and their products. During the consideration of the life insurance company provisions, the Congress expressed concern about two issues: (1) the amount of taxes paid by companies in the life insurance industry; and (2) the relative tax burden of mutual (policyholder-owned) and stock (shareholder-owned) life insurance companies. The interim report responds to the congressional directive contained in the 1984 Act that the Treasury Department conduct a study of those issues.

My testimony today will first discuss the rules governing the taxation of life insurance companies before and after the 1984 Act. Second, I will discuss the results of the Treasury Department's interim report on the amount of taxes paid by life insurance companies since the 1984 Act and the relative tax burdens of the mutual and stock segments of the life insurance industry. The analysis of the revenue effect of the 1984 Act is based upon data reported to the Treasury Department in a special survey of life insurance companies. These data are an important improvement over information previously available from financial statements and IRS statistics.

Although the interim report contains information that may assist the Congress in its review of these issues, I would like to emphasize at the outset that the Treasury Department is not here today either to evaluate the success of the 1984 Act in properly taxing life insurance companies or to suggest the appropriate tax burden of the life insurance industry or the mutual or stock segments. We intend to continue our analysis of life insurance company tax rules and possible changes, and to present the final report on life insurance company taxation to the Congress early next year.

I. Summary of Prior and Current Law Taxation of Life Insurance Companies

Since 1921, life insurance companies have been subject to tax under three different sets of rules. Between 1921 and 1958, life insurance companies were taxed only on "free" investment income. Free investment income was the amount of investment income that was not needed to fund obligations to policyholders. This amount was calculated under formulas that changed over the years. Income and losses from underwriting operations (*e.g.*, premium income and benefits paid to policyholders) were ignored as were gains and losses from the sale of investment assets.

Between 1958 and 1984, life insurance companies were taxed under a complex "three-phase" system enacted by the Life Insurance Company Tax Act of 1959 (the "1959 Act"). The three phases referred to the three different tax bases that could be applicable to a life insurance company. The first tax base was the company's free ("taxable") investment income. The second tax base was the company's gain from operations. The gain from operations tax base included premium income and investment income not needed to fund obligations to policyholders. In calculating gain from operations, deductions were allowed for additions to reserves for future obligations. The amount of the reserve deductions was generally equal to the amount of the additions to the reserves required by state regulators. In addition, limited deductions were allowed for policyholder dividends and certain "special deductions."

Under the 1959 Act, a life insurance company was taxed on the lesser of its taxable investment income or its gain from operations. In calculating its gain from operations, however, the amount of deductions for policyholder dividends and special deductions was limited to $250,000, plus the amount by which the gain from operations (before these deductions) exceeded taxable investment income. Thus, these deductions could not reduce a company's taxable income to more than $250,000 below its taxable investment income. If a company's gain from operations exceeded its taxable investment income, the company was taxed on 50 percent of such excess. The untaxed gain from operations (along with the special deductions) was added to a deferred tax account and, subject to certain limitations, was taxed only when distributed to shareholders. When triggered, this deferred tax account was the third tax base under the 1959 Act.

The existence of multiple tax bases under the 1959 Act produced differing tax treatment of different types of income. For example, a company that had reached the limit on the deduction of policyholder dividends and special deductions would be taxed on the receipt of additional investment income, but not on the receipt of additional underwriting income. Life insurance companies were able to manipulate the character of their income by entering into so-called "modified coinsurance" transactions.

In a modified coinsurance transaction, the ceding company retained ownership of the assets and the reserve liabilities connected with the risks reinsured. Former section 820 of the Code, however, permitted the parties to treat the transaction as if the assets and reserves had been transferred to the reinsurer. As part of a modified coinsurance transaction, the reinsurer would pay "experience refunds" to the ceding company. The experience refunds reflected investment income earned by the ceding company (which under section 820 was deemed to be earned by the reinsurer) but were characterized as underwriting income to the ceding company. Thus, a modified coinsurance transaction had the effect of converting taxable investment income of the ceding company into more favorably taxed (or untaxed) underwriting income.

The special treatment of modified coinsurance transactions under former section 820 of the Code was repealed by the 1982 Act. At the same time, however, the limitation on the deductibility of policyholder dividends was revised for a temporary two-year period. In general, under the revised limitation, a partial deduction (85 percent for stock companies and 77.5 percent for mutual companies) was allowed for all policyholder dividends. Several other favorable tax provisions were enacted for a temporary two-year period.

The rules for taxing life insurance companies were substantially revised in 1984 in response to concerns that the 1959 Act rules were unduly complex, did not work well in a high interest rate environment, and taxed life insurance companies differently from other corporations. Under the 1984 Act, life insurance companies are taxed on a single income tax base corresponding generally to the tax base applicable to other corporations. Many of the special deductions and accounting rules that had applied under the 1959 Act were repealed. Even with these changes, however, the tax base of life insurance companies differs from that of other corporations in three significant respects.

First, 1984 Act allowed life insurance companies a "special life insurance company deduction" and a "small life insurance company deduction." The "special" deduction, which was repealed by the Tax Reform Act of 1986, was equal to 20 percent of the company's taxable income from insurance businesses, and had the effect of reducing the maximum marginal rate of tax on this income from 46 percent to 36.8 percent. The "small company" deduction, which applies to companies with assets of less than $500 million, is equal to 60 percent of the first $3 million of the company's taxable income from insurance businesses, and is phased out at income levels of between $3 million and $15 million.

Second, as under the 1959 Act, life insurance companies are allowed to deduct additions to life insurance reserves and similar items. In calculating the maximum amount of the reserves, the 1984 Act required that the reserves be calculated using Federally prescribed rules. In general, the Federally prescribed reserve rules specify a tax reserve method and require use of the highest interest rate and most recent mortality or morbidity table permitted to be used by insurance regulators in a majority of states. For taxable years beginning after 1987, the interest rate that must be used in calculating reserves is the greater of the prevailing state rate or a five-year average of the Federal mid-term rate.

Third, to address the perceived tax advantage of the mutual form of organization, the 1984 Act imposed a limitation on the deduction by mutual life insurance companies of policyholder dividends. Under section 809 of the Code, the deduction of policyholder dividends by a mutual company is reduced by the company's "differential earnings amount." The differential earnings amount is equal to the product of the mutual company's average equity base and the "differential earnings rate." The differential earnings rate, in turn, is equal to the excess of the "imputed earnings rate" (90.55 percent of a three-year average of the earnings rates of the 50 largest stock life insurance company groups) over the average earnings rate of all mutual life insurance companies for the second calendar year preceding the taxable year. The differential earnings amount for a taxable year is "recomputed" in the subsequent taxable year. The recomputed amount reflects the average mutual earnings rate for the calendar year in which the taxable year begins (rather than the second preceding calendar year). The difference between the differential earnings amount and the recomputed differential earnings amount (the so-called "true-up") is included in income, or deducted, in the subsequent year.

For example, the differential earnings amount of mutual companies for 1985 was calculated using the 1983 average mutual earnings rate of 10.166 percent. The recomputed differential amount for 1985 was calculated using the 1985 average mutual earnings rate of 13.135 percent. The difference between the differential earnings amount for 1985 and the recomputed differential earnings amount for 1985 (*i.e.*, 2.969 percent of each company's 1985 average equity base) was allowed as a deduction in calculating the taxable income of each mutual life insurance company in 1986.

Prior to 1981, life insurance companies were not permitted to join in the filing of consolidated income tax returns with affiliated corporations that were not life insurance companies. Thus, income and losses of life insurance companies and affiliated non-life companies could not be used to offset one another. The filing of consolidated returns by life and non-life companies has been permitted since 1981, subject to two restrictions. First, consolidated returns may be filed by a life company and a non-life company only if they have been affiliated for the preceding five years. Second, the amount of non-life losses that can be offset against the income of life companies is limited to the lesser of 35 percent of the non-life losses or 35 percent of the life company income. The latter restriction does not limit the use of life insurance losses to offset income of non-life affiliates.

II. Analysis of the Revenue Effects of Recent Legislation Changing the Taxation of Life Insurance Companies

Revenue estimates generally depend on four factors: (1) the level of economic activity, including both the macro-economic national forecast as well as the market share of the particular economic activity affected; (2) the taxpayers' economic situation, including types of products sold, portfolio choice, and form of organizations; (3) how the specific changes in the tax law affect particular taxpayers' economic situations independent of behavior changes; and (4) how taxpayers react to the tax law changes. If these factors are misspecified or forecasted incorrectly, estimated receipts will differ from actual collections. "Offsetting" errors will often reduce the discrepancy (*e.g.*, an overestimated tax rate may be accompanied by an underestimated tax base), but the chances of this occurring for estimates that affect a specific industry or particular companies are much less likely. As a result of the many different factors involved, it is difficult to estimate accurately the revenue effects of proposed tax legislation.

Estimates of the four revenue estimating factors described above for the life insurance industry were generally based on historical data from tax returns and regulatory data. With respect to the 1982 and 1984 life insurance company tax changes, the data were particularly difficult to interpret for three reasons: (1) the occurrence of significant changes in the insurance industry and its products; (2) the different definitions of the life insurance industry in the available data sources; and (3) the effect of consolidation on life insurance industry tax statistics. The Appendix appearing at the end of this testimony contains a discussion of the data that were available at the time the estimates of the 1984 Act were made.

For the life insurance industry during the 1980's, it has been particularly difficult to estimate revenue changes, because of the changing nature of the industry's products and practices, the limitations of the available information, and the significant tax law changes. The use of modified coinsurance from 1979 to 1981 unexpectedly decreased insurance industry taxes. The explosion of new life insurance products in the early 1980's, the availability of consolidation with non-life insurance companies starting in 1981, and the temporary tax law changes combined with the general economic downturn in 1982-83 made predicting the amount of industry revenues before the 1984 Act changes difficult. Finally, the complete overhaul of the life insurance industry's tax rules in 1984 made estimating the effects on the industry and the consequent tax collections extremely uncertain.

Estimated Revenue Effects at the Time of the 1984 Act

The complete overhaul of the life insurance industry's tax rules in 1984 made it extremely difficult to estimate the revenue effects of specific tax provision changes. Thus, the principal focus of the legislative debate was on the expected receipts from the industry after the tax law changes, rather than the revenue change from the legislation. Nevertheless, estimates by the Treasury and the Joint Committee on Taxation (JCT) of the level of receipts from the industry after the 1984 Act were quite similar. The level of receipts from the life insurance industry after the 1984 Act changes was expected to grow from $3.0 billion in calendar 1984 to between $3.8 and $3.9 billion in 1988, as shown in Table 1. These estimates took into account the effects of consolidation for the life insurance subgroups.

Estimates of the revenues from the mutual and stock segments of the life insurance industry were made for 1984, as shown in Table 2. For calendar year 1984, the total life insurance industry was expected to pay $3.0 billion, with approximately 55 percent paid by the mutual segment ($1.6 billion with rounding) and 45 percent paid by the stock segment ($1.4 billion).

Total Life Insurance Industry Taxes Paid in 1984 and 1985

To obtain information on taxes paid by life insurance companies in 1984 and 1985, the Treasury Department conducted a special survey of life insurance companies. The Treasury Department's survey was sent to the largest (measured by assets) 50 mutual life insurance companies, the largest 198 stock life insurance companies, and a random sample of smaller mutual and stock companies.

Table 3 presents the estimates of taxes paid by the life insurance industry[1] from the Treasury survey in terms comparable to those used in the original estimates of receipts from the 1984 Act shown in Table 2. The life insurance industry paid $2.4 billion in taxes in calendar year 1984, compared to $3.0 billion

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[1] Taxes paid are as reported on Federal tax returns but may differ from actual collections of the Federal government in cases of consolidated returns with non-life losses.

Table 1

Treasury and Joint Committee Estimates of Life Insurance Industry Receipts Before and After the 1984 Act Changes
($ billions)

	Fiscal Year				
	1984	1985	1986	1987	1988
Treasury Estimates					
Baseline Before 1984 Act	3.0	4.0	4.3	4.6	5.0
1984 Act Changes	-0.5	-0.9	-1.0	-1.1	-1.2
Baseline After 1984 Act	2.5*	3.1	3.3	3.5	3.8
Joint Committee on Taxation Estimates					
Baseline Before 1984 Act	3.1	3.5	3.7	4.1	4.4
1984 Act Changes	-0.1	-0.3	-0.4	-0.5	-0.5
Baseline After 1984 Act	3.0	3.1	3.4	3.6	3.9

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Treasury, Office of Tax Analysis and the Joint Committee on Taxation, calculations as of June 1984 at the end of the Conference Committee.

Details may not add due to rounding.

* Difference in FY 1984 estimate from JCT due to Treasury's lower estimate of 1983 CY receipts with the full effect of end of the CY 1982 and 1983 safety net rules shown in the change between FY 1984 and 1985. The Treasury's 1984 calendar year receipts estimate was $3.0 billion.

Table 2

Estimate of Calendar Year 1984 Life Insurance Industry Tax
Liabilities After the 1984 Act Changes
by Mutual and Stock Segments Made at The Time of the Legislation
($ billions)

	Mutual Life Companies	Stock Life Companies	Total
Gain From Operations 1/	10.7	6.0	16.7
Less: Allowable Policyholder Dividends 2/	5.6	1.7	7.3
Gain From Operations After Policyholder Dividends	5.1	4.3	9.4
Less: Net Operating Loss Deductions	*	0.4	0.4
Less: Small Business Deduction	*	0.2	0.2
Less: Special Life Insurance Deduction	1.0	0.7	1.7
Net Income Less Deficits	4.1	3.0	7.1
Taxable Income	4.2	3.1	7.3
Tax Before Credits	1.9	1.4	3.3
Less: Tax Credits	0.3	0.1	0.4
Tax After Credits	1.6	1.4	3.0

Department of the Treasury
Office of Tax Analysis

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SOURCE: Office of Tax Analysis August 1984 calculations.

1/ After adjustment for change in reserve deductions.

2/ Estimate of mutual segment's allowable policyholder dividends assumed a $37.4 billion equity base and a 16.5 percent applicable imputed earnings rate.

*Less than $50 million.

Detail may not add due to rounding.

Table 3

Life Insurance Industry 1/ Tax Liabilities for
Mutual and Stock Segments for 1984 and 1985
($ billions)

	1984			1985		
	Mutual Life Companies 2/	Stock Life Companies	Total	Mutual Life Companies 2/	Stock Life Companies	Total
Gain From Operations 3/	11.3	10.2	21.5	13.9	11.3	25.2
Less: Allowable Policyholder Dividends	8.0	4.2	12.2	8.7	4.9	13.6
Gain From Operations After Policyholder Dividends	3.2	6.0	9.3	5.2	6.4	11.6
Less: Net Operating Loss Deductions	0.4	1.7	2.0	0.8	1.0	1.8
Less: Small Business Deduction	0.1	0.2	0.2	0.1	0.2	0.3
Less: Special Life Insurance Deduction	0.6	0.9	1.5	0.8	1.2	2.0
Taxable Income 4/	2.3	3.4	5.7	3.4	4.0	7.4
Tax Before Credits 4/	1.0	1.4	2.4	1.4	1.6	3.0
Less: Tax Credits	*	*	0.1	0.1	*	0.1
Tax After Credits 4/	1.0	1.4	2.4	1.3	1.6	2.9

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Preliminary results from 1987 Treasury Department Survey of Mutual and Stock Life Insurance Companies.

NOTE: All figures weighted to estimate industry totals. Figures exclude specially surveyed Canadian-owned companies.

* Not available
1/ Includes companies that file separate, life/life consolidated, or life/nonlife consolidated returns.
2/ Includes stock life insurance company subsidiaries of mutual life companies.
3/ For comparability with Table 3.3, before policyholder dividend deductions and net operating loss deductions and after income offset by nonlife losses.
4/ Taxable income includes mutual segment "true-up" in 1985 of approximately $0.95 billion for an additional $0.35 billion tax liability in 1985 reflecting the mutual segment's 1984 actual experience. Taxable income of the mutual segment in 1986, not shown on this table, includes a negative "true-up" of approximately $0.95 billion for a reduction of $0.35 billion tax liability in 1986 reflecting the mutual segment's 1985 actual experience.

estimated at the time of the 1984 legislation.[2] The life insurance industry paid $2.9 billion in calendar year 1985, compared to $3.2 billion estimated at the time of 1984 legislation.

The taxes paid by the life insurance industry shown in Table 3 are determined on a life subgroup basis, allowing for losses from consolidated non-life companies to offset partially the life subgroup's taxable income and for some reallocation of tax credits between the subgroups. The use of the life subgroup after consolidation basis permits comparison with the revenue estimates made at the time of the 1984 Act. In evaluating the tax rules of life insurance companies, however, it may be appropriate to examine the tax law effects of the life subgroup before consolidation with non-life companies. Estimates of tax liabilities of the life subgroup before consolidation are contained in the Appendix to this testimony.

The shortfall in expected revenues from the life insurance industry in 1984 is largely attributable to an underestimate of $1.6 billion of allowable net operating loss deductions. The shortfall in expected revenues in 1985 is also largely attributable to an underestimate of allowable net operating loss deductions.

The large net operating loss deductions claimed in 1984 and 1985 were an unexpected result of the 1982 Act's temporary relief provisions, the availability of consolidation, and the economic downturn in 1983. The temporary relief provisions removed the limitation on deductions of policyholder dividends contained in the 1959 Act, permitting the accumulation of large net operating losses in 1982 and 1983. According to IRS data, life insurance companies generated $5.5 billion in net operating losses in 1982 and 1983. Before 1980, the largest annual deficit for the industry had been less than $250 million.[3] Almost $4 billion of these net operating losses were carried forward as deductions in 1984 and 1985. Because of normal lags in reporting of tax statistics, this effect of the 1982 Act was not apparent at the time the revenue estimates were made for the 1984 Act.

Gain from operations before policyholder dividends was about $4.8 billion higher in 1984 than projected, but policyholder dividends were $4.9 billion higher. Although these differences offset each other for the industry, they did not for the stock

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[2] Tax liability generated from life insurance activity may affect tax payments in future years. For instance, the "true-up" for section 809, and the carryover of unused net operating losses and tax credits from 1984 activity affect 1985 tax payments.

[3] Department of the Treasury, Interim Report to the Congress on Life Insurance Company Taxation, p. 41.

and mutual segments separately, as discussed below. These offsetting differences are largely due to the 1984 Act's change in the definition of policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Under the 1984 Act, policyholder dividends specifically include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction), premium adjustments, and experience-rated refunds. Because of these changes, gain from operations after policyholder dividends is the most comparable measure of what was projected at the time of the 1984 Act.

Segment Balance Receipts in 1984

The revenue estimates of the 1984 Act projected that the mutual segment of the life insurance industry would pay approximately $1.6 billion in tax and the stock segment would pay approximately $1.4 billion in tax in 1984. Actual collections from the industry in 1984 were $1.0 billion for the mutual segment (or $1.35 billion including the "true-up" for 1984 paid in 1985) and $1.4 billion for the stock segment.

The stock segment paid approximately the same amount of tax after credits in 1984 as estimated at the time of the legislation. The stock segment's taxable gain from operations after policyholder dividends was $1.7 billion higher than estimated. The stock segment's higher taxable income (net of the special life insurance deduction) was offset almost exactly by the underestimate of its net operating loss deductions.

The mutual segment paid less tax in 1984 than originally estimated at the time of the legislation due to an overestimate of the mutual segment's gain from operations after policyholder dividends. Unlike the stock segment, whose gain from operations before policyholder dividends increased by more than the increase in its policyholder dividends, the mutual segment's gain from operations before policyholder dividends was higher by only $0.6 billion while its allowable policyholder dividend deductions were higher than estimated by $2.4 billion.

Approximately one-quarter of the $1.5 billion overestimate of the gain from operations (after policyholder dividends and the special life insurance deduction) was due to an overestimate of the mutual segment's average equity for purposes of the section 809 policyholder dividend deduction limitation. The 1984 estimates assumed that the mutual segment's average equity base would be $37.4 billion. The actual mutual equity base as reported by the IRS for 1984 was $32.1 billion. The overestimate of the mutual equity base resulted in allowance of approximately $0.4 billion additional policyholder dividend deductions, or approximately $150 million less tax liability, assuming a 36.8 percent marginal tax rate in 1984.

The overestimate of the mutual segment's equity was the result of two factors. First, the estimated equity was based on regulatory data, which differ in scope and measurement from the tax definitions used in section 809. Second, possible tax-minimizing behavior on the part of the mutual segment in reducing their equity as measured for section 809 purposes may have been underestimated.

The mutual segment had an additional tax liability in 1985 due to their lower than expected earnings rate in 1984. The mutual segment had an average earnings rate (i.e., gain from operations after policyholder dividends) of 5.746 percent in 1984. Thus, the recomputed differential earnings rate for 1984 was 10.754, as compared with the statutory 7.8 percent "transition" differential earnings rate for 1984. Consequently, the mutual segment paid a "true-up" rate of 2.954 percent of their 1984 average equity on their 1985 tax returns. The additional taxable income in 1985 from the 1984 "true-up" was approximately $950 million, or an additional $350 million in tax liability, assuming a 36.8 percent marginal tax rate.

Segment Balance Receipts in 1985

The original estimates of the 1984 Act implied approximately $3.2 billion in receipts, $1.7 billion paid by the mutual segment and approximately $1.4 billion paid by the stock segment of the life insurance industry in calendar year 1985. Actual receipts from the two industry segments estimated from the Treasury survey shown on Table 3 indicate the mutual segment paid $1.3 billion ($0.6 billion excluding the estimated $350 million 1984 "true-up" reflected in 1985 returns and the negative $350 million 1985 "true-up" reflected in 1986 returns), and the stock segment paid $1.6 billion.

The stock segment's tax payments in 1985 were higher than in 1984 due to an increase of approximately 10 percent in gain from operations and a $0.7 billion decline in net operating loss deductions. Both the stock and mutual segments realized large amounts of capital gains in 1985 which increased their gains from operations, and their earnings rates for section 809 purposes.

The mutual segment's tax payments in 1985 were lower than estimated due to a smaller gain from operations after policyholder dividends and a larger net operating loss deduction. The mutual segment's gain from operations after policyholder dividends in 1985 was about the same as that projected for it in 1984, and thus none of the expected growth in gain from operations occurred. In addition, the mutual segment's net operating loss deduction increased to $0.8 billion in 1985, when no significant amount of net operating loss deductions by mutual companies was anticipated in 1985. These two differences account for most of the shortfall in expected revenues in 1985.

The mutual segment's gain from operations after policyholder dividends in 1985 of $5.2 billion included approximately $950 million attributable to the "true-up" from 1984 resulting from the higher recomputed differential earnings rate. Thus, approximately $350 million of additional tax liability that was attributable to 1984 activity was paid by mutual companies in 1985. In addition, the mutual companies' 1985 differential earnings rate was calculated as 6.157 percent, but the 1985 recomputed differential earnings rate was only 3.188 percent. Thus, a negative "true-up" rate of -2.969 percent arising from 1985 activity resulted in approximately $950 million less taxable income in 1986. The negative 1985 "true-up" reduced mutual companies' tax liability in 1986 by approximately $350 million. If both the 1984 "true-up" and the 1985 negative "true-up" are excluded from the 1985 figures, the mutual segment's tax liability for 1985 would be $0.6 billion.

After excluding the 1984 "true-up", the mutual segment's gain from operations after policyholder dividends was $4.3 billion in 1985. Like 1984, the mutual segment's gain from operations after policyholder dividends and the special life insurance deduction was overestimated by approximately $850 million. A combination of explanations are possible:

- o The activity of the mutual segment was overestimated, possibly resulting from an overestimate of total life insurance activity, the mutual segment's market share of the industry, or the mutual segment's rate of profitability on its life insurance business.

- o The equity base of mutual companies in 1985 was overestimated as it was in 1984. The overestimation of the mutual equity base accounts for approximately one-quarter of the difference.

- o Taxable gains from operations may have been overestimated by underestimating the companies' tax-minimizing behavior.

- o The original estimates underestimated the earnings rates of the stock segment during the 1981-83 period which enter into the calculation of the imputed earnings rate under section 809. The statutory rate of 16.5 percent was thought to be higher than the average earnings rate of the 50 largest stock company groups during the 1981-83 base period. In fact, the average stock earnings rate during the base period was 18.221 percent, which resulted in the 1985 imputed earnings rate (16.323 percent) being lower than the 1985 current stock earnings rate (18.026 percent).

III. Conclusion

The recent changes to life insurance company taxation have resulted in less additional revenue than had been predicted. In particular, the tax payments of the life insurance industry and the relative shares paid by the different industry segments in 1984 and 1985 did not meet Congressional expectations.

Differences between estimated receipts and taxes paid largely reflect the difficulty in predicting accurately life insurance company taxes. Actual income tax collections depend on a number of factors which are difficult to predict accurately, including general macroeconomic conditions and relative market shares of and within the life insurance industry. Moreover, the significant changes in the practices of life insurance companies, their products, and tax rules during the last decade and the inadequacies of available data upon which to base estimates have magnified prediction problems. Thus, the "shortfall" in actual collections does not necessarily imply that the 1984 Act changes have not been effective in taxing life insurance companies more like other corporations.

The Treasury Department believes that it is more appropriate for tax legislation to attempt to measure accurately the economic income of companies than to attempt to collect a particular amount of revenue from an industry or from the different segments of an industry. We intend to continue to evaluate the tax rules affecting life insurance companies and to report to the Congress early next year.

This concludes my prepared remarks. I would be happy to answer any questions.

APPENDIX

Comparison of Tax Liabilities From Different Data Sources

Several measures of tax liabilities of the life insurance industry were available at the time the 1984 estimates were made. The most readily available industry data are from financial statements. However, these data are based upon a definition of the group of companies that comprise the life insurance industry that is different from the tax definition of the life insurance industry. Financial statement information and tax statistics also use different concepts to measure income and taxes. On the other hand, the tax statistics published by the IRS include only partial information regarding the effects of consolidation. As a result of these defects in the available data, the Treasury Department conducted a special survey of life insurance companies to evaluate the taxation of life insurance companies. The Treasury survey was designed to assess accurately the taxes paid by the life insurance industry both before and after consolidation with non-life companies using the tax code's definition of the industry, taxable income, and tax liability.

Table 4 compares preliminary estimates of tax liabilities of the life insurance industry reported on the Treasury's survey with statistics from other sources.[4] The table shows seven different measures of tax liabilities of the life insurance industry in 1984 and 1985. The first three measures in Table 4 are liabilities on life insurance company tax returns as reported in the Treasury survey. These measures use tax return statistics and the tax definition of life insurance companies. The first two survey measures are tax after credits. The only difference between the first two survey measures is the degree of consolidation with non-life companies. The third survey measure is tax before credits. The third survey measure differs from the first two, because it does not include the effects of consolidation or take into account tax credits.[5] In general, "all consolidated companies" includes the effects of income and allowable losses of all companies filing consolidated returns with a life insurance company, and "life insurance subgroup (after non-life losses)" includes the effects of allowable losses of non-life companies filing consolidated returns with a life company. The "life insurance subgroup (before non-life losses)" does not include the effects of allowable losses of non-life affiliated companies.

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[4] The Treasury survey requested the latest available tax return information including amended returns as of August 1987. Later amended returns and audit adjustments will result in further changes in tax liability.

[5] Tax after credits was not calculated for the life subgroup (before non-life losses) because the survey collected tax credits used on a consolidated basis.

The fourth measure in Table 4 is the tax after credits of the life insurance industry as reported by the IRS Statistics of Income (SOI) program. This measure is from tax returns, but includes taxes from a different sample of companies. The SOI classifies consolidated returns by industry based on the industry group from which the largest percentage of total receipts is derived. As a result, a significant amount of taxes of life insurance companies included in the Treasury survey measure is not included in the SOI reported total. The SOI data also report bottom-line taxes from consolidated returns. For both 1984 and 1985, the SOI measure of taxes is less than the two tax return measures of taxes from the Treasury survey.

The fifth, sixth, and seventh measures in Table 4 report annual financial statement taxes. The fifth measure in Table 4 presents the financial statement measure of taxes paid by the life insurance industry in the Treasury survey. This measure is based upon a sample of life insurance companies consistent with the tax law, but taxes reported on financial statement are higher than taxes reported on tax returns by the same companies due to differences in financial and tax accounting. The final two measures are reports of financial statements taxes from A.M. Best's Aggregates and Averages and from the American Council of Life Insurance's Life Insurance Fact Book. These latter two measures are based on samples of life insurance companies' regulatory statements.

Taxes reported on financial statements are generally higher than tax return measures for several reasons. Tax liabilities are measured differently for tax and financial reporting purposes. Financial statement amounts are estimates of tax liabilities that are made several months before a company files a tax return. The taxes reported on financial statements may include amounts never reported on tax returns, such as assessed tax deficiencies relating to audits of prior year tax returns. Where financial and tax accounting differ on the timing of income recognition, the financial statement taxes may include amounts that are not actually paid to the Treasury until later years due to tax deferral. In addition, the regulatory statements do not allow consolidation with non-life companies, although life insurance companies have been allowed to file consolidated tax returns with non-life companies since 1981.

Comparison of Measures of Tax Liabilities of Life Insurance Companies From the Treasury Department's Survey, SOI Tax Statistics, and Financial Statements for 1984 and 1985
($ millions)

	1984			1985		
	Mutual Life Companies	Stock Life Companies	Total	Mutual Life Companies	Stock Life Companies	Total
<u>Tax Return Measures</u>						
Treasury Survey						
All Consolidated Companies	891	1,467	2,357	1,211	1,542	2,754
Life Subgroup (after non-life losses)	974	1,426	2,400	1,282	1,601	2,883
Life Subgroup (before non-life losses) 1/	1,083	1,759	2,842	1,482	2,119	3,601
SOI Tax Statistics	704	558	1,262	914	1,341	2,256
<u>Financial Statement Measures</u>						
Financial Statements from Treasury Survey	1,212	1,643	2,855	2,080	2,270	4,359
Financial Statements from A.M. Best	1,231	1,525	2,756	2,084	2,049	4,133
Financial Statements from ACLI	N/A	N/A	2,785	N/A	N/A	4,134

Department of the Treasury
Office of Tax Analysis

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SOURCE: Preliminary results from <u>1987 Treasury Department Survey of Mutual and Stock Life Insurance Companies</u>, Internal Revenue Service <u>Corporation Source Book of Statistics of Income</u>, A.M. Best <u>Aggregates and Averages Life-Health 1986</u>, and American Council of Life Insurance <u>Life Insurance Fact Book</u>.

NOTE: All figures weighted to estimate industry totals. Figures exclude specially surveyed Canadian-owned companies.

N/A = Not Available.

1/ Amounts shown are tax before credits.

TREASURY NEWS

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FOR RELEASE AT 4:00 P.M.
September 27, 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 October 6, 1988. This offering will provide about $ 150 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,841 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, October 3, 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 July 7, 1988, and to mature January 5, 1989 (CUSIP No. 912794 QZ0), currently outstanding in the amount of $7,432 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,000 million, to be dated October 6, 1988, and to mature April 6, 1989 (CUSIP No. 912794 RR7).

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 October 6, 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 $ 1,715 million as agents for foreign and international monetary authorities, and $ 4,610 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).

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 27, 1988

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $8,782 million of $32,282 million of tenders received from the public for the 2-year notes, Series AF-1990, auctioned today. The notes will be issued September 30, 1988, and mature September 30, 1990.

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

	Yield	Price
Low	8.52%*	99.964
High	8.53%	99.946
Average	8.53%	99.946

*Excepting 2 tenders totaling $100,000.

Tenders at the high yield were allotted 75%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 54,720	$ 54,710
New York	28,638,300	7,689,010
Philadelphia	39,230	37,230
Cleveland	83,510	72,110
Richmond	184,790	63,940
Atlanta	54,075	53,825
Chicago	1,362,350	192,830
St. Louis	98,445	77,445
Minneapolis	41,325	40,325
Kansas City	118,425	116,425
Dallas	38,275	28,260
San Francisco	1,496,435	283,935
Treasury	72,290	72,290
Totals	$32,282,170	$8,782,335

The $8,782 million of accepted tenders includes $1,227 million of noncompetitive tenders and $7,555 million of competitive tenders from the public.

In addition to the $8,782 million of tenders accepted in the auction process, $740 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,146 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
SEPTEMBER 28,1988

CONTACT: DAVID S. LIEBSCHUTZ
(202) 376-4302

SAVINGS BONDS NOW PROCESSED LIKE CHECKS

There is good news for the more than 40,000 financial institutions that redeem U.S. Savings Bonds: It's going to get easier. Beginning October 1, 1988, agents will be able to take advantage of a new processing system known as "EZ CLEAR." This system allows paying agents to process savings bonds in much the same way they process checks.

According to Richard L. Gregg, Commissioner of Treasury's Bureau of the Public Debt, "For nearly 50 years agents have been required to process bonds as 'exception' items. This has been a costly, time-consuming and largely manual process. Our new system is completely different. EZ CLEAR utilizes the modern high-speed technology of the check world to simplify and accelerate the processing of savings bonds."

The Bureau and the Federal Reserve Banks have been testing the new system since November 1986. Based on the improved efficiency of the new system and the extremely favorable reaction of the paying agents, the Bureau decided to make EZ CLEAR available to all agents. Currently, the 520 participating institutions in EZ CLEAR are processing over 58,000 paid bonds per day (about 14.5 million per year). All authorized paying agents redeem nearly 60 million bonds each year.

Under EZ CLEAR, redeemed bonds can be submitted to correspondents or Federal Reserve Banks either in mixed or separately sorted cash letters in a similar fashion to the way that checks are submitted. In addition, paying agents will be reimbursed by Treasury more promptly because they will receive redemption fees monthly rather than quarterly. Although the terms and conditions are not affected, customers may notice that the bonds themselves have been redesigned to look and function more like checks.

Financial institutions should contact Federal Reserve Check Processing Offices for detailed information and specific instructions on how to participate in EZ CLEAR.

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TREASURY NEWS

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

TEXT AS PREPARED
Embargoed for Release
Upon Delivery, Expected
at 4:00 p.m. (Berlin Time)

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Joint Annual Meetings of the
International Monetary Fund and World Bank
Berlin
September 27, 1988

Chairman Feldt, Chairman Dennis, Managing Director Camdessus, President Conable, fellow Governors and distinguished guests:

It is a great pleasure to join you for the forty-third joint Annual Meetings of the International Monetary Fund and the World Bank. This is the first such meeting held in Germany. It is especially appropriate that it takes place in Berlin. This city is a symbol of individual liberty and economic freedom for millions of people. As President Kennedy said 25 years ago: "All free men, wherever they may live, are citizens of Berlin."

Future historians will record that we have come together at a time when these fundamental principles of individual liberty and freedom have received a new impetus. Economic prosperity and progress flourish only where the rights of the individual are respected and protected, and private initiative is encouraged.

But, with the privilege of freedom comes responsibility. As individuals pursue their personal goals, they must consider the broader interest of their neighbors. And so it is with nations. In pursuing our national objectives, we must recognize our shared responsibilities to improve the world in which we live.

Two fundamental principles should guide us as we consider how to meet this challenge. First, the only lasting prosperity for any of us is sustained prosperity for all of us. Second, the achievement of global prosperity in a world of limited resources requires their prudent use. These principles should guide us as we make the difficult choices to extend benefits to future generations.

And as we undertake this task, four mutually reinforcing pillars continue to support our efforts -- the economic policy coordination process, the cooperative debt strategy, the IMF and the World Bank. Let me address each of these in turn.

Building Economic Prosperity

Global economic prosperity begins with sound policies and strong performance in the industrial world. Over the past three years, the major industrial countries have built a new pillar -- economic policy coordination -- to buttress global expansion and development.

This has helped to reinvigorate our economies. Economic growth in the major industrial countries will approach 4 percent this year, providing a solid footing for all countries. Importantly, this higher growth has been achieved without a resurgence of inflation. A reduction in our external imbalances is also occurring. Consequently, prospects are excellent for sustained growth with low inflation and exchange rate stability.

The policy coordination process represents a pragmatic approach to strengthening the international monetary system. It involves a discipline that encourages each of us to take actions whose benefits transcend national boundaries. The United States, for example, has implemented measures to reduce its budget deficit. We do not intend to stop here. Other countries are also pursuing monetary and fiscal policies that foster growth without igniting inflation. Most of us need to reduce trade imbalances further, and all of us need to promote open markets. In addition, structural barriers to growth must be substantially reduced if we are to unleash the vitality of our economies.

Spreading Prosperity to Developing Nations

Policy coordination has provided an improved framework for achieving prosperity in the industrial nations. But this is not enough. Our prosperity must be shared. We should not rest until the benefits of hard work and sound policies are broadly realized throughout the world. There is a necessity, indeed an urgency, to raise living standards throughout the developing nations.

Some developing countries have already made great progress. The newly industrialized economies of Asia have made tremendous strides through the energy and initiative of their people. They have also benefited from the open trading system. Now they should take greater responsibility for sustaining this system by opening their economies and exchange rates to market forces.

For the heavily indebted nations, the course has been more difficult. However, the international debt strategy has provided a working basis for addressing the debt problem. This strategy has become our second pillar for building global prosperity. It is dynamic and has adapted to changing global circumstances. Its principles remain valid. Growth stands at the center -- the product of sound economic policies. International financial institutions and commercial banks support these efforts. The strategy is credible because it recognizes the necessity for economic reform, the scarcity of global financial resources, and the political realities of economic development.

Many debtor countries have adopted tough economic measures. They have tackled fiscal imbalances, liberalized trade, introduced realistic exchange rates, and generally allowed a greater role for market forces. These actions required great political courage. Their reward has been a resumption of growth that with continued effort can be sustained.

Despite this progress, we cannot ignore the serious problems we still face -- both in financial flows and policies. On the finance side, there have been shortfalls. The response has been the menu approach which offers an innovative range of opportunities for new finance, cooperative arrangements with international financial institutions, and techniques which contribute to growth and also have the benefit of debt reduction.

I have in mind especially market-based techniques which are voluntary and do not depend upon resources from international financial institutions, or which may otherwise shift private risk to the public sector. We should not forget that if the stock of private debt is to be reduced, we must embrace only techniques that private markets find acceptable and which simultaneously maintain the willingness of private lenders to continue financing future development.

Debtor countries need to renew efforts to enhance domestic savings, to attract home the capital of their own people, and to open their economies to the productive potential of foreign investment. Inflation must be defeated and economies freed from controls. There is no realistic substitute for these policies if debtor countries are to muster resources for growth in a world that is short of capital.

Also, we need to harness private ingenuity in all our countries. We all welcome additional official resources, but we must recognize their limitations and ensure that we preserve the essential principles on which our debt strategy is based. Otherwise, the prospects for true reform, sustainable growth and a return of debtors to world capital markets will be dimmed -- and we will miss the opportunities we now see before us.

Consequently, the United States regards with skepticism proposals that may appear to conform to the basic principles of the debt strategy, but which in practice will produce only an illusion of progress. Indeed, such proposals will make the debt problem intractable -- by weakening the international institutions on which we depend, by undermining the difficult but lasting reforms the debtor nations are making, and by building political opposition among taxpayers in creditor countries. We must see proposals for what they are, not for what they purport to be.

If we embark on a course that involves the transfer of risk from the private to the public sector, a true and lasting solution to the restoration of sustained growth among debtor nations will have escaped. And then, when official resources have been exhausted, as they will be; when our international institutions have been made static and vulnerable, and they will be; when private lenders have long since withdrawn from the financing of development, we will still face exactly the same problems we see today. But our firepower will be gone, there will be divisions among us, and we will be reduced to words, not actions.

Role of the IMF

The IMF is the monetary pillar for cooperative international efforts to promote a stable international environment. It is one of the key means by which all of us blend our energies and resources to build global prosperity. In recent years, the Fund has modified its policies and facilities to meet the changing needs of its members.

The Fund, however, should remain faithful to its basic principles. Let us remember that the IMF began as a revolving pool of resources to which all members contribute and from which all members in need may draw. A revolving fund must revolve, with payments made in a timely fashion. The existence of deeply embedded arrears strike at the core of this fundamental IMF principle.

We welcome the IMF's three part strategy to overcome the arrears problem. It includes preventive measures to stop a further buildup of arrears, a collaborative approach to deal with existing arrears, and remedial actions to safeguard the IMF's financial position. The United States stands ready to participate in this strategy if all the essential elements are in place.

We have been a strong supporter of the IMF, and we will remain so. However, at a time of competing demands and budget constraints, the case for additional quota resources must be compelling. There should be a clear vision of the IMF in the 1990's, and a demonstrated need for more funds -- not simply a presumption that more is better. Finally, the arrears problem poses a hurdle to any increase in IMF resources. If our countries are expected to use scarce financial resources wisely, our international institutions must do no less.

Role of the World Bank

The World Bank is the fourth pillar on which our global prosperity rests. It is the key multilateral institution for transforming resources into better lives. Through its lending, the Bank is promoting structural reforms which are essential for sustained growth.

With the recently ratified General Capital Increase (GCI), the Bank will now have the resources to address the needs of developing countries. The United States strongly supports the GCI. I am happy to report a major step forward for our participation with the approval last week of GCI legislation by key congressional committees.

With the provision of new resources, the Bank must take into account the potential impact of its operations on the poor, on the environment and on the private sector. Properly designed projects for infrastructure and for agricultural technologies can help bring the benefits of growth to the poorer segments of the population.

Environmental concerns continue to be a high priority for the United States. We strongly support President Conable's decision to establish a central Environmental Department and regional environmental units. This should reinforce the Bank's efforts in this area.

The Bank should strengthen its efforts to promote greater reliance on the private sector. It is important to support the growing recognition by developing countries that approaches to development which suppress market forces do not work.

Conclusion

Let me close by expressing my admiration for what you have accomplished over these past years. Through policy coordination, the debt strategy, and our international institutions, prosperity is being advanced throughout the world.

The IMF and World Bank have exercised leadership and imagination during a difficult period. They have earned our appreciation and deserve our continued strong support. As we seek solutions to the challenges which confront us, I look forward to working with my new colleague Michel Camdessus, my old friend Barber Conable, and each of you.

Together there is no limit to what we can accomplish in building a better world for our children and grandchildren.

Thank you.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 28, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $7,025 million of $22,552 million of tenders received from the public for the 4-year notes, Series P-1992, auctioned today. The notes will be issued September 30, 1988, and mature September 30, 1992.

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	8.74% *	100.033
High	8.77%	99.934
Average	8.76%	99.967

*Excepting 2 tenders totaling $1,510,000.
Tenders at the high yield were allotted 26%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 27,964	$ 27,964
New York	19,637,528	5,964,871
Philadelphia	20,079	20,079
Cleveland	40,017	40,017
Richmond	55,735	28,155
Atlanta	24,692	23,952
Chicago	1,196,636	381,156
St. Louis	28,523	26,303
Minneapolis	30,731	29,731
Kansas City	47,795	47,715
Dallas	17,918	14,438
San Francisco	1,405,663	402,063
Treasury	18,821	18,821
Totals	$22,552,102	$7,025,265

The $ 7,025 million of accepted tenders includes $ 666 million of noncompetitive tenders and $ 6,359 million of competitive tenders from the public.

In addition to the $ 7,025 million of tenders accepted in the auction process, $420 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $500 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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

FOR IMMEDIATE RELEASE
SEPTEMBER 30, 1988

CONTACT: DAVID S. LIEBSCHUTZ
(202) 376-4302
or
L. RICHARD KEYSER
(202) 755-1591

TREASURY AND HUD CALL FHA INSURANCE FUND DEBENTURES

The Departments of Treasury and Housing and Urban Development announced today the call of all Federal Housing Administration (FHA) General Insurance Fund debentures (MM series), outstanding as of September 30, 1988, with interest rates of 9 percent or higher. The date of the call for the redemption of the over $18 million in debentures will be January 1, 1989, with the semi-annual interest due January 1 paid with the debenture principal.

Record owners of the debentures as of September 30, 1988, will be notified by mail of the call and given instructions for submission. Those owners who cannot locate the debentures should contact the Claims Section of the Bureau of the Public Debt (300 13th St SW, Room 429; Washington, DC 20239-0001) for assistance.

No transfers or denominational exchanges in debentures covered by the call will be made on or after October 1, 1988, nor will any special redemption purchases be processed.

The Federal Reserve Bank of Philadelphia has been designated to process the redemptions and to pay final interest on the called debentures. To insure timely payment of principal and interest on the debentures, they should be delivered by December 1, 1988 to:

The Federal Reserve Bank of Philadelphia
Securities Division
P.O. Box 90
Philadelphia, PA 19105-0090

TREASURY NEWS

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

CONTACT: Office of Financing
202/ 376-4350

FOR IMMEDIATE RELEASE
October 3, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,031 million of 13-week bills and for $ 7,010 million of 26-week bills, both to be issued on October 6, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 5, 1989			:	26-week bills maturing April 6, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.22%	7.46%	98.175	:	7.43%	7.83%	96.244
High	7.23%	7.47%	98.172	:	7.47%	7.87%	96.224
Average	7.23%	7.47%	98.172	:	7.46%	7.86%	96.229

Tenders at the high discount rate for the 13-week bills were allotted 85%.
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	$ 32,875	$ 31,195	:	$ 29,280	$ 29,280
New York	23,899,945	6,024,425	:	21,700,255	5,652,755
Philadelphia	31,270	31,270	:	18,475	18,475
Cleveland	38,170	37,845	:	29,725	29,725
Richmond	43,185	43,185	:	40,935	40,935
Atlanta	35,635	35,635	:	30,845	30,845
Chicago	1,449,410	45,410	:	1,303,460	141,460
St. Louis	35,510	31,260	:	29,530	25,530
Minneapolis	5,555	5,555	:	6,540	6,540
Kansas City	48,055	47,995	:	47,965	47,965
Dallas	34,330	24,330	:	33,865	26,765
San Francisco	1,832,580	277,580	:	1,701,020	408,020
Treasury	394,995	394,995	:	551,460	551,460
TOTALS	$27,881,515	$7,030,680	:	$25,523,355	$7,009,755
Type					
Competitive	$24,172,835	$3,322,000	:	$20,713,385	$2,199,785
Noncompetitive	1,113,655	1,113,655	:	1,097,060	1,097,060
Subtotal, Public	$25,286,490	$4,435,655	:	$21,810,445	$3,296,845
Federal Reserve	2,510,135	2,510,135	:	2,100,000	2,100,000
Foreign Official Institutions	84,890	84,890	:	1,612,910	1,612,910
TOTALS	$27,881,515	$7,030,680	:	$25,523,355	$7,009,755

An additional $51,910 thousand of 13-week bills and an additional $773,890 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-23

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.
October 4, 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 October 13, 1988. This offering will provide about $775 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,232 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, October 11, 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 July 14, 1988, and to mature January 12, 1989 (CUSIP No. 912794 RA 4), currently outstanding in the amount of $7,006 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 April 14, 1988, and to mature April 13, 1989 (CUSIP No. 912794 RS 5), currently outstanding in the amount of $9,062 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 October 13, 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 $1,831 million as agents for foreign and international monetary authorities, and $3,648 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.
October 5, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $6,750 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $6,750 million of 7-year notes to refund $3,198 million of 7-year notes maturing October 15, 1988, and to raise about $3,550 million new cash. The public holds $3,198 million of the maturing 7-year notes, including $330 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $6,750 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 $276 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

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

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Attachment

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED OCTOBER 17, 1988

October 5, 1988

<u>Amount Offered</u>:

To the public	$6,750 million

<u>Description of Security</u>:

Term and type of security	7-year notes
Series and CUSIP designation	H-1995 (CUSIP No. 912827 WT 5)
Maturity date	October 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	April 15 and October 15
Minimum denomination available ..	$1,000

<u>Terms of Sale</u>:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None

<u>Payment Terms</u>:

Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

<u>Key Dates</u>:

Receipt of tenders	Wednesday, October 12, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, October 17, 1988
b) readily-collectible check ..	Thursday, October 13, 1988

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

OCT 03 1988

Dear Senator :

This is to reiterate you of the opposition of the Department of the Treasury to a proposal we understand that Senator Kerry will likely offer as an amendment to the drug bill. The proposal would require foreign banks and other financial institutions to keep records of large U.S. currency transactions and to provide the records to U.S. authorities in drug cases. If a bank failed to do so, it would be virtually precluded from access to the United States banking system.

We believe this proposal is unenforceable, detrimental to U.S. economic interests, and most importantly, counterproductive to ongoing international cooperation in the area of drug trafficking and money laundering. Our allies regard this unprecedented extraterritorial imposition of a bank regulatory requirement as an affront to their sovereignty. Diplomatic protests have been filed with the Department of State on behalf over a dozen European countries.

We are particularly distressed that enactment of this proposal could jeopardize the anticipated December ratification of the U.N. (Vienna) Convention Against Narcotics Trafficking. This convention will oblige signatory countries to enact money laundering legislation and to provide judicial assistance in drug money laundering cases. In the long run, these measures will be more effective than currency reporting in the fight against international drug trafficking.

We trust that you will agree that this is not a good or effective approach to the problem of international money laundering. I appreciate your consideration of this matter.

Sincerely,

Salvatore R. Martoche

Salvatore R. Martoche
Assistant Secretary
(Enforcement)

The Honorable
United States Senate
Washington, D.C. 20510

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

October 7, 1988

David W. Mullins, Jr. Joins Treasury

Secretary of the Treasury Nicholas F. Brady today announced that David W. Mullins, Jr. joined the Department of the Treasury. Dr. Mullins will oversee matters pertaining to domestic finance policy.

Prior to joining the Department, Dr. Mullins was a Professor of Business Administration at the Harvard University Graduate School of Business Administration. He received a B.S. in administrative sciences from Yale University and an S.M. in finance from the Sloan School of Management at the Massachusetts Institute of Technology. After earning a Ph.D. in finance and economics at M.I.T., he joined the faculty of the Harvard Business School where he taught finance in the MBA, executive and doctoral programs.

Professor Mullins was faculty chairman of Harvard's Corporate Financial Management program, an executive program for senior financial officers of major corporations. In addition, he has served as course head for the first year MBA finance course. He taught the Capital Markets course in the MBA program.

Professor Mullins has been a consultant to a wide variety of firms and governmental agencies and has taught in numerous executive training programs in the U.S. and abroad. He recently served as Associate Director of the Presidential Task Force on Market Mechanisms.

In teaching, research, and consulting, Professor Mullins specialized in capital markets and corporate finance.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 11, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,006 million of 13-week bills and for $7,025 million of 26-week bills, both to be issued on October 13, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 12, 1989			:	26-week bills maturing April 13, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.28%	7.52%	98.160	:	7.45%	7.85%	96.234
High	7.34%	7.58%	98.145	:	7.46%	7.86%	96.229
Average	7.32%	7.56%	98.150	:	7.46%	7.86%	96.229

Tenders at the high discount rate for the 13-week bills were allotted 84%.
Tenders at the high discount rate for the 26-week bills were allotted 37%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 42,365	$ 42,365	:	$ 34,230	$ 34,230
New York	20,252,030	5,262,030	:	26,431,200	6,155,405
Philadelphia	23,395	23,395	:	15,635	13,635
Cleveland	49,000	49,000	:	27,875	27,875
Richmond	45,355	45,355	:	45,250	45,250
Atlanta	41,855	41,855	:	28,550	28,175
Chicago	910,015	351,015	:	985,705	40,705
St. Louis	33,805	33,645	:	35,360	30,955
Minneapolis	7,630	7,630	:	7,910	7,910
Kansas City	49,170	49,140	:	44,915	44,880
Dallas	37,630	37,630	:	34,430	24,430
San Francisco	1,591,735	638,575	:	1,309,585	83,335
Treasury	424,270	424,270	:	487,990	487,990
TOTALS	$23,508,255	$7,005,905	:	$29,488,635	$7,024,775
Type					
Competitive	$20,309,975	$3,807,625	:	$24,927,930	$2,464,070
Noncompetitive	1,222,830	1,222,830	:	1,061,225	1,061,225
Subtotal, Public	$21,532,805	$5,030,455	:	$25,989,155	$3,525,295
Federal Reserve	1,847,530	1,847,530	:	1,800,000	1,800,000
Foreign Official Institutions	127,920	127,920	:	1,699,480	1,699,480
TOTALS	$23,508,255	$7,005,905	:	$29,488,635	$7,024,775

An additional $28,980 thousand of 13-week bills and an additional $380,820 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

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
October 11, 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 October 20, 1988. This offering will provide about $ 875 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,125 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, October 17, 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 January 21, 1988, and to mature January 19, 1989 (CUSIP No. 912794 RB2), currently outstanding in the amount of $ 16,092 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 August 15, 1988, and to mature April 20, 1989 (CUSIP No. 912794 RU0), currently outstanding in the amount of $ 7,021 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 October 20, 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 $ 1,284 million as agents for foreign and international monetary authorities, and $ 3,773 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

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

FOR IMMEDIATE RELEASE
October 12, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $6,754 million of $16,138 million of tenders received from the public for the 7-year notes, Series H-1995, auctioned today. The notes will be issued October 17, 1988, and mature October 15, 1995.

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%interest rate are as follows:

	Yield	Price
Low	8.72%	99.510
High	8.75%	99.356
Average	8.73%	99.459

Tenders at the high yield were allotted 61%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 8,806	$ 8,806
New York	14,051,634	6,083,604
Philadelphia	4,952	4,952
Cleveland	10,711	10,711
Richmond	16,580	16,530
Atlanta	8,367	8,357
Chicago	1,127,456	348,206
St. Louis	23,263	7,263
Minneapolis	3,384	3,384
Kansas City	9,667	9,667
Dallas	7,322	6,322
San Francisco	863,865	244,365
Treasury	1,675	1,675
Totals	$16,137,682	$6,753,842

The $6,754 million of accepted tenders includes $306 million of noncompetitive tenders and $6,448 million of competitive tenders from the public.

In addition to the $6,754 million of tenders accepted in the auction process, $150 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $276 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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

FOR RELEASE UPON DELIVERY
Expected at 9:00 A.M.
October 13, 1988

Testimony of Marcus W. Page
Deputy Fiscal Assistant Secretary of the Treasury Department
before the
Commerce, Consumer, and Monetary Affairs Subcommittee
of the
Committee on Government Operations

Mr. Chairman and members of the Committee, I appreciate the opportunity to provide you with an update on the accomplishments of the Financial Management Service and Treasury's ongoing activities to improve financial information in Executive Branch agencies.

With me this morning is Commissioner Douglas of the Financial Management Service who will cover the significant progress that FMS has made in improving financial management across government, particularly in cash management, debt collection, and the central financial systems. These recent successes have produced substantial dollar savings over the last four years. During that time we have successfully replaced 90% of our central financial systems. We now have wide recognition in the private sector as a leader in innovative cash management practices, as a major force in electronic funds transfer with our Vendor Express program, and as a pace setter in the application of security technology to electronic payments.

The Financial Management Service has an exceptionally strong career staff that has set strategic objectives, laid out tactical plans, and successfully completed project after project, system after system, and the results in the central financial operations of government have been substantial. Drawing from this experience, we have underway now a program to help other executive agencies upgrade their financial systems and products. Treasury is uniquely qualified to carry out a government-wide upgrade of financial management because we touch in one way or another all of the payments, all of the collections, all interagency financial transactions, all banking relationships, most of the financial reporting, and most of the investment management programs. Treasury has taken on this assignment and will produce the same successful results that we have in our central financial activities. And, we will do it in cooperation with the program agencies, respecting their individual and often unique managerial needs.

NB-30

At this point, Commissioner Douglas will describe the major elements of the Financial Management Service's improvement program. Upon his completion, I will deal specifically with the four questions in your letter to Secretary Brady.

Mr. Chairman,

1. Your first question asks how FMS is carrying out the policies of OMB Circular A-127.

   - Two years ago, FMS established a Financial Systems Program staff to work directly with the 23 departments and major agencies initially targeted for financial system improvement.

   - Joint OMB/Treasury management hearings were held to negotiate and set specific systems priorities and goals for each agency.

   - Each agency has submitted a financial systems improvement plan detailing methods to reach their goals.

   - The three central agencies: Treasury, OMB, and GAO have worked cooperatively to establish three important financial systems standards: the Standard General Ledger, the financial systems core requirements document, and the revised Treasury reporting requirements that tie directly to the Standard General Ledger.

   - The FMS Program staff is monitoring closely agency performance against the financial systems plans. Each agency is evaluated on:

     - Establishing standard coding structures and operating procedures
     - Having the capability of producing department-wide reports
     - Establishing a single primary accounting system
     - Implementing the Standard General Ledger
     - Providing interface between subsidiary systems and the primary system; and
     - Reaching compliance with Section 4 of the Federal Manager's Financial Integrity Act.

   - Periodically, Treasury and OMB hold management hearings with the agencies to review agency progress.

- o We believe this approach is effective, given the resources available. For example, thirteen agencies have implemented the Standard General Ledger, six are implementing this fiscal year, three more in 1990, and one in 1991. Twenty agencies have met FMFIA, Section 4, internal control requirements, with one scheduled each of the next three years. Twelve agencies have primary accounting systems in place, three more in this fiscal year, and the remainder in 1990, 1991, and 1992.

2. <u>Your second question asks how implementation of A-127 and other FMS initiatives will accomplish four specific needs.</u>

(a) The first -- financial reporting overlaps and inconsistency is well on the way to resolution. Direct integration of Treasury's reporting requirements with the Standard General Ledger account structure is a major step toward consistent and effective reporting. Perhaps even more important, Treasury has installed a fully electronic reporting system that requires agencies to telecommunicate their financial data in standard formats. This system uses front end edits to assure consistency of reporting. It also has solved most of our problems with late reporting as over a thousand reporting activities across the nation can telecommunicate their financial data and receive Treasury reconcilation reports without the delays common to paper reporting.

(b) Improving agency financial systems through A-127 will contribute to management efficiency in the Executive Branch. As many of our departments and agencies have had dozens of incompatible systems serving their bureaus and field locations, it has been difficult for management to obtain consistent financial information at department level. This often resulted in labor intensive exercises to meet unexpected reporting deadlines. But beyond responding to budget and other information crises, is it not reasonable to expect a manager to better manage program mission objectives if the knowledge of budget status, cost of operations availability of assets and collectability of receivables is close at hand. The objective of our systems' improvement program is to gather financial data quickly and to make it available with micro-computer based analytical tools so that managers can assemble the facts needed to make effective decisions.

(c) Implementation of A-127 and the FMS financial analysis program has augmented Executive Branch accountability. Initially, the focus has been on Federal receivables and debt collection, but will soon be expanded to improve control of other assets, such as, equipment and inventories. That is the importance of the Standard General Ledger. It helps focus management attention on assets and liabilities, rather than total concentration on the budgetary accounts.

(d) The final item listed is Congress's need for meaningful financial information on Executive Branch operations. Certainly, improved financial systems across the Executive Branch will help. It is also fair to say that agencies currently provide good financial data, on the cash basis and the obligation basis. However, other financial information could be improved to better meet Congressional needs.

3. Your third question asks how FMS is using the Standard General Ledger as an information standardization measure. We have made it a requirement. We have tied all Treasury reporting to that structure. We are analyzing agency reporting on an account-by-account basis to determine compliance with the structure. Our electronic reporting requires standard record formats. We are making good progress on standard financial information.

4. Finally, your letter asks what the best state government systems can do for accountability that is not done well in Federal systems and will the planned A-127 improvements meet those capabilities. Most Federal financial systems provide reliable information for cash management and budget execution purposes. Federal systems fall short in two areas. First, most Federal systems do not focus attention on managing our assets and liabilities. Second, many Federal systems do not provide complete information on the cost of programs and projects. Our A-127 implementation will improve asset/liability management. In some respects, Federal systems may well exceed state government capabilities. A-127 implementation will also provide cost information for all business-type accounts, reimbursable operations and other accounts where managers need such information.

Mr. Chairman, I thank you for the opportunity to appear before the Subcommittee. Commissioner Douglas and I are available to answer any questions.

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TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
October 14, 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 October 27, 1988, and to mature October 26, 1989 (CUSIP No. 912794 SM 7). 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 $9,284 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, October 20, 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 October 27, 1988. In addition to the maturing 52-week bills, there are $13,116 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 $ 1,929 million as agents for foreign and international monetary authorities, and $5,853 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 $ 15 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.

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
October 17, 1988

Contact: Bob Levine
566-2041

The U.S. Treasury Department and Federal Reserve welcome the economic measures recently announced by the Government of Mexico. The U.S. financial authorities believe that these measures build upon the progress already achieved in the sustained adjustment effort undergone by the Mexican economy. Mexico's adjustment record, particularly the process of fiscal consolidation and the structural transformation of its external sector, has established the basic conditions for the renewal of sustained economic growth.

In the context of normal consultations between countries with close economic relations, U.S. and Mexican authorities have agreed that Mexico's strengthened economic policies merit support. Accordingly, the U.S. Treasury and Federal Reserve are prepared to develop a short-term bridge loan of up to $3.5 billion, depending on the development of loan programs by Mexico with the World Bank and the International Monetary Fund.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 17, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,077 million of 13-week bills and for $7,006 million of 26-week bills, both to be issued on October 20, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 19, 1989			26-week bills maturing April 20, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.33%	7.57%	98.147	7.50%	7.90%	96.208
High	7.36%	7.60%	98.140	7.56%	7.97%	96.178
Average	7.36%	7.60%	98.140	7.55%	7.96%	96.183

Tenders at the high discount rate for the 13-week bills were allotted 44%.
Tenders at the high discount rate for the 26-week bills were allotted 79%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 29,910	$ 29,910	$ 25,800	$ 25,800
New York	26,055,610	6,415,470	21,144,975	5,787,475
Philadelphia	24,095	24,095	17,560	17,560
Cleveland	37,435	26,285	21,490	21,490
Richmond	38,730	38,730	29,610	29,610
Atlanta	34,170	34,170	28,720	28,720
Chicago	1,212,020	41,350	998,775	267,775
St. Louis	28,435	24,435	22,680	20,470
Minneapolis	12,185	7,185	9,700	4,700
Kansas City	41,035	41,035	39,745	39,745
Dallas	26,940	16,940	29,075	24,075
San Francisco	1,372,130	124,130	1,272,100	292,000
Treasury	252,780	252,780	446,605	446,605
TOTALS	$29,165,475	$7,076,515	$24,086,835	$7,006,025
Type				
Competitive	$26,137,335	$4,048,375	$20,312,655	$3,231,845
Noncompetitive	925,765	925,765	923,355	923,355
Subtotal, Public	$27,063,100	$4,974,140	$21,236,010	$4,155,200
Federal Reserve	1,972,500	1,972,500	1,800,000	1,800,000
Foreign Official Institutions	129,875	129,875	1,050,825	1,050,825
TOTALS	$29,165,475	$7,076,515	$24,086,835	$7,006,025

An additional $44,125 thousand of 13-week bills and an additional $372,675 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

TREASURY NEWS

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

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October 17, 1988

For delivery at the Swiss National Bank, Zurich, Switzerland, October 17, 1988, and for the session on Harmonization of Economic Policies, Volatility of Interest and Exchange Rates, and World Economic Disequilibrium at the Lugano International Banking Symposium October 18, 1988, 9:00 a.m. - noon, Lugano, Switzerland

Choosing Types of Volatility in a World of Change

Michael R. Darby
Assistant Secretary for Economic Policy
U.S. Department of the Treasury

The topic for this morning's session and the comparatively meager time available to address it reminds me of the high school history teacher who set only one question for a half-hour examination: "Explain the Second World War -- use both sides of the paper if necessary."

Faced this morning with a similarly impossible challenge, I hope to address some of the fundamental issues by pulling my academic hat out of the closet and concentrating on two topics. The first is some work which I, my coauthors, and others have done comparing the volatility of economic variables under the Bretton Woods and floating rate systems. The other is how the Federal Reserve System has dealt with volatility of real exchange rates across regions of the United States. I hope that my observations are of more than purely historical interest and may be informative in thinking about the possible evolution of the European Monetary System. Some of you may have a positive role in that evolutión while others of us must assess whether 1992 represents a milestone in an ongoing process or a fundamental change in our relationship with the Community.

Those of us who are not members of the Community are understandably concerned that tearing down barriers to the free flow of goods, services, and capital among the members of the Community must not become the occasion for erecting barriers between the Community and nonmember trading partners. We have certainly been heartened by Community leaders who have provided assurances of strong support for the view that greater openness within the Community is not to be bought through exclusion of others. Nonetheless, I believe that continued vigilance is required because trade and capital barriers -- and variations in them -- have been a traditional tool for limiting volatility in exchange rates or monetary policy. If those barriers are removed at the national level, there may still be temptation to impose them for those traditional reasons at the Community level.

Volatility under and after Bretton Woods

Across regions or countries there must be a mechanism or strategy for adjusting to continuous changes in the equilibrium level of the real exchange rate -- the relative purchasing power of a given amount of money. Monetary or exchange-rate systems embody choices as to which variables will do the adjusting or, in the terms of this session's title, exhibit volatility.

These changes in equilibrium real exchange rates are not unlike those observed in prices on the stock exchanges and other asset markets: The confluence of many minor factors moves the equilibrium real exchange rate up or down a little bit each week -- each day or hour really -- and, on occasion, a change in a major fundamental factor can cause a large movement up or down in the equilibrium real exchange rate. Even if no major fundamental change occurs over a long period of time, the cumulation of small day-to-day movements makes the real exchange rate at the end hard to predict at the beginning of the period. Thus, the realities of a changing world mean that a truly stable system is one which allows for compensating movements -- the question is which variables should adjust to underlying change.

The monetary, financial, and trade system by which regions or nations are linked can ultimately deal with these movements in the real exchange rate in only four ways: by movements in the nominal exchange rate, by movements in relative money supplies and price levels, by forestalling major changes in tax and other policies which would result in major changes in the equilibrium real exchange rate, or by making offsetting changes in other fundamental policies.

A unified monetary system, to which we shall return, emphasizes adjustment of relative money supplies and price levels in response to variations in equilibrium real exchange rates. My coauthor James Lothian and I recently examined the empirical evidence on how this underlying volatility was handled under the Bretton Woods system of pegged exchange rates and the ensuing system of floating exchange rates. Some of our results were quite predictable while others were not.

As expected, international parity conditions dominated the longer run trends in monetary policies of the nonreserve countries under the Bretton Woods system. Much greater monetary independence was evidenced under floating rates, although there was evidence that the previous nonreserve countries continued to engage in only partially sterilized intervention. It is hardly surprising that nominal exchange rates would be more responsive and monetary policies less responsive under floating than pegged exchange rates.

A more paradoxical result is that there is nonetheless substantial evidence that real variables and especially interest rates moved more closely together under floating than pegged rates. We believe this reflects the attenuation of the use of controls on trade and capital flows which followed the breakdown of the Bretton Woods system. These controls made the different national economies more closed and thus less subject to variability in equilibrium real exchange rates. Variations in the control regimes were a popular tool, often the first resort, used to offset variability in equilibrium real exchange rates. Alterations in monetary policy or, in extremis, nominal exchange rates came later. Controls, particularly capital controls, seem to have little attraction to countries that do not attempt to maintain pegged exchange rates and were abandoned by them.

Let me expand on this point for a moment by drawing on results in our NBER monograph with Anna Schwartz and others on The International Transmission of Inflation. Under the Bretton Woods system, the Federal Reserve acted as the reserve central bank, quite properly determining monetary policy based on domestic conditions without regard to reserve flows, the balance of payments, or other external conditions. Inconsistencies arose because the other countries maintaining pegged exchange rates with the dollar were unwilling to allow their monetary conditions to adjust passively to changes in the equilibrium real exchange rate or in Federal Reserve policy. Speculators, perhaps inevitably, seemed to spot fundamental disequilibrium long before a convincing case could be made for adjusting the exchange rate. Exchange rate adjustments were the last resort of a humiliated government or the first act of their successors. Instead, policy fundamentals affecting the equilibrium real exchange rate -- notably controls on the flows of capital and goods -- became vital tools to offset other forces changing the real exchange rate or changes in Federal Reserve policy which were undesirable in terms of the domestic goals of the particular nonreserve country. Only over time would the cumulative burden on trade and freedom of more and more controls -- required to pursue simultaneously conflicting exchange-rate and monetary goals -- become so heavy that it became obvious to everyone that revaluation of the nominal exchange rate and relaxation of controls was a necessity. Thereafter, the cumulative process would begin again pending another crisis.

But here I overstate my case. Variable controls did not eliminate entirely the pressure for nonreserve countries to adjust to changes in the equilibrium real exchange rate or reserve-country monetary policy. Exchange rates were pegged for substantial periods, and monetary policy in nonreserve countries did reflect a weighting of those pressures and the domestic goals. Nonetheless, it was very difficult for separate, independent central banks to long accept the dictates of one of their number and of the randomly walking equilibrium real exchange rate.

International trade has risen sharply as a percentage of GNP since the breakdown of the Bretton Woods system. A number of observers had expected the opposite since more variable nominal exchange rates doubtless do impose a burden international trade. Nonetheless, the facts seem to tell us that this method of accommodating underlying change is less burdensome than a strategy which implicitly embodies trade and capital barriers.

<u>Unified Monetary Systems</u>

As we look forward to 1992, it might be interesting to consider briefly the system in the United States by which twelve regional central banks have managed to coexist peacefully without either controls or floating exchange rates among their respective currencies. A unified monetary system like the Federal Reserve System chooses to deal with real exchange rate movements in very particular and automatic ways: First, there can be no changes in nominal exchange rates so long as the system survives. Ultimately, one authority determines the overall quantity of money or price level in the system with relative money supplies adjusting as required by movements in equilibrium real exchange rates.

In the early days of the Federal Reserve System, the New York Federal Reserve Bank was the independent authority with the other Federal Reserve Banks adjusting their money supplies as required to maintain parity with New York. In the 1930s, power shifted to Washington and particularly the Federal Open Market Committee which now determines national monetary conditions with the relative money supplies of the twelve Federal Reserve Banks adjusting to maintain parity among their respective dollars.

There are great attractions to a system of free and open trade in goods, services, and capital and of sure, fixed exchange rates. In the United States, for example, most people don't even notice the seal on each piece of currency indicating which of the twelve Federal Reserve Banks is its issuer. Against these attractions must be weighed those occasions in which a region suffers, say, from a worldwide collapse in the prices obtained by a major industry. This would be painful enough in itself, but the resulting collapse in desired investment depreciates the equilibrium real exchange rate of the suffering region with the other regions. Since it is impossible for one of the Reserve Banks to devalue its currency against the other Reserve Banks, this real depreciation is automatically effected by a deflation in the region. In this case, monetary policy necessarily exacerbates a bad situation in the one region unless a major inflation is elected for the rest of the system.

Reducing Volatility in Real Equilibrium Exchange Rates

Each strategy for dealing with commercial and financial relations across nations or regions clearly involves costs as well as benefits. For the United States, the unified monetary system is obviously the right choice, but I still suspect that there have been state governors who would have availed themselves of an option to float or devalue or impose capital controls if it had been available to them.

Coordination of fiscal policies across nations or regions can reduce the costs associated with any of the three basic strategies. It does so by reducing the underlying volatility in equilibrium real exchange rates. Suppose, for example, that two countries undertake similar fiscal policy initiatives, but begin them three years apart. The real exchange rate might sharply appreciate when the first country moves and then move back to its original level when the second country moves. The implied dislocations involved in moving between tradeable and nontradeable production would be avoided if the countries coordinated the timing of their moves.

Efforts to coordinate fiscal policy, like most worthwhile projects, are not easy. First, we must have a clear understanding of how fiscal policy moves equilibrium real exchange rates. It does so by changing the desired gap between investment and national saving. On the one hand, anything that makes a region or country a better place to invest appreciates its equilibrium real exchange rate. We certainly saw that process in America as we moved first to lower our tax rates on capital relative to other countries while freeing our markets. We saw it operate in reverse after Tax Reform was proposed with the effect of raising capital taxation, which previously had been cut further than planned due to unexpectedly rapid disinflation. As other nations moved toward lower taxes and freer markets, our equilibrium share of world investment fell back toward more normal levels, reinforcing the depreciation of the real exchange rate between 1985 and 1987.

On the other hand, anything that reduces national saving tends to appreciate the equilibrium real exchange rate. Proponents of the twin-deficits approach argue that the size of the government deficit -- that is, government dissaving -- is crucial here. However, I believe it is the level and type of expenditures and taxes which affect national saving. The change in the level of the budget deficit is a potentially misleading gauge of the magnitude or even direction of the effects of fiscal policy on national saving and the exchange rate. Reductions in the budget deficit are a high priority of the government, but they must come through expenditure reductions not tax increases. Our econometric estimates at Treasury support in large part the Ricardian view that offsetting movements in private saving very largely neutralize the effects on national saving of variations in taxes on the budget deficit. A simple example will illustrate the point. In 1987, American GNP grew by some $250 billion with falling unemployment. Based on normal relations, that should have accounted for a $20 to $30 billion increase in private saving. As measured in the national income accounts, the general government deficit fell by $40 billion and is now lower relative to GNP than two thirds of our G-7 partners. If you were to follow the twin-towers approach, a $20 to $30 billion increase in private saving and a $40 billion decrease in government dissaving should have resulted in a $60 to $70 billion increase in national saving. But national saving actually went up by only $33 billion, trivially more than would have been predicted from the normal relationship between consumption on the one hand and GNP growth and unemployment on the other. In other words, private saving was reduced nearly dollar for dollar as government revenues and government saving increased.

This does not mean that reducing the government deficit is not a high priority. But it is crucial that it be done the right way -- by holding down expenditures. Our estimates indicate that over the short and medium run, each dollar of reduction in government expenditures on real goods and services increases national saving by 80 cents compared to only 20 cents for a dollar of tax increase. This increases not only our national saving but world saving.

Regardless of whether or not the effect of capital taxation on investment demand, as I argue, is rather more important than the magnitude of the budget deficit in moving the equilibrium real exchange rate, an interesting question remains: The reduction in tax rates around the world spawned by emulation of our successful policy leaves us all better off. Since we never could have achieved consensus in 1981, isn't it better that America went ahead alone even at the cost of the 1981-84 dollar appreciation which was subsequently reversed?

The American federal system puts the dominant role in fiscal policy in the hands of the central government, but leaves an important degree of freedom to experiment in the hands of the state and local governments. These experiments are not always successful and do move equilibrium real exchange rates among the states, but the range of variability in those rates remains easily tolerable within the framework of an automatically adjusting unified monetary system. Certainly, no pattern of regional dissents is obvious in the minutes of the Federal Open Market Committee.

This perspective suggests that a degree of fiscal harmonization which appears as a 1992 goal may well so complement the removal of trade and capital barriers that the variability of equilibrium real exchange rates among the community is little increased if not actually reduced. Friends like us, who are not members of the Community, certain believe that the opening of individual national markets within the Community over the next four years should provide the occasion for increased, not reduced trade between us.

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Ladies and gentlemen, I thank you for your attention and hope that you found these remarks informative, or at the very least provocative. Thank you.

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Remarks by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
before the
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New York, New York
October 17, 1988

Berlin Diary: An Assessment of the 1988 IMF/World Bank Annual Meetings

Introduction

It is a great pleasure to join you once again in New York. As many of you know, I have strong ties to Manhattan. I was born here and I lived and worked here for many years earlier in my career. As a sign in Times Square used to read: "If the United States is a melting pot, New York makes it bubble." Or, as my favorite Gotham cafe crooner, Bobby Short, put it: "New York is a bad habit one never wants to lose." Thank you for inviting me once again to speak with you in the city that is the navel of the financial universe.

Since I last met with you in 1987, the Institute has undergone a name change which reflects the financial revolution that has occurred in the 1980s. All bankers are now international bankers and your bottom line is influenced as much by events abroad as by developments in your own country.

A few weeks ago the international financial community met in Berlin for the 1988 annual meetings of the IMF and the World Bank. Today I would like to share with you my assessment of what happened in Berlin. The issues discussed there -- economic growth, trade imbalances, exchange rates and international debt -- are critical to the success of your efforts. It is not surprising, therefore, that the number of bankers far exceeded the government officials at the meetings.

In contrast to recent years, the 1988 annual meetings produced few surprises and no fundamental changes in approach. In part, this reflected the political reality of a transition to a new U.S. Administration. It also reflected, however, the fact that 1988 was a pretty good year for the world economy and a general reluctance to change horses when the horse you are riding appears to be winning the race.

NB-35

Economic Policy Coordination and the World Economy

The major industrial countries are turning in a solid economic performance this year. Growth is approaching 4 per-cent -- the best since 1984 and better than had been expected earlier in the year. Furthermore, the pattern of growth among industrial nations is supportive of balance of payments adjustment objectives. Thus, while growth in domestic demand in the United States is slowing, the growth of this component of GNP in the other Summit countries is strengthening, and will, in fact, be twice as fast as in the United States this year. This, coupled with the effects of earlier exchange rate changes, is facilitating a sizeable reduction in our trade and current account deficits. The trade deficit for the first eight months of 1988 was running at an annual rate some $30 billion below the defict recorded in 1987.

A major element of this improved economic picture is an acceleration of investment to nearly 7 percent in the industrial countries. This will add to capacity, and permit greater output and employment <u>without</u> higher prices. Indeed, stronger growth is being achieved with continued moderate inflation. While we must remain vigilant, and recent monetary measures demonstrate that we will, there is no evidence that generalized price pressures are emerging. The fall in interest rates from the peaks achieved following the Fed's latest discount rate hike suggests that inflationary expectations are easing, in part due to lower oil prices.

The framework of economic policy coordination among the seven major industrial countries has been essential to the progress that has been achieved over the last three years. A principal objective of the G-7 meeting in Berlin was to demonstrate that the coordination process is working, that the participants are committed to strengthening it further, and that cooperation in exchange markets is continuing. The solid performance turned in this year provides convincing evidence that coordination is producing the desired results and reinforces confidence that the basic policy directions that have been agreed are correct and should be continued.

There is no complacency among the G-7, however. Countries with large external and budget deficits need to strengthen their fiscal positions. In the United States, we have already made significant strides in reducing the Federal budget deficit, but we share the concerns of our trading partners and consider further progress a high priority. Similarly, surplus countries must maintain strong domestic demand growth.

The coordination process represents a pragmatic approach to strengthening the international monetary system. It involves a discipline that encourages each participant to take actions whose benefits transcend national boundaries. Despite the accomplishments of the past few years, coordination is still in its infancy and there is room for strengthening the discipline of the system. At Berlin, a start was made in integrating structural reforms into the process, focusing initially on financial market liberalization.

In the area of financial market reform, an issue of particular concern to this group involves the European Community's (EC) plan to achieve an integrated market by 1992. The United States has long supported European integration and believes that this process could have major benefits for the world economy.

However, you may be aware that officials of the EC Commission 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.

If applied on a narrow or mirror-image basis, this standard of reciprocity could discriminate against non-European firms seeking entry to the EC and against third-country 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.

Frankly, we find this reciprocity concept very troubling. 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 non-European 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.

As representatives of the international banking community, you have a special interest in seeing to it that EC 1992, which is meant to liberalize different sectors of the European market, not end up having precisely the opposite effect. It would indeed be unfortunate if the application of reciprocity in the EC financial sector resulted in a response from the U.S. Government that damaged the present national treatment standard upon which your operations in the world's largest financial market now rest.

The G-7 is also working to improve the functioning of the international monetary system by further strengthening the current coordination process. As the process of coordination 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 need further strengthening and reform of the system, but what form and direction should this take? These are precisely the issues that are being examined by the G-7. The development of the economic coordination process is evolutionary. Improvements have been and will continue to be made in a step-by-step manner that may not appear dramatic, but will nevertheless produce the improved international monetary system we all seek.

International Debt

The debt of developing countries was another key focus of attention at the meetings. There was broad recognition that the current market-based, case-by-case strategy for achieving recovery and growth in these countries is the correct one. The key policymaking bodies of the IMF and the World Bank -- the Interim Committee and the Development Committee -- reiterated their support for this approach, which has evolved significantly since its initiation in October 1985. They reinforced the importance of economic reforms by debtor countries and identified increased foreign direct investment as an additional source of financing which would not add to the level of debt.

As Secretary Brady indicated in his address to the meetings, this strategy has produced progress in improving the situation of the major debtors, and the prospects for these countries are brighter. Current account deficits have been reduced, and growth has been strengthened. Most debtors are adopting market-oriented reforms to foster growth. Those governments that have sustained such reform efforts -- Chile, Colombia, and Turkey, for example -- have achieved the strongest economic performance and are either approaching or have achieved a return to voluntary access to financial markets. For the 15 major debtors as a whole, economic growth has improved substantially since the 1982-83 period. Trade is expanding, and critical interest/export ratios have declined by nearly one-third.

The progress is encouraging, yet it was agreed that further efforts need to be made to reform debtor economies and to pursue adjustment and growth. Concern was expressed about the adequacy of commercial bank financing, and the need to ensure sufficient financial support for the process of adjustment was underscored.

Consequently, participants agreed that the "menu" approach should be broadened further through voluntary, market-based techniques to increase financial flows or to reduce the stock of debt without transferring risk from private lenders to official creditors. This will require innovation and creativity on the part of debtors and commercial banks alike.

A number of proposals have been advanced to facilitate the securitization of part of commercial bank debt or to encourage new financing. Most, however, appear to require either additional financing from the multilateral institutions or other measures to shift risk from the private to the public secor to make them viable.

As Secretary Brady pointed out, the United States regards with skepticism proposals that may appear to conform to the basic principles of the debt strategy but which in practice will produce only an illusion of progress, at considerable public expense. True market-based, voluntarily agreed alternatives -- such as those contained in the "menu" of options for the recent successful Brazilian financing package -- support both new financing and debt reduction while avoiding these pitfalls.

A special attempt to address the needs of the poorest countries was outlined in Toronto this summer and was most recently endorsed in Berlin. This approach would provide more generous debt relief for the very poorest countries through official reschedulings in the Paris Club. Under this initiative, official creditors could choose among several options when negotiating rescheduling agreements in the Paris Club: concessional interest rates with shorter maturities; longer repayment periods at commercial rates; partial write-offs of debt service obligations; or a combination of these options. This new Paris Club approach is limited to the very poorest countries, as it is in these nations where the burden of official debt is relatively high. We expect that two or three sub-Saharan African countries will benefit from use of these broader options this fall.

Role of the IMF and World Bank

The Berlin meetings provided an opportunity for the Interim and Development Committees to provide guidance on major policy issues. The IMF and World Bank are the central institutions for cooperative international efforts to promote a sound world economy. The ability of the IMF and World Bank to fulfill their responsibilities is of major importance to you as international lenders.

These two institutions are responsible for promoting sound policies in borrowing countries. This, of course, is central to preserving the creditworthiness on which your lending rests. The resources provided by the Fund and Bank are often critical to assembling the financial packages to deal with LDC debt problems. And, they serve as indispensable coordinators and catalyzers that bring together the disparate interests and objectives of the myriad financial institutions that today are involved in international lending.

The progress that has been achieved in dealing with LDC debt problems and preserving a stable international financial system is due in no small part to the efforts of the IMF and World Bank. It is in everyone's interests -- the banks, the LDC borrowers, and the creditor governments -- that they be preserved as financially strong and effective institutions.

It is for this reason that the Interim Committee devoted a substantial portion of its agenda to the large and growing problem of arrears on IMF obligations. In a few short years, arrears have grown from a negligible amount to over $2 1/2 billion, more than double IMF reserves. Had the IMF been a private institution, the regulators would have stepped in long ago.

Unless addressed promptly, the arrears problem will erode the monetary character of the institution, undermine its central role in the system and weaken its financial integrity, perhaps irreparably. The Interim Committee received a report from the IMF Executive Board describing a three-part approach for addressing arrears. It includes preventive measures to avoid a further buildup of overdue obligations, an intensified collaborative approach to help members restore normal financial relations with the IMF, and remedial actions to protect the Fund's financial position in the event the member does not cooperate. The United States believes that this approach offers the opportunity, perhaps the last, to make a real breakthrough and is urging the Executive Board and members to move ahead expeditiously to implement it. The United States is prepared to cooperate constructively in this effort and will do its part.

The Interim Committee also discussed the issue of a possible increase in IMF quotas as part of the current Ninth General Review of IMF quotas. The review is scheduled to be concluded next April and no decisions were therefore expected at this meeting. A wide divergence of view exists, however, on the principal issues of the size and distribution of a quota increase. At a time of scarce financial resources and budget constraints, the case for an increase in IMF resources must be compelling. There must be a demonstrated need that additional resources are required, a case that does not now exist given the IMF's $45 billion in loanable resources. There must be an agreed vision of the IMF's role in the 1990s, so that our taxpayers will know how the resources will be used. And, the arrears problem must be dealt with so that those taxpayers, and their legislative representatives, will not think that good money is being thrown after bad.

The discussion of World Bank issues in the Development Committee focused on how the resources provided by the recently agreed General Capital Increase (GCI) are to be used. In particular, considerable attention and support was given to the World Bank's renewed efforts in the area of poverty reduction and in protecting the poor in adjustment programs. In this connection, agreement was reached on the timetable and agenda for the negotiations on the Ninth Replenishment of IDA. Finally, the Committee stressed that protecting the environment and conserving natural resources should be critical elements in World Bank lending.

Conclusion

Let me close by observing that the annual meetings of the IMF and World Bank have traditionally been a time for stocktaking and course setting. This year was no exception and, to summarize, the report card issued at the Berlin meetings had the following features. The world economy is on a much more solid footing than it was when the decade began. Growth continues, but it is now more balanced and, as a result, external imbalances are being reduced. Inflation remains low and investment is accelerating. The international debt strategy remains valid and progress continues to be made.

These are indeed positive developments and ones which this group should welcome for a very simple reason -- it will allow your firms to do a greater volume of profitable business.

Thank you very much.

TREASURY NEWS

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FOR RELEASE AT 4:00 P.M.
October 18, 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 October 27, 1988. This offering will provide about $ 875 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,116 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, October 24, 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 July 28, 1988, and to mature January 26, 1989 (CUSIP No. 912794 RD8), currently outstanding in the amount of $7,283 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated October 27, 1988, and to mature April 27, 1989 (CUSIP No. 912794 RV8).

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 October 27, 1988. In addition to the maturing 13-week and 26-week bills, there are $ 9,284 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 $ 1,834 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,849 million as agents for foreign and international monetary authorities, and $ 5,921 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
OCTOBER 19, 1988

CONTACT: LARRY BATDORF
566-2041

U.S.-GERMAN INCOME TAX TREATY NEGOTIATIONS NEARING CONCLUSION

U.S.-German income tax treaty negotiations were held from October 10 to October 14. There is now substantial agreement on all important points in the new treaty and the few open questions should be resolved at a concluding session in December 1988. The parties plan to initial the treaty at this meeting.

Treaty ratification is expected in 1989.

-oOo-

NB-37

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
October 19, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $9,000 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,000 million of 2-year notes to refund $10,904 million of 2-year notes maturing October 31, 1988, and to paydown about $1,900 million. The public holds $10,904 million of the maturing 2-year notes, including $1,232 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,000 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 $639 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

NB-38

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED OCTOBER 31, 1988

October 19, 1988

Amount Offered:	
To the public	$9,000 million
Description of Security:	
Term and type of security	2-year notes
Series and CUSIP designation	AG-1990 (CUSIP No. 912827 WU 2)
Maturity date	October 31, 1990
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	April 30 and October 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, October 26, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, October 31, 1988
b) readily-collectible check ..	Thursday, October 27, 1988

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

FOR IMMEDIATE RELEASE October 19, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of September 1988.

As indicated in this table, U.S. reserve assets amounted to $47,788 million at the end of September, up from $47,778 million in August.

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					
Aug.	47,778	11,061	9,058	18,017	9,642
Sep.	47,788	11,062	9,074	18,015	9,637

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.

NB-39

File Copy
10/19/88

I. OVERVIEW AND BACKGROUND

Chapter 1

OVERVIEW

A. Introduction

Section 482 of the Internal Revenue Code[1] authorizes the Secretary of the Treasury to allocate income, deductions, and other tax items among related taxpayers to prevent evasion of taxes or to reflect their incomes clearly. The Tax Reform Act of 1986 [hereinafter 1986 Act] amended section 482 for the first time in many years by providing that the income from a transfer or license of intangible property must be commensurate with the income attributable to the intangible. The Conference Committee report stated:

> The conferees are also aware that many important and difficult issues under section 482 are left unresolved by this legislation. The conferees believe that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect.[2]

In response to this recommendation, the Internal Revenue Service and the Treasury Department have reexamined the theory and administration of section 482, with particular attention paid to transfers of intangible property. This study presents the findings and recommendations of the Service and Treasury.

The study is divided into four parts. Part I recounts the history of section 482 and the evolution of issues leading to the 1986 amendments. Part I also contains recommendations and suggestions for further consideration to assure both thoughtful analysis by taxpayers in setting transfer prices and disclosure of information to permit adequate development of transfer pricing issues on examination.

The problems that have been encountered in relation to transfers of intangible property are both legal and administrative. The 1986 Act clarifies the legal standard for determining arm's length pricing by stating that transfer prices

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1 Unless otherwise stated, all references to sections and regulations are to the Internal Revenue Code of 1986 and the regulations promulgated thereunder.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986) [hereinafter 1986 Conf. Rep.].

for intangible property must be "commensurate with income." Part II discusses Congress' 1986 change to section 482 and explains that this standard requires periodic, and generally prospective, adjustments to transfer prices to reflect significant changes in the income attributable to intangible property. In any event, transfer prices must be determined on the basis of true comparables if they in fact exist. Part II concludes that the commensurate with income standard is fully consistent with the arm's length principle.

The primary administrative difficulty relating to transfers of intangible property is the failure of the regulations to specify a so-called fourth method of income allocation for situations in which comparable transactions do not exist. This problem has been particularly acute with respect to high profit intangibles. Part III of the study explores the economic theory underlying section 482 and proposes a methodology for allocating income, and thereby determining transfer prices in such cases, which draws upon various methods that have been used on an ad hoc basis by the Service, taxpayers, and the courts. The methodology would utilize functional analysis and allocate income by using comparable transactions when they exist, arm's length rates of return when comparables do not exist, and a profit split approach when neither comparables nor arm's length rates of return can be used to allocate all intangible income.

Part IV examines cost sharing arrangements and relevant implications arising from the 1986 legislation.

The specific chapters in each part and the appendices to the study are described below.

B. Part I: Background

Chapter 2 reviews the history of particular transfer pricing legislation and regulations before 1986, including regulations promulgated in 1968, which are still in effect today.

Chapter 3 discusses administrative problems. This chapter is supplemented by a survey of selected International Examiners and Group Managers, summarized in Appendices A and B, which sought information about how the section 482 regulations work in practice. Significant problems include access to pricing information and difficulties in applying pricing methods to transfers of intangible assets. The chapter includes recommendations regarding the maintenance of transfer pricing information in the taxpayer's books and records, which would be required to be provided to the IRS immediately upon request in an examination, summary reporting of the taxpayer's transfer pricing methodology on Forms 5471 and 5472, and the assertion of appropriate penalties for failure to disclose information or for substantial understatements of income.

The regulations place strong emphasis on finding comparable unrelated party transactions as a guide for evaluating related party transactions. Chapter 4 discusses the search for comparables in the decided cases, and concludes that comparables are often either absent or misused when transfers of intangible property are at issue.

The regulations provide that, when comparables are unavailable, some other appropriate method of allocating income among related parties may be used. Chapter 5 examines the decided cases to see what other methods have been used, including profit splits, rates of return, income to expense ratios, and customs valuations.

C. <u>Part II: Section 482 After the 1986 Tax Reform Act</u>

Chapter 6 focuses on the "commensurate with income" standard incorporated into section 482 by the 1986 Act. After describing the legislative history, the chapter discusses limitations some have suggested on the scope of the standard, and explains its application to normal profit potential intangibles as well as to high profit potential intangibles.

Chapter 7 addresses an issue of major concern to the foreign trading partners of the United States: compatibility with international transfer pricing standards. The chapter concludes that the arm's length standard is the accepted international norm for making transfer pricing adjustments. The study reaffirms that Congress intended the commensurate with income standard to be consistent with the arm's length standard, and that it will be so interpreted and applied by the Internal Revenue Service and the Treasury Department.

Chapter 8 discusses the need under the commensurate with income standard to make periodic adjustments to intangible income allocations. Recommendations address the issues of the frequency of review, retroactivity, lump sum payments, and set-offs.

Taxpayers and practitioners have long advocated safe harbors as a solution to many of the problems arising under section 482. Chapter 9 discusses safe harbors in theory and analyzes some of the safe harbors that have been proposed. While the Service and Treasury do not categorically reject the possibility that some useful safe harbors might be developed, none of those currently proposed appears satisfactory.

D. <u>Part III: Methods for Valuing Transfers of Intangibles</u>

The current regulations adopt a market-based approach, distributing income among related parties the way a free market would distribute it among unrelated parties. Some critics have suggested that a unitary business approach, eliminating the fiction of arm's length dealing and accounting for economies of related party dealing through a formulary method, might be more theoretically sound. Chapter 10 examines these arguments and concludes that the market-based arm's length standard remains the better theoretical allocation method.

Chapter 11 discusses the formulation of a methodology for applying the arm's length standard to transfers of intangible property. Beginning with a discussion of the use of exact and inexact comparables, the chapter proposes as an additional method an arm's length return method that, with appropriate adjustments, could be used in a large percentage of cases. For cases involving intangibles in which comparables and the arm's length return method cannot account for all income to be allocated, a profit split addition to the arm's length return method is described.

E. Part IV: Cost Sharing Arrangements

Chapter 12 presents a description of cost sharing arrangements and describes the history of their tax treatment, comparing the detailed section 482 cost sharing regulations that were proposed in 1966 with the terse version actually promulgated in 1968. The chapter reviews foreign experience with cost sharing, a 1984 Congressional recommendation that the cost sharing rules be expanded, and the special rules governing cost sharing arrangements between possessions corporations and their domestic affiliates.

The legislative history regarding the change to section 482 in the 1986 Act states that Congress intended to permit bona fide cost sharing arrangements, but expected the economic results of such arrangements to be consistent with the commensurate with income standard. Chapter 13 identifies and discusses various issues related to the use of cost sharing arrangements after the 1986 Act.

F. Appendices

Appendices A and B to the study summarize the results of a survey of Service personnel about the administration of section 482. Appendix C analyzes the transfer pricing law and practices of selected jurisdictions. Appendix D describes the publicly available information about third party licensing practices. Appendix E contains 14 examples that illustrate how the principles explained in the study are applied in different factual contexts.

G. Future Agenda

This study reflects input from taxpayer groups, practitioners, and other concerned members of the public, as well as the combined experience and careful thought of those in the government charged with enforcing section 482. Nevertheless, it is only a beginning; it sets forth conclusions and recommendations in some areas, and describes the need for further study in others.

In the study, input is requested on specific issues from taxpayers and practitioners. More generally, however, readers are urged to provide any comments that would be useful in formulating a fair and workable system of administering a statute that has challenged taxpayers and the government alike. It is anticipated that comments will be taken into account in drafting proposed regulations and in examining additional issues not discussed in this study -- including such areas as the services portion of the section 482 regulations, the impact of currency fluctuations on transfer pricing, a more detailed review of functional analysis, and the proper methodology for valuing assets under the various "fourth method" approaches described in Chapter 11.

Comments should be forwarded in triplicate to the Office of Associate Chief Counsel (International), Branch 1, 950 L'Enfant Plaza South, S.W., Room 3319, Washington, D.C. 20024. Comments are requested to be filed by February 15, 1989.

Chapter 2

TRANSFER PRICING LAW AND REGULATIONS BEFORE 1986

A. Early History

The Commissioner was generally authorized to allocate income and deductions among affiliated corporations in 1917.[3] He could require related corporations to file consolidated returns "whenever necessary to more equitably determine the invested capital or taxable income...." The earliest direct predecessor of section 482 dates to 1921, when legislation went beyond authority to require consolidated accounts and authorized the Commissioner to prepare consolidated returns for commonly controlled trades or businesses to compute their "correct" tax liability.[4] This legislation was passed partly because possessions corporations, ineligible to file consolidated returns with their domestic affiliates, offered opportunities for tax avoidance.[5] As early as 1921, Congress perceived the potential for abuse among related taxpayers engaged in multinational transactions.

When the predecessor to current section 482 was incorporated into the 1928 Revenue Act (as section 45), the provision was removed from the expiring consolidated return provisions and significantly expanded.[6] The Commissioner's authority to make an adjustment under section 45 was expressly predicated upon his duty to prevent tax avoidance and to ensure the clear reflection of the income of the related parties (to determine their "true tax liability," in the words of the legislative history).[7]

B. Regulations and the Courts -- through the early 1960s

For many years, the small number of United States companies with multinational affiliates meant that section 482 had little impact in the international context. Prior to the early 1960s, the primary focus of the Service's enforcement efforts using

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[3] Regulation 41, Articles 77-78, War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917).

[4] Rev. Act of 1921, ch. 136, §240(d), 42 Stat. 260 (1921).

[5] S. Rep. No. 275, 67th Cong., 1st Sess. 20 (1921).

[6] Rev. Act of 1928, ch. 852, §45, 45 Stat. 806 (1928).

[7] H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

section 482 was domestic. Regulations issued in 1935[8] (under section 45) remained in effect substantially unchanged until 1968.

The regulations set forth the arm's length standard as the fundamental principle underlying section 482: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[9] They did not, however, mandate the use of any particular allocation method.

The case law interpreting section 482 and its predecessors took a broad approach. The concepts of "evasion of taxes"[10] and "clear reflection of income"[11] were developed into far-reaching weapons to attack a variety of tax abuses. The predecessors of section 482 were used to prevent recognition of a tax loss on securities following a tax-free transfer from the corporation that had incurred, but could not use, the loss,[12] and to prevent the mismatching of the expenses incurred by one corporation in growing crops from the income artificially realized by another corporation from harvesting and selling those crops.[13]

The courts applied a number of different standards for determining when transactions were conducted at arm's length.

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[8] Treas. Reg. 86, §45-1(b) (1935).

[9] Id.

[10] Asiatic Petroleum Co. v. Comm'r, 79 F.2d 234, 236 (2d Cir.), cert. denied, 296 U.S. 645 (1935) (concept of evasion for this purpose includes civil tax avoidance).

[11] Central Cuba Sugar Co. v. Comm'r, 198 F.2d 214, 215 (2d Cir.), cert. denied, 344 U.S. 874 (1952) (application of clear reflection standard does not require proof of tax avoidance motive).

[12] National Securities Corp. v. Comm'r, 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943).

[13] Central Cuba Sugar, supra n. 11; Rooney v. U.S., 305 F.2d 681 (9th Cir. 1962).

Transactions were scrutinized to determine if related parties received full, fair value,[14] a fair and reasonable price,[15] or a fair price including a reasonable profit.[16]

Before 1964, it was generally understood that section 482 could not be used by the Service to place taxpayers, in effect, on a consolidated return basis.[17] In 1964, the Tax Court used section 482 to combine the incomes of two separate corporations that operated a downtown clothing store and its suburban branch store.[18] This case raised concerns among taxpayers over the use of section 482 in substance to ignore separate corporate entities.

C. Developments in the 1960s

By the early 1960s, the business and regulatory climate in which U.S. and foreign multinationals operated changed substantially. In 1961, the Treasury Department urged that significant changes be made in the taxation of U.S. enterprises with foreign affiliates. In particular, Treasury contended that section 482 was not effectively protecting U.S. taxing jurisdiction.[19]

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[14] Friedlander Corp. v. Comm'r, 25 T.C. 70, 77 (1955).

[15] Polack's Frutal Works v. Comm'r, 21 T.C. 953, 975 (1954).

[16] Grenada Industries v. Comm'r, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir.), cert. denied, 346 U.S. 819 (1953).

[17] Seminole Flavor Co. v. Comm'r, 4 T.C. 1215 (1945); cf. Moline Properties v. Comm'r, 319 U.S. 436 (1943). In extreme cases of income shifting, other legal theories such as assignment of income, substance over form, disregard of corporate entity, or treatment of corporate entity as an agent have been used by courts to attribute income to the appropriate person or corporate entity. These theories are beyond the scope of this paper, and they are generally not used by courts when section 482 is also applicable. See, e.g., Hospital Corporation of America v. Comm'r, 81 T.C. 520 (1983) (foreign affiliate not treated as a sham; section 482 applied for use of U.S. parent's intangibles).

[18] Hamburgers York Road, Inc. v. Comm'r, 41 T.C. 821 (1964); Aiken Drive-In Theatre Corp. v. U.S., 281 F.2d 7 (4th Cir. 1960) (the shifting of an abandonment loss from one corporation to another created an inaccurate picture of income, justifying use of section 482).

[19] Hearings on the President's 1961 Tax Recommendations Before the Committee on Ways and Means, 87th Cong., 1st Sess., vol. 4, at 3549 (1961) (statement of M. Caplin, Commissioner of

In 1962, Congress considered how to stop U.S. companies from shifting U.S. income to their foreign subsidiaries.[20] While the Ways and Means Committee observed that under existing law the Service could prevent this practice by allocating income under section 482, it proposed further legislation to minimize "the difficulties in determining a fair price," particularly in instances "where there are thousands of different transactions engaged in between a domestic company and its foreign subsidiary."[21]

The Ways and Means Committee proposal as adopted by the House would have added to section 482 a new subsection dealing with sales of tangible property between U.S. corporations and their foreign corporate affiliates.[22] Unless the taxpayer could demonstrate its use of an arm's length price under the comparable uncontrolled price method, taxable income was to be apportioned between related parties under a formula based on their relative economic activities. In addition, no income was to be allocated to a "foreign organization whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States."[23]

The Senate version of the 1962 Revenue Bill, which prevailed in conference, omitted the House provision. Instead, the Finance Committee concluded that section 482 already provided ample regulatory authority to prevent improper multinational allocations.[24] The Conference Committee endorsed this approach, stating:

> The conferees on the part of both the House and the Senate believe that the objectives of section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482.

Internal Revenue, "Problems in the Administration of the Revenue Laws relating to the Taxation of Foreign Income").

[20] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 28 (1962).

[21] Id.

[22] H.R. 10650, 82d Cong., 2d Sess., §6 (1962).

[23] Id.; see H.R. Rep. No. 1447, 87th Cong., 2d Sess. 537-38 (1962).

[24] See, e.g., Hearings on H.R. 10650 Before the Senate Committee on Finance, 87th Cong., 2d Sess., pt. 7, at 2913, 3011-3012 (1962) (statements by P. Seghers and D. N. Adams).

> Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.[25]

D. The Current Regulations

Treasury responded by promulgating regulations, issued in final form in 1968, that (with only a few changes) govern transfer pricing practices today.[26] Those regulations reaffirmed the arm's length standard as the principal basis for transfer pricing adjustments but attempted, for the first time, to establish rules for specific kinds of intercompany transactions. The final regulations applied to the performance of services, the licensing or sale of intangible property, and the sale of tangible property.[27]

1. Services. In determining an arm's length charge for services, section 1.482-2(b)(3) of the regulations provides:

> For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.

The regulations do not provide any specific guidance for determining what the charge in independent transactions would have been in the absence of comparable transactions with independent parties.

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[25] H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962).

[26] Proposed regulations were issued in 1965, were withdrawn and reproposed in 1966, and were issued in final form in 1968. Proposed Treas. Reg. §§1.482-1(d) and 2, 30 Fed. Reg. 4256 (1965); Proposed Treas. Reg. §§1.482-1(d) and 2, 31 Fed. Reg. 10394 (1966); and T.D. 6952, 1968-1 C.B. 218.

[27] In addition to the tangible and intangible property and the services regulations, there are safe harbors and other rules for interest rates on related party loans, Treas. Reg. §1.482-2(a), and rules similar to the services rules for related party leasing transactions, Treas. Reg. §1.482-2(c). These rules are generally not discussed in this paper.

2. Intangible Property. As to the licensing or sale of intangible property, section 1.482-2(d)(2)(ii) of the regulations provides:

> In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

The intangible property portion of the regulations contemplate a failure to find appropriate comparables. Where they are unavailable, the regulations list 12 factors to be taken into account, including prevailing rates in the industry, offers of competitors, the uniqueness of the property and its legal protection, prospective profits to be generated by the intangible, and required investments necessary to utilize the intangible.[28] The regulation offers little or no guidance, however, in determining how much relative importance particular factors are to be given.

3. Tangible Property. Finally, the section 482 regulations set out detailed rules for determining the transfer prices of tangible personal property. Section 1.482-2(e)(2)(4) of the regulations describes three specific methods for determining an appropriate arm's length price: the comparable uncontrolled price method, the resale price method, and the cost plus method. All three rely on comparable transactions to determine an arm's length price, either directly or by reference to appropriate markups in comparable unrelated transactions. The regulations mandate that the three enumerated methods be used in the order set forth. They also authorize other unspecified methods, which have come to be known generically as "fourth methods":

> Where none of the three methods of pricing ... can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used. [Emphasis supplied.][29]

The specific transaction-oriented models described above for making transfer pricing determinations were adopted in lieu of

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[28] Treas. Reg. §1.482-2(d)(2)(iii).

[29] Treas. Reg. §1.482-2(e)(1)(iii).

"mechanical safe havens" based on profit margins, percentage mark-ups or mark-downs, and the like, which had been suggested by various taxpayers commenting on proposed regulations issued in 1965 and 1966. Such safe harbors were rejected for two reasons. First, because of the extraordinary range of returns earned at arm's length, even within a single industry or company, no principled and equitable basis for such safe harbors could be devised. Second, any effective safe harbor income allocation would inevitably serve as a "floor," applying only to those taxpayers not able to document a more advantageous fact pattern.[30] As discussed in Chapter 9, infra, the concerns raised by safe harbors still have not been satisfactorily dispelled.

E. Conclusion

In general, the section 482 regulations relating to services, intangible property, and tangible property rely heavily on finding comparable transfer prices or comparable transactions. The regulations provide little guidance for determining transfer prices in the absence of comparables.

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[30] Surrey, Treasury's Need to Curb Tax Avoidance in Foreign Business through the Use of Section 482, 28 J. Tax'n 75 (1968).

Chapter 3

RECENT SERVICE EXPERIENCE IN ADMINISTERING SECTION 482

In order to determine what difficulties International Examiners are encountering in administering the regulations, a questionnaire was prepared through the joint efforts of Treasury, Chief Counsel, and International Examination personnel. The questionnaire was sent to selected International Examiners (IEs) and IE Group Managers. In addition, selected IRS economists, IEs, Group Managers, and IRS trial attorneys were interviewed.

The results of the analysis of the questionnaires have been compiled and are set forth in Appendix A. Included in Appendix B is a completed questionnaire reflecting the aggregate data supplied by the respondents.[31] In general, the survey and interviews revealed no surprises. The two primary problems in administering section 482 have been the difficulty of obtaining pricing information from the taxpayers during an examination and the difficulty of valuing intangibles -- including the valuation of intangible property in connection with sales of tangible property. This chapter discusses these problems, makes several related suggestions regarding disclosure of information and penalties, and suggests that the early use of counsel and economic experts would alleviate these problems.

A. Service's Access to Pricing Information

A significant threshold problem in the examination of section 482 cases has been IRS access to relevant information to make pricing determinations. In some cases, relevant information

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[31] IEs and Group Managers were requested to complete one questionnaire for each of the three cases they considered to be their most important section 482 cases. In some instances respondents had not had experience with three important section 482 cases, so that fewer responses were made to some questions. In others, some respondents answered based on their general experience, rather than the particular case for which the questionnaire was completed. In many instances the categorization of particular issues entails a great deal of judgment. For example, a case such as Hospital Corporation of America, supra n. 17, could be viewed as a services case, an allocation of income case, a profit split case, or an intangibles case. For these reasons we have used the results of the questionnaire throughout this paper primarily for purposes of illustration. However, the results, where used, represent and correspond with the experiences of persons interviewed and others in the Service responsible for administering section 482.

is not furnished by the taxpayer to the examining agent.[32] In other cases, long delays are experienced by agents in receiving information, in most cases without explanation for the delays. In many cases, delays in responding to IE requests for information exceed one year.[33] Because of the emphasis upon timely closing of large cases in the recent past, section 482 cases have been closed without receiving necessary information or without the opportunity for agents to follow up on information that has been provided.[34]

The experience of the agents has been that the vast majority of taxpayers, when asked, are unable to provide an explanation of how their intercompany pricing was established.[35] This may account in large part for the denial of access to information and delays encountered by IEs.

In recent years the Service has placed an emphasis on examination of transactions with subsidiaries located in tax haven jurisdictions.[36] Because of the financial and commercial secrecy laws that exist in tax haven jurisdictions, IRS access to third party data has been significantly hampered. Problems with access to information because of foreign secrecy laws have been to some extent alleviated by the enactment of section 982[37] and by a broad interpretation of the IRS administrative summons power

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[32] Many of the requests for information that are not honored concern transactions with third parties that would provide comparables for analyzing a potential section 482 adjustment. Appendix B, _infra_, at Question 18C.

[33] Appendix B, _infra_, at Question 19.

[34] Appendix B, _infra_, at Question 13, and Appendix A, _infra_, at 4-5.

[35] Appendix B, _infra_, at Question 14.

[36] General Accounting Office, Report to the Chairman, Committee on Ways and Means, _IRS Audit Coverage: Selection Procedures Same for Foreign and other U.S. Corporations_ 26-29 (1986) [hereinafter GAO, _IRS Audit Coverage_].

[37] Under section 982, a taxpayer which, without reasonable cause, fails to produce, within 90 days, foreign based documents sought by the agent during the course of the examination through the use of a formal document request may be precluded from introducing the documents sought in a subsequent court proceeding. A special court proceeding is established at which the taxpayer may show reasonable cause for failing to produce the requested documents or otherwise move to quash the formal document request.

by the courts.[38] However, as will be subsequently discussed, agents have failed to use the section 982 and administrative summons procedures aggressively.

Because of the dramatic increase in recent years in direct foreign investment in the United States,[39] the examination of transactions between foreign parents and their U.S. affiliates will become an increasingly more important part of the international examination program. A survey of rates of return on these companies based on IRS statistics of income ("SOI") data reveals a substantially lower than average profit in this country reported by these companies, which may involve transfer pricing policies.[40]

In practice, examinations of United States subsidiaries of foreign parents have developed into some of the Service's most difficult examinations. A primary reason for the difficulty is that agents are unable to obtain timely access to necessary data, which is typically in the hands of the parent company. In many cases, foreign parent companies refuse to produce this information upon request. An additional difficulty encountered by agents is that foreign parent corporations may not be subject to information reporting requirements similar to U.S. requirements.[41]

Both the administrative summons procedures[42] and the formal document request procedures[43] are tools that are available to IEs to compel production of information necessary to determine whether a section 482 adjustment is appropriate. Unfortunately,

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[38] Vetco v. United States, 644 F.2d 1324 (9th Cir. 1981), cert. denied, 454 U.S. 1098 (1982) (summons for books and records of Swiss controlled foreign corporation enforced notwithstanding potential violations of the Swiss Penal Code).

[39] Foreign direct investment in the United States increased from about $34.6 billion in 1977 to about $100.50 billion in 1984. GAO, IRS Audit Coverage, supra n. 36, at 10.

[40] Hobb, Foreign Investment and Activity in the United States through Corporations, 1983, SOI Bulletin 53-68 (Summer 1987); see BNA Daily Tax Report, April 1, 1987, at G2.

[41] Wheeler, SEC Requires Less Disclosure from Foreign Corporations, Tax Notes, October 12, 1987, at 195-197.

[42] Section 7602; United States v. Toyota Motor Corp., 561 F. Supp. 348 (C.D. Cal. 1983); United States v. Toyota Motor Corp., 569 F. Supp. 1158 (C.D. Cal. 1983).

[43] Section 982.

for a variety of reasons, IEs seldom serve administrative summonses or section 982 requests.[44] The most common reason given for failing to use these procedures is the time delay necessary to follow them, which conflicts with the need to close the examination. Another reason given in many cases was the necessity of maintaining a good working relationship with the taxpayer, which IEs feared would be harmed if these procedures were used.

Although section 6001 contains a general requirement that a taxpayer maintain adequate books and records, the section 482 regulations are generally silent with regard to records and their accessibility to either support or to determine arm's length prices.[45] Thus, the current regulations do not advise taxpayers specifically of the type of information that is necessary in order to determine compliance with section 482. Specific information on transactions between parent and subsidiary corporations is required on forms 5471 and 5472, which have been widely used by agents in planning and conducting section 482 examinations.

Service experience has been that many taxpayers do not rely upon any form of comparable transactions or other contemporaneous information either in planning or in defending intercompany transactions.[46] Although the legislative history to the 1986 Act expresses concern that industry average royalty rates are used by taxpayers to justify royalties for high profit intangibles,[47] the more serious problem has been that the taxpayer, not having structured the transaction with any comparable in mind, seeks to defend its position by finding whatever transaction or method gets closest to the transfer price initially chosen, whether that be an industry average rate of return or some other type of comparable.

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[44] In the survey conducted as part of this study, IEs reported using summonses and section 982 requests in approximately 5% and 4%, respectively, of the cases reported in the survey. Appendix B, infra, at Questions 21, 22.

[45] An exception in Treas. Reg. §1.482-2(b)(7) requires adequate records to verify costs or deductions used in connection with a charge for services to an affiliate.

[46] Appendix B, infra, at Question 57.

[47] H.R. Rep. No. 426, 99th Cong., 1st Sess. 424 (1985) [hereinafter 1985 House Rep.]. The survey revealed that in approximately 41% of the cases in which taxpayers relied upon comparables, industry averages were used. Appendix A, infra.

Problems related to information and aggressive return positions would be alleviated if the regulations specifically set out a taxpayer's responsibility to document the methodology used in establishing intercompany transfer prices prior to filing the tax return and to require that such documentation be provided within a reasonable time after request. The documentation should include references to any comparable transactions, rates of return, profit splits, or other information or analyses used by the taxpayer in arriving at transfer prices. In general, a taxpayer making relatively minor investments would not be required to obtain information regarding comparable transactions outside of its own knowledge of its business affairs and those of its competitors, but to use information and analyses that generally would have been produced by the taxpayer in the course of developing its business plan. However, a taxpayer engaging in a major transaction or one involved in a complex profit split analysis involving significant high profit intangibles[48] would be expected to gather and analyze the types of information illustrated by the examples in Appendix E which, once again, is information likely to be produced by the taxpayer in developing its business plan. In the absence of comparables, taxpayers should be required at a minimum to apply a rate of return analysis or profit split methodology that may be prescribed in regulations under which the taxpayer would identify assets and functions performed by it and its affiliates and identify the rate of return or profit split that the taxpayer believes should be assigned or allocated to each activity or function.

Furthermore, Forms 5471 and 5472 should be revised to include summary information describing how intercompany prices were determined and an attestation that the documentation required to be maintained under the section 482 regulations, as described above, was available at the time of preparation of the return and will be made available at the start of an IRS examination. Requiring information to be made available at the beginning of an audit would alleviate problems of receiving either too little or too much information near the expiration of the statute of limitations.

The Service and Treasury believe that taxpayer compliance in the transfer pricing area with respect both to disclosure of information and to conformity with the arm's length standard would be enhanced by the proper assertion of appropriate penalties. While the penalty imposed by section 6661 for substantial understatement of tax can apply, to date the Service has only infrequently imposed penalties in connection with making

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[48] See discussion infra Chapter 11.

section 482 adjustments.[49] The Internal Revenue Service is currently engaged in a comprehensive study of the role of civil tax penalties,[50] as are many other interested parties. It, therefore, seems timely to focus now on the effectiveness of existing penalties in encouraging compliant taxpayer behavior and penalizing unjustified positions in the transfer pricing area. Consideration should be given to when the section 6661 penalty should be raised and whether it is adequate to deter instances where taxpayers do not make intercompany pricing decisions upon a reasonable basis, or whether a new penalty should be proposed.

The Service and Treasury are interested in recommendations in this area, including such specific comments as to the type and amount of penalties, and whether there should be certain transaction oriented thresholds that ought to apply before any penalty could be asserted. For example, a transaction specific penalty (similar to the overvaluation penalty of section 6659) may be an appropriate means of deterring substantial deviations from the commensurate with income standard. Specific consideration should be given to whether the applicable penalty provisions should be amended to apply if there is a substantial deviation from the appropriate commensurate with income payment regardless of whether there is disclosure on the tax return of the manner in which taxpayers computed transfer prices. Disclosure of the taxpayer's method of computing a transfer price can not adequately inform the Service as to whether such a transfer price substantially deviates from the appropriate section 482 transfer price absent a thorough audit. Consequently, such disclosure should not prevent the imposition of a penalty for substantial deviation from the correct section 482 transfer price.[51] Since it is possible to use the provisions of section 367(d) to deter abusive situations (_see_ discussion of section 367(d) _infra_ Chapter 6), it may also be appropriate to clarify how taxpayers may avoid imposition of penalties in the context of section 367 adjustments.

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[49] Under Rev. Proc. 88-37, 1988-30 I.R.B. 31, a taxpayer that reports intercompany transactions, on Schedules G and M of Form 5471, may avoid the substantial understatement penalty. _See_ Rev. Proc. 85-26, 1985-1 C.B. 580 (amended returns or statements made following commencement of a CEP examination may avoid assertion of the substantial understatement penalty).

[50] Commissioner's Penalty Study, _A Philosophy of Civil Tax Penalties_ (discussion draft June 8, 1988).

[51] _See_ discussion of the commensurate with income standard and periodic adjustments _infra_ Chapters 6 and 8.

B. Intangibles

A significant portion of section 482 adjustments proposed in recent years have involved an adjustment for pricing with respect to the licensing or other transfer of intangibles.[52] Because of the absence of comparables in many cases, intangible transfers generally are the most problematic of adjustments due to the inherent difficulty of valuing intangibles under the existing regulations. As previously noted in Chapter 2, the intangible property portion of the regulations contemplate a failure to find appropriate comparables and list 12 factors to be taken into account in valuing intangibles in the absence of comparables. No guidance is given, however, in determining the relative importance of particular factors.

In a significant number of cases, IEs relied upon sections of the regulations other than the intangibles portion to make a transfer pricing adjustment.[53] Intangibles are often transferred by incorporation into tangible property that is sold or rented. In these types of cases, the taxpayers have not been required to isolate the value of the intangible.[54] Incorporating a return on an intangible in a transfer price for tangible property does not alleviate, however, the difficulty of valuing the intangible.

A common example is the transfer of tangible property with a trademark, trade name, or recognizable logo attached. It is clear from the regulations that a trademark, trade name, or logo is an intangible.[55] The regulations governing the sales of tangible property specify that, in applying the comparable uncontrolled price, resale price, and cost plus methods, adjustments must be made for sales with or without trademarks, provided there is a reasonably ascertainable effect on the price.[56] In some cases adjustments for trademarks are relatively easy to make. The analysis, however, becomes much more complex if there are no similar products sold (with or without

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[52] In the survey conducted for the study, an adjustment was made under Treas. Reg. §1.482-2(d) in about 50% of the reported cases. Appendix B, infra, at Question 68.

[53] In approximately 40% of the cases reported in the survey, IEs cited the inability to value an intangible as the reason why they failed to follow the intangibles section of the regulations. Appendix B, infra, at Question 72.

[54] Rev. Rul. 75-254, 1975-1 C.B. 243.

[55] Treas. Reg. §1.482-2(d)(3).

[56] See, e.g., Treas. Reg. §§1.482-2(e)(2)(ii) and example (2), 1.482-2(e)(3)(ii) example (2), and 1.482-2(e)(4)(iii)(c).

trademarks) on which to base a comparison. Setting a transfer price for a product in such a case involves the same difficult exercise as setting a royalty rate for a licensed intangible. One of the recent pharmaceutical cases presents an example of this latter situation since it involved the sale of unique pharmaceutical products.[57]

Intangibles may also be transferred in the form of services. In some circumstances, taxpayers have attempted to shift large amounts of income to tax haven subsidiaries by "loaning" a few key employees to a tax haven affiliate. By loaning employees, the parent company may simultaneously provide services and transfer valuable intangible know-how. In transactions which are structured as an intangibles transfer, it is difficult to value services rendered in connection with the transfer of intangible property, which may be necessary for purposes of determining the source of the income.[58]

A particularly difficult aspect of valuing intangibles has been determining what part of an intangible profit is due to manufacturing intangibles and what part is due to marketing

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[57] Eli Lilly & Co. v. Comm'r, 84 T.C. 996 (1985), rev'd in part, aff'd in part and remanded, Nos. 86-2911 and 86-3116 (7th Cir. August 31, 1988) [Lilly]. See the discussion of Lilly, infra, Chapters 4 and 5.

[58] In certain circumstances, no separate allocation is required for services performed in connection with the transfer of intangible property. Treas. Reg. §1.482-2(b)(8). Services are rendered in connection with the transfer of intangible property if they are merely ancillary or subsidiary to the transfer of the intangible property. The regulations give as an example of ancillary services start-up help given to a related entity in order for it to integrate a trade secret manufacturing process into its operations. The regulations then state that, should the transferor continue to render services after the process has been integrated into the manufacturing process, a separate allocation for services would be required under the regulations. The experience of the IEs is that the current regulations fail to give them specific guidance on how to determine when services rendered in connection with the transfer of an intangible require a separate allocation.

Appendix D discusses results of a preliminary survey of data available at the SEC. This data has the potential to determine when unrelated parties would extract a specific charge for services rendered in connection with the transfer of an intangible.

intangibles.[59] This problem has particular significance in section 936, since the possessions corporation is generally entitled to a return only on manufacturing intangibles when it elects the cost sharing method under section 936(h).

Problems with intangibles underlie the amendment made to section 482 by the 1986 Act, as discussed in Part II. The intangibles section of the section 482 regulations should be modified to provide a specific analysis to be used when comparable uncontrolled transactions do not exist. The method should provide for appropriate allocations of income when multiple intangibles (such as marketing and manufacturing intangibles) are present in the same set of transactions. Part III is devoted to the subject of an appropriate methodology for allocating intangible income.

C. Application of Pricing Methods for Transfers of Tangible Property

When considering an adjustment with respect to the transfer price for tangible property, the regulations require both the taxpayer and the Service to follow a priority of pricing methods: first, the comparable uncontrolled price method must be attempted, then resale price method, then cost plus method, and, if none of them are applicable, some other method or combination of the prior methods.[60] Five prior studies using data available from both the Service and multinational corporations have examined the frequency with which each of these methods has been used. The results of these surveys are set forth below:

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[59] In Lilly, supra n. 57, the Tax Court ultimately determined the parent company's marketing return based upon using its "best judgment." Lilly, 84 T.C. at 1167; See also G. D. Searle and Co. v. Comm'r [Searle], 88 T.C. 252, 376 (1987).

[60] Treas. Reg. §§1.482-2(e)(1)(ii) and (iii).

Report	Percentage of Cases in which Various § 482 Pricing Methods Were Used			
	CUP	Resale	Cost Plus	Other
1973 Treas. Report [61]	20	11	27	40
Conference Bd Report [62]	28	13	23	36
Burns Report [63]	24	14	30	32
GAO [64]	15	14	26	47
1984 IRS Survey[65]	41	7	7	45
1987 IRS Survey (overall)	32	8	24	36
1987 IRS Survey[66] (tangible property)	31	18	37	14

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[61] Treasury Department News Release, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (Jan. 8, 1973), reprinted in 1973 Standard Federal Tax Report (CCH) par. 6419.

[62] Tax Allocations and International Business: Corporate Experience with Section 482 of the Internal Revenue Code, Conference Board Report No. 555 (1972).

[63] Burns, How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey, 54 J. Tax'n 308 (1980).

[64] General Accounting Office, Report by the Comptroller General to the Chairman, House Committee on Ways and Means, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (1981) [hereinafter GAO, IRS Could Better Protect U.S. Tax Interests].

[65] IRS Publication No. 1243, IRS Examination Data Reveal an Effective Administration of Section 482 Regulations (1984).

[66] As stated earlier, the percentages from the 1987 survey do not represent a scientifically valid random sample. They are based upon responses to a questionnaire sent to selected groups of International Examiners who responded with respect to a small number of cases selected by them. Compared to the 1984 survey undertaken by the Assistant Commissioner (Examination), however, they suggest one significant trend: a substantial increase in the use of the cost plus method with a corresponding decrease in cases classified as either "comparable uncontrolled price" or "other." Such a trend would probably be due to an emphasis during the last several years on examining cases that involved manufacturing activities in tax haven jurisdictions. See GAO, IRS Audit Coverage, supra n. 36, at 26-29.

Recent Service experience has been that the starting point for analyzing any pricing issue begins with the search for a comparable uncontrolled transaction. For a significant number of cases, these transactions can be found, although frequently not without a great deal of ingenuity and persistence by the examining agent or other Service personnel.[67] If comparable uncontrolled prices do not exist, IEs or Service economists will seek to locate comparable transactions based on functions performed and risks borne by the entity at issue. This type of an issue lends itself to resale price or cost plus, depending upon the circumstances. If neither comparable uncontrolled prices nor comparable uncontrolled transactions can be found, a variety of fourth methods may be used.

One justification given for the current priority of methods in the regulations is that both the taxpayer and the Service are thus directed to a common frame of analysis to avoid the problem of the Service using one method while the taxpayer uses another method. However, as currently structured, the regulations literally require that both the taxpayer and the agent attempt to apply the methods in priority order. Because the resale price method generally applies only to distributors of goods, while the cost plus method applies generally to manufacturers, there does not seem to be any reason in theory why the agent or taxpayer should attempt to apply the resale price method before applying the cost plus method.[68] In practice, taxpayers and agents rely upon comparable uncontrolled prices or transactions, when they exist. When they do not exist, agents or taxpayers use whatever method they believe best reflects the economic realities of the transaction at issue. While there are valid theoretical reasons for retaining the priority of the comparable uncontrolled price method,[69] there do not seem to be any valid reasons for preferring resale price over cost plus or another method, or for preferring resale price or cost plus over some other economically sound method. Rather, the method used should generally be the one for which the best data is available and for which the fewest number of adjustments are required.

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[67] Appendix B, infra, at Questions 62-64.

[68] In Lilly, supra n. 57, the IRS notice of deficiency was based upon the cost plus method while the taxpayer initially attempted to rely upon the resale price method. The Tax Court rejected application of the cost plus method and, also, the taxpayer's analysis under both the resale price and "fourth" methods. It ultimately adopted a profit split method for the first two years at issue and a CUP method for the final year. See discussion of Lilly infra Chapters 4 and 5.

[69] See discussion of this issue infra Chapter 11.

One technique that is missing from the section 482 regulations that in practice is used extensively by the international examiners is functional analysis. This analysis focuses on the economic functions performed by the affiliated parties to a transaction and the economic risks borne by each of the parties.[70] This technique is used by IEs and Service economists not as a method standing alone but rather as a means of verifying that prices or transactions are truly comparable to the situation under examination or as a basis for a fourth method.

As discussed in section B, intangibles are often transferred by incorporation into tangible property that is sold, and setting a transfer price for a product in such a case involves the same difficult exercise as setting a royalty rate for a licensed intangible. The difficulty of valuing intangibles is, therefore, as much a problem in the context of sales of property as in the case of licenses or other transfers of intangibles.

D. <u>Use of Specialists and Counsel</u>

The use of counsel and economic specialists at the examination level would ameliorate some of the problems, discussed above, of obtaining information and dealing with difficult intangible pricing cases. Legal assistance during examination is needed to assist in obtaining relevant information and in determining whether an appropriate legal basis exists for a proposed adjustment. Economists are needed in many cases to perform a functional analysis and to help evaluate the proper returns to be accorded to the related parties. Other experts may be required to analyze practices within the taxpayer's industry. The goal of the attorney, the economist, and other specialists should be to assist the IE in obtaining all relevant facts and to determine whether an adjustment may be sustained on appropriate legal and economic theories if the matter ever results in litigation.

For section 482 cases developed 10 years ago, it would have been normal for the IE to develop the case without the assistance of an economist or without the assistance of a Chief Counsel attorney. Authority and expertise in international tax matters were then split between the National Office Examination function and the Director, Foreign Operations District. Legal expertise in international tax matters was diffused among at least four national office divisions and was limited in field offices.

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[70] I.R.M. §4233(523.2). The Manual states that almost all cases can be analyzed using a functional analysis.

In May 1986 the Office of the Assistant Commissioner (International) was created to provide an emphasis upon, and a focal point for, development of international issues at the examination stage. The Office of Associate Chief Counsel (International) was created in March 1986 to provide a similar focal point for legal issues. In addition, a network of International Special Trial Attorneys and senior District Counsel attorneys has been created to litigate significant international tax cases, including section 482 cases. More importantly, these field attorneys and their National Office counterparts have been encouraged to assist the field in developing these cases, and IEs are encouraged to use their assistance.[71]

Within the last several years, the Service has substantially increased the number of economists available to assist IEs and has decentralized those activities from the national office to three key District offices: Baltimore, New York, and Chicago. Use of economists in major section 482 examinations that do not involve safe harbors is now required.[72]

One criticism that has been made concerning the more extensive use of counsel and experts at the examination stage is that the time necessary to complete an examination (already lengthy) will be further extended. Service experience has been, however, that increased use of specialists has not unduly delayed disposition of the examination in the vast majority of the cases.[73] Furthermore, the early use of specialists in some cases will prevent erroneous adjustments from ever being made, thus saving both taxpayers and the government substantial sums of time and money.

E. Conclusions & Recommendations

Access to pricing information

1. The failure of the taxpayer to document the methodology used to establish transfer prices under the section 482 regulations and delays or failure by taxpayers in supplying information to IEs are significant problems that hamper the IRS in its administration of section 482.

2. The section 482 regulations are deficient in not requiring taxpayers to document intercompany pricing policies and to supply information upon examination.

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[71] I.R.M. §4233(524).

[72] I.R.M. §42(12)3.

[73] Appendix B, _infra_, at Question 32.

The section 482 regulations should be amended to require taxpayers to document the methodology used to establish transfer prices prior to filing the tax return and to provide such documentation during examination within a reasonable time after request. The documentation should include references to any comparable prices or transactions, rates of return, profit splits or other information or analysis used by the taxpayer in arriving at the transfer price.

3. Forms 5471 and 5472 should be revised to include: (a) summary information describing how intercompany prices were determined; and (b) an attestation that the documentation described in paragraph 2, supra, was available at the time of preparation of the return and will be made available at the start of an IRS examination.

4. IEs experiencing difficulties in obtaining transfer pricing information have failed to deal with non-compliant taxpayers through the issuance of section 982 requests and administrative summonses. The Service should more aggressively pursue noncompliant taxpayers that delay, without justification, in producing relevant pricing information by using the section 982 and administrative summons procedures.

5. The assertion of appropriate penalties is a necessary but often ignored element of transfer pricing compliance. In conjunction with the Service's broad-based review of penalties, the Government should determine whether existing penalties are sufficient to: (a) compel taxpayers to provide thorough and accurate information as set forth in paragraphs 2 and 3 supra; and (b) deter taxpayers from setting overly aggressive and unjustified transfer prices that are inconsistent with the commensurate with income standard. If it is felt that existing penalties are inadequate, legislative solutions should be pursued. The Service and Treasury encourage comments in this area, including the type of penalty, such as a transaction based penalty, that might be proposed.

Intangibles

6. Establishing appropriate transfer prices for intangibles has been a significant problem because of the inherent difficulty of valuing intangibles -- particularly when intangibles are transferred simultaneously with the transfer of tangible property or the provision of services.

7. The intangibles section of the section 482 regulations should be modified to provide a specific method of analysis to be used when comparable uncontrolled transactions do not exist. This method should provide for appropriate allocation when multiple intangibles (such as marketing and manufacturing intangibles) are present in the same set of transactions. Part III is devoted to the subject of an appropriate methodology for allocating intangible income.

Application of pricing method for transfers of tangible property

8. The current priority for the comparable uncontrolled price method should be retained, since such prices generally provide the best evidence of what unrelated parties would do in an arm's length transaction. There does not appear to be any reason to retain the current priority of the resale price method over the cost plus method, or for preferring resale price or cost plus over some other economically sound method. Rather, the method used should generally be the one for which the best data is available and for which the fewest number of adjustments are required.

9. Since intangibles are often incorporated into tangible property that is sold, the difficulty of valuing intangibles is as much of a problem in many transfers of tangible property as in the context of licenses or other transfers of intangible property.

Use of specialists and counsel

10. The use of counsel and economic specialists at the examination level would ameliorate the problems of obtaining information and dealing with the difficult intangible pricing cases. Chief Counsel attorneys familiar with transfer pricing issues should be involved in significant cases at an early stage to make sure that relevant information necessary for the examination is being obtained and that a technical basis for a potential adjustment exists. An economist needs to be involved at an early stage to perform a functional analysis and to evaluate the proper returns to be accorded to the related parties. The goal of the attorney, the economist, and other specialists should be to assist the IE in obtaining all relevant facts and to determine whether an adjustment may be sustained on appropriate legal and economic theories if the matter ever results in litigation.

Chapter 4

THE SEARCH FOR COMPARABLES

A. Introduction

As explained in Chapter 2, the section 482 regulations rely heavily on finding comparable goods, services, and intangibles to determine whether an arm's length price has been used. Where such comparables exist -- where arm's length transactions bearing a reasonable economic resemblance to those being examined have occurred in the free market -- application of the regulations is relatively straightforward. Where no comparables can be found, or where similar items are only distantly comparable, the regulations leave the Service, the taxpayers, and the courts with little guidance.

This chapter examines several recent cases decided under section 482 to assess the use of comparables by the parties and the courts, whether in the context of either sales of tangible property, the provision of services, or licenses or other transfers of intangible property. These cases show that comparables are often difficult to locate, and may be misused or misinterpreted even if they are found. In most of the cases discussed in this chapter, no comparables were available. The courts' resolution of the issues in the absence of comparables is discussed in Chapter 5.

B. Specific comparables

In recent years, transfer pricing cases involving highly profitable products -- which usually are associated with unique intangibles -- have severely tested the comparables approach of the present section 482 regulations. This problem is illustrated by the Lilly[77] case. In Lilly, the U.S. parent corporation, Lilly U.S., transferred highly profitable manufacturing intangibles, including patents and know-how (primarily relating to the drugs Darvon and Darvon-N), to its newly-formed U.S. subsidiary in Puerto Rico, Lilly P.R., in a tax-free exchange for Lilly P.R. stock under section 351. The Service took the position that the income associated with those intangibles should be allocated to Lilly U.S., notwithstanding their tax-free transfer to Lilly P.R.

In preparation for trial, the government's experts surveyed the most successful U.S. pharmaceutical products. They discovered that the patents to such products were rarely transferred, except to a related party. The government argued that unrelated parties would not have transferred the Darvon

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[77] Supra n. 57.

intangibles and that, accordingly, there were no comparable marketplace transactions. While the Tax Court did not fully subscribe to the government's theory of the case, it nevertheless was not able to find appropriate comparables for the patented products in question for the first 2 years at issue, 1971 and 1972.[78] The court proceeded to make its own allocations, basing its adjustments on the proposition that a distortion of income was created by the transfer of intangibles from Lilly U.S. to Lilly P.R. in exchange for Lilly P.R. stock. In the Tax Court's view, the distortion arose because it felt that Lilly would have demanded a stream of income from the transferred Darvon intangibles in order to fund a proportionate part of its ongoing general research and development efforts. The Tax Court also used a profit split approach to increase the return of Lilly U.S. on marketing expenditures and intangibles.[79] On appeal, the Seventh Circuit rejected the Tax Court's allocation to support research and development, but affirmed its profit split methodology.

In Searle,[80] the petitioner transferred the patents (or licenses) on its most successful pharmaceutical products to its U.S. subsidiary, SCO, operating in Puerto Rico. These intangibles represented products accounting for approximately 80 percent of the petitioner's profits and sales. As in Lilly, the government argued that a section 482 allocation from SCO to the petitioner was appropriate.

The petitioner, relying on section 1.482-2(d)(2)(ii) of the regulations, argued that, since it had originally acquired two of the transferred intangibles by licensing agreements carrying royalties of ten percent and eight percent of net sales, an unrelated party would not have paid more than a royalty in this range for the intangible property transferred to SCO. The court, however, found that the original licenses were not comparable; the products were licensed from European pharmaceutical firms prior to their approval by the FDA, and thus could not have been marketed in the United States at the time of the license. The

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[78] For 1973, the Tax Court was able to use a comparable uncontrolled price approach because the Darvon patent had expired. However, numerous adjustments were made to reach a transfer price.

[79] See discussion of the Tax Court's profit split analysis infra Chapter 5.

[80] Supra n. 59.

court concluded that the intangibles to SCO were significantly more valuable than the "mere licensing agreements" upon which the taxpayer relied.[81]

Ultimately, the court found, despite the voluminous record, that "there is little hard evidence from which we can determine what consideration petitioner would have demanded had the transactions under scrutiny here taken place between unrelated parties dealing at arm's length."[82]

Problems with finding or applying comparables for valuable intangibles have not been limited to pharmaceutical companies. In Hospital Corporation of America,[83] a U.S. hospital management company, HCA, entered into negotiations to recruit professional and non-professional staff to manage a state-of-the-art hospital in Saudi Arabia. It formed a Cayman Islands corporation, LTD, ostensibly to negotiate and perform the management contract. HCA performed services for LTD and made available at little cost all of its know-how, experience, management systems knowledge, and other intangibles. The parties offered no evidence of comparable transactions, and the court identified none. Nevertheless, the court allocated 25% of the income to LTD as compensation for its management service.

The Tax Court was also unable to find appropriate comparables in Ciba-Geigy Corp. v. Comm'r.,[84] where the Service sought to reduce royalties paid by a U.S. subsidiary to its foreign parent for the rights to manufacture and sell a herbicide. Unlike the approach taken by the courts in Lilly for 1973, where multiple adjustments were made to a third party transaction in order to determine a comparable price, the court in Ciba-Geigy rejected as comparables licenses of the same product to unrelated parties because of differences in geographic markets, years of the license, and differences in required purchases of raw materials.[85] Instead the court relied upon testimony from an unrelated party about what his company would have been willing to pay in the form of a royalty for the same rights.

The comparability of third party resale price margins was at issue in E.I. DuPont de Nemours & Co. v. United States

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[81] Id. at 375.

[82] Id. at 376.

[83] Supra n. 17.

[84] 85 T.C. 172 (1985).

[85] Id. at 225-26.

[DuPont].[86] In that case, the U.S. parent company incorporated DuPont International S.A., DISA, in Switzerland to serve as a super distributor of DuPont products in Europe. Internal DuPont memos indicated that DuPont planned to sell its goods to DISA at prices below fair market value, so that on resale most of the profits would be reported in a foreign country having much lower tax rates than the United States.[87] Although for many products DISA performed no special services for either DuPont or its customers, DuPont structured its pricing to DISA anticipating that the latter would capture 75 percent of the total profits involved, although DISA actually realized less than this percentage. The Service reallocated much of this profit back to the parent.

The government introduced expert testimony at trial to the effect that, after the allocations, DISA's ratio of gross income to total operating costs was greater than that achieved by 32 specific firms that were functionally similar to DISA. Additionally, it was shown that, after the allocations, DISA's return on capital was greater than that of 96 percent of 1133 companies surveyed.[88]

The taxpayer, on the other hand, relied solely upon the resale price method. It contended that similar companies selling similar products experienced average markups of between 19.5 and 38 percent, comparing favorably with DISA's 26 percent gross profit margin. In rejecting the taxpayer's position the court made the following comments:

> Taxpayer tells us that a group of 21 distributors, whose general functions were similar to DISA's, provides the proper base of comparison. Beyond the most general showing that this group, like DISA, distributed manufactured goods, there is nothing in the record showing the degree of similarity called for by the regulation. No data exist to establish similarity of products (with associated marketing costs), comparability of functions, or parallel geographic (and economic) market conditions. Rather, the record suggests significant differences. Defendant has

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[86] 608 F.2d 445 (Ct. Cl. 1979).

[87] The facts in DuPont are similar to the abuse relating to the use of foreign base sales companies to defer the taxation of income in the United States that Congress sought to end through the Subpart F provisions enacted in the Revenue Act of 1962. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 28 (1962).

[88] See discussion infra Chapter 5 regarding the income to costs ratio and return on capital methods used in DuPont.

introduced evidence that the six companies plaintiff identifies most closely with DISA all had average selling costs much higher than DISA. Because we agree with the trial judge and defendant's expert that, in general, what a business spends to provide services is a reasonable indication of the magnitude of those services, and because plaintiff has not rebutted that normal presumption in this case, we cannot view these six companies as having made resales similar to DISA's. They may have made gross profits comparable to DISA's but their selling costs, reflecting the greater scale of their services or efforts, were much higher in each instance. Moreover, the record shows that these companies dealt with quite different products (electronic and photographic equipment) and functioned in different markets (primarily the United States).[89]

Another case that raised questions of comparability is United States Steel v. Comm'r.[90] There, the Service contended that Navios, the petitioner's wholly owned shipping company, was charging the petitioner more than an arm's length rate for shipping ore from Venezuela to United States ports. The government relied on evidence that, had U.S. Steel contracted with other shippers for the same tonnage per year, it would have paid considerably lower rates. The petitioner countered that, because Navios charged unrelated steel producers the same rate as the petitioner, a perfect comparable was available from which to determine an arm's length price. The government contended that the unrelated third party transactions were not comparable because they were few in number, they were not based on a continuing long-term relationship, and the volume shipped was much smaller than the ten million tons annually shipped by Navios for U.S. Steel.

The Tax Court did not decide the case on the basis of comparables. Instead, the court focused on constructed freight charges and on the profit that the tax haven subsidiary was projected by the taxpayer to earn on the activities it undertook.

On appeal, the Second Circuit held that, if appropriate comparables were available to support the petitioner's prices, no section 482 allocation would be sustained despite evidence tending to show that the activities resulted in a shifting of tax liability among controlled taxpayers.[91] The appellate court

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[89] Supra n. 86.

[90] 617 F.2d 942 (2d Cir. 1980), rev'g T.C. Memo. 1977-140.

[91] 617 F.2d at 951.

accepted the third party transactions as comparables and reversed the Tax Court on this issue, notwithstanding the substantial economic differences from the related party transactions.

C. Industry Statistics as Comparables

The Service and taxpayers have relied on industry statistics in several cases to justify or defend against section 482 allocations. Industry statistics have generally been offered as evidence of comparable uncontrolled prices or for markup percentages under the resale price or cost plus methods. The courts, however, have been reluctant to accept such statistics in the absence of a specific showing of comparability.

In the DuPont case, discussed supra, the taxpayer relied on gross profit margins of drug and chemical wholesalers contained in the Internal Revenue Service's Source Book of Statistics of Income for 1960 to support a gross profit margin of 26 percent. The gross profit margins of these companies averaged 21 percent and ranged from 9 to 33 percent. The court noted that in applying the resale price method it was necessary to find substantially comparable uncontrolled resellers. Because there was no indication from the Source Book that the necessary degree of comparability was present, the court rejected the taxpayer's industry statistics.

The government relied upon the Source Book of Statistics of Income in PPG Industries Inc. v. Comm'r,[92] to allocate a substantial portion of the income of a Swiss corporation to its U.S. parent. Rejecting this approach, the court found the Source Book evidence wanting because it could not be determined whether comparable transactions were involved.

In Ross Glove Co. v. Comm'r,[93] the Service allocated income from a foreign glove manufacturer to its U.S. parent. The government relied upon expert testimony that the glove manufacturing industry was not a high profit industry, and that a typical glove manufacturer rarely had a year in which gross profits equalled three percent of sales. The court rejected this testimony because it did not relate to the rate of return earned by Philippine glove manufacturers, such as the taxpayer's subsidiary, whose profits generally were higher than those of

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[92] 55 T.C. 928 (1970).

[93] 60 T.C. 569 (1973).

U.S. manufacturers. Industry statistics were also rejected as unreliable in Edwards v. Comm'r[94] and in Nissho Iwai American Corp. v. Comm'r.[95]

D. The Regulations in the Absence of Comparables

The only detailed transfer pricing methods in the regulations rely in one way or another on comparables. The cases discussed in this chapter, in which comparables were generally unavailable, suggest that the regulations fail to resolve the most significant and potentially abusive fact patterns. This failure was noted both in the Court of Claims opinion and the trial judge's opinion in DuPont. Trial Judge Willi, after finding for the government, suggested that the current regulatory structure was wholly inadequate:

> At least where the sale of tangible property is involved, the Commissioner's regulations seem to accommodate nothing short of a "pricing method" to determine the question of an arm's length price. Treas. Reg. §1.482-2(3)(e)(1)(iii). Moreover, as plaintiff has correctly noted, the regulation approach seems to rule out net profit as a relevant consideration in the determination of an arm's length price, this despite Congress' encouragement to the contrary, as expressed in H. R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962) (Conference Report).
>
> As evidenced by the magnitude of the record compiled in this case, the resolution by trial of a reallocation controversy under section 482 can be a very burdensome, time-consuming and obviously expensive process -- especially if the stakes are high. A more manageable and expeditious means of resolution should be found.[96]

In difficult cases for which comparable products and transactions do not exist, the parties and the courts have been forced to devise ad hoc methods of their own -- so-called "fourth methods" -- to determine appropriate allocations of income. The next chapter describes the methods that the courts have used to resolve these issues.

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[94] 67 T.C. 224 (1976).

[95] T.C. Memo. 1985-578.

[96] 78-1 USTC para. 9374, at 83,910 (Ct. Cl. Trial Div. 1978).

E. Conclusion

The failure of the regulations to provide guidance in the absence of comparable products and transactions has created problems in cases involving sales of tangible property, the provision of services, and licenses or other transfers of intangible property. Taxpayers and the courts have been forced to devise ad hoc "fourth methods" to resolve such cases.

Chapter 5

FOURTH METHOD ANALYSIS UNDER SECTION 482

A. Introduction

Although the "other method" provision of section 1.482-2(e)(1)(iii) (commonly known as the "fourth method") by its terms applies only to tangible property transfer pricing cases, the term "fourth method" has been used to describe any case resolved by using a method not specifically described in the regulations, typically when comparable uncontrolled transactions were unavailable. This chapter discusses the use of the "fourth method" approach in the decided cases, including cases involving the sale of tangible property, the licensing or other transfer of intangible property, and the provision of services.

B. Profit Splits

The most frequent alternative method used by the courts in the absence of comparables is the profit split approach. Under this approach, the court determines the total profits allocable to the transactions at issue and simply divides them between the related parties in some ratio deemed appropriate by the court. The validity of the method, of course, rests on the accurate determination of total profits and the reasonableness of the factors used to set the profit split ratio.

An illustration of the profit split method is found in Lilly.[97] After rejecting the resale price and cost plus pricing methods advocated by the parties because of the absence of comparables, the Tax Court attempted to find an appropriate fourth method under section 1.482-2(e)(1)(iii) of the regulations. The court cited a number of studies and surveys indicating that fourth methods were used by the Service approximately one-third of the time, and determined that a profit split approach was permissible.[98]

In adopting the profit split approach, the Tax Court relied heavily on PPG Industries Inc.[99] The court there, in considering the allocation of income between PPG and its foreign subsidiary, applied a profit split analysis (which produced a 55-45 profit split in favor of PPG) to buttress the court's primary analysis using the comparable uncontrolled price method.

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[97] Supra n. 57. See discussion of Lilly supra Chapter 4.

[98] 84 T.C. at 1148-49. The results of these surveys and studies are referenced in Chapter 3, supra.

[99] Supra n. 92.

The Tax Court in Lilly also found support in Lufkin Foundry & Machine Co. v. Comm'r,[100] in which it had used a profit split method. On appeal, the Fifth Circuit rejected the Tax Court's profit split approach because the court had not attempted to apply the three specific pricing methods in the regulations and because, by itself, a profit split approach was not sufficient evidence of what parties would have done at arm's length. However, the court in Lilly distinguished the Fifth Circuit's reversal of the Tax Court's holding on the following grounds:

> The three preferred pricing methods detailed in the regulations are clearly inapplicable due to a lack of comparable or similar uncontrolled transactions. Petitioner's evidence amply demonstrates that some fourth method not only is more appropriate, but is inescapable.[101]

After providing for location savings,[102] manufacturing profit, marketing profit, and a charge for ongoing general research and development performed by the parent, the Tax Court in Lilly arrived at undivided profits of $25,489,000 for 1971 and $19,277,000 for 1972.[103] It considered these amounts to be the profits from intangibles, consisting of manufacturing intangibles belonging to Lilly P.R. and marketing intangibles belonging to Lilly U.S. The court rejected the taxpayer's argument that its marketing intangibles were of little value and assigned 45 percent of the intangible income to Lilly U.S. as a marketing profit and 55 percent of the intangible income to Lilly P.R. as a manufacturing profit. The court did not explain how it arrived at the 45-55 split, other than stating that it used its best judgment and that it bore heavily against the

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[100] T.C. Memo. 1971-101, rev'd, 468 F.2d 805 (5th Cir. 1972).

[101] 84 T.C. at 1150-51.

[102] "Location savings" were specifically authorized for certain Puerto Rican affiliates by Rev. Proc. 63-10, 1963-1 C.B. 490, 494. Location savings do not otherwise automatically accrue to an affiliate, but under the arm's length standard of section 482 are distributed as the marketplace would divide them.

[103] 84 T.C. at 1168, n. 102.

taxpayer because it failed to prove the arm's length prices for Lilly P.R.'s products.[104] On appeal, the Seventh Circuit affirmed the Tax Court's profit split.[105]

The Searle[106] case was tried by the Tax Court shortly after Lilly. The primary facts that distinguished Searle from Lilly were that Searle transferred nearly all of its highly profitable manufacturing intangibles to its Puerto Rican subsidiary and that Searle did not purchase the products produced in Puerto Rico, but instead marketed them in the United States as an agent for its subsidiary. While the court could not technically apply a fourth method under the regulations governing sales of tangible property (since there were no intercompany sales), the court nevertheless imposed a profit split similar in result to the profit split imposed in Lilly.

In Searle, the Tax Court did not specifically determine the revenue that each of the parties should earn from manufacturing and marketing or which party should bear the expenses of research and development and administration. While suggesting that additional royalties were due Searle for the intangibles provided to SCO, the court stated that "whether our allocation herein is considered an additional payment for services or for intangibles that were not transferred or as a royalty payment for intangibles themselves, the result is the same."[107]

A profit split approach is also contained in section 936(h) of the Code, added by the Tax Equity and Fiscal Responsibility Act of 1982, effective for years beginning after December 31, 1982. In general, section 936(h) authorizes a profit split election under which the combined taxable income of the possessions affiliate and the U.S. affiliate, with respect to products produced in whole or in part in the possession, will be allocated 50 percent to the possessions affiliate and 50 percent to the U.S. affiliate. If a profit split election is made, section 482 is not available for any further allocation.

The section 936(h) 50-50 profit split does not, however, provide any logical support for 50-50 profit splits in cases not falling within the narrow scope of the section. Thus, even though the Tax Court and Congress have moved in the direction of 50-50 profit splits in some limited cases, it would appear that profit splits should only be used in the absence of appropriate

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[104] 84 T.C. at 1167.

[105] See discussion supra Chapter 4.

[106] Supra n. 59. See discussion of Searle supra Chapter 4.

[107] 88 T.C. at 376.

comparables, and then only after a careful analysis of what functions each party has performed, what property they have employed, and what risks they have undertaken. When one affiliate's role in the transactions has been extremely limited, a 50-50 profit split may not be at all appropriate.

Such a lopsided division of relevant factors occurred in Hospital Corporation of America.[108] The court's opinion recites in great detail the numerous services HCA provided for LTD in negotiating the management contract and in staffing and operating the hospital, as well as the numerous intangibles that HCA provided, such as its substantial experience, know-how, and management systems. Under these circumstances it would be extremely difficult to estimate accurately the arm's length value for the large volume of services and intangibles made available. It was certainly easier for the court to look at the relative value of the functions that each party performed, so that a profit split ratio could be developed. The court in HCA did just that, adopting a 75-25 (75 for HCA and 25 for LTD) split of the profits previously reported by LTD.[109] Unfortunately, there is no discernible rationale contained in the opinion for such a split.

Hospital Corporation of America, like Searle, was not a transfer pricing case and therefore was not a fourth method case under the tangibles pricing regulation. However, both of these cases illustrate that, when highly profitable, unique intangibles are at issue, traditional methods of valuation will often fail because comparables are unavailable. In these circumstances a profit split approach appears reasonable as long as it is based on a careful functional analysis to determine each party's economic contribution to the combined profit.

C. Rate of Return; Income to Expense Ratios

Although profit splits are being used more frequently, the courts have used other methods as well to justify transfer pricing adjustments. Two of these methods are illustrated by the DuPont[110] case.

In defending the Service's section 482 allocations, the government used two different methods. The first method was computing the ratio of gross income to total operating costs (known as the "Berry ratio" because it was first used by the Government's expert witness, Dr. Charles Berry). DISA's Berry

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[108] Supra n. 17. See discussion supra Chapter 4.

[109] 81 T.C. at 601.

[110] Supra n. 86. See discussion supra Chapter 4.

ratio before the allocation was 281.5 percent of operating expenses for 1959 and 397.1 percent for 1960. After the section 482 allocation, DISA's Berry ratio was 108.6 for 1959 and 179.3 for 1960. A survey of six management firms, five advertising firms, and 21 distributors (firms which were generally functionally similar to DISA) revealed average Berry ratios ranging from 108.3 to 129.3. Thus, DISA's combined Berry ratio for 1959 and 1960 before the allocation was about three times higher than the average for the other firms. As noted by the court, in over a hundred years of those companies' experience, none of them had ever achieved the ratios claimed by DISA. Even after the allocation, its Berry ratio was somewhat higher than that of the comparable firms.[111]

The second approach, developed by Dr. Irving Plotkin, was to compare DISA's rate of return on capital to that of 1133 companies that did not necessarily have functional similarities to DISA, but instead reflected a comprehensive selection from industry as a whole. Prior to the allocation, DISA had a rate of return of 450 percent in 1959 and 147.2 percent in 1960 -- rates higher than those of all 1133 other companies. Even after the allocation, DISA's rate of return exceeded that of 96 percent of the 1133 companies surveyed.[112] Based on this evidence the court sustained the Service's allocations.

While the Berry ratio and the rate of return analysis found in DuPont are interesting, it should be kept in mind that the court may have looked favorably on this evidence partly because it indicated that even after the allocation DISA earned greater profits than almost any other corporation, whether comparable or not. These methods were not used directly to make a section 482 adjustment, but rather to support the reasonableness of the Service's allocation.

Evidence relating to rates of return was also presented in Lilly.[113] No general research and development costs for new drugs were being charged by the parent to the subsidiary. The Tax Court determined that a substantial adjustment should be made to the income of the Puerto Rican subsidiary to reflect a proportional payment by the subsidiary of the general research and development expense of the parent.[114] The difference between

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[111] Id. at 456.

[112] Id.

[113] 84 T.C. at 1157, 1161.

[114] The court relied upon testimony by the Service's accounting expert, Dr. James Wheeler, to show that, if the taxpayer had transferred the rest of its successful products to

the rates of return to the two entities was not, however, due solely to the understating of the subsidiary's research and development expense (as determined by the court), but was also attributable to the presence of valuable intangibles that were not properly reflected in the transfer price. A rate of return analysis was used to identify what appeared to be excessive rates of return on assets, so that further inquiry could be made to determine if the returns were in fact excessive and, if so, why.

The rate of return analysis and other information contained in the report by Dr. Wheeler was as follows:[115]

	1971	1972	1973
Return on Average Employed Assets:[116]			
Parent (consolidated return)	19.9%	23.8%	30.4%
Puerto Rican Subsidiary	138.4%	142.6%	100.7%
Adjusted Taxable Income to Net Sales:[117]			
Parent (consolidated return)	16.9%	20.4%	24.7%
Puerto Rican Subsidiary	69.6%	68.9%	58.8%
Operating Expenses to Sales:			
Parent (consolidated return)	41.5%	39.8%	38.9%
Puerto Rican Subsidiary	9.8%	11.6%	16.2%

Puerto Rico under terms similar to its transfer of Darvon, its return would have been insufficient to enable it to continue funding its R&D program, which the court characterized as the "life-blood" of a successful pharmaceutical company. 84 T.C. at 1160-1161. As noted previously in Chapter 4, supra, the Tax Court was reversed on this issue.

[115] 84 T.C. at 1086-88, 1092-93. See Wheeler, An Academic Look at Transfer Pricing in a Global Economy, Tax Notes, July 4, 1988, at 91.

[116] These assets must also have been recorded on Lilly's financial books of account; thus some intangible assets are not included. In a recent article, it was noted that Eli Lilly had a five year average return on shareholders equity of 23 percent (on an after-tax basis). Who's Where in Profitability, Forbes, January 11, 1988, at 216. Compare this consolidated return on assets with the return in excess of 100 percent earned by the Puerto Rican subsidiary during the years 1971-1973.

[117] The adjusted taxable income for the subsidiary does not reflect the exclusion provided by section 931 of the Internal Revenue Code of 1954 and excludes interest income.

Computations based on the record in Searle[118] and reflected in the companies' income tax returns (also part of the record) show a similar disproportion. By way of indirect comparison, in 1968 (the year before intangibles were transferred to Puerto Rico), Searle reported taxable income of approximately $46,700,000 on sales of approximately $81,800,000. In the years before the Tax Court, Searle's sales declined to approximately $38,200,000 in 1974 and $46,700,000 in 1975, resulting in losses of $9,800,000 in 1974 and $23,100,000 in 1975. During these years the Puerto Rican subsidiary had net sales and income of:

Year	Net sales	Net income
1974	$114,784,000	$74,560,000
1975	138,044,000	72,240,000

The rates of return on assets based on the company's tax return position were as follows:[119]

	1974	1975
Return on Average Employed assets:		
Parent (consolidated return)	(31.2%)	(42.3%)
Puerto Rico Subsidiary	109.2%	119.0%
Cost of Goods Sold to Sales:		
Parent (consolidated return)	54.0%	56.2%
Puerto Rico Subsidiary	13.3%	13.6%
Operating Expenses to Sales:		
Parent (consolidated return)	98.7%	106.5%
Puerto Rico Subsidiary	35.4%	35.6%

It is important to note that the data regarding rate of return and other evidence presented by the government in Lilly and Searle did not necessarily provide the court or the parties with a definitive, quantitative transfer price or charge for intangibles. Rather, like Dr. Plotkin's testimony in DuPont, it was used to support the reasonableness of a resulting allocation or determination.[120] As discussed in Chapter 11, the Service and Treasury believe that, in cases where no comparables exist, a more refined rate of return analysis can be used to establish a transfer price and not merely to verify the reasonableness of an allocation.

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[118] Supra n. 59.

[119] Wheeler, supra n. 115, at 91.

[120] The Seventh Circuit in Lilly, supra n. 57, discounted this type of evidence because it called into question Lilly P.R.'s ownership of the intangibles at issue.

D. Customs Values

An additional approach to transfer pricing that has occasionally been used in litigation is that of adopting the values set by the United States Customs Service. For example, in Ross Glove Co.,[121] the Tax Court accepted the taxpayer's use of the markup used by Customs in valuing gloves imported from the Philippines for purposes of applying the cost plus method. However, in Brittingham v. Commissioner,[122] the Tax Court made it clear that it would not bind taxpayers to their own declared Customs' valuations where it could be shown that those values were erroneous.[123]

E. Conclusions and Recommendations

1. Over the years the courts, and in particular the Tax Court, have used various fourth methods for determining appropriate arm's length prices for section 482 allocations. A profit split is appropriate in some cases to establish a transfer price on an arm's length basis because unrelated parties are concerned about the respective shares of potential profits when entering into a business arrangement.[124] The problem with the profit split approach taken by the courts, however, is not that the courts have focused on the wrong elements of the transaction, but that they generally have failed to adopt a consistent and predictable methodology.

2. The rate of return on assets and costs to income ratio methods used in DuPont provide some reasonable basis for allocating income and determining transfer prices in the absence of comparables. However, these methods have not yet been sufficiently developed by the courts to fill the gap in analysis left by the section 482 regulations when comparable uncontrolled transactions cannot be located. A profit split or other method

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121 Supra n. 93. See discussion supra Chapter 4.

122 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979).

123 Largely in response to the Brittingham case, Congress enacted section 1059A in 1986. This section generally forces an importer to use a value for income tax purposes no greater than the value declared for customs purposes.

124 See J. Baranson, Technology and the Multinationals at 64 (1978).

should be developed to determine transfer prices in the absence of comparables, which is the subject of Part III of this study.

II. SECTION 482 AFTER THE 1986 TAX REFORM ACT

Part I of the study described the history of section 482, its administration by the Service, and its interpretation by the courts. The lack of specific guidance in the tangible property, intangible property, and services provisions of the section 482 regulations to resolve cases for which appropriate comparables do not exist -- notably cases involving high profit intangibles -- has caused significant problems for taxpayers, the Service, and courts alike.

The amendment made by the 1986 Act to section 482 is Congress' response to the problem described in Part I of determining transfer pricing for high profit intangibles. Specifically, section 482 was amended to provide that income from a transfer or license of intangible property shall be commensurate with the income attributable to the intangible. This Part II discusses the scope of the commensurate with income standard and the requirement for periodic adjustments. The compatibility of these changes with the international norm for transfer pricing -- the arm's length principle -- is also discussed. Finally, this part explores the role of safe harbors for avoiding adjustments under section 482.

Chapter 6

THE COMMENSURATE WITH INCOME STANDARD

A. Legislative History

The 1986 Act amended section 482 to require that payments to a related party with respect to a licensed or transferred intangible be "commensurate with the income"[124] attributable to

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[124] (e) Treatment of Certain Royalty Payments.--

(1) In General.-- Section 482 (relating to allocation of income and deductions among taxpayers) is amended by adding at the end thereof the following new sentence: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

(2) Technical Amendment.-- Subparagraph (A) of section 367(d)(2) (relating to transfers of intangibles treated as transfer pursuant to sale for contingent payments) is amended by adding at the end thereof the following new sentence: "The amounts taken into account under clause (ii) shall be commensurate with

the intangible. The provision applies to both manufacturing and marketing intangibles.[125] The legislative history clearly indicates Congressional concern that the arm's length standard as interpreted in case law has failed to allocate to U.S. related parties appropriate amounts of income derived from intangibles.[126] The amendment is a clarification of prior law. Accordingly, it should not be assumed that the Service will cease taking positions that it may have taken under prior law.

The primary difficulty addressed by the legislation was the selective transfer of high profit intangibles to tax havens. Because these intangibles are so often unique and are typically not licensed to unrelated parties, it is difficult, if not impossible, to find comparables from which an arm's length

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the income attributable to the intangible."

Sec. 1231(e)(1), Tax Reform Act of 1986, 100 Stat. 2085 (1986).

[125] For this purpose, intangibles are broadly defined by reference to section 936(h)(3)(B) under which intangible property includes any:

(i) patent, invention, formula, process, design, pattern, or know-how;

(ii) copyright, literary, musical, or artistic composition;

(iii) trademark, trade name, or brand name;

(iv) franchise, license, or contract;

(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or

(vi) any similar item,

which has substantial value independent of the services of any individual. See also Treas. Reg. §1.482-2(d)(3)(ii) and Rev. Rul. 64-56, 1964-1 C.B. 113, regarding the treatment of know-how as property in a section 351 transfer.

[126] 1985 House Rep., supra n. 47, at 420-427; 1986 Conf. Rep., supra n. 2, at II-637-638. Several commentators have suggested that the phrase "commensurate with income" derives from Nestle Co., Inc. v. Comm'r, T.C. Memo. 1963-14, where the Tax Court sanctioned a taxpayer's post-agreement increase in royalties paid by an affiliate for a very profitable intangible license. The opinion states that "[s]o long as the amount of the royalty paid was commensurate with the value of the benefits received and was reasonable, we would not be inclined to, nor do we think we would be justified to, conclude that the increased royalty was something other than what it purported to be." (Emphasis supplied). There is, however, nothing in the legislative record to indicate that this is the case or to indicate Congressional approval or disapproval of the result in Nestle

transfer price can be derived. When justifying the compensation paid for such intangibles, however, taxpayers often used comparisons with industry averages, looked solely at the purportedly limited facts known at the time of the transfer, or did not consider the potential profitability of the transferred intangible (as demonstrated by post-agreement results). Taxpayers relied on intangibles used in vastly different product and geographic markets, compared short-term and long-term contracts, and drew analogies to transfers where the parties performed entirely different functions in deriving income from the intangible.

Congress determined that the existing regime, which depends heavily upon the use of comparables and provides little clear guidance in the absence of comparables, was not in all cases achieving the statutory goal of reflecting the true taxable income of related parties. Congress therefore decided that a refocused approach was necessary in the absence of true comparables. The amount of income derived from a transferred intangible should be the starting point of a section 482 analysis and should be given primary weight.[127] Further, it is important to analyze the functions performed, and the economic costs and risks assumed by each party to the transaction, so that the allocation of income from the use of the intangible will be made in accordance with the relative economic contributions and risk taking of the parties.[128] The application of the functional analysis approach to the actual profit experience from the exploitation of the intangible allocates to the parties profits that are commensurate with intangible income. Looking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible.

In determining the income that forms the basis for application of the commensurate with income standard, what time frame should be used as a point of reference: the time of the transfer alone, or an annual or other periodic basis? The legislative history reflects Congressional concern that, by confining an analysis of an appropriate transfer price to the time a transfer was made, taxpayers could transfer a high profit potential intangible at an early stage and attempt to justify use of an inappropriate royalty rate by claiming that they did not

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[127] 1985 House Rep., _supra_ n. 47, at 426.

[128] 1986 Conf. Rep., _supra_ n. 2, at II-637.

know that the product would become successful.[129] Accordingly, for these reasons, Congress determined that the actual profit experience should be used in determining the appropriate compensation for the intangible and that periodic adjustments should be made to the compensation to reflect substantial changes in intangible income as well as changes in the economic activities performed and economic costs and risks borne by the related parties in exploiting the intangibles.[130] As discussed further below, this is consistent with what unrelated parties would do.

The legislative history indicates that the commensurate with income standard does not prescribe a specific, formulary approach for determining an intangible transfer price. For example, it does not automatically require that the transferor of the intangible receive all income attributable to the exploitation of the intangible. It does not prescribe (nor depend for its application upon) a specific legal form for transfers of intangible property. Thus, it applies to licenses of intangible property, sales of tangible property which incorporate valuable intangibles, and to transfers of intangibles through the provision of services. Nor does it mandate any specific treatment of the transferor or transferee. In particular, the provision does not mandate a "contract manufacturer" return for the licensee in all cases.[131]

B. Scope of Application

The scope of the commensurate with income standard is not discussed in the legislative history. Two proposals have been made for limiting the scope of the standard, one based on potential double taxation and one limiting the application of the provision to the types of cases that prompted the legislative change.

1. Double Taxation and Related Issues. Double taxation can occur when two countries have different rules of allocation; have the same rules but interpret or apply them differently in actual operation; have the same rules and interpret and apply them in the same way, but do not allow correlative adjustments; or

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[129] 1985 House Rep., *supra* n. 47, at 424.

[130] *Id.* at 425-426.

[131] *Id.* at 426.

permit correlative adjustments in theory but do not remove procedural barriers (e.g., statutes of limitation on refund claims).[132]

Taxpayers and others have argued that the commensurate with income standard will necessarily increase the incidence of double taxation, and that therefore Congressional intent should not be fully implemented. As described more fully in the next chapter, the correct application of the commensurate with income standard is premised soundly on arm's length principles. The Service and Treasury therefore do not believe that the commensurate with income principle will increase the incidence of double taxation.

Indeed, in fairly common cases where the commensurate with income standard will be applied -- outbound transfers of intangibles from U.S. parents to foreign subsidiaries -- the issue of double taxation does not arise. In these situations, the foreign tax credit provisions of U.S. domestic law (including the foreign sourcing and characterization of royalties relating to intangibles used overseas) will normally prevent the double taxation of earnings.[133] Furthermore, the outbound transfer patterns that were the subject of Congressional concern involve transfers to manufacturing affiliates located in tax havens, where there is no potential for double taxation. The question of whether the appropriate amount of income is attributed to foreign operations in these cases is, therefore, whether the correct amount of income is eligible for deferral from U.S. tax and whether it is properly characterized for foreign withholding tax purposes, rather than the issue of double taxation.

2. Legislative Impetus. The commensurate with income standard was clearly intended to overcome problems encountered in applying the section 482 regulations to transfers of high profit potential intangibles, such as those at issue in Lilly and Searle. Because of its origin as a response to the problem of

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[132] International Fiscal Association, Cahiers de Droit Fiscal International (Studies on International Fiscal Law), Vol. LVI, at I-6 (1971).

[133] So long as the foreign affiliate ultimately pays out its residual earnings as a dividend and exhausts its remedies for obtaining an adjustment in the foreign jurisdiction, the total amount of foreign source income on the U.S. return in the relevant limitation category (and, therefore, the amount of limitation under section 904) will be the same no matter what the amount of royalty, and the taxes paid by the foreign affiliate will be deemed paid by the U.S. parent. The operation of the foreign tax credit will thus prevent any double taxation on those earnings irrespective of the amount of the royalty payment for U.S. tax purposes.

high profit intangibles, it has been suggested that the commensurate with income standard should be limited to transfers of high profit intangibles to affiliates in low tax jurisdictions.[134] The statute, however, applies to all related party transfers of intangibles, both inbound and outbound,[135] without quantitative or qualitative restrictions. Furthermore, the economic theory of arm's length dealing underlying the methods set forth in this study apply to all transfers of intangibles, regardless of the type of intangible or residence of the licensee. Consequently, the commensurate with income standard should apply to transfers of all related party intangibles, not just the high profit potential intangibles. The analysis set forth in Chapter 11 provides a framework for implementing the commensurate with income standard that can be applied to all intangible transfers, rather than merely to high profit potential intangibles.

C. Application of Commensurate with Income Standard to Normal Profit and High Profit Intangibles

1. Normal Profit Intangibles. In related party transfers of normal profit intangibles, there are likely to be comparable third party licenses. Such licenses can produce evidence of arm's length dealings. The arm's length bargaining of the unrelated parties over the terms of the arrangement reflects each party's judgment about what its share of the combined income (or appropriate expense reimbursement) ought to be. Hence, each has made a judgment that the remuneration it expects to receive is commensurate with the income attributable to its exploitation of the intangible.

Application of the commensurate with income standard to normal profit intangibles will ordinarily produce results consistent with those obtained under pre-1986 law in those cases where economically appropriate comparables were used. For example, the licensing agreement for the formula to a particular brand of perfume is likely to have many "inexact" comparables.[136] If appropriate comparables exist, they can be examined to determine an arm's length, or commensurate with income, return. Thus, in many cases the appropriate income

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[134] Wright & Clowery, The Super-Royalty: A Suggested Regulatory Approach, Tax Notes, July 27, 1987, at 429-436.

[135] 1986 Conf. Rep., supra n. 2, at II-637.

[136] See discussion of the concepts of inexact and exact comparables infra Chapter 11.

allocation under both the existing regulations and the commensurate with income standard will be the same, provided that internal and external standards of comparability are met.[137]

2. High Profit Potential Intangibles. As described in Chapter 4, the difficulty in applying section 482 to high profit potential intangibles[138] is that unrelated party licenses of comparable intangibles almost never exist. Consequently, if the appropriate related party transfer price for a high profit potential intangible is expressed in terms of a royalty, the result may not bear any resemblance to a third party license for a normal intangible. That is, owing to the intangible's enormous profitability, an allocation under the commensurate with income standard, if made solely through a royalty rate adjustment, might be so large compared to normal product royalty rates that it does not look like an arm's length royalty. Therefore, one might argue that an extraordinarily high rate could never be an arm's length royalty merely because third party royalties are never that high.

From an economic perspective, however, an unprecedented or "super-royalty" rate may be required to appropriately reflect a relatively minor economic contribution by the transferee and achieve a proper allocation of income.[139] As discussed in Chapter 11, the commensurate with income standard, in requiring a "super-royalty" rate in order to achieve a proper allocation of income in such a case, does not mandate a rate in excess of arm's length rates. Nor does it permit taxpayers to set a "super-

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[137] See discussion of the concepts of internal and external comparability infra Chapter 11.

[138] The term high profit potential intangibles refers to those products which generate profits far beyond the normal returns found in the industry. No specific definition or formula for determining whether an item is a high profit potential product is suggested herein. Nonetheless, hypothetical products such as an AIDS vaccine, a cure for the common cold, or a cheap substitute for gasoline would all fit into this concept because of the enormous consumer demand for such a product, the market protection provided by a patent, and the corresponding potential for enormous profitability. Similarly, a patented product that just happens to work better than others, or produces the same result with fewer side effects, may also qualify.

[139] The German tax authorities have faced a similar situation, and the imputation of very high royalty rates has led to the charge that the imputed royalties are not arm's length. See Jacob, The New "Super-Royalty" Provisions of Internal Revenue Code 1986: A German Perspective, 27 European Taxation 320 (1987).

royalty" rate in excess of arm's length rates. For example, enactment of the commensurate with income standard would not justify royalty increases in excess of arm's length rates by U.S. affiliates of foreign parent corporations (or vice versa).

Rather than creating a new class of royalty arrangements, the enactment of the commensurate with income standard reflects the recognition that, for certain classes of intangibles (notably high profit potential intangibles for which comparables do not exist), the use of inappropriate comparables had failed to produce results consistent with the arm's length standard. Enactment of the commensurate with income standard was thus a directive to promulgate rules that would give primary weight to the income attributable to a transferred intangible in determining the proper division of that income among related parties. In the rare instance in which there is a true comparable for a high profit intangible, the royalty rate must be set on the basis of the comparable because that remains the best measure of how third parties would allocate intangible income.

D. Special Arrangements

1. Lump sum sales or royalties. Some commentators have suggested that the commensurate with income standard should not prohibit the use of non-contingent, lump sum royalty or sale payments. While the Service and Treasury agree that parties are free to structure their transactions as either a sale or license, the economic consequences of a lump sum payment arrangement generally must resemble those under a periodic payment approach in order to satisfy the commensurate with income standard, unless the taxpayer can demonstrate, by clear and convincing evidence, that such treatment is inappropriate on the basis of arm's length arrangements, *i.e.*, an exact or inexact comparable transaction.[140] By its terms, the amendment to section 482 applies to *any* transfer of an intangible, which includes an outright transfer by sale or license for a non-contingent, lump sum amount.[141] Furthermore, exempting such arrangements from the commensurate with income standard would elevate form over substance and encourage non-arm's length lump sum arrangements designed to circumvent the new rules. Thus, periodic adjustments may be required under the commensurate with income standard even in the case of lump sum sale or royalty arrangements.[142]

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[140] *See infra* Chapter 11.

[141] 1985 House Rep., *supra* n. 47, at 425.

[142] *See* discussion of the mechanism for making adjustments to lump sum payments *infra* Chapter 8.

2. Interaction with Section 367(d). Section 367(d), enacted as part of the 1984 Tax Reform Act, provides that when intangible property is transferred by a U.S. person to a foreign corporation in a transaction described in section 351 or 361, the transferor shall be treated as receiving annual payments, over the useful life of the property, contingent on productivity or use of the property, regardless of whether such payments are actually made. These payments are treated as U.S. source income. A subsequent disposition to an unrelated party of either the intangible property or the stock in the transferee triggers immediate gain recognition. The 1986 Act made the commensurate with income standard applicable in computing payments attributable to the transferor under section 367(d). The periodic adjustment of lump sum royalty or sale payments would merely achieve parity with section 367(d) transfers.[143] Section 367(d) may also suggest that certain exceptions from the periodic payment approach may be appropriate -- e.g., transfers to corporations in which an unrelated corporation has a substantial enough interest that an objective valuation of the transferred intangible can be considered to be arm's length.[144]

Sales and licenses of intangibles are generally not subject to section 367(d), since they are not transactions described in section 351 or 361. The temporary regulations state that, when an actual license or sale has occurred, an adjustment to the consideration received by the transferor shall be made solely under section 482, without reference to section 367(d).[145] However, if the purported sale or license to the related person is for no consideration[146] or if the terms of the purported sale or license differ so greatly from the substance of an arm's length transfer that the transfer should be considered a sham,[147] the transfer will be treated as falling within section 367(d).

In essence, the commensurate with income standard treats related party transfers of intangibles as if an intangible had been transferred for a license payment that reflects the

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[143] Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 432-433 (1984) [hereinafter General Explanation of the DRA of 1984].

[144] The Service and Treasury invite comments as to whether this possible exception should be under a different standard than the concept of control under section 482.

[145] Treas. Reg. §1.367(d)-1T(g)(4)(i).

[146] Id.

[147] Treas. Reg. §1.367(d)-1T(g)(4)(ii).

intangible's value throughout its useful life, a result similar to section 367(d). Because the section 367(d) source of income rule can apply to certain transactions cast in the form of a sale or license, the temporary regulations could be amended to specify which sales or licenses are subject to both the commensurate with income standard and the U.S. source income characterization of section 367(d). Moreover, a license payment that is less than some specific percentage of the appropriate arm's length amount could be considered so devoid of economic substance that the arm's length charge should be subject to section 367(d). Thus, those related party transfers which deviate substantially from the proper commensurate with income payment would be subject to 367(d), even if cast in the form of a sale or license.

3. Cost sharing agreements. The legislative history envisions the use of bona fide research and development cost sharing arrangements as an appropriate method of attributing the ownership of intangibles *ab initio* to the user of the intangible, thus avoiding section 482 transfer pricing issues related to the licensing or other transfer of intangibles.[148] Use of cost sharing arrangements had previously been encouraged in connection with the enactment in 1984 of section 367(d).[149] Cost sharing arrangements are discussed in detail in Chapters 12 and 13, *infra*.

E. Conclusions

1. Congress enacted the commensurate with income standard because application of existing rules had not focused appropriate attention upon the income generated by the transfer of an intangible in situations in which comparables do not exist.

2. Application of the commensurate with income standard requires the determination of the income from a transferred intangible, and a functional analysis of the economic activities performed and the economic costs and risks borne by the related parties in exploiting the intangible, so that the intangible income can be allocated on the basis of the relative economic contributions of the related parties. The commensurate with income standard does not mandate a "contract manufacturer" return for the licensee in all or even most cases.

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[148] 1986 Conf. Rep., *supra* n. 2, at II-638.

[149] General Explanation of the DRA of 1984, *supra* n. 143, at 433.

3. The commensurate with income standard requires that intangible income be redetermined and reallocated periodically to reflect substantial changes in intangible income, or changes in the economic activities performed and economic costs and risks borne by the related parties.

4. The application of the functional analysis approach to the actual profit experience from the exploitation of intangibles is consistent with what unrelated parties would do and is, therefore, consistent with the arm's length principle.

5. Because the commensurate with income standard is consistent with arm's length principles, it should not increase the incidence of double taxation.

6. The commensurate with income standard applies to all types of intangible property transfers between related parties, not just high profit potential intangibles, including both inbound and outbound transfers of intangibles. In the cases of normal profit intangibles in which comparables normally exist, the new standard, like prior law, will ordinarily base the analysis on comparable transactions, with refinements in the definition of appropriate comparables. In any event, intangible income must be allocated on the basis of comparable transactions if comparables exist.

7. Lump sum sale and royalty payments for intangibles generally will be subject to the commensurate with income standard.

Chapter 7

COMPATIBILITY WITH INTERNATIONAL TRANSFER PRICING STANDARDS

A. Introduction

Shortly after passage of the 1986 Act, various U.S. taxpayers and representatives of foreign governments expressed concern that the enactment of the commensurate with income standard was inconsistent with the "arm's length" standard as embodied in tax treaties and adopted by many countries for transfer pricing matters. As a result, they argued, the application of the commensurate with income standard would lead to double taxation for which no remedy would exist under treaties, because of application of transfer pricing standards by the United States that would be inconsistent with those applied by various other foreign governments.[150]

To allay fears that Congress intended the commensurate with income standard to be implemented in a manner inconsistent with international transfer pricing norms and U.S. treaty obligations, Treasury officials publicly stated that Congress intended no departure from the arm's length standard, and that the Treasury Department would so interpret the new law.[151] Treasury and the Service continue to adhere to that view, and believe that what is proposed in this study is consistent with that view.

B. The Arm's Length Standard as an International Norm

The problem of double taxation arising from different transfer pricing methods has been addressed through intergovernmental negotiation and agreement, principally in bilateral tax treaties that specifically provide for certain adjustments by the treaty partners to the tax liability of any entity when its dealings with related entities differ from those that would have occurred between unrelated parties. For example, an OECD model income tax convention permits adjustments to the

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[150] See discussion supra Chapter 6 regarding relief from double taxation pursuant to the foreign tax credit provisions and sourcing rules of United States internal law.

[151] Letter from J. Roger Mentz, Assistant Secretary (Tax Policy) of the Department of Treasury to Representative Philip M. Crane (May 26, 1987); Remarks of Stephen E. Shay, International Tax Counsel of the Department of Treasury before the International Fiscal Association (February 12, 1987). Appendix C to this study summarizes the legal and administrative approaches similar to those described throughout this study taken by some of our major treaty partners in dealing with transfer pricing issues.

profits of an enterprise where, in dealing with related enterprises, "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises...."[152] If the adjustment is consistent with that standard, the OECD Model Convention calls for the other contracting state to make an adjustment to the profits of the enterprise in its jurisdiction to take into account the first state's adjustments.[153] If differences of opinion arise between the two states as to the proper application of this standard, the OECD Model Convention calls for the competent authorities of the respective jurisdictions to consult with one another.[154] The other major model used by countries in negotiating their tax treaties, the United Nations Model Double Taxation Convention Between Developed and Developing Countries, contains an Article 9 entitled "Associated Enterprises" that is not materially different.[155]

In 1981, the Treasury Department released a model income tax treaty that it uses as a starting point for negotiating income tax treaties with other countries.[156] Although this model has been revised in a number of particulars to account for the many changes in U.S. tax law since the time of its release, the provisions governing associated enterprises have not changed. The basic provision is virtually identical to the OECD Model Convention.[157]

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[152] Organization of Economic Cooperation and Development, Committee on Fiscal Affairs, Model Double Taxation Convention on Income and on Capital, Art. 9(1) ("Associated Enterprises") (1977) [hereinafter OECD Model Convention].

[153] Id. at Art. 9(2).

[154] Id.

[155] United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102, at 27 (1980) [hereinafter U.N. Model Convention].

[156] U.S. Treasury Dept., Proposed Model Convention Between the United States of America and .... for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (1981).

[157] The United States model adds a third paragraph to the OECD Model Convention Article 9 that reserves to each state the right to make adjustments under its internal law. The purpose of this paragraph is only to make explicit that the use of the word "profits" in the OECD model does not constrain either jurisdiction to make adjustments, consistent with the arm's

The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues;[158] and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases.[159] This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard.[160]

It is equally clear as a policy matter that, in the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm's length standard.

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length standard of paragraph 1, with respect to deductions, credits, or other allowances between related persons. This provision reads as follows:

> 3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income, deductions, credits, or allowances between persons, whether or not residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasions of taxes or clearly to reflect the income of any of such persons. Id.

[158] U.N. Model Convention, supra n. 155, at 106; see generally Organization for Economic Cooperation and Development, Report of the Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises (1979) [hereinafter OECD, Transfer Pricing and Multinational Enterprises].

[159] See, e.g., Cross-Border Transactions Between Related Companies: A Summary of Tax Rules (W. R. Lawlor, ed. 1985) (discussion of transfer pricing practices of twenty-five different countries, most of which take the arm's length standard as their basic rule of transfer pricing).

[160] A recent article has suggested that the arm's length standard for transfer pricing should not limit the transfer pricing practices of governments. Langbein, The Unitary Method and the Myth of Arm's Length, Tax Notes, Feb. 17, 1986, at 625.

C. Reference to Profitability under the Arm's Length Standard

Because the arm's length standard is the international norm, a serious potential for disputes over primary taxing jurisdiction would exist if the United States were to implement the commensurate with income standard in a manner that violates arm's length principles. Does a system which, only in the absence of appropriate comparable transactions, places primary emphasis upon the income (or profits) related parties earn from exploiting an intangible violate the arm's length standard, as understood in the international context?

Probably the most commonly referenced expression of the arm's length standard as understood by the nations that have adopted it is a report issued in 1979 by the OECD.[161] This report adopts the general principle of arm's length pricing for all transactions between related parties. Concerning transfers of intangible property, the report states:

> The general principle to be taken as the basis for the evaluation for tax purposes of transfer prices between associated enterprises under contracts for licensing patents or know-how is that the prices should be those which would be paid between independent enterprises acting at arm's length.[162]

It is useful to refer to those methods that the report considers inconsistent with its arm's length concept to aid in defining such concept. These the report refers to as "global" methods for transfer pricing. They would include, for example, "allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria."[163] The report criticizes these methods as necessarily arbitrary.[164]

The report also notes that the effect of its arm's length approach, as distinguished from those it criticizes, is:

> [T]o recognise the actual transactions as the starting point for the tax assessment and not, in other than

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[161] OECD, Transfer Pricing and Multinational Enterprises, supra n. 158.

[162] Id. at 51.

[163] Id. at 14.

[164] Id. at 14-15.

> exceptional cases, to disregard them or substitute other transactions for them. The aim in short is, for tax purposes, to adjust the price for the actual transaction to an arm's length price.[165]

Nowhere, however, does the report suggest that the profits of the related enterprises are irrelevant to this determination. Indeed, there are several instances where the report specifically authorizes an inquiry into profits or profitability. For example, the report notes:

> [Its criticism of global methods] is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total profits of the relevant [multinational enterprise] may not be helpful, as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.[166]

In arriving at an arm's length price, the report specifically authorizes an analysis of economic functions performed by each related party in determining "when a profit is likely to arise and roughly what sort of profit it is likely to be."[167]

Other references to profits occur in the report. For example, in the section of the report relating to the sale of tangible goods entitled "Methods of Ascertaining an Arm's Length Price," methods are outlined that permit reference to comparable profits or returns on capital invested as a means of determining the appropriate transfer price. These methods are viewed by the report as a supplement to the traditional approach of looking to comparable transactions, but they are clearly suggested as appropriate tools for arriving at a proper transfer price.[168]

With regard to valuing transfers of intangible property, the report notes that, "[o]ne of the common approaches employed in practice is to make a pragmatic appraisal of the trend of an enterprise's profits over a long period in comparison with those of other unrelated parties engaged in the same or similar

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[165] _Id._ at 19.

[166] _Id._ at 15.

[167] _Id._ at 17.

[168] _Id._ at 42-43.

activities and operating in the same area."[169] The report questions whether this approach is practical, because it would be difficult to isolate respective profits due to different accounting methods, and difficult to know-how to apportion the overall profit between the two parties. No suggestion is made, however, that such a method could never be used in the absence of comparable transactions because it conflicts in principle with the arm's length standard.[170]

D. Periodic Adjustments under the Arm's Length Standard

The next chapter describes an important element of the commensurate with income standard -- periodic adjustments must be made in appropriate cases to reflect actual profit experience under the license. As noted in that chapter, there are sound arm's length reasons to require such adjustments -- principally the rarity of long-term, fixed licenses negotiated at arm's length, particularly with respect to high profit potential intangibles, and the fact that actual profit experience under a license indicates in most cases anticipated profits that would have been considered by unrelated parties. Moreover, that chapter permits taxpayers to avoid adjustments over time if they can demonstrate on the basis of arm's length evidence that no such adjustments would have been made by unrelated parties. The Service and Treasury therefore believe that such periodic adjustments as will be made under the new standard will be consistent with the arm's length standard as embodied in U.S. double taxation treaties.

E. Resolution of Bilateral Issues

The Service and Treasury recognize that implementation of the commensurate with income standard in all its particulars, including periodic adjustments, treatment of lump-sum payments[171] and access to information to perform the necessary analysis, may lead to differences with the competent authorities

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[169] Id. at 54.

[170] The objection raised in the report regarding the type of analysis advocated in this report is not that it violates the arm's length standard, but that it may call for more information than can be practically obtained and analyzed by the tax authorities. See id. at 15. As noted in Appendix D, the degree of detail and analysis that will be called for under the new methodology will depend in each case on the magnitude of the potential for income shifting. Further, in cases of transfers of routine intangibles, available comparable licenses will generally obviate the need for almost all of this information.

[171] See the discussion infra Chapter 8.

of our treaty partners and perhaps more general issues of treaty policy and interpretation. Recognizing this, the United States competent authority and the Treasury Department should be receptive to the concerns of foreign governments, and endeavor to seek bilateral solutions insofar as those concerns can be accommodated in a manner consistent with Congressional intent in enacting the commensurate with income standard.

F. Conclusions

1. The arm's length standard requires that each entity calculate its profits separately and that related party transactions be priced as if unrelated parties had entered into them. Reference to the profits (including the trend of those profits over time) of related parties to determine a royalty in a licensing transaction is intended to reflect what unrelated parties would do and, therefore, is consistent with the arm's length standard.

2. The arm's length standard as accepted by the international community does not preclude reference to profits of related parties to allocate income, but in fact encompasses such an approach as a supplement to the traditional approach of looking to comparable transactions. It is, therefore, reasonable to conclude that such an approach is consistent with international norms as applied to situations in which comparables do not exist.

3. The approach taken by Congress in enacting the commensurate with income standard and the approaches suggested in Chapters 8 and 11, infra, for implementing that standard, including the provision for periodic adjustments, are consistent with internationally recognized arm's length principles. Applied in a manner consistent with arm's length principles, the commensurate with income standard is not likely to increase international disputes over the right of primary taxing jurisdiction.

4. The United States competent authority and the Treasury Department should endeavor whenever possible to seek bilateral solutions to problems that may arise with our treaty partners in the interpretation and administration of the commensurate with income standard.

Chapter 8

PERIODIC ADJUSTMENTS

A. Introduction

As discussed in Chapter 6, an intangible transfer price that is commensurate with the income attributable to the intangible must reflect the "actual profit experience realized as a consequence of the transfer."[172] The "commensurate with income" language requires that changes be made to the transfer payments to reflect substantial changes in the income stream attributable to the intangible as well as substantial changes in the economic activities performed, assets employed, and economic costs and risks borne by related entities.

The Congressional directive to the Service to make adjustments to intangible returns that reflect the actual profit experience is in part a legislative rejection of R.T. French v. Comm'r.[173] That case endorsed the view that a long-term, fixed rate royalty agreement could not be adjusted under section 482 based on subsequent events that were not known to the parties at the original contract date. Thus, underlying the directive is perhaps a view that contractual arrangements between unrelated parties -- particularly those involving high profit intangibles -- are not entered into on a long term basis without some mechanism for adjusting the arrangement if the profitability of the intangible is significantly higher or lower than anticipated. A very preliminary review of unrelated party licensing agreements obtained from the files of the Securities and Exchange Commission, discussed in Appendix D, and other input received to date, seems to support this view. Indeed, as a matter of long term business strategy, unrelated parties may renegotiate contractual arrangements even absent explicit renegotiation provisions to reflect revised expectations regarding an intangible's profitability.[174]

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[172] 1985 House Rep., supra n. 47, at 425.

[173] 60 T.C. 836 (1973).

[174] Since related parties always have the ability to renegotiate contractual arrangements, explicit contractual provisions permitting renegotiation of related party arrangements would have little meaning and, therefore, should not be a prerequisite for making adjustments. Furthermore, related party contracts that contain these provisions will not necessarily lead to results that conform to the experience of unrelated parties operating under similar circumstances. If the contract proves more profitable than expected, the parties can refuse to renegotiate or adjust it, despite explicit provisions in the

Aside from the empirical evidence of what unrelated parties seem to do, actual profit experience is generally the best indication available, absent comparables, of anticipated profit experience that arm's length parties would have taken into account at the outset of the arrangement. It is, therefore, perfectly consistent with the arm's length standard to treat related party license agreements generally as renegotiable arrangements and to require periodic adjustments to the transfer price to reflect substantial changes in the income stream attributable to the intangible.[175]

Intangible transfer prices will in any event be determined on the basis of comparables if they exist. If a particular taxpayer demonstrates that it has comparable long-term, non-renegotiable contractual arrangements with third parties, the arm's length standard will preclude periodic adjustments of the related person intangible transfer price. In that event, a comparable would exist by definition, which would determine the consideration for the related person transfer, both initially and over time. Comparables are always the best measure of arm's length prices. In the case of a high profit intangible, however, a third party transaction generally must be an exact comparable in order for the transaction to constitute a valid comparable.[176]

It may also be possible in certain other cases to exclude subsequent profit experience from consideration under the arm's length standard. To do so, the taxpayer would need to demonstrate each of the following to avoid an adjustment based on subsequent profit experience:

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contract which permit or require them to do so. Thus, requiring that related party contracts mimic the terms of unrelated party contracts will not alone ensure that the results experienced by the related parties under those contracts will approximate arm's length dealing. 1985 House Rep., supra n. 47 at 425-426. Without the ability to make changes for adjustments over time, related party agreements will be observed when they suit the tax needs of the parties and amended or changed when they work to their detriment. Compare R.T. French Co. v. Comm'r, 60 T.C. 836 (1973), with Nestle Co., Inc. v. Comm'r, T.C. Memo. 1963-14.

[175] Periodic adjustments will also obviate the need for the often fruitless inquiry into the state of mind of the taxpayer and its affiliate at the outset.

[176] See the discussion infra Chapter 11, regarding the role of comparables in determining whether an adjustment over time is necessary.

1. That events had occurred subsequent to the license agreement that caused the unanticipated profitability;

2. That the license contained no provision pursuant to which unrelated parties would have adjusted the license; and

3. That unrelated parties would not have included a provision to permit adjustment for the change that caused the unanticipated profitability.

For example, assume that there are twelve heart drugs that perform similar therapeutic functions, none of which has a dominant market share. Several of these drugs are licensed to unrelated parties under long term arrangements which do not provide a mechanism for adjusting the royalty payments because of subsequent changes. The taxpayer's drug, which is licensed to a related party, uses an active ingredient which is different from the other products with which it competes. The competitors' drugs, however, lose all of their market share during the course of the license agreement because their products are found to cause serious side effects, and the licensed product's profits increase dramatically. In this case, if the taxpayer could prove the three factors above, the taxpayer could avoid an adjustment based on the increase in profitability.

As noted earlier, Congress was particularly concerned about taxpayers attempting to justify low-royalty transfers at an early stage based on the purported inability to predict subsequent product success.[177] Because of this concern, it would be appropriate to impose a high standard of proof, such as a clear and convincing evidence standard, on taxpayers in order to demonstrate that subsequent profitability could not have been anticipated. In no event should this test be available to taxpayers if inexact comparable licenses with no provision for periodic adjustments cannot be found in the marketplace.

A substantial change in intangible income will not necessarily result in an adjustment. As discussed in Chapter 6 and described in Chapter 11, determining the intangible income is merely the first step in the analysis of allocating intangible income. The second step involves allocating income on the basis of the activities performed and economic costs and risks borne by the parties. If intangible income increases solely due to the efforts of the transferee, then the increase in intangible income will be allocated exclusively to the transferee, and no adjustment will be made to the income of the transferor.

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[177] 1985 House Rep., _supra_ n. 47, at 424.

B. Periodic Review

Annual adjustments may not be required to reach the appropriate amount of income under the commensurate with income standard. Adjustments are not required for minor variations in intangible income, only for substantial changes in intangible income.[178] Several issues are raised by this requirement. How often should the taxpayer review its transfer pricing structure to determine whether income is being properly reported and to avoid potential penalties? How often may the Service make adjustments in the course of examination? Should the regulations define substantiality? Should the adjustments be applied retroactively or prospectively? Should periodic adjustments be made in the case of a sale of intangibles and other situations involving lump sum payments? Should set-offs be permitted?

The frequency with which a taxpayer should review its related party intangible transfer agreements and how often the Service should be able to make adjustments are not questions that can be governed by inflexible rules. When the transferee experiences a substantial change in its profits from the intangible resulting from some particular event (whether anticipated or not), a review by the taxpayer is clearly warranted; further, an adjustment by the Service is warranted unless the taxpayer can demonstrate, by clear and convincing evidence, that the conditions discussed above for avoiding an adjustment based on subsequent profit experience are met. Even absent a clear-cut event, it is possible that gradual changes over time may create a substantial deviation from the parties' expectations at the time they entered into the contract.

In general, taxpayers should review transfer pricing arrangements relating to intangibles (especially high profit intangibles) as often as necessary to assure that their transfer prices are consistent with substantial changes in intangible income that may have occurred since the inception of the current transfer pricing arrangements. For industries that undergo rapid technological change or for products that have a relatively short life, this standard may dictate annual review. In short, the taxpayer should review its pricing structure relating to intangibles as often and thoroughly as necessary to assure that income is reported on its U.S. tax return in a manner that is consistent with the commensurate with income standard. Taxpayers that fail to do so risk the imposition of the substantial understatement or other appropriate penalty.[179]

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[178] Id. at 426.

[179] As discussed supra in Chapter 3, the regulations or statute should be amended to ensure adequate disclosure of transfer pricing methodology and penalize unjustified

On the other hand, the Service should be permitted to make a transfer pricing adjustment without necessarily having to demonstrate that its proposed adjustment is justified by identifiable changes in intangible income compared with a prior taxable year. In other words, if the adjustment can be supported on the basis of exact or inexact comparables, or on the basis of the rate of return analysis or such other methodology as is adopted by the Service for use in cases in which exact or inexact comparables do not exist,[180] then the Service should not have to demonstrate that the adjustment specifically relates to identifiable changes in intangible income occurring since the last taxable year examined. An approach whereby the Service would be estopped from making an adjustment, absent clearly identifiable changes in intangible income, because of the Service's prior acceptance of some commensurate with income amount in a prior year would present problems of proof that are not necessarily relevant to the appropriateness of the adjustment. At most, consideration should be given only to requiring that the proposed adjustment to income be substantial in relation to the income reported by the taxpayer from the transaction -- and then only for audits subsequent to the first in-depth audit of transfer prices conducted for taxable years after 1986.

It may be advisable to publish in the Internal Revenue Manual a list of factors that, if one or more changes substantially, would indicate that there may be a substantial change in intangible income that may warrant an examination of the taxpayer's intangible transfer pricing. These factors might include: (a) the size and number of markets penetrated; (b) the product's market share; (c) the product's sales volume; (d) the product's sales revenue; (e) the number of uses for the technology; (f) improvements to the technology; (g) marketing expense; (h) production costs; (i) the services provided by each party in connection with the use of the intangible; and (j) the product's profit margin or the process' cost savings.[181]

Any periodic adjustments that are made under the commensurate with income standard generally should be made prospectively -- i.e., for the taxable year under audit and subsequent taxable years (provided that there is no further substantial change in the intangible income and other relevant

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substantial understatements of tax resulting from nonconformity to the arm's length standard.

[180] See infra Chapter 11.

[181] See also the factors set forth in Treas. Reg. §1.482-2(d)(2)(iii).

facts). Unless unrelated parties would have set a different royalty rate on the date of the transfer based upon expectations of future high profitability or other facts known on the date of transfer, the arm's length standard would require only that the transfer price be commensurate with actual income -- i.e., that the transfer price be changed only as the intangible income changes.

C. Lump Sum Payments

As discussed in Chapter 6, the commensurate with income standard applies to transfers of intangibles by sale or license for noncontingent, lump sum amounts. Thus, periodic adjustments may be required under the commensurate with income standard in the case of lump sum sale or royalty arrangements as well as periodic royalty arrangements. In the case of a lump sum sale, how should the Service make a section 482 allocation if it is not apparent until many years after the sale that the lump sum payment was insufficient under the commensurate with income standard?

One possibility would be to recharacterize the sale as a license, thereby giving the Service the ability to require additional royalty payments sufficient to satisfy the commensurate with income standard. It is clear, however, that parties dealing at arm's length occasionally sell intangibles. Thus, failure to recognize sale arrangements for related party transactions could be viewed as a deviation from the arm's length standard.

Alternatively, the Service could recognize the transfer as a sale but make a section 482 allocation to increase the initial lump sum payment. Unless taxpayers using lump sum sale arrangements were required by regulation or statute to keep the statute of limitations open for the payment year, the statute of limitations could bar adjustments to a lump sum payment in closed taxable years, contrary to Congressional intent. Moreover, other problems would exist in adjusting the lump sum even if the statute of limitations were open. For example, any mid-stream adjustment to the initial lump sum made before the statute of limitations expires on the year of sale would necessarily be based on a projection of future profits over the remaining life of the intangible that could be too high or too low. Furthermore, any mechanism, whether elective or mandatory, that would keep the statute of limitations for the year of transfer open for extended periods would disrupt the examination process by unduly delaying the closing of audits.

A lump sum sale arrangement should instead be treated as an open transaction to assure that the sale over time satisfies commensurate with income standard. This approach is the only approach which recognizes the transaction as a sale, allows for adjustments of the sale price under the commensurate with income standard, and minimizes the statute of limitation and other problems inherent in making adjustments to income in the year of the sale. Under this approach, a lump sum sale payment made in the year of the transfer would result in gain taxable in the year of transfer but would then be treated as a prepayment of the commensurate with income amounts. No section 482 allocation would be required until the aggregate commensurate with income amounts exceed the prepayments.

Under this method, the lump sum is treated as invested on the date of the lump sum payment in a hypothetical certificate of deposit ("C.D.") maturing on the last day of taxpayer's current tax year bearing interest at the appropriate federal funds rate based on the anticipated life of the intangible (for U.S. developed intangibles) or the appropriate rate in the development country. At the end of year one the balance of the C.D. investment would be computed. From this amount, the amount of the commensurate with income amount would be subtracted. The remaining balance would then be treated as invested in a C.D. maturing at the end of year two. At the end of each tax year a computation similar to that done at the end of year one would be made. When the C.D. balance is exhausted, the taxpayer would be required thereafter to include the entire commensurate with income amount in income each year.

Consider, for example, an intangible that is transferred for $1,000 and that would demand a commensurate with income amount in each of ten years as shown:

	Col. 1 Lump sum $1000 payment increased by time value return (assume 10%) at end of year (Col. 3 plus returns on Col. 3 amount)	Col. 2 Commensurate with Income Amount (assumed)	Col. 3 Remaining lump sum payment at beginning of year (prior year Col. 1 less prior year Col. 2)
Year 1	$ 1100	$ 100	$ 1000
2	1100	100	1000
3	1100	200	900
4	990	200	790
5	850	200	650
6	715	500	215
7	237	500	-0-
8		500	-0-
9		200	-0-
10		200	-0-

The $1,000 lump sum payment would be converted as shown in column 1 into a stream of income which is offset by the commensurate with income amount in column 2 until the stream of income is exhausted in year 7. Thereafter, the commensurate with income amount would be fully included in the transferor's income.[182]

Because section 482 may be applied only by the Service, no refunds could be allowed if an excessive lump sum was paid. However, to prevent abuse of outbound lump sum payments in inbound licensing arrangements, the Service would be allowed to adjust excessive lump sum payments that clearly exceed the commensurate with income standard.

D. Set-Offs in Royalty Arrangements

It is possible that the initial royalty rate set by the parties could be too large in some years and too small in other years when analyzed under the commensurate with income standard. Under existing regulations, section 482 adjustments traditionally have been made on a year-by-year basis. Only intra-year set-offs of proposed adjustments against excessive income derived on related party transactions are authorized under section 1.482-

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[182] It has been suggested that the commensurate with income standard will result in all gains from the sale of intangibles being treated as royalties under the Internal Revenue Code and under our tax treaties, because of the provision in the Code and those treaties covering gains contingent on productivity, use or disposition of the relevant intangible. There is no intention by the Service or Treasury to eliminate the possibility of sale treatment for transfers of intangibles in appropriate cases, either for treaty purposes or for U.S. withholding tax purposes. Further, the Service and Treasury believe that the mere fact that subsequent profits may be taken into account in appropriate cases by U.S. tax authorities in determining transfer prices on audits, or that a lump sum is treated as a deposit on the appropriate section 482 transfer price in order to assure that a commensurate with income adjustment can be made notwithstanding the statue of limitations, does not have this effect. The terms of the transaction itself (i.e., whether it provides for contingent consideration based, e.g., on sales volume or units sold) will determine treatment under the royalty article. Further, even if the commensurate with income standard were incorporated by reference into the relevant sales document, there is no necessary relationship between productivity, use or disposition and a proper commensurate with income payment. For example, sales might increase dramatically in a given year, but the method called for may result in no increase in payments, or the taxpayer may have an arm's length basis for making no adjustment.

1(d)(3) of the regulations.[183] Thus, the Service could make adjustments in some years without making an allowance for excessive royalties paid in other years. Assume, for example, that a license generates a fixed royalty amount on an intangible that produces fluctuating income due to business cycles or changes in demand. Over time, the royalty may be an appropriate one on average, but in some years it may be too low and in others too high.

Because of the problems inherent in an open transaction approach, the current rule prohibiting multi-year set-offs should be retained. The potentially harsh effect of this rule will be mitigated by the fact that periodic adjustments generally should be made only in cases of substantial changes in circumstances and by the ability of taxpayers to adjust their own arrangements prospectively, reducing or increasing the royalty, to account for changed circumstances. It will also create an incentive for taxpayers to examine their arrangements periodically to see whether an adjustment favorable to them would be appropriate.

E. Conclusions

1. Periodic adjustments are necessary in order to reflect substantial changes in the income stream produced by a transferred intangible, taking into account the activities performed, assets employed, and economic costs and risks borne by the related parties.

2. Requiring periodic adjustments is consistent with the arm's length principle, since unrelated parties generally provide some mechanism to adjust for change in the profitability of transferred intangibles and since actual profit experience generally is the best indication available of the anticipated profit experience that unrelated parties would have taken into account at the outset of the arrangement.

3. Taxpayers should review transfer pricing arrangements relating to transferred intangibles as often and as thoroughly as necessary to assure that income is reported over time in a manner consistent with the commensurate with income standard.

4. Periodic adjustments made under the commensurate with income standard generally should be prospective unless a different royalty rate would have been set on the date of transfer based upon expectations of the parties and the facts known as of the date of transfer.

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[183] But see Treas. Reg. §1.482-2(d)(1)(ii)(d), Ex. 3, which appears to allow an inter-year set-off.

5. A lump sum sale of an intangible should be characterized as an open transaction whereby the lump sum sale payment results in gain at the time of transfer, but is then treated as a prepayment of the commensurate with income amounts. No section 482 allocation would be required until the aggregate commensurate with income amounts exceed the prepayment.

6. Multi-year set-offs of proposed adjustments against excessive related party income derived in other taxable years will not be permitted.

Chapter 9

THE NEED FOR CERTAINTY: ARE SAFE HARBORS THE SOLUTION?

A. Introduction

One of the most consistent criticisms of the section 482 regulations is that they do not provide taxpayers with enough certainty to establish intercompany prices that will satisfy the Service without overpaying taxes. Based on the government's experience in litigation, the current section 482 regulations also fail to provide the Service and the courts with sufficiently precise rules to make appropriate section 482 adjustments, especially when third party comparables are not available.[184] One of the most common suggestions for solving these problems is to amend the section 482 regulations to adopt safe harbors, or simple, mechanical, bright-line tests that may be used in lieu of the fact-specific arm's length inquiry under section 482.[185]

B. General Problems with Safe Harbors

While numerous safe harbors have been proposed, they generally have taken two forms: (1) absolute safe harbors that grant the taxpayer total freedom from a section 482 adjustment once the criteria for the safe harbor are satisfied, and (2) conditional safe harbors that produce a rebuttable presumption or a shift in the burden of proof in the taxpayer's favor, but that may be overcome by the Service through evidence showing that a section 482 adjustment is necessary.

Although various types of safe harbors are available, they all have one common element that makes them both attractive to the taxpayer and potentially troublesome to the government: they generally would serve only to reduce tax liability. Taxpayers for which a safe harbor would produce a lower tax liability than the appropriate normative rule would use it. Those for which a safe harbor would produce a higher tax liability than the appropriate normative rule generally would not seek the protection of the safe harbor but would apply the normative rule. Reducing administrative costs, or the need for certainty, may encourage some taxpayers to use a safe harbor in marginal situations even if application of the normal rule would result in

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[184] GAO, IRS Could Better Protect U.S. Tax Interests, supra n. 64, at 63; ABA Comm. on Affiliated and Related Corporations, Administrative Recommendation No. 8 (1986) [hereinafter ABA Admin. Rec.]; Langbein, supra n. 160, at 655.

[185] See GAO, IRS Could Better Protect U.S. Tax Interests, supra n. 64, at 48-50.

a tax savings. In general, however, the only benefit a safe harbor offers from the Service's perspective is a saving of administrative costs.

Ideally, safe harbor standards should be easy and inexpensive vehicles for selecting cases that warrant closer scrutiny. The perfect safe harbor would result in the elimination of all insignificant cases and the selection of cases for detailed analysis by taxpayers and further examination by the Service that would more likely produce sustainable, significant adjustments if analyzed incorrectly by the taxpayer. The question is whether there are any safe harbors that are capable of approaching these goals.

A look at the Service's experience with section 482 safe harbors is instructive. The best example is the safe harbor for interest rates found in section 1.482-2(a)(2)(iii). From the Service's point of view, results under this safe harbor have been mixed at best. The safe harbor was originally set between 4 and 6 percent. This was probably sufficient in 1968, but it soon became inappropriately low. However, the government was very slow to change the safe harbor range as interest rates rose.[186] The safe harbor for interest now tracks the Federal rates required to be determined for purposes of the original issue discount rule under section 1274(d), which reflect market rates and are adjusted monthly. While this is probably a satisfactory solution, many taxpayers were able to gain a substantial windfall while the government made successive attempts to choose an appropriate safe harbor rate.

Another example of a safe harbor is found in section 1.482-2(c)(2)(ii) of the regulations, which provides a safe harbor computation of an arm's length rental for the use of tangible property. Experience has demonstrated that this safe harbor was overly generous to taxpayers (<u>i.e.</u>, requiring too little rent). It was repealed by regulations finalized this year.[187] No substitute safe harbor has been provided to date.[188]

The government's experience in the section 482 area has been that safe harbors have generally treated amounts as arm's length

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[186] The following changes have been made to the safe harbor interest rate: 6-8 percent effective January 1, 1976; 11-13 percent effective July 1, 1981; 100-130 percent of the applicable Federal rate effective May 9, 1986. Final regulations were published on June 13, 1988. T.D. 8204, 1988-24 I.R.B. 11.

[187] T.D. 8204, 1988-24 I.R.B. 11.

[188] <u>See</u> Treas. Reg. §1.482-2(c)(2)(ii).

that were usually different from market rates. This result is even more likely to occur in the transfer pricing area because of the inherent difficulty of constructing valuation safe harbors for the types of intangible and tangible property that have created transfer pricing problems under section 482. Furthermore, because of the complexity of the regulatory process and the difficulty in obtaining reliable data, adjustments or corrections to safe harbor standards would be slow. In any event, the fundamental deficiencies of safe harbors are not resolved by continually reviewing and revising the rates, or by intentionally setting the safe harbor on the conservative side for protection of the revenue. If safe harbors are set at non-market rates, they will be used only by taxpayers that will benefit by making or receiving payments at those rates.

C. Specific Proposals

The following lists some of the safe harbors that have been proposed and includes a short explanation of some of the reasons why they have not been endorsed by the Service and Treasury.

1. Pricing Based on Industry Norms. This approach is contrary to the legislative history of the section 482 changes in the 1986 Act.[189] Industry norms generally do not reflect arm's length prices for highly profitable intangibles. Accordingly, any safe harbors based on industry norms or statistics would permit transfer prices that would be far different from the arm's length standard in the most significant cases.

2. Profit Split -- Minimum U.S. Profit. This approach would guarantee that the United States would capture a certain minimum of the profit in transfer pricing cases, perhaps 50 percent. The commensurate with income standard is designed to divide the income involved between related parties to "reasonably reflect the relative economic activity undertaken by each."[190] A safe harbor that splits profits a certain way in all cases would be inconsistent with the case-by-case factual determination that is necessary to measure the economic contribution made by each of the related parties. Furthermore, a fixed U.S. profit requirement would be objectionable to other countries when intangibles were developed outside the United States.

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[189] 1985 House Rep., supra n. 47, at 424-25.

[190] Id.

3. Profit Split Based on Taxpayer's Proportionate Share of Combined Costs (ABA Proposal).[191]

The problem with this safe harbor is that it presumes that different types of expenses contribute equally to the combined profit. For example, expenses incurred for highly skilled technical services might contribute proportionately more to the combined profit than those incurred for unskilled services. Furthermore, it might be very difficult to determine what indirect expenses (including, for example, research and development expenses) are attributable to particular products, and taxpayers might be able to manipulate the profit split by shifting expenses from one product to another or one entity to another (such as by "loaning" employees).

4. Profit Split Based on Share of Combined Costs and Assets (ABA Proposal).[192] The second ABA safe harbor is a modification of the first one. Instead of relying entirely on relative expenses, it relies 50 percent on expenses, and 50 percent on the fair market value of the assets used in the production of the property involved in the sale. However, at a minimum not less than 25 percent of the combined taxable income would be allocated to the buyer. If one of the parties employed its assets in a very inefficient manner, it would nevertheless be rewarded in the same manner as if it were highly efficient. Additionally, assets could be arbitrarily shifted from one entity to another; difficult questions of property valuation could arise; and property could be purchased just to tip the balance of profits. Because of those problems, a party could receive a substantial amount of the combined taxable income, yet be doing very little to earn the income.

5. Insubstantial Tax Benefit Test. This safe harbor would be available if the rate of tax in the foreign jurisdiction was at least 90 percent of the U.S. rate. The theory behind this safe harbor is that taxpayers will use arm's length pricing if no overall tax savings result from doing otherwise. While this approach may have some pragmatic appeal, there are still several problems with it. An adjustment under section 482 does not depend on an intent to avoid taxes. Even if the taxpayer is overpaying its worldwide tax liability, if U.S. income is being

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[191] ABA, Admin. Rec., supra n. 184, at 14. The ABA proposals are applicable only to the transfer of tangible property. Other proposals apply only to intangible property. Because many of the safe harbors would have the same advantages and disadvantages regardless of the type of property involved, this discussion does not address the different types of property separately.

[192] Id. at 14-15.

understated, an adjustment should be made. Furthermore, as a policy matter the United States will not cede its taxing jurisdiction to a foreign country other than by treaty. Accordingly, if a taxpayer intentionally or inadvertently shifts income to a high tax jurisdiction it should be subject to a section 482 adjustment without the benefit of a safe harbor. As a practical matter, however, the Service proposes relatively few adjustments between a U.S.-based parent company and its affiliates located in another jurisdiction whose effective tax rate is nearly the same or higher. Different problems are presented by foreign-based parents and their U.S. affiliates.

6. Profit Distribution Test. This safe harbor would be satisfied if at least 25 percent of the pre-royalty net profit of an affiliate was distributed to the parent. This test is directly contrary to the commensurate with income concept. If an affiliate is responsible for only 10 percent of the economic activity in question it should not be able to keep up to 75 percent of the profit involved.

7. Prior Settlement Test. Under this proposal, when the Service had accepted a specific pricing method in a prior examination, the burden would be on the Service to show that the pricing method is unreasonable for the current year. This safe harbor is unacceptable because there could be any number of reasons why the Service had accepted a particular pricing method. To force the Service to demonstrate that the previously agreed upon method has become unreasonable could help perpetuate an error or make it more difficult to adjust to changing circumstances.

D. Burden-Shifting Safe Harbors

Some of the safe harbor proposals would operate by shifting the burden of proof to the Service. It has been proposed, for example, that a taxpayer's full disclosure of the method by which it determines its transfer prices would shift the burden of proof to the government. (See Chapter 3, *supra*, for a description of IEs' experiences in seeking information.) Section 6001 requires all taxpayers to maintain adequate books and records to substantiate positions taken on the tax return, including section 482 issues. Thus, a taxpayer could obtain a shift in the burden of proof merely by complying with the law.

The Service and Treasury do not believe that "burden-shifting" safe harbors are a viable approach. The critical issues presented in the section 482 area are almost always factual in nature, and taxpayers are almost always uniquely familiar with -- and in exclusive possession of -- the relevant facts. To place the burden of proof on the government in this situation would be unworkable.

E. Conclusions and Recommendations

1. Historical experience with safe harbors indicates that they generally result in unwarranted windfalls for taxpayers, without significant benefits for the government.

2. In the highly factual section 482 context, no one safe harbor or combination of safe harbors has yet been proposed that would be useful but not potentially abusive.

3. While the possibility that useful safe harbors could be developed is not categorically rejected, additional section 482 safe harbors are not recommended at the present time.

III. METHODS FOR VALUING TRANSFERS OF INTANGIBLES

A significant reason for the enactment of the commensurate with income standard was the failure to properly take into account the income earned by related parties in exploiting intangibles. As detailed in earlier chapters, inappropriate comparables or ad hoc profit split approaches have been used to analyze cases involving related party transfers of unique intangibles.

This part of the study seeks to define the appropriate use of comparable transactions. It also proposes an alternative method of analysis that does not directly rely upon comparable transactions. Fourteen detailed examples applying the methods described in this part are set forth in Appendix E. These methods are generally consistent with various methods of income allocation used by the Service, taxpayers, and the courts under pre-1986 Act law and, if adopted, would appropriately be applicable to cases arising prior to the 1986 Act.

Chapter 10

ECONOMIC THEORIES CONCERNING THE IMPLEMENTATION OF SECTION 482

A. Introduction

The current section 482 regulations use a market-based approach to income allocation. The goal of this approach is to distribute income in the same way that the market would distribute the income; that is, related parties should earn the same returns that unrelated parties would earn under similar circumstances. This approach is implemented through separate accounting in which an individual transfer price is determined for each transaction.[193]

The argument for the market-based method to allocate income was articulated by Stanley Surrey, former Assistant Secretary (Tax Policy), who discussed the way that unrelated parties are taxed:

> Tax administrators do not question transactions that are governed by the marketplace. If Company A sells goods to unrelated Company B at a certain price or furnishes services at a particular price, the income of both companies is determined by using that price. One

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[193] A variation of this approach retains the goal of a market-based allocation but claims that in some situations the target is best reached by an estimate, or that average prices can be used for certain transactions. The estimate can be provided by some type of formulary apportionment.

> company may be large and the other small; one may be a monopoly; one may be financially strong and the other in a weak condition. But these and other factors which may affect the price at which the transaction occurs are not the concern of the tax administrator.[194]

Having established the tax system's acceptance of the marketplace, he concludes:

> Presumably, most transactions are governed by the general framework of the marketplace and hence it is appropriate to seek to put intra-group transactions under that general framework. Thus, use of the standard of arm's length, both to test the actual allocation of income and expense resulting under controlled intra-group arrangements and to adjust that allocation if it does not meet such standard, appears in theory to be a proper course.[195]

Recent criticism has questioned whether the market-based arm's length approach is flawed as a matter of general principle. An alternative approach might be based on the concept of an integrated business. Loosely defined, an integrated business consists of firms under common control and engaged in similar activities. Proponents of the alternative approach assert that one cannot assume that related parties conduct market-based transactions within the entity. They claim that, because an entity will not act as if its parts are unrelated, it does not make sense to try to account for individual transactions in the way that unrelated parties subject to market forces would account for similar transactions. Under this theory, the allocation of income can only be accomplished by applying some formula chosen by the government.

This chapter explores the tension between these alternative approaches, and suggests a way to apply the arm's length principle to an integrated business. It concludes that the market-based arm's length approach remains the best theoretical allocation method.

B. The Arm's Length Approach in an Integrated Business: Theory

The goal of a market-based approach is to ensure that the return to an economic activity is allocated to the party performing the economic activity. Critics of the market-based

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[194] Surrey, Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions, 10 Law and Policy in International Business 409, 414 (1978).

[195] Id. at 414.

approach argue that an arm's length price will not achieve this goal. Relevant practical issues are how close one can get to the right price and whether getting that price is costly relative to settling for an estimate.

One commentator has suggested that the difficulties encountered in administering the current regulations stem not from practical considerations, but rather from fundamental problems inherent in applying a market-based approach to transactions of integrated businesses.[196] Specifically, it has been argued that the flaw in an arm's length approach is that it does not allow a return to the form of organization. That is, because an integrated enterprise is presumably more efficient, it will be able to execute an integrated economic activity at a lower cost than a series of independent firms whose joint efforts are necessary to execute the same series of transactions. This omission creates a "continuum price problem," a situation in which the sum of the returns for separate services rendered by independent parties is less than the actual return of the combined group. This argument grows out of the literature on the reasons for the existence of multinationals.[197]

That multinationals may exist because of integrated or "firm-specific" economies does not require a rejection of the arm's length principle. Transfer prices are supposed to reflect the contribution of the activity and assets utilized in each location to economic income. Therefore, each party should earn at least as much as it could have earned as an unrelated party under alternative arrangements.

Furthermore, an analysis of "alternative arrangements" need not be restricted to analyzing conventional arm's length transactions. Consider a U.S. firm that owns the worldwide rights to a unique patented drug that it wishes to sell into a new market (and assume that the drug or patent is valuable in its own right and that marketing activity, for example, is not an important factor). The firm could license the use of the patent to unrelated parties to produce the drug in the new market. Alternatively, the firm could enter into a joint venture by

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[196] Langbein, supra n. 160, at 627.

[197] Caves explains that many multinationals exist because of a failure in the market for intangibles. R. Caves, Multinational Enterprise and Economic Analysis (1982). In essence, intra-firm transactions can be more profitable than inter-firm transactions because of the expense of negotiating complete contracts or the inability of a firm to capture the full value of a piece of knowledge through contracts with unrelated parties without fully explaining the knowledge and thus eliminating its value.

affiliating with a company that has the ability to produce the drug. If the pharmaceutical firm entered into a joint venture it would probably be able to negotiate a very large share of the profits given the value of the patent, because any number of local firms could provide the labor and capital necessary to mix and package the drug.

There are, therefore, two types of arm's length transactions to consider -- one in which the parties remain independent and another in which the two parties make an arm's length agreement to affiliate by merger, joint venture, acquisition, or simply through the hiring of local labor and capital within a subsidiary. Restricting attention to transactions between parties that remain unrelated can fail to accomplish the objective of allocating to each party its contribution to income, if such transactions do not accurately reflect the actual relations between the related parties.

Another way of describing the arm's length agreements that have to be considered is to say that they are the arrangements that would be made between unrelated parties if they could choose to have the costs of related parties -- i.e., to use the related party technology. In general, tax rules should distort business decisions as little as possible because rules that minimize such distortions will lead to the greatest possible production efficiency. Transfer pricing rules will allow the most efficient production technology to come to the fore if, holding the cost functions constant, they result in the same tax burdens whether or not the parties are related. In other words, if unrelated parties somehow had access to the technology available to related parties, their operations should not result in more or less total taxes than would be paid by a multinational using this technology. The difficulty, of course, is the practical application of this interpretation of the arm's length standard.

C. The Arm's Length Approach in an Integrated Business: Practice

The arm's length approach can be more correctly applied to an integrated business by using certain tools of microeconomic theory. The continuum price problem arises when a vertically or horizontally integrated production technology that is available to multinational corporations results in lower costs than a non-vertically or horizontally integrated technology, which unrelated parties would have to use. How can an examination of unrelated party transactions lead to a satisfactory resolution of the transfer pricing problem?

As a first step, consider an industry in which there is no difference in costs between related party and unrelated party dealings; there is only one production technology, and it is available to the parties in both types of arrangements. There is thus no continuum price problem, and the arm's length standard, as traditionally interpreted, can be applied. It is likely that both unrelated party and related party transactions will actually occur in the marketplace, and it should be possible to observe prices from the former and use them to determine the incomes of each party in the latter.

This procedure satisfies the objective described in section B above of using information about unrelated parties operating at arm's length to determine the allocation of income in the related party setting. The related parties that sell intermediate goods will be given the same gross revenues as the corresponding unrelated parties; related parties that purchase them will have the same cost of goods sold as corresponding unrelated parties. Further, it has already been assumed that the two sets of parties operate in the same market and have the same cost structure; therefore, the external prices and internal costs will be equal. Thus, the related parties will have the same net taxable incomes as the corresponding unrelated parties. They should therefore have the same total tax burden as the unrelated parties with which they are competing.

Now return to the situation in which a vertically or horizontally-integrated technology, available only to multinational companies, is dominant. If multinational corporations are able to produce at lower cost, then in the long run it should be difficult for the smaller companies to continue in existence. Therefore, arm's length prices may be unavailable. An appropriate transfer pricing result will be achieved if each related party were assigned the income that the corresponding unrelated party would earn, if the latter were using the efficient cost structure.

Microeconomic theory leads to an unambiguous and natural statement of what the income of unrelated parties should be in these circumstances. As long as the industry under analysis is competitive and the factors of production are homogeneous and mobile between sectors, it is assumed that "economic," "excess," or "above-normal" profits will be zero in the long run.[198] That is, each firm will earn just enough to be able to pay for the land, labor, capital, and other factors of production that it uses to produce its outputs.

The zero economic profit concept does not state that taxable income should be zero. If owners of the firm have supplied it

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[198] For a narrative explanation of the zero profit condition, see R. Lipsey and P. Steiner, Economics 229-231 (6th ed. 1981). For a mathematical presentation of the implications of this condition, see J. Henderson and R. Quandt, Microeconomic Theory 107-110 (3d ed. 1980).

with capital or other inputs, the firm should earn enough to be able to reward the shareholders for these factors; otherwise, the shareholders would be wise to find a better investment. Rather, the zero profit concept implies that in a competitive industry there should be an equality between the gross revenues of a firm and the summation of the market returns that are or could be earned by all of the factors of production that the firm employs. If gross revenues were higher than this amount, then the firm would be earning "above-normal" profits; the existence of "above-normal" profits would attract other firms to enter the industry until these "above-normal" profits disappeared through competition. If gross revenues were lower than this amount, a firm would not be able to earn enough to reward all of the factors it employs and, in the long run, would have to shrink or disappear.

This equality between revenue and the sum of returns to each factor of production may be used to determine the proper allocation of income among the related parties within the multinational. Specifically, subject to the discussion in section D *infra* regarding monopoly situations and intangibles, one should measure the factors of production used by each related party and compute the returns that each one would earn on its best alternative use in the marketplace. The sum of these amounts yields the total input returns that each related party would have to earn if it were an unrelated enterprise. The sum also equals the amount that the multinational enterprise would have to pay an unrelated party to get it to produce the same outputs (employing the same inputs and using the same technology) as the related party does. Attributing this gross income to each related party will result in its tax base being equal to the hypothetical unrelated party alternative; therefore, the tax burden will be equal. Thus, there will be no tax incentive or disincentive to related party transactions.

The theory discussed above implies that a competitive firm's gross revenue, which equals price times quantity of output, will be equal to the returns that the factors it employs could earn in the marketplace. The traditional arm's length approach looks at the gross revenue side of this equation; the alternative procedure outlined above looks at the input side. It starts by identifying the factors of production employed by the firm, determining the returns that these factors would earn in the marketplace, and computing the sum. In short, the traditional approach looks for the prices that the firm's outputs would command in the marketplace, whereas the alternative approach seeks to determine the returns that the firm's factors would earn in the marketplace. Both approaches are equally consistent with the basic goal of the arm's length principle, which is to use information about unrelated parties operating at arm's length to determine the allocation of income in a related party setting.

D. Further Practical Problems

There are two further practical difficulties in applying the arm's length approach to integrated business economies: application of the approach to monopoly situations and valuation of intangibles. This section briefly describes these difficulties and suggests possible approaches to solving them.

1. Monopoly Situations. In a market that cannot be entered by more than one or a few firms, the existence of "above-normal" profits cannot be ruled out, because potential competitors will not be able to compete them away. The equality discussed above between gross revenue and the returns that factors could earn in the marketplace, and the results derived from it, cannot then be assumed to hold.

However, it may still be possible to apply the basic idea. For example, consider a situation in which a corporation has been granted worldwide patent rights to a unique product. The company still can choose between exploiting this patent through related party or unrelated party dealings, and it would be worthwhile for this decision to be made free of distortions that could be caused by transfer pricing rules. To get an unrelated corporation to provide a good or service, the company would have to pay the unrelated corporation the sum of the returns that would be earned by the factors it would employ. Therefore, it would still be proper to use the alternative procedure to determine the income of the related corporation.[199]

2. Valuation of Intangibles. The starting point for the alternative application of the arm's length approach is to measure the factors of production employed by the related parties, and to determine the returns that they would earn in the

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[199] In more complicated situations, both the affiliated corporation and any potential unrelated party participant may each possess monopoly rights that allow them to earn above-normal profits. In deciding whether to use such an unrelated party, a corporation would have to consider what would happen if it attempted to bargain with it. There are analyses, relating to economic game theory, that attempt to predict what the range of outcomes would be in such a bilateral monopoly situation. If the outcome, specifically the income of the potential unrelated party, can be predicted, then it would be proper to use it to determine the income of the corporation's affiliate. This is so, to repeat, because this procedure would allow the corporation's choice between using an affiliate versus an unrelated party to be made free of tax distortions. To implement this procedure, however, one would need to analyze the theoretical models of bargaining situations in detail, and this analysis is beyond the scope of the present discussion.

marketplace. This procedure can be implemented in a straightforward fashion only if the factors can be identified and measured.

However, there is at least one factor of production, intangible assets, for which it is often difficult to assign a precise value. These assets are often unique and it is frequently difficult to decide what returns they would earn if separately employed in the marketplace.

One should not conclude that the presence of any intangible asset will make the alternative procedure impossible to implement. It may be that only one of the related parties employs intangible assets to any significant degree. In this situation it suffices to measure the factors of production employed by the party with measurable assets and to allocate the residual income to the related party employing significant intangible assets. If both parties employ intangible assets, valuation becomes more difficult and, in some cases, judgmental, but not impossible.

E. Conclusions

1. The arm's length standard remains the theoretically preferable approach to income allocation. Microeconomic theory can be utilized to apply the arm's length standard to an integrated operation.

2. In certain situations, production technologies may be such that unrelated parties operating at arm's length can be expected to coexist with vertically or horizontally integrated multinational corporations. In these cases, arm's length prices should exist and their application to related party transactions should lead to appropriate results. This is the traditional approach embodied in the section 482 regulations.

3. In other situations, vertically or horizontally integrated technologies available only in related party dealings may dominate. Third party prices will be difficult to find in these cases; moreover, the use of the rare third party prices that occur may be inappropriate. However, since information may exist as to the arm's length returns attributable to the factors of production employed by one or both of the related parties, this information can be used to modify the traditional approach and take account of the integrated businesses.

Chapter 11

ARM'S LENGTH METHODS FOR EVALUATING TRANSACTIONS INVOLVING INTANGIBLE PROPERTY

A. Introduction

This chapter discusses the methodology for implementing the arm's length principle for transactions involving intangible property. The goal of this chapter is to propose a theoretical framework for analyzing the situations that have caused the greatest amount of difficulty in the transfer pricing area in order to generate further consideration of the difficult issues involved.

B. Role of Comparable Transactions

"Exact comparables," which are those involving the transfer of the same intangible property, supply the best evidence of what unrelated parties would do in a related party transaction. The weight to be given to evidence of "inexact" comparables, which generally are those involving different but economically similar intangible property, is not so clear. Nor is the resort to inexact comparables automatically justified by the arm's length principle. This section first outlines the standards for exact comparables. It then discusses the appropriate role for inexact ones.

1. Exact Comparables: Two Examples

Exact comparables are most likely to occur in connection with the transfer of common products that embody intangibles that are widely available to producers, such as the once unique technology now employed in pocket calculators, digital watches, or microwave ovens. Comparability in such cases of widely available technology is usually easy to demonstrate.

The existence of an exact comparable for unique intangible property, however, is not inconceivable. Consider a multinational company that acquires an unrelated company whose only assets are a small amount of cash, equipment, and the rights to a valuable new invention. If, immediately after this acquisition, the multinational sells those rights to a subsidiary, there really can be no question as to the proper transfer price: it is the acquisition price minus the cash and value of the equipment. In fact, because this comparable is available, any other arrangement could be held suspect. Assume further that the subsidiary and the parent have no other transactions in the initial and following years. The subsidiary's income should include the return to the intangible in all future years, assuming that the subsidiary paid the arm's length consideration at the time of the initial transfer.

As a second example, consider a U.S. corporation that decides to exploit one of its intangibles. It sets up a Mexican subsidiary to serve the Latin American market, while it licenses the Asian rights to an unrelated Korean company. Assume further that the Asian and Latin American markets, and the parent's dealing between the Korean company and the Mexican subsidiary, are comparable in all important aspects. The Korean licensing arrangement should determine the Latin American subsidiary's allocation of income from the transfer of the intangible.

2. Standards For Exact Comparables

The assumptions made in these examples raise the crucial question: How is one to know if a potential comparable is indeed exact? The first requirement is that the comparable transaction involve the same intangible property transferred under substantially similar circumstances. Thus, an exact comparable should involve the same patent, product design, process, trademark, or other intangible transferred to the related party.

However, licenses of intangibles are usually exclusive. Therefore, it is extremely unlikely that the same intangible would be licensed to two different parties for the same use and geographic market. The standards for exact comparables should not require these aspects to be identical.

Instead, two types of additional standards should be met. First, the comparable transaction and the related party arrangement must take place in substantially similar economic environments; these standards may be called "external" ones. Second, the transactions must contain substantially similar contractual features; they must satisfy "internal" standards of comparability.

No amount of general discussion of these standards is likely to turn them into objective tests. As in all matters concerning transfer pricing, facts and circumstances must determine the outcome of specific cases. The following observations, however, may suggest some useful guidelines.

a. "External" Standards

In examining external standards, the essential question is whether unrelated parties would regard the economic environment of the transaction under examination as similar to that of the proposed comparable transaction. In other words, would unrelated parties earn substantially similar profits from a substantially similar transaction? For example, the size and level of economic development of the markets should be substantially similar.[200] If one market is much larger, or if the product is already accepted in one market and not the other, one can presume that unrelated parties would not arrive at the same arrangements to license an intangible into these two markets. As another example, one market may contain many competitors, but in the other a licensee can expect to have a monopoly for a number of years. Again, it is reasonable to conclude that unrelated parties would come to different terms in negotiating licenses for these markets.

Another set of external standards concerns transactions between the licensor and licensee that are collateral to the transfer of the intangible in question. If the parties to one transaction have substantial dealings in the intangible with third parties (such as a cross-licensing arrangement) but the parties to the other set of transactions do not, external standards of comparability are not satisfied. There are clearly reasons why unrelated parties will reach different outcomes if they expect to have further dealings than if they do not. For example, an isolated exchange should not be taken as exactly comparable to a continuing transactional relationship. The comparable used in the U.S. Steel decision[201] has been criticized on this basis.

Finally, the level of economic risks being assumed and the functions performed by each party must be similar. Clearly, it would be inappropriate to compare a related party transaction where the affiliate engages solely in manufacturing a product with a transaction in which the unrelated party not only manufactures but also must market the product.

b. "Internal" Standards

To meet this set of standards, the contractual aspects of the transactions being compared must be substantially similar in all important aspects. The most obvious ones include the amount and form of compensation for the transferred intangible. The most common compensation form is a royalty determined as a percentage of sales or quantity produced, but, as Appendix D discusses, other forms are sometimes used. If the comparable transaction contains accelerator or decelerator clauses under which the royalty increases or decreases as sales increase, for example, such clauses should appear in the related party transaction. Other elements of a transaction can have a significant effect on the income realized by unrelated parties to a license or similar agreement. These elements must be

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[200] Rev. Rul. 87-71, 1987-2 C.B. 148.

[201] See discussion supra Chapter 4.

substantially similar in order for the unrelated party transaction to be an exact comparable. For example, if the unrelated party agreement provides for the licensee to receive a specified level of technical assistance and training, the related party transaction should contain similar rights. Similarly, if one agreement calls for the licensee to perform significant marketing or product development, while in the other the licensor performs the marketing, the agreements lack internal comparability.

3. Exact Comparables and Periodic Adjustments

A comparable that is exact at the outset of a transaction may lose its exactness over time. There should therefore be two requirements of continued use of the exact comparable over time. First, the arrangements must be consistent in their provision for options and other types of contingency clauses so that they provide for substantially the same types and amounts of adjustments for changing circumstances. Second, the comparables will not remain exact over time unless related parties perform these adjustments as unrelated parties do, under circumstances that are comparable.

Is the concept of an exact comparable so rigid that the results of related party and unrelated party agreements must be the same? Consider a U.S. company that licenses an intangible to two unrelated parties, one in Asia and one in Latin America. It is reasonable to predict that the arrangements will be similar if the economic environments are similar. However, it will probably not be the case that the U.S. company will realize the same income from the two transactions in every year. Business cycles, for example, vary across locations over time. The Asian licensee may have a very profitable experience when times are "lean" in Latin America, or vice versa.

The standards for exact comparables should not require year-by-year equality between the results of the unrelated party arrangement and of the related party one if it is reasonable to conclude that the long-term results will be comparable. Related parties should not be required to exercise rights they might have, if unrelated parties do not in fact exercise them.

4. The Role of Inexact Comparables

This section describes the appropriate role for unrelated party transactions that cannot satisfy one or more of the standards for exact comparables. Because of the unpredictable outcomes that inexact comparables have caused in the past, one might argue that they simply should not be used. However, the data presented in Appendix A suggests that some continued use of inexact comparables would be appropriate. The International Examiners reported that they made some use of comparables in making transfer pricing adjustments 75 percent of the time.[202] Although the reported use of comparables for transfers of intangibles in general was lower, it was higher (76.5 percent) for marketing intangibles.[203] The IEs did not report making final determinations based solely on these comparables in all these cases, but that they made some use of them. Clearly, in practice, inexact comparable transactions provide significant information, even with respect to transfers of intangible property.

The problem, therefore, is not that inexact comparables are useless or misleading. Rather, either they have been given too much emphasis in many cases or inappropriate comparables have been used. The proper conclusion is that it is appropriate to make use of them, but that it is inappropriate to determine transfer prices solely on the basis of inexact comparables. This conclusion is fully consistent with the arm's length principle. The arm's length approach requires that exact comparables, when they are available, should determine transfer pricing allocations of income. However, it does not follow that the same is true of inexact comparables. That is, inexact comparables should be resorted to only when exact comparables are unavailable. Further, they should not be given priority over the alternative method outlined in section C of this chapter in all cases.

5. Selection of Appropriate Inexact Comparables

Once it is determined that an exact comparable does not exist, how should inexact comparables be selected? The most obvious point is that the external and internal standards discussed previously should parallel those in the transaction at issue as closely as possible. For example, if the unrelated parties in the potential comparable operate in a very different economic environment -- if the market is much smaller or the related parties carry on a much broader set of transactions -- then the comparable should not be used to justify the related party arrangement. Similarly, if the intangible in the unrelated party transaction is at a very different stage of development or concerns a dissimilar product or service, then its use as a comparable is inappropriate.

In more traditional terms, an unrelated party arrangement should be used as an inexact comparable if the differences between it and the related party transaction can be reflected by a reasonable number of adjustments that have definite and ascertainable effects on the terms of the arrangement. The current regulations for section 482, although silent on this

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202 Appendix A, infra.

203 Id.

issue in connection with transfers of intangible property, discuss it quite carefully in connection with transfers of tangible property. They mention that adjusting a sale for differences in transportation costs or minor physical modifications would probably be appropriate, but that an adjustment for the presence or absence of a trademark would not.[204]

This approach should be extended to transfers of intangible property. For example, unrelated party arrangements frequently require the licensor to provide a specified amount of training or expert assistance to the licensee for a brief period.[205] It may be possible to adjust a comparable that includes such a provision by comparing it with an arrangement that does not, or that provides for less assistance.

At the other extreme, consider an attempt to compare an unrelated party license with a related party license when the unrelated party licensee performs different functions than the related party licensee. For example, the former may be responsible for substantial marketing, while the latter may not. It seems clear that the effect of this difference would not be definite and ascertainable. Therefore, an adjustment for it would be too speculative to be appropriate.

Similarly, intangibles differ in their fundamental profitability. Attempting to compare a low-profit intangible to a high-profit one by adjusting for this difference would clearly be too speculative to be appropriate. Comparable transactions involving intangibles that are likely to be of typical or average profitability are therefore appropriate inexact comparables only if the related party intangible under analysis is typical or average.

The current regulations contain a list of twelve factors which are essentially internal and external standards that might be examined in order to determine whether an unrelated party license is an appropriate inexact comparable. As many observers have pointed out, however, it is difficult to derive useful guidance from this list, because it does not discuss the relative weights to be placed on the factors in a given situation. For example, prospective profits to be realized from the intangible appears late in the list, but after the 1986 Tax Reform Act this factor must be given special consideration. In contrast, the first listed item cites prevailing industry rates,

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[204] Treas. Reg. §1.482-2(e)(2)(ii).

[205] <u>See</u> <u>infra</u> Appendix D for further discussion of unrelated party licenses.

which should not be relied upon unless the intangible being transferred is demonstrably average, based on observable indicators of profitability.

Another approach that provides a framework for use of inexact comparables is "functional analysis." Although not explicitly mentioned in the regulations, this procedure is outlined in the IRS Manual[206] and has been found to be a useful place to start in transfer pricing situations. In essence, the goal of functional analysis is to identify the economic activities actually undertaken or to be undertaken by the parties in both the related party situation and unrelated party situation. The most appropriate comparables may be chosen by identifying the ones in which the unrelated parties carry on the same major economic activities as the related parties. Section C of this chapter examines functional analysis in the context of the arm's length rate of return method. Functional analysis is an equally valid approach for analyzing comparables on the basis of the similarity between the economic activities performed.[207]

6. Use of Inexact Comparables And Periodic Adjustments

It is inappropriate to use inexact comparables to justify a related party transaction merely by analyzing similarities at the time of the initial transfer. For example, there may be valid inexact comparables that justify the establishment of a related party agreement with a fifteen percent royalty rate. These comparables may further justify fixing this rate for two years. Even if no adjustment were required during the first two years, in year three the taxpayer may not continue to rely upon the prior inexact comparables unless, after re-examination, use of these comparables remains appropriate.

Suppose a significant change occurs during the term of a license agreement. For example, suppose a taxpayer licenses a product design to a related party. At the time of the transfer, the taxpayer makes a good faith estimate that the product will be a routine one, and will attain 10-25 percent of its market. Based on this fact, the taxpayer gathers information on comparable transactions (none of which can meet the standards for an exact comparable). The information indicates that a royalty rate of 10 percent of sales is appropriate. The comparables contain varying duration and contingency clauses. In

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[206] I.R.M. §600 et seq.

[207] As Appendix D stresses, it is insufficient merely to replicate a royalty rate in order to achieve a comparable license. For example, the technological services provided by the licensor may have a large impact on the profitability of the license from the licensor's perspective.

year three, the product design becomes uniquely popular and garners 95 percent of the market. Given this set of facts, the inexact comparables previously used may no longer be used in year three and succeeding years to justify the 10% related party royalty rate.[208]

Although unlikely, the taxpayer may find inexact comparables involving products with a 95 percent market share that demonstrate that the 10 percent royalty rate is still appropriate. More realistically, suppose that there are comparables that show that products in the taxpayer's industry with a 95 percent market share typically command a much higher royalty, or, as may be more likely, that there are no comparables for such a situation. In such case, the taxpayer must use the arm's length return method outlined in section C below either to justify the royalty rate previously set or to adjust the related party arrangement to bring it into compliance with the results of this new analysis.

C. <u>An Arm's Length Return Method</u>

The previous chapter discusses why a method that looks to arm's length returns, as distinct from arm's length prices, is appropriate. This section discusses how such a method should operate. Although some of the terminology in this section may be new, most of the techniques discussed in it are not. One of the main arguments for the development of an arm's length return method, in fact, is that taxpayers, the Service, and especially the courts have found it necessary to use ad hoc and incompletely developed versions of such a method in the past and will undoubtedly continue to do so in the future. Therefore, the goal of this discussion is to lay a foundation for this approach so that it may be used to achieve more consistent and satisfactory results.

1. <u>Basic Arm's Length Return Method</u>

a. <u>General Description</u>

Consider a U.S. company, Widgetco, that holds worldwide patent rights to the widget, a high-tech light gathering device that is expected to be a vital component in certain satellites and scientific instruments. Widgetco intends to exploit this patent in the following way. A foreign affiliate will manufacture the widgets, under license from Widgetco. Besides utilizing the license, Widgetco and the affiliate will engage in

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[208] There may be other cases where the taxpayer can demonstrate an arm's length basis for continuing to use inexact comparables. <u>See</u> discussion <u>infra</u> Chapter 8 regarding periodic adjustments.

the following transactions. Widgetco will sell various types of microchips, seals and filters to the affiliate, which will also buy some of these products from unrelated suppliers. The affiliate will use these components to manufacture the widgets and sell them to Widgetco, which will market and distribute them. Widgetco maintains a research staff that developed the widget and will continue to try to improve it.

It would be very difficult to depend purely on comparable transactions, as traditionally defined, to establish the proper allocation of income in this sort of "round trip" transfer-pricing situation. There are three separate types of comparables that would have to be found. The first is a set of prices for the components the parent will sell to the affiliate. The second is the royalty that the affiliate should pay to the parent under the production license. The third is the transfer price for the finished widgets. Although it may be possible to find exact comparables for one of these types of transactions, such as the purchase price of some of the components, it will in general be impossible to find comparables for all three. Further, finding an answer to only one aspect of the problem provides little help in deciding the proper allocation of income between the related parties.

Another approach would be to try to find one or more comparable transactions in which a company contracts with an unrelated party to manufacture a product similar to the widget. It is likely that these transactions will not be good inexact comparables. In general, the form, risks, and extent of relationships in the related party case will at least appear to be quite different from those in a contract manufacturer transaction. Among other things, the foreign affiliate carries raw material, work-in-process, and finished goods inventories and should receive a normal market return on its activities that reflects its investment in such assets and the moderate risk that manufacturers using routine manufacturing processes bear with respect to their investment in manufacturing facilities and inventories. Using the terminology of the previous section, a contract manufacturer transaction is likely to fail both the external and internal standards for inexact comparables, because both the types of transactions between the parties and the terms of their agreements will differ. While comparables of this type should not be discarded from all consideration (because this type of comparable may provide useful information), it would be improper to base a resolution of the transfer pricing issue solely on such information.

An arm's length return approach would start from a different perspective. It would seek to identify the assets and other factors of production that will be used by the related parties in the relevant line of business and would try to assign market returns to them.

The first step in this process is to perform a functional analysis -- i.e., to break down each line of business into its component activities or functions. It should then be possible to identify which of the functions utilize only factors of production that can be measured and assigned market returns and those which do not. In most cases, identifying functions with measurable factors will lead to distinguishing between those functions that make significant use of preexisting intangible assets and those that do not. In Widgetco's case, Widgetco owns several types of assets that are difficult to measure, including the widget patent and other manufacturing intangibles, the ongoing enterprise value of the research staff, and the marketing intangibles. On the other hand, the foreign affiliate utilizes measurable factors of production, assuming that the manufacturing process is a routine one. Specifically, the affiliate employs labor, plant, equipment, working capital, and what might be called "routine" manufacturing intangibles--i.e., know-how related to efficiency in routine manufacturing processes that most manufacturers develop through experience. Since it is easier to evaluate the factors of production to be used by the foreign affiliate, the market rate of return analysis will focus on the affiliate. As the theoretical analysis in the previous chapter demonstrates, focusing on the return of the affiliate in this manner is a valid extension of the arm's length principle.

Next, income should be assigned to each of the functions with measurable factors -- here the functions performed by the affiliate. The reason for identifying measurable factors (and, therefore, focusing on the affiliate) is that the functions that employ measurable factors will probably be carried on by a wide range of unrelated parties for which information will probably be available regarding market returns earned by them. A market return consistent with the returns of unrelated parties can be assigned to each of the affiliate's functions since they all employ measurable factors. Once returns are identified for all of the affiliate's functions, the residual income from the line of business is then allocated to Widgetco.

Assume, as stated, that the only function to be performed by Widgetco's foreign affiliate is manufacturing and that this function does not involve the significant use of intangible property developed by the affiliate or purchased by it from unrelated parties. Under the rate of return method, the assets of the foreign affiliate would be divided into liquid working capital and all other assets (i.e., the production assets). The actual return on the liquid working capital will be identified and allocated to the foreign affiliate. Rates of return on production assets used in similar manufacturing activities of similar risk must be identified or estimated.[209] Income will then be allocated to the affiliate for its manufacturing activity in an amount equal to the identified or estimated rate of return as applied to its production assets. This rate of return would include, by definition, a return on routine manufacturing intangibles that manufacturers commonly possess as well as a return for assuming normal business risks that manufacturers bear with respect to their investment in manufacturing facilities and inventories.[210] The residual amount of income from the line of business is allocated to Widgetco.

The same allocation would be made to the foreign affiliate if it sold its output to a second affiliate and not back to Widgetco. In neither case would the foreign affiliate receive a return for marketing its product.

b. Use of Arm's Length Information

There are two ways that arm's length information can be used to allocate income to the activities of the Widgetco manufacturing affiliate. The first method has been previously described -- to identify the unrelated parties' rates of return on assets utilized in a particular function, taking into account only the non-liquid assets relevant to the function in the line of business being examined. If satisfactory measures of the unrelated parties' assets are available, it should be possible to calculate an appropriate rate of return for each function and apply it to the related party's assets utilized in that function.

The second way to use the arm's length information is to measure it against a yardstick other than rates of return on assets. A common alternative is the ratio of income to operating costs. For example, in the DuPont case,[211] an expert witness, Dr. Charles Berry, computed the ratio of gross income before reduction by operating costs and interest to operating costs for DISA, DuPont's Swiss affiliate, and for a number of unrelated. parties performing similar functions. This analysis is useful to measure returns on service activities and in other situations where assets are difficult to measure consistently or, more generally, where there is reason to believe that the relationship between income and costs is more stable or easier to measure than the relationship between income and assets. As is

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[209] Because manufacturing is a broad category, the function or activity would be defined more precisely. An example might be "medium instrumentation fabrication, assembly, and testing."

[210] See discussion of risk infra section E.

[211] See discussion supra Chapter 4.

true with assets, it is important to consider the types of costs and their relationships to income earned, not just the totals. For example, some analysts have used the ratio of gross income to "above the line" costs. This approach is suspect if the unrelated parties incur proportionately larger amounts of "below the line" costs, such as advertising, than the related affiliate incurs.

The use of both types of unrelated party information is consistent with the fundamental goal of the basic arm's length return method, which is to use information about unrelated parties to determine the returns that would have been earned had the related parties' activities been undertaken at arm's length. Therefore, both approaches are potentially applicable depending upon the availability of either type of information and the appropriateness of using either type of information in the particular circumstances.

c. Applicability of Basic Arm's Length Return Method

The basic arm's length return method should have wide, but not universal, applicability in situations where exact or inexact comparable transactions are not available. It will not be sufficient alone, however, when both of the related parties own preexisting and significant intangible assets that are vital to the success of the project -- for example, if Widgetco's foreign affiliate actively markets the products it manufactures in a manner that utilizes significant self-developed marketing intangibles. In such cases, it will be difficult to find a set of unrelated parties that possess the same type and amount of intangible assets as the affiliate and are thus able to perform the same activities. It will be difficult, therefore, to obtain the arm's length information needed to assign a return to either affiliate's activities.

This discussion is not meant to imply, however, that the basic arm's length return method is to be avoided whenever an affiliate possesses any amount of intangible assets. It is unlikely, for example, that any manufacturing operation is so simple that it does not involve the use of some intangibles. An affiliate engaged only in manufacturing may employ a skilled labor force, and the efforts expended in recruiting and training it may create at least some amount of going concern type of intangible. Further, the affiliate's experience in producing the parent's designs may lead to the development of some amount of know-how. These facts alone, however, should not prevent the application of the basic method. The reason is that unrelated parties performing similar activities will, in general, possess these types of "routine" intangibles. Therefore, by measuring the return on assets that unrelated parties earn for performing similar activities and bearing similar risks, the basic method will automatically capture the returns earned by these "routine" intangibles and will properly attribute them to the affiliate. It is only when the affiliate owns some type of intangible that is of major importance to the enterprise, and which few unrelated parties possess, that the basic method is insufficient standing alone to resolve the issue.

The basic arm's length return method will probably be appropriate for most manufacturing affiliates. It should be possible to observe the rates of return on assets or ratios of income to costs that are earned by unrelated parties performing similar manufacturing activities involving similar risks and amounts of routine intangibles. It is possible to think of exceptions, however. Consider a corporation that has assembled a large and valuable team of engineers and skilled craftsmen within a European subsidiary in order to develop or perfect a complex manufacturing process. If no or few unrelated parties would be capable of performing this development activity, the basic arm's length return method will not be sufficient standing alone to resolve the case.

Similarly, the basic method will be applicable to many distribution and marketing affiliates. An affiliate that sets up and maintains a distribution network undoubtedly possesses a going concern intangible; an affiliate that markets products to industrial customers by participating in trade shows and maintaining a staff of salespersons undoubtedly possesses some amount of know-how. However, it seems likely that these sorts of activities are undertaken by unrelated parties that possess similar amounts of going concern value and know-how. Therefore, it should be possible to determine the arm's length returns on assets for these activities, which will include the appropriate returns to these "routine" intangibles. In other situations, however, the basic method alone will not suffice.

2. Profit Split Addition to the Basic Arm's Length Return Method

Although the basic arm's length return method should be widely applicable, there are situations in which its use alone will clearly be inadequate. A large multinational corporation may have foreign subsidiaries that have research, marketing, planning, manufacturing, and other divisions that are as large and active as those of all but the biggest U.S. companies. Therefore, these affiliates may perform complex functions, take significant risks and own significant intangible assets equal to those of the typical parent corporation. If so, the basic arm's length return method would be impossible to apply because exact or inexact comparables, or rates of returns, for these complex functions are generally unavailable.

Consider Teachem, a U.S. company that is a world leader in designing and producing educational toys. It serves its major overseas market, Western Europe, through a French sales affiliate, Enseignerem. Teachem is planning to license a new set of designs to Enseignerem, who will modify them in minor ways, such as translating the instructions and markings, and who will hire local contract manufacturers to produce them. Enseignerem will utilize its own trademark and be responsible for all aspects of marketing and distribution in Europe. It will decide which of the toys to include in its line, set its own advertising budget, and design campaigns to promote the new line and its Enseignerem trademark. It also maintains a sales force and distribution network. Teachem maintains a research and testing staff to develop new products. The affiliate does not.

Assume further that Teachem has a business policy of not licensing its designs to unrelated parties. Exact comparables will therefore be absent, and inexact comparables may be difficult to find. How would an arm's length return approach be applied to determine the appropriate royalty rate to be paid by Enseignerem for the use of Teachem's designs? The first step is to identify the functions performed by the parent and the subsidiary in the line of business in which the licensed designs are used (the sale of new toy designs in the European market). The parent should be allocated the returns on the basic product designs, while the subsidiary is entitled to the returns to be earned by its trademarks, marketing efforts, and distribution network, plus any intangibles related to the modifications.

The next step is to identify the functions that employ measurable factors -- i.e., activities that do not involve the use of significant intangible assets. These activities should be analyzed using the basic arm's length return method. Enseignerem's distribution and manufacturing activities may be examples. It should be possible to find unrelated parties that perform these types of activities and incur similar business risks. Thus, it should be possible to determine an arm's length rates of return on assets (or income-to-costs ratio) for each activity and apply the arm's length rate or ratio to the appropriate related party factors. The resulting income should then be allocated to the party performing the activity. In this case, income attributable to distribution and manufacturing activities would be allocated to Enseignerem. If the parent corporation performs or is to perform routine activities involving the line of business, they too should be analyzed using the basic method.

These two steps will leave a quantity of income not yet allocated and a set of activities involving significant intangible assets not yet accounted for. The goal of the first two steps is to isolate the income that is attributable to the significant intangible assets owned by the corporate group as a whole and used in the line of business in question -- primarily the designs owned by Teachem and the marketing intangibles (including the trademark) owned by Enseignerem.

The goal of the remaining step is to identify the intangible income attributable to the relevant line of business and then split that income according to the relative value that the marketplace would put on each party's significant intangible assets had they been employed by unrelated parties operating at arm's length. The intangible income is equal to the combined net income from the line of business less the income allocated under the prior steps to functions with measurable factors -- i.e., the residual combined net income determined after applying the basic rate of return method to activities with measurable factors of the parties. In splitting this residual amount between the related parties, it is not necessary to place a specific value on each party's intangible assets, only a relative value. Of course, it is easier to state this principle than to describe in detail how it is to be applied in practice. In many cases, there will be little or no unrelated party information that will be useful in determining how the split would be determined in an arm's length setting. Furthermore, the costs of developing intangibles, even if known, may bear no relationship to value, especially in the case of legally protected intangibles, and generally should not be used to assign relative values to the parties' intangible assets. Splitting the intangible income in such cases will largely be a matter of judgment. There are two possible sources of arm's length information, however.

First, it may be possible to find unrelated parties that engage in similar activities and that use similar intangibles. The unrelated party transactions must be economically similar, of course, including the level of economic risks assumed. It would be inappropriate to use a profit split derived from a situation in which the unrelated parties' intangibles were much less (or more) profitable than those owned by the related parties. Further, it would be inappropriate to compare the split derived from a transaction in which an unrelated party conducted only wholesale level marketing, for example, with a related party situation in which an affiliate markets products to consumers. These requirements resemble the standards discussed above for inexact comparables. The analysis of unrelated party profit splits should explain the relationship between the observed profit splits and the overall profitability of the significant intangibles involved with a reasonable degree of accuracy. It is also necessary to analyze the functions that the unrelated licensors and licensees perform and the risks that they bear. Comments in this area should focus on how such an analysis can be implemented.

Second, in some circumstances, a taxpayer may have arm's length evidence of the value of its own or its affiliate's intangibles. For example, a taxpayer may have recently purchased its affiliate and may have some basis for determining the value of the intangible assets using the purchase price.

3. Arm's Length Return Method and Periodic Adjustments

Issues involving periodic adjustments are easier to analyze for the arm's length return method than for the methods involving comparable transactions. Because the basic arm's length return method looks to the factors of production used by the parties, the income allocation should adjust as the factors change. Thus, as an affiliate's plant, equipment, and other measurable factors change from the projections in the initial analysis, the income allocated to them should change. Similarly, the profit split percentage is intended to reflect the relative values of significant intangible assets owned by the parties. When the value of intangibles belonging to one of the parties has changed, the percentage should be changed. For example, a dramatic increase in sales may be due to either a recent product improvement or an extensive marketing campaign, in which case proportionately more profit should be assigned to the developing or marketing affiliate, respectively.

These conclusions are not intended to imply, however, that there must be year-by-year equality between the related parties' incomes and the results of an ideal application of the method. The prior discussion of long-run versus year-by-year results is again relevant. For example, consider an independent firm that uses only plant and equipment. Although it should earn the market rate of return in the long run, it will, in general, experience lower returns or even losses in "lean" times and higher returns at the other end of the business cycle. Periodic adjustments will be required for significant changes in income. Therefore, changes (either negative or positive) that are less than significant may tend to even out in a long-term equilibrium. The absence of a requirement for an adjustment over time when insubstantial changes in income occur is a corollary of the rule that de minimis adjustments will not be made. Chapter 8 discusses this issue, including reasons why explicit inter-year set-offs would not be practicable, in more detail.

D. Priority And Coordination Among Methods

The previous sections of this chapter discussed two broad approaches for analyzing transfers of intangible property: an approach based on comparable transactions and one based on arm's length returns to factors employed. Which is to be used in a given situation? The answer is clear in one case. If an exact comparable is present, it and only it should be used to determine the allocation of income from the transfer. It follows from the definition of exactness that there can be no better evidence of what unrelated parties operating at arm's length would have done.

Finding an exact comparable, however, can be extremely difficult. In the majority of cases, particularly contested ones, the allocation of income will come from either the inexact comparable method or the arm's length return method. The facts and circumstances of each case should determine which method -- or methods -- should be used.

There are four basic types of cases. In the first, the intangible for which a section 482 transfer price is being determined is comparable, to those used by unrelated taxpayers and each of the related parties is expected to employ significant and complex intangibles. The inexact comparables method should be chosen.

In the second case, the section 482 intangible is unique, and the affiliate utilizing the intangible will engage in functions that use only measurable factors of production and routine amounts of intangibles. The basic arm's length return method should be used.

In the third case, the section 482 intangible has many competitors and the affiliate using the intangible will engage in simpler kinds of functions. Both of the methods are potentially applicable. Under the theory on which they are based, they should yield similar results. This situation should, in practice, be the easiest for the taxpayer to analyze and should engender the least amount of controversy.

In the final case, the section 482 intangible is unique and both of the related parties own one or more significant intangibles that will be used in exploiting it. This is the hardest case. The profit-split version of the arm's length return method must be used.

E. Risk-Bearing in Related Party Situations

Economic environments are full of uncertainty, and this fact must be recognized in all methods of income allocation. In general, in a related party transaction, the market reward for taking risks must be allocated to the party truly at risk.

Companies take risks in all dealings in the marketplace, and are rewarded for doing so. Some of this risk disappears in related party transactions. The legislative history of the Tax Reform Act of 1986 noted:

> In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced

> with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets.[212]

How should risk be accounted for in related party transactions? The riskiness of true economic activities gives rise to greater returns in the marketplace; therefore, if one part of an enterprise is inherently more risky than another, more income should be allocated to it. This allocation should be based on the risks arising out of the true economic activities undertaken by the parts of the enterprise, not on mechanisms that merely shift risks within the group.

This conclusion has implications for the proper application of both the comparables approach and the arm's length return approach. First, in searching for appropriate comparables, one should look for situations in which an unrelated party contracted to perform an economic activity that is about equal in riskiness to the activity done by the affiliate; it would be inappropriate to rely on comparables in which the unrelated party undertook a significant risk of some kind not undertaken by the related party. Likewise, in applying the arm's length rate of return method, unrelated party rates of return should be used only if they reflect similar levels of risk. But merely stating that unrelated party transactions must bear the same level of risk as the related party begs the question of what risks the related party should be allowed to assume. It's necessary to decide first what risks may be appropriately assumed by the related parties, depending on the functions that each performs. Only then is it possible to identify what unrelated party arrangements are comparable so that comparable rates of return (or inexact comparable transactions) can be determined.

Returning to the Widgetco example, the affiliate, as the manufacturer, is at risk both with respect to its investment in plant and equipment and with respect to inventories. The risk with respect to plant and equipment will be significant only if the facilities cannot be used for other purposes without

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[212] 1985 House Rep., supra n. 47, at 424 (1985). A line of court cases not directly relevant to section 482 has reached a similar conclusion. In Carnation and succeeding cases, members of an affiliated group of corporations were denied deductions for "insurance premium" payments to another member of the group that insured predominantly risks of the group. The courts decided that no true insurance was present, because there was no true risk shifting between the parent and its affiliates. Carnation Co. v. Comm'r, 71 T.C. 400 (1979), aff'd, 640 F.2d 410 (9th Cir. 1980), cert. denied, 454 U.S. 965 (1981).

incurring significant additional costs. If there is risk that the product will not be successful because there is uncertainty that the product will perform as anticipated or have the usages anticipated, then that risk should be borne by Widgetco as owner of the manufacturing intangible (the patent) and should not be reflected in the affiliate's rate of return. The affiliate's return should reflect only the moderate level of risk borne by manufacturers of products that are reasonably expected to achieve market acceptance. Likewise, if there is uncertainty that the product will be marketed successfully, then that marketing risk also should not be borne by the affiliate but should probably be shared in some fashion by the owner of the manufacturing intangible and the marketer, depending upon the extent to which anticipated profits from the enterprise are attributable to the manufacturing intangibles or the marketing activities.

On the other hand, assume that the risk does not relate to undue uncertainty regarding the anticipated performance or usage of the product or the market acceptability of the product. Assume, instead, that it is highly uncertain whether the product can be produced cheaply enough to make the enterprise viable, or that it is uncertain whether the manufacturing process will produce the product with the same quality as prototypes produced in the laboratory. These risks are risks inherent in the manufacturing function and should probably be shared in some fashion between the owner of the manufacturing intangible and the manufacturing affiliate. If the manufacturing affiliate is itself developing an efficient production process that attempts to achieve low production costs or to assure consistency in quality of output, then the affiliate should be allocated a return that reflects a substantial portion of that risk being borne by the manufacturing affiliate. (In such case, the manufacturing affiliate would bring to bear significant manufacturing process intangibles which would necessitate the application of the profit split addition to the basic arm's length return method.) If, instead, the owner of the intangible has also developed the production process without significant contribution by the manufacturing affiliate, then a separate manufacturing intangible related to the production process has been created, and the owner of such intangible is entitled to an arm's length return. The manufacturing affiliate's return should not bear more than the moderate level of risk borne by manufacturers of products that are reasonably expected to achieve market acceptance.

F. Coordination with Other Aspects of Transfer Pricing

The purpose of this chapter is to provide a framework for the development of new methods for allocating income from intangible property. Therefore, methods for allocation of income in situations involving provision of services[213] or transfers of tangible property[214] may appear at first glance to be outside the scope of the present discussion. However, the rules for intangible property must be coordinated with the rules for other types of transactions between related parties for obvious reasons. Transfers of tangible property and provision of services frequently accompany a transfer of intangible property; all three are often bundled into a single economic transaction. Further, if the rules relating to one type of transaction become more or less favorable to taxpayers, then they will easily be able to find ways to structure their transactions to take advantage of the disparities.

It may be helpful to establish a priority for single economic transactions that involve more than one type of transfer. For example, licensing agreements often contain clauses that require the licensor to provide training or other services to the licensee. Further, transfers of tangible property often involve intangibles, since the goods transferred often depend for their value on embodied trademarks or patents. In these cases, the basic allocation of income issue should be settled under the rules to be developed for intangible property.

G. Conclusions and Recommendations

1. An approach incorporating two alternative methods for determining transfer prices for intangibles would achieve more appropriate allocations of income and greater consistency in result.

2. The first method uses exact or inexact comparables when they exist.

    a. An exact comparable is the same intangible licensed to an unrelated parties, when the circumstances surrounding it and the related party transfer are similar. The price derived from this method has priority over all others.

    b. An inexact comparable is an intangible very similar to the intangible transferred to a related party, but not identical. Differences must be definite and ascertainable. If the other intangible, the contractual arrangements, or the economic circumstances are too different, it may not be used as a comparable.

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213 Treas. Reg. §1.482-2(b).

214 Treas. Reg. §1.482-2(e).

3. The second method uses an arm's length return analysis instead of looking for a comparable transaction and adopting that transfer price as the section 482 transfer price for the related party transfer.

   a. The basic arm's length return approach applies when one party to the transaction performs economic functions using measurable assets or other factors, but not using significant intangibles of its own. The first step is to break down the relevant line of business into its component activities or functions and measure the factors (generally assets) utilized by the party performing the simpler set of functions. Income attributable to those functions is determined by identifying rates of return to assets or other factors of unrelated entities performing similar economic activities and assuming similar economic risks, and applying a comparable rate of return to the assets or other factors of the related party. Any residual income is thereby effectively assigned to the other party. The royalty rate or other transfer price for intangibles utilized by the related party must be set to achieve the allocation of residual income to the other party.

   b. When both parties perform complex economic functions, bear significant economic risks, and use significant self-developed intangibles, a profit split analysis must be added to the basic rate of return method. Under the profit split analysis, the combined net income from the line of business must first be determined. The profit split analysis assigns the residual net income, determined after applying the basic rate of return method to the measurable assets of the parties, between the parties based upon the relative values of the parties' unique intangibles.

4. While the standards for exact or inexact comparables do not require year-by-year equality between results of the unrelated party arrangements and related party arrangements, unrelated party arrangements can lose their comparability over time as the facts and circumstances relevant to the standards for comparability change. In such case an adjustment to allocations of income may be necessary. Under the arm's length return method, income allocations reflect the functions performed by the parties and -- <u>i.e.</u>, they reflect the measurable factors of production and the value of significant intangibles employed by the parties in performing those functions. Therefore,

income allocated to the related parties under the arm's length return method will change as the functions performed or the factors of production or value of intangibles employed by the parties change.

5. Other than in the case of exact comparables, there should be no priority among these methods. However, each is designed to be utilized under a specific set of facts, so the underlying fact pattern should determine the method or methods to be used.

6. Risk should be accounted for under all methods described in this chapter, since the market rewards risk takers. However, the risk premium should be attributed to the affiliate undertaking the economic function in which the risk inheres.

IV. COST SHARING ARRANGEMENTS

Preceding parts of this study have analyzed the proper prices to be applied, or amount of income to be allocated, when an intangible is transferred between related parties. Cost sharing arrangements are an alternative method by which related parties can develop and exploit intangibles. The history of such arrangements, their acceptance for tax purposes, and an outline of rules that should be followed for post-1986 cost sharing arrangements are discussed in this part.

Chapter 12

HISTORY OF COST SHARING

A. Introduction

In general, a cost sharing arrangement is an agreement between two or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any property that is developed. Because each participant "owns" specified rights to any intangibles developed under the arrangement, no royalties are paid by the participants for exploiting their rights to such intangibles. The Conference Report accompanying the 1986 Act indicates that Congress did not intend to preclude the use of bona fide research and development cost sharing arrangements. However, Congress expected the results produced under a bona fide cost sharing arrangement to be consistent with results under the commensurate with income standard.[215]

Cost sharing arrangements have long existed at arm's length between unrelated parties. Typically, unrelated parties pool their resources and expertise in a joint effort to develop a specified product in exchange for a share of potential profits. The Service has little experience with ordinary unrelated party cost sharing arrangements because they are at arm's length and normally do not have unusual tax consequences.[216]

In view of the limited information currently available on both related and unrelated cost sharing agreements, the Service and Treasury would appreciate receiving information from taxpayers regarding their contractual arrangements and experience with cost sharing.

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[215] 1986 Conf. Rep., _supra_ n. 2, at II-6.

[216] _See generally_ Rev. Rul. 56-543, 1956-2 C.B. 327, revoked by Rev. Rul. 77-1, 1977-1 C.B. 161; _see also_ Gen. Couns. Mem. 36,531 (December 29, 1975).

B. 1966 Proposed Section 482 Regulations

Proposed Treas. Reg. §1.482-2(d)(4), published on August 2, 1966, provided extensive rules for cost sharing arrangements.[217] The proposed regulations permitted any affiliate (other than one in the trade or business of producing intangible property) to participate in the cost sharing arrangement, provided that the intangible property was intended for use in connection with the active conduct of the affiliate's business. The regulations specifically authorized cost sharing arrangements for single projects, but did not disqualify multiple projects or continuing arrangements. The sharing of costs and risks was required to be proportional to the anticipated benefits to be received by each member from the arrangement. Cost sharing was required to be based on sales, profits or other variable criteria.

The 1966 proposed regulations did not explicitly address the "buy-in" question -- that is, the compensation to be paid to the developer or owner of intangibles that are made available at the time the arrangement commences. They did, however, require that an arm's length amount be paid to the affiliate that provides intangibles that substantially contribute to the arrangement. Any required section 482 allocation for services provided by other affiliates was also to be included as a cost of the arrangement.

The proposed cost sharing regulations were ultimately abandoned in favor of the simpler general requirements presently contained in section 1.482-2(d)(4).

C. Current Regulations

The current rules in section 1.482-2(d)(4) state that a cost sharing agreement must be in writing and provide for the sharing of costs and risks of developing intangible property in return for a specified interest in the property that may be produced. A bona fide cost sharing arrangement must reflect an effort in good faith by the participants to bear their respective shares of all costs and risks on an arm's length basis. The terms and conditions must be comparable to those that would have been adopted by unrelated parties in similar circumstances.[218]

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[217] 31 Fed. Reg. 10394 (1966).

[218] Whether a particular cost sharing agreement meets the requirements of section 482 is generally a factual question not appropriate for a private letter ruling. There have been private letter rulings regarding issues that are peripheral to the central question of whether a cost sharing agreement is bona fide. However, none of these rulings concerned the characteristics necessary for an agreement to be considered bona

D. Foreign experience with cost sharing agreements

The 1979 OECD report on Transfer Pricing and Multinational Enterprises[219] stated that, although international cost sharing agreements for research and development costs were not common, some had recently been entered into by large multinational enterprises. The OECD report indicated that, with the exception of the United States, none of its members had laws or regulations pertaining specifically to cost sharing arrangements. A major concern expressed by the OECD report was that the participants to the arrangement be in a position to benefit from any intangibles developed under the arrangement before the cost sharing payments would be allowed as deductible expenses. The OECD report stated that the United States did not require a profit mark-up for research and development activities performed. The OECD report reflected a consensus, however, that a profit mark-up would be appropriate when research was performed at the specific request of a member of the cost sharing group. There was also a consensus that withholding taxes should not apply to cost sharing payments when paid.

A few countries have specifically addressed cost sharing arrangements since publication of the OECD report. Germany has developed guidelines[220] for the use of cost sharing agreements in cases in which expenses for research and development can only be valued in the aggregate. Division of the costs must be based on the extent that each party actually benefits or expects to benefit from the arrangement. When determining costs incurred, no profit element is recognized for tax purposes. Appropriate costs to be shared may include a contribution to general and administrative costs.

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fide under the current regulations. See Priv. Ltr. Ruls. 8111103, 8002001, 8002014, and 7704079940A.

[219] OECD, Transfer Pricing and Multinational Enterprises, supra n. 158, at 55-62.

[220] The guidelines for cost sharing agreements are found in paragraph 7 of the German Transfer Pricing Guidelines. English and French translations of these guidelines are contained in Raedler-Jacob, German Transfer Pricing/Prix de Transfert en Allemagne (Kluwer Law and Taxation Publishers, Devender, Netherlands, and Metzner, Frankfurt, Germany 1984). The guidelines are also available in International Bureau of Fiscal Documentation, Tax Treatment of Transfer Pricing (Amsterdam, Netherlands 1987).

E. Deficit Reduction Act of 1984

Section 367(d), enacted in 1984, provides that a transfer of intangibles to foreign corporations in an exchange described in section 351 or 361 is to be treated as a sale, with the transferor being treated as receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for annual payments contingent on productivity, use, or disposition of the property. Such payments are treated as reductions of the foreign entity's earnings and profits and as U.S. source income to the U.S. recipient. The "Blue Book" discussion of section 367(d) indicates that it is to have no application to bona fide cost sharing arrangements.[221] The Blue Book further recognized that it may be appropriate for the Treasury Department to elaborate on the current cost sharing rules to address problems with cost sharing arrangements.[222]

F. Cost Sharing under Section 936(h)

After 1982, the intangible income of a domestic corporation qualifying for the possessions tax credit must be included in the income of its U.S. shareholders, unless the possessions corporation either elects the cost sharing method or elects the 50% of combined taxable income method, both of which are contained in section 936(h). Under the section 936(h) cost sharing election, the possessions corporation must pay its share of the affiliated group's total research and development costs based on the ratio of sales by the affiliated group of products produced in the possession to total sales by the affiliated group of all products. The cost sharing payment must be computed with respect to "product areas" rather than single projects. "Product areas" are defined, in general, by reference to the three-digit Standard Industrial Classification codes (SIC codes) promulgated by the Commerce Department. Cost sharing payments made by the possessions corporation are not treated as income to the recipient but reduce otherwise allowable expenses.

A possessions corporation making the cost sharing election is treated as owning the manufacturing intangibles utilized in its business, and the income from such intangibles then becomes eligible for the possessions tax credit. Pricing of products between a possessions corporation electing the cost sharing method and its domestic U.S. affiliates must still meet the requirements of section 482, taking into account that the possessions corporation is treated as owning the manufacturing intangibles.

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[221] General Explanation of the DRA of 1984, supra n. 143, at 433.

[222] Id.

Pursuant to an amendment made by the 1986 Act, a possession corporation making the cost sharing election must pay the greater of 110% of the pre-1986 statutory cost sharing amount or the royalty required to be paid to the developer of the intangibles under the commensurate with income standard.[223] Given the special circumstances in which the section 936(h) cost sharing provisions apply and the 1986 Act changes, section 936(h) cost sharing arrangements do not provide much guidance with regard to the appropriate requirements for other cost sharing arrangements.

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[223] Section 936(h)(5)(C)(i)(I), as amended by §1231(a)(1)(A), Pub. L. No. 99-514, 100 Stat. 2085 (1986).

Chapter 13

COST SHARING AFTER THE TAX REFORM ACT OF 1986

A. Introduction

The Conference Report to the 1986 Act states that, while Congress intends to permit cost sharing agreements,[224] it expects cost sharing arrangements to produce results consistent with the purposes of the commensurate with income standard in section 482 -- i.e., that "the income allocated among the parties reasonably reflect the actual economic activity undertaken by each." The Committee Report also emphasized three potential problems that should be addressed in any revision of section 1.482-2(d)(4).

The first problem is selective inclusion in the arrangement of high profit intangibles. The Report states:

> Under a bona fide cost sharing arrangement, the cost sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within an appropriate product area, and the cost of research and development at all relevant development stages would be included.[225]

The second issue concerns the basis on which contributions are to be measured. The Report states:

> In order for cost-sharing arrangements to produce results consistent with changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally be proportionate to profit as determined before research and development.[226]

The third specific Congressional concern relates to the "buy-in" issue. The Report states:

> In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time, or is otherwise

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[224] 1986 Conf. Rep., supra n. 2, at II-638.

[225] Id.

[226] Id.

> effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to effectively reflect its investment.[227]

This chapter examines these and other issues that have arisen with regard to the requirements for a bona fide cost sharing arrangement after the Tax Reform Act of 1986. It should be made clear at the outset that, if an arrangement is not bona fide, any payments made under the cost sharing agreement will be considered as offsets to the arm's length price that should have been paid for the intangibles. While section 1.482-2(d)(4) limits adjustments by the Service in the context of cost sharing arrangements to an adjustment of contributions paid, this regulation presupposes that the arrangement is bona fide. If the arrangement is not bona fide, normal arm's length standards would apply, including the commensurate with income standard.

B. Products Covered

In section 936(h), product area research is defined generally by reference to the three-digit Standard Industrial Classification (SIC) codes, meaning that the section 936(h) cost sharing arrangement covers research and development costs over a very broad product area.[228] As described above, the legislative history to the 1986 Act contemplates that a section 482 cost sharing arrangement should cover all research and development costs within an "appropriate product area." The approach in section 936 and in the 1986 Act legislative history contrasts to the proposed 1966 regulations. Cost sharing arrangements described in the 1966 proposed regulations could cover a single project, although multi-project or product area cost sharing agreements were not prohibited.

As discussed in section C below, broad product area cost sharing arrangements raise the issue of whether the potential benefits are proportionate to the participants' cost sharing payments. This issue is of particular concern in cost sharing arrangements of foreign-owned multinational groups if U.S. persons are participants, since cost sharing payments made by U.S. participants are deductible for U.S. tax purposes.[229]

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[227] Id.

[228] Section 936(h)(5)(C)(i)(I).

[229] Another potential abuse may arise in the context of a domestic affiliate that is a co-developer of the intangible, or otherwise participates in a de facto cost sharing arrangement. In such cases, the foreign entity may try to avoid the characterization of a cost sharing arrangement in order to

On the other hand, single product arrangements present the potential that cost sharing may be employed solely for high profit potential intangibles, such that foreign affiliates of U.S. multinational groups acquire the rights to such intangibles without bearing the cost of research related to low profit potential intangibles and unsuccessful research. The incentive to include selectively only high profit potential intangibles in a cost sharing arrangement is most acute when tax haven entities are the primary or predominate participants in the arrangement.[230]

Three-digit SIC code product areas would seem to be the appropriate scope of most cost sharing arrangements. Both the Service or the taxpayer should be permitted to demonstrate, however, that a narrower or broader agreement is more appropriate. Taxpayers choosing a narrower agreement would need to show that the agreement is not merely an attempt to shift profits from successful research areas while leaving expenses of unsuccessful or less successful areas to be absorbed by the U.S. or higher tax affiliates. For example, some members of a multinational food and beverage group might be interested in research and development to develop a multi-purpose artificial sweetener, yet their respective food and beverage product lines might be sufficiently diverse (or might be products for which research and development is not necessary) that a single product agreement would be appropriate. Taxpayers choosing a broader agreement would need to show that the agreement is not being used to charge U.S. affiliates or other participants for research and development without reasonable prospect of benefit. From the Service's perspective, a product area that is broader or narrower than three-digit SIC codes may be necessary to avoid these distortions.

C. Cost Shares and Benefits

Underlying all of the problems discussed in the legislative history of the 1986 Act in relation to cost sharing arrangements is the fundamental principle that the costs borne by each of the participants should be proportionate to the reasonably anticipated benefits to be received over time by each participant from exploiting intangibles developed under the cost sharing arrangement. This cost share/benefit principle has several facets, including the appropriate product area to be covered

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extract royalties from the domestic affiliate, particularly where the withholding tax on the royalties is reduced by a tax treaty and the royalty income is not taxed or lightly taxed by the foreign jurisdiction.

[230] See Lilly, supra n. 57, at 1150.

(discussed in section B above), definition of costs to be covered (discussed in section D below), and the measurement of anticipated benefits and several other issues discussed below.

1. Assignment of exclusive geographic rights. In general, the computation of cost shares should reflect a good faith effort to measure reasonably anticipated benefits to be derived from the arrangement. While it is difficult under the best of circumstances to predict what benefits each of the participants will derive, it is virtually impossible to do so unless the participants are assigned specific exclusive geographic rights to intangibles developed under the arrangement. Specific assignment of rights could take the form of assigning the rights to manufacturing intangibles relating to products to be sold in the United States to a U.S. affiliate, rights related to European markets to an Irish affiliate, rights related to Middle Eastern and Pacific rim markets to a Singapore affiliate, etc. In such case, the U.S. affiliate would derive the income attributable to the manufacturing intangibles developed under the arrangement with respect to any sales in U.S. markets regardless of whether ultimately the U.S. affiliate is manufacturing the products sold in U.S. markets. (As discussed below, however, the participants must be those expected to exploit the intangibles by performing the manufacturing function themselves.)

Alternatively, exclusive worldwide rights to different types of intangibles developed under the arrangement could be assigned to particular participants. This latter type of arrangement would warrant special scrutiny to assure that the cost shares reflect reasonably anticipated benefits.[231] Moreover, if research activities are not common to the various types of intangibles produced under the arrangement, then the research related to each type of intangible should be charged to the specific affiliate that will receive the rights to that type of intangible. This is particularly true of arrangements where one of the parties produces components. The Service and Treasury would welcome comments on this topic. In short, such research activities are not the proper subject of a cost sharing arrangement.

For various reasons, including consistency with longstanding section 367(a) policy, U.S. geographic rights should never be permitted to be assigned under a cost sharing arrangement to a foreign person if either: (1) the participants are part of a U.S. owned multinational group; (2) a significant portion of the research is performed in the United States; or (3) any U.S. person participates in the arrangement. Accordingly, U.S. rights could be acquired by a foreign person only in the case of a

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[231] As discussed in the next paragraph, rights to exploit an intangible in the U.S. must belong to a U.S. affiliate.

foreign-owned multinational group that conducts the research overseas and does not include any U.S. affiliates as a participant in the arrangement.

2. Overly broad agreements. The principle that cost shares be proportionate over time to the reasonably anticipated benefits may affect the issue of whether cost sharing arrangements are overly broad in terms of the products covered or the affiliates participating in the agreement. For instance, a manufacturing conglomerate makes widgets and gadgets. An overall cost sharing agreement for research and development may be inappropriate if a particular affiliate does not make both widgets and gadgets. If a disproportionate amount of research and development relates to widgets but affiliate A manufactures only gadgets, affiliate A would be subsidizing the research for the widget manufacturers. Although every participant in a cost sharing agreement should not be required to benefit from every intangible that may be produced, cost shares should be proportionate to the reasonably anticipated benefits. It may be necessary, therefore, either to have separate cost sharing agreements for widget and gadget research, to adjust affiliate A's cost share to reflect the costs related to gadget research, or to exclude affiliate A from the cost sharing arrangement.[232]

3. Direct exploitation of intangibles by participants. The cost share/benefit principle may otherwise affect who may participate in a cost sharing arrangement. In general, the benefit to be derived under a cost sharing arrangement is the right to use a developed intangible in the manufacture of a product. Therefore, the participant must be in a position to

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[232] The exclusion of affiliate A from the cost sharing arrangement raises the question of which of the other participants should pay for research related to intangibles that may be used by affiliate A. For various reasons, not all affiliates that anticipate using the intangibles developed under the cost sharing agreement may actually participate in the arrangement. For example, there may be reason to exclude a particular affiliate that manufactures only certain types of products and therefore will use only certain types of intangibles developed under the arrangement. Alternatively, the arrangement may not be recognized under foreign law for tax purposes, such that a deduction for cost sharing payments would be denied. In such cases, some affiliate must fund research for intangible rights to be used in manufacturing by the nonparticipants. While there is no clear answer, it seems appropriate that the affiliate that performs the research should fund and receive the residual rights.

exploit the intangible in the manufacture of products.[233] It is not necessary that all participants be capable of manufacture at the time costs are being incurred, so long as it is reasonably anticipated that the participants will be capable of manufacture once the intangibles are developed and will use intangibles developed under the arrangement in the manufacture of products.[234]

4. Measurement of anticipated benefits. In order to determine whether cost shares are proportionate to reasonably anticipated benefits, it is necessary to measure the anticipated benefits. Obviously there has to be some prediction, rough though it may be, of the kinds of intangibles likely to be produced and the relative proportion of units that will be produced and sold under the rights of each participant. In many cases, estimated units of production may be an appropriate measure of benefit assuming that there is a uniform unit of production that can be used as a measuring device. If there is no uniform unit of production, then sales value may be an appropriate measure, if measured at the same level of production

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[233] As a roughly analogous requirement, the 1966 regulations required that participants use the intangibles developed under the cost sharing arrangement in the active conduct of their trade or business. Prop. Treas. Reg. §1.482-2(d)(4)(ii)(b), 31 Fed. Reg. 10,394 (1966). The 1966 regulations would also have excluded as participants companies in the trade or business of performing research for others. This latter exclusion seems unnecessary so long as the affiliate that performs the research and development funds an appropriate portion of the research and development costs and is capable of using the intangible rights that it acquires under the agreement in the manufacture of products.

[234] Expectations will not always prove true, and in some situations the participant that acquires certain rights to intangibles developed under the cost sharing agreement will not ultimately directly exploit those rights. For example, assume that a Dutch affiliate acquires the European rights to intangibles developed under the arrangement with the anticipation of manufacturing products for European markets in Ireland. It later appears that it will be necessary for various reasons to have a locally incorporated entity manufacture in Germany products to be sold in the German market. Unless the German rights to the intangible are transferred in a contribution to capital or other tax free transaction, the German rights would have to be licensed or sold to the German affiliate. In either case the intangible would be subject to section 482 and, generally, the subpart F provisions would treat the resulting royalty or sales income as foreign personal holding company income includible in subpart F income.

or distribution for all participants. As stated in section A above, however, the Conference Report anticipated that cost shares be proportionate to profit as determined before research and development. Given the legislative history, therefore, neither units of production nor sales would be an appropriate measure if it were apparent (or became apparent during the course of the agreement) that profitability differed substantially with respect to various participants' rights. This would be true, for example, in situations in which geographic markets differ significantly in terms of production costs, market barriers, or other factors that bear significantly on profitability. In such cases, estimated gross profit or net profit may have to be used, or some adjustments may have to be made to cost shares determined on the basis of units of production or sales.

It is not realistic, however, to expect taxpayers in most instances to be able to estimate gross or net profit margins from estimated sales. Even estimates of units produced or sales value probably would be imprecise. It may be that a cost sharing agreement should not be recognized if units of production or sales are not appropriate measures and gross or net margins are extremely difficult to estimate. In such cases, the relationship between cost shares and anticipated benefits may simply be too tenuous.

5. Periodic adjustments. The language in the legislative history that the results of cost sharing arrangements be consistent with changes made by the 1986 Act to royalty arrangements has one other obvious implication. The cost shares should be adjusted periodically, on a prospective basis, to reflect changes in the estimates of relative benefits, including a change in the measurement standard if that becomes appropriate. In any event there is always a risk that the cost sharing agreement could subsequently be rejected as a bona fide arrangement if the estimates of benefits derived under the arrangement proved to be so substantially disproportionate to the cost shares that the estimates of benefits cannot be considered to have been made in good faith. Periodic adjustments to the cost sharing arrangement would reduce that risk.

D. Costs To Be Shared

In general, the costs to be shared should include all direct and indirect costs of the research and development undertaken as part of the arrangement. Direct costs would include expenses for salaries, research materials, and facilities. However, there should be a limitation on the annual inclusion of costs for depreciable assets that is consistent with U.S. tax accounting principles. Otherwise, deductions for outbound payments may be overstated. Indirect costs should include a portion of overall corporate management expense and overall interest expense that is allocated and apportioned to research and development activities in a manner consistent with U.S. expense allocation principles. The costs to be reimbursed should be net of any charges for research undertaken on specific request or for any government subsidies granted.[235]

E. Buy-in requirements

As previously stated, the legislative history to the 1986 Act states that a party to a cost sharing arrangement that has contributed funds or incurred risks for development of intangibles at an earlier stage must be appropriately compensated by the other participants -- hence the requirement for a buy-in payment. One of the primary reasons for adopting cost sharing provisions is to avoid the necessity of valuing intangibles. Yet, if there are intangibles that are not fully developed that relate to the research to be conducted under the cost sharing arrangement, it is necessary to value them in order to determine an appropriate buy-in payment.

There are three basic types of intangibles subject to the buy-in requirement. A participant may own preexisting intangibles at various stages of development that will become subject to the arrangement. A company may also conduct basic research not associated with any product. Finally, there may be a going concern value associated with a participant's research facilities and capabilities that will be utilized.

Fully developed intangibles command a royalty to the extent used by other participants and are generally not appropriately incorporated into a cost sharing arrangement. Thus, royalties for preexisting developed intangibles may not be included in the buy-in payment, but instead are subject to the general rules of the commensurate with income standard. Because a subsequent substantial deviation in the income stream from the intangible might require an adjustment, it is important to identify separately the income stream and royalties related to preexisting developed intangibles. In many situations, research is performed with respect to preexisting intangibles in order to improve the preexisting intangibles (improved software, for

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[235] It is generally expected that there will not be a profit element in cost sharing agreements. A profit should be required, however, for research performed at the specific request of a group member or a for a person outside the arrangement group. OECD, Transfer Pricing and Multinational Enterprises, supra n. 158, at p. 119. In either case, the amount received should reduce the costs to be shared. One item that should not be included in the costs to be shared among the participants is the buy-in cost of transferring intangibles from the party by whom they were developed to the other participants. This general subject is discussed in section E below.

example) or to develop the next generation of intangibles. The requirement for an adjustment to the royalty paid for the intangible would not apply if the intangible is enhanced in value solely as a result of research undertaken after inception of the cost sharing arrangement.

The buy-in payment should reflect the full fair market value of all intangibles utilized in the arrangement and not merely costs incurred to date. To permit a buy-in based on cost would be inconsistent with the provisions of section 367(d) which effectively precluded the tax-free transfer of intangibles and, by implication, the transfer of intangibles at cost.[236] The buy-in payment could take the form of lump sum or periodic payments spread over the average life expectancy of contributed intangibles -- perhaps on a declining basis since intangibles generally have greater value in the earlier stages of their life cycle. Obviously, periodic payments should reflect the time value benefit of not making a lump sum payment at the inception of the agreement.

A "buy-out" occurs when a participant withdraws from a cost sharing arrangement. Having funded a portion of research and development prior to withdrawal, that person owns a share of whatever the agreement has borne to date and must be compensated by the other participants for the value of what the arrangement has produced to date and not merely reimbursed for costs incurred to date.

A "secondary buy-in" is required when new members are admitted after a cost sharing agreement is in place. If a new member is acquiring a portion of the geographic rights of one of the original participants, any buy-in amount should be paid to the affiliate whose geographic rights are being reduced. Once again, in order for the buy-in to be arm's length, any new member must compensate the original participants in a manner similar to the original buy-in computation, but based upon current values and not merely costs incurred to date.

F. <u>Marketing Intangibles</u>

The 1986 amendment to section 482 provides that the term "intangible property" shall have the same meaning as in section 936(h)(3)(B). The section 936 definition of intangible property includes marketing intangibles. This does not mean, however,

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[236] The legislative history of the 1984 Act states that the provisions of section 367(d) can be avoided by selling intangibles subject to the application of section 482 to the sale. S. Rep. No. 169, 98th Cong., 2nd Sess., vol. 1 at 368 (1984). The legislative history did not contemplate that a transfer at cost would avoid the application of section 367(d).

that marketing intangibles are necessarily the proper subject of cost sharing rules developed with manufacturing intangibles in mind.

In general, marketing costs yield a present benefit (even if also a future benefit) and, therefore, are currently deductible expenses for which a charge must be made under the services provisions of the section 482 regulations if the benefit therefrom accrues to a related person.[237] (Research expenses related to manufacturing intangibles generally do not yield present benefits but, nevertheless, are currently deductible pursuant to the special provisions of section 174.) In the context of marketing expenses, the services regulations under section 482 presently serve the same function as would rules governing cost sharing arrangements in identifying the potential beneficiaries of a marketing expense and requiring an appropriate charge (albeit with a profit element in certain cases). There seems to be no need for an additional regime to deal with the tax treatment of cost sharing arrangements related to marketing expenses. Comment is requested, however, concerning any situations which are believed not to be covered by the section 482 services regulations or any perceived problems which arise under those regulations as they affect marketing expenses.

G. Character of Cost Sharing Payments

Under section 936(h), the amount of any required cost sharing payment is not treated as income of the recipient, but instead reduces the amount of deductions otherwise allowable.[238] More generally, when expenditures are made with the expectation of reimbursement, they are treated as loans, and therefore the reimbursement does not constitute gross income to the recipient.[239] Accordingly, cost sharing payments are not income to the recipient but, instead, reduce costs which are otherwise deductible in computing taxable income and earnings and profits. Since cost sharing payments are not gross income to the recipient, no U.S. withholding tax would be imposed on outbound cost sharing payments made by a U.S. person to a foreign person.

Characterizing cost sharing payments in this manner also reduces the amount of research and development expenses of the entity performing the research that are subject to allocation under the rules of section 1.861-8 and increases the amount subject to allocation by the participants making the cost

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[237] Treas. Reg. §1.482-2(b)(2).

[238] Section 936(h)(5)(C)(i)(IV)(a); Treas. Reg. §1.936-6(a)(5).

[239] Boccardo v. U.S., 12 Cl. Ct. 184 (1987).

sharing payments.[240] Furthermore, since the payments received by the entity performing the research will not constitute income, payments received by a U.S. entity from foreign affiliates are not foreign source income to the U.S. entity.

For purposes of calculating the credit allowable under section 41 for research expenditures, members of a commonly controlled group of corporations may disregard intercompany reimbursements for research expenditures.[241] This rule treats a U.S. company that actually performs U.S. situs research as incurring 100 percent of the research expenses for purposes of calculating the research credit, even if the U.S. company is reimbursed for a portion of those expenses pursuant to a section 482 cost sharing arrangement.

One group of taxpayers has suggested that the regulations should allow a cost sharer to denominate its rights under a cost sharing arrangement as a geographically exclusive, no-royalty, perpetual license if a license is required to obtain local country tax benefits or if the parent would be in a better position to protect against infringement than the subsidiary. If under U.S. law, the participant is clearly the beneficial owner of intangibles developed under the cost sharing arrangement, then labeling its interest as a "license" will not change the characterization for U.S. tax purposes, even if legal title to the rights are held by its parent serving as nominee owner of such rights. Therefore, whatever label is applied to the arrangement for foreign law purposes generally would not affect its U.S. tax treatment unless the label affects substantive legal rights relating to the intangible.

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[240] Section 1.861-8 sets out rules for allocating and apportioning deductions between U.S. and foreign source gross income. A special allocation rule gives companies the right to allocate fewer U.S. research and development expenses to foreign source income, even though the income generated by the expenses is foreign source. Treas. Reg. §1.861-8(e)(3)(B)(ii). Under the 1986 Act, 50 percent of all amounts allowable as a deduction for qualified domestic research and experimental expenditures is apportioned to income from sources within the United States, with only the remaining 50 percent apportioned on the basis of gross sales or gross income of companies benefitting from the research and development. This special provision applies only to expenses incurred in tax years after August 1, 1986, and on or before August 1, 1987. §1216, P.L. 99-514, 100 Stat. 2085 (1986). Provisions similar in concept are currently under consideration in Congress.

[241] Treas. Reg. §1.44F-6(e); Priv. Ltr. Rul. 8643006 (July 23,1986).

H. Possessions Corporations

The cost sharing payment made by a possessions corporation pursuant to the special cost sharing election under section 936(h)(5)(I) must be determined under those rules and not under a contractual cost sharing arrangement that would otherwise govern the charges incurred by the participants. Indeed, the statute and regulations explicitly provide that the section 936(h) cost sharing payment shall not be reduced by a contractual cost sharing payment.[242] Under section 936(h), the cost sharing payment by the possessions corporation must equal the greater of the amount required under the new commensurate with income standard or 110% of the pre-1986 Act statutory cost sharing amount. Under the commensurate with income standard, the cost sharing amount must at least equal the fair market royalty which would have to be paid to the developer if the manufacturing intangibles had been licensed (even in cases in which the intangible had previously been transferred in a section 351 exchange).

The amount paid under section 936(h) entitles the possessions corporation to be treated as the owner of manufacturing intangibles previously developed by its U.S. affiliates. The fact that a possessions corporation has entered into a cost sharing arrangement for the development of future intangibles and is paying a lesser amount under that arrangement does not affect the amount required under the section 936(h) cost sharing election. Indeed, since the section 936(h) cost sharing payment is compensation for intangibles previously developed and the section 482 cost sharing payment made pursuant to the contractual cost sharing agreement is for the cost of developing new intangibles, both amounts appropriately must be paid initially -- one by statutory election and the second pursuant to the contractual arrangement. It might be argued that, once intangibles are developed under the section 482 cost sharing arrangement, the possessions corporation's section 936 cost sharing payment should be reduced so that the possessions corporation does not pay a second time for that intangible. The statute, however, precludes that result.

I. Administrative requirements

Taxpayers seeking to enter into cost sharing arrangements should be required to make a formal election and to document the specifics of the agreement contemporaneously. Any U.S. participant should be required to include a copy of the agreement with its first return filed subsequent to the agreement's effective date. Taxpayers making the election would agree to

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[242] Section 936(h)(5)(c)(i)(I); Treas. Reg. §1.936-6(a)(3).

produce, in English and in the United States, the records of foreign participants necessary to verify the computation and appropriateness of the respective cost shares within 60 days of a request by the Service. These records would include identification of the SIC code or other basis used to determine products covered by the agreement, and summary information concerning sales, gross margins, and net income derived with respect to such products. The House Report accompanying the 1986 Act suggests that the Service should require similar records to be kept and produced under the authority of section 6001 for section 936(h) cost sharing agreements.[243]

J. Transitional Issues for Existing Cost Sharing Agreements

It is unlikely that there will be preexisting cost sharing agreements that will meet all of the standards described above. If such agreements are not recognized, the Service and taxpayers will encounter significant problems in determining ownership of preexisting intangibles and the treatment of the payments that have been made pursuant to the preexisting agreements. Some type of grandfather treatment would therefore appear to be appropriate. One possibility would be to permit any cost sharing agreement that conforms to the requirements of the existing regulations, and that has been in existence for more than 5 years prior to 1987, to be recognized fully if conformed within a certain period after the promulgation of the new rules with respect to matters other than the buy-ins that occurred prior to June 6, 1984 (the effective date of section 367(d)). If the cost sharing agreement has been in effect for less than 5 years and the agreement does not conform substantially to the new rules, then the old agreement would not be recognized. If a new agreement that conforms to the new rules is adopted, then all payments pursuant to the old agreement would be taken into account as an adjustment to any required buy-in payments relating to the new agreement.[244]

K. Conclusions and Recommendations

1. Congress intended to permit cost sharing arrangements if they produce results consistent with the commensurate with income standard in section 482.

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[243] 1985 House Rep., supra n. 47, at 418-419.

[244] This approach is generally consistent with the cost sharing regulations published in 1968, which permitted pre-existing cost sharing agreements to be modified within 90 days of publication of the section 482 regulations. Treas. Reg. §1.482-2(d)(4).

2. Three-digit SIC code product areas seem to be the appropriate scope for most cost sharing arrangements. Both the Service and the taxpayer should be permitted to demonstrate, however, that a narrower or broader agreement is more appropriate.

3. The fundamental principle underlying the concerns identified in the legislative history of the 1986 Act with respect to cost sharing is that costs borne by each of the participants must be proportionate to the reasonably anticipated benefits to be received over time by the participants from exploiting intangibles developed under a cost sharing arrangement. This principle has several implications.

   a. In order for taxpayers to make a good faith effort to predict anticipated benefits, it is essential that the participants be assigned specific and exclusive geographic rights to intangibles developed under the arrangement. U.S. geographic rights generally should not be permitted to be assigned to a foreign person.

   b. Cost sharing arrangements may be overly broad in terms of products covered or affiliates participating in the agreement if some participants would utilize only a narrow range of intangibles developed under the agreement.

   c. Since the benefit to be derived under a cost sharing arrangement is the right to use developed intangibles in the manufacture of a product, participants must generally be capable of manufacturing and using developed intangibles in the manufacture of products.

   d. In estimating anticipated benefits, units of production or sales value generally would be an acceptable unit of measure unless profitability would reasonably be expected to differ significantly with respect to various participants' rights. In the latter instance, some adjustments must be made, or some other standard of measurement utilized, to reflect more accurately the reasonably anticipated benefits to be derived by the participants.

   e. Cost shares should be adjusted periodically, on a prospective basis, to reflect changes in the estimates of relative benefits, including a change in the measurement standard if that becomes necessary.

4. The costs to be shared should include all direct and indirect costs determined in a manner consistent with U.S. tax accounting and expense allocation principles.

5. A party that contributes funds or incurs risks for development of intangibles at an earlier stage must be appropriately compensated by the other participants in the form of a buy-in for the value of preexisting intangibles (including basic research and the going concern value of research capability).

   a. Fully developed intangibles command a royalty and should not be incorporated into a cost sharing agreement, with the result that the buy-in may not reflect compensation for fully developed intangibles.

   b. A secondary buy-in is required whenever a participant withdraws from a cost sharing arrangement or a new participant enters the arrangement.

6. Expenses relating to marketing intangibles are presently governed by the services provisions of the section 482 regulations. There seems to be no need for marketing expenses to be subject to a cost sharing regime developed for manufacturing intangibles.

7. Cost sharing payments are not income to the recipient but, instead, reduce costs that are otherwise deductible for purposes of computing taxable income and earnings and profits. Consequently, outbound cost sharing payments are not subject to U.S. withholding tax, and inbound payments are not foreign source income.

8. Since a section 936(h) cost sharing payment is compensation for intangibles previously developed and a section 482 cost sharing payment is for the cost of developing new intangibles, both amounts appropriately must be paid initially if a possessions corporation making the section 936(h) cost sharing election enters into a section 482 cost sharing arrangement. Under the statute, the section 936(h) payment may in no event be reduced to reflect amounts paid under a section 482 cost sharing agreement.

9. Taxpayers should be required to make a formal election if they enter into a cost sharing arrangement, to file

a copy of the agreement with their return, and produce records necessary to verify the computation and appropriateness of the respective cost shares.

10. Cost sharing agreements in existence for more than five years prior to 1987 should be grandfathered if they conform in certain respects with new rules to be promulgated. Other agreements will not be bona fide unless and until they substantially conform to the new rules.

APPENDIX A

ANALYSIS OF QUESTIONNAIRE RESPONSES

A. IRS Access To Pricing Information

- Significant section 482 issues were identified by IEs over 70% of the time and by the domestic agent about 10% of the time.

- Significant section 482 issues were initially identified using the following sources:

Source	Percentage of Responses
Form 5471	50.36%
Form 5472	23.74%
Financial Data	13.67%
Prior Exam	7.19%
Industry Experience	2.88%
Customs Data	2.16%

- Time alloted to develop the 482 issue was determined by:

	Percentage of Responses
Case Manager	51.32%
Domestic Group Mgr	7.78%
I.E. Manager	35.53%
Branch Chief	5.26%

- About 66% of the IEs reported that the decision on time allotment was made after receiving adequate opportunity to analyze the section 482 issue.

- Almost 90% percent of respondents stated the time alloted to examine the section 482 issue was flexible.

- Factors affecting time allotment were:

	Percentage of Responses
Potential yield	32.84%
Assurance of yield	4.48%
Both of the above	28.35%
Neither of the above	34.33%

- Annual Reports to shareholders were used to identify or develop section 482 issues in 34% of the cases.

- The portions of the Annual Report specifically considered for identification or development of section 482 issues were:

	Percentage of Responses
Income Tax Notes	19%
Segment Information Note for Product Line	31%
Segment Information for Geographic Area	36%
Other	14%

- 65% of respondents thought that information on Forms 5471 and 5472 was helpful in planning exams.
- In 29% of the reported cases, section 482 issues were identified and not pursued. In 20% of the reported cases, section 482 issues were identified and not changed.
- The taxpayer had no readily available basis to support its section 482 transaction in almost 75% of the cases.
- In over 50% of the reported cases, taxpayers failed to make timely and complete responses to questions asked in developing section 482 issues.
- More than 66% of the responses indicate that there was no reasonable explanation for any delay in responding to questions aimed at developing section 482 issues.
- Reasons given for delays in responding to IDRs:
  - Tax department staffing.
  - Records located overseas.
  - Foreign parent refused to produce records.
  - Extremely detailed requests for information from the foreign subsidiaries.
  - Lack of cooperation existed between the parent and subsidiary.
- Unreasonable delays in responding to requests for information concerned:
  - Control of affiliates -- 34.4% of responses.
  - Existence of comparable transactions with third parties -- 48.5% of responses.

- Terms of comparable transactions with third parties - 48.5% of responses.

- The average length of delay to responses was 12.2 months. The portion of the delay deemed as reasonable by the responding IEs averaged 2.2 months.

- Using a summons to obtain information was considered as follows:

	Percentage of Responses
Considered	41%
Discussed with taxpayer	34%
Employed	5%

- IE descriptions of circumstances in which issuance of a summons was considered:

  - Formal summons discussed - not used because case manager felt that the action would close the door to future cooperation in domestic audits.

  - It was felt that the issuance of a summons for records would only delay the overall development and completion of the case.

  - Summons considered due to delay in response to agent and economist. Not issued as taxpayer eventually did respond, although the responses were generally inadequate.

  - Used as a threat to speed-up IDR response time. Generally not useful.

  - Taxpayer complained that our request was overly broad. After discussion with Branch Chief, including the use of section 982 and summons, Taxpayer offered an alternative to books and records, under which most of the information requested was eventually received.

- Section 982 procedures arose to the following extent:

	Percentage of Responses
Considered	26.6%
Discussed	17.6%
Employed	4.0%

- IE descriptions of the circumstances in which section 982 was considered:
  - The section 982 procedures were mentioned in opening conference.
  - Taxpayer's practice was to furnish as little information as possible with approximately a 90-day turn around time. When subsequent IDRs needed to be issued, the same practice was followed.
  - Taxpayer is well aware of our open year policy and planned closing dates. IE was of the opinion that taxpayer feels if they use delaying tactics the case will become "old" and will be closed out undeveloped. Taxpayer's delaying tactics prevented the issuance of follow up IDRs. Taxpayer refused to furnish its parent's cost data for the products that were at issue.
  - Taxpayer was late in providing data after initial adjustments were prepared. Taxpayer's attorney's tactic was to continue indefinite discussion of the issue, including appeals to the National Office.
  - Taxpayer's responses to IDRs took from 6 months to a year. The audit was stretched out to the point that the planned audit closing date became a problem.
  - Section 482 issues were raised on the previous audit. The prior examiner received virtually no information from the taxpayer. Detailed information was submitted by the taxpayer in the Appeals protest. This information was used by the IE and the economist in subsequent years.
  - Taxpayer clearly not responsive to IDRs that could hurt him. In three cycles, the key IDRs were not answered.
  - District allows taxpayers excessive amount of time to respond to IDRs. A two year audit cycle takes five years to complete.
- According to responding IEs, the following adversely affected the development of section 482 issues:

	Number of Responses	
	Yes	No
a) 3.0, 5 open years policies	21	44
b) Planned audit closing dates	28	39
c) Taxpayer tactics	31	30

- Competent Authority considerations affected the resolutions of 10% of the reported cases.

- Only 3% of respondents claimed that competent authority considerations affected their decision to pursue any section 482 issue.

- Appeals settled 28% of the section 482 issues in the reported cases.

- 69% of respondents disagreed with the terms of the Appeals settlement.

- Counsel was involved in 26% of cases settled by Appeals.

- 76% of respondents did not receive a copy of the Appeals settlement.

- The section 482 issues were resolved at the examination level 43.4% of the time in the reported cases.

- The IE was appropriately consulted in 90% of the reported cases resolved by Examination.

- The section of the 482 regulations providing the basis for Examination's resolution was:

	Percentage of responses
Comparable uncontrolled price	32%
Resale price method	8%
Cost plus method	24%
Other	36%

- The IE agreed with the resolution by Examination 85.7% of the time.

B. Application of Pricing Methods

- IEs stated that the taxpayer used comparables as follows with regard to section 482 transactions:

	Percentage of responses
Planning transactions	9%
Defending transactions	33%
Did not rely on comparables	58%

- 71% of IEs who responded stated that the comparables used were not made available to them at or near the beginning of the examination.

- Description of comparable(s) relied on by taxpayer in planning or defending its section 482 transaction:

  - In performance of services, taxpayer tried to establish comparables based on charges to third parties.

  - The taxpayer presented pricing data with an unrelated distributor of similar property in a different country.

  - Sales invoices to third parties.

  - Contracts between unrelated third parties.

  - Taxpayer claimed it was charging the same royalties to all of its foreign subsidiaries.

  - Taxpayer secured quote from third party in small quantity transaction.

  - Weighted average of Canadian CFC's third party sales. Method required by Revenue Canada.

  - Sales to 50% owned subsidiaries.

  - Industry norms.

- Only 19% of those responding accepted the taxpayer's comparables.

- Examples of explanations why taxpayer's comparables were not accepted:

- The taxpayer was looking only at the services and not looking at the overall transaction, i.e. providing services, the transfer of technology and other intangibles.

- The comparables did not reflect true arm's length pricing because they ignored the fact that the parent performed substantial marketing, distribution, and trademarking functions, or the circumstances were otherwise different.

- The taxpayer's method generated approximately 185% of the combined profit to the low tax entity and a loss to the U.S. parent.

- The taxpayer's comparables included very small volumes.

- The taxpayer relied on comparables based on "industry norms" in 41% of the cases reported.

- Description of industry average "comparables" submitted by the taxpayer to support its assertions:

  - Robert Morris Associates -- Annual Statistics by SIC Code of Gross Profit Margins for Wholesale Automotive Equipment Dealers.

  - Taxpayer relied on published AFRA demurrage rates.

  - Taxpayer used the average resale mark-ups for the industry.

- Comparables were used as a basis for adjustment in about 75% of the cases reported.

- Representative sources for finding comparables relied upon by IEs:

  - The IRS Economist used industry (construction) comparables. The services that the offshore company performed were that of a construction manager. The economist determined that, based on comparables, the offshore company should receive a comparable profit. The remaining profit was allocated back to the taxpayer for services and intangibles.

  - Economist used industry statistics from docketed cases and SEC reports of unrelated taxpayers.

  - Taxpayer was requested and did provide comparable transactions of its manufacturer parent with its unrelated distributors.

- Information from third parties with respect to comparable transactions (a similar product under similar circumstances in a similar market).
- License agreement with related and unrelated parties.
- Analysis of industry, consulting with ISP, contacting other IEs examining similar companies.
- Third party agreements for similar services or intangibles with same taxpayer in same circumstances.
- Obtained Form 10K information from several U.S. entities and used to establish the arm's length price on a cost plus basis.
- Third party sales of taxpayer and compiled statistics from "Robert Morris & Associates - Annual Statement Studies."

• The following are descriptions of significant problems encountered by IEs in developing a comparable:

- The information sought from third parties was old - 5 to 6 years. In one instance the third party relocated and finding records was difficult. Records were not organized when obtained.
- Difficulty in acquiring information from third parties and obtaining permission to use data from the third party.
- Adjusting for differences in geographic markets.
- There are no comparables at this level of distribution. All manufacturing/sales companies in this industry are related.
- The products manufactured and sold by the Puerto Rican affiliates were the high volume, profitable products. The functions performed by the subsidiaries did not correspond to any third party situation. Consequently, the comparables identified were useless.

• Methods used in proposing tangible property adjustments by percentage of response:

Comparable Uncontrolled Price	31%
Resale Price Method	18%
Cost Plus Method	37%
Other Method	14%

- A majority of IEs who responded claim that the priority of methods was useful in development or analysis of the tangible price issue.

- Market penetration was not considered as a factor when determining section 482 adjustment in about 75% of the cases reported.

- The taxpayer's documentation considered the priority of pricing methods in 50% of the cases reported where documentation existed.

- Excerpts of descriptions of "other methods" used by the taxpayer to justify its pricing policies.

  - Taxpayer claimed intercompany price was arm's length because it was negotiated between the lower tier sub and its foreign parent.

  - Taxpayer contended all income attributable to intangibles belonged to the Puerto Rican affiliate.

  - Prior appellate settlements.

  - Taxpayer attempted to identify other charges made by the parent to its subsidiaries that were equivalent to the royalty adjustment that was proposed.

  - Taxpayer explained its method as being required by Revenue Canada.

  - "Old fashioned business know-how".

- In over 75% of the cases reported, the taxpayer relied on a profit split to determine its transfer price.

- Descriptions of taxpayer's methods of computing profit split:

  - Market penetration accounted for any difference in price.

  - Resale price.

  - Taxpayer computes revenues of products made in Puerto Rico then reduced them by: cost of sales P.R., an R&D cost sharing amount based on section 936(h), selling and administrative expenses based on a fractional calculation and other income or expenses using section 936(h) - this gave CTI of which they considered the P.R. entity to possess half.

- Taxpayer used prior Appeals settlement profit split.

- Taxpayer allowed its domestic subsidiaries a profit of 6% on the cost incurred by such subsidiaries.

- Taxpayer used profit earned by the parent on other transactions with related parties. Taxpayer's contention is that the subsidiary's high profit is irrelevant as long as the parent made an adequate profit on the transaction.

- Taxpayer claimed that the marketing company should recover all of its marketing costs (11% of sales) plus derive a profit (4% of sales).

C. <u>Services</u>

- The IEs proposed an adjustment for services in 32.8% of the reported cases.

- In 43% of the reported cases, difficulty in applying the services regulations was the primary reason for not making an adjustment.

- Difficulties reported by IEs in applying the service regulations included:

  - Determining for whose benefit services were provided.

  - Undue burden on the IE to: (1) isolate costs, (2) determine whether the service was an integral part of the business, and, (3) develop comparables to determine proper adjustment.

  - Determining what services were rendered, by whom, the amount of time spent rendering the service, and the cost of the service.

  - The service regulations do not allow a profit in the allocation.

- Examples of difficulties in deciding whether to propose an adjustment for services rendered or intangibles transferred included:

  - Taxpayer only wanted to charge for services at the same rate they generally charged third parties. IE used a functional analysis to show that know-how was also transferred to related parties but not to third parties.

  - Taxpayer does purchasing for a subsidiary and picks up a 5% profit. IE had no idea if the profit mark-up was appropriate.

  - Taxpayer allocated a portion of cost based on time spent by officers. Because of the 25 percent rule, the IE was prevented from making an adjustment.

D. Intangibles

- 50% of the cases reported involved a significant transfer of intangibles.

- Adjustments were made under Treas. Reg. §1.482-2(d) in about 50% of the reported cases.

- Factors reported by IEs as affecting the decision to proceed under services or sales of tangible property regulations rather than under the intangibles section:

a)	Inability to separately identify the intangible	39.2%
b)	Inability to document the transfer	17.4%
c)	Inability to value the intangible	43.4%

- IE recommend changes in the regulations that would have made an adjustment for intangibles more feasible:

  - Spell out that T/P's reputation is an intangible.

  - Clarify that a CFC should not get a marketing profit if they don't do marketing.

- In reported cases involving the transfer of intangibles to a related party, the taxpayer acknowledged the transfer at the outset of the examination 48.6% of the time.

- Documentation produced by taxpayers with respect to the transfers of intangibles:

  - Unrelated professional appraisal
  - Corporate minutes and legal documents
  - Licensing agreements

    a. With related entities
    b. With unrelated entities

  - Section 351 transfer documents
  - Section 367 ruling

- Marketing intangibles were involved in 25% of the intangible cases.

- Data relied upon or method of intangible valuation:
  - Advertising and marketing expenses
  - Trade name and trademark defense costs
  - Distribution costs
  - Market dominance - 3rd party brokerage statements - market studies - royalties textbooks - profit and loss comparisons - patent infringement cases - prevailing rates in the industry.
  - Compared rates charged by taxpayer to unrelated parties.
  - Used functional analysis to show that CFCs were not active in crude oil trading. Only administrative and communication services were performed. Economist determined an arm's length service fee due the CFC for services performed, then used the residual method to value the income to be allocated to the domestic subsidiary.
- Taxpayers used a cost sharing agreement with a related party in 17 1/2% of the cases reported.
- Description of cost sharing agreements:
  - Parent billed Puerto Rican subsidiary for their share of R&D.
  - R&D costs shared based on percentage of sales. Direct costs charged to entity deriving benefit.
  - Reimbursed for R&D, marketing, and administration.
  - Share in R&D and reimbursed marketing costs.

E. Use of Specialists and Counsel

- The following specialists were involved with reported cases:

	Percentage of responses
Engineer	18%
Economist	59%
Appraiser	2%

- IE descriptions of issues considered by specialist and how the specialist was brought into the case:

  - Economist performed a functional analysis of activities of CFCs and identified comparables. The economist was requested after the taxpayer prepared a section 482 study to refute the proposed adjustment. In order to be successful in Appeals or court, an economist was considered essential.

  - An economist was requested to assist in developing the third party comparables found by the IE and to assist in assessing taxpayer's arguments.

  - An economist was involved in the prior year and, accordingly, was requested for the current cycle. An engineer was needed to assess the electrical engineering function of the related companies.

  - An economist was requested for a valuation of risk capital.

  - An engineer was used to compare the CFC shop to unrelated shops. An economist found comparable mark-ups.

  - An economist was used on an informal basis as to procedure and appropriate percentage of profit.

  - An economist was used on the royalty expense issue and to evaluate a trademark transfer; engineer was used to evaluate a fee structure.

- The economist was requested to review our position with respect to imputation of royalty and technical service income. Looking beyond this, the economist suggested that a potential pricing issue existed. The economist was assigned late in the examination and was not granted the time needed to develop the pricing issues.

- The economist added support in the development of the transfer of intangibles issue. The economist was brought into the case after we recognized and began developing the issue.

- An economist was requested by IE - used to establish arm's length pricing of foreign autos.

- An appraiser was brought in by the IE and the Case Manager to evaluate the sale of U.S. entity's stock at book value and to establish control elements.

- The economist performed a functional analysis on Puerto Rican operations. It was difficult to attack taxpayer's pricing as long as we accepted the function of the Puerto Rican subsidiary as a full-fledged manufacturer.

- IE received informal advice on a stewardship issue.

• According to the IEs, specialists were brought in at appropriate times in 91% of the reported cases.

• Specialists raised additional issues in 9% of the reported cases.

• 79% of respondents thought that specialists' reports were particularly useful in proposing issues.

• Brief descriptions of specialists' reports which were helpful:

- The economist report was very useful since it discussed, in depth, the functional analysis and comparables used in determining the arm's length rates for intangibles and services.

- Economist report supported the IE's conclusion that market penetration was not prevalent in the years under examination, which was the thrust of the taxpayer's argument.

- Economist report gave a basis for reasonable profit factor in pricing computation.

- The economist's report was useful in establishing the service fee for CFC and the function of taxpayer's worldwide trading activity.

- The report made a good case for treating the subsidiary as a contract manufacturer. Prior to that, taxpayer was maintaining its position that the resale method applied.

- The economist developed a method of joining data secured by means of a private survey with data from a public source. The economist revealed to the agent a number of other sources that are available for statistical analysis and comparisons.

- Specialist's reports were used:

	Percentage of Responses
To support an adjustment	87.5%
Not used	10.0%

- Responses indicate that specialists did not cause an undue delay in 90% of the cases.

- 14% of respondents stated that restrictions were placed on their use of a specialist.

- The taxpayer employed a specialist in 27% of the reported cases.

- The taxpayer's use of a specialist was as follows:

	Percentage of Responses
Planning section 482 transaction	25%
Involved in audit	80%

- IRS Counsel was involved in 39% of the reported cases.

- 14% of respondents claimed that had counsel been involved, their cases would have been better developed.

- Counsel was involved at a timely stage of case development in 76% of reported cases.

- Persons who determined that counsel should become involved were:

	Percentage of Responses
Case Manager	22%
Domestic Group Manager	3%
IE Manager	38%
IE	32%
Industry Specialist	5%

The types of legal assistance rendered:

Activity	Percentage of Responses
District Counsel technical assistance	61%
National Office technical advice	11%
Summons review	20%
Section 982 proceedings review	7%

The assistance rendered by counsel was considered useful in development of section 482 issues in 68% of responses.

APPENDIX B

SECTION 482 QUESTIONNAIRE--INTERNATIONAL EXAMINERS

CASE NAME ______________________________ Years ________________

PLEASE ATTACH A COPY OF YOUR EXAMINATION REPORT ON THIS CASE TO YOUR RESPONSE TO THIS QUESTIONNAIRE.

Please check the appropriate column(s). Check:

(A) if the listed section 482 issue was present in this case;
(B) if the taxpayer agreed to the proposed adjustment; and
(C) if the taxpayer did not agree to the proposed adjustment.

Please enter the dollar amount of the proposed adjustment in column (D).

	(A)	(B)	(C)	(D)
Transfer pricing	[36]	[17]	[20]	$ 5.9 billion
Income allocation (other than transfer pricing)	[22]	[2]	[19]	$ 1.1 billion
Expense allocation (not including cost sharing agreements)	[19]	[12]	[19]	$ 105 million
Cost sharing agreements	[1]	[0]	[0]	$
Intangibles	[16]	[5]	[10]	$ 460 million
Services	[10]	[3]	[8]	$ 34 million
Interest	[17]	[10]	[10]	$ 175 million
Rental expense	[1]	[1]	[0]	$ —
Gain allocation	[2]	[1]	[1]	$ 27 million
Miscellaneous	[5]	[2]	[2]	$ 58 million

(Please briefly identify. Do not further identify or discuss in this questionnaire any routine adjustments to the general and administrative or overhead expenses of related parties.)

[ ] Please check here if this case involved section 936.

[ ] Please check here if you have answered question 100 on this questionnaire.

1. Who initially identified the significant 482 issues in this case? (Please check the appropriate box or boxes and briefly identify the issues raised by each.)

Domestic agent	[9]	______
Case manager	[0]	______
Domestic group manager	[0]	______
Yourself	[57]	______
I.E. group manager	[1]	______
Economist	[3]	______
Other	[10]	______

If other, please identify. ______

2. Please list each of the significant 482 issues in this case in the spaces provided below. (Use an additional sheet to identify other significant 482 issues, if any.) Please also indicate how each of these issues was initially identified (whether by you or by someone else) by filling in the number corresponding to the method used to identify the issue in the space below.

(1) Form 5471
(2) Form 5472
(3) Financial data
(4) Prior exam
(5) Experience with the industry
(6) Customs data
(7) Other (please briefly explain in the appropriate space)
(8) Do not know how issue was identified by another person

	Issue	How identified?
A.	(1) 70	
B.	(2) 33	
C.	(3) 19	
D.	(4) 10	
E.	(5) 4	
F.	(6) 3	
	(7)	

3. Who principally determined the amount of time alloted to developing the 482 issues in this case?

A. Case manager [39]
B. Domestic group manager [6]
C. I.E. manager [27]
D. Branch chief [4]
E. Exam chief [0]

4. Was the decision on time allotment made after you had an adequate opportunity to analyze the 482 issues?

Yes [41] No [22]

5. Was the time allotment flexible?

Yes [51] No [6]

6. Was the amount of time alloted to the development of the 482 issues in this case affected either by the potential yield or the likelihood that there would be a yield? (Check one.)

A. Potential yield affected allotment [22]
B. Assurance of yield affected allotment [3]
C. Both affected the allotment [19]
D. Neither affected the allotment [23]

7. Did you use one or more annual reports to shareholders to identify or develop a 482 issue?

Yes [24] Please continue.
No [46] Skip to question 10.

8. Which of the following portions of the annual report, if any, were specifically considered? (Check if considered.)

A. The income tax note to the financial statement [8]
B. The segmental information note for product line data [13]
C. The segmental information note for geographic area data [15]
D. Other [6]
(please identify)______________________

3 identified

9. Who initiated the use of annual reports in your consideration of the 482 issues in this case?

A.	Yourself	[22]
B.	Domestic group manager	[0]
C.	Case manager	[0]
D.	I.E. group manager	[0]
E.	Domestic agent	[2]
F.	Other	[3]

(please identify)________________________

10. Was the information required to be reported on Forms 5471 or 5472 (or predecessor forms) helpful or inadequate in planning the exam?

Generally helpful	[36]
Generally inadequate	[19]

11. Please briefly describe any specific information required to be reported on these forms that you found helpful in planning your examination in this case.

46

12. Please briefly describe any specific respects in which the information now required to be reported on Forms 5471 and 5472 was (or would have been) inadequate in this case. What specific additional information reporting requirements would have been useful in the planning and conduct of your examination in this case? (For example, would your case development have been improved if taxpayers were affirmatively required to disclose the transfer pricing method relied upon by the taxpayer?)

36

13. Were there any identified 482 issues that were not pursued or that were no-changed?

A. Not pursued? Yes [19] No [47]
B. No-changed? Yes [10] No [40]

If you answered yes to either question, please briefly identify the issue(s) and explain.

23

14. Did the taxpayer have readily available the basis and support for its section 482 transactions?

Yes [19] No [51]

15. Did the taxpayer generally make timely and complete responses to the questions in your IDRs that were asked to develop the 482 issues in this case?

Yes [31] Please skip to question 20.
No [40] Continue.

16. Were there reasonable explanations for any delays by the taxpayer in responding to the questions you asked in IDRs that were aimed at developing the 482 issues in this case?

Yes [13] Please continue.
No [27] Skip to question 18.

17. Please briefly describe any reasonable bases for the delays.

16

18. Please indicate whether the taxpayer unreasonably delayed responding to any questions in your IDRs that dealt with the following:

	Yes	No
A. Control of affiliates	[11]	[21]
B. The existence of its comparable transactions with third parties	[19]	[16]
C. The terms of its comparable transactions with third parties	[16]	[17]

19. In the spaces below, please estimate the length of any delay and the portion of the delay, if any, that was reasonable.

Total time delayed	12.2 mos
Reasonable portion of delay	2.2 mos

20. Did IRS management become involved in attempting to secure information from the taxpayer? If so, indicate each management level involved and whether the information sought was obtained as a result of that involvement.

	Level	Was the requested information obtained? Yes	No
A. No involvement	[26]		
B. Group Chief	[35]	[22]	[19]
C. Branch Chief	[15]	[11]	[9]
D. Exam Chief	[4]	[2]	[10]
E. District Director	[3]	[1]	[10]

21. Was the use of summonses considered, discussed with the taxpayer, and/or employed?

	Yes	No
Considered?	[28]	[41]
Discussed?	[21]	[40]
Employed?	[3]	[54]

If you answered yes to any of the above, please briefly describe the circumstances and the results obtained.

24

(space continues)

22. Was the use of section 982 considered, discussed with the taxpayer, and/or employed?

	Yes	No
Considered?	[17]	[47]
Discussed?	[9]	[42]
Employed?	[2]	[49]

If you answered yes to any of the above, please briefly describe the circumstances and the results obtained.

13

23. Did you work with an economist, engineer, appraiser or other specialist on the case?

		Yes	No	
A.	Engineer?	[10]	[46]	
B.	Economist?	[40]	[28]	
C.	Appraiser?	[1]	[49]	
D.	Other?	[9]	[40]	(If other, please briefly describe.)

If you have answered yes to any of the above, please continue.

If you answered no to all of the above, please skip to question 34.

24. Please briefly describe the issue(s) considered by any specialist(s) and how the specialist(s) was (were) brought into the case.

43

(space continues)

25. Was (were) the specialist(s) involved in the case at an appropriate time?

[40] Yes, all specialists were brought into the case at appropriate times.
[4] No, not all specialists were brought into the case at appropriate times.

If no, please briefly explain.

26. Did the specialist(s) raise new 482 issues?

Yes [4] Please continue.
No [40] Skip to question 28.

27. Please briefly identify the 482 issues initially raised by the specialist(s) in the case.
9

28. Were any of the specialists' reports useful to you?

Yes [33] Please continue.
No - [9] Skip to question 30.

29. Please briefly identify which report(s) was (were) useful, and why.
34

(space continues)

30. Please briefly indicate which report(s) was (were) not useful, and why.
12

31. How were specialists' reports used in connection with your proposed adjustment? (If more than one specialists' report was prepared in this case, please fill in the appropriate number of reports in the spaces provided.)

A. Report recommended against the adjustment [1] ______
B. Used to support adjustment [35] ______
C. Not used to support adjustment [4] ______

32. Did the involvement of any specialist unduly delay the case?

Yes [4] No [40]

33. Did anyone place a restriction on your use of a specialist?

Yes [6] No [38]

If yes, who? (Please identify.) ______

34. Did the taxpayer employ a specialist?

Yes [18] Please continue.
No [48] Skip to question 36.

35. Was the taxpayer's specialist utilized in planning the transaction, in refuting a proposed adjustment, or both?

---	Yes	No
Involved in planning?	[4]	[12]
Involved in audit?	[16]	[4]

36. Did Counsel become involved in the case?

Yes [27] Please skip to question 38.
No [42] Continue.

37. Would the case have been better developed if Counsel had become involved?

Better developed [6]
No difference [37]

Please skip to question 43.

38. Was Counsel involved at a timely stage?

Yes [22] Please skip to question 40.
No [7] Continue.

39. Would the case have been better developed if Counsel had become involved at an earlier time?

Better developed [6] No difference [4]

40. Who determined that Counsel should become involved?

A. Case manager [8]
B. Domestic group manager [1]
C. I.E. manager [14]
D. Exam Chief [0]
E. Yourself [12]
F. Industry Specialist [2]

41. Please check the appropriate box to indicate the type of assistance rendered by Counsel in this case.

		Oral	Written
A.	District Counsel technical assistance	[18]	[9]
B.	National Office technical advice	[0]	[5]
C.	Summons review	[4]	[5]
D.	Section 982 proceeding review	[1]	[2]

42. Was the assistance rendered by Counsel useful in your development of the 482 issues in this case?

Yes [19] No [9]

43. Did any of the following adversely affect your development of 482 issues in this case?

		Yes	No
A.	3.0, 5 open years policies	[21]	[44]
B.	Planned audit closing dates	[28]	[39]
C.	Taxpayer tactics	[31]	[30]
D.	Other	[7]	[27]

If you checked yes for C. or D., please briefly explain.____

____

____

____

44. Were any of the 482 issues resolved in Examination?

Yes [30]. Please continue.
No [39]. Skip to question 50.

45. Did Examination's resolution involve only the 482 issues in the case alone or was it part of a broader resolution?

482 issues resolution only	[23]
Part of over-all resolution	[7]

46. Were you appropriately consulted regarding the resolution of the 482 issue(s) in the case that were resolved in Examination?

Yes [27] No [3]

47. Which provisions of the 482 regulations provided the basis for Examination's resolution of 482 transfer pricing issues in this case?

A.	Comparable uncontrolled price	[8]
B.	Resale price method	[2]

(question continues)

C. Cost plus [6]
D. Any "other" reasonable method [9]

48. Did you agree with the resolution?

Yes [24] No [4]

If no, please briefly explain.

49. Did Competent Authority considerations affect Examination's resolution of any section 482 issue in this case?

Yes [3] No [28]

If yes, please briefly describe the transaction that gave rise to this concern.

50. Did Competent Authority considerations affect your decision to pursue or not pursue any section 482 issue in this case?

Yes [2] No [67]

If yes, please briefly explain.

51. Did Appeals settle any section 482 issue in this case?

Yes [17] Please continue.
No [44] Skip to question 54.

52. Did you agree with the terms of Appeals' settlement of the 482 issue(s) in this case?

Yes [5] No [11]

If no, please briefly explain.

53. Was Counsel involved in the Appeals settlement?

Yes [5] No [14]

54. Did you receive a copy of Appeals' final report on this case?

Yes [9] No [29]

55. In this case, were there difficulties establishing "control" for purposes of section 482?

Yes [5] No [64]

56. Was control established by means other than direct or indirect ownership of a majority of the stock of a controlled corporation?

Yes [7] No [61]

If yes, please briefly explain how control was established.

57. Did the taxpayer rely on comparables either in planning or defending its 482 transactions?

[7] Relied on comparables in planning transactions.
[24] Relied on comparables in defending transactions.
[42] Did not rely on comparables in either planning or

defending transactions. Please skip to question 62.

58. Were those comparables made available to you at or near the beginning of the examination?

Yes [9] No [22]

59. Please briefly describe the comparable(s) relied upon by the taxpayer in planning or defending its 482 transactions.

27 ______________________________

60. Did you accept the taxpayer's comparables?

Yes [5] No [22]

If no, please briefly explain why. ______________________________

61. Did the taxpayer rely upon comparables based on "industry norms" in planning or defending its transfer pricing?

Yes [11] No [16]

If yes, please briefly describe the data provided by the taxpayer to support its assertions.

____

62. Did you seek to use a comparable as a basis for making any 482 adjustments in this case?

Yes [42] Please continue.
No [25] If either you or the taxpayer sought to rely or relied on comparables, skip to question 67. Otherwise, skip to question 68.

63. Did you actually use a comparable as the basis for making the 482 adjustments in the case?

Yes [34] No [12]

64. How did you identify the comparable you used or sought to use?

40 ____________________

65. Were you able to properly develop information regarding the comparable you used or sought to use?

Yes [32] No [11]

66. Please briefly describe any significant problems you encountered in attempting to develop the comparable you used or sought to use.

23 ____________________

67. What kind of adjustments, if any, were needed for both the taxpayer and Service comparables to achieve arm's length? (Please check all that apply.)

(question continues)

Government comparable		Taxpayer comparable
[9]	warranties and rebates	[2]
[12]	level of market	[7]
[8]	geographic market	[4]
[9]	volume of transactions	[8]
[6]	length of agreement	[4]
[12]	product differences	[5]
[9]	terms of sale	[5]
[4]	currency translation	[1]
[12]	other	[6]

If other, please explain briefly.

12

68. In your opinion, did this case involve any significant transfer or permissive use of any of the following: a patent, invention, formula, process, trade secret, design, brand name, pattern, know-how, marketing expertise, or show-how?

Yes [34] Please continue.
No [33] Skip to question 79.

69. Please briefly describe the patent, etc.

35

70. Did you specifically make an adjustment in this case for intangibles under Treas Reg. 1.482-2(d)?

Yes [19] Please skip to question 73.
No [20] Continue.

71. In making an adjustment for (1) related party services, or (2) the transfer pricing of tangible property, did you take the transfer or use of intangibles into account?

(question continues)

Yes [11] Please continue.
No [15] Skip to question 73.

72. What factors dictated the decision to proceed under the services or sales of tangible property regulations rather than make an adjustment under the intangibles regulations?

A. Inability to separately identify the transferred intangibles [9]
B. Inability to document the transfer or use [4]
C. Inability to value the intangibles [10]
D. Other [1]

If other, please explain. ______________________________

____

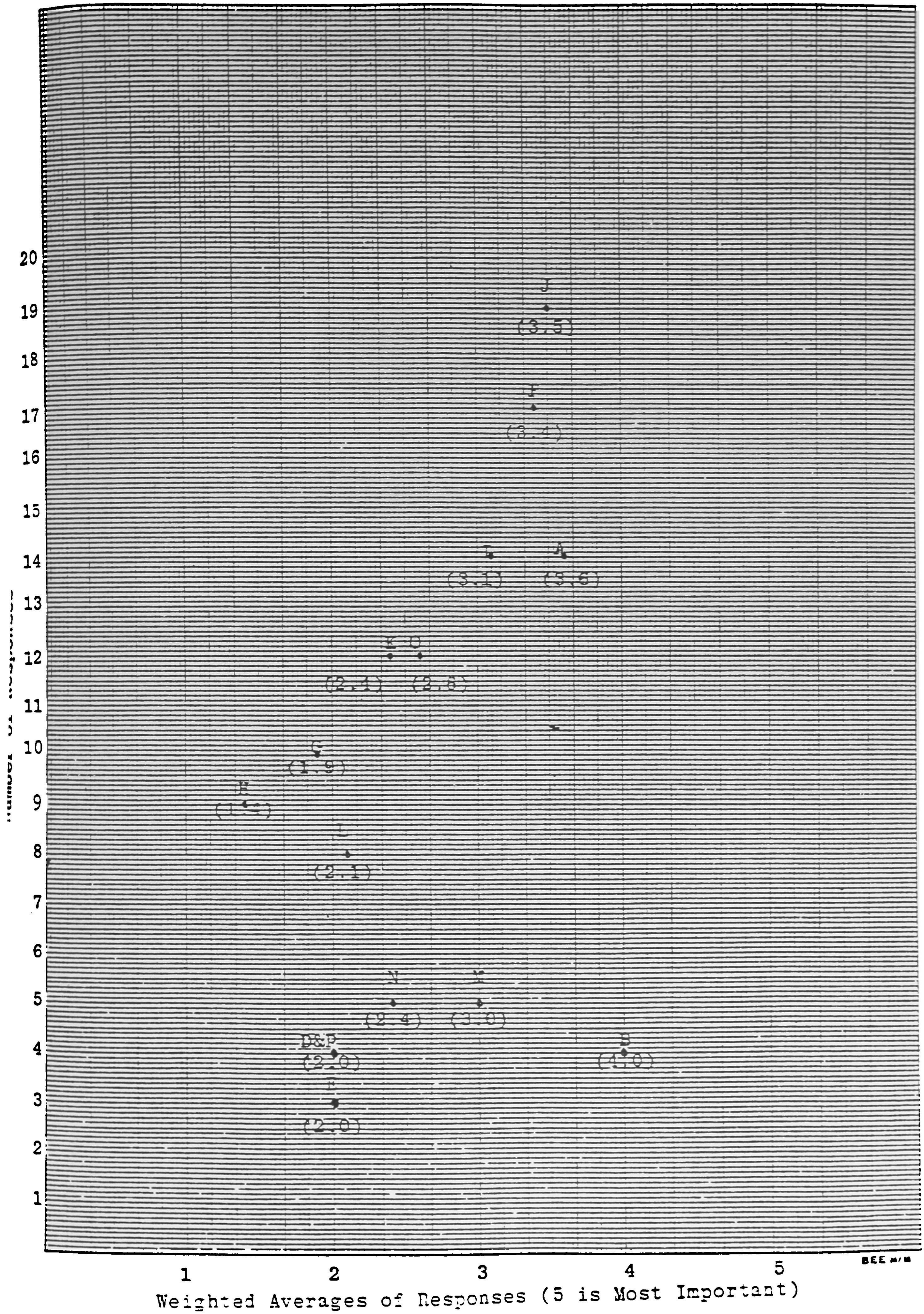
____

73. Which of the following factors were most important to you and to the taxpayer in determining the arm's length pricing for the most significant transferred intangible in this case? Please select up to five factors that were most important to you and to the taxpayer and number them in decreasing order of importance (i.e., five is most important, one is least) in the appropriate spaces.

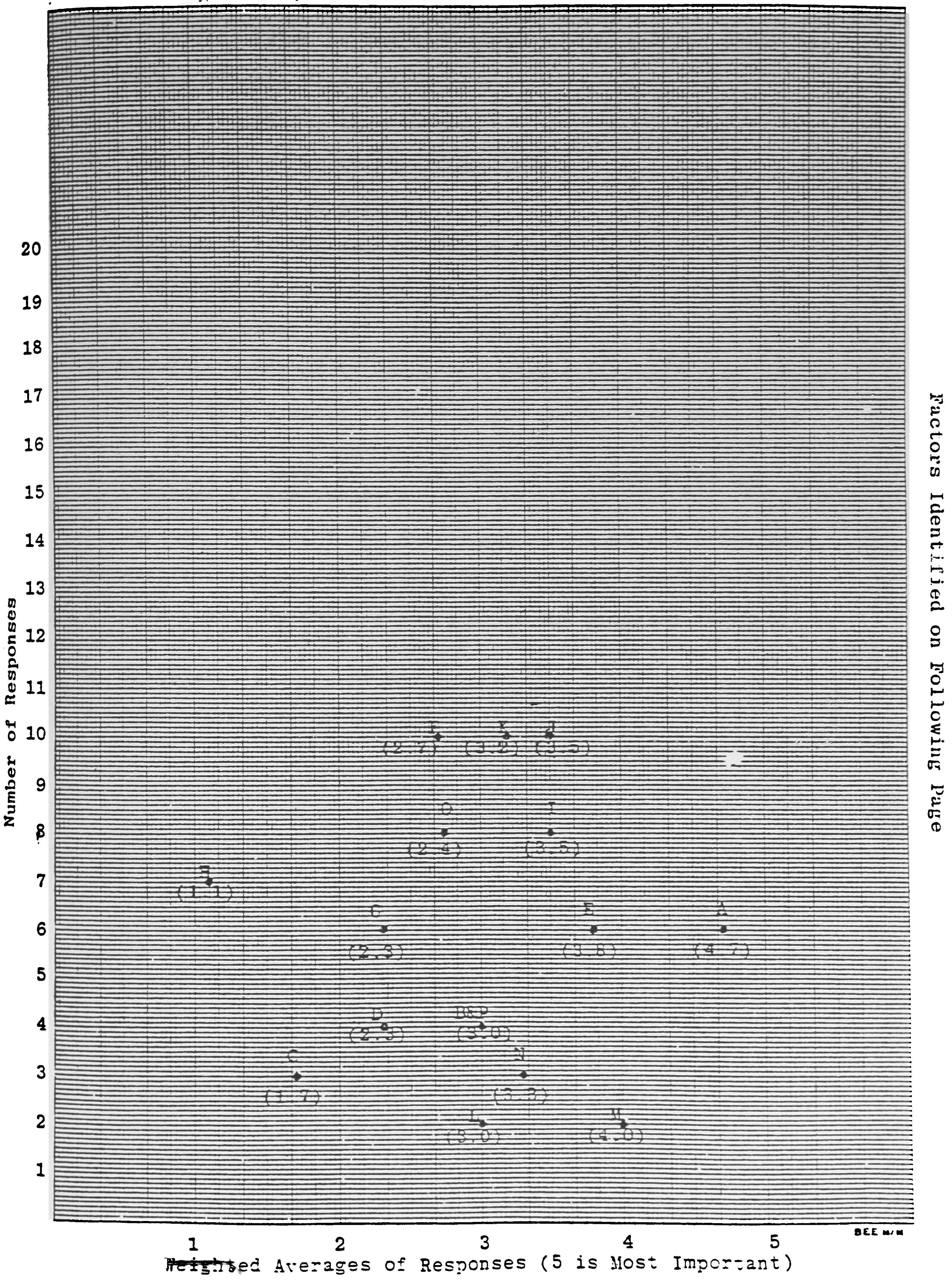
		Government Responses	Government Weight	Taxpayer Responses	Taxpayer Weight
A.	Prevailing rates in the same industry for similar property	14	3.6	6	4.7
B.	Offers of competing transferors	4	4.0	4	3.0
C.	Bids of competing transferees			3	1.7
D.	Limitations on geographic area covered	4	2.0	4	2.3
E.	Nonexclusivity of grant	3	2.0	6	3.8
F.	Uniqueness of the transferred property	17	3.4	10	2.7
G.	Likelihood of continuing uniqueness	10	1.9	6	2.3
H.	Patent or other legal protections	9	1.4	7	1.1
I.	Services rendered in connection with the transfer of property	14	3.1	8	3.5
J.	Prospective profits to be realized by the transferee from the property	19	3.5	10	3.5
K.	Costs to be saved by the transferee as the result of the transfer of the property	12	2.4	10	3.2

(question continues)

Determining Arm's Length Pricing of Transferred Intangibles



Factors Considered Most Important by Taxpayers in Determining Arm's Length Pricing of Transferred Intangibles



The key to the factors on the previous pages are:

A. Prevailing rates in the same industry for similar property

B. Offers of competing transferors

C. Bids of competing transferees

D. Limitations on geographic area covered

E. Nonexclusivity of grant

F. Uniqueness of the transferred property

G. Likelihood of continuing uniqueness

H. Patent or other legal protections

I. Services rendered in connection with the transfer of property

J. Prospective profits to be realized by the transferee from the property

K. Costs to be saved by the transferee as a result of the transfer of the property

L. Capital investment and start-up expenses of the transferee

M. Availability of substitutes for the transferred property

N. Prices paid by third parties where the property is resold or sublicensed to them

O. Transferor's costs of development

P. Other facts or circumstances

L. Capital investment and start-up expenses of the transferee	8	2.1	2	3
M. Availability of substitutes for the transferred property	5	3.0	2	4
N. Prices paid by third parties where the property is resold or sublicensed to them	5	2.4	3	3.3
O. Transferor's costs of development	12	2.6	8	2.4
P. Other facts or circumstances (please explain)	4	2.0	4	3.0

74. Did the taxpayer acknowledge at the outset the existence of a transfer of intangibles to a related party in this case?

Yes [18] Please continue.
No [11] Skip to question 76.

75. What documentation for the intangible transfer did the taxpayer produce? Please briefly describe.

14

76. What changes, if any, in the intangibles regulations would have made an adjustment for intangibles more feasible in this case?

19

77. If there were marketing intangibles involved in the case, did you attempt to value such marketing intangibles separate and apart from the manufacturing or other intangibles involved in the case?

(question continues)

Yes [9] Please continue.
No [27] Skip to question 79.

78. Please briefly describe the method utilized to value the marketing intangibles in this case and the type of data you relied upon.
14

79. Did the 482 issues in this case involve the pricing of tangible property?

Yes [40] Please continue.
No [28] Skip to question 82.

80. Which method did you use in proposing your adjustment?

A. Comparable uncontrolled price?

Yes [15] Please continue.
No [26] Skip to part G. of this question.

Please check the appropriate box if you relied on:

(1) transactions between the same taxpayer (or a related taxpayer) and third parties; or

(2) transactions between two parties both of which were not related to your taxpayer.

[4] Relied only on related party transactions. Please skip to part G. of this question.

[13] Relied on one or more unrelated party transactions. Continue.

B. Please briefly describe the unrelated party transaction(s) you relied upon to develop your comparable(s).

(space for answer on next page)

C. Were you able to disclose to the taxpayer the terms of the comparables(s) you documented through unrelated party transactions?

No. [5] Please continue.
Yes. [6] Skip to part G. of this question.

D. Please briefly describe the reasons (promises of confidentiality, etc.) that you were unable to discuss the terms of the comparable with the taxpayer.

6

E. If it became necessary, would you have been able to disclose the terms of the comparable(s) you documented through unrelated party transactions as evidence in court?

No. [2] Please continue.
Yes. [5] Skip to part G. of this question.

F. Please briefly describe any impediments to your introduction of the terms of the comparable(s) in court that were different than those described in part D. of this question. (If no difference, please write "Same.")

(space continues)

G. Resale price method? Yes [9] No [21]

H. Cost-plus method? Yes [18] No [13]

I. "Other" method? Yes [7] No [17]

If other, please describe briefly the "other method" used by you.

81. Was the priority of methods required under Treas. Reg. sec. 1.482-2(e) useful or detrimental in your development or analysis of the tangible transfer price issue?

Useful [19] Detrimental [17]

If detrimental, please briefly explain.

82. In considering any proposed adjustments under section 482, did you consider whether the taxpayer's interest in "penetrating" a new market needed to be taken into account?

Yes [17] No [47]

83. In its responses to your proposed adjustments, did the taxpayer argue that your proposed pricing adjustments needed to be modified to take into account its market penetration goals?

(question continues)

Yes [5] Please continue.
No [62] Skip to question 87.

84. For how many years had the taxpayer sold in that market?

9 responses 17.88 years (average)

85. Did you accept the taxpayer's contentions?

Yes [2] Skip to question 87.
No [6] Please continue.

86. If you rejected all or part the taxpayer's contentions with respect to market penetration, please briefly explain.

5

87. Did the taxpayer provide you with contemporaneous documentation regarding the methods it used to set its transfer prices?

Yes [16] Please continue.
No [48] Skip to question 89.

88. Did the taxpayer's documentation expressly consider the priority of pricing methods set out in Treas. Reg. sec. 1.482-2(e)?

Yes [10] No [10]

89. Please describe briefly any "other method" used by the taxpayer to justify its pricing policies.

32

90. Did the taxpayer contend in Examination that its "other reasonable method" of transfer pricing resulted in an appropriate profit split, or did it rely on a profit split to determine its transfer prices?

Yes [14] Please continue.
No [49] Skip to question 92.

91. Please briefly describe the taxpayer's means of computing the profit split it utilized or defended as appropriate.

11

92. Did this taxpayer utilize a cost sharing agreement with a related party?

Yes [12] Please continue.
No [58] Skip to question 95.

93. Please briefly describe the cost sharing agreement.

11

94. Please briefly describe any adjustments you proposed to make to the expense allocations required by this agreement.

4

95. In this case, did you have difficulty deciding whether to propose making a 482 adjustment based on --

(1)- services performed by one related party on behalf of another;

or --

(2) transfers of intangibles between the related parties?

(Example: Did you have to decide between proposing an adjustment based on (1) a parent corporation's "training" its new subsidiary's employees, or (2) the parent's transfer of "know-how" to the new subsidiary?)

Yes [19] Please continue.
No [43] Skip to question 97.

96. Please briefly describe the issue.______________________________

18

97. In this case, did you consider proposing an adjustment based on the provision of services by one related party to another?

Yes [22] Please continue.
No [45] Skip to question 100.

98. If your proposed adjustments did not include an adjustment with respect to related party services, was your decision based on difficulties in applying the services regulations under section 482?

Yes [13] Please continue.
No [17] Skip to question 100.

99. Please briefly describe any specific difficulties you had applying the services regulations.

8

100. If we have overlooked asking about any significant 482 issues that you believe could be better addressed in regulations, please take the time to identify the issue, the regulation, and any thoughts you have about how that regulation might better address the issue. Please do not confine yourself to the issues raised in this case. Please attach additional sheets if necessary.

APPENDIX C

TRANSFER PRICING LAW AND PRACTICES OF SELECTED U.S. TREATY PARTNERS

CANADA

The statutory basis for transfer pricing allocations is section 69(2) of the Income Tax Act[1] that provides as follows:

> Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length as to price, rental, royalty or other payment for or for the use or reproduction of any property or as consideration for the carriage of goods or passengers, or other services, an amount greater than the amount (in this subsection referred to as the "reasonable amount") which would have been reasonable in the circumstances if the non-resident and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or payable therefor.

Section 69(3) of the Income Tax Act provides as follows:

> Where a non-resident person has neither paid nor agreed to pay to a taxpayer with whom he was not dealing at arm's length as to price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, the amount that would have been reasonable in the circumstances if the non-resident person and taxpayer had been dealing at arm's length, that amount shall, for the purposes of computing the taxpayer's income under this Part, be deemed to have been received or receivable by the taxpayer therefor.

Sections 69(2) and (3) apply to all taxpayers including individuals, unincorporated businesses, trusts, and corporations. However, section 69(2) applies only when the Canadian taxpayer has paid more than a reasonable amount and does not apply when the Canadian taxpayer has paid less than a reasonable amount. Similarly, section 69(3) applies only when the Canadian taxpayer has received less than a reasonable amount and does not apply when the Canadian taxpayer has received more than a reasonable amount.

---

1 Income Tax Act, S.C. 1970-71-72.

Interpretation of this statute by the Canadian government has been provided in an Information Circular issued by the Department of National Revenue in 1987.[2] In this Circular, Revenue Canada interprets the phrase "reasonable in the circumstances" to mean the price that would have prevailed if the parties to the transaction had been dealing at arm's length. In applying this arm's length standard, Revenue Canada has endorsed the methods enumerated in the 1979 OECD report on Transfer Pricing and Multinational Enterprises. Although the methods are not prioritized as to the order that they must be used, Revenue Canada has expressed a preference for the comparable uncontrolled price method and the following sequence of tests:

1. Sales by the taxpayer to unrelated parties;
2. Comparable transactions between unrelated third parties;
3. Resale price method;
4. Cost plus method; and
5. Any other method in support of the other methods or where the other methods are inappropriate.[3]

These methods apply to the sale of goods as well as to the acquisition or disposition of intangible property. With respect to royalty rates on the disposition of intangibles, Revenue Canada's Information Circular states that, in determining an arm's length rate, the focus will be on:

a) prevailing rates in the industry;
b) terms of the license, including geographic limitations and exclusivity of rights;
c) singularity of the invention and the period for which it is likely to remain unique;
d) technical assistance, trade-marks, and "know-how" provided along with access to the patent;
e) profits anticipated by the licensee; and,
f) benefits to the licensor arising from sharing information on the experience of the licensee.[4]

In addition, when only use of the intangible is transferred, it must be determined whether the transferee's payment is "in fact

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[2] Department of National Revenue Information Circular No. 87-2, International Transfer Pricing and Other International Transactions (Feb. 27, 1987).

[3] *Id*. at paras. 13-19.

[4] *Id*. at para. 46.

for the use of the intangible for the year -- as opposed to a payment for its outright acquisition or other capital outlay."[5]

FRANCE

The statutory basis for transfer pricing allocations is Article 57 of the French General Tax Code which is as follows:

> In assessing income tax due by enterprises which are subordinated to or controlled by enterprises established outside France, the income to which is indirectly transferred to the latter, either by increasing or decreasing purchase or sale prices, or by any other means, shall be restored to the trading results shown in the account. The same procedure is followed with respect to undertakings which are controlled by an enterprise or a group of enterprises also controlling enterprises located outside France.
>
> * * *
>
> Should specific data not be available for making the adjustments provided for the preceding paragraph, the taxable profits are determined by comparison with those of similar undertakings run normally.[6]

The tax administration has endorsed the 1979 OECD Report on Transfer Pricing and Multilateral Enterprises, although the OECD guidelines are not binding on the French authorities.[7] In enforcing Article 57, the authorities generally compare profit margins of similar entities to identify any abnormalities.[8]

A similar approach is apparently taken with respect to the payment of royalties by a French taxpayer in that a deduction will be allowed for the payment only to the extent that the net income of the payee or subsidiary is at least equal to that realized by a French enterprise engaged in a similar activity.

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[5] Id. at para. 42.

[6] Code General des Impots, art. 57.

[7] See Instruction Administrative (May 4, 1973), published in Bulletin Official de la Direction Generale des Impots 4A-2-73.

[8] BNA, No. 364-9253, France: Transfer Pricing Within Multinational Enterprises and Article 56 of the French General Tax Code 11 (1980).

Furthermore, under the French exchange control law, all royalty agreements with and payments to nonresidents must be reported, prior to payment, to the National Institute of Industrial Property.[9]

The experience of the Office of Assistant Commissioner (International) is that French companies filing consolidated returns that include foreign subsidiaries must agree to allow French tax authorities on-site inspection of the subsidiaries' books and records; that, as indicated above, profit experience is a very important factor in examinations; and that no guidelines have been developed for evaluation of royalty cases involving transfer of intangibles. When intangibles are transferred to a tax haven, payments received on account of the transfer are deemed to be unreasonable, and the burden is on the taxpayer to establish that the payments are reasonable.

Although cost sharing arrangements are permitted,[10] the French authorities do not have specific rules applicable to such arrangements.

GERMANY

The statutory basis for intercompany pricing adjustments includes Article 8(3) of the Corporation Tax Law, which states that hidden distributions of income do not reduce taxable income.[11] Section 31 of the Corporation Tax Regulations interprets "hidden distributions" to include a benefit granted by a company to a related person, outside the normal statutory profit distributions, which an orderly and conscientious manager would not have granted to an unrelated party under comparable circumstances.[12]

Similarly, Article 1(1) of the Foreign Tax Affairs Law states that where the income of a taxpayer resulting from his business relationship with a related person is reduced because the taxpayer, within his business relationship extending to a foreign country, has agreed on terms and conditions which deviate from those unrelated third parties would have agreed upon under the same or similar circumstances, then his income shall, notwithstanding other provisions, be determined as if the income had been earned under terms and conditions agreed upon between

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9 Id. at 11.

10 Id. at 11.

11 Koerperschaftsteuergesetz art. 8(3).

12 Koerperschaftsteuerrichtlinien §31.

unrelated third parties.[13] Article 1(1) applies to all related or affiliated taxpayers, including individuals, partnerships, and corporations.

Paragraph 2.1.1 of the Transfer Pricing Guidelines of 1983[14] (hereinafter referred to as Guidelines) requires that business dealings between related parties be evaluated on the principle of arm's length dealings between independent parties acting in a situation of free competition.

Paragraphs 2.2.2 through 2.2.4 of the Guidelines list the following as the standard methods for evaluating transfer prices: comparable uncontrolled price method, resale price method, and cost plus method. In contrast to section 1.482-2(e)(1)(ii), which requires that these methods be used in the order prescribed if the circumstances of the case permit, paragraph 2.4.1 of the Guidelines states that, "[t]here is no single correct sequence of standard methods for the examination of transfer prices which applies to all groups of cases." Also, paragraph 2.4.2 of the Guidelines, similar to the "fourth method" provision of section 1.482-2(e)(1)(iii), allows use of a combination of the three standard methods or of other methods.

In cases involving transfers of intangibles to offshore manufacturing affiliates, paragraph 5.1.1 of the Guidelines recognizes that a determination must be made whether the transferor has received an adequate consideration for the transfer of the intangible. Paragraph 5.2.2 of the Guidelines states that an arm's length price for transfer of an intangible is to be determined under "an appropriate method." Paragraph 5.2.3 of the Guidelines indicates that the preferable method is the comparable uncontrolled price method but, if the facts of a case will not support application of this method:

> then the starting point for the examination is the consideration that a sound business manager of the licensee enterprise would only pay a royalty up to an amount which leaves the enterprise <u>with an acceptable commercial profit</u> from the licensed product. [Emphasis added.]

According to paragraph 5.2.4 of the Guidelines, the cost plus method may be used "in exceptional cases." One such exceptional case is described in paragraph 3.1.3 (Example 3) of the Transfer Pricing Guidelines of 1983, as follows:

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13 Koerperschaftsteuergesetz art. 1(1).

14 <u>See</u> Intl. Bureau of Fiscal Documentation, <u>The Tax Treatment of Transfer Pricing</u> (1987) (English translation).

> An enterprise transfers particular manufacturing functions to a foreign subsidiary corporation. Production and marketing by the foreign corporation are closely tied in with the business of the domestic enterprise.
>
> The articles produced are purchased by the parent corporation under a long-term arrangement. The subsidiary corporation with its limited range of production could not in the long run survive as an independent corporation. Between unrelated parties the production would have been carried out on a sub-contract basis.... The transfer price can accordingly be determined using the cost plus method.

This approach is essentially the same as that of the IRS in the Lilly case, discussed supra, Chapters 4 and 5.

One commentator, Mr. Friedhelm Jacob, Counselor for Tax Affairs at the West German Embassy in Washington, D.C., has noted that, in contrast to the 1986 Tax Reform Act amendments to section 482, which require adjustments over time for substantial changes in circumstances, the German approach has been that the determination of fair market consideration for an intangible is made at the time of the transfer.[15]

Paragraph 2.4.3 of the Guidelines recognizes that related entities may enter into bona fide cost sharing arrangements and that such arrangements can affect transfer prices. Under paragraph 7.1.1 of the Guidelines, cost sharing arrangements are to be taken into consideration in making transfer price income allocations between the entities involved in the arrangement. However, full costs, direct and indirect, must be calculated and included under a recognized accounting method. If the cost sharing arrangement is to be recognized, the services must be distinguishable and the aggregate of the costs must be separable as to the services. No profit is permitted in such an arrangement. Furthermore, a taxpayer seeking a deduction for a cost sharing payment must have "a specific right, definite both in nature and scope, to benefit from the activities of the central organization."

The experience of the Office of the Assistant Commissioner (International) has been that, if the comparable uncontrolled price method cannot be utilized, the German tax authority generally allows a price or royalty that leaves the enterprise with an acceptable commercial profit from the sale or license,

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[15] Jacob, The New "Super-Royalty" Provisions of Internal Revenue code 1986: A German Perspective, 27 European Taxation 320 (1987).

although there are no published industrial safe harbor profit norms. With respect to the transfer of intangibles, the tax authority does not consider that the intangible property itself was used when a person acquires the goods or merchandise produced with the intangible.

JAPAN

Article 66-5 of Japan's Special Taxation Measures Law is effective for taxable years beginning on or after April 1, 1986.[16] This law applies only to corporations (and certain other legal entities recognized under Japanese law), but does not apply to individuals, unincorporated joint ventures, and similar entities. Furthermore, Art. 66-5 applies only to transactions between a foreign corporation and a corporation that is subject to Japanese tax and only when the two entities are related by at least a 50 percent direct or indirect ownership.

Article 66-5 is as follows:

> (1) In the event that, during a business year commencing on or after April 1, 1986, a corporation ("Corporation A") has conducted sale or purchase of assets, provision of services or other transactions with a foreign affiliated corporation ("Corporation B") which has a relationship with Corporation A in which one of the corporations in question, directly or indirectly, owns a number of shares comprising 50 percent or more of the total number of issued shares of the other one or has any other special relationship with Corporation A ("Special Relationship") and, in connection with such above mentioned transaction ("Transaction"), if the amount of consideration of which payment was received by Corporation A from Corporation B was less than an arm's length price, or if the amount of consideration which Corporation A paid to Corporation B was greater than an arm's length price, then, for purposes of corporate income taxation of Corporation A for the said business year, the Transaction will be deemed to have been carried out at an arm's length price.

Paragraph (2) of Article 66-5 lists the methods by which the arm's length price is to be determined, although in contrast to section 1.482-2(e)(1)(ii) the methods are not prioritized as to

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[16] Japan Special Taxation Measures Law, art. 66-5 (March 31, 1986), an outline of which is contained in Appendix I, to the Speech of Toshiro Kiribuchi, Deputy Commissioner (International Affairs), National Tax Administration, at the International Tax Institute Seminar, New York, N.Y. (June 2, 1986).

the order in which they must be employed. In the case of sale or purchase of inventory assets, the permissible methods are comparable uncontrolled price, resale price, cost plus, and, if none of the first three methods may be applied, a method "similar to" the first three methods or "other methods prescribed by cabinet order." In the case of other transactions (i.e., that do not involve the sale or purchase of inventory assets), the arm's length price is determined by "a method which is equivalent to" the comparable uncontrolled price method, the resale price method, the cost plus method, and, if none of the first three methods may be applied, a method "equivalent to" or a method which is "similar to" one of the first three methods.[17]

The comparable uncontrolled price method is described generally as the price that would have been paid between a buyer and a seller who are unrelated, where the sale or purchase of inventory is the same type of inventory as the inventory involved in the subject transaction, and the circumstances, including commercial level and transaction volume, are similar. It is permissible to use this method where the transactions are not precisely comparable, but it is possible to adjust for differences.[18]

The resale price method is described as the price computed by deducting a normal amount of profit (meaning an amount computed by multiplying the resale price by a normal profit percentage) from the amount of consideration when a buyer of inventory assets involved in the subject transaction resells inventory assets to a person with which it has no special relationship.[19]

The cost plus method is described as the price computed by adding a normal amount of profit (meaning an amount computed by multiplying the amount of costs by a normal profit percentage), to the amount of the costs of the seller to acquire, by purchase, manufacture, or other acts, the inventory assets involved in the subject transaction.[20]

The guidance given by the Japanese legislation for determinating an arm's length price for the transfer of an intangible asset is that methods similar to comparable

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[17] Special Taxation Measures Law, art. 66-5, §2(i) and (ii).

[18] Special Taxation Measures Law, art. 66-5, §2(i)(a).

[19] Special Taxation Measures Law, art. 66-5, §2(i)(b).

[20] Special Taxation Measures Law, art. 66-5, §2(i)(c).

uncontrolled price, resale, and cost plus methods can be used, and that, if none of these methods is applicable, a fourth method may be used.

A unique aspect of Japan's transfer pricing law is a pre-confirmation system whereby a Japanese parent or subsidiary may request pre-approval of a sale or purchase price from a foreign related entity from the tax administration. The purpose for this procedure is to reduce the number of transfer pricing cases and to eliminate uncertainties in international transactions. No such procedure is available under U.S. law, and the IRS would not grant such a ruling because of the factual nature of the issue. The Japanese experience to date is that taxpayers are taking a "wait and see" attitude towards the pre-confirmation procedure.[21]

UNITED KINGDOM

The statutory basis under U.K. law for adjustments to transfer prices is section 770 of the Income and Corporation Taxes Acts of 1988 [ICTA]. This section provides that where any property is sold and:

(a) the buyer is a body of persons over whom the seller has control, or the seller is a body of persons over whom the buyer has control, or both the buyer and the seller are bodies of persons over whom the same person or persons has or have control; and

(b) the property is sold at a price ("the actual price") which is either --

(i) less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length ("the arm's length price"), or

(ii) greater than the arm's length price,

then, in computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price, and of the buyer where the

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[21] Go, Kawada, Director, Office of International Operations, National Tax Administration, Remarks at the International Tax Institute Seminar, New York, N.Y. (June 27, 1988).

> actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price.[22]

This section applies to rentals, grants and transfers of rights, interests or licenses, loan interest, patent royalties, management fees, payments for services, and payments for goods.

Guidance with respect to application of section 770 of the ICTA is provided in Notes published by Inland Revenue.[23]

An Inland Revenue Note defines "arm's length price" as the price which might have been expected if

> the parties to the transaction had been independent persons dealing at arm's length, i.e. dealing with each other in a normal commercial manner unaffected by any special relationship between them.[24]

The Note dealing with methods of arriving at arm's length prices is as follows:

> In ascertaining an arm's length price the Inland Revenue will often look for evidence of prices in similar transactions between parties who are in fact operating at arm's length. They may however find it more useful in some circumstances to start with the resale price of the goods or services etc. and arrive at the relevant arm's length purchase price by deducting an appropriate mark-up. They may find it more convenient on the other hand to start with the cost of the goods or services and arrive at the arm's length price by adding an appropriate mark-up. But they will in practice use any method which seems likely to produce a satisfactory result. They will be guided in their search for an arm's length price by the considerations set out in the OECD Report on Multinationals and Transfer Pricing. (This Report examines the considerations which need to be taken into account in

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[22] Income Tax Acts of 1988, §770.

[23] Thomas, Richard, Deputy to Assistant of Taxes, Board of Inland Revenue, Remarks at the International Tax Institute Seminar, New York, N.Y. (June 27, 1988).

[24] <u>The Transfer Pricing Of Multinational Enterprises, Notes by the UK Inland Revenue</u> (Jan. 26, 1981), at 1, <u>reprinted in</u> Int'l Bureau of Fiscal Documentation, <u>Tax Treatment of Transfer Pricing</u> (1987).

arriving at arm's length prices in general and also in particular in the context of sales of goods, the provision of intra-group services, the transfer of technology and rights to use trade marks within a group and the provision of intra-group loans).[25]

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[25] Id. at 3.

APPENDIX D

AN EMPIRICAL ANALYSIS OF THE MARKETPLACE FOR INTANGIBLES

A. Introduction

One question that has been raised during the preparation of the paper is whether the requirement for periodic adjustments in certain situations is consistent with the manner in which unrelated parties structure arrangements involving transfers of intangibles. Additionally, the Congressional concern about related party use of inappropriate comparables raises questions about which characteristics of unrelated party arrangements should be included in related party arrangements. This appendix draws upon academic work that examines actual licensing experience by unrelated parties in an effort to address this issue.[1] Although each of the papers examined had a different goal, the underlying data collected through surveys or interviews with licensees and licensors provides relevant information about what unrelated parties do.

In addition to synthesizing other authors' work on technology transfers, the Service and Treasury have collected a sample of license agreements drawn from the records of the Securities and Exchange Commission ("SEC"). The SEC requires that companies disclose license agreements that are "material" to the operation of the company.[2] The disclosures to the SEC provide a potential data base of over five hundred agreements. Only sixty of these agreements have been analyzed for this report. The choice of agreements in the sample was largely dictated by the ease of discovery and the availability of documents within the SEC's files. The sample consists of forty agreements for the manufacturing industry, most of which are clustered in the Standard Industrial Classifications (SIC) for pharmaceutical preparations, toilet preparations, electronic computing equipment, semiconductors, surgical and medical equipment, and ophthalmic goods. The other twenty agreements are for the services industry, mostly within the SICs for computer programming, computer software, and research and development laboratories.

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[1] Authors who rely on statistics that include related party transactions are quick to point out that the numbers are biased due to potentially tax motivated manipulations. See, e.g., Katz and Shapiro, How to License Intangible Property, 101 Quarterly Journal of Economics 567-589 (1986).

[2] "Material" is an accounting concept that describes items about which a prudent investor ought reasonably to be informed. For an explanation of a "material contract," see Item 10 of the Instructions to the Exhibit Table for Form 10-K, 17 C.F.R. § 229.601.

In this study, the SEC documents have been used primarily for further illustration of the points raised by other authors. Further examination of the SEC agreements will be conducted after publication of this study, with a view toward relating them to financial accounting and tax data of the firms involved, and publishing the results. An analysis of available data might give a more complete picture of the incomes realized by the two parties to the transaction and suggest criteria for determining a profit split in comparable cases.

B. Goal of Licensing Agreements

Parties contemplating entering into a license agreement are ultimately concerned with the income they can expect to receive from the arrangement. The existence of proprietary knowledge suggests that production and sale of the product will result in profits that are greater than those necessary to provide a normal rate of return to the inputs provided by both parties. The actual division of these profits will depend on each party's forecast of the total profits, and on the relative bargaining strength of the two parties.

Some authors have formally diagrammed and discussed the negotiating range of unrelated parties.[3] The basic premise is that the parties are concerned with the split of the net income from the product. Baranson reports that Bendix officials "indicated that, if a broad cross-section of American industry were polled, one would find that the average goal is a return to the licensor equal to about one-third of the profit of a well-run, well-established licensee with a broad market."[4] Caves *et al.* find that the licensor will capture an average of forty per cent of the expected profits that remain after the deduction of a normal return on capital. According to their sample, the range of the split leaves one-third to one-half of the profits to the licensor.[5] Contractor's overview of the literature suggests that licensors "should settle for a 25 to 50 percent share of the licensee's incremental profit."[6]

These averages can not necessarily be used to replicate an individual arm's length deal because they do not, for example,

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[3] *See, e.g.*, F. Contractor, *International Technology Licensing*, at Chapter 3 (1981).

[4] J. Baranson, *Technology and the Multinational* 64 (1978).

[5] Caves, Crookell, and Killinger, *The Imperfect Market for Technology Licenses*, 45 Oxford Bull. of Economics and Statistics 249, 258 (1983).

[6] Contractor, *supra* n. 3, at 125.

control for the specific economic activities undertaken by the parties. They do show that unrelated parties enter negotiations for a license agreement with expectations about the total profits that they think will be earned from the exploitation of the intangible, and about the share of the profit that they can expect to receive.

C. Payment Terms for a License

Although the goal is to capture a portion of the profits, the provisions in license agreements rarely specify that a percentage of the profits will be paid as compensation for the right to exploit the intangible. This may be because the licensor fears that the accounting for profits can be manipulated too easily by a licensee, who may be able to choose what costs are included. Instead, a royalty that is a percentage of the net selling price is typically chosen.[7] Fifty-eight percent of the agreements in the SEC sample used a royalty based on the net selling price.[8] This means of achieving the split of profits from the intangible leads to a more easily verifiable number for the licensor.

Of the SEC agreements that have royalties based on the net selling price, 40 percent have a constant royalty rate. Because costs vary over time, a flat royalty rate will lead to a different profit split on a year-by-year basis. Therefore, an examination of the returns over the lifetime of the agreement is necessary to determine the true division of the profits.

Some agreements apparently attempt to even out the returns earned by varying the royalty rate. A number of different structures are possible. Some agreements have a royalty rate that declines over time; others are structured so that the rate rises and then falls. Thirty per cent of the SEC agreements that have royalties based on the net selling price vary the royalty rate over the years of the agreement.

The remaining 30 percent of agreements with royalties based on the net selling price vary the royalty rate based on total

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[7] The net selling price is typically the price charged by the licensee to unrelated parties on an f.o.b. factory basis after deduction for state and local sales taxes and, sometimes, after deduction for quantity discounts.

[8] Recall that the sample size is small and was not chosen randomly. All percentages provided are purely illustrative and should not be accorded the weight one would give to a larger, randomly selected sample.

sales of the product. This structure may be most clearly tied to the returns that the licensor requires. It may also provide incentives to the licensee; this aspect will be discussed below.

Not all compensation packages are based on a percentage of the net selling price. Eighteen percent of the agreements in the SEC sample require a royalty per unit. Once again, the royalty per unit may be constant or it may change as more units are sold. In the SEC sample, 60 percent of the royalties per unit were constant, and 40 percent declined per unit as the number of units increased. The licensor may prefer to base the royalty on units sold instead of on net selling price if the licensee is contemplating discounts or if the intangible may be sold as part of a larger package, such as when software is distributed free of charge to the buyer of a computer. In the SEC sample, 80 percent of the royalty per unit agreements occurred in licenses for computer software. Computer software would seem to be the type of product for which "free" samples may be provided or which may be part of a package deal. Indeed, 67 percent of the sample agreements in the SIC code for "Computer Programming and Software" contain royalties per unit.[9]

Some agreements combine advance or lump sum fees with a royalty based on sales or units. Different factors might explain these payments in different settings. If the licensee's country of incorporation limits the allowable royalty rate, an initial lump-sum fee might be used to ensure that the licensor earns the required return.[10] Alternatively, the goal of a front-end fee may be to lower the licensor's risk by ensuring a minimum return. In the SEC sample, 16 percent of the agreements with per unit or net selling price royalties also have initial lump sum fees.

Another means of lowering the licensor's risk is for the licensee to prepay a nonrefundable amount of money against which future royalty obligations are credited. In addition, a minimum payment may be due each year. If the total royalties paid are less than this amount, the licensee must pay the difference to the licensor. Forty-seven percent of the agreements with per unit or net selling price royalties contain this type of arrangement.

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[9] This product specific use of a certain type of royalty base is the type of information that one would hope to find in more situations after a thorough examination of the SEC data.

[10] If the licensee's country of incorporation intends to limit the compensation flowing out of the country, attempts to provide a lump sum payment may only serve to shift the analysis. In addition to limiting the royalty rate, the country may also challenge the lump sum payment.

Finally, a lump sum fee may provide the sole compensation for the use of an intangible for a certain number of years. Twenty percent of the SEC agreements used a one time, lump sum payment or annual lump sum payments. Such an arrangement fixes the return that the licensor will receive. This payment scheme leaves the licensee to absorb all the variance in the amount earned. Just as in the minimum payment scheme, if the product is much less popular than expected, the licensee will absorb the loss. However, unlike the minimum payment scheme, if the product is much more popular than expected, the licensee will reap all of the unexpected rewards. This type of arrangement could provide a strong incentive to the licensee to concentrate resources on selling the product.

Forcing the licensee to absorb the risk may not be the only reason that lump sum fees are chosen. The licensor may have patented a new technique or instrument that the licensee wishes to use to attempt to create another product. In this case there is no readily apparent unit to be produced, nor is anything being sold initially. Therefore, a lump sum fee may be the only practical means of compensating the licensor for the use of the patent. Lump sum fees may also be used to settle disputes over patent infringement claims.

D. Provisions Which May Affect Returns

Other clauses in the agreement, which do not explicitly affect payment, may affect the returns earned by the licensor and the licensee. For example, the licensor may require the licensee to perform a certain amount of marketing. This clause can be very specific, and may require that a certain amount be spent or that a certain percentage of the licensee's marketing expenditures be devoted to the licensor's product.[11] Alternatively, the marketing or advertising clause may be open-

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[11] One agreement states that:

> [I]n each License Year during the term of this Agreement, Licensee shall expend a sum equal to 2% of the Net Sales of Licensed Products...for trade and consumer advertising of Licensed Products under the Licensed Trademarks. All such advertising shall be in accordance with the provisions of this Agreement. Licensee shall furnish Licensor with copies of each such advertisement and with proof of such advertising expenditure.

The agreement goes on to define advertising and to require that "such advertising shall have been submitted to Licensor and received its prior written approval."

ended, requiring that the licensee use its "best efforts."[12] Although such a clause does not readily translate into a dollar figure, it potentially gives the licensor the ability to terminate the agreement or to file suit if unsatisfied with the results.

One might expect to find these clauses in licenses for products in which advertising plays a pivotal role in determining the success of the product. Indeed, in the SEC sample, these marketing or advertising clauses seem to be particularly prevalent in the SIC code for toilet preparations. Seventy-three percent of the agreements in the SEC sample that contain advertising clauses are for licenses with respect to clothing articles or toilet preparations. Once again, certain features of agreements seem to be product specific. This suggests that a comprehensive analysis of the marketplace for intangibles should ideally focus on individual product groups.

In addition to lowering the licensor's risk, these marketing clauses imply that the licensee is engaging in a significant economic activity beyond the manufacture and distribution of the good that embodies the intangible. One would expect that the performance of this additional activity would affect the returns that each party anticipated.

A major factor affecting the licensor's return from licensing the intangible is the amount of technical support required as a condition of the license. The total expense of transferring a technology to a licensee will depend on the technology and on the licensee's level of expertise. Transfer costs include the physical transfer costs of plans, specifications, and designs, as well as the cost of training the licensee to make use of them. Since the licensor has typically already created the product being licensed, the cost of transferring the technology may be the biggest resource cost to the licensor. Indeed, Contractor finds that the most important factor in determining the licensor's return on an agreement is the amount of technical services provided.[13] By carefully limiting the amount of service automatically provided, the licensor can minimize uncertainty of return from the transfer.

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[12] One such clause reads: "[Licensee] shall use its best efforts to document, package, market, distribute, advertise and promote the Use of the Software. All advertising and promotion...shall be undertaken at [the licensee's] expense...."

[13] Contractor, _supra_ n. 3, at 123, n. 6.

Additional technical support is sometimes provided on a time and expense basis.[14] The split between "free" technical support and additional support for which the license is charged varies depending on the circumstances. Additional detail would be necessary to test hypotheses concerning how expectations about technical support affect technical assistance provisions and how these provisions affect the whole licensing package. The SEC data reveal a variety of solutions to the technical assistance question. Some set a specific time period for "free" technical support.[15] Others require that technical assistance be reimbursed at cost,[16] at a fixed rate,[17] or at the lowest rate charged by the licensor to third parties.[18] As is true of the

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[14] Baranson, supra n. 4, at 65, n. 4.

[15] A license for the design, use, and sale of laser accessories with a per unit royalty provides:

> Upon [licensee's] request, [licensor] shall give or shall cause to be given to [licensee] such technical assistance and shall give or shall cause to be given to [licensee's] employees such training for 6 months after the date hereof as [licensee] may reasonably require in connection with the transfer of technology provided in the preceding paragraph....

[16] A license to manufacture and sell clothing using the licensor's trademark with a royalty based on net sales notes:

> Licensor agrees to furnish technical aid to the licensee (including information concerning advertising, packaging and customer lists) if requested in writing, provided that the licensee pays all of the expenses for such aid....

[17] A 1985 license agreement to modify and sell software where the license makes regular, fixed royalty payments says:

> [Licensor] agrees to provide technical assistance concerning the Software to licensee, upon request by Licensee, in the development of the Modified Software; provided, however, that in addition to all other sums payable under this Agreement, Licensee agrees to pay [licensor] the sum of $100.00 per hour for all labor provided by [licensor], plus reimbursement for all expenses incurred by [licensor] in providing such technical assistance to Licensee.

[18] A license for the use of a new type of laser where the licensee provides fixed annual royalty payments requires:

marketing clauses in a licensing agreement, a licensor may need to balance the desire to push all of the technical costs onto the licensee with the need to ensure that the licensed intangible is used productively.

E. Preparing for Surprises

An arm's length license agreement is shaped by each party's expectations about costs, sales, and the overall profit potential from the use of the intangible. The parties' expectations may differ, and they may differ markedly from the actual profit experience with the product. Therefore, even if both parties are pleased with the royalty rate to be paid, the level of technical services to be provided, and any marketing clauses or clauses on market restrictions, it is possible that future events will leave one or both of the parties dissatisfied with the arrangement.

There are two types of surprises from which the parties may desire protection. One surprise occurs if further development of the intangible significantly improves the product's profitability. The other occurs if several years of actual profit experience lead to a change in expectations about future profitability.

The first surprise is of particular concern to the licensor. In order to insure against this risk, many license agreements contain "grant back" or "technology flowback" clauses. These clauses specify that the licensor receives, free of charge, any enhancements to the technology that are developed by the licensee. These clauses serve to discourage the licensee from doing its own R&D and potentially competing with the licensor. They further protect the licensor from losing out on serendipitous discoveries by the licensee. Caves et al. found grant back clauses in 43 percent of the 257 agreements they studied. However, the clauses appeared 76 percent of the time in agreements involving "dominant product" licensors.[19]

> [Licensor] shall make available such technical assistance as [licensee] may reasonably request for understanding or exploiting the Proprietary Technology at [licensor's] standard rates, and under terms that are no less favorable than those extended to any of its other customers.

[19] Caves, supra n. 5, at 261, n. 5. A dominant product is one that accounts for more than 60% of a firm's sales. This classification relates only to the level of the firm's diversification. It does not make any distinction with regard to the overall profitability of the product. Id. at 252.

The second type of surprise, changes in the parties' expectations about future profitability, can create problems from which both licensors and licensees may want relief. Termination clauses provide one kind of protection in these circumstances. In one agreement, a license for the use of a trade name, the licensee was required to meet certain sales targets. This type of arrangement allows the licensor to exit from the deal or renegotiate if the volume is insufficient to realize the expected returns from the intangible.

In other cases, termination clauses allowed the parties to end the contract, without cause, after giving notice. This safety valve may not lead to actual termination but instead may offer an opportunity for renegotiation if one of the parties thinks that its returns are inadequate. The structure of termination clauses varies. Clauses may allow immediate termination, or they may require several years' notice. Manufacturers' distributors can typically be dropped by the manufacturer to whom they are under contract on 30 days' notice.[20] At the other end of the spectrum, some terminations without cause are tied to the length of a patent. However, not all agreements involving patent life specify such a long period before renegotiation is considered. Thirty-four percent of the SEC agreements provide for termination without cause for the licensee, while 21 percent allow the licensor to terminate without cause after a given period of time.

Some agreements have no termination clause except for cause. There are several situations in which a license might be likely to lack a termination clause. If the licensee was required to make a substantial initial investment in order to make use of the intangible, one can hypothesize that the licensee would not enter into the agreement if the licensor could easily pull out of the deal. Another type of agreement without a termination clause might be one involving the license of products, such as computer software, that have a very short lifespan. In this case the relevant life is so short that termination is not a useful option; both parties must choose correctly the first time. Related to this group are agreements that are scheduled to end after a specific, and relatively short, length of time. These agreements will automatically be renegotiated if the parties wish to extend the license.

Fifty-five percent of the SEC sample agreements allow no termination except for cause. However, of this subset, 22 percent are agreements that have a specified length of less than

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[20] Galante, Quickie Divorce Curbs Sought By Manufacturer's Distributors, Wall Street Journal, July 13, 1987, at 25.

three years, and another six percent are agreements of five or six years in duration. These agreements seem to fall into the category of licenses with relatively short lengths.

Twenty-eight percent of the SEC sample agreements without a termination clause (16 percent of the total sample) were agreements with a duration of ten years or more. More information on these licenses would need to be gathered in order to test the hypothesis that extended licenses tend to exist when the licensee is required to make a substantial initial investment.[21]

Of the remaining agreements with no termination clause, 22 percent were for agreements with lump sum payments and 22 percent were for agreements of indeterminate length. The latter group typically specified that the agreement lasted until the patent expired; these patent expiration dates were not readily available.[22]

The existence of termination clauses shows that companies are concerned about their ability to predict the total profits from the exploitation of an intangible. Regardless of the existence of termination clauses, agreements do get renegotiated. The frequency of renegotiation would give information about the "surprises" that occurred and the companies' ability to predict the outcome of a license agreement. Although it is not possible to make general statements about the overall frequency of renegotiations or terminations based on the sample of agreements we examined, some examples of renegotiations were found. A license to manufacture and sell clothing under a trademark was renegotiated in the second year of a six year term. The amended agreement provided the licensor with a royalty rate, based on net selling price, one percentage point higher than the original rate. However, the new agreement also lowered the percentage of the net selling price to be spent by the licensee on advertising by one-half a percentage point.

Other agreements provide clear evidence that the parties contemplated the possibility that renegotiation might be necessary. One agreement, with no termination clause, provides for renegotiation of the royalty rate after three years. At that

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[21] In addition, representative information on all licenses, regardless of term, that require the licensee to make a substantial investment would be necessary in order to test the hypothesis that a large initial investment by the licensee leads to a license of long duration.

[22] These agreements could be of short duration; several of the other license agreements in the sample were for patents with only two or three years left before expiration.

time, "[B]oth the royalty rate and the scope of the Patented Portions will be renegotiated...[to] aggregate to not less than 1.5 percent and not more than 2.5 percent of the Royalty Portion selling price of such Licensed Products." Another agreement provides for renegotiation after certain events occur, instead of after a certain time period. This is a 15 year agreement which the licensee can terminate on six months' notice. It says: "Licensor or Licensee are unable at the Effective Date of this Agreement to value on a proportionate basis the future worth to Licensee of the rights presently owned by Licensor in the Technological Field...." The agreement goes on to provide for current royalty payments and for additional payments, depending on the outcome of certain events.

This discussion of terminations and renegotiations shows that there is no single way of dealing with uncertainty. Ultimately, much more detailed analysis would have to be undertaken to determine what circumstances lead unrelated parties to renegotiate or terminate contracts.

F. Conclusions and Recommendations

The agreements filed with the SEC and those analyzed in the academic work provide a body of information concerning arm's length transactions involving intangible property. This body of information points out key factors that should be considered when determining the proper allocation of income in related party situations. The SEC data and other sources will be further analyzed in greater detail following publication of this paper. For example, patterns might be disclosed between royalty rates and specific levels of technical assistance, or marketing expenditures, either in general or by specific industry groups. Moreover, a study of the prevalence of, and circumstances that trigger, termination or renegotiation clauses (as well as the results following exercise of the clause) might be helpful in determining when unrelated parties exercise these rights.

APPENDIX E

EXAMPLES OF METHODS FOR VALUING TRANSFERS OF INTANGIBLES

Preamble to Examples

The examples that follow illustrate the principles and methods described in Chapter 11. They are intended to set forth what the Service and Treasury believe is an ideal application of these principles and methods to specific factual situations. They are intended to serve as guidance for taxpayers in planning their pricing transactions as well as for both taxpayers and the Service on audit. In large part, the types of information set forth are based upon information used by IEs and economists on audit and used by taxpayers or outside economists for planning purposes.

In general, it is expected that the amount of information about comparable transactions, rates of returns, and costs for a taxpayer's industry and claimed comparable transactions will be the greatest following a full examination of the taxpayer's return. But, as Chapter 3 makes clear, taxpayers have a burden to document contemporaneously, and to justify, their transfer pricing policies and their return positions. The Service and Treasury recognize the practicalities involved in locating and analyzing the type of information set forth in certain of these examples when transactions are planned or returns filed. In general, the taxpayer making a relatively minor investment would not be expected to have gathered and analyzed data outside of its own knowledge of its business affairs and those of its competitors. As Chapter 3 indicates, however, a taxpayer engaging in a transaction involving high profit intangibles should arguably be expected to gather and analyze the type of information set forth in certain of the examples, to the extent that it is available, contemporaneously with the transaction.

Example 1: Exact Comparable

Hydrangea, Inc. is a U.S. developer, producer, and marketer of business software for personal computers. It has developed a new line of specialized accounting software that it expects to sell mainly in foreign markets.

Hydrangea expects that this product will have a life cycle similar to most other products in its line. Thus, it expects that this software will have a peak productive life of three to five years. If it is moderately successful, there will be a small, declining market after that, as obsolescence sets in. If the product is very successful, Hydrangea may decide to develop an enhanced, substantially modified version after the peak period, which it would treat as a new product.

Hydrangea has decided to serve the market in country F for this software by licensing it to an unrelated country F corporation, Fleur, with which it has had satisfactory dealings in the past. Specifically, Hydrangea and Fleur have negotiated a licensing agreement with the following terms. Fleur receives an exclusive license to market Hydrangea's product in country F and agrees to pay Hydrangea 20 percent of the net selling price for each copy it sells. Fleur agrees not to market competing products while the license is in effect. Fleur will market the product under its brand name and will perform the necessary work to modify the product to integrate it into its own line of accounting software. Hydrangea agrees to provide Fleur, for free, with any corrected, revised, and enhanced versions of the software that it releases publicly during the first four years. (Fleur and Hydrangea understand that, after that period, the latter is permitted to develop an enhanced, substantially modified product and to call for new negotiations with Fleur, find another licensee, or market the new product itself.) The agreement grants Fleur a perpetual license to the current product. During the first four years, neither party can terminate without cause; after that period, Fleur can terminate with six months' notice.

Hydrangea will serve the market in country B through its wholly owned local subsidiary, Royal Hydrangea. The markets in countries F and B are substantially similar in size, sophistication, and ability to use business software intended for personal computers. Royal Hydrangea performs the same functions as Fleur relating to marketing and distribution of accounting software. Thus, it will modify the product as necessary for local requirements; it has been and will continue to be responsible for marketing its products and developing its trademark; and, it maintains a distribution network, including a sales staff. For these reasons, Hydrangea concludes the external standards for using the Fleur agreement as an exact comparable are satisfied.

Hydrangea satisfies the internal standards by including all important features of the Fleur agreement in its agreement with Royal Hydrangea. Thus, the royalty is set at 20 percent of net selling price. The provisions concerning corrections and revisions are also, therefore, included, as are the provisions concerning duration and termination.

Each year, Hydrangea reexamines its related party arrangement to determine if the exact comparable approach is still valid. Specifically, it determines whether the two markets are still similar, and whether Fleur and Royal Hydrangea still perform similar functions. If these aspects of the external standards have substantially changed, or if Fleur terminates its agreement, Hydrangea must reestablish the appropriateness of its related party transaction, which may require adjusting the royalty rate.

Example 2: Unavailability of Comparables

A U.S. company has developed a unique good that it believes will capture 80 percent of the relevant market. The U.S. company plans to produce the good in the United States and to license the rights to production and sale for the rest of the world to its foreign subsidiary. The U.S. company can find no examples of situations in which an unrelated party licensed the rights to production for a product that captured such a large share of the market. Therefore, the company should use the arm's length return method in order to set the appropriate royalty rate with its foreign subsidiary.

Example 3: Inexact Comparable

Shampoo Inc., a well known hair-care products corporation in the United States, plans to set up a subsidiary in country Z in order to introduce its line of products in country Z. The subsidiary will manufacture, distribute, and market the products using the Shampoo trademark. When planning the appropriate transfer price for the license, Shampoo officials started with the knowledge that one of their competitors, Condition Corp., licensed a line of hair-care products to an unrelated party in country Z, Lotions, Inc.

The Condition license covers the formulas for all of Condition's hair-care products as well as the Condition trademark. The license gives Lotions the right to manufacture, distribute, and market the licensed products. Terms include an exclusive license in country Z for a term of four years paying a royalty of four percent of the net selling price. The licensor agrees to provide the licensee with product formulations, scientific data, manufacturing know-how, marketing, public relations, and related assistance. The licensee must adhere to strict quality control standards in manufacturing, distribution, and marketing. The licensor has the right to inspect operations of the licensee to verify such quality. The licensee is prohibited from manufacturing, importing, or marketing competing products in country Z.

From the terms of the agreement it is clear that Lotions performs the same functions that Shampoo's subsidiary in country Z will perform. It is also clear that Condition provides the same type of services and quality control for Lotion's operations that Shampoo will provide for its subsidiary in country Z. It is anticipated that Shampoo's subsidiary will have a volume of sales similar to Lotion's once its operations are fully developed. Finally, Shampoo knows that the gross margin, (net sales - cost of sales)/net sales, on sales of Shampoo's products in the United States is similar to the gross margin achieved by Condition in the United States, which indicates that their manufacturing processes and sales activities have comparable efficiencies. Therefore, it is appropriate for Shampoo to set a royalty rate of four percent of the net selling price for a four year term.

Example 4: Likely Use of Inexact Comparables

Computers Inc., a U.S. software company that specializes in games, plans to acquire the rights to manufacture, market, and distribute a new computer game, Gizmo, created by its European subsidiary. Gizmo will be an addition to Computers' existing line of games. Computers Inc. projects that the total number of Gizmo copies distributed will be close to the industry average. Numerous third party licenses for computer software are available. Computers examines these licenses for appropriate inexact comparables and should be able to determine the appropriate royalty amount and other terms for its agreement with its affiliate from the third party agreements.

Example 5: Basic Arm's Length Return Method: U.S. Importer and Distributor

TravelFun is a large publicly traded foreign corporation with a U.S. subsidiary, TravelUS. TravelFun produces a unique recreational product using sophisticated and highly sought-after production technology. TravelUS imports the assembled product and distributes it under the Travel name. TravelUS has the exclusive right to develop the Travel name in the United States. Because of the importance of the intangibles, TravelUS must apply the rules governing the transfer of intangible property.

TravelFun does not license the Travel name to unrelated parties, nor does it allow unrelated parties to distribute the product. Therefore, no exact comparables are available. Similar products exist that could potentially serve as inexact comparables; however, none of them are sold to unrelated distributors. Therefcre, when TravelFun sets up its policy for transfer prices of units sold into the United States for 1989 it uses the rate of return method. In order to apply the method properly, the following information is necessary: 1) a general description of the functions that TravelUS performs, 2) financial information on companies performing similar functions, and 3) analyses of appropriate rates of return.

1) Functions of TravelUS. TravelUS imports the product from TravelFun and distributes it to retailers. TravelUS is

responsible for developing the marketing strategy in the United States.

2) Companies performing similar functions. Initially, TravelFun seeks data about publicly traded independent operators of wholesale distribution businesses. A search of the appropriate SIC categories yields a number of companies that differ in the following ways: 1) some are importers, while others acquire their products in the United States; 2) some are distributors of final products, while others distribute parts; and, 3) some apply intensive marketing, while others do not. Examination of these firms' published financial information indicates that the sample should be narrowed to 16 firms in order to reflect more clearly the functions performed by TravelUS. TravelUS is an importer that distributes final products and performs an important marketing function. Each firm in the final sample has some combination of these characteristics. Balance sheet and income data are then collected for the sample of 16 companies.

3) Analysis of appropriate rates of return. The company evaluates the available information in order to determine the appropriate ratios on which to base its comparisons. Comparable asset data are not available for all firms in the sample. Therefore, an attempt must be made to determine a rate of return for TravelUS based on available cost data for the sample of firms. A number of ratios can be considered as a means of determining an appropriate return on costs. Possibilities include the ratio of gross profit to operating expenses (the Berry ratio), the ratio of operating income to the cost of sales and operating expenses, and the ratio of net pre-tax income to total expenses. The choice of the appropriate ratio will depend on the composition of the sample and the stability of the ratios over time.

For the sample of 16 companies, all of the ratios lead to similar results. TravelUS retains the information that supports this claim, but upon examination presents only the analysis using the Berry ratio. As defined above, the Berry Ratio is the ratio of gross profit to operating expense:

$$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Operating Expenses}}.$$

Net sales are total revenue from sales less cash discounts to customers for payment within a specified time. Cost of sales is also referred to as cost of goods sold, including freight charges. Operating expenses include selling expenses such as sales salaries and commissions, advertising and marketing expenses, depreciation expenses, supplies, office salaries, and payroll taxes. The major expense not included in either cost of goods sold or operating expenses is interest expense.

For the 16 firms in the sample the average Berry Ratio is 1.40 with a standard deviation of .15. (The minimum ratio was 1.17 and the maximum was 1.61.) TravelUS uses the average ratio, 1.40, in order to determine the payment that should be made to the parent. Additional information that will be necessary includes net sales, operating expenses, and cost of sales that are not included in the payment to the parent for the product.

TravelUS projects sales of 20,000 units, net sales revenue for 1989 of $100 million, and operating expenses of $30 million. Cost of Sales are projected to be $2 million plus transfer payments to TravelFun. Plugging this information into the equation for the Berry ratio yields:

$$1.40 = \frac{\$100 \text{ mil.} - [\$2 \text{ mil} + 20{,}000 \text{ x }]}{\$30 \text{ mil}}$$

Therefore, x, the transfer price paid for each unit, is $2800. TravelUS will pay TravelFun $2800 per unit of import and projects that it will pay TravelFun a total of $56 million in 1989.

<u>Example 6: Basic Arm's Length Return Method: Foreign Subsidiary Serving Local Market</u>

Counter Inc., a U.S. corporation that specializes in over-the-counter drugs, plans to set up a subsidiary in country X. The subsidiary will manufacture, distribute, and market Counter's products in country Z. The manufacturing process is not particularly complex. The subsidiary will set up its own distribution network, which will be of average size for the industry. Further, it will perform its own marketing; however, because the subsidiary will, in general, sell "generic" products that will sell under its customers' brand names and trademarks, its marketing activities will involve contacting drug stores and other selling concerns, and not the development of a unique, consumer-level marketing intangible.

Counter's search for unrelated party licenses for comparable products proves fruitless. The search does yield a number of licenses in which the functions performed by each party are similar. The products are not similar enough to over-the-counter drugs to be classified as inexact comparables; however, the level of manufacturing, the type of distribution network, and the type of marketing performed in each case are similar. Therefore, Counter searches for information about the returns earned by each of these companies. Analysis of the income statements and balance sheets of the firms in the sample yields an average rate of return earned. This average can be used by Counter to determine the royalty rate to be paid by its subsidiary in country Z.

Example 7: Basic Arm's Length Return Method: Foreign Subsidiary Producing for U.S. Market

A U.S. corporation has developed and patented the formula for a new heart drug that has fewer potential side effects than any drug in existence. The U.S. corporation plans to manufacture the drug in a foreign subsidiary to be located in country Y, which has very low labor costs. The completed product will be returned to the parent for sale in the United States. In addition, some of the manufactured drug will be shipped from the manufacturing subsidiary to a marketing subsidiary in country X for sale in Europe. The parent wishes to fashion the transaction so that a royalty will be paid by the subsidiary to the parent for the right to manufacture and sell the drug. The parent and the subsidiary in X will then pay the manufacturing subsidiary for the finished product.

The following information is known or projected:

1. The drug will sell for $2.00 per pill.

2. The volume of sales in the United States in 1989 will be approximately 900 million pills.

3. The volume of sales in Europe in 1989 will be approximately 600 million pills.

4. Marketing and distribution costs in the United States are estimated to be $14.4 million.

5. Marketing and distribution costs incurred by the country X subsidiary are estimated to be $9.6 million.

6. The manufacturing subsidiary's costs will be as follows:

Cost of Chemicals	$110 million
Operating Expenses	$ 75 million
License Payments	To be determined
All Other Expenses	$ 5 million

7. The manufacturing subsidiary will have the following assets:

Cash	$ 12 million
Factory	$360 million

8. The manufacturing subsidiary will have the following income:

Interest Income	$ 1 million
Revenue from Sale of Drug	To be determined

There are no transfers by unrelated parties that would provide an inexact comparable for either the license the parent grants to the manufacturing subsidiary or for the pill that is sold to the parent and to the marketing subsidiary. There are other companies that perform similar marketing and manufacturing functions. The difficult piece to measure is the value of the patent which is held by the parent. Therefore, the parent turns to the arm's length return method as the appropriate method. The parent will find proper rates of return for the manufacturing and marketing segments of production and allocate to itself the residual profits.

A sample of manufacturers in locations with low labor costs shows that manufacturers earn an average rate of return on their manufacturing assets of 12 percent. The subsidiary's total manufacturing assets, the factory, cost $360 million. Prices should be structured so that the manufacturing subsidiary earns profits of $44.2 million ($43.2 million return on the factory asset plus the known $1 million return on cash).

If all of the drug were resold to the parent, the split between the cost of the final pill and the license payment would be unimportant as long as the correct amount of income remained allocated to the subsidiary. However, in this case the final product is also being sold to the subsidiary in country X, so the correct split is important.

Information on marketers and distributors of drugs shows that they earn approximately cost plus 25 percent, both in the United States and in country X. Based on the costs outlined above, the parent should earn net income of $3.6 million on its distribution and marketing activities, and the Country X subsidiary should earn net income of $2.4 million. Revenue from the sale of the heart drug will be approximately $1800 million in the United States and $1200 million in Europe. Therefore, the manufacturing subsidiary should charge $1.98 per pill.

Total revenue received by the manufacturing subsidiary will be $2971 million ($2970 million from sales and $1 million from interest income.) The royalty to be paid to the parent will be a percentage of the net sale price of $1.98. The correct royalty rate, r, can be determined by the following equation, which shows the manufacturing subsidiaries revenues and costs:

Net Income = Total Revenue - Cost of Chemicals
($44.2 mil.) ($2971 mil.) ($110 mil.)

- Operating Expenses - Other Expenses
($75 mil.) ($5 mil.)

- Royalties Paid
[(1500 mil.)($1.98)r]

Solving for r shows that r equals .921.

Therefore, the appropriate royalty rate is 92.1 percent of the net selling price of $1.98.

Example 8: Likely Use of Basic Arm's Length Return Method

A U.S. company manufactures electronic equipment for sale in the United States. The U.S. company designs the equipment and licenses the designs to its foreign subsidiary. The subsidiary assembles the circuit boards and other components for the products and sells them to the parent. For transfer pricing purposes, the parent searches for the rate of return earned by independent computer assembly operations in order to determine the amount of income that should be attributed to its foreign subsidiary.

Example 9: Likely Use of Either Inexact Comparables or Basic Arm's Length Return Method

A U.S. company manufactures and markets a line of sportswear. The company plans to introduce the same line of clothing to Europe through its European subsidiary. The subsidiary will manufacture, market, and distribute the casual wear using the parent's trademark. The clothing is marketed toward middle income consumers and is projected to sell at prices and earn a market share similar to several other brands which are marketed to this group. The parent has two options when setting its transfer pricing policy. If unrelated party licenses of trademarks for clothing can be located, then these inexact comparables can be used to establish appropriate terms for the license agreement. If information is available on the returns earned by unrelated parties that perform functions similar to the European subsidiary, then the rate of return method can be employed.

Example 10: Profit Split Method using Split Observed in Arm's Length Transaction

ABC is a U.S. corporation that produces advanced machine tools. It maintains a large artificial intelligence research lab, which has made significant advances in computer vision. Recently, this work has begun to yield marketable products.

Specifically, ABC has developed a "sighted" numerically controlled machine tool (NCMT) that can be programmed to recognize the pieces on which it should perform its fabrication tasks. ABC expects this new device to be a significant advance over competing NCMTs because the pieces will not have to be precisely aligned before the fabrication operations can be performed; therefore, the "sighted NCMT" should be much easier to operate and integrate into an assembly line. The key element in this advance is the software that allows the NCMT to determine the precise position and orientation of a piece placed on its operating deck. ABC has obtained worldwide patent protection for this software. As is true of most of ABC's products, the device must be substantially modified for each customer's specific application, and ABC maintains a large and expert engineering staff to accomplish this.

ABC projects that devices based on the new technology will eventually become an important source of revenues and profits for the company. During the first three to five years, ABC expects to have no significant competitors, and plans to market the devices to the high price, high mark-up, low volume, most technologically advanced segment of the NCMT market. After that period, as the technology becomes more common, ABC expects that sighted NCMTs will, in general, replace other types of NCMTs and that its lead will enable it to capture a significant share, perhaps 50 percent or more, of the overall NCMT market.

ABC-Europe is a wholly owned subsidiary of ABC incorporated in country X. All of ABC's products currently sold in Europe are produced and marketed by this company. ABC-Europe maintains its own research and engineering staffs and manufactures all of the devices it sells. A majority of the products in its line involve technology licensed from ABC, but a significant fraction depend on technology developed through its own research efforts. ABC-Europe performs all of the marketing for Europe, and its engineering staff performs the necessary development work of the devices for each customer.

ABC plans to transfer the European rights to exploit the software and associated technology for sighted NCMTs to ABC-Europe. ABC has no plans to license the technology to an unrelated party; therefore, no exact comparable is available. ABC has conducted a search for inexact comparables; although the search does turn up unrelated party transactions involving licenses of machine tool devices and patents, ABC has concluded that none of them can meet the standards for the inexact comparable method. Specifically, none of the potential comparables are for devices which involve profit margins as high as the sighted NCMTs will have in the short run, nor market shares as large as ABC anticipates having in the long run.

ABC next considers the basic arm's length return method. It concludes that ABC-Europe's activities in exploiting the sighted NCMT technology can be split into four functions: (a) conducting research to search for uses in the European market, (b) marketing the devices, including participating in trade shows, conducting demonstrations, and providing technical assistance (mass-market retail-level advertising is not necessary in this industry), (c) designing the specific devices to meet the requirements of each customer's application, and (d) manufacturing and distributing the devices.

ABC concludes that some but not all of these functions can be analyzed under the basic arm's length return method. Once each customer's design has been set, manufacture of the devices will not be much more complicated than current NCMTs, and ABC is familiar with firms that manufacture current-generation NCMTs according to others' designs. Therefore, ABC concludes that function (d) can be analyzed in this way; specifically, it concludes that a rate of return to operating assets of 16 percent is the average for firms that perform this function. Marketing is not a major activity in this industry, because the customers are extremely knowledgeable. ABC deals with firms that perform marketing functions for it; based on its knowledge of these firms, ABC concludes that a 20 percent ratio of income to costs is a reasonable way to value the contribution of function (b).

Functions (a) and (c), however, cannot be analyzed in this way. ABC-Europe's staff of scientists and engineers, while smaller than ABC's, is still one of the largest and most expert in Europe. ABC knows of no independent firm in the machine tool industry, in the United States or Europe, that would be able to conduct research, development, or design work as satisfactorily as or on a scale comparable to ABC-Europe. Therefore, ABC concludes that it would be inappropriate to value the contributions that ABC-Europe's performance of these functions will make toward selling sighted NCMTs in Europe by multiplying the assets employed by a rate of return, or multiplying the costs incurred by an income-to-costs ratio. In short, a profit-split approach is necessary.

Although ABC's search for comparables did not turn up appropriate licenses in the machine tool industry, other transactions between unrelated parties were found. For example, ABC obtained information about the following transaction: a group of professors, in partnership with their university, established a consortium to patent and exploit a process through which a new product can be produced by a genetic engineering technique. The consortium bargained at arm's length with several large chemical companies, and negotiated a licensing agreement with one of them. The licensee manufactures the product, tailors it to meet the specific needs of various groups of farmers, and markets it. The product has no significant competitors and has

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ABC next gathers information about the chemical company and the industry in which it operates. It is able to determine that the chemical company maintains a large staff of scientists and engineers which performs functions concerning the new product that are comparable to the research and development activities that ABC-Europe will perform. The chemical company undertakes significantly more marketing activities than will ABC-Europe, and the manufacturing process for the product is not comparable. Further, ABC is able to determine the following information: (a) the product sells for $27 per pound; (b) production costs are ten dollars per pound; (c) independent firms that produce chemicals using similar production techniques earn profits equal to 20 percent of costs; (d) marketing and distribution expenses are three dollars per pound, and (e) independent firms that perform similar marketing and distribution activities earn 33 percent of expenses.

This information allows ABC to determine the profit split between the basic technology contributed by the university consortium, on the one hand, and the research, development, and application activities and know-how contributed by the chemical company, on the other. Specifically, the latter's profit per pound, net of royalty and expenses, is seven dollars ($7 = $27 - $7 - $10 - $3). Of this amount, two dollars should be attributed to the manufacturing activity and one dollar to the marketing and distribution ($2 = $10 x 0.20, and $1 = $3 x 0.33). This leaves four dollars per unit as the return to the chemical company's know-how and skills as to R&D and application of technology to its customers' needs. The university's income is the seven dollars royalty. Therefore, the profit split is 64 percent (64 percent = 7 / (7 + 4)) for the licensor's basic technology and 36 percent (36 percent = 4 / (7 + 4)) for the intangibles employed by the licensee. (Note that the licensor and licensee each earn 50 percent of the total profits, since they each earn seven dollars per pound; however, 50 percent vs. 50 percent is not the relevant profit split for this situation, because it does not distinguish between the profits for the manufacturing and marketing functions.)

Finally, ABC is able to determine the proper arrangement for its license to ABC-Europe. There are many ways ABC could structure the arrangement. One would simply be to specify that ABC-Europe (a) determine gross profits from sales of sighted NCMTs (with gross profits defined as sales receipts minus manufacturing and marketing costs), (b) subtract 16 percent of the value of assets used in manufacturing the devices, (c) subtract 20 percent of the marketing costs, (d) subtract 36 percent of the remainder, and, finally, (e) remit the remaining amount to ABC as a royalty.

Alternatively, ABC could use additional information about ABC-Europe's future activities to set a more traditional licensing arrangement. ABC's projections for sales of sighted NCMTs in Europe during the first three years of operations include the following figures. The devices will sell, on average, for $100,000 each. Cost of production will be $56,000 and will require $50,000 of production assets per device. Marketing costs will be $5,000 per device. These projections imply that gross profits, defined as sales receipts minus manufacturing and marketing costs, equal $39,000 per machine. Of this amount, ABC-Europe should be allocated $8,000 for the manufacturing function and $1,000 for marketing ($8,000 = $50,000 x 0.16 and $1,000 = $5,000 x 0.20). Remaining profits are thus $30,000 per device. This amount should be split 64 percent to ABC and 36 percent to ABC-Europe; thus, ABC should be allocated $19,200 per device and ABC-Europe the remaining $10,800. A more traditional licensing arrangement, therefore, would require that ABC-Europe pay ABC a royalty equal to 19.2 percent of sales (19.2 percent = $19,200 / $100,000).

If ABC chooses the former type of arrangement, periodic adjustments to it are less likely to be necessary, because the allocation of income between ABC and its affiliate will automatically adjust to a large extent. ABC should reconsider periodically, however, whether the manufacturing rate of return to assets, the marketing income to cost ratio, and the profit split percentages are still appropriate. If ABC chooses the latter type of licensing arrangement, many more periodic adjustments to it will likely be necessary. Specifically, in addition to considering the preceding factors, ABC must determine if actual experiences depart from the projections enough to imply significant changes in the appropriate allocation of income. If so, ABC will have to recalculate the sales based royalty rate by substituting the relevant actual figures for the projections in the preceding paragraph.

Example 11: Profit Split Method Using Information about Relative Values of Preexisting Intangibles

Teachem is a U.S. corporation that designs, produces, and markets educational toys in the U.S. It maintains a staff of educational psychologists and engineers to develop and design the toys, which are perceived as uniquely high quality and sell at a premium. Enseignerem is a wholly owned affiliate of Teachem and is incorporated in country F. It is one of the largest toy companies in Europe. It was, and still is, the largest toy company in country F when it was acquired by Teachem a number of years ago. Enseignerem incurs large advertising and other marketing costs to develop its trademark and reputation as a producer of high quality educational toys. It is responsible for its own marketing strategies, which are different in important respects from Teachem's marketing efforts in the United States. For example, Enseignerem maintains a large sales force that calls on schools and other institutions, and institutional sales account for a much larger proportion of its revenues.

Teachem has recently developed a new line of electronic toys and intends to license the European rights to the designs to Enseignerem. Teachem does not plan to license them to any unrelated parties; therefore, an exact comparable is not available. Further, Teachem expects that Enseignerem will be able to capture its usual high market share, especially in the institutional market, and will be able to sell the toys for its usual significant premiums over its competitors. For these reasons, Teachem decides that suitable inexact comparables will probably not be available.

Teachem next considers the basic arm's length return method. Enseignerem will perform three functions with respect to the new line of toys. It will be responsible for manufacturing them; specifically, it will negotiate contracts and supervise independent contract manufacturers who will actually produce the toys. Second, it will distribute them. Third, Enseignerem will be responsible for all aspects of marketing them.

The first two functions can be analyzed under the basic arm's length return method. Teachem projects that the new toys will sell for $100 each in Europe. Payments to the contract manufacturers will be approximately $40 per toy. Enseignerem has found that distribution costs, including transportation and costs of holding inventories, are usually one-half of production costs, and expects that the new line will be typical in this regard. Therefore, Teachem projects that distribution costs will be $20 per toy. Finally, Enseignerem expects to incur costs of four dollars per toy relating to the supervision of the contract manufacturers. These costs include the salaries of engineers who will be assigned to visit and test the contractors, and premiums for liability insurance.

In some of its product lines, Enseignerem employs contract manufacturers who are willing to distribute, as well as produce, the items. By comparing these contracts with those calling for manufacturing only, Teachem concludes that the independent firms that perform distribution earn a return for it equal to 25 percent of the distribution costs. Teachem therefore allocates five dollars per toy to Enseignerem for the distribution function ($5 = $20 x 0.25). Teachem also decides that a 25 percent income-to-costs ratio is appropriate for the first function, responsibility for manufacturing. Thus, Teachem allocates one dollar per toy to the affiliate as the return for performing it ($1 = $4 x 0.25).

Teachem decides that the affiliate's final function, marketing, cannot be analyzed by the basic method. Enseignerem is not planning to incur any significant costs attributable solely to the new toys. In general, it focuses its advertising on promoting the Enseignerem reputation rather than displaying a single item, and does not plan to issue a separate catalog or set up a separate sales force for the new line. Therefore, Teachem decides that it is not possible to identify or measure the costs or assets that Enseignerem will devote to the new product line. However, it would clearly be wrong to conclude that Enseignerem deserves no return for the marketing function, because its preexisting reputation, sales force, and knowledge of its market are crucial to the success of the new product line in Europe. Therefore, a profit split is necessary.

To summarize the analysis to this point, the toys are projected to earn a gross profit of $36 each ($36 = $100 - $40 - $20 - $4). Of this amount, six dollars should be allocated to Enseignerem for the functions analyzed with the basic method. Thus, $30 per toy is left as the combined return to Teachem's product designs and Enseignerem's trademark, sales force, and other marketing intangibles. The next step is to split these profits in a way that reflects the relative economic values of these sets of intangibles.

Teachem concludes that the new line of toys is similar to other lines that the corporate group has introduced in the past few years in terms of the importance of the underlying design relative to marketing intangibles. Specifically, the designs involved a typical amount of research and development effort and the toys will be marketed in ways similar to, and with similar intensity as, other products. Teachem analyzes its own performance record and educational toy industry information on the relative importance of design and marketing intangibles therein. Based on a good faith analysis of this data, Teachem concludes that it is reasonable to assign a relative value of the design intangibles equal to one-half the value of marketing intangibles. Accordingly, it allocates ten dollars of the $30 to be split to itself and the remaining $20 to Enseignerem.

Teachem can structure the arrangement in any form that achieves the appropriate allocation of income, ten dollars per toy to the parent and $20 to Enseignerem. Specifically, it could establish an agreement in which Enseignerem pays Teachem a royalty for the European rights to the product designs at a rate of ten percent of sales. In future years, Teachem must reexamine its arrangement and, if any key element in the analysis described above changes significantly, must adjust the royalty rate accordingly.

Example 12: Likely Use Of Profit Split Method

The research staff of a European company that manufactures and markets food products has just created a chemical compound that will alter the way that the human digestive system reacts to sugar. The company believes that by adding the compound to its products, the products will pass through the human digestive system without being absorbed. The compound is unique because it leaves the taste of the product unchanged. No information is known about the possible side effects of this compound. The company wants to use this discovery to offer a whole line of diet products. The European company has a U.S. subsidiary that presently manufactures and markets existing products in the United States. The U.S. subsidiary also has a research staff. Because the prime market for this new product is the weight-conscious United States, the parent licenses the compound to the U.S. subsidiary for development and for the extensive and expensive testing that will be necessary in order to obtain approval from the Food and Drug Administration. Because the product is unique and because the subsidiary performs such complex functions, the profit split arm's length return method is probably most appropriate.

Example 13: Periodic Adjustments to Reflect Changes in Functions

A U.S. corporation produces and markets widgets in the United States and it has a subsidiary in country X that produces and markets widgets in Europe. The U.S. parent is in the early stages of developing a new super-widget. In 1988 it is clear that this could be a major breakthrough in widget technology; however, the manufacturing process is still cumbersome. It is unclear whether the process can be developed to the point that it would be possible to mass-produce the super-widget. The U.S. parent believes that the team of employees at its subsidiary in country X is best suited for the time-consuming and expensive job of developing the process to produce the super-widget.

In determining an appropriate transfer price for the license of the technology, the parent can find no inexact comparable for the super-widget. Similarly, the basic arm's length return method is not feasible because neither party is performing standardized functions. Therefore, the U.S. parent attempts a profit split analysis.

Based on the best information available in 1988, the U.S. corporation predicts that the development process should be completed by 1994. An increasing number of super-widgets will be produced between 1988 and 1994; however, only in 1994 will true assembly-line style production be feasible. Based on an analysis of the relative costs incurred by the parent and by the subsidiary, and on an analysis of the relative returns earned by unrelated parties when risky products are jointly developed, a 50-50 profit split on the returns of the design of the super-widget is adopted by the parent.

By the end of 1989, as the parent is filing its 1989 tax returns and is rechecking its transfer price policy for 1990, super-widgets are being successfully mass-produced at close to the volume predicted for 1994. Instead of requiring the extended development process predicted two years earlier, establishing production was more similar to the effort necessary when adjusting production lines for improved versions of products. Accordingly, the parent adjusts its transfer price policy to a basic arm's length return analysis for its subsidiary in country X. Specifically, the parent determines the average rate of return earned by independent companies that manufacture a product similar in complexity to super-widgets. Because the parent is particularly cautious and feels it would be difficult to sustain its profit split for 1989, it also modifies the 1989 policy to a rate of return analysis. While at the outset of this transaction it appeared that the subsidiary in country X would be required to use significant intangibles of its own to establish the production process, the actual experience of the parties was that no unique intangibles were contributed by the subsidiary. The decrease of five years in the time expected to develop production to the 1994 level constitutes a significant change that requires an adjustment.

<u>Example 14: Periodic Adjustments to Reflect Changes in Indicators of Profitability</u>

A U.S. pharmaceutical company has patented the formula for a new anti-arthritic drug with fewer side effects that those in existence. The U.S. parent's subsidiary in country Y will manufacture the drug and market it worldwide. There are numerous third party licenses for the existing anti-arthritic drugs. The parent decides that these products are comparable because it feels that its product will be a close competitor to them, and will sell for a similar price and capture a similar market share. Specifically, it believes that its drug will capture approximately 15 percent of the market, as do several of the existing products. The parent uses the eight percent royalty on net selling price that is found in those licenses and adopts other significant features of such licenses as well. For example, the length of the agreement is for the length of the patent.

The U.S. parent reviews its license with the subsidiary at the start of year two and finds that its drug has only an eight percent market share. However, the market share seems to be continuing to grow. Indeed, at the beginning of year three its market share is 16 percent and at the beginning of year four its market share is 21 percent. In each of these years the U.S. parent decides that the inexact comparable is still appropriate.

By the end of year four the popularity of this drug has skyrocketed and it captures 50 percent of the market. Since this share of the market is far beyond that captured by any of the third party licenses, it can no longer be assumed that the level of overall profitability for the product licensed to the related party is similar to that for the products licensed to unrelated parties. Specifically, to the extent that market share is an indication of the mark-up that can be charged on a product, the related party product, which captures 50 percent of the market, is probably much more profitable than products that capture only 15 percent of the market. Therefore, the present inexact comparables are no longer valid. A search for other inexact comparables fails to produce a license involving a similar market share. Therefore, the parent turns to a basic arm's length return analysis to determine what its subsidiary should earn.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 20, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,018 million of 52-week bills to be issued October 27, 1988, and to mature October 26, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.54%	8.11%	92.376
High -	7.57%	8.15%	92.346
Average -	7.57%	8.15%	92.346

Tenders at the high discount rate were allotted 81%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 14,655	$ 14,655
New York	24,154,200	7,747,650
Philadelphia	11,990	10,990
Cleveland	18,840	18,840
Richmond	49,545	49,535
Atlanta	17,190	17,000
Chicago	1,082,325	345,645
St. Louis	19,020	16,830
Minneapolis	10,745	9,795
Kansas City	19,740	19,740
Dallas	22,485	12,485
San Francisco	1,932,930	600,930
Treasury	153,520	153,520
TOTALS	$27,507,185	$9,017,615
Type		
Competitive	$24,750,150	$6,260,580
Noncompetitive	442,035	442,035
Subtotal, Public	$25,192,185	$6,702,615
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	15,000	15,000
TOTALS	$27,507,185	$9,017,615

An additional$537,700 thousand of the bills will be issued to foreign official institutions for new cash.

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TREASURY NEWS

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

October 21, 1988

Edith E. Holiday
Assistant Secretary of the Treasury
(Public Affairs and Public Liaison) and
Counselor to the Secretary

Edith (Ede) E. Holiday was confirmed by the United States Senate as Assistant Secretary of the Treasury for Public Affairs and Public Liaison on October 19, 1988 and was sworn into office by Secretary Nicholas F. Brady on October 20, 1988. President Reagan had nominated Ms. Holiday for this position earlier this month. Ms. Holiday will also continue to serve as Counselor to the Secretary, a role she assumed after joining the Department of the Treasury in September 1988.

Prior to joining the Department, Ms. Holiday was Chief Counsel and National Financial and Operations Director for the Bush/Quayle 88 Presidential Campaign. Previously she served as Director of Operations for George Bush for President and Special Counsel for the Fund for America's Future.

In 1984 and 1985, Ms. Holiday was Executive Director for the President's Commission on Executive, Legislative and Judicial Salaries. She practiced law with the firm of Dow Lohnes & Albertson in 1983 and 1984 and with the firm of Reed Smith Shaw & McClay from 1977 to 1983. Ms. Holiday also served as Legislative Director for then U.S. Senator Nicholas F. Brady.

Ms. Holiday was graduated from the University of Florida (B.S., 1974; J.D., 1977). Born in Middletown, Ohio, she resides in Atlanta, Georgia and is married to Terrence B. Adamson. She is the daughter of Mr. and Mrs. Harry Holiday, Jr., formerly of Middletown, Ohio, currently of Delray Beach, Florida and Highlands, North Carolina.

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TREASURY NEWS

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

EMBARGOED FOR RELEASE
AT 4:00 P.M. EDT
OCTOBER 24, 1988

October 24, 1988

CONTACT: Bob Levine
566-2041

Treasury Department Report to the Congress on International Economic and Exchange Rate Policy

The Treasury Department issued today a report to the Congress on exchange rates and international economic policy pursuant to the 1988 Omnibus Trade and Competitiveness Act.

The report provides the Congress with an assessment of the impact of exchange rate changes and international economic policies on the U.S. and world economies. The report analyzes the underlying causes of exchange market trends and the effects on the U.S. economy and external position. It also describes multilateral efforts to improve the coordination of economic policies among the major industrial countries and considers the exchange rate policies of certain countries with large external surpluses.

The report concludes that the world economy is on a solid footing which provides the foundation for continued growth with low inflation and a more stable international monetary system. An improved level and pattern of growth among the major industrial countries and the effects of past exchange rate changes are producing more appropriate and sustainable trade balances among the major industrial countries. In particular, a substantial reduction in the U.S. trade deficit is occurring (amounting to about $30 billion in 1988) and further improvements are expected. The significant strengthening of the U.S. competitive position and more rapidly growing foreign markets is resulting in sharply higher U.S. net exports which is serving as an important stimulus for continued growth of the economy.

In its consideration of exchange rate policies, the report concludes that Korea and Taiwan have been pursuing exchange rate policies which prevent effective balance of payments adjustment and provide an unfair competitive advantage. As provided in the trade legislation, the United States is initiating negotiations with both countries on an expedited basis to ensure that the exchange rates for their currencies are adjusted regularly and promptly.

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DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

October 15, 1988

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PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains comprehensive reporting requirements designed to provide the Congress with information to assess the impact of exchange rates and international economic policies on the domestic economy. The impetus for this report reflected widespread dissatisfaction with the large swings in exchange rates and the emergence of substantial external imbalances. It also reflected a desire on the part of the Congress to increase the accountability of the Executive Branch for the impact of international economic and exchange rate policies on the economy.

The report is to include, inter alia, an analysis of currency market developments, an evaluation of the economic factors underlying exchange market conditions, a description of currency intervention or other official actions to affect exchange rates, and an assessment of the effects of exchange rate changes on the U.S. economy and external position. The report is to describe also the results of negotiations to improve the coordination of economic policies among the major industrial countries and to deal with countries that are manipulating exchange rates within the meaning of the legislation to obtain an unfair competitive advantage. Finally, the report is to describe key issues in recent IMF consultations on U.S. economic policies and provide recommendations for changes in U.S. policies to attain a more appropriate and sustainable external position.

This is the initial report submitted to the Congress pursuant to these provisions. Part II provides a description of the economic policy coordination process developed by the major industrial countries to address concerns with the operation of the international monetary system. Part III examines global economic performance in recent years as the basis for understanding developments in the foreign exchange markets and the measures necessary to achieve improved global growth, reduced external imbalances and greater currency stability. Part IV analyzes recent exchange market developments, including the dollar's movement in terms of the currencies of major U.S. trading partners, and U.S. foreign exchange market intervention. Part V reviews U.S. economic and balance of payments developments, including the net investment position and international capital flows of the United States, and provides an assessment of the impact of exchange rate changes on U.S. competitiveness, the external sector and the economy in general. Part VI highlights key domestic and international economic policy issues for the United States.

PART II: DEVELOPMENT OF THE ECONOMIC POLICY COORDINATION PROCESS

Overview

Major structural changes in the world economy have intensified the need for more consistent and compatible policies and performance among the major industrial countries. In particular, the globalization of financial markets has reduced substantially the independence that domestic policy-makers had anticipated they would enjoy under flexible exchange rates as wide currency swings involved unacceptable economic and social costs. The liberalization of international trade and investment and the development of global integrated production facilities have increased substantially the importance of the external sector for all countries. Also, the greater balance in economic size among the major countries requires that effective external adjustment be a shared responsibility of a number of countries. No single nation, whether it be in surplus or deficit, can be expected to undertake a disproportionate share of the adjustment role.

Against this background, the major industrial countries have developed a process for coordinating economic policies for the purpose of achieving sustained global growth with low inflation, reduced external imbalances, and greater stability of exchange rates. This process, which reflects a major U.S. initiative, has been developed gradually over the last few years.

From Plaza to Berlin

The 1985 Plaza Agreement represented the first major step in the coordination process. At the Plaza Hotel meeting in New York, the G-5 (United States, Japan, Germany, France, and United Kingdom) agreed on the direction national economic policies and exchange rates should take to facilitate growth and external adjustment. More fundamentally, the Plaza Agreement represented a new commitment by the major industrial countries to work together more intensively to encourage global economic prosperity, and thereby to enable each country to better achieve its own domestic objectives.

The Plaza Agreement fostered an orderly exchange rate realignment and new policy undertakings consistent with balance of payments adjustment requirements, including a gradual and substantial depreciation of the dollar to improve U.S. competitiveness and measures to achieve better balance in global growth. The success of the Plaza Agreement provided momentum for further efforts to coordinate economic policies.

At the 1986 Tokyo Summit, a framework for multilateral surveillance of the economies of the major industrial countries, using economic indicators, was developed. The Tokyo Summit also formed the G-7 (G-5 countries plus Canada and Italy) in order to bring to bear the political leadership of the Heads of State or Government to the coordination process.

At the 1987 Venice Summit, the G-7 refined the economic policy coordination process. In particular, they agreed to:

- o Use short-term performance indicators to review and assess current economic trends;
- o Develop medium-term objectives and projections for each country and for the group as a whole that are mutually consistent both individually and collectively; and
- o Consider the consistency of short-term performance with the medium-term objectives and to determine whether there are significant deviations from an intended course that require remedial actions.

The February 1987 Louvre Accord and the G-7 Statement of December 22, 1987, represented important milestones in implementing the strengthened coordination process. At the Louvre, the G-7 agreed on new undertakings to improve the prospects for global growth and adopted specific understandings and cooperative arrangements to reflect their view that their currencies were then within ranges broadly consistent with economic fundamentals and policy intentions.

The December 22, 1987 G-7 Statement demonstrated the resilience of the coordination process in the face of the October stock market crash. In the period following the crash, the major industrial countries coordinated reductions in interest rates and fiscal measures to improve growth, including the two-year package of measures to reduce the U.S. budget deficit provided in the agreement between the President and the Congress. The G-7 reaffirmed the policy directions that they were pursuing and agreed to new arrangements for exchange market cooperation.

The 1988 Toronto Summit furthered the progress made in strengthening economic policy coordination, including the addition of a commodity-price indicator. This indicator -- consisting of a basket of a wide range of commodities including, inter alia, gold and oil -- supplements existing national indicators in assessing and reaching judgments about economic policies and performance. It is to be used as an additional analytical tool in examining global price trends, not as an automatic trigger for policy action or an anchor for currencies.

Furthermore, it was decided to broaden the coordination process to include structural policies as a complement to macroeconomic measures. This reflected a growing recognition that the removal of structural impediments to growth and adjustment would improve the effectiveness of fiscal, monetary and exchange rate policies.

The coordination process is now firmly in place and functioning. At the 1988 IMF/World Bank Annual Meetings in Berlin, the G-7 met to review the recent performance and prospects for their economies based on the short-term performance indicators and medium-term objectives and projections developed under the economic policy coordination process. They noted that the policies and commitments that their countries have undertaken are producing the desired results in terms of sustaining growth and reducing external imbalances. Furthermore, they agreed that though little inflationary pressure was evident, continued vigilance is necessary and recent monetary policy measures have demonstrated the will to contain price pressures. Finally, they reiterated their commitment to pursue policies that will maintain exchange rate stability and to continue to cooperate closely on exchange markets.

Where We Stand

The successful implementation of the economic policy coordination process has allowed the major countries to put into place a comprehensive approach to improve consistency and compatibility of their economic policies and achieve a more sustainable pattern of current account balances and exchange rates. A regular dialogue now occurs at the political level on key economic issues by the major industrial countries. Greater discipline and rigor is achieved through efforts to establish mutually consistent medium-term objectives and projections for each country and the group as a whole. Indicators are used to assess whether current performance is compatible with the agreed objectives and projections and to determine whether there is a need to consider possible remedial actions.

The improvement in global economic performance and prospects -- discussed at length in the following section -- is in large measure attributable to the successes in strengthening coordination. In particular:

- Surplus and deficit countries are implementing policies to sustain growth and reduce external imbalances.

  - In the United States, domestic demand is now growing more slowly than output, thus releasing resources for the external sector. The budget deficit is also declining and, as a share of GNP, has been reduced from a peak of 6.3 percent in Fiscal Year 1983 to slightly over 3 percent at present.

  - Japan and Germany have adopted important policy measures to promote strengthened domestic demand and reduced reliance on export-led growth. Japan, for example, adopted a major domestic stimulus package in 1987. Germany, for its part, has initiated an important round of tax reforms and advanced to 1988 a significant portion of the tax cuts planned for 1990.

- The G-7 monetary authorities are cooperating closely and have undertaken coordinated actions to assure that sound growth and low inflation will continue.

- A substantial and sustained adjustment of external imbalances is occurring which is producing a more appropriate pattern of trade and current account positions.

- The major countries have intensified their cooperation on exchange markets, based on specific understandings and shared commitments.

- Protectionist pressures have been firmly resisted.

<u>Next Steps</u>

The coordination process is continuing to evolve and more remains to be done to improve its functioning. The G-7 are committed to making the process work and to strengthen it further. They believe that the gradual step-by-step evolution of the economic policy coordination process represents the most realistic and practical path towards improving the functioning of the international monetary system.

- 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 towards 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 trade and payments arrangements that will produce an open and growing world economy. This involves appropriate fiscal, monetary and structural policies as well as exchange rates. The indicator system that has been developed covers this full range of policies.

- Third, the system can encourage corrective policy actions through the use of indicators and peer pressure.

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

- Fifth, the coordination and indicator process provides 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.

- Finally, the process is credible. In today's era of global economic integration and instant communications, credibility is critical. 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. In addition, such an approach might not give adequate regard to political realities or to the force and speed with which financial flows now move.

PART III: WORLD ECONOMIC PERFORMANCE AND OUTLOOK

Industrial Country Economic Developments and Prospects

o Overview

Any assessment of the performance of currency markets must start with an analysis of macroeconomic developments in the major countries. The industrial countries have turned in an impressively steady economic performance over the past 18 months, and recent developments give good reason to expect the current expansion to continue at least into 1990. Average real GNP growth of the seven largest economies (G-7) strengthened appreciably in 1987 and, contrary to the expectations of many observers in the wake of last October's stock market crash, will be even stronger this year.

Moreover, a welcome shift is underway in the pattern of growth among the major economies, providing essential support for ongoing efforts to reduce large current account imbalances. In surplus countries, domestic demand growth is exceeding GNP growth, while in the United States, domestic demand growth is below GNP growth. These efforts are bearing fruit: the U.S. trade and current account deficits are on a clear downward trend in both real and nominal terms; the Japanese and German external surpluses have also peaked and, like the U.S. deficit, are dropping as a share of GNP.

While average inflation rates have risen somewhat over the past year, they have done so from exceptionally low levels. The available evidence suggests that inflation will remain modest and contained. Overall, the industrial economies appear to be on a path of balanced, sustainable growth characterized by moderate inflation, expanding trade flows and reduced external imbalances.

o Economic Expansion Continues

The economic expansion that got underway in the industrial countries in 1983 has continued, and indeed strengthened, since early 1987. Aggregate real GNP growth accelerated during the second half of 1987. Measured on a fourth quarter over fourth quarter basis, average real growth in the G-7 countries exceeded 4.5 percent in 1987. This remarkably strong year-end 1987 outturn both raised the overall G-7 growth rate for the year (to 3.4 percent vs. 2.7 percent in 1986) and imparted considerable growth momentum going into 1988.

This solid performance stands in striking contrast to the prevailing expectations of a sharp economic downturn in the wake of the October 1987 events. Fears of strongly negative wealth effects producing a serious contraction in consumer spending have not been confirmed by events in 1988, nor has there been any significant retrenchment of investment spending and intentions.

In fact, during the first half of 1988 aggregate private consumption in the G-7 countries has remained on a steady, moderate growth path, providing essential support for overall GNP growth as well as world trade. Business fixed investment in the seven largest economies has shown impressive strength and is on course this year to register its best growth rate since 1984.

Overall growth in the industrial economies has not only been more robust than widely anticipated, but substantially better balanced as well. Several points are worth highlighting in this regard.

Most importantly, the G-7's improved aggregate economic performance has been broadly shared, resulting in a much more evenly distributed and, therefore, more sustainable international growth pattern. The composition of growth in the key surplus and deficit economies has shifted significantly, providing decisive support for the international adjustment process.

In the United States, domestic demand growth has slowed, helping to reduce the rate of import absorption and to make productive capacity available to meet the substantially higher demand for U.S. exports. In fact, the U.S. economy was strongly export-driven in 1987, with the sharp, price-adjusted improvement in U.S. net exports pushing average GNP growth from 2.8 percent in 1986 to 3.4 percent in 1987 even though domestic demand growth dropped from 3.7 percent to 3.0 percent over the same period.

The counterpart to this more balanced growth picture in the United States is generally more balanced growth in the industrial countries with large external surpluses. This is especially so for Japan. Aided by stimulative fiscal and monetary policies and terms of trade gains, Japanese domestic demand growth has accelerated rapidly, outstripping overall real GNP growth since 1986 and replacing net exports as the driving force of growth. Last year, for example, Japanese domestic demand grew 5.1 percent, while real GNP growth was 4.2 percent. Key contributors to this stronger home-grown growth have been equipment investment and construction, along with private consumption.

Germany presents a qualitatively similar picture, though quantitatively its performance is less striking. As with Japan, domestic demand growth has been the source of overall economic growth since 1986, while the external side has been exerting a net contractionary impact; i.e., net exports have been declining in real terms. In 1987, domestic demand rose nearly 3.0 percent in real terms though the external drag held growth to only 1.8 percent. Tax reductions and terms of trade gains have contributed to the relatively stronger domestic demand, providing a welcome boost to private consumption growth and import absorption.

An important contributor to the generally better aggregate industrial country growth has been a pronounced pick-up recorded in business investment. Recent developments here are quite at variance with earlier speculation that the October 1987 market break would severely undermine business confidence and willingness to invest.

Since the second quarter of last year, business equipment investment in the United States has grown by over 16 percent. Solid, though not as vigorous, equipment investment growth has also been underway in both Germany and Japan, with both countries experiencing strong advances in the first two quarters of 1988. For the United States, this stronger investment trend promises, inter alia, expanded capacity to meet export demand without encountering production bottlenecks, while for the surplus countries it directly boosts domestic demand and enhances their prospects for durable, internally generated growth.

o Near-Term Growth Prospects

The growth momentum provided by last year's buoyant second half, coupled with favorable recent developments, virtually guarantees that overall real growth in the industrial countries will increase further in 1988. Many forecasters expect average G-7 growth of nearly 4.0 percent; this would be the best result since 1984, which was by far the strongest growth of the current expansion.

As importantly, the qualitative improvement in the industrial country growth picture -- its distribution across the key countries and its composition within them -- should persist. Specifically, domestic demand growth this year will again be relatively stronger than GNP growth in the key surplus countries. The most recent forecasts from the IMF indicate that in Japan, real domestic demand growth is expected to accelerate to about 7.5 percent versus real GNP growth of 5.5 to 6.0 percent; in Germany, domestic demand growth is forecast to remain at about 3.0 percent for 1988 while real GNP also expands in the 3.0 percent range. In contrast, GNP growth in the United States this year will again be led by exports and investment, rising 3.5 percent compared with domestic demand growth of 2.6 percent.

Among the G-7, Japan will again register the highest GNP growth rate for the year, due entirely to surging domestic demand. Indeed, propelled mainly by much higher investment and consumer spending growth, Japanese domestic demand this year should post by far its highest growth rate of the entire decade. As a result, import growth will strengthen further, and will substantially exceed export growth for the third consecutive year. This welcome outturn reflects the impact of past price and exchange rate developments coupled with deliberate policy steps.

GNP growth in the four major European economies (Germany, France, U.K., and Italy) is also expected to increase this year, producing an aggregate average rate of about 3.0 percent for the group. The pace of domestic demand will again outstrip GNP, though the gap between the two will likely narrow from 1987. Within the group, domestic demand growth is expected to be particularly buoyant in the U.K. and Italy. German domestic demand growth will remain the prime motor of overall growth in 1988. Canadian domestic demand growth will remain strong in 1988.

o Inflation: Still Moderate and Contained

Well into their sixth consecutive year of expansion, the G-7 countries have an average consumer price inflation rate that is substantially below its level when the upswing began in 1983. Indeed, last year's rate of 2.9 percent was less than half of what it was during the trough of the recession in 1982. This is in sharp contrast to earlier expansions, which were characterized by rising rather than falling inflation. Indeed, aggregate inflation rates have been, in the last two or three years, the lowest rates in 20 years. This is surely one of the salient economic achievements of the decade.

The exceptionally low inflation rates recorded in 1986 have given way over the past 18 months to somewhat higher, but still moderate rates. This in large part reflects the impact of a variety of special developments. In particular, oil and other commodity prices were generally firmer in 1987 after substantial declines in 1986. Thus, the domestic pass-through effects of lower commodity prices tended to diminish during the year.

In addition, past appreciation of many national currencies against the dollar tended to further reduce the domestic cost of imports, which heavily dampened inflation in those countries. In Japan and Germany, for example, inflation averaged 0.4 and zero percent, respectively, in 1986 and 1987. U.S. inflation was somewhat higher over the same period (averaging about 2.8 percent), mainly reflecting the import price pass-through of past exchange rate changes.

Thus far in 1988, inflation in the major industrial countries is running at an average rate of around 3 percent, or just slightly above last year's annual average. A number of key trends suggest persuasively that this moderate rate is likely to persist. The concerns of a significant inflation acceleration that have emerged periodically over the past year seem largely overdrawn and unsupported by actual developments. In particular, various price dampening factors (such as wage and monetary restraint and soft oil prices) appear to be providing an effective offset to potentially price boosting developments such as high capacity utilization in some sectors and past non-oil commodity price increases.

The major industrial countries must remain vigilant against inflation and be prepared to take prompt appropriate action if the situation deteriorates. But current developments provide a good measure of confidence that inflation is likely to be modest.

o Trade and Current Account Developments

Steady economic growth in the industrial countries has helped world trade volume expand at an average annual rate of about 5 percent since the recovery got underway in 1983. Latest available estimates indicate that trade volume growth strengthened to nearly 6.0 percent in 1987, both reflecting and underpinning the international adjustment process. In addition, trade growth accelerated further during the latter part of 1987, leading most forecasters to anticipate yet another increase in overall growth in 1988.

The industrial countries remained the major contributors to overall world trade growth, though trade by the non-oil developing countries expanded substantially. Aggregate industrial country import volume growth actually slowed from about 9.0 percent in 1986 to about 7.0 percent in 1987. However, this largely reflected shifts in the distribution of trade flows, shifts which themselves reflect the major international adjustment process that is presently underway.

In particular, import volume growth in the United States decelerated sharply in 1987 (from about 15 percent in 1986 to about 5 percent) while export volume growth surged from less than 3 percent in 1985 to nearly 12 percent last year. Continued moderate economic growth this year and past exchange rate changes are helping to prolong this trend; during the first half of 1988, exports grew at more than double the rate of import growth.

Developments elsewhere reflect the other side of the pronounced adjustment in the United States. For example, Japanese import volume growth has averaged nearly 10 percent annually over the past two years after averaging only about 1 percent during the previous six. Japanese export growth, on the other hand, was actually negative over the 1986-87 period after a series of large annual increases in previous years. The most recent data (for the second quarter of 1988) show a fairly sharp contraction in real exports of goods and services while imports rose nearly 5 percent relative to the first quarter.

In the other key surplus country, Germany, developments also confirm the ongoing adjustment process, though less dramatically. German export growth averaged about 2 percent in 1986-87 after 7.5 percent in 1984-85. On the import side, however, recent increases have been more limited -- from 4.7 percent growth in 1984-85 to just under 6.0 percent in 1986-87. Nevertheless, import volume growth has exceeded export volume growth since 1986. During the first quarter of this year, import volume accelerated strongly while export volume remained essentially unchanged.

These welcome shifts in trade flows have obviously been integral to the progress that has been made thus far in reducing the major industrial countries' large accumulated trade and current account imbalances. And this progress has been considerable.

This can perhaps be seen most clearly by focusing on national external imbalances expressed as a proportion of a country's GNP, which allows direct comparison and eliminates valuation problems created by exchange rate changes. The U.S. trade deficit has been cut from 3.4 percent of GNP in 1986 to a projected 2.6 percent this year; the U.S. current account deficit by this measure is projected to decline from 3.3 to 2.8 percent of GNP. Over the same period, Japan's trade surplus is expected to decline from 4.7 percent of GNP to 3.2 percent, and its current account surplus from 4.4 to 2.8 percent. Germany's current account surplus is estimated to narrow from 4.4 percent to 3.8 percent of GNP, though its trade surplus remains virtually unchanged in relation to GNP.

In terms of dollar values (as opposed to volume terms) the adjustment appears to be less substantial. This is due importantly to the impact of the large price and exchange rate shifts which tend to obscure the real underlying adjustment that has been occurring in both deficit and surplus countries. Sharp dollar depreciation between early 1985 and the end of 1987 tended to decrease the value of foreign country imports (which would widen a nominal surplus) while increasing the value of U.S. imports (which tends to boost our own deficit in nominal dollar terms).

This problem notwithstanding, however, progress is being made in nominal terms as well. As described more fully in Part V, the U.S. trade and current account deficits are projected to decline this year by $30 billion and $20 billion, respectively, with further improvements occurring next year. Japan's current account surplus should fall by around $5 billion this year and considerably more in 1989 as the effects of past exchange rate changes and strong domestic demand filter through. In nominal terms, Germany's current account surplus is widely forecast to be reduced next year.

Economic Situation of the Developing Nations

o Non-OPEC Developing Countries

While it is difficult to generalize about the diverse group of non-OPEC developing countries, there has been broad improvement in the major macroeconomic indicators for the group as a whole since 1982-83 when the international debt crisis emerged.

Growth performance for the group of non-oil developing countries has improved from the sharp deceleration experienced in the 1981-83 period. For the aggregate of 137 non-OPEC developing countries, growth in 1987 was on the order of 3-1/2 to 4 percent, down somewhat from the roughly 4-1/2 percent rate experienced in 1986, but still well above the 2 percent average rate of population increase. The 1986-87 growth performance compares favorably with the weak growth performance by the group in the 1982-83 period, when growth was on the order of only 1 to 2 percent a year.

The aggregate current account deficit for the group of non-oil developing countries has also strengthened compared to the high, and ultimately unsustainable, levels experienced in the early 1980s. In 1987, the aggregate current account deficit excluding official transfers for the non-OPEC developing countries is estimated to have improved to a level of roughly $20 billion, down from a 1986 current account deficit of just over $30 billion. The 1987 improvement is attributable to export volumes and receipts growing more rapidly than import payments. The current account deficits in 1986-87 represent a major improvement over the deficits of more than $80 billion per year recorded in the early 1980s.

Much of the improvement in 1987 was accounted for by the larger surpluses of Mexico, Korea, Brazil and Taiwan. The deficits of the poorer officially-financed developing countries increased in 1987 in line with increased official financing flows.

Inflation in 1987 remained steady for most non-OPEC LDCs. While average inflation for the entire group increased in 1987, this is largely attributable to the poor three-digit inflation performances of Argentina, Brazil, Mexico, Peru and Syria. Outside these countries, inflation was generally low (under 10 percent), steady or improving.

The estimated aggregate debt service ratio for the 24 major non-OPEC developing countries in 1987 implies some easing in the debt servicing burden on these countries relative to 1985-86. This improvement is attributable to higher export earnings, lower interest rates and debt reschedulings for Mexico (1985-86) and Argentina (1987). For a smaller group of heavily indebted countries (such as Argentina, Brazil, Chile, Colombia, Ivory Coast, Mexico, Morocco, Peru and the Philippines), the improvement in the debt service ratio was more modest.

The 1988 outlook for the aggregate of 137 non-OPEC LDCs is for continued positive real growth, an improving pattern of current account deficits, some improvement in the debt situation, and generally controlled inflation outside of a few major countries.

o Fifteen Heavily Indebted Countries

The fifteen heavily indebted developing countries have also made progress since 1982-83 in several key economic and financial areas. GDP growth in 1987 was about 2-1/2 percent, a significant improvement over the average 1-1/2 percent per annum decline experienced in 1982-83. Average GDP growth in 1985-86 was even higher, in the 3-1/2 to 4 percent range, as many of these debtors implemented stabilization programs which also reduced inflation rates considerably. The aggregate current account deficit improved substantially to about $9 billion in 1987 from the unsustainably high $50 billion levels in 1981 and 1982. The aggregate debt service ratio improved to under 40 percent in 1987, down from the 45 percent average for 1982-83, as a result of lower interest payments and recent debt relief operations.

The outlook for 1988 is for somewhat lower GDP growth for the group as a whole. However, this result is attributable to a decline in Brazilian growth from the 1987 level. Excluding Brazil, the aggregate growth of the other countries is expected to continue improving. The aggregate current account balance for the group as a whole is expected to remain steady as both export and imports grow in 1988. The debt service ratio is projected to rise somewhat as some of the large debtors settle debt service arrears which arose in 1987.

o Sub-Saharan Africa

For the group of Sub-Saharan African countries (excluding South Africa and Nigeria), GDP growth, while still relatively weak, is considerably improved in comparison with the early 1980s. In 1987, GDP growth for the group was about 2-1/2 percent, significantly higher than the average 1/2 percent growth experienced during 1982-83 and only slightly below the average 3 percent per annum growth during the 1970s. The group's aggregate current account deficit (excluding official transfers) improved significantly between 1981 and 1985 before increasing in 1986 and 1987, as official grants and loans rose sharply. The debt service ratio for the group was above 25 percent during the mid-1980s, but is expected to fall below that level in 1987.

The outlook for 1988 is for accelerated GDP growth to about 3-1/2 percent. Higher exports and increased official assistance flows are expected to allow continued import growth and some deterioration in the current account deficit.

o OPEC

For the OPEC countries, the aggregate current account balance, excluding official transfers, improved in 1987 to a $5 billion deficit, down sharply from a 1986 deficit in excess of $20 billion. Weak oil prices and the consequent sharp reduction in oil revenues in 1986-87 forced most OPEC countries to cut import levels, and created financial problems for several of the debtor OPEC countries outside the Persian Gulf. The current account deficit is expected to increase in 1988 as oil prices remain weak and imports rise.

Asian Newly Industrialized Economies (NIEs)

o Overview

In recent years, the four Asian NIEs (Korea, Taiwan, Hong Kong, and Singapore) have emerged as a significant force in the international trading system. Since 1970, their share of world exports has more than tripled to 7.4 percent. Moreover, most of these economies have accumulated external surpluses that are contributing significantly to global imbalances. In 1987, the current account surpluses of the NIEs amounted to $29.7 billion, accounting for 14.9 percent of the total global surplus. Taiwan and Korea especially enjoy large current account surpluses -- two to four times those of Japan and Germany as a proportion of GNP.

The United States is a major market for a wide variety of NIE exports and a significant share of the U.S. trade deficit reflects transactions with the NIEs. The U.S. trade deficit with the Asian NIEs increased tenfold from 1980 to 1987 to $34.8 billion, representing nearly a quarter of the total U.S. trade deficit. However, in the first 7 months of 1988, the deficit with the four declined somewhat, reflecting in part a significant decline in our deficit with Hong Kong.

The factors that are responsible for the growth of the Asian NIEs' external surpluses vary among the NIEs and generalizations are difficult. However, the hard work and initiative of their people and the ardent export orientation of these economies are certainly important elements. Production for export has also been pursued at the expense of domestic consumption and improved living standards within some of these economies. The expansion of the world trading system, and of the U.S. economy especially, has also been an important factor benefiting all of the NIEs.

Undervalued exchange rates have also been a major factor in the increase in the external surplus of the NIEs. In the cases of Taiwan and Korea, the undervaluation is the direct result of currency intervention by the central bank, capital controls, and administrative mechanisms aimed at preventing the exchange rate from reflecting market forces and achieving competitive gain. Among the four, where currency appreciation has occurred, it has tended to lag far behind that of other major U.S. trading partners such as Japan and Germany. Thus, some of their exchange rate policies have directly influenced, and frequently frustrated, multilateral efforts to reduce global imbalances.

Action by some of these economies to permit their currencies to move in line with market forces and the underlying strength of their economies is required to sustain the recent decline in the U.S. trade deficit and contribute to further global adjustment. Other policy changes, including structural reforms to give greater emphasis to domestic demand as a source of growth and, in the case of Korea and Taiwan, measures to liberalize their trade and capital flows restrictions, are also necessary.

Since mid-1986, we have conducted discussions with the four -- most intensively with Korea and Taiwan -- about these issues.

- Taiwan

The strength of Taiwan's economy, its small foreign debt, and its large external surpluses and international reserves point to the need for a stronger currency. However, Taiwan continues to prevent the necessary appreciation of its currency through intervention in the currency market, use of an undervalued basket of currencies to determine the exchange rate's value, and capital controls. High tariffs and other import controls continue to add to the problem, despite recent significant trade liberalization.

The New Taiwan (NT) dollar has been under a managed floating system with its daily value determined against the U.S. dollar based on interbank transaction rates. Taiwan authorities have also stated recently that the central bank is utilizing a basket of currencies as a guide to the management of the exchange rate. However, the weights of the component currencies are unknown and the basket was established using an undervalued base. In the past, the Central Bank of Taiwan has intervened heavily to prevent NT dollar appreciation. In addition, Taiwan maintains capital controls, particularly on inflows of foreign exchange, which facilitate its ability to prevent currency appreciation.

Taiwan has registered the greatest movement among the NIEs in terms of currency appreciation -- 25 percent since the start of the period of U.S. dollar appreciation in July 1980 and 40 percent since the Plaza Agreement in September 1985. However, the NT dollar's appreciation still lags significantly behind that of the yen and the German mark, which have strengthened by 92 percent and 60 percent, respectively, since Plaza. Despite periods of stability in 1987, the authorities moved the rate substantially. In 1988, the rate has not appreciated and in fact has actually depreciated by over 1 percent this year.

Taiwan's external position has been the most distorted of the four NIEs. In 1987, its global current account surplus was $18.1 billion or 18.5 percent of GNP, compared to 3.6 percent of GNP for Japan and 4 percent of GNP for Germany. In addition, its foreign exchange reserves climbed by 66 percent from 1986 to 1987 to $76.7 billion (28 months of imports). The overall trade surplus reached

$20.7 billion in 1987 and the bilateral surplus with the United States totalled $17.4 billion (18 percent of GNP). Due primarily to the appreciation of the NT dollar from late 1986 through 1987 and gold imports from the United States, Taiwan's bilateral trade surplus with the United States has fallen by 39 percent so far in 1988, but it is not a sustainable reduction. Gold purchases are a temporary phenomenon and cannot contribute to structural adjustment of bilateral imbalances. Indeed, purchases have now virtually ceased. Thus, excluding central bank gold purchases in the early part of the year, the decline in Taiwan's surplus with the United States is less than 16 percent. Now that both NT dollar appreciation and gold imports from the United States have stopped, the improvement in the imbalance has also stalled and as of April 1988, larger Taiwanese surpluses have begun to reemerge.

Taiwan's economy continues to be one of the world's best performers, which also suggests that the currency would be strengthening if market forces were given freer rein. In 1988, real GNP growth is likely to be 8.5 percent on top of 11 percent last year, while inflation remains very low.

Taiwan has made significant success in liberalizing its trade regime. However, it has not been sufficient to lead to a significant reduction in its external surpluses. Tariffs have been lowered substantially in successive rounds of tariff reductions, representing an important step forward. However, tariffs remain prohibitively high on many products, especially agricultural products. Also, market access for U.S. insurance companies and financial institutions and protection of intellectual property rights have improved.

Under Section 3004 of the legislation, the Secretary of the Treasury must "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." Within the meaning of the legislation, Taiwan is considered to be manipulating its exchange rate. Taiwan's underlying economic fundamentals strongly suggest that further appreciation would occur if capital and exchange restrictions were dismantled and market forces were given freer rein. Taiwan has a strong economy with a large global current account surplus, a large bilateral surplus with the United States, its foreign exchange reserves have risen sharply and yet its currency is depreciating. Pursuant to provisions of Section 3004, the United States intends to initiate bilateral negotiations with Taiwan on an expedited basis for the purpose of ensuring that Taiwan regularly and promptly adjusts the rate of exchange between the NT dollar and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair trade advantage.

o <u>Korea</u>

Korea's strong economic fundamentals -- 3 consecutive years of double digit real growth, large and growing external surpluses, substantial prepayment of external debt, and reserve accumulation -- also point to an undervalued exchange rate. The Korean authorities have used administrative arrangements and strict capital controls to perpetuate the undervaluation of their currency. As with Taiwan, numerous tariff and non-tariff barriers continue to restrict Korean imports and prevent a sizable shift in its external surpluses, despite recent progress on trade liberalization.

The value of the Korean won is established administratively by the Korean authorities based on an undisclosed basket of currencies of Korea's trading partners and on "policy variables," chiefly the balance of payments target. Tight restrictions on capital inflows coupled with severe monetary restraint and close control of the Korean financial sector, enhance the authorities' ability to control the exchange rate and limit exchange rate appreciation. Although the Korean won has appreciated 12 percent so far this year, appreciation since the Plaza Agreement in September 1985 amounts to only 26 percent, which is very modest compared with 40 percent for the NT dollar and 92 percent for the yen. The disparity in the period since 1980 is even greater. Accordingly, despite recent wage increases, the competitiveness of Korea's exports remains quite strong.

The strength of Korea's recent economic performance reflects in part the degree to which the undervaluation of its currency has strengthened its competitive advantage. Led by exports, which account for about 40 percent of GNP, real GNP expanded by about 25 percent in 1986 and 1987 combined. The current account, which had recorded steadily declining deficits since 1980, registered a surplus of $4.7 billion in 1986, which more than doubled in 1987 to nearly $10 billion, greatly exceeding the authorities' expectations in both years. The 1987 current account surplus was equal to 8.3 percent of GNP, compared to 3.6 percent for Japan and 4 percent for Germany.

Korea took advantage of its 1986/1987 current account surpluses to prepay substantial portions of its external debt, reducing the total from $46.7 billion at end-1985 (54 percent of GNP) to $35.6 billion at end-1987 (30 percent of GNP). Thus, the burden of Korea's once heavy external debt burden has been substantially reduced.

The outlook for 1988 is equally robust. Korea should experience 10 percent real GNP growth, rising employment and inflationary pressures, a current account surplus exceeding $11 billion, and a further reduction of external debt. Moreover, international reserves, which were relatively flat in 1987, have increased by over $7 billion so far this year. Thus, Korea's goal of becoming a net international creditor, like Japan, is within reach by end-1989, nearly 2 years ahead of target.

Under Section 3004 of the legislation, the Secretary of the Treasury must "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." Within the meaning of the legislation, Korea is considered to be manipulating its exchange rate. Given Korea's strong underlying economic fundamentals, further exchange rate appreciation within a framework of liberalized trade, exchange, and capital controls, is clearly required. As such, the United States also intends to initiate bilateral negotiations with Korea on its exchange rate policy to allow for balance of payments adjustment and to eliminate the unfair trade advantage.

o Hong Kong

Hong Kong's economy and policy framework are different from those of Korea and Taiwan in important ways. First, it is essentially a free port: tariffs are few and non-tariff barriers are virtually non-existent. Second, it has no capital and exchange controls. Third, its current account surplus in 1987 was smaller, $1.3 billion or 3 percent of GNP; and its global trade account was at near balance.

However, despite the smaller current account surplus and global trade balance, Hong Kong has sustained large bilateral surpluses with the United States. Hong Kong's trade surplus with the United States in 1987 was $5.9 billion (13.8 percent of GNP). Our imbalance with Hong Kong is falling, having dropped by 28 percent in the first 8 months of 1988, compared to the same period last year.

Last year, the economy exhibited some signs of over-heating, registering real GDP growth of 13.6 percent, with inflation of 5.5 percent, and growing labor shortages. This situation has continued in 1988, as growth and inflation are expected to be 8 percent and 7 percent, respectively.

The Hong Kong (HK) dollar is the NIE currency most closely linked with the U.S. dollar. The HK dollar was fixed at the rate of HK$7.8 to US$1 in 1983 to preserve confidence in the HK dollar during negotiations on the transfer of sovereignty to China in 1997. Given the continued uncertainty caused by the upcoming political transition, Hong Kong authorities do not want to de-link the currency from the U.S. dollar. Even so, a case could be made that an appreciation of the currency could help to reduce the inflationary pressures in the economy. The HK dollar has depreciated by 37 percent against the U.S. dollar since July 1980 and, given the fixed link in effect since October 1983, has remained unchanged since the Plaza Agreement in September 1985.

o <u>Singapore</u>

Like Hong Kong, Singapore can also be distinguished from Taiwan and Korea in important respects. It has one of the most open trading regimes in the world and does not maintain controls on capital transactions. Also, Singapore's current account surplus is relatively modest -- $500 million in 1987 or 2.6 percent of GNP, while the overall trade account was in deficit by $3.9 billion.

Singapore's trade balance with the United States was in deficit until 1984, but grew to a surplus of $2.1 billion last year. Although this is the lowest of our bilateral deficits with the NIEs in absolute terms, it is large relative to the size of Singapore's economy (10 percent of GDP) and has continued to expand this year (up 12 percent).

Singapore's economy is performing strongly, registering a broadly based 8.8 percent increase in real GDP in 1987.

Reserves have been increasing, contributing to a rise in the money supply. This reflects in part capital inflows associated with Singapore's role as a regional banking center, but may also suggest some intervention to resist market forces for appreciation. However, this has not translated into proportionately higher domestic prices due to the offsetting effect of modest exchange rate appreciation on import prices.

The Singapore dollar is based on a secret basket of currencies. Its value is influenced by the Monetary Authority of Singapore (MAS) via intervention in the exchange market, ostensibly with a view toward controlling inflation. However, the basket appears to be largely dominated by the U.S. dollar, thus leading to roughly parallel movements in the two currencies. The Singapore dollar has appreciated against the U.S. dollar by 5 percent since July 1980 and by 9 percent since Plaza.

Thus, while Singapore's exchange rate policy has undoubtedly contributed to its success, it is not clear that it has been a major problem impeding adjustment of global imbalances. Still, Singapore's growing imbalance with the United States and increase in reserves point to the need for a close monitoring of its external policy, including its exchange rate policy.

PART IV: EXCHANGE MARKET DEVELOPMENTS

Overview

This section reviews currency market developments since the February 22, 1987 Louvre Accord and examines experience with cooperation on exchange rates among the monetary authorities of the Group of Seven (G-7) industrial countries. During this period, a framework for cooperation on exchange rates was developed which complemented the broader economic policy coordination efforts to promote growth and external adjustment.

Greater stability in currency markets emerged during this period, although there have been episodes of substantial exchange rate pressures and rate movements. The improvement in market conditions reflects several factors, including the attainment of more balanced global growth and external adjustment discussed in Part III, closer cooperation on monetary policies and exchange market operations, and enhanced market confidence in the economic policy coordination process.

Trends in exchange rates since Louvre can be divided into three distinct subperiods. The period following the Accord witnessed greater currency stability as market confidence in and the results of the coordination effort increased. The period following the sharp drop in the world's equities markets in mid-October 1987 resulted in a renewed decline of the dollar due to a sharp deterioration in expectations about economic growth and external adjustment as well as a substantial change in interest rates which resulted in a narrowing of interest rate differentials favoring dollar placements. Finally, the G-7's December 22, 1987 statement, reaffirming the commitment to effective coordination of economic policies and cooperation on exchange rates, initiated a period of renewed currency stability which is continuing.

From Louvre to the Stock Market Crash

In the Louvre Accord of February 22, 1987, the major industrial countries agreed on new undertakings to improve the prospects for global growth and adopted specific measures and cooperative arrangements to reflect their view that their currencies were then within ranges broadly consistent with economic fundamentals and policy intentions. The prospect of more balanced global growth and greater exchange rate stability eased the market's sense of downside risk in holding dollars and contributed to a gradual increase in demand for dollars. Consequently, exchange rate movements in this period on balance were limited, with the dollar depreciating by about 4 percent against other major currencies.

The change in market expectations emerged only gradually over the period and was at times shaken by ongoing developments. Initially, expectations were for further dollar depreciation, based on the belief that adjustment of world trade imbalances would be slow, that interest differentials favoring dollar placements were insufficient, and that the G-7 authorities were not committed enough to exchange rate stability to make major economic policy adjustments. Also, there was widespread concern whether foreign investors would continue at then prevailing interest and exchange rate levels to buy U.S. assets and fears that U.S. political pressures would lead to protectionist trade legislation that could hamper global growth and adjustment. Pursuant to the new currency understandings, the G-7 intervened actively in the exchange markets, of which dollar purchases by the U.S. authorities totalled about $4.8 billion.

Subsequently, policy measures and statements by G-7 authorities demonstrated a strong commitment to exchange rate stability which enhanced market confidence. In particular, the Venice Summit in mid-June reaffirmed the Louvre Agreement regarding exchange rates and announced a plan for enhanced multilateral surveillance. Also contributing to dollar demand were market expectations that the U.S. economy would shift increasingly toward export-led growth and better economic performance in the United States than overseas, particularly in Europe. Tensions in the Persian Gulf added an element of "safe haven" demand for dollars. Consequently, the dollar rose through mid-summer.

In mid-August 1987, a renewed wave of dollar selling developed following the disappointing news that June trade data showed a deficit larger than in any previous month in 1987, thus heightening concern about progress in reducing global trade imbalances. By late in the month, the dollar had declined through levels not seen since late spring 1987. The dollar's decline, and increased U.S. employment and capacity utilization, also created expectations of a possible rise in inflation and further downward pressure on the dollar. U.S. interest rates moved sharply upward and, on September 4, the Federal Reserve increased its discount rate "to deal effectively and in a timely way with potential inflationary pressures". Subsequently, demand for dollars increased and pressures in the currency market diminished.

The market remained sensitive, however, to possible monetary and interest rate developments. For some time, central bank officials in both Japan and Germany had repeatedly expressed their desire to counter possible inflationary pressures. Subsequent interest rate increases overseas led the market to conclude that -- given the G-7 commitment to exchange rate stability -- U.S. interest rates must also move up. This expectation received further support by the release in October of U.S. trade statistics for August showing another large deficit. After the trade release, U.S. stock and bond markets deteriorated as expectations of higher interest rates grew and fears emerged that coordination was breaking down.

From October 19 to December 21, 1987

The period following the sharp drop in world equity markets on October 19, 1988, witnessed a decline of the dollar of about 7 percent against other major industrial countries. The decline reflected a deterioration in market expectations regarding prospects for growth and balance of payments adjustment in the world economy and changes in interest differentials which adversely affected investment in dollar assets.

In particular, there were widespread expectations that the United States would be more adversely affected by the stock market decline than other major industrial countries. Stock ownership in the United States was larger and more widespread than in other countries, leading to the belief that the wealth effects of the decline would have a more pervasive impact on consumption and investment. Moreover, reduced domestic growth was expected to contribute to a larger federal budget deficit as tax revenues fell and expenditures increased. The increased budget deficit was seen as exacerbating the savings and investment imbalance in the economy and creating increased demand for foreign capital that could be attracted only with a lower dollar. The release of monthly trade data pointing to continued large deficits tended to support these expectations.

The G-7 response to the stock market crash demonstrated forcefully the resilience and flexibility of the coordination process. In the United States, negotiations on additional measures to reduce the budget deficit were initiated, resulting in an historic two-year budget agreement between the President and the Congress. A coordinated round of interest rate reductions were implemented which resulted in a sharp drop in interest rates and in a narrowing of interest differentials favoring dollar assets. Germany introduced new measures to improve domestic growth and investment. The major stimulus package introduced earlier by Japan also began to have its effects on domestic growth. Finally, concerted intervention in exchange markets, including purchases of $2.4 billion by U.S. authorities, helped to maintain orderly exchange markets.

Developments Following the December 22, 1987 Statement of the G-7

The December 22, 1987, G-7 Statement initiated a period of renewed exchange rate stability. The statement, which brought together the range of measures that had been implemented in response to the crash, particularly the U.S. budget deficit reduction agreement, provided increased market confidence in the coordination process, especially the willingness of participants to implement necessary policy actions. Moreover, confidence was bolstered as evidence mounted that the long awaited adjustment of external imbalances was occuring. Consequently, the dollar recovered from the temporary lows reached following the stock market decline and has been more stable subsequently.

The improvement in market confidence did not occur overnight. In the period following the statement the dollar depreciated sharply before stabilizing at the turn of the year. In response, coordinated intervention efforts increased, with the United States purchasing $3 billion in cooperation with other G-7 countries. By early spring, however, fears of a recession on the heels of the stock market decline had been replaced by growing confidence that moderate economic growth would continue. Moreover, during the spring, interest rate differentials favoring dollar placements widened, and market expectations of higher U.S. interest rates prompted increased demand for dollars. Successive favorable U.S. trade reports were seen as confirming that the trade deficit was narrowing and that the decline of the dollar was finally reducing import demand. Also, the market questioned investment prospects in Germany, and capital outflows from Germany ran at a record pace following discussion about the imposition of a 10 percent withholding tax. Consequently, demand for dollar assets increased, and the dollar began to appreciate.

On the eve of the Toronto Summit, the market doubted that the G-7 would resist significant dollar appreciation and consequently regarded the Summit's subsequent endorsement of G-7 exchange rate cooperation as a readiness to tolerate a higher dollar. These expectations were reinforced by a view that the Federal Reserve System would tend toward a more restrictive monetary posture. In early August, the Board of Governors raised the discount rate, and the dollar was temporarily bid up to a 20-month high of over DM 1.92. Later, the dollar neared ¥ 137 after a statement by Japanese officials appeared to sanction some yen depreciation.

Subsequently, however, some monetary policy adjustments overseas and an easing of U.S interest rates from the highs reached following the discount rate rise eased upward pressure on the dollar. By mid-October, the dollar had dropped back to levels prevailing around the time of the Toronto Summit.

G-7 Cooperation on Currency Markets

With the Plaza Agreement of September 22, 1985, the G-7 industrial nations embarked on a process of intensified cooperation on currency markets that has continued to the present. This cooperation was enhanced through the Louvre Accord and subsequent understandings, and it has been adjusted as necessary to reflect market and economic conditions. This close and continuing cooperation, including the active participation of the United States, has served to make the markets more aware of and sensitive to official intentions. This has served to enhance the effectiveness of the intervention beyond the actual amounts involved. Thus, from the Louvre Accord of February 22, 1987 through July 1988, the United States, in cooperation with G-7 and other foreign monetary authorities, have made net purchases of some $7.1 billion. This amount includes net purchases of over $8.5 billion in 1987 and net sales of about $1.4 billion during 1988 through July. The reduced scale of operations in 1988 reflected an improvement in exchange rate stability relative to 1987.

The evidence of this period suggests that official intervention in the currency market has played a useful complementary role in supporting G-7 economic policy coordination efforts. First, the intervention has generally been supportive of and consistent with broader economic policy coordination efforts. Second, the market has had confidence, despite occasional doubts, that the G-7 monetary authorities are prepared to make policy adjustments as necessary to further coordination efforts. As a consequence, the market has tempered somewhat its reactions to isolated economic statistics that appear to lie outside estimates of underlying trends in fundamentals. Third, G-7 operations in the foreign exchange market have been conducted on a concerted and cooperative basis with agreed objectives and responsibilities. Key to the growing effectiveness of G-7 cooperation on exchange rates is precisely that it has reflected close consultations and specific understandings on objectives and responsibilities.

In these circumstances, intervention can have a positive effect on foreign exchange market expectations and important spillover effects in domestic securities and money markets. There have been questions whether foreign exchange market intervention can be considered effective if it has no monetary impact (i.e., whether it is "sterilized" or not), but such questions have proven difficult to answer definitively in practice. Recent experience suggests that, in the context of cooperation on exchange markets and broader economic policy coordination, intervention can be more helpful than previously thought.

PART V: U.S. ECONOMIC AND BALANCE OF PAYMENTS SITUATION

Emergence of the Deficit

Starting in 1982, the U.S. economy embarked on the longest peacetime expansion in post-WWII history, now entering its seventh year and creating over 18 million jobs. At the same time, however, the U.S. began to move into increasing external deficits. These deficits reflected four fundamental factors.

First, the U.S. expansion was earlier, and more robust, than occurred in the other major industrial countries. Between the low point of the U.S. recession in the fourth quarter of 1982 and the fourth quarter of 1984, the U.S. GNP grew in real terms at an average of 5.8 percent per year, compared with a 3.4 percent average for the other industrial countries.

This "growth gap" was a reversal of historic trends -- during the 1960s, U.S. growth averaged 4.0 percent vs. 6.2 percent for the other industrial countries; during the 1970s, the U.S. grew 2.8 percent on average, vs. 3.8 percent for the other industrial countries. The contrast in performance in the eighties was especially marked compared with Europe, where employment growth was negative and industrial production stagnant.

Second, serious LDC debt problems emerged in 1982, with Mexico's declaration of its inability to service its foreign debt. The debt situation forced retrenchment in several major U.S. overseas markets, which had previously been among the fastest-growing outlets for U.S. exports. U.S. exports to Latin America nearly doubled in value terms between 1978-81; they declined by 40 percent (balance of payments basis) between 1981-83, and still were nearly 20 percent ($8 billion) below their 1981 level in 1987.

A third major fundamental development which influenced the U.S. trade and current account was the emergence of the Asian NIEs as major producers of a broad range of low-priced manufactures, exported aggressively to the U.S. market.

Finally, exchange markets responded to these fundamental factors in ways which reinforced their effect on the U.S. trade balance. Traditional analysis would suggest that the dollar should have begun to depreciate as the current account went into deficit during 1983-84. However, the reverse occurred with the dollar strengthening sharply as capital flowed into dollar assets on an unprecedented scale. This reflected several factors.

- Foreign investors were attracted by the robust domestic expansion, both absolutely and relative to others;

- Tax measures to improve after-tax rates of return and remove withholding also improved the U.S. investment climate; and

- There was some "safe haven" element related to LDC debt problems.

These factors all attracted capital to the United States, putting upward pressure on the dollar in the process. Looked at another way, the favorable investment climate increased U.S. investment demand relative to U.S. savings. Meanwhile, investment abroad seemed less attractive, given modest growth performance, despite relatively high national savings rates.

The dollar continued to strengthen through early 1985, peaking over 40 percent, on a trade-weighted basis in nominal terms against other major currencies, above its 1980 level. The effects of exchange rate changes on trade flows operate with quite long lags -- most studies suggest 2-3 years for the full impact to be felt. Thus, U.S. trade and current account deficits -- and counterpart surpluses elsewhere -- continued to increase after 1985, peaking in 1987 at $160 billion (trade) and $154 billion (current account) respectively.

During the past few years, however, the factors which continued to favor investment in the United States tended to be overtaken by progress in improving the relative investment climate abroad:

- Other countries acted to lower marginal tax rates, and made important strides in the areas of deregulation and privatization.

- The disparity in growth performance shifted, closing the "growth gap". The U.S. expansion slowed to a more sustainable pace while foreign growth -- aided recently by stimulative policies -- has accelerated.

- In addition, with growth resuming in many LDCs as their financing problems have eased in comparison with the early 1980s, U.S. exports to Latin America are expanding again (albeit modestly apart from Mexico).

- At the same time, by late last year, the dollar had reversed the 1981-85 run-up on average, against the other major currencies. Some major NIE currencies also have appreciated.

Recent Developments and Outlook for the Trade Balance

Reflecting these developments, the U.S. trade and current account deficits peaked in 1987, and are now on an improving trend. The improvement showed up first in real or volume terms. On this basis, the trade deficit peaked in late 1986, and has declined in six of the last seven quarters. The balance in value terms leveled-off towards the end of 1987, but clear signs of improvement on this basis did not appear until the first quarter of this year. The delayed reaction probably reflected a combination of factors:

- o Slow pass-through of the exchange rate change to import prices as foreign suppliers accepted a squeeze on profit margins to avoid raising prices, thus protecting their U.S. competitive position and market share.

- o U.S. exports must grow substantially faster than imports just to hold the trade deficit constant, let alone allow the trade balance to improve. In 1987, imports were over 1-1/2 times as large as exports ($410 billion vs. $250 billion); if exports and imports were to grow at similar rates, the trade balance would continue to deteriorate.

- o Many models indicate that U.S. imports are somewhat more responsive to U.S. income growth than are our exports to foreign income growth. Thus, U.S. growth which equals or exceeds foreign growth hurts our trade deficit. Relative growth rates in the U.S. and the other industrial countries have been less favorable for our trade balance in the 1980s than was the case in the 1960s and 1970s.

The improvement on the trade account which has emerged in 1988 appears to be broadly-based in both product and geographic terms, involving substantial increases in exports and slower import growth. The improvement has been most marked against the other major industrial countries where the dollar has experienced the greatest depreciation. These are also the countries with large external surpluses, the clear counterpart of the U.S. deficit.

In the first half of this year, the trade deficit on a balance-of-payments basis was running at a seasonally adjusted annual rate of $130 billion, down $30 billion from both the first half of 1987 and 1987 as a whole. The second quarter trade deficit on a seasonally adjusted balance-of-payments basis was $29.9 billion, down $5.2 billion from the first quarter, which in turn was $6.0 billion below fourth quarter 1987. This second quarter figure, at an annual rate of $120 billion, was the lowest quarterly deficit figure since the second quarter of 1985. The second quarter deficit also declined substantially ($17 billion annual rate) in real terms, continuing the trend which emerged in the third quarter of 1986.

Strong export growth has been the major contributor to the reduction in the trade deficit during the first half of 1988, with exports up 33 percent in value terms over the first half of 1987, while imports rose only 12 percent. Second quarter exports were up 6 percent ($4.4 billion) from the first quarter, compared with a 1 percent ($0.9 billion) decline in imports.

Exports grew across-the-board in terms of geographic area, but strongest growth was vis-a-vis Western Europe, the Asian NIEs, Canada, Japan, and Mexico. Export growth was also broadly-based across product categories, with values up 30 percent or more for 5 of 6 principal end-use commodity categories, covering 90 percent of total exports. By contrast, import strength was concentrated in two end-use categories that appear to reflect strong U.S. industrial production and investment spending rather than foreign competitiveness. Capital goods imports were up 24 percent and industrial supplies and materials up 19 percent from a year earlier, while imports in all other categories rose only 4-1/2 percent in value.

July-August trade data reinforce the picture of sustained improvement in U.S. trade performance.

- The average monthly deficit (Customs basis census data, seasonally adjusted) was $9.3 billion, compared with a $9.6 billion monthly average for the second quarter, $10.9 billion deficit for first quarter, and $12.8 billion for fourth quarter 1987. For the first eight months of 1988, the trade deficit was running at a seasonally adjusted annual rate $31 billion below the same period in 1987.

- Exports have continued strong, with increases over year-earlier levels in the 30 percent range, roughly three times the rate of growth of imports.

- A major factor in this improvement in trade performance continues to be exchange rate change, although strong foreign growth this year is also exerting a positive influence. On a regional basis, over 80 percent of the total improvement in the trade deficit for the first eight months of 1988 compared with 1987 has been accounted for by improvement against the major industrial countries and the Asian NIEs.

- o Reflecting these effects on U.S. competitiveness, export growth has been broadly based by product categories. Import strength was concentrated in the two categories of capital goods and industrial supplies and materials. Auto imports, a major contributor to the earlier surge in the trade deficit, are virtually flat in the first eight months of this year compared with the same period in 1987.

Current Account

The current account includes both merchandise trade and trade in services. The services component of the U.S. current account has deteriorated less rapidly than the trade balance, in large part reflecting the strength of net investment income, especially income from U.S. direct investment abroad. While the U.S. trade deficit was worsening from $36 billion in 1982 to $160 billion in 1987, net direct investment income was rising from $18 to $42 billion.

Reflecting strong direct investment income, which acted to offset deterioration in portfolio income and other invisible payments, the overall surplus on invisibles transactions worsened only gradually, from $28 billion in 1982 to $6 billion in 1987. (However, 1987 was buoyed by an extraordinary fourth quarter bulge of $9 billion in capital gains on U.S. direct investment abroad, most of which resulted from a rise in the dollar value of investments in countries whose currencies appreciated against the dollar.)

In the first half of 1988, the current account deficit was $70.3 billion, down $5.2 billion from an unusually low second half of 1987, and $8.2 billion below the first half of last year.

- o Trade balance improvement more than accounts for the reduced current account deficit so far in 1988.

- o In the second quarter, the services portion of the current account was in deficit (by about $500 million), for the first time since at least 1960.

The current account deficit should continue to improve in the remainder of 1988, and continue in 1989. The expected improvement, however, will be more gradual than the trade deficit due to the continued erosion of our services balance. The major factor in this erosion is a growing deficit on net investment earnings, as the U.S. net asset position continues to deteriorate.

Capital Flows

Analysis of international capital flows has become extremely complex with increased liberalization and internationalization of capital markets. The size of gross capital flows dwarfs trade and current account transactions, as illustrated by the fact that one week's volume of foreign exchange transactions ($200 billion per day) roughly equals the yearly total of current account transactions. These developments mean that highly fungible capital can respond very rapidly, through a variety of channels, to perceived changes in the economic fundamentals.

The major recent event influencing the pattern of capital flows appears to have been the October 1987 stock market crash. Reflecting this development, capital movements in the fourth quarter of 1987 showed major swings in two categories -- foreign purchases of U.S. non-Treasury securities (which shifted to net sales) and official purchases of U.S. assets, which rose sharply in response to dollar weakness as net foreign private inflows dried up. Securities purchases remained low in the first quarter of 1988, with an apparent continuation of major recorded official inflows.

However, these further official inflows almost certainly reflect a delayed impact of fourth quarter events, as central banks moved 1987 intervention proceeds from initial Euro-market placements to direct official accounts with the Federal Reserve. These movements could also explain the substantial shift in private banking flows, from inflows to outflows, between the fourth quarter of 1987 and the first quarter of this year. By the second quarter of this year, the effects of October had substantially been worked out and private capital inflows resumed.

U.S. Investment Position

Developments in the U.S. net international asset position are simply a mirror-image of the large trade and current account deficits we have been running in recent years. Published data on the U.S. net international investment position show us as net debtors internationally by $368 billion at the end of 1987. There is some question as to how much weight to place on the precise published figures of our investment position itself. The latest Commerce Department presentation of the U.S. international investment position notes several possible sources of understatement of both assets and liabilities, and includes this caveat: ".... the net investment position is only a rough illustration, rather than a precise measure, and should be treated with caution."

But while the precise level of U.S. foreign net indebtedness is uncertain, the trend is clear: the United States borrows abroad each year an amount equal to the U.S. current account deficit. (By the same token, Japan is a net supplier of capital to the world by an amount equal to its current account surplus.)

Concerns have been raised by some that the need to finance ongoing U.S. current account deficits, involving increasing levels of U.S. indebtedness to foreigners, has put the U.S. in a position in which foreign lenders could exact increasingly advantageous terms. For example, it is argued that if foreigners become increasingly unwilling to provide capital to the United States, substantial interest and exchange rate adjustments would be needed to induce foreigners to resume their lending.

Such concerns are exaggerated or unwarranted in the current circumstances. The receipts of income on U.S. assets abroad still are running roughly equal to U.S. payments on liabilities to foreigners. The United States does not face a significant net debt service burden, either absolutely or as a share of GNP -- the U.S. net external debt at about 8 percent of GNP is modest by international standards. Also, the United States remains an extremely attractive place for investment. As discussed previously, pursuant to the G-7 coordination process, the major countries are promoting sustained growth with low inflation, reducing external imbalances, and fostering greater stability of exchange rates. In this context, U.S. economic performance is strong. The composition of output has shifted from consumption to investment and net exports, while substantial progress has been made in reducing the budget and trade deficits. The United States is the largest economy in the world and continues to maintain one of the most open investment climates. The U.S. financial markets remain the largest, deepest and most resilient in the world.

Assessment of Progress and Prospects

The trade legislation requires the Treasury to assess the effects of exchange rates on the domestic economy and U.S. competitiveness. As indicated, exchange rate changes have been a major factor, though not the only one, in the turnaround in the U.S. trade deficit which began in late 1986. Exchange rate change operates directly via changes in U.S. cost/price competitiveness. The so-called "real" exchange rate (exchange rate adjusted for changes in relative inflation) is a frequently-used measure of changes in competitiveness.

The real exchange rate, measured against 13 currencies covering roughly 67 percent of U.S trade, has declined over 20 percent from its peak in early 1985, and has been on average this year over three percent below its end-1980 level.

(Against the major industrial countries with the largest surpluses, Japan and Germany, the dollar has depreciated by about 47 percent and 37 percent in nominal terms, respectively, since the Plaza.) Data on unit labor costs in manufacturing, another frequently cited indicator of competitiveness, also show substantial U.S. gains during the period of dollar depreciation since early 1985. Of course, strong U.S. productivity growth in manufacturing, coupled with wage restraint, have also been important factors in strong U.S. competitiveness.

The effects of exchange rate related improvements in U.S. competitiveness on the trade and current account have been described above. These improvements have had direct favorable effects on the performance of the the domestic economy.

The improvement in trade volumes beginning in late 1986 has been a major factor sustaining the U.S. expansion into its seventh year. Trade deficit improvement contributed nearly one-quarter of real GNP growth between the third quarter 1986, when trade deficit improvement in real terms began to emerge, and the second quarter of 1988. The share of growth contributed by the external sector has been rising -- during the first half of this year, improvement in real net exports accounted for over one-half of the 3.2 percent annual rate of GNP growth.

Inflation has been cut by roughly two-thirds since the Administration took office -- from the 12 to 13 percent range at the turn of the decade to the roughly 4 to 4-1/2 percent maintained since 1982 (as measured by the consumer price index and after allowance for shifts in widely fluctuating energy prices). Currently, major price indicators show only scant evidence of any acceleration. The consumer price index has increased by an annual rate of 4.6 percent so far this year, or close to the 4.4 percent increase during all of 1987 and about in line with the Administration forecast of last summer. The drought contributed modestly to higher prices this year, but overall is expected to have only a minor impact on price levels.

Employment growth has remained robust (over 3 million additional jobs in 1987) despite the shift from domestic demand-led growth to the current situation with net exports making a major contribution. In particular, manufacturing employment has shown renewed vitality, after declines in 1985 and 1986.

The favorable trend in the trade balance should be sustained over the remainder of the year and in 1989, despite the dollar appreciation earlier in the year. Recent exchange rate developments should be interpreted in light of the October 1987 stock market break. After being relatively stable during much of 1987, the dollar depreciated sharply in the aftermath of the October stock market crash as markets overestimated the negative effects of the crash. This overreaction was temporary. The dollar today, while above the low levels reached temporarily at end-1987, is still 4 percent (on a real trade-weighted basis) below the pre-October crash levels. Furthermore, the average value of the dollar so far this year is down over 6 percent from last year's average. Contrary to popular belief, the U.S. has not lost competitiveness.

In addition, experience post-1985 indicates a weakening of the linkage between exchange rate change and import prices, which historical experience of the 1970s and early 1980s might have led us to expect. Thus, the transitory lows of late 1987 and early 1988 were too brief to have a significant effect on prices of traded goods. For both these reasons, it seems unlikely that movements in the dollar so far this year will significantly alter the outlook for sustained trade and current account improvement.

On a more fundamental issue, many trade forecasting models predict that progress will not be sustained -- that favorable exchange rate effects will run out after 2 to 3 years, after which time the trade balance will again begin to deteriorate. However, this analysis takes little or no account of several very important developments which should contribute to sustained improvement in the trade deficit over the longer-term, without further exchange rate change.

- o Strengthened U.S. competitiveness is much broader-based than simple exchange rate calculations, or even unit labor cost comparisons, show. Intense competitive pressures during the period of dollar strength forced U.S. producers and workers to make fundamental changes in the way they operate, increasing efficiency and cutting costs while improving quality. A convincing indicator of this longer-term change is the recent strength of capital spending, showing the willingness of U.S. firms to commit -- at current exchange rate levels -- substantial financial resources to increase capacity in response to strong export demand, on top of the very strong export growth already experienced to date.

- o A second factor in adjustment of the deficit which has longer-run implications is the strong inflows of direct investment, noted previously in this report. These inflows are strongly motivated by a desire on the part of foreign producers to remain competitive in the U.S. market, and defend (or increase) existing U.S. market shares. The new investments create U.S. based production of products previously exported to the United States. This import-replacing aspect of foreign direct investment in the United States is most clearly present in the automobile sector, but is an inherent element of the process in other industries as well.

- Finally, assumptions of "no policy change" are a standard feature of model-based projections of trade flows. The essence of the G-7 coordination process, described previously in this report, is that policies are under regular review, with an eye to possible changes in light of developments in the underlying fundamentals. The G-7 countries are agreed that a further reduction in external imbalances is desirable in both surplus and deficit countries. They are committed to implementing the policies necessary to build on the progress that has been achieved.

The "sustainability" of the U.S. external position is a concept that is often raised but little understood. There is no accepted methodology for quantifying a "sustainable" current account as it depends on the willingness of the market to provide sufficient financing at a particular level and pattern of exchange rates. This, in turn, reflects judgments by the market regarding the economic policies and prospects for the United States and other major countries. Such judgments are based on assessments of a broad range of factors including monetary, fiscal and tax policies as well as considerations regarding safety and soundness of particular investments and political stability.

While there may be a wide divergence of views regarding such issues, most observers would agree that a continued reduction in external imbalances is necessary and desirable. The adjustment of external imbalances will result in a corresponding reduction in the capital flows needed to finance the remaining imbalances. This adjustment will continue to be accomplished in an orderly fashion so long as the markets believe that the major countries are pursuing sound policies that will result in a reduction of the imbalances in the context of adequate growth with low inflation. The major industrial countries are committed to implementing the policies necessary to build on the considerable progress that has been achieved.

PART VI: CONCLUSION

In an increasingly integrated world, the achievement of a more stable, open and growing global economy requires sound and consistent policies, particularly among the major industrial economies. The G-7 is making significant progress in achieving this objective through the economic policy coordination process.

- o The United States is now entering the seventh consecutive year of growth, the longest peacetime expansion in its post-war history. Recent growth has been characterized by a shift in the composition of demand, with domestic demand slowing to below the rate of growth in output. This shift has released resources to facilitate a reduction in the external deficit. The United States must persevere in its efforts to reduce its budget and trade deficits and avoid protectionism. Indeed, in recent consultations with the United States, the International Monetary Fund welcomed the reductions achieved in the U.S. fiscal deficit. It recommended that: fiscal adjustment, emphasizing expenditure restraint, continue to play a major role in increasing national savings to allow the external balance to improve further; the Federal Reserve demonstrate continued vigilance to keep inflation firmly in check; the firm stance against protectionism be maintained; and the United States continue to play its constructive role in international efforts to coordinate policies and to resolve the debt problems of the developing countries.

- o In Japan, domestic demand growth has outstripped GNP since 1986, aided by stimulative fiscal and monetary policies and terms of trade gains. Growth this year will be the highest among the G-7. Meanwhile, Japan is experiencing very little inflation and its trade and current account surpluses, albeit large, are declining in both real and nominal terms. To continue this progress, Japan must sustain strong domestic demand growth and restructure its economy to reduce the reliance on export-led growth.

- o In Germany, domestic demand growth has also been the source of overall growth since 1986 -- though not as strongly as in Japan -- with tax reductions boosting private consumption and import absorption. Germany has also experienced little inflation in recent years, and its current account surplus is being reduced moderately. Germany must continue its efforts to promote domestic demand and to free up labor and capital markets to allow employment to grow and generate growth in its productive capacity.

While the major countries bear a special responsibility in these efforts to reduce external imbalances in the context of sustained growth, others have a clear and complementary role to play.

- The global current account surpluses of the four <u>Asian NIEs</u> have expanded rapidly, reaching $30 billion in 1987. Their bilateral trade surplus with the United States has also been large and growing, amounting to $35 billion last year. Undervalued exchange rates, particularly in Taiwan and Korea, have been a major factor in this expansion. In the cases of Taiwan and Korea, this undervaluation is a direct result of central bank currency intervention, capital controls, and administrative guidance designed to prevent their exchange rates from reflecting market forces and to achieve a competitive advantage. These policies, coupled with a lack of structural reforms to strengthen domestic demand and numerous trade restrictions, have frustrated multilateral efforts to reduce global imbalances.

  - Since mid-1986, the United States has conducted discussions with the four, particularly Taiwan and Korea, about these issues.

  - Under Section 3004 of the Omnibus Trade and Competitiveness Act, the Secretary of the Treasury must "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." Within the meaning of the legislation, Taiwan and Korea are considered to be manipulating their exchange rates.

  - Pursuant to the provisions of Section 3004, the United States intends to initiate bilateral negotiations with Taiwan and Korea on an expedited basis for the purpose of ensuring that these two countries regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair trade advantage.

- The <u>developing countries</u> must continue to implement structural reforms to promote sustained growth, reduce current account deficits and achieve a return to voluntary access to capital markets. Their efforts, along with those of the international financial community, are showing results. Sustaining this progress will require continuing efforts by debtors and creditors.

The global economy finds itself today on strong and solid footing. This strength will facilitate sustained efforts to assure continued progress in promoting balanced growth with low inflation, reducing external imbalances and fostering greater stability of exchange rates.

Yet, the process of economic policy coordination is still in its beginning stages. Far more remains to be done. In particular, the major countries will need to pursue the broad range of macroeconomic and structural policies that will reduce external imbalances in the context of sustained growth. Exchange rates have an appropriate role to play in these efforts, but they represent only one of the many and often more important economic factors that affect growth prospects and competitive positions. It is this wider range of fundamentals that the coordination process is seeking to address in order to promote lasting stability. All countries have important responsibilities in these efforts.

APPENDIX

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3.	U.S. Trade with Asian NIES and Currency Changes
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6.	Balance of Payments: Capital Flows, 1986-88Q2

Charts

1.	U.S. Dollar vs. Yen and DM
2.	Real Trade-Weighted Dollar

Table 1

Economic Performance of Key Industrial Countries

	GNP Growth 1/ 1987	GNP Growth 1/ 1988	Domestic Demand Growth 1987	Domestic Demand Growth 1988
US	3.4 (5.0)	3.5 (2.8)	3.0 (4.4)	2.6 (1.7)
Japan	4.2 (5.5)	5.8 (4.5)	5.1 (6.8)	7.4 (5.7)
Germany	1.8 (2.4)	2.9 (2.2)	3.1 (3.3)	3.2 (1.8)
France	2.2 (2.8)	2.9 (2.4)	3.3 (3.4)	3.0 (3.0)
U.K.	4.4 (4.5)	4.0 (3.8)	4.1 (4.9)	6.1 (5.0)
Italy	3.1 (2.8)	3.0 (2.9)	4.7 (4.8)	3.8 (3.8)
Canada	4.0 (6.1)	4.2 (3.0)	4.7 (8.5)	5.3 (3.4)
G-7 2/	3.4 (4.6)	4.1 (3.2)	3.7 (4.9)	4.2 (3.2)

	Inflation 3/ 1987	Inflation 3/ 1988	Current Account 4/ 1987	Current Account 4/ 1988
US	3.7	4.1	-3.4	-2.8
Japan	0.1	1.1	+3.6	+2.8
Germany	0.2	1.2	+4.0	+3.8
France	3.3	2.5	-0.5	-0.3
U.K.	4.1	4.6	-0.4	-2.4
Italy	4.6	4.9	-0.1	-0.3
Canada	4.4	3.9	-1.9	-1.8
G-7 2/	2.9	3.2	-0.3	-0.3

1/ Real GNP/GDP (or domestic demand) growth rates, annual average; figures in parentheses are fourth quarter over fourth quarter growth rates; 1988 figures are IMF projections except for U.S. (which are Mid-session Budget Review projections).

2/ Weighted by GNP.

3/ Consumer prices; 1988 figures are IMF estimates.

4/ Calculated as percent of GNP; negative indicates deficit. 1988 figures are IMF projections, except for U.S. (Treasury projection).

Table 2

Economic Performance of Developing Countries

	Real GDP Growth (%) 4/		
	1982-83	1986	1987
	(annual changes in percent)		
Non-OPEC 1/	1.3	4.5	3.7
Sub-Saharan Africa 2/	0.6	3.6	2.3
15 Major Debtors 3/	-1.6	3.8	2.4

	Consumer Price Inflation 4/		
	1982-83	1986	1987
	(annual changes in percent)		
Non-OPEC 1/	55	54	80
Sub-Saharan Africa 2/	24	24	26
15 Major Debtors 3/	74	77	116

	Current Account Balance (excluding Official Transfers)		
	1982-83	1986	1987
	(Billions of U.S. Dollars)		
Non-OPEC 1/	-68	-33	-22
Sub-Saharan Africa 2/	-10	-9	-11
15 Major Debtors 3/	-34	-16	-9

1/ 137 developing countries. Excludes European countries, South Africa, and the Peoples' Republic of China.
2/ Excludes South Africa and Nigeria.
3/ Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Yugoslavia, Venezuela.
4/ Weighted averages. Weights are U.S. dollar values of 1982 GDP.

Table 3

U.S. TRADE WITH ASIAN NIES AND CURRENCY CHANGES

U.S. Trade Deficit with Asian NIEs [1]
(U.S. $ Billions)

	1980[2]	1986[2]	1987[2]	%Change[3]
Hong Kong	-2.1	-5.8	-5.9	181%
Korea	0.2	-7.0	-9.4	n.a.
Singapore	1.1	-1.3	-2.1	n.a.
Taiwan	-2.8	-14.7	-17.4	521%
TOTAL NIEs	-3.6	-28.8	-34.8	867%
Total U.S.	-25.5	-144.3	-159.2	524%
% Total U.S.	14%	20%	22%	

[1] Totals may not equal sum of components due to rounding.
[2] U.S. balance of payments adjusted data.
[3] From 1980 to 1987.

Cumulative Change against US$* as of October 14, 1988

from:	7/22/80	9/20/85	end-87	Rate on 10/14
HK$	-37.13%	0.01%	-0.69%	HK$ 7.81
Won	-17.18%	25.93%	11.54%	W 710.3
Singapore$	4.61%	8.92%	-1.32%	S$ 2.02
NT$	24.57%	40.21%	-1.21%	NT$ 28.90
¥	74.24%	91.54%	-2.23%	¥ 126.42
DM	-3.75%	59.95%	-11.51%	DM 1.80

* This table is calculated in terms of the movement of the foreign currency against the U.S. dollar, as this is the way the Asian NIEs measure their foreign currency movements. Thus, foreign currency appreciation is represented by a (+) and depreciation by a (-).

Table 4

Measurements of Dollar Movements
Versus G-7 Currencies Since Key Dates
Percent dollar appreciation (+) or depreciation (-)

as of October 14, 1988

Value of the dollar in terms of:	Floating Begins 3/20/73 to date	Dollar Peak 2/26/85 to date	Plaza Agreement 9/22/85 to date	Louvre Accord 2/22/87 to date	December Statement 12/22/87 to date
Japanese yen	-51.6	-51.1	-47.2	-16.9	+0.8
German mark	-35.5	-47.6	-36.9	-0.5	+11.7
Sterling	+41.2	-40.3	-22.5	-12.4	+4.8
French franc	+37.5	-41.4	-29.4	+2.0	+12.7
Canadian dollar	+21.0	-14.0	-12.5	-9.4	-7.6
Italian lira	+139.9	-37.5	-30.1	+4.1	+13.1

Source: London midday rates.

Table 5

United States

BALANCE of PAYMENTS TRADE and CURRENT ACCOUNT DETAIL: 1986 - 88Q2
(in $ billion)

	Years		1987				1988	
	1986	1987	Q1	Q2	Q3	Q4	Q1	Q2
Exports	224.0	249.6	56.8	59.9	64.9	68.0	75.3	79.7
Agricultural	27.4	29.5	6.5	7.1	8.3	7.6	9.0	9.7
NonAgricultural	196.6	220.1	50.3	52.7	56.6	60.4	66.3	70.0
Imports	-368.5	-409.9	-96.7	-99.4	-104.6	-109.2	-110.5	-109.6
Petrol & Prods	-34.4	-42.9	-8.8	-10.1	-12.8	-11.3	-10.0	-10.2
NonPetroleum	-334.1	-367.0	-87.9	-89.3	-91.8	-97.9	-100.5	-99.4
TRADE BALANCE	-144.5	-160.3	-39.9	-39.6	-39.7	-41.2	-35.2	-29.9
Net Investment Income	23.1	20.4	5.1	1.7	1.1	12.5	1.2	-1.7
Direct Investment	33.0	41.8	9.4	6.9	6.7	18.8	7.2	5.7
(of which Capital Gains/Losses on U.S. Investments Abroad)	9.6	15.6	4.7	0.9	1.0	9.0	0.9	-2.0
Portfolio Investment	-9.9	-21.4	-4.3	-5.2	-5.6	-6.3	-6.0	-7.4
Net Other Services	-2.1	-0.6	0.1	0.1	-0.4	-0.5	0.2	1.3
Military	-4.4	-2.4	-0.1	-0.2	-0.9	-1.3	-1.0	-0.9
Travel & Fares	-8.1	-9.1	-2.4	-2.2	-2.2	-2.3	-1.9	-1.5
Other Transport	-1.3	-1.2	-0.2	-0.3	-0.3	-0.3	-0.3	0.1
Fees, Royals & Misc	11.6	12.0	2.8	2.8	3.0	3.4	3.4	3.5
Unilat Transfers	-15.3	-13.4	-3.0	-3.1	-3.0	-4.4	-3.1	-2.9
Remits & Pensions	-3.6	-3.4	-0.9	-0.9	-0.9	-0.8	-0.9	-0.8
Government Grants	-11.7	-10.0	-2.1	-2.2	-2.1	-3.5	-2.2	-2.1
NET INVISIBLES	5.7	6.3	2.2	-1.3	-2.3	7.7	-1.8	-3.4
CURRENT-ACCOUNT BALANCE	-138.8	-154.0	-37.6	-40.9	-42.0	-33.5	-36.9	-33.3

Source: SURVEY OF CURRENT BUSINESS, Sept 1988

Table 6
United States

BALANCE OF PAYMENTS CAPITAL FLOWS: 1986 - 88Q2
(inflows (+) outflows (-); in $ billion)

	YEARS		1987				1988	
	1986	1987	Q1	Q2	Q3	Q4	Q1	Q2
U.S. Reserve Assets (Incr(-) Decr(+))	0.3	9.1	2.0	3.4	0.0	3.7	1.5	0.0
Other US-Govt Assets	-2.0	1.2	-0.1	-0.1	0.3	1.1	-1.0	-0.8
Foreign Official Assets:	35.5	45.0	14.0	10.3	0.6	20.0	24.7	5.8
Industrial	29.4	49.2	16.6	17.5	-0.9	16.1	20.8	6.7
OPEC	-9.3	-10.0	-2.8	-2.7	-1.7	-2.8	-1.4	-1.8
Other	15.5	5.7	0.2	-4.5	3.3	6.7	5.2	0.9
Banks, net:	19.8	47.2	15.8	-4.5	29.6	6.3	-0.1	14.8
Claims	-60.0	-40.5	21.9	-22.4	-16.5	-23.5	17.1	-14.0
Liabilities	79.8	87.8	-6.1	18.0	46.2	29.8	-17.2	28.8
Securities, net	65.6	27.1	14.5	11.7	7.7	-6.8	3.6	14.8
Foreign Securities	-4.3	-4.5	-1.6	-0.1	-1.0	-1.8	-4.5	1.6
U.S.Treas Securities	3.8	-7.6	-2.8	-2.4	-2.8	0.5	6.9	4.5
Other U.S. Securities #	66.0	39.2	19.0	14.2	11.5	-5.6	1.2	8.7
U.S. Direct Invest. Abroad	-22.9	-41.4	-11.6	-6.2	-5.9	-17.8	-6.0	-1.6
Reinvested Earnings	-19.7	-35.7	-8.9	-6.7	-5.6	-14.4	-4.4	-4.9
Equity & Inter-Co Debt #	-3.2	-5.8	-2.7	0.5	-0.3	-3.3	-1.7	3.3
For. Direct Invest. in U.S.	34.1	42.0	8.0	7.2	15.0	11.7	7.3	13.4
Reinvested Earnings	-2.3	2.5	1.6	0.7	2.1	-1.9	3.3	0.9
Equity & Inter-Co Debt	36.4	39.4	6.3	6.5	12.9	13.7	4.0	12.4
Other U.S.-Corp., net	-7.1	5.3	1.2	4.2	-0.3	0.2	1.7	0.0
Claims	-4.2	3.1	-0.5	2.6	-0.2	1.2	-0.3	0.0
Liabilities	-2.9	2.2	1.7	1.6	-0.1	-1.0	2.0	0.0
NET CAPITAL FLOWS	123.3	135.5	43.7	26.1	47.1	18.6	31.6	46.5
Statistical Discrepancy	15.6	18.5	-10.7	15.7	0.3	13.2	0.5	-12.3
TOTAL *	138.8	154.0	33.0	41.8	47.3	31.8	32.2	34.2

Source: Sept 1988 SURVEY OF CURRENT BUSINESS

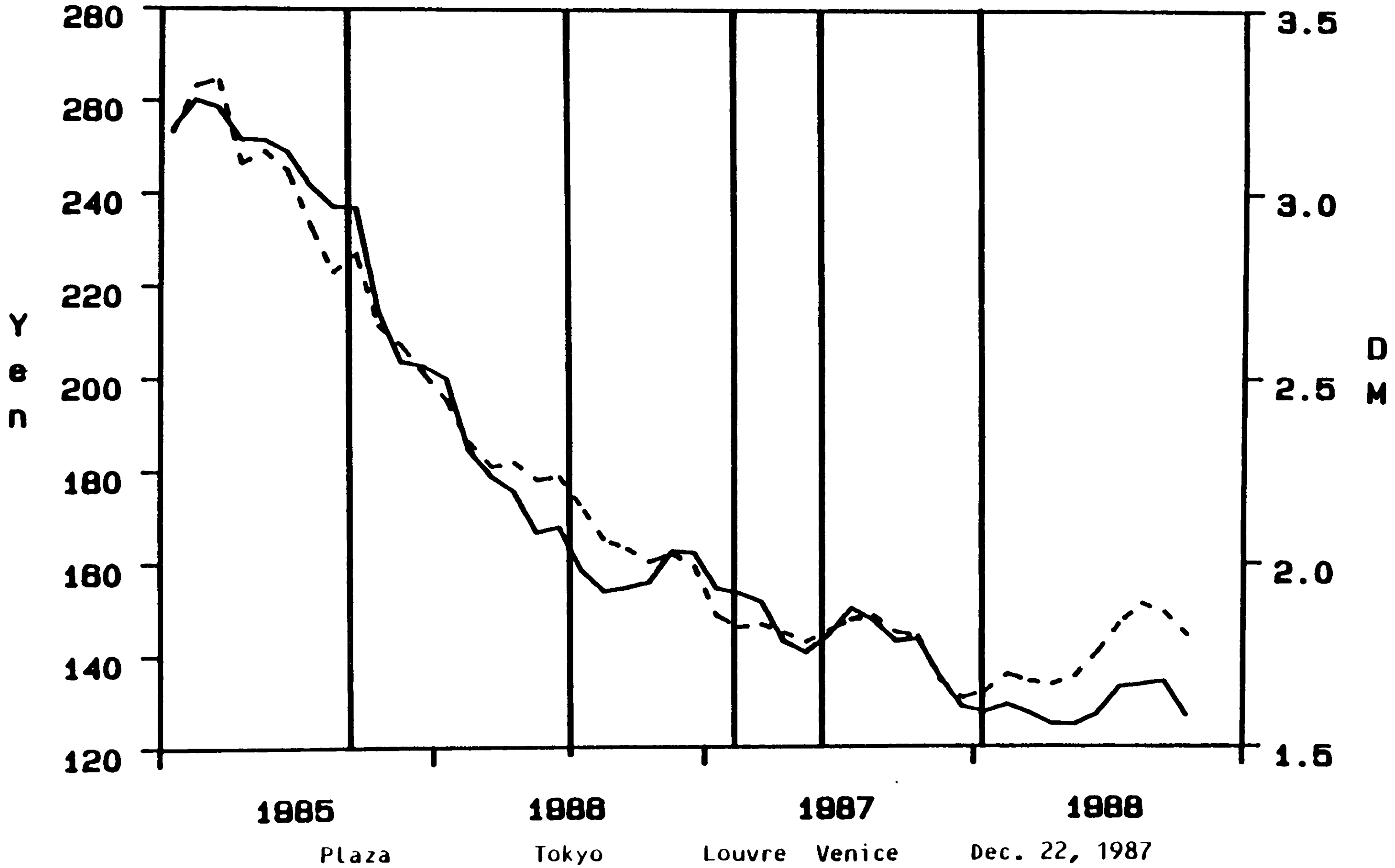
Adjusted to treat Inter-Company borrowing by U.S. corporations from Netherlands Antilles financing subsidiaries as US-Securities, rather than Direct-Investment, transactions.

* Equals seasonally-unadjusted Current Account Balance, with reversed sign.

Chart 1

US Dollar vs. Yen (solid) and DM (dotted)

Monthly Averages*



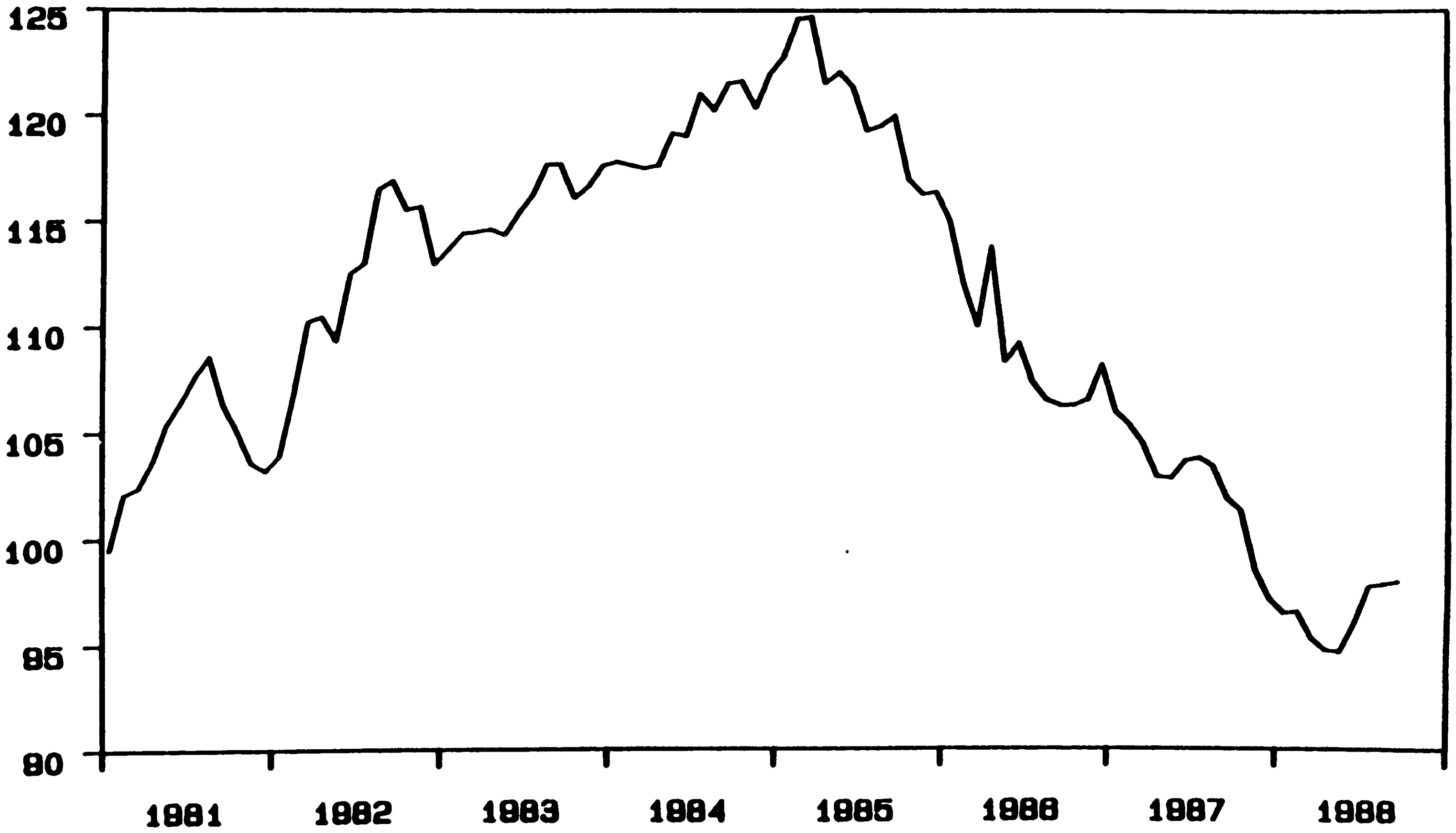
Downward Movement Shows Dollar Depreciation

*Last observation: 10/14

Chart 2

Real Trade-Weighted Dollar*

(December 1980 = 100)



Downward Movement Shows Dollar Depreciation

* Against basket accounting for 2/3 U.S. trade.

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202/376-4350

FOR IMMEDIATE RELEASE
October 24, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,005 million of 13-week bills and for $7,017 million of 26-week bills, both to be issued on October 27, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 26, 1989			:	26-week bills maturing April 27, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.41%a/	7.66%	98.127	:	7.50%	7.90%	96.208
High	7.46%	7.71%	98.114	:	7.55%	7.96%	96.183
Average	7.45%	7.70%	98.117	:	7.54%	7.95%	96.188

a/ Excepting 1 tender of $860,000.

Tenders at the high discount rate for the 13-week bills were allotted 66%.
Tenders at the high discount rate for the 26-week bills were allotted 8%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 33,210	$ 33,210	:	$ 33,375	$ 33,375
New York	21,296,920	5,400,220	:	22,061,810	5,764,810
Philadelphia	27,845	27,845	:	22,610	22,610
Cleveland	37,880	37,880	:	33,510	33,510
Richmond	41,905	41,905	:	39,825	39,825
Atlanta	29,865	29,865	:	25,820	25,820
Chicago	1,070,360	436,360	:	991,515	468,315
St. Louis	30,155	28,155	:	25,245	21,325
Minneapolis	9,890	9,890	:	12,950	8,350
Kansas City	40,630	40,630	:	38,955	37,955
Dallas	30,815	24,115	:	33,245	23,645
San Francisco	1,401,060	481,060	:	1,425,200	84,600
Treasury	413,575	413,575	:	452,370	452,370
TOTALS	$24,464,110	$7,004,710	:	$25,196,430	$7,016,510
Type					
Competitive	$21,190,320	$3,730,920	:	$20,906,480	$2,726,560
Noncompetitive	1,076,950	1,076,950	:	1,031,730	1,031,730
Subtotal, Public	$22,267,270	$4,807,870	:	$21,938,210	$3,758,290
Federal Reserve	1,921,860	1,921,860	:	1,700,000	1,700,000
Foreign Official Institutions	274,980	274,980	:	1,558,220	1,558,220
TOTALS	$24,464,110	$7,004,710	:	$25,196,430	$7,016,510

An additional $33,920 thousand of 13-week bills and an additional $253,580 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-43

TREASURY NEWS

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

October 24, 1988

Charles H. Dallara
Assistant Secretary of the Treasury for Policy Development
and Senior Advisor for Policy

Charles H. Dallara was confirmed by the United States Senate as Assistant Secretary of the Treasury for Policy Development on October 19, 1988, and was sworn into office by Secretary Nicholas F. Brady on October 20, 1988. President Reagan had nominated Dr. Dallara for this position earlier this month.

As Assistant Secretary for Policy Development, Dr. Dallara will continue to serve as Senior Advisor for Policy to the Secretary of the Treasury, a role he assumed in September. He will support the Secretary in the monitoring and development of policies covering the full range of the Department's activities. He will also be responsible for the oversight of the Executive Secretary and the functions of the Executive Secretariat.

Since 1984, Dr. Dallara has also been serving as United States Executive Director of the International Monetary Fund (IMF). He had served as Senior Deputy Assistant Secretary of the Treasury for International Economic Policy from 1985 to 1988, and prior to this had held a variety of other positions at the Treasury, and served as the U.S. Alternate Executive Director at the IMF.

Dr. Dallara received his Ph.D., M.A., and M.A.L.D. from the Fletcher School of Law & Diplomacy, Tufts University, and a B.A. in economics from the University of South Carolina. He also served as an officer in the U.S. Navy from 1970-1974.

Dr. Dallara was born on August 25, 1948 in Spartanburg, South Carolina to Harry P. and Margaret Dallara. He is married, has two children, and resides in Falls Church, Virginia.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE

October 24,1988

Washington-- The Department of the Treasury today announced that it has directed the Internal Revenue Service to delay until May 1, 1989 the issuance of determination letters for terminating defined benefit plans with assets in excess of liabilities if all or a portion of the excess assets are to be recovered by the employer. This temporary delay applies to determination letter applications for such terminating plans that are filed with the Internal Revenue Service on or after October 24, 1988. The temporary delay does not apply to the issuance of a determination letter upon the termination of any defined benefit plan if the application for the letter was filed with the Service prior to October 24, 1988, or if the parties affected by the plan termination were provided, prior to October 24, 1988, with 60-day notices of intent to terminate the plan, as required by section 4041(a)(2) of the Employee Retirement Income Security Act of 1974.

Applications for determination letters received by the Service on or after October 24, 1988 will continue to be processed in the ordinary course, with taxpayers afforded the opportunity to discuss the terms of the letter as it is processed. Determination letters with respect to such applications will be issued beginning May 1, 1989. Since the processing of applications under existing procedures requires several months, the May 1, 1989 issuance date will result in only minimal delay in the issuance of letters.

While the Treasury Department believes the current policies regarding plan terminations are sound and does not anticipate any changes in this area, the delay in the issuance of letters until May 1, 1989 will provide an opportunity for additional review of the guidelines applicable to determination letters for terminating plans.

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TREASURY NEWS

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

Oct. 24, 1988

NOTICE TO THE PRESS

At 2:15 pm today the Treasury Department's report to Congress on international economic and exchange rate policy will be made available to accredited media only in room 4121 of the main Treasury building. A briefing by a senior Treasury official will follow at 3 pm.

The report and briefing will be embargoed for release at 4:00 pm. Come in through the 15th street entrance. Contact: Bob Levine 566-2041.

No Cameras

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.

CONTACT: Office of Financing
202/376-4350

October 25, 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 $14,400 million, to be issued November 3, 1988. This offering will provide about $600 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,801 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 Standard time, Monday, October 31, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated August 4, 1988, and to mature February 2, 1989 (CUSIP No. 912794 RE 6), currently outstanding in the amount of $7,367 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated November 3, 1988, and to mature May 4, 1989 (CUSIP No. 912794 RW 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 November 3, 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 $1,882 million as agents for foreign and international monetary authorities, and $3,776 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
October 26, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,014 million of $25,136 million of tenders received from the public for the 2-year notes, Series AG-1990, auctioned today. The notes will be issued October 31, 1988, and mature October 31, 1990.

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	8.31%	99.891
High	8.34%	99.837
Average	8.33%	99.855

Tenders at the high yield were allotted 88%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 58,130	$ 58,130
New York	21,066,055	7,946,255
Philadelphia	38,740	38,740
Cleveland	68,755	68,755
Richmond	91,455	90,840
Atlanta	41,200	38,200
Chicago	1,372,515	213,515
St. Louis	93,755	85,745
Minneapolis	41,750	40,725
Kansas City	119,165	119,165
Dallas	23,135	23,135
San Francisco	2,034,140	203,140
Treasury	87,245	87,245
Totals	$25,136,040	$9,013,590

The $9,014 million of accepted tenders includes $1,146 million of noncompetitive tenders and $7,868 million of competitive tenders from the public.

In addition to the $9,014 million of tenders accepted in the auction process, $980 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $639 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

October 28, 1988

Contact: Art Siddon (202) 566-5252
Barbara Clay (202) 395-3080

FOR IMMEDIATE RELEASE
October 28, 1988

JOINT STATEMENT OF
NICHOLAS F. BRADY, SECRETARY OF THE TREASURY
AND
JOSEPH R. WRIGHT
ACTING DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
ON
BUDGET RESULTS FOR FISCAL YEAR 1988

SUMMARY

The Treasury Department is today releasing the September Monthly Treasury Statement of Receipts and Outlays of the United States Government, which shows the actual budget totals (including social security) for the fiscal year that ended on September 30, 1988. The statement shows:

- -- total receipts of $909.0 billion;
- -- total outlays of $1,064.1 billion; and
- -- a total deficit of $155.1 billion.

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Table 1.--TOTAL RECEIPTS, OUTLAYS, AND DEFICITS
(in billions of dollars)

	Receipts	Outlays	Deficit (-)
1987 Actual....................	854.1	1,003.8	-149.7
1988 Estimates and Actual:			
February a/.................	909.2	1,055.9	-146.7
July b/.....................	913.4	1,065.8	-152.3
Actual......................	909.0	1,064.1	-155.1

a/ February 1988 from the 1989 Budget.
b/ July 1988 from the Mid-Session Review of the 1989 Budget.

DEFICIT

The deficit for 1988 was $155.1 billion, $2.8 billion higher than the July estimate. Although the 1988 deficit was $5.4 billion higher than the 1987 deficit, the underlying trend in the deficit, excluding temporary factors, remains downward, as indicated in Table 2.

Table 2.--FEDERAL DEFICIT 1983-1988
(in billions of dollars)

	Actual
1983............................	-207.8
1984............................	-185.3
1985............................	-212.3
1986............................	-221.2
1987............................	-149.7
1988............................	-155.1

After declining by a record $71.5 billion in 1987, the deficit increased by $5.4 billion in 1988. However, this can be attributed to a number of special factors that reduced the deficit in 1987 below its trend level.

The phase-in of the Tax Reform Act of 1986 added $21.5 billion to receipts in 1987 but reduced tax collections by $4.5 billion in 1988. Timing changes, such as the one day shift in military pay, and one-time savings, such as the sale of Conrail, held down net outlays by $10.5 billion in 1987. Were it not for these special factors, the deficit would have declined by $31.1 billion between 1987 and 1988.

RECEIPTS

Receipts were estimated in the February budget at $909.2 billion, and were revised upward to $913.4 billion in the July Mid-Session Review. Actual receipts for 1988 were $909.0 billion, $4.5 billion lower than the July estimate. Most of the $4.5 billion difference is attributable to lower than anticipated collections of individual income taxes.

Receipts Changes by Source

-- Individual Income Taxes and Employment Taxes and Contributions were below the July estimate by $4.0 billion and $0.7 billion respectively. Lower than estimated withholding was in large part responsible for the shortfall in these receipts.

-- Corporation Income Taxes were $94.2 billion, $0.8 billion higher than the $93.4 billion estimated in July, largely because estimated payments of 1988 tax liability were higher than expected.

-- Excise Taxes were $35.5 billion, $0.9 billion more than the July estimate.

-- Customs Duties were $16.2 billion, $0.9 billion lower than the July estimate, and substantially offsetting the higher excise taxes.

-- Miscellaneous Receipts were $19.9 billion, $0.6 billion less than the July estimate. Lower than estimated deposits of earnings by the Federal Reserve System account for $0.2 billion of the shortfall.

OUTLAYS

Total outlays in the February budget were estimated at $1,055.9 billion. This estimate was increased by $9.9 billion, to $1,065.8 billion in the Mid-Session Review, reflecting the net impact of technical reestimates, policy changes, and a revised economic forecast. Actual 1988 outlays were $1,064.1 billion, $1.7 billion below the July estimate.

The $1.7 billion decrease from the July estimate reflects the net impact of numerous increases and decreases. Outlays were higher than anticipated for the Department of Defense - Military ($4.7 billion above the July estimate) and the Federal Home Loan Bank Board ($3.0 billion above the July estimate). These and other increases were more than offset by lower than anticipated outlays for the Agriculture Department ($2.9 billion below the July estimate), Military and other funds appropriated to the President ($2.2 billion below the July estimate), the Federal Deposit Insurance Corporation ($1.8 billion below the July estimate), and other agencies.

Outlay Changes by Agency and Program

The major outlay changes since the July Mid-Session Review are described below. Table 3, which follows this discussion, displays the estimates for February and July and the actual levels by agency and major program.

Funds Appropriated to the President.--Outlays of Funds Appropriated to the President were $7.3 billion, $2.2 billion lower than the $9.4 billion estimated in July.

-- Foreign Military Sales Credit.--Collections exceeded outlays for the Foreign Military Sales Credit program by $0.1 billion. In July it was estimated that net outlays would be $1.5 billion. Net outlays were $1.5 billion lower than estimated in July, due to greater than expected loan refinancings and slower than expected loan disbursements.

-- Military Sales Programs.--Outlays for military sales programs were $0.1 billion, $0.8 billion lower than the $0.9 billion estimated in July, due mainly to higher sales activity and resulting higher offsetting receipts than expected in July.

Department of Agriculture.--Outlays of the Department of Agriculture were $44.0 billion, $2.9 billion lower than the $46.9 billion estimated in July.

-- Commodity Credit Corporation and Foreign Assistance.--Outlays were $13.3 billion, $1.0 billion lower than the July estimate of $14.3 billion, because the impact of the 1988 drought was greater than assumed in July. Commodity prices were higher than expected, thus reducing final deficiency payments and net lending activity.

-- Federal Crop Insurance Corporation.--Outlays were $0.4 billion, $1.0 billion below the July estimate of $1.4 billion, largely due to a slower than expected settlement of claims resulting from the 1988 drought.

-- All Other Agriculture.--Outlays of all other Agriculture Department programs were $30.3 billion, $0.9 billion lower than the July estimate of $31.2 billion. Outlays of the Rural Electrification Administration were lower by $0.2 billion due primarily to lower advances of guaranteed Federal Financing Bank loans and higher prepayments of Rural Telephone Bank loans. Other outlay changes are a result of numerous differences across the department.

Department of Defense-Military.--Outlays of the Department of Defense-Military were $281.9 billion, $4.7 billion higher than the $277.3 billion estimated in July. This was due to unanticipated funding requirements from the decline in the value of the U.S. dollar, the absorption of military and civilian pay raises, and increased medical costs. In addition, there was faster than planned execution of prior year programs.

Department of Education.--Outlays of the Department of Education were $18.2 billion, $0.7 billion lower than the July estimate of $19.0 billion due to a write-off of unexpended balances and to slower than anticipated spending in education grant programs.

Department of Energy.--Outlays of the Department of Energy were $11.2 billion, or $0.3 billion higher than the $10.9 billion estimated in July, due mainly to faster than planned execution in atomic energy defense programs.

Department of Health and Human Services -- except Social Security.--Outlays were $159.0 billion, $1.6 billion below the $160.6 billion estimated in July.

-- Medicare outlays were $87.7 billion, $0.6 billion below the July estimate. The Omnibus Budget Reconciliation Act of 1987 (OBRA 87) mandated that the payment of Medicare claims would be no faster than ten days starting on July 1, 1988. HHS underestimated the impact of this change in the timing of payments, which resulted in outlays lower than planned.

-- Medicaid.--Medicaid outlays were $30.5 billion, $0.3 billion lower than the $30.8 billion estimated in July, due to the underestimate of the savings from the ten day delay mandated by OBRA 87. Since Medicaid is the payor of last resort, delays by the first payor, Medicare, caused delays in Medicaid as well, resulting in lower actual outlays.

-- Public Health Service.--Outlays by the Public Health Service were $11.4 billion, $0.3 billion higher than the $11.1 billion estimated in July, due to faster than estimated spending.

Department of Housing and Urban Development.--Outlays by the Department of Housing and Urban Development were $19.0 billion, $0.5 billion lower than estimated in July, due to slower than anticipated outlays in subsidized housing programs for very-low-income families.

Department of Transportation.--Outlays of the Department of Transportation were $26.4 billion, $0.3 billion higher than the July estimate of $26.1 billion.

-- Federal Highway Administration.--Outlays were $14.0 billion, $0.6 billion higher than the July estimate, due to greater State cash drawdowns than anticipated.

-- Other.--Outlays were $0.3 billion lower than the $12.7 billion estimated in July, due to lower spending by the Coast Guard and the Maritime Administration's Federal Ship Financing Fund.

Department of the Treasury.--Outlays were $202.5 billion, $0.2 billion higher than the July estimate of $202.3 billion.

-- Interest on the Public Debt.--Interest on the public debt was $214.1 billion, $0.5 billion higher than the $213.7 billion estimated in July, due to higher interest rates.

-- Other.--Other outlays were $0.4 billion lower than estimated in July due to a number of factors, including lower claims, judgments, and relief payments, lower Federal Financing Bank interest payments to the Office of Personnel Management, and delays in expected obligations in operating accounts.

Office of Personnel Management.--Outlays of the Office of Personnel Management were $29.2 billion, $0.4 billion higher than the July estimate of $28.8 billion primarily because more retiring employees elected to receive lump-sum payments than had been estimated.

Veterans Administration --Outlays were $29.2 billion, $0.5 billion higher than the $28.8 billion estimated in July, primarily because supplemental funds were made available to pay certain veterans compensation payments earlier than expected.

Federal Deposit Insurance Corporation.--Outlays were $2.1 billion, $1.8 billion lower than the July estimate of $4.0 billion because of a delay in the settlement of two large assistance cases.

Federal Home Loan Bank Board.--Outlays were $8.1 billion, $3.0 billion above the July estimate of $5.1 billion, because the costs of assisting troubled savings institutions were substantially greater than anticipated.

Table 3.--1987 and 1988 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1987 Actual	1988 Estimate February	1988 Estimate July	1988 Actual
Receipts by Source				
Individual income taxes	392,557	393,395	405,188	401,181
Corporation income taxes	83,926	105,567	93,361	94,195
Social insurance taxes and contributions:				
Employment taxes and contributions	273,028	303,069	305,787	305,093
On-budget	(59,626)	(63,170)	(63,601)	(63,602)
Off-budget	(213,402)	(239,899)	(242,186)	(241,491)
Unemployment insurance	25,575	23,727	24,531	24,584
Other retirement contributions	4,715	4,717	4,713	4,658
Subtotal, Social insurance taxes and contributions	303,318	331,513	335,031	334,335
Excise taxes	32,457	35,342	34,669	35,540
Estate and gift taxes	7,493	7,567	7,567	7,594
Customs duties	15,085	16,399	17,086	16,198
Miscellaneous receipts	19,307	19,380	20,510	19,909
Total, Receipts	854,143	909,163	913,411	908,953
On-budget	(640,741)	(669,264)	(671,225)	(667,462)
Off-budget	(213,402)	(239,899)	(242,186)	(241,491)
Outlays by Major Agency				
Legislative branch and the Judiciary	2,989	3,302	3,351	3,189
Executive Office of the President	109	124	124	121

Table 3.--1987 and 1988 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

		1988		
		Estimate		
	1987 Actual	February	July	Actual
Funds Appropriated to the President:				
International Security Assistance:				
Foreign Military Sales Credit	3,758	-2,264	1,464	-75
Economic Support Fund	3,466	3,362	3,362	3,184
Other	-404	995	740	1,164
International development assistance	2,673	2,932	2,934	2,980
International monetary programs	-575	---	---	-136
Military sales programs	1,386	186	869	106
Other	102	23	60	29
Subtotal, Funds Appropriated to the President	10,406	5,233	9,429	7,252
Agriculture:				
Commodity Credit Corporation and foreign assistance	23,424	18,862	14,319	13,284
Federal Crop Insurance Corporation	-296	491	1,425	411
Rural Electrification Administration	-238	-1,187	-1,589	-1,825
Farmers Home Administration	3,748	6,810	7,341	7,277
Food and Nutrition Service	18,435	20,000	19,850	19,581
Other	4,520	5,738	5,561	5,276
Subtotal, Agriculture	49,593	50,715	46,907	44,003
Commerce	2,156	2,485	2,489	2,279
Defense-Military:				
Military personnel	72,020	75,453	75,453	76,337
Operation and maintenance	76,178	80,433	80,433	84,480
Procurement	80,744	79,166	79,166	77,166
Research, development, test, and evaluation	33,596	33,127	33,127	34,792

Table 3.--1987 and 1988 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1987 Actual	1988 Estimate February	1988 Estimate July	1988 Actual
Other	11,399	9,096	9,096	9,165
Subtotal, Defense-Military	273,938	277,275	277,275	281,940
Defense-Civil	20,659	22,284	22,284	22,047
Education	16,800	18,796	18,970	18,246
Energy	10,688	10,506	10,853	11,161
Health and Human Services -- except Social Security:				
Medicare	81,640	87,657	88,237	87,676
Medicaid	27,435	30,664	30,829	30,462
Public Health Service	9,886	11,088	11,092	11,408
Other	29,933	31,024	30,416	29,445
Subtotal, Health and Human Services -- except Social Security	148,893	160,432	160,573	158,991
Health and Human Services -- Social Security	202,422	214,695	214,052	214,178
Housing and Urban Development:				
Housing payments	9,852	10,954	10,914	11,108
Federal Housing Administration fund	-555	281	1,387	1,134
Government National Mortgage Association	-675	193	289	208
Community development grants	2,991	2,980	2,980	3,044
Other	3,851	4,145	3,888	3,461
Subtotal, Housing and Urban Development	15,464	18,553	19,457	18,956
Interior	5,054	5,407	5,382	5,152
Justice	4,333	5,151	5,159	5,426

Table 3.--1987 and 1988 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1987 Actual	1988 Estimate February	1988 Estimate July	1988 Actual
Labor:				
Training and employment services	3,545	3,717	3,717	3,701
Advances to the unemployment trust fund and other funds	168	30	114	95
Unemployment trust fund	20,527	17,500	18,700	18,598
Other	1,999	1,733	2,002	2,005
Intrabudgetary transactions	-2,786	-971	-2,517	-2,528
Subtotal, Labor	23,453	22,009	22,016	21,870
State	2,788	3,321	3,321	3,421
Transportation:				
Federal Highway Administration	12,738	13,400	13,375	14,002
Urban Mass Transportation Administration	3,299	3,535	3,122	3,266
Federal Aviation Administration	4,895	5,311	5,265	5,192
Other	4,499	4,077	4,341	3,944
Subtotal, Transportation	25,431	26,323	26,102	26,404
Treasury:				
Exchange Stabilization Fund	-1,410	-176	-1,490	-1,498
Interest on the public debt	195,390	210,058	213,654	214,145
Offsetting receipts	-23,693	-24,030	-23,812	-23,771
Other	10,058	13,045	13,988	13,596
Subtotal, Treasury	180,345	198,898	202,340	202,472
Environmental Protection Agency	4,903	4,853	4,859	4,872
General Services Administration	74	-135	-22	-285
National Aeronautics and Space Administration	7,591	9,112	9,112	9,092
Office of Personnel Management	26,966	28,493	28,838	29,191

Table 3.--1987 and 1988 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1987 Actual	1988 Estimate February	1988 Estimate July	1988 Actual
Small Business Administration	-72	280	128	-54
Veterans Administration	26,952	27,623	28,754	29,244
Other independent agencies:				
District of Columbia	267	523	523	520
Export-Import Bank	-2,300	-985	-985	-894
Federal Deposit Insurance Corporation	-1,438	2,268	3,982	2,146
Federal Emergency Management Agency	544	644	703	551
Federal Home Loan Bank Board	4,755	2,189	5,087	8,078
Postal Service	1,593	2,223	2,083	2,229
Railroad Retirement Board	4,196	4,116	4,139	4,147
Tennessee Valley Authority	1,091	992	1,198	1,089
Other (net)	5,557	5,918	5,955	5,495
Subtotal, other independent agencies	14,266	17,886	22,685	23,361
Undistributed offsetting receipts:				
Other interest	-903	---	---	-1
Employer share, employee retirement (on-budget)	-27,259	-28,670	-28,683	-28,957
Employer share, employee retirement (off-budget)	-3,300	-4,298	-4,302	-4,071
Interest received by on-budget trust funds	-29,752	-34,321	-34,643	-34,481
Interest received by off-budget trust funds	-5,290	-7,271	-7,294	-7,416
Rents and royalties on the Outer Continental Shelf lands	-4,021	-3,155	-3,757	-3,548
Sale of major assets	-1,875	---	---	---
Subtotal, undistributed offsetting receipts	-72,400	-77,715	-78,679	-78,473

For Fiscal Year 1988
Through September 30, 1988,
and Other Periods

Final[1] Monthly Treasury Statement of Receipts and Outlays of the United States Government

Department of the Treasury
Financial Management Service

Summary - page 2

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Deficit Financing - page 20

Receipts/Outlays by Month - page 26

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Receipts by Source/Outlays by Function - page 29

Explanatory Notes - page 30

[1] This publication contains the final budget results for fiscal year 1988.

Introduction

The *Monthly Treasury Statement of Receipts and Outlays of the United States Government (MTS)* is prepared by the Department of the Treasury, Financial Management Service, and after approval by the Fiscal Assistant Secretary of the Treasury, is normally released on the 15th workday of the month following the reporting month. The publication is based on data provided by Federal entities, disbursing officers, and Federal Reserve banks.

Audience

The *MTS* is published to meet the needs of: Those responsible for or interested in the cash position of the Treasury; Those who are responsible for or interested in the Government's budget results; and individuals and businesses whose operations depend upon or are related to the Government's financial operations.

Disclosure Statement

This statement summarizes the financial activities of the Federal Government and off-budget Federal entities conducted in accordance with the Budget of the U.S. Government, i.e., receipts and outlays of funds, the surplus or deficit, and the means of financing the deficit or disposing of the surplus. Information is presented on a modified cash basis: receipts are accounted for on the basis of collections; outlays of receipts are treated as deductions from gross receipts; revolving and management fund receipts, reimbursements and refunds of monies previously expended are treated as deductions from gross outlays; and interest on the public debt (public issues) is recognized on the accrual basis. Major information sources include accounting data reported by Federal entities, disbursing officers, and Federal Reserve banks.

Triad of Publications

The *MTS* is part of a triad of Treasury financial reports. The *Daily Treasury Statement* is published each working day of the Federal Government. It provides data on the cash and debt operations of the Treasury based upon reporting of the Treasury account balances by Federal Reserve banks. The *MTS* is a report of Government receipts and outlays, based on agency reporting. The *U.S. Government Annual Report* is the official publication of the detailed receipts and outlays of the Government. It is published annually in accordance with legislative mandates given to the Secretary of the Treasury.

Data Sources and Information

The Explanatory Notes section of this publication provides information concerning the flow of data into the *MTS* and sources of information relevant to the *MTS.*

Table 1. Summary of Receipts, Outlays, and the Deficit/Surplus of the U.S. Government, Fiscal Years 1987 and 1988, by Month (in millions)

Period	Receipts	Outlays	Deficit/Surplus (-)
FY 1987			
October	$59,012	$84,302	$25,290
November	52,967	80,054	27,087
December	78,035	90,404	12,369
January	81,771	83,928	2,157
February	55,463	83,842	28,379
March	56,515	84,446	27,931
April	122,897	84,155	-38,742
May	47,691	83,328	35,637
June	82,945	83,568	623
July	64,223	86,562	22,339
August	60,213	82,009	21,796
September	92,410	77,206	-15,204
Year-to-Date	**854,143**	**[1] 1,003,804**	**[1] 149,661**
FY 1988			
October	62,354	93,164	30,810
November	56,987	84,009	27,022
December	85,525	109,889	24,363
January	81,791	65,895	-15,896
February	60,355	84,382	24,027
March	65,730	95,013	29,283
April	109,323	95,554	-13,769
May	59,711	82,295	22,583
June	99,205	90,071	-9,134
July	60,690	83,634	22,944
August	69,479	92,561	23,082
September	97,803	87,588	-10,214
Year-to-date	**$908,953**	**[1] $1,064,055**	**[1] $155,102**

[1] The outlays by month for FY 1987 have been increased by a net of $737 million to reflect reclassification of the Thrift Savings Fund receipts of $743 million and Federal Retirement Thrift Investment Board (FRTIB) administrative expenses of $6 million to a non-budgetary status. The Federal Retirement Thrift Investment Board outlays by month for FY 1988 have been adjusted by a net of $1,084 million. Data for fiscal years 1987 and 1988 previously reported by Treasury for Federal Savings and Loan Insurance Corporation and FRTIB have been reclassified in consultation with the Office of Management and Budget resulting in revised totals as shown above. Historical tables in the Budget will be changed to agree with Treasury totals with the exception of a difference of $7 million for the Small Business Administration and the administrative expenses for the FRTIB. OMB will continue to reflect the administrative expenses for the FRTIB in budgetary totals.

Note: Details may not add to totals due to rounding.

Source: Financial Management Service, Department of the Treasury.

Table 2. Summary of Budget and Off-Budget Results and Financing of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	Current Month	Actual Fiscal Year to Date	Budget Estimates Full Fiscal Year[1]	Actual Previous Fiscal Year to Date (1987)	Budget Estimates Next Fiscal Year (1989)[1]
Total on-budget and off-budget results:					
Total receipts	$97,803	$908,953	$913,411	$854,143	$974,045
On-budget receipts	75,586	667,462	671,225	640,741	711,958
Off-budget receipts	22,217	241,491	242,186	213,402	262,087
Total outlays	87,588	1,064,055	1,065,759	1,003,804	1,096,740
On-budget outlays	70,071	861,364	863,303	809,972	885,877
Off-budget outlays	17,518	202,691	202,456	193,832	210,863
Total surplus (+) or deficit (−)	+10,214	−155,102	−152,348	−149,661	−122,695
On-budget surplus (+) or deficit (−)	+5,515	−193,901	−192,078	−169,231	−173,919
Off-budget surplus (+) or deficit (−)	+4,699	+38,800	+39,730	+19,570	+51,224
Total on-budget and off-budget financing	−10,214	155,102	152,348	149,661	122,695
Means of financing:					
By Borrowing from the public	14,665	166,171	132,708	151,717	117,780
By Reduction of operating cash, increase (−)	−31,444	−7,963	16,436	−5,052	.....
By Other means	6,564	−3,106	3,204	2,996	4,915

[1]Based on the Mid-Session Review of the FY 1989 Budget released by the Office of Management and Budget on July 28, 1988.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Figure 1. Monthly Receipts, Outlays, and Budget Deficit/Surplus of the U.S. Government, Fiscal Years 1987 and 1988

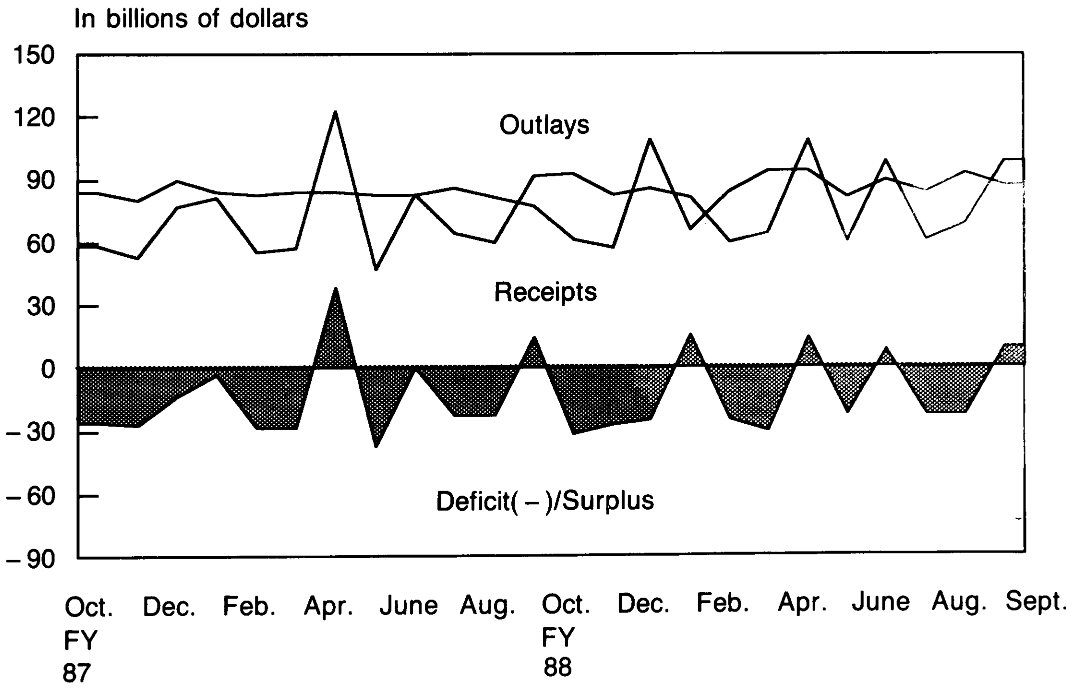

Figure 2. Monthly Receipts of the U.S. Government, by Source, Fiscal Years 1987 and 1988

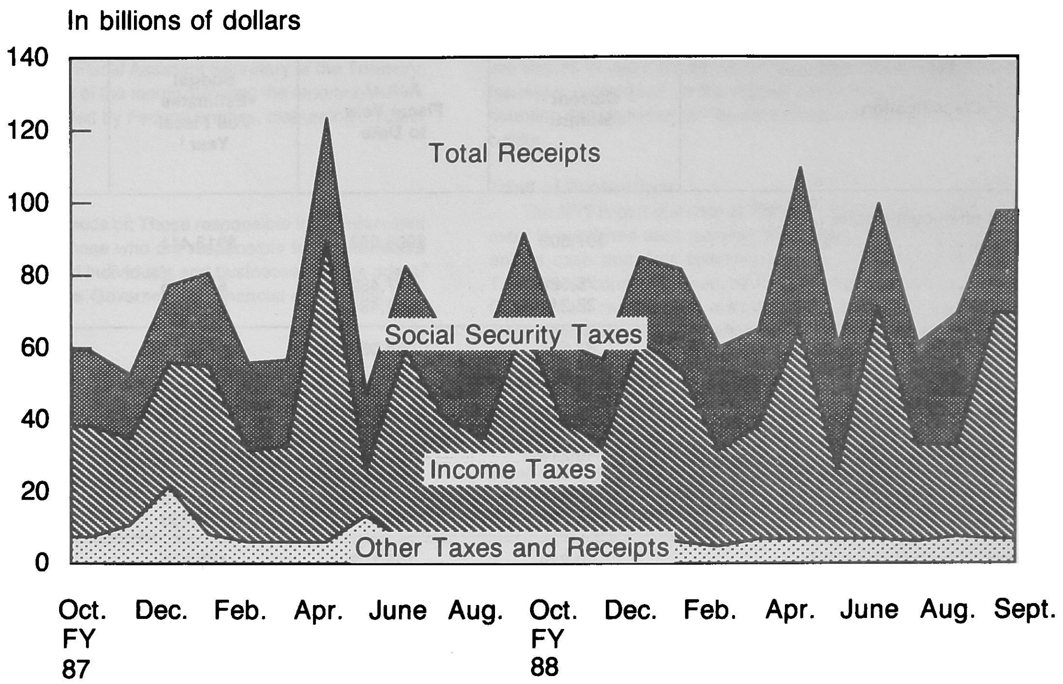

Figure 3. Monthly Outlays of the U.S. Government, by Function, Fiscal Years 1987 and 1988

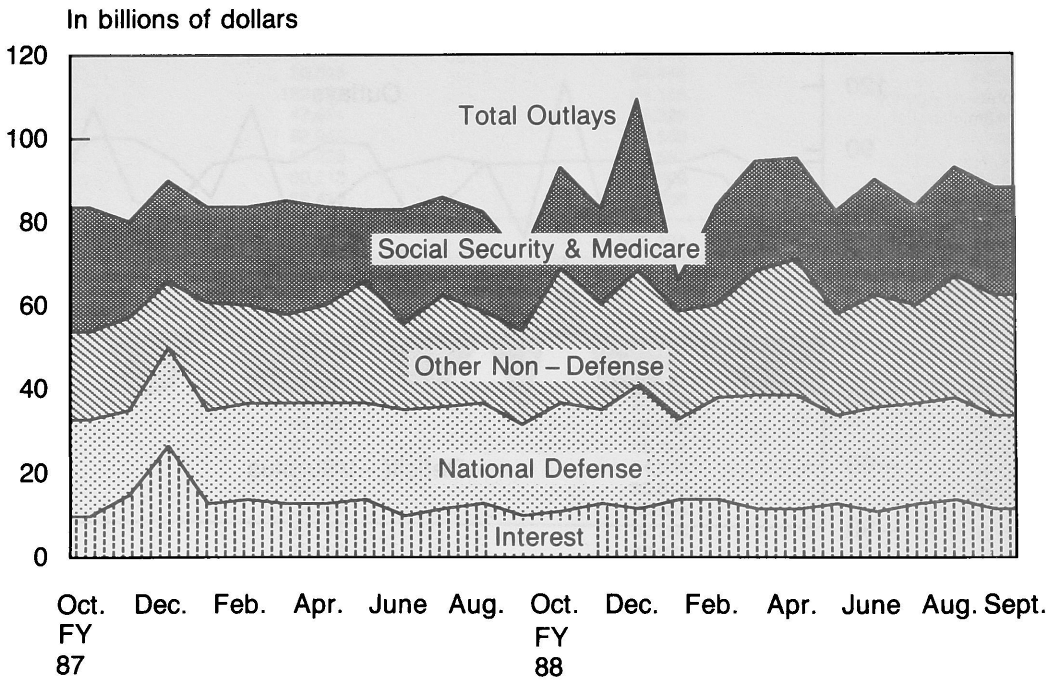

Table 3. Summary of Receipts and Outlays of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	Actual This Month	Actual This Fiscal Year to Date	Actual Comparable Prior Period	Budget Estimates Full Fiscal Year[1]
Budget Receipts				
Individual income taxes	$41,784	$401,181	$392,557	$405,188
Corporation income taxes	20,668	94,195	83,926	93,361
Social insurance taxes and contributions:				
Employment taxes and contributions (off-budget)	22,217	241,491	213,402	242,186
Employment taxes and contributions (on-budget)	5,774	63,602	59,626	63,601
Unemployment Insurance	285	24,584	25,575	24,531
Other retirement contributions	418	4,658	4,715	4,713
Excise taxes	3,158	35,540	32,457	34,669
Estate and gift taxes	678	7,594	7,493	7,567
Customs duties	1,367	16,198	15,085	17,086
Miscellaneous receipts	1,454	19,909	19,307	20,510
Total Receipts	**97,803**	**908,953**	**854,143**	**913,411**
(On-budget)	**75,586**	**667,462**	**640,741**	**671,225**
(Off-budget)	**22,217**	**241,491**	**213,402**	**242,186**
Budget Outlays				
Legislative Branch	161	1,852	1,812	1,942
The Judiciary	93	1,337	1,178	1,409
Executive Office of the President	8	121	109	124
Funds Appropriated to the President	-1,547	7,252	10,406	9,429
Department of Agriculture	2,764	44,003	49,593	46,907
Department of Commerce	211	2,279	2,156	2,489
Department of Defense—Military	21,036	281,940	273,938	277,275
Department of Defense—Civil	1,913	22,047	20,659	22,284
Department of Education	1,611	18,246	16,800	18,970
Department of Energy	813	11,161	10,688	10,853
Department of Health and Human Services, except Social Security	14,298	158,991	148,893	160,573
Department of Health and Human Services, Social Security	17,973	214,178	202,422	214,052
Department of Housing and Urban Development	1,584	18,956	15,464	19,457
Department of the Interior	725	5,152	5,054	5,382
Department of Justice	427	5,426	4,333	5,159
Department of Labor	1,462	21,870	23,453	22,016
Department of State	356	3,421	2,788	3,321
Department of Transportation	2,511	26,404	25,431	26,102
Department of the Treasury:				
Interest on the Public Debt	15,250	214,145	195,390	213,654
Other	-2,206	-11,673	-15,045	-11,314
Environmental Protection Agency	459	4,872	4,903	4,859
General Services Administration	255	-285	74	-22
National Aeronautics and Space Administration	530	9,092	7,591	9,112
Office of Personnel Management	2,222	29,191	26,966	28,838
Small Business Administration	-26	-54	-72	128
Veterans Administration	3,091	29,244	26,952	28,754
Other independent agencies	6,924	23,361	14,266	22,685
Allowances, undistributed	...	...	...	...
Undistributed offsetting receipts:				
Interest	-418	-41,898	-35,945	-41,937
Other	-4,892	-36,576	-36,455	-36,742
Total Outlays	**87,588**	**[2]1,064,055**	**[2]1,003,804**	**1,065,759**
(On-budget)	**70,071**	**861,364**	**809,972**	**863,303**
(Off-budget)	**17,518**	**202,691**	**193,832**	**202,456**
Surplus (+) or deficit (-)	**+10,214**	**[2]-155,102**	**[2]-149,661**	**-152,348**
(On-budget)	**+5,515**	**-193,901**	**-169,231**	**-192,078**
(Off-budget)	**+4,699**	**+38,800**	**+19,570**	**+39,730**

[1]Based on the Mid-Session Review of the FY 1989 Budget released by the Office of Management and Budget on July 28, 1988.

[2]The outlays by month for FY 1987 have been increased by a net of $737 million to reflect reclassification of the Thrift Savings Fund receipts of $743 million and Federal Retirement Thrift Investment Board (FRTIB) administrative expenses of $6 million to a non-budgetary status. The FRTIB outlays by month for FY 1988 have been adjusted by a net of $1,084 million.

... No Transactions.

Source: Financial Management Service, Department of the Treasury.

Table 4. Receipts of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Receipts	Refunds (Deduct)	Receipts	Gross Receipts	Refunds (Deduct)	Receipts	Gross Receipts	Refunds (Deduct)	Receipts
Individual income taxes:									
Withheld	$27,209			$341,435			$322,463		
Presidential Election Campaign Fund	1			33			33		
Other	16,793			132,199			142,957		
Total—Individual income taxes	44,003	$2,219	$41,784	473,668	$72,487	$401,181	465,453	$72,896	$392,557
Corporation income taxes	21,380	712	20,668	109,683	15,487	94,195	102,859	18,933	83,926
Social insurance taxes and contributions:									
Employment taxes and contributions:									
Federal old-age and survivors ins. trust fund:									
Federal Insurance Contributions Act taxes	18,557	.....	18,557	207,880	512	207,368	179,409	374	179,035
Self-Employment Contributions Act taxes	1,714	.....	1,714	12,929	.....	12,929	10,181	.....	10,181
Deposits by States	4	.....	4	40	.....	40	5,325	.....	5,325
Other	(**)	.....	(**)	(**)	.....	(**)	(**)	.....	(**)
Total—FOASI trust fund	20,275	.....	20,275	220,849	512	220,337	194,916	374	194,541
Federal disability insurance trust fund:									
Federal Insurance Contributions Act taxes	1,778	.....	1,778	19,949	48	19,901	17,251	29	17,222
Self-Employment Contributions Act taxes	164	.....	164	1,245	.....	1,245	990	.....	990
Receipts from Railroad Retirement Account	.....	.....	.....	.....	.....	.....	.....	.....	.....
Deposits by States	(**)	.....	(**)	9	.....	9	649	.....	649
Other	.....	.....	.....	.....	.....	.....	(**)	.....	(**)
Total—FDI trust fund	1,942	.....	1,942	21,203	48	21,154	18,889	29	18,861
Federal hospital insurance trust fund:									
Federal Insurance Contributions Act taxes	4,939	.....	4,939	56,200	147	56,052	50,969	113	50,857
Self-Employment Contributions Act taxes	448	.....	448	3,517	.....	3,517	2,816	.....	2,816
Receipts from Railroad Retirement Board	.....	.....	.....	332	.....	332	330	.....	330
Deposits by States	(**)	.....	(**)	−42	.....	−42	1,989	.....	1,989
Total—FHI trust fund	5,387	.....	5,387	60,007	147	59,859	56,105	113	55,992
Railroad retirement accounts:									
Rail industry pension fund	216	8	207	2,315	32	2,283	2,310	18	2,292
Railroad social security equivalent benefit	179	.....	179	1,460	.....	1,460	1,342	.....	1,342
Total—Employment taxes and contributions	27,999	8	27,991	305,833	740	305,093	273,562	533	273,028
Unemployment insurance:									
State taxes deposited in Treasury	208	.....	208	18,310	.....	18,310	19,134	.....	19,134
Federal Unemployment Tax Act taxes	87	10	77	6,178	258	5,920	6,232	152	6,080
Railroad Unemployment taxes	(**)	.....	(**)	195	.....	195	204	.....	204
Railroad debt repayment	(**)	.....	(**)	158	.....	158	157	.....	157
Total—Unemployment insurance	295	10	285	24,841	258	24,584	25,727	152	25,575
Federal employees retirement contributions:									
Civil service retirement and disability fund	404	.....	404	4,501	.....	4,501	4,562	.....	4,562
Foreign service retirement and disability fund	2	.....	2	33	.....	33	48	.....	48
Other	(**)	.....	(**)	3	.....	3	3	.....	3
Total—Federal employees retirement contributions	407	.....	407	4,537	.....	4,537	4,613	.....	4,613
Other retirement contributions:									
Civil service retirement and disability fund	12	.....	12	122	.....	122	102	.....	102
Total—Social insurance taxes and contributions	28,712	18	28,694	335,333	998	334,335	304,004	685	303,318
Excise taxes:									
Miscellaneous excise taxes[1]	1,536	66	1,470	18,246	603	17,643	16,553	760	15,793
Airport and airway trust fund	368	(**)	368	3,195	6	3,189	3,066	6	3,060
Highway trust fund	1,275	.....	1,275	14,406	292	14,114	13,159	127	13,032
Black lung disability trust fund	45	.....	45	594	.....	594	572	.....	572
Total—Excise taxes	3,224	66	3,158	36,441	901	35,540	33,350	893	32,457
Estate and gift taxes	689	11	678	7,784	190	7,594	7,668	175	7,493
Customs duties	1,409	42	1,367	16,690	492	16,198	15,574	489	15,085
Miscellaneous receipts:									
Deposits of earnings by Federal Reserve banks	1,276	.....	1,276	17,163	.....	17,163	16,817	.....	16,817
All other	168	−9	178	2,748	2	2,746	2,510	20	2,490
Total—Miscellaneous receipts	1,444	−9	1,454	19,911	2	19,909	19,327	20	19,307
Total—Receipts	100,861	3,058	97,803	999,510	90,557	908,953	948,234	94,091	854,143
Total—On-budget	78,644	3,058	75,586	757,459	89,996	667,462	734,429	93,688	640,741
Total—Off-budget	22,217	.....	22,217	242,051	560	241,491	213,805	403	213,402

[1]Includes amounts received for windfall profits tax pursuant to P.L. 96-223.
. . .No Transactions
(**)Less than $500,000.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Legislative Branch:									
Senate	$28	(**)	$28	$336	$1	$335	$314	$1	$313
House of Representatives	47	(**)	47	568	1	567	495	1	494
Joint items	9	......	9	92	......	92	83	......	83
Congressional Budget Office	2	......	2	17	......	17	16	......	16
Architect of the Capitol	9	$1	8	126	7	119	118	9	109
Library of Congress	15	......	15	283	......	283	370	......	370
Government Printing Office:									
Revolving fund (net)	13	......	13	-25	......	-25	4	......	4
General fund appropriations	8	......	8	103	......	103	91	......	91
General Accounting Office	30	......	30	326	......	326	301	......	301
United States Tax Court	2	......	2	24	......	24	22	......	22
Other Legislative Branch agencies	1	......	1	19	......	19	19	......	19
Proprietary receipts from the public	......	(**)	(**)	......	5	-5	......	5	-5
Intrabudgetary transactions	-1	......	-1	-3	......	-3	-6	......	-6
Total—Legislative Branch	**162**	**1**	**161**	**1,866**	**14**	**1,852**	**1,827**	**15**	**1,812**
The Judiciary:									
Supreme Court of the United States	2	......	2	17	......	17	16	......	16
Courts of appeals, district courts, and other judicial services	86	......	86	1,258	......	1,258	1,100	......	1,100
Other	5	......	5	62	......	62	61	......	61
Total—The Judiciary	**93**	......	**93**	**1,337**	......	**1,337**	**1,178**	......	**1,178**
Executive Office of the President:									
Compensation of the President and the White House Office	2	......	2	26	......	26	25	......	25
Office of Management and Budget	3	......	3	41	......	41	37	......	37
Other	3	......	3	55	......	55	47	......	47
Total—Executive Office of the President	**8**	......	**8**	**121**	......	**121**	**109**	......	**109**
Funds Appropriated to the President:									
International Security Assistance:									
Guarantee reserve fund	565	103	462	1,182	523	659	714	831	-117
Foreign military sales credit	180	2,950	-2,770	4,324	4,399	-75	4,468	709	3,758
Economic support fund	325	......	325	3,184	......	3,184	3,466	......	3,466
Military assistance	64	......	64	607	......	607	356	......	356
Peacekeeping operations	5	......	5	36	......	36	46	......	46
Other	6	......	6	49	......	49	51	......	51
Proprietary receipts from the public	......	-47	47	......	188	-188	......	739	-739
Total—International Security Assistance	1,145	3,005	-1,860	9,383	5,110	4,273	9,100	2,279	6,820
International Development Assistance:									
Multilateral assistance:									
Contributions to International Financial Institutions:									
International Development Association	......	......	......	620	......	620	546	......	546
Inter-American Development Bank	......	......	......	138	......	138	221	......	221
Other	......	......	......	476	......	476	276	......	276
International Organizations and Programs	18	......	18	263	......	263	263	......	263
Total—Multilateral assistance	18	......	18	1,498	......	1,498	1,306	......	1,306
Agency for International Development:									
Functional Development Assistance Program	103	......	103	1,474	......	1,474	1,391	......	1,391
Operating Expenses, Agency for International Development	34	......	34	505	......	505	355	......	355
Payment to Foreign Service Retirement and Disability Fund[1]	......	......	......	......	......	......	45	......	45
Other	45	5	40	266	43	223	297	31	266
Proprietary receipts from the public	......	54	-54	......	798	-798	......	763	-763
Total—Agency for International Development	182	59	123	2,245	841	1,404	2,088	794	1,294
Trade and Development Program	1	......	1	20	......	20	18	......	18
Peace Corps	11	......	11	146	......	146	125	......	125
Overseas Private Investment Corporation	8	15	-7	54	165	-110	56	142	-86
Other	4	(**)	4	38	15	22	35	19	16
Total—International Development Assistance	226	74	151	4,000	1,021	2,980	3,628	954	2,673

Table continued on next page.

Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Funds Appropriated to the President:—Continued									
International Monetary Programs	-$16	.....	-$16	-$136	......	-$136	-$575	.....	-$575
Military Sales Programs:									
Foreign military sales trust fund	683	.....	683	9,057	......	9,057	9,910	.....	9,910
Other	49	$16	33	271	$257	13	247	$267	-21
Proprietary receipts from the public	......	543	-543	.....	8,964	-8,964	......	8,504	-8,504
Other	4	......	4	29	......	29	102	.....	102
Total—Funds Appropriated to the President	**2,091**	**3,638**	**-1,547**	**22,604**	**15,352**	**7,252**	**22,412**	**12,005**	**10,406**
Department of Agriculture:									
Departmental Administration	3	......	3	93	......	93	88	.....	88
Agricultural Research Service	46	.....	46	540	......	540	527	.....	527
Cooperative State Research Service	29	......	29	302	......	302	281	.....	281
Extension Service	23	......	23	318	......	318	319	......	319
Foreign Agricultural Service	5	......	5	84	......	84	78	......	78
Foreign Assistance Programs	268	.....	268	1,060	......	1,060	1,083	.....	1,083
Agricultural Stabilization and Conservation Service:									
Conservation Program	89	......	89	494	......	494	158	.....	158
Other	85	......	85	23	......	23	55	....	55
Federal Crop Insurance Corporation	119	2	117	581	170	411	602	898	-296
Commodity Credit Corporation:									
Price support and related programs	548	1,233	-685	23,614	11,394	12,219	30,910	8,721	22,189
National Wool Act Program	[2] -128	......	-128	5	......	5	152	...	152
Rural Electrification Administration	775	578	197	3,856	5,681	-1,825	3,006	3,244	-238
Farmers Home Administration:									
Public enterprise funds:									
Agricultural credit insurance fund	264	175	89	5,643	3,025	2,618	6,099	3,536	2,564
Rural housing insurance fund	573	242	332	6,243	2,632	3,611	5,991	5,193	798
Rural development insurance fund	287	-39	325	2,927	2,477	450	2,348	2,557	-210
Other	1	(**)	1	1	(**)	(**)	-2	(**)	-2
Rural water and waste disposal grants	11	.....	11	136	......	136	157	......	157
Salaries and expenses	32	.....	32	397	......	397	384	......	384
Other	5	......	5	64	.....	64	56	......	56
Total—Farmers Home Administration	1,172	377	795	15,411	8,134	7,277	15,034	11,286	3,748
Soil Conservation Service:									
Conservation operations	35	......	35	450	...	450	362	......	362
Water resource management and improvement	17	.....	17	203	......	203	227	......	227
Other	5	......	5	49	.....	49	43	......	43
Animal and Plant Health Inspection Service	21	......	21	340	.....	340	324	.....	324
Agricultural Marketing Service:									
Funds for strengthening markets, income, and supply	55	......	55	382	.....	382	391	.....	391
Other	[3] -22	......	-22	131	......	131	93	3	90
Food Safety and Inspection Service	31	......	31	391	......	391	373	......	373
Food and Nutrition Service:									
Food stamp program	1,081	......	1,081	13,144	......	13,144	12,405	......	12,405
Nutrition assistance for Puerto Rico	(**)	....	(**)	1	.....	1	2	......	2
Child nutrition programs	147	.....	147	4,286	.....	4,286	4,045	......	4,045
Women, infants and children programs	161	.....	161	1,852	.....	1,852	1,702	......	1,702
Other	34	.....	34	297	...	297	281	......	281
Total—Food and Nutrition Service	1,423	.....	1,423	19,581	....	19,581	18,435	.....	18,435
Forest Service:									
National Forest system	-348	......	-348	964	.....	964	1,231	......	1,231
Construction	28	.....	28	243	.....	243	228	......	228
Forest research	12	......	12	136	......	136	120	......	120
Forest Service permanent appropriations	235	.....	235	450	......	450	424	......	424
Cooperative work	533	.....	533	707	.....	707	72	......	72
Other	25	.....	25	188	.....	188	156	......	156
Total—Forest Service	484	......	484	2,688	.....	2,688	2,231	.....	2,231
Other	26	3	23	289	37	252	288	33	255
Proprietary receipts from the public	......	152	-152	......	1,462	-1,462	......	1,281	-1,281
Intrabudgetary transactions	......	......	.....	.....	......	......	(**)	......	(**)
Total—Department of Agriculture	**5,108**	**2,344**	**2,764**	**70,882**	**26,879**	**44,003**	**75,059**	**25,466**	**49,593**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of Commerce:									
General Administration	$55	$4	$51	$334	$118	$216	$454	$78	$377
Bureau of the Census	21	.....	21	333	.....	333	217	.....	217
Economic and Statistical Analysis	8	.....	8	76	.....	76	63	.....	63
Promotion of Industry and Commerce	18	.....	18	213	.....	213	243	.....	243
Science and technology:									
National Oceanic and Atmospheric Administration	93	1	92	1,236	12	1,224	1,096	22	1,074
Patent and Trademark Office	10	.....	10	95	.....	95	86	.....	86
National Institute of Standards and Technology	8	.....	8	119	.....	119	113	.....	113
National Telecommunications and Information Administration	4	.....	4	34	.....	34	34	.....	34
Total—Science and Technology	115	1	114	1,484	12	1,472	1,329	22	1,307
Other	6	.....	6	27	.....	27	(**)	.....	(**)
Proprietary receipts from the public	.....	5	-5	.....	53	-53	.....	45	-45
Intrabudgetary transactions	-1	.....	-1	-5	.....	-5	-6	.....	-6
Total—Department of Commerce	**221**	**10**	**211**	**2,461**	**182**	**2,279**	**2,301**	**145**	**2,156**
Department of Defense—Military:									
Military personnel:									
Department of the Army	2,568	.....	2,568	29,196	.....	29,196	27,273	.....	27,273
Department of the Navy	2,348	.....	2,348	25,795	.....	25,795	24,008	.....	24,008
Department of the Air Force	1,795	.....	1,795	21,346	.....	21,346	20,739	.....	20,739
Total—Military personnel	6,710	.....	6,710	76,337	.....	76,337	72,020	.....	72,020
Operation and Maintenance:									
Department of the Army	2,136	.....	2,136	24,762	.....	24,762	22,259	.....	22,259
Department of the Navy	2,281	.....	2,281	28,358	.....	28,358	24,893	.....	24,893
Department of the Air Force	2,016	.....	2,016	23,752	.....	23,752	20,587	.....	20,587
Defense agencies	750	.....	750	7,608	.....	7,608	8,438	.....	8,438
Total—Operation and Maintenance	7,183	.....	7,183	84,480	.....	84,480	76,178	.....	76,178
Procurement:									
Department of the Army	798	.....	798	15,578	.....	15,578	15,839	.....	15,839
Department of the Navy	1,705	.....	1,705	28,800	.....	28,800	29,201	.....	29,201
Department of the Air Force	2,397	.....	2,397	30,845	.....	30,845	33,815	.....	33,815
Defense agencies	198	.....	198	1,943	.....	1,943	1,889	.....	1,889
Total—Procurement	5,097	.....	5,097	77,166	.....	77,166	80,744	.....	80,744
Research, Development, Test, and Evaluation:									
Department of the Army	326	.....	326	4,624	.....	4,624	4,721	.....	4,721
Department of the Navy	574	.....	574	8,828	.....	8,828	9,176	.....	9,176
Department of the Air Force	1,034	.....	1,034	14,302	.....	14,302	13,347	.....	13,347
Defense agencies	608	.....	608	7,038	.....	7,038	6,352	.....	6,352
Total—Research, Development, Test, and Evaluation	2,541	.....	2,541	34,792	.....	34,792	33,596	.....	33,596
Military Construction:									
Department of the Army	124	.....	124	1,712	.....	1,712	1,979	.....	1,979
Department of the Navy	157	.....	157	1,756	.....	1,756	1,569	.....	1,569
Department of the Air Force	138	.....	138	1,616	.....	1,616	1,778	.....	1,778
Defense agencies	59	.....	59	789	.....	789	527	.....	527
Total—Military construction	479	.....	479	5,874	.....	5,874	5,853	.....	5,853
Family housing	273	.....	273	3,082	.....	3,082	2,908	.....	2,908
Revolving and Management Funds:									
Public Enterprise Funds	3	(**)	3	20	2	17	-58	2	-60
Intragovernmental Funds:									
Department of the Army	-90	.....	-90	213	.....	213	477	.....	477
Department of the Navy	-251	.....	-251	478	.....	478	1,526	9	1,517
Department of the Air Force	42	.....	42	654	.....	654	453	.....	453
Defense agencies	-242	.....	-242	-342	.....	-342	1,067	.....	1,067
Other	31	31	(**)	371	327	44	357	330	28
Proprietary receipts from the public	.....	392	-392	.....	829	-829	.....	813	-813
Intrabudgetary transactions	-318	.....	-318	-26	.....	-26	-28	.....	-28
Total—Department of Defense—Military	**21,459**	**423**	**21,036**	**283,098**	**1,158**	**281,940**	**275,092**	**1,154**	**273,938**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of Defense—Civil									
Corps of Engineers:									
General investigations	$15	......	$15	$132	......	$132	$125	......	$125
Construction, general	93	......	93	1,058	......	1,058	951	......	951
Operation and maintenance, general	166	......	166	1,358	......	1,358	1,345	......	1,345
Flood control, Mississippi River and coastal emergencies	46	......	46	298	......	298	319	......	319
Other	5	......	5	388	......	388	74	......	74
Proprietary receipts from the public	......	$21	-21	......	$187	-187	......	$82	-82
Total—Corps of Engineers	327	21	306	3,234	187	3,047	2,814	82	2,732
Military retirement fund:									
Payments to military retirement fund	......	......	......	10,285	......	10,285	10,524	......	10,524
Military retirement fund	1,614	......	1,614	19,009	......	19,009	18,078	......	18,078
Retired pay	(**)	......	(**)	2	......	2	3	......	3
Intrabudgetary transactions	......	......	......	-10,285	......	-10,285	-10,524	......	-10,524
Education benefits fund	-11	......	-11	-73	......	-73	-195	......	-195
Other	4	(**)	4	70	1	70	49	1	48
Proprietary receipts from the public	......	1	-1	......	7	-7	......	6	-6
Total—Department of Defense—Civil	**1,934**	**21**	**1,913**	**22,242**	**194**	**22,047**	**20,748**	**89**	**20,659**
Department of Education:									
Office of Elementary and Secondary Education:									
Compensatory education for the disadvantaged	281	......	281	4,028	......	4,028	3,210	......	3,210
Impact aid	55	......	55	708	......	708	704	......	704
Special programs	1	......	1	443	......	443	889	......	889
Chicago litigation	(**)	......	(**)	(**)	......	(**)	......	......	......
Indian education	-5	......	-5	18	......	18	40	......	40
Total—Office of Elementary and Secondary Education	332	......	332	5,197	......	5,197	4,843	......	4,843
Office of Bilingual Education and Minority Languages Affairs	14	......	14	160	......	160	141	......	141
Office of Special Education and Rehabilitative Services:									
Education for the handicapped	135	......	135	1,466	......	1,466	1,339	......	1,339
Rehabilitation services and handicapped research	125	......	125	1,537	......	1,537	1,405	......	1,405
Payments to institutions for the handicapped	7	......	7	89	......	89	122	......	122
Office of Vocational and Adult Education	144	......	144	1,276	......	1,276	1,231	......	1,231
Office of Postsecondary Education:									
College housing loans	1	4	-3	71	444	-373	99	657	-558
Student financial assistance	530	......	530	5,220	......	5,220	4,780	......	4,780
Guaranteed student loans	200	......	200	2,779	......	2,779	2,548	......	2,548
Higher education	102	......	102	412	......	412	419	......	419
Howard University	23	......	23	169	......	169	218	......	218
Higher education facilities loans	(**)	......	(**)	-70	......	-70	-85	......	-85
Other	4	......	4	27	......	27	......	......	......
Total—Office of Postsecondary Education	859	4	855	8,607	444	8,163	7,979	657	7,322
Office of Educational Research and Improvement	[4]-19	......	-19	144	......	144	190	......	190
Departmental Management	21	......	21	296	......	296	285	......	285
Proprietary receipts from the public	......	3	-3	......	81	-81	......	80	-80
Total—Department of Education	**1,618**	**7**	**1,611**	**18,770**	**524**	**18,246**	**17,537**	**737**	**16,800**
Department of Energy:									
Atomic energy defense activities	882	......	882	7,913	......	7,913	7,451	......	7,451
Energy programs:									
General science and research activities	69	......	69	763	......	763	697	......	697
Energy supply, R and D activities	163	......	163	2,025	......	2,025	1,912	......	1,912
Uranium supply and enrichment activities	62	......	62	1,137	......	1,137	1,053	......	1,053
Fossil energy research and development	30	......	30	326	......	326	316	......	316
Naval petroleum and oil shale reserves	14	......	14	187	......	187	149	......	149
Energy conservation	31	......	31	340	......	340	271	......	271
Strategic petroleum reserve	30	......	30	562	......	562	782	......	782
Federal energy regulatory commission	7	......	7	99	......	99	95	......	95
Alternative Fuels Production	(**)	......	(**)	1	......	1	1	......	1
Nuclear waste disposal fund	29	......	29	405	......	405	446	......	446
Other	21	......	21	310	......	310	263	......	263
Total—Energy Programs	457	......	457	6,154	......	6,154	5,984	......	5,984
Power Marketing Administration	225	39	186	1,380	1,188	192	1,345	1,088	258
Departmental Administration	30	......	30	387	......	387	377	......	377
Proprietary receipts from the public	......	744	-744	......	3,298	-3,298	......	3,291	-3,291
Intrabudgetary transactions	1	......	1	-188	......	-188	-91	......	-91
Total—Department of Energy	**1,596**	**782**	**813**	**15,647**	**4,486**	**11,161**	**15,068**	**4,379**	**10,688**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of Health and Human Services, Except Social Security:									
Public Health Service:									
Food and Drug Administration	$45	(**)	$45	$466	$3	$463	$424	$2	$422
Health Resources and Services Administration:									
Public enterprise funds:									
Medical facilities guaranteed and loan fund	......	...	.....	......	......	......	−6	−6	....
Other	1	...	1	28	9	19	15	6	10
Health resources and services	107	.....	107	1,535	.....	1,535	1,489	.....	1,489
Indian Health Service	94	.....	94	951	......	951	866	.....	866
Centers for Disease Control	52	......	52	614	......	614	466	.....	466
National Institutes of Health:									
Cancer Research	119	.....	119	1,404	.....	1,404	1,246	.....	1,246
Heart, Lung, and Blood Research	97	......	97	959	.....	959	822	.....	822
Diabetes, Digestive and Kidney Diseases	39	......	39	518	.....	518	472	.....	472
Neurological and Communicative Disorders and Stroke	42	......	42	506	......	506	424	.....	424
Allergy and Infectious Diseases	43	......	43	542	......	542	392	.....	392
General Medical Sciences	51	.....	51	586	.....	586	467	.....	467
Child Health and Human Development	27	.....	27	363	....	363	314	.....	314
Other research institutes	74	.....	74	909	......	909	661	...	661
Research resources	10	.....	10	332	......	332	286	.....	286
Other	57	...	57	215	......	215	137	.....	137
Total—National Institutes of Health	559	......	559	6,334	.....	6,334	5,222	......	5,222
Alcohol, Drug Abuse, and Mental Health Administration	86	...	86	1,237	.....	1,237	1,200	....	1,200
Office of Assistant Secretary for Health	26	...	26	256	......	256	211	......	211
Total—Public Health Service	969	(**)	969	11,420	12	11,408	9,888	2	9,886
Health Care Financing Administration:									
Grants to States for Medicaid	2,854	.....	2,854	30,462	...	30,462	27,435	......	27,435
Payments to health care trust funds	1,046	.....	1,046	26,463	....	26,463	21,298	......	21,298
Other	17	......	17	53	......	53	81	−18	99
Federal hospital insurance trust fund:									
Benefit payments	4,516	......	4,516	52,022	...	52,022	49,967	....	49,967
Administrative expenses and construction	92	.....	92	707	...	707	836	....	836
Total—FHI trust fund	4,607	......	4,607	52,730	......	52,730	50,803	......	50,803
Federal supplementary medical ins. trust fund:									
Benefit payments	3,066	.....	3,066	33,682	......	33,682	29,937	...	29,937
Administrative expenses and construction	73	...	73	1,265	......	1,265	900	..	900
Total—FSMI trust fund	3,140	......	3,140	34,947	......	34,947	30,837	......	30,837
Total—Health Care Financing Administration	11,664	......	11,664	144,654	......	144,654	130,454	−18	130,472
Social Security Administration:									
Payments to social security trust funds	293	...	293	5,768	.....	5,768	5,615	.....	5,615
Special benefits for disabled coal miners	75	....	75	919	.....	919	955	.....	955
Supplemental security income program	1,805	.....	1,805	12,345	......	12,345	10,909	......	10,909
Total—Social Security Administration	2,173	......	2,173	19,032	......	19,032	17,480	......	17,480
Family Support Administration:									
Program Administration	12	.....	12	78	...	78	56	.....	56
Family Support Payments to States	794	.....	794	10,764	...	10,764	10,540	.....	10,540
Low Income Home Energy Assistance	32	.....	32	1,585	.....	1,585	1,829	..	1,829
Refugee and Entrant Assistance	33	.....	33	321	...	321	387	..	387
Community Services	34	.....	34	408	...	408	361	...	361
Interim assistance to states for legalization	9	......	9	10	...	10	.....	...	......
Other	4	.....	4	90	...	90	137	.....	137
Total—Family Support Administration	918	......	918	13,256	......	13,256	13,311	......	13,311
Human Development Services:									
Social services	172	....	172	2,666	.....	2,666	2,688	....	2,688
Human development services	233	....	233	2,216	.....	2,216	1,959	....	1,959
Payments to states for foster care and adoption assistance	73	....	73	1,004	.....	1,004	802	....	802
Total—Human Development Services	478	......	478	5,886	......	5,886	5,448	......	5,448
Departmental management	[4]−54	......	−54	117	......	117	149	....	149
Proprietary receipts from the public	......	$803	−803	......	8,819	−8,819	......	6,553	−6,553
Intrabudgetary transactions:									
Payments for health insurance for the aged:									
Federal supplementary medical insurance trust fund	−978	...	−978	−25,418	..	−25,418	−20,299	..	−20,299
Payments for tax and other credits:									
Federal hospital insurance trust fund	−68	....	−68	−1,125	......	−1,125	−999	.....	−999
Total—Department of Health and Human Services, Except Social Security	**15,101**	**804**	**14,298**	**167,822**	**8,831**	**158,991**	**155,431**	**6,537**	**148,893**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month Gross Outlays	This Month Applicable Receipts	This Month Outlays	Current Fiscal Year to Date Gross Outlays	Current Fiscal Year to Date Applicable Receipts	Current Fiscal Year to Date Outlays	Prior Fiscal Year to Date Gross Outlays	Prior Fiscal Year to Date Applicable Receipts	Prior Fiscal Year to Date Outlays
Department of Health and Human Services, Social Security:									
Federal old-age and survivors insurance trust fund:									
Benefit payments	$16,326	......	$16,326	$192,541	.....	$192,541	$182,055	......	$182,055
Administrative expenses and construction	120	......	120	1,730	......	1,730	1,542	.....	1,542
Payment to railroad retirement account	......	.....	......	2,790	.....	2,790	2,557	......	2,557
Interest on normalized tax transfers	......	......	......	836	..	836	625	...	625
Total—FOASI trust fund	16,446	.....	16,446	197,897	......	197,897	186,780	......	186,780
Federal disability insurance trust fund:									
Benefit payments	1,788	....	1,788	21,416	......	21,416	20,436	....	20,436
Administrative expenses and construction	32	......	32	803	......	803	738	.....	738
Payment to railroad retirement account	......	......	.....	61	......	61	57	.....	57
Interest on normalized tax transfers	.....	......	.....	80	......	80	60	......	60
Total—FDI trust fund	1,820	......	1,820	22,360	......	22,360	21,290	......	21,290
Proprietary receipts from the public	......	(**)	(**)	.....	(**)	(**)	......	$33	−33
Intrabudgetary transactions [5]	−293	......	−293	−6,079	.....	−6,079	−5,614	.....	−5,614
Total—Department of Health and Human Services, Social Security	**17,973**	**(**)**	**17,973**	**214,178**	**(**)**	**214,178**	**202,456**	**33**	**202,422**
Department of Housing and Urban Development:									
Housing Programs:									
Public enterprise funds:									
Federal Housing Administration fund	636	$587	49	7,319	$6,184	1,134	5,734	6,289	−555
Housing for the elderly or handicapped fund	24	45	−21	825	503	322	929	525	404
Other	−2	6	−8	29	63	−34	86	64	22
Rent supplement payments	4	......	4	47	....	47	48	....	48
Homeownership assistance	13	......	13	177	.....	177	182	.....	182
Rental housing assistance	82	......	82	628	.....	628	638	....	638
Rental housing development grants	3	......	3	66	.....	66	66	.....	66
Low-rent public housing	57	......	57	776	......	776	773	.....	773
Public housing grants	37	......	37	261	.....	261	(**)	.....	(**)
College housing grants	1	.....	1	20	......	20	20	.....	20
Lower income housing assistance	766	.....	766	9,133	......	9,133	8,125	.....	8,125
Supportive housing demonstration program	(**)	......	(**)	(**)	......	(**)	.....	.....	....
Other	6	......	6	22	.....	22	−44	.....	−44
Total—Housing Programs	1,628	638	991	19,304	6,750	12,554	16,556	6,878	9,678
Public and Indian Housing:									
Payments for operation of low-income housing projects	194	......	194	1,489	.....	1,489	1,388	.....	1,388
Low-rent housing—loans and other expenses	90	13	77	1,272	99	1,173	1,474	118	1,356
Total—Public and Indian Housing	284	13	271	2,760	99	2,662	2,862	118	2,744
Government National Mortgage Association:									
Management and liquidating functions fund	8	9	−1	118	309	−191	138	601	−463
Guarantees of mortgage-backed securities	49	54	−5	627	719	−92	211	398	−187
Participation sales fund	(**)	......	(**)	491	......	491	−25	......	−25
Total—Government National Mortgage Association	57	62	−5	1,236	1,028	208	323	998	−675
Community Planning and Development:									
Public enterprise fund	6	13	−7	99	312	−213	74	162	−88
Community Development Grants	275	......	275	3,044	......	3,044	2,992	(**)	2,991
Urban development action grants	15	.....	15	216	......	216	354	.....	354
Rental rehabilitation grants	18	....	18	114	......	114	99	.....	99
Other	8	......	8	53	......	53	27	.....	27
Total—Community Planning and Development	323	13	310	3,525	312	3,213	3,547	162	3,384
Management and administration	11	......	11	297	.....	297	308	.....	308
Other	7	....	7	22	....	22	25	......	25
Total—Department of Housing and Urban Development	**2,310**	**726**	**1,584**	**27,145**	**8,189**	**18,956**	**23,621**	**8,157**	**15,464**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of the Interior:									
Land and minerals management:									
Bureau of Land Management:									
Management of lands and resources	$66	.....	$66	$538	.....	$538	$450	.....	$450
Payments in lieu of taxes	104	.....	104	103	.....	103	105	.....	105
Other	10	.....	10	171	.....	171	165	.....	165
Minerals Management Service	52	.....	52	561	.....	561	541	.....	541
Office of Surface Mining Reclamation and Enforcement	26	.....	26	349	.....	349	325	.....	325
Total—Land and minerals management	258	.....	258	1,723	.....	1,723	1,586	.....	1,586
Water and science:									
Bureau of Reclamation:									
Construction program	89	$26	62	713	$84	629	718	$83	635
Operation and maintenance	15	.....	15	151	.....	151	133	.....	133
Other	190	.....	190	185	.....	185	197	.....	197
Geological Survey	27	.....	27	451	.....	451	400	.....	400
Bureau of Mines	12	2	10	157	21	136	153	20	133
Total—Water and science	332	28	304	1,657	105	1,552	1,601	103	1,498
Fish and wildlife and parks:									
United States Fish and Wildlife Service	64	.....	64	700	.....	700	590	.....	590
National Park Service	100	.....	100	1,023	.....	1,023	988	.....	988
Total—Fish and wildlife and parks	164	.....	164	1,723	.....	1,723	1,577	.....	1,577
Bureau of Indian Affairs:									
Operation of Indian programs	101	.....	101	963	.....	963	930	.....	930
Construction	8	.....	8	89	.....	89	88	.....	88
Indian tribal funds	[3] −26	.....	−26	368	.....	368	311	.....	311
Other	6	1	5	94	28	66	71	11	60
Total—Bureau of Indian Affairs	89	1	88	1,514	28	1,485	1,401	11	1,390
Territorial and International Affairs	74	.....	74	344	.....	344	460	.....	460
Departmental offices	(**)	.....	(**)	86	.....	86	75	.....	75
Proprietary receipts from the public:									
Receipts from oil and gas leases, national petroleum reserve in Alaska	.....	(**)	(**)	.....	1	−1	.....	1	−1
Other	.....	156	−156	.....	1,750	−1,750	.....	1,498	−1,498
Intrabudgetary transactions	−9	.....	−9	−12	.....	−12	−34	.....	−34
Total—Department of the Interior	**910**	**185**	**725**	**7,036**	**1,884**	**5,152**	**6,668**	**1,613**	**5,054**
Department of Justice:									
Legal activities	105	.....	105	1,204	.....	1,204	977	.....	977
Federal Bureau of Investigation	109	.....	109	1,384	.....	1,384	1,216	.....	1,216
Drug Enforcement Administration	37	.....	37	506	.....	506	412	.....	412
Immigration and Naturalization Service	90	.....	90	963	.....	963	689	.....	689
Federal Prison System	62	3	58	984	43	941	764	40	724
Office of Justice Programs	33	(**)	33	341	(**)	341	237	(**)	237
Other	−6	.....	−6	87	.....	87	78	.....	78
Total—Department of Justice	**431**	**3**	**427**	**5,469**	**43**	**5,426**	**4,373**	**40**	**4,333**
Department of Labor:									
Employment and Training Administration:									
Training and employment services	310	.....	310	3,701	.....	3,701	3,545	.....	3,545
Community service employment for older Americans	29	.....	29	324	.....	324	370	.....	370
Federal unemployment benefits and allowances	11	.....	11	131	.....	131	108	.....	108
State unemployment insurance and employment service operation	−10	.....	−10	29	.....	29	38	.....	38
Advances to the unemployment trust fund and other funds	13	.....	13	95	.....	95	168	.....	168
Other	5	.....	5	64	.....	64	63	.....	63

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of Labor:—Continued									
Employment and Training Administration:—Continued									
Unemployment trust fund:									
Federal-State unemployment insurance:									
State unemployment benefits	$886	.....	$886	$13,542	.....	$13,542	$15,370	.....	$15,370
State administrative expenses	231	.....	231	2,399	.....	2,399	2,333	.....	2,333
Federal administrative expenses	-17	.....	-17	103	.....	103	68	.....	68
Veterans employment and training	10	.....	10	133	.....	133	133	.....	133
Repayment of advances from the general fund	2,271	.....	2,271	2,271	.....	2,271	2,433	.....	2,433
Railroad unemployment benefits	6	.....	6	113	.....	113	164	.....	164
Other	7	.....	7	37	.....	37	24	.....	24
Total—Unemployment trust fund	3,393	.....	3,393	18,598	.....	18,598	20,527	.....	20,527
Total—Employment and Training Administration	3,751	.....	3,751	22,940	.....	22,940	24,820	.....	24,820
Labor-Management Services	4	.....	4	65	.....	65	57	.....	57
Pension Benefit Guaranty Corporation	57	$129	-71	445	$723	-278	516	$588	-72
Employment Standards Administration:									
Salaries and expenses	14	.....	14	195	.....	195	176	.....	176
Special benefits	107	.....	107	216	.....	216	210	.....	210
Black lung disability trust fund	55	.....	55	639	.....	639	643	.....	643
Special workers compensation expenses	6	.....	6	75	.....	75	72	.....	72
Occupational safety and health administration	22	.....	22	226	.....	226	215	.....	215
Mine safety and health administration	12	.....	12	164	.....	164	147	.....	147
Bureau of Labor Statistics	7	.....	7	169	.....	169	154	.....	154
Departmental management	10	.....	10	147	.....	147	133	.....	133
Proprietary receipts from the public	.....	156	-156	.....	159	-159	.....	315	-315
Intrabudgetary transactions	-2,299	.....	-2,299	-2,528	.....	-2,528	-2,786	.....	-2,786
Total—Department of Labor	**1,747**	**285**	**1,462**	**22,752**	**882**	**21,870**	**24,356**	**903**	**23,453**
Department of State:									
Administration of Foreign Affairs:									
Salaries and expenses	237	.....	237	1,737	.....	1,737	1,497	.....	1,497
Acquisition and maintenance of buildings abroad	37	.....	37	335	.....	335	263	.....	263
Payment to Foreign Service retirement and disability fund	144	.....	144	230	.....	230	301	.....	301
Foreign Service retirement and disability fund	27	.....	27	287	.....	287	240	.....	240
Other	-2	.....	-2	20	.....	20	33	.....	33
Total—Administration of Foreign Affairs	443	.....	443	2,608	.....	2,608	2,334	.....	2,334
International Organizations and Conferences	20	.....	20	547	.....	547	360	.....	360
Migration and Refugee Assistance	24	.....	24	378	.....	378	341	.....	341
International Narcotics Control	6	.....	6	87	.....	87	60	.....	60
Other	6	.....	6	69	.....	69	52	.....	52
Proprietary receipts from the public	.....	(**)	(**)	.....	2	-2	.....	12	-12
Intrabudgetary transactions	-144	.....	-144	-266	.....	-266	-348	.....	-348
Total—Department of State	**356**	**(**)**	**356**	**3,423**	**2**	**3,421**	**2,800**	**12**	**2,788**
Department of Transportation:									
Federal Highway Administration:									
Highway trust fund:									
Federal-aid highways	1,503	.....	1,503	13,829	.....	13,829	12,614	.....	12,614
Other	2	.....	2	84	.....	84	50	22	28
Other programs	10	.....	10	89	.....	89	97	.....	97
Total—Federal Highway Administration	1,515	.....	1,515	14,002	.....	14,002	12,760	22	12,738
National Highway Traffic Safety Administration	17	.....	17	206	.....	206	208	.....	208

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of Transportation:—Continued									
Federal Railroad Administration:									
Grants to National Railroad Passenger Corporation	(**)	......	(**)	$591	......	$591	$597	......	$597
Other	$30	$29	$1	28	$42	-14	204	-$5	209
Total—Federal Railroad Administration	29	29	1	619	42	577	802	-5	806
Urban Mass Transportation Administration:									
Formula grants	122	.....	122	1,937	......	1,937	1,822	......	1,822
Discretionary grants	62	......	62	696	.....	696	668	......	668
Other	47	......	47	634	......	634	810	......	810
Federal Aviation Administration:									
Operations	171	......	171	2,281	.....	2,281	2,215	......	2,215
Other	2	(**)	2	43	(**)	43	78	(**)	78
Airport and airway trust fund:									
Grants-in-aid for airports	117	.....	117	825	.....	825	917	.....	917
Facilities and equipment	98	.....	98	1,043	.....	1,043	892	......	892
Research, engineering and development	19	.....	19	170	.....	170	170	......	170
Operations	73	.....	73	830	.....	830	622	......	622
Total—Airport and airway trust fund	306	...	306	2,868	......	2,868	2,602	......	2,602
Total—Federal Aviation Administration	478	(**)	478	5,192	(**)	5,192	4,895	(**)	4,895
Coast Guard:									
Operating expenses	144	......	144	1,798	.....	1,798	1,707	......	1,707
Acquisition, construction, and improvements	65	.....	65	414	......	414	389	......	389
Retired pay	29	.....	29	360	......	360	350	......	350
Other	7	(**)	7	155	5	150	140	5	135
Total—Coast Guard	245	(**)	244	2,726	5	2,721	2,586	5	2,581
Maritime Administration:									
Public enterprise funds	16	24	-8	417	427	-10	795	263	531
Operating-differential subsidies	23	......	23	230	......	230	227	.....	227
Other	4	......	4	117	......	117	98	......	98
Other	12	2	10	148	12	136	123	13	110
Proprietary receipts from the public	......	4	-4	......	19	-19	.....	55	-55
Intrabudgetary transactions	(**)	......	(**)	-16	......	-16	-8	.....	-8
Total—Department of Transportation	**2,570**	**59**	**2,511**	**26,908**	**504**	**26,404**	**25,785**	**354**	**25,431**
Department of the Treasury:									
Departmental Offices	-10	......	-10	-1,270	.....	-1,270	-1,353	.....	-1,353
Financial Management Service:									
Salaries and expenses	20	.....	20	250	.....	250	231	..	231
Claims, Judgements, and Relief Acts	43	.....	43	1,409	.....	1,409	361	..	361
Energy Security Reserve	11	....	11	80	......	80	56	...	56
Other	4	.....	4	33	.....	33	272	......	272
Total—Financial Management Service	78	.....	78	1,772	......	1,772	919	...	919
Federal Financing Bank	2,184	2,417	-233	16,490	16,703	-213	13,976	14,454	-478
Bureau of Alcohol, Tobacco and Firearms:									
Salaries and expenses	16	....	16	213	...	213	179	....	179
Internal Revenue collections for Puerto Rico	12	.....	12	210	...	210	225	.....	225
United States Customs Service	78	.....	78	1,347	...	1,347	1,029	......	1,029
Bureau of Engraving and Printing	-6	.....	-6	-30	...	-30	-41	......	-41
United States Mint	-26	.....	-26	79	...	79	71	.....	71
Bureau of the Public Debt	15	.....	15	202	...	202	195	.....	195

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Department of the Treasury:—Continued									
Internal Revenue Service:									
Salaries and expenses	$1	.....	$1	$87	.....	$87	$80	.....	$80
Processing tax returns	142	.....	142	1,684	.....	1,684	1,344	.....	1,344
Examinations and appeals	121	.....	121	1,791	.....	1,791	1,576	.....	1,576
Investigation, collection and taxpayer service	117	.....	117	1,422	.....	1,422	1,162	.....	1,162
Payment where earned income credit exceeds liability for tax	19	.....	19	2,698	.....	2,698	1,410	.....	1,410
Refunding internal revenue collections, interest	133	.....	133	1,681	.....	1,681	1,941	.....	1,941
Other	1	$1	(**)	8	$7	1	4	$4	(**)
Total—Internal Revenue Service	533	1	532	9,370	7	9,363	7,517	4	7,513
United States Secret Service	33	.....	33	382	.....	382	312	.....	312
Comptroller of the Currency	16	2	14	217	209	8	184	207	-23
Interest on the public debt:									
Public issues (accrual basis)	14,615	.....	14,615	168,926	.....	168,926	157,170	.....	157,170
Special issues (cash basis)	636	.....	636	45,219	.....	45,219	38,220	.....	38,220
Total—Interest on the public debt	15,250	.....	15,250	214,145	.....	214,145	195,390	.....	195,390
Other	3	.....	3	33	.....	33	99	.....	99
Proprietary receipts from the public	.....	315	-315	.....	3,254	-3,254	.....	2,925	-2,925
Receipts from off-budget Federal entities	.....	.....	.....	-916	.....	-916	-685	.....	-685
Intrabudgetary transactions	-2,399	.....	-2,399	-19,601	.....	-19,601	-20,083	.....	-20,083
Total—Department of the Treasury	**15,780**	**2,735**	**13,045**	**222,644**	**20,172**	**202,472**	**197,935**	**17,590**	**180,345**
Environmental Protection Agency:									
Salaries and expenses	58	.....	58	763	.....	763	674	.....	674
Research and development	17	.....	17	204	.....	204	206	.....	206
Abatement, control, and compliance	53	.....	53	598	.....	598	576	.....	576
Construction grants	249	.....	249	2,514	.....	2,514	2,920	.....	2,920
Hazardous substance superfund	87	.....	87	830	.....	830	540	.....	540
Other	3	(**)	3	148	(**)	148	657	1	656
Proprietary receipts from the public	.....	9	-9	.....	59	-59	.....	21	-21
Intrabudgetary transactions	.....	.....	.....	-125	.....	-125	-650	.....	-650
Total—Environmental Protection Agency	**467**	**9**	**459**	**4,932**	**60**	**4,872**	**4,924**	**21**	**4,903**
General Services Administration:									
Real property activities	273	.....	273	-332	.....	-332	-84	-1	-84
Personal property activities	-48	.....	-48	102	.....	102	133	.....	133
Information Resources Management Service	33	.....	33	-103	.....	-103	-56	.....	-56
Federal property resources activities	1	.....	1	6	.....	6	39	.....	39
General activities	11	.....	11	141	.....	141	125	.....	125
Proprietary receipts from the public	.....	12	-12	.....	101	-101	.....	78	-78
Other	.....	2	-2	.....	-3	3	.....	6	-6
Total—General Services Administration	**268**	**14**	**255**	**-187**	**98**	**-285**	**157**	**83**	**74**
National Aeronautics and Space Administration:									
Research and development	233	.....	233	2,916	.....	2,916	2,436	.....	2,436
Space flight, control, and data communications	147	.....	147	4,362	.....	4,362	3,518	-79	3,597
Construction of facilities	17	.....	17	166	.....	166	149	.....	149
Research and program management	132	.....	132	1,648	.....	1,648	1,409	.....	1,409
Other	.....	.....	.....	.....	.....	.....	(**)	.....	(**)
Total—National Aeronautics and Space Administration	**530**	.....	**530**	**9,092**	.....	**9,092**	**7,512**	**-79**	**7,591**
Office of Personnel Management:									
Government payment for annuitants, employees health benefits	195	.....	195	2,113	.....	2,113	1,592	.....	1,592
Payment to civil service retirement and disability fund	15,572	.....	15,572	15,572	.....	15,572	15,803	.....	15,803
Civil service retirement and disability fund	2,353	.....	2,353	28,140	.....	28,140	25,798	.....	25,798
Employees health benefits fund	737	1,012	-276	8,751	9,110	-359	7,269	7,065	204
Employees life insurance fund	99	121	-22	1,053	1,796	-743	987	1,689	-702
Retired employees health benefits fund	2	1	1	13	12	1	13	10	2
Other	[3] -26	.....	-26	72	.....	72	104	.....	104
Intrabudgetary transactions:									
Civil service retirement and disability fund:									
General fund contributions	-15,572	.....	-15,572	-15,572	.....	-15,572	-15,803	.....	-15,803
Other	-3	.....	-3	-33	.....	-33	-33	.....	-33
Total—Office of Personnel Management	**3,357**	**1,135**	**2,222**	**40,110**	**10,918**	**29,191**	**35,730**	**8,764**	**26,966**

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Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Small Business Administration:									
Public enterprise funds:									
Business loan and investment fund	$64	$83	-$19	$921	$959	-$38	$1,385	$1,395	-$10
Disaster loan fund	10	40	-30	293	641	-348	368	730	-362
Other	4	1	2	45	16	29	32	14	18
Other	20	......	20	303	......	303	282	......	282
Total—Small Business Administration	97	124	-26	1,562	1,616	-54	2,067	2,139	-72
Veterans Administration:									
Public enterprise funds:									
Loan guaranty revolving fund	213	-83	295	2,809	1,649	1,160	2,342	1,959	382
Direct loan revolving fund	1	3	-2	15	95	-80	17	50	-33
Other	38	37	1	495	491	4	468	498	-29
Compensation and pensions	1,792	......	1,792	15,328	......	15,328	14,426	......	14,426
Readjustment benefits	40	......	40	725	......	725	812	......	812
Medical care	825	......	825	10,045	......	10,045	9,500	......	9,500
Medical and prosthetic research	18	......	18	197	......	197	195	......	195
General operating expenses	25	......	25	781	......	781	720	......	720
Construction projects	52	......	52	641	......	641	535	....	535
Post-Vietnam era veterans education account	17	......	17	303	.....	303	284	....	284
Insurance funds:									
National service life	84	......	84	1,096	......	1,096	1,034	......	1,034
United States government life	3	......	3	37	......	37	40	......	40
Veterans special life	7	4	3	84	160	-76	76	154	-78
Other	15	......	15	120	......	120	70	.....	70
Proprietary receipts from the public:									
National service life	......	33	-33	......	422	-422	......	442	-442
United States government life	......	(**)	(**)	......	(**)	(**)	......	(**)	(**)
Other	......	38	-38	......	433	-433	......	375	-375
Intrabudgetary transactions	-6	......	-6	-184	......	-184	-88	......	-88
Total—Veterans Administration	3,123	32	3,091	32,493	3,249	29,244	30,431	3,479	26,952
Independent agencies:									
Action	14	......	14	153	......	153	159	......	159
Board for International Broadcasting	31	......	31	194	......	194	156	.....	156
Corporation for Public Broadcasting	......	......	......	214	......	214	200	.....	200
District of Columbia:									
Federal payment	......	......	......	550	......	550	560	.....	560
Proprietary receipts from the public	......	......	......	......	30	-30	......	293	-293
Equal Employment Opportunity Commission	11	......	11	176	......	176	158	.....	158
Export-Import Bank of the United States	376	146	230	2,156	3,050	-894	2,709	5,009	-2,300
Federal Communications Commission	8	17	-9	101	49	52	88	9	79
Federal Deposit Insurance Corporation	2,101	1,668	433	14,748	12,603	2,146	9,031	10,468	-1,438
Federal Emergency Management Agency:									
Public Enterprise Funds	17	39	-22	177	376	-199	198	405	-207
Disaster Relief	10	......	10	187	......	187	219	......	219
Salaries and expenses	13	......	13	145	......	145	120	......	120
Emergency management and planning assistance	18	......	18	299	......	299	297	......	297
Emergency food distribution and shelter program	2	......	2	120	......	120	114	......	114
Federal Home Loan Bank Board:									
Public enterprise funds:									
Federal Home Loan Bank Board revolving fund	7	6	1	62	62	1	40	52	-12
Federal Savings and Loan Insurance Corp. fund	3,073	72	3,001	15,635	7,558	8,077	7,188	2,421	4,767
Federal Trade Commission	5	......	5	69	......	69	66	......	66
Intragovernmental agencies:									
Appalachian Regional Commission	8	(**)	8	150	2	148	150	2	148
Washington Metropolitan Area Transit Authority	......	......	......	49	......	49	52	......	52
Other	(**)	......	(**)	3	(**)	3	3	.....	3
Interstate Commerce Commission	3	......	3	43	......	43	42	......	42
Legal Services Corporation	49	......	49	306	......	306	309	......	309
National Archives and Records Administration	4	......	4	102	......	102	96	......	96
National Credit Union Administration:									
Credit union share insurance fund	6	6	(**)	351	344	7	328	321	7
Central liquidity facility	-5	8	-13	86	308	-222	39	236	-198
Other	5	(**)	5	(**)	1	-2	3	2	1

Table continued on next page.

Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Independent agencies:—Continued									
National Foundation on the Arts and the Humanities:									
National Endowment for the Arts	$21	......	$21	$167	.....	$167	$155	......	$155
National Endowment for the Humanities	13	......	13	134	.....	134	135	.....	135
Institute of Museum Services	(**)	......	(**)	21	......	21	20	.....	20
National Labor Relations Board	9	......	9	132	......	132	127	.....	127
National Science Foundation	162	......	162	1,665	......	1,665	1,562	......	1,562
Nuclear Regulatory Commission	[3] −149	.....	−149	232	.....	232	393	......	393
Panama Canal Commission	−9	......	−9	151	$113	38	456	$441	15
Postal Service:									
Public Enterprise Funds	3,969	$1,751	2,218	33,349	31,636	1,712	30,783	29,840	943
Payment to the Postal Service Fund	......	......	......	517	....	517	650	......	650
Railroad Retirement Board:									
Federal windfall subsidy	28	.....	28	349	.....	349	373	......	373
Federal payments to the railroad retirement accounts	2	......	2	248	.....	248	91	.....	91
Payment to railroad unemployment insurance trust fund	......	.....	......	−1	......	−1	......	......	....
Milwaukee railroad restructuring, administration	(**)	......	(**)	(**)	.....	(**)	2	.....	2
Railroad retirement accounts:									
Social Security Equivalent Benefit Account	325	......	325	3,854	.....	3,854	3,834	.....	3,834
Benefits payments and claims	206	......	206	2,484	.....	2,484	2,284	.....	2,284
Advances to the railroad retirement account from the FOASI trust fund	−68	......	−68	−802	......	−802	−757	......	−757
Advances to the railroad retirement account from the FDI trust fund	−3	......	−3	−42	......	−42	−44	......	−44
Disbursements for the payment of FOASI benefits	68	....	68	805	.....	805	756	.....	756
Disbursements for the payment of FDI benefits	3	......	3	41	.....	41	42	......	42
Administrative expenses	6	......	6	62	......	62	58	......	58
Interest on refunds of taxes	7	......	7	31	......	31	29	......	29
Other	(**)	......	(**)	2	.....	2	1	.....	1
Intrabudgetary Transactions:									
Railroad retirement account:									
Payments from other funds to railroad retirement trust funds	......	......	......	−2,851	.....	−2,851	−2,614	......	−2,614
Interest on advances to railroad accounts	−5	.....	−5	−15	......	−15	−8	......	−8
Federal payments to the railroad social security equivalent benefit account	......	......	......	224	.....	224	162	......	162
Federal payments to the rail industry pension fund	......	......	......	−242	.....	−242	−13	......	−13
Total—Railroad Retirement Board	569	......	569	4,147	......	4,147	4,196	.....	4,196
Securities and Exchange Commission	9	.....	9	126	......	126	108	......	108
Smithsonian Institution	23	......	23	260	.....	260	242	......	242
Tennessee Valley Authority	487	346	140	6,015	4,926	1,089	6,728	5,637	1,091
United States Information Agency	74	......	74	843	(**)	843	831	1	830
Other independent agencies	71	21	50	682	97	585	736	46	690
Total—Independent agencies	**11,003**	**4,079**	**6,924**	**84,516**	**61,156**	**23,361**	**69,449**	**55,184**	**14,266**
Undistributed offsetting receipts:									
Other Interest	.....	(**)	(**)	......	1	−1	......	903	−903
Employer share, employee retirement:									
Legislative Branch:									
United States Tax Court:									
Tax court judges survivors annuity fund	......	......	......	(**)	......	(**)	(**)	......	(**)
The Judiciary:									
Judicial survivors annuity fund	......	......	......	......	......	......	−1	......	−1
Department of Defense—Civil:									
Military retirement fund	−1,602	......	−1,602	−18,382	......	−18,382	−18,288	.....	−18,288
Department of Health and Human Services:									
Federal old-age and survivors insurance trust fund (OFF-BUDGET)	−327	......	−327	−3,716	......	−3,716	−3,011	.....	−3,011
Federal disability insurance trust fund (OFF-BUDGET)	−31	......	−31	−355	......	−355	−289	.....	−289
Federal hospital insurance trust fund	−159	.....	−159	−1,804	.....	−1,804	−1,700	.....	−1,700
Department of State:									
Foreign Service retirement and disability fund	−4	......	−4	−62	......	−62	−58	.....	−58
Office of Personnel Management:									
Civil Service retirement and disability fund	−2,578	......	−2,578	−8,708	......	−8,708	−7,212	....	−7,212
Subtotal	−4,701	......	−4,701	−33,028	......	−33,028	−30,559	......	−30,559

Table continued on next page.

Table 5. Outlays of the U.S. Government, September 1988 and Other Periods (in millions)—Continued

Classification	This Month			Current Fiscal Year to Date			Prior Fiscal Year to Date		
	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays	Gross Outlays	Applicable Receipts	Outlays
Undistributed offsetting receipts:—Continued									
Interest received by trust funds:									
The Judiciary:									
Judicial survivors annuity fund	......	......	.....	-$10	......	-$10	-$10	.....	-$10
Department of Defense—Civil:									
Education benefits fund	(**)	......	(**)	-46	......	-46	-31	......	-31
Military retirement fund	$12	......	$12	-4,450	......	-4,450	-3,219	.....	-3,219
Soldiers' and Airmen's Home permanent fund	-4	.....	-4	-17	......	-17	-18	......	-18
Corps of Engineers	-28	....	-28	-61	.....	-61	-6	......	-6
Department of Health and Human Services:									
Federal old-age and survivors insurance trust fund (OFF-BUDGET)	-99	.....	-99	-6,758	.....	-6,758	-4,495	......	-4,495
Federal disability insurance trust fund (OFF-BUDGET)	1	.....	1	-657	......	-657	-795	....	-795
Federal hospital insurance trust fund	-36	.....	-36	-5,169	.....	-5,169	-3,994	....	-3,994
Federal supplementary medical insurance trust fund	-39	.....	-39	-828	......	-828	-1,019	.....	-1,019
Department of Labor:									
Unemployment trust fund	-22	......	-22	-2,341	......	-2,341	-1,909	.....	-1,909
Department of State:									
Foreign Service retirement and disability fund	(**)	......	(**)	-358	......	-358	-313	.....	-313
Department of Transportation:									
Airport and airway trust fund	-5	......	-5	-893	......	-893	-880	.....	-880
Highway trust fund	-35	......	-35	-1,193	......	-1,193	-1,278	.....	-1,278
Environmental Protection Agency:									
Other	8	......	8	7	......	7	-2	......	-2
Post-closure liability trust fund	-1	......	-1	-3	......	-3	(**)	.....	(**)
Office of Personnel Management fund:									
Civil Service retirement and disability fund	-31	......	-31	-17,348	.....	-17,348	-15,537	.....	-15,537
Veterans Administration:									
United States government life insurance fund	(**)	......	(**)	-16	......	-16	-18	.....	-18
National service life insurance fund	-1	......	-1	-982	.....	-982	-947	....	-947
Independent agencies:									
Railroad Retirement Board:									
Railroad retirement account	-21	......	-21	-573	......	-573	-454	.....	-454
Other	-55	......	-55	-126	......	-126	-74	.....	-74
Subtotal	-356	......	-356	-41,822	......	-41,822	-34,999	.....	-34,999
Unrealized Discount on trust fund investments	-61	......	-61	-74	.....	-74	-44	.....	-44
Rents and Royalties on the Outer Continental Shelf lands	......	$190	-190	.....	$3,548	-3,548	....	$4,021	-4,021
Sale of major assets	....	......	.....	.....	......	......	.....	1,875	-1,875
Total—Undistributed offsetting receipts	-5,119	190	-5,309	-74,924	3,549	-78,473	-65,601	6,799	-72,400
Total outlays	105,195	17,606	87,588	1,233,998	169,943	[6]1,064,055	1,159,424	155,620	[6]1,003,804
Total On-Budget	87,677	17,606	70,071	1,031,307	169,943	861,364	965,558	155,587	809,972
Total Off-Budget	17,518	(**)	17,518	202,691	(**)	202,691	193,865	33	193,832
Total Surplus (+) or Deficit			+10,214			[6]-155,102			[6]-149,661
Total On-Budget			+5,515			-193,901			-169,231
Total Off-Budget			+4,699			+38,800			+19,570

MEMORANDUM

Receipts offset against outlays (In millions)

	Current Fiscal Year to Date	Comparable Period Prior Fiscal Year
Proprietary receipts	$34,630	$35,469
Receipts from off-budget Federal entities	916	685
Intrabudgetary transactions	159,508	145,727
Total receipts offset against outlays	195,053	181,881

[1]A $35 million payment to the foreign service retirement and disability fund was erroneously reported as operating expenses, Agency for International Development.
[2]The Fiscal Year 1988 Appropriation Act for the Commodity Credit Corporation provided that $126,108,000.00 of the Corporation's appropriation would be used to cover expenses applicable to "special activities (wool program)" This advance appropriation was not credited to the wool program as a non-expenditure transfer but was recorded as a receipt netted against outlays.
[3]Includes adjustments between appropriations.
[4]Includes prior month adjustments.
[5]Includes FICA and SECA tax credits, non-contributary military service credits, special benefits for the aged, and credit for unnegotiated OASI benefit checks.
[6]The outlays by month for FY 1987 have been increased by a net of $737 million to reflect reclassification of the Thrift Savings Fund receipts of $734 million and Federal Retirement Thrift Investment Board (FRTIB) administrative expenses of $6 million to a non-budgetary status.The FRTIB outlays by month for FY 1988 have been adjusted by a net of $1,084 million.
... No transactions.
(**) Less than $500,000.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Table 6. Means of Financing the Deficit or Disposition of Surplus by the U.S. Government, September 1988 and Other Periods (in millions)

Assets and Liabilities Directly Related to Budget and Off-budget Activity	Net Transactions (–) denotes net reduction of either liability or asset accounts			Account Balances Current Fiscal Year		
	This Month	Fiscal Year to Date		Beginning of		Close of This month
		This Year	Prior Year	This Year	This Month	
Liability accounts						
Borrowing from the public:						
Public debt securities, issued under general financing authorities:						
Obligations of the United States, issued by:						
United States Treasury	$26,538	$252,061	$224,973	$2,335,277	$2,560,800	$2,587,338
Federal Financing Bank	[1] –155	–155	....	15,000	15,000	[1] 14,845
Total public debt securities	26,384	251,906	224,973	2,350,277	2,575,800	2,602,183
Agency securities, issued under special financing authorities (See Schedule B. For other agency borrowing, see Schedule C)	2,106	7,469	269	4,929	10,291	12,398
Total federal securities	28,490	259,375	225,242	2,355,206	2,586,091	2,614,581
Deduct:						
Federal securities held as investments of government accounts (See Schedule D)	13,824	93,204	73,525	457,444	536,824	550,649
Total borrowing from the public	14,665	166,171	151,717	1,897,761	2,049,267	2,063,932
Premium & discount on public debt securities	–1,174	–4,201	247	–9,702	–12,729	–13,902
Total borrowing from the public less premium & discount	13,492	161,970	151,964	1,888,060	2,036,538	2,050,030
Accrued interest payable to the public	6,499	2,354	2,232	31,712	27,567	34,067
Allocations of special drawing rights	11	53	324	6,270	6,311	6,322
Deposit funds[2]	–683	–609	–1,830	9,114	9,188	8,505
Miscellaneous liability accounts (includes checks outstanding etc.)	2,489	–3,265	–2,421	13,633	7,879	10,368
Total liability accounts	**21,808**	**160,504**	**150,269**	**1,948,788**	**2,087,484**	**2,109,292**
Asset accounts (deduct)						
Cash and monetary assets:						
U.S. Treasury operating cash:[3]						
Federal Reserve account	8,633	3,904	1,606	9,120	4,390	13,024
Tax and loan note accounts	22,811	4,059	3,446	27,316	8,564	31,375
Balance	31,444	7,963	5,052	36,436	12,954	44,398
Special drawing rights:						
Total holdings	16	–5	784	9,078	9,058	9,074
SDR certificates issued to Federal Reserve Banks	....	....	....	–5,018	–5,018	–5,018
Balance	16	–5	784	4,060	4,040	4,056
Reserve position on the U.S. quota in the IMF:						
U.S. subscription to International Monetary Fund:						
Direct quota payments	....	....	....	19,699	19,699	19,699
Maintenance of value adjustments	40	193	1,186	3,230	3,383	3,423
Letter of credit issued to IMF	47	–1,854	–2,366	–12,855	–14,756	–14,709
Dollar deposits with the IMF	–35	4	–2	–66	–28	–62
Receivable/payable (–) for interim maintenance of value adjustments	–24	739	588	257	1,020	996
Balance	28	–918	–594	10,265	9,318	9,347
Loans to International Monetary Fund	–35	–354	–405	642	323	288
Other cash and monetary assets	561	906	–1,908	9,408	9,754	10,314
Total cash and monetary assets	32,014	7,592	2,928	60,811	36,390	68,403
Miscellaneous asset accounts	419	–1,079	–1,653	5,714	4,216	4,635
Total asset accounts	**32,432**	**6,513**	**1,275**	**66,525**	**40,606**	**73,038**
Excess of liabilities (+) or assets (–)	**–10,624**	**+153,991**	**+148,993**	**+1,882,263**	**+2,046,878**	**+2,036,254**
Transactions not applied to current year's surplus or deficit (See Schedule A for details)	410	1,111	668	....	701	1,111
Total budget and off-budget federal entities [Financing of deficit (+) or disposition of surplus (–)]	**–10,214**	**+155,102**	**+149,661**	**+1,882,263**	**+2,047,579**	**+2,037,365**

[1] Includes a redemption of $155 million for Federal Financing Bank obligations not reported in the September 1988 Daily Treasury Statement or the Monthly Statement of the Public Debt of the U.S. These publications will be adjusted in October 1988.

[2] The outlays by month for FY 1987 have been increased by a net of $737 million to reflect reclassification of the Thrift Savings Fund receipts of $734 million and Federal Retirement Thrift Investment Board (FRTIB) administrative expenses of $6 million to a non-budgetary status. The FRTIB outlays by month for FY 1988 have been adjusted by a net of $1,084 million.

[3] Major sources of information used to determine Treasury's operating cash include the Daily Balance Wires from Federal Reserve Banks, reporting from the Bureau of Public Debt, electronic transfers through the Treasury Financial Communications System and reconciling wires from Internal Revenue Service Centers. Operating cash is presented on a modified cash basis, deposits are reflected, as received; and withdrawals are reflected as processed.

... No transactions.

Note: Details may not add to totals due to rounding.

Source: Financial Management Service, Department of the Treasury.

Table 6. Schedule A—Analysis of Change in Excess of Liabilities of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	This Month	Fiscal Year to Date: This Year	Fiscal Year to Date: Prior Year
Excess of liabilities beginning of period:			
Based on composition of unified budget in preceding period	$2,046,878	$1,880,606	$1,732,827
Adjustments during current fiscal year for changes in composition of unified budget:			
Classification of FDIC securities as budgetary transactions	....	....	442
Classification of FSLIC securities as budgetary transactions	....	920	....
Reclassification of Federal Retirement Thrift Investment Board to a non-budgetary status	....	737	....
Excess of liabilities beginning of period (current basis)	2,046,878	1,882,263	1,733,270
Budget surplus (–) or deficit:			
Based on composition of unified budget in prior fiscal year	–10,214	155,102	149,661
Changes in composition of unified budget	....	....	....
Total surplus (–) or deficit (Table 2)	–10,214	155,102	149,661
Total—on-budget (Table 2)	–5,515	193,901	169,231
Total—off-budget (Table 2)	–4,699	–38,800	–19,570
Transactions not applied to current year's surplus or deficit:			
Seigniorage	–37	–470	–458
Proceeds from sales of loan assets with recourse	–330	–539	....
Profit on sale of gold	–37	–37	–173
Net gain (–)/loss for IMF loan valuation adjustment	–6	–63	–37
Total—transactions not applied to current year's surplus or deficit	–410	–1,111	–668
Excess of liabilities close of period	**2,036,254**	**2,036,254**	**1,882,263**

Table 6. Schedule B—Securities issued by Federal Agencies Under Special Financing Authorities, September 1988 and Other Periods (in millions)

Classification	Net Transactions (–) denotes net reduction of liability accounts: This Month	Net Transactions: Fiscal Year to Date: This Year	Net Transactions: Fiscal Year to Date: Prior Year	Account Balances Current Fiscal Year: Beginning of This Year	Account Balances: Beginning of This Month	Account Balances: Close of This month
Agency securities, issued under special financing authorities:						
Obligations of the United States, issued by:						
Export-Import Bank of the United States	....	....	–$6	(**)	(**)	(**)
Federal Deposit Insurance Corporation	–$108	$682	–242	$200	$990	$882
Federal Home Loan Bank Board:						
Federal Savings and Loan Insurance Corporation	2,214	8,814	920	920	7,520	9,733
Obligations guaranteed by the United States, issued by:						
Department of Defense:						
Family housing mortgages	(**)	–5	–22	15	11	11
Department of Housing and Urban Development:						
Federal Housing Administration	5	–59	62	178	115	120
Department of the Interior:						
Bureau of Land Management	....	....	–2	13	13	13
Department of Transportation:						
Coast Guard:						
Family housing mortgages	....	....	....	(**)	(**)	(**)
Obligations not guaranteed by the United States, issued by:						
Department of Defense:						
Homeowners assistance mortgages	–4	2	4	7	12	9
Department of Housing and Urban Development:						
Government National Mortgage Association	....	–1,965	–200	1,965	....	....
Independent agencies:						
Postal Service	....	....	....	250	250	250
Tennessee Valley Authority	....	....	–245	1,380	1,380	1,380
Total agency securities	**2,106**	**7,469**	**269**	**4,929**	**10,291**	**12,398**

....No transactions.
(**)Less than $500,000.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Table 6. Schedule C (Memorandum)—Federal Agency Borrowing Financed Through the Issue of Public Debt Securities, September 1988 and Other Periods (in millions)

Classification	Transactions: This Month	Transactions: Fiscal Year to Date: This Year	Transactions: Fiscal Year to Date: Prior Year	Account Balances Current Fiscal Year: Beginning of: This Year	Account Balances Current Fiscal Year: Beginning of: This Month	Account Balances Current Fiscal Year: Close of This month
Borrowing from the Treasury:						
Housing and Other Credit Guarantee Program, AID	$3	$25	$20	$20	$42	$45
Commodity Credit Corporation	441	-9,210	-3,831	20,969	11,318	11,759
Federal Emergency Management Agency:						
National Insurance Development Fund	....	16	21	97	113	113
Federal Financing Bank	-3,505	-9,652	-812	140,952	134,805	131,300
Federal Housing Administration:						
General insurance	30	460	125	1,596	2,026	2,056
Special risk insurance	....	2	3	1,935	1,937	1,937
General Services Administration:						
Pennsylvania Avenue Development Corporation	....	....	-2	50	50	50
Rural Communication Development Fund	....	....	....	25	25	25
Rural Electrification Administration	....	.....	....	7,865	7,865	7,865
Rural Telephone Bank	....	....	....	759	759	759
Secretary of Agriculture, Farmers Home Administration:						
Rural housing insurance fund	340	295	1,740	5,981	5,936	6,276
Agricultural credit insurance fund	330	81	2,690	10,756	10,507	10,837
Rural development insurance fund	335	680	1,035	2,896	3,241	3,576
Federal Crop Insurance Corp	....	....	....	113	113	113
Secretary of Education:						
College housing loans	....	-944	-538	2,049	1,105	1,105
Secretary of Energy:						
Bonneville Power Administration	-185	-52	385	1,844	1,977	1,792
Secretary of Housing and Urban Development:						
Housing for the elderly or handicapped	....	325	550	5,901	6,226	6,226
Low-Rent Public housing	50	850	810	....	800	850
Secretary of the Interior:						
Bureau of Mines, helium fund	....	....	....	252	252	252
Railroad retirement account	....	....	....	2,128	2,128	2,128
Railroad retirement social security equivalent fund	196	111	141	2,144	2,059	2,255
Secretary of Transportation:						
Aircraft purchase loan guarantee program	....	9	-11	1	10	11
Federal ship revolving fund	....	95	-955	420	515	515
Railroad revitalization and improvement	6	6	-12	....	....	6
Regional rail reorganization	-36	-36	32	128	128	92
Smithsonian Institution:						
John F. Kennedy Center parking facilities	....	....	....	20	20	20
Tennessee Valley Authority	....	....	....	150	150	150
Veterans Administration:						
Veterans direct loan program	....	....	....	1,730	1,730	1,730
Ocean Freight	....	-22	16	22	....	....
Total agency borrowing from the Treasury financed through issues of public debt securities	-1,995	-16,961	1,407	210,803	195,837	193,842

Table 6. Schedule C (Memorandum)—Federal Agency Borrowing Financed Through the Issue of Public Debt Securities, September 1988 and Other Periods (in millions)—Continued

Classification	Transactions			Account Balances Current Fiscal Year		
	This Month	Fiscal Year to Date		Beginning of		Close of This month
		This Year	Prior Year	This Year	This Month	
Borrowing from the Federal Financing Bank:						
Funds Appropriated to the President:						
Foreign military sales	-$2,950	-$3,076	$367	$19,164	$19,038	$16,088
Overseas Private Investment Corporation	...	-1	-1	1	...	...
Department of Agriculture:						
Rural Electrification Administration	49	-2,094	-248	25,438	23,296	23,345
Farmers Home Administration:						
Agriculture Credit Insurance Fund	...	-385	-385	28,010	27,625	27,625
Rural Development Insurance Fund	-968	-3,148	170	8,048	5,868	4,900
Rural housing Insurance Fund	...	-2,980	-150	28,951	25,971	25,971
Department of the Navy	...	-29	40	1,788	1,759	1,759
Department of Education:						
Student Loan Marketing Association	-30	-30	-30	4,940	4,940	4,910
Department of Energy	...	50	...	...	50	50
Department of Health and Human Services, Except Social Security:						
Medical Facilities Guarantee and Loan Fund	...	-11	-25	192	182	182
Department of Housing and Urban Development:						
Low Rent Housing Loans and Other Expenses	...	-37	-37	2,074	2,037	2,037
Community Development Grants	-4	-37	22	355	322	318
Department of Interior:						
Territorial and International Affairs	-1	-2	-2	60	59	59
Department of Transportation:						
Grants to National Railroad Passenger Corporation	-2	-9	-5	55	48	46
General Services Administration:						
Federal Buildings Fund	...	-8	-7	395	387	387
National Aeronautics and Space Administration:						
Space Flight, Control and Data Communications	...	90	-80	809	899	899
Small Business Administration:						
Business Loan and Investment Fund	-42	-142	-149	1,662	1,563	1,521
Independent Agencies:						
Export-Import Bank of the United States	-269	-1,506	-1,805	12,463	11,226	10,958
National Credit Union Administration	...	7	7	111	118	118
Postal Service	...	1,238	1,499	4,353	5,592	5,592
Tennessee Valley Authority	180	1,084	1,293	18,210	19,114	19,293
Washington Metropolitan Transit Authority	...	...	...	177	177	177
Total borrowing from the Federal Financing Bank	**-4,037**	**-11,025**	**475**	**157,258**	**150,271**	**146,234**

... No transactions.

Note: This table has been expanded to include lending by the Federal Financing Bank accomplished by the purchase of agency financial assets, by the acquisition of agency debt securities, and by direct loans on behalf of an agency. The Federal Financing Bank borrows from Treasury and issues its own securities and in turn may loan these funds to agencies in lieu of agencies borrowing directly through Treasury or issuing their own securities.

Note: Details may not add to totals due to rounding.

Source: Financial Management Service, Department of the Treasury.

Table 6. Schedule D—Investments of Federal Government Accounts in Federal Securities, September 1988 and Other Periods (in millions)

Classification	Net Purchases or Sales (−)			Securities Held as Investments Current Fiscal Year		
	This Month	Fiscal Year to Date		Beginning of		Close of This month
		This Year	Prior Year	This Year	This Month	
Federal funds:						
Department of Agriculture	$2	$4	$2	$6	$8	$9
Department of Commerce	(**)	4	4	15	20	19
Department of Energy	−8	256	84	1,506	1,771	1,763
Department of Health and Human Services	....	−12	5	12	....	....
Department of Housing and Urban Development:						
Federal Housing Administration:						
Federal Housing Administration fund:						
Public debt securities	(**)	−277	957	6,482	6,205	6,205
Agency securities	....	−134	(**)	134	....	....
Government National Mortgage Association:						
Management and liquidating functions fund:						
Public debt securities	−463	−50	−346	71	484	22
Agency securities	....	−6	−2	72	65	65
Guarantees of mortgage-backed securities:						
Public debt securities	4	103	221	1,522	1,622	1,625
Agency securities	1	−5	8	17	11	12
Participation sales fund:						
Public debt securities	....	−2,164	−79	2,164	....	....
Agency securities	....	−12	....	12	....	....
Other	15	193	(**)	(**)	178	193
Department of the Interior:						
Public Debt Securities	21	−220	−2,757	1,249	1,008	1,029
Agency Securities	2	2	....	....	....	2
Department of Labor	70	284	70	479	693	763
Department of Transportation	12	28	14	160	176	189
Department of the Treasury	−101	−1,512	2,464	2,945	1,534	1,433
Veterans Administration:						
Veterans reopened insurance fund	−4	8	19	627	639	635
Independent agencies:						
Export-Import Bank of the United States	−504	−355	319	443	591	88
Federal Emergency Management Agency:						
National insurance development fund	55	207	196	196	349	403
Federal Savings and Loan Insurance Corporation:						
Public debt securities	−797	813	−3,891	826	2,436	1,640
Agency securities	....	−55	−12	55	....	....
Postal Service	−2,484	−640	785	4,588	6,432	3,949
National Credit Union Administration	9	241	177	1,561	1,793	1,802
Other	78	410	6	1,242	1,575	1,653
Total public debt securities	−4,096	−2,678	−1,750	26,098	27,515	23,420
Total agency securities	3	−210	−6	290	76	80
Total Federal funds	**−4,092**	**−2,888**	**−1,756**	**26,388**	**27,591**	**23,499**
Trust funds:						
Legislative Branch:						
United States Tax Court	....	(**)	(**)	2	3	3
Library of Congress	−1	....	....	1	3	1
The Judiciary:						
Judicial survivors annuity fund	....	9	6	119	128	128
Department of Agriculture	−13	−6	9	14	21	8
Department of Defense—Military	(**)	1	−1	8	8	9
Department of Defense—Civil:						
Military Retirement Fund	−506	10,673	9,768	30,637	41,816	41,310
Other	−121	128	284	769	1,017	897
Department of Health and Human Services:						
Federal old-age and survivors insurance trust fund:						
Public debt securities	4,508	38,781	21,408	58,356	92,629	97,137
Agency securities	....	....	....	....	....	....
Federal disability insurance trust fund	184	153	−1,143	7,193	7,161	7,345
Federal hospital insurance trust fund:						
Public debt securities	1,026	15,704	12,489	50,374	65,052	66,078
Agency securities	....	−405	−50	405	....	....
Federal supplementary medical insurance trust fund	−1,601	160	−3,258	6,166	7,928	6,326
Other	(**)	2	−35	5	6	6

Table continued on next page.

Table 6. Schedule D—Investments of Federal Government Accounts in Federal Securities, September 1988 and Other Periods (in millions)—Continued

Classification	Net Purchases or Sales (−)			Securities Held as Investments Current Fiscal Year		
	This Month	Fiscal Year to Date		Beginning of		Close of This month
		This Year	Prior Year	This Year	This Month	
Trust funds:—Continued						
Department of the Interior:						
Public debt securities	$30	−$31	$53	$212	$151	$181
Agency securities	122	122	...	...	...	122
Department of Labor:						
Unemployment trust fund	−1,497	8,280	6,677	27,917	37,695	36,197
Other	−3	−1	−2	33	36	32
Department of State:						
Foreign service retirement and disability fund	125	450	534	3,474	3,799	3,924
Other	...	(**)	(**)	(**)	...	...
Department of Transportation:						
Airport and airway trust fund	109	1,194	1,341	9,937	11,022	11,132
Highway trust fund	−510	757	1,192	12,691	13,958	13,448
Other	−11	66	36	363	440	429
Department of the Treasury	25	70	29	134	179	204
Environmental Protection Agency	109	731	443	737	1,359	1,468
Office of Personnel Management:						
Civil service retirement and disability fund:						
Public debt securities	16,250	18,299	22,704	176,748	178,797	195,048
Agency securities	...	−175	...	175	...	...
Employees health benefits fund	268	356	−210	1,208	1,296	1,564
Employees life insurance fund	21	767	677	8,078	8,824	8,845
Retired employees health benefits fund	−1	−1	−2	2	2	1
Veterans Administration:						
Government life insurance fund	−3	−21	−23	222	204	201
National service life insurance:						
Public debt securities	−48	450	357	9,990	10,489	10,440
Agency securities	...	−135	...	135	...	...
Veterans special life insurance fund	−3	76	78	1,093	1,171	1,168
General Post Fund National Homes	...	1	1	21	22	22
Independent agencies:						
Federal Deposit Insurance Corporation	−589	−1,475	1,184	17,040	16,154	15,565
Federal Emergency Management Agency	−1	−1	(**)	1	1	...
Harry S. Truman Memorial Scholarship Trust Fund	(**)	2	(**)	45	46	46
Japan-United States Friendship Commission	(**)	1	(**)	17	18	18
Railroad Retirement Board	48	1,095	690	6,688	7,735	7,783
Other	(**)	16	42	47	63	63
Total public debt securities	17,795	96,686	75,331	430,342	509,233	527,028
Total agency securities	122	−593	−50	715	...	122
Total trust funds	**17,917**	**96,093**	**75,281**	**431,057**	**509,233**	**527,150**
Grand total	**13,824**	**93,204**	**73,525**	**457,444**	**536,824**	**550,649**

... No transactions.
(**)Less than $500,000.
Note: Investments are in public debt securities unless otherwise noted.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Table 7. Receipts and Outlays of the U.S. Government by Month, Fiscal Year 1988 (in millions)

Classification	Oct.	Nov.	Dec.	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Fiscal Year To Date	Comparable Period Prior F.Y.
Receipts														
Individual income taxes	$32,429	$25,039	$36,537	$43,987	$25,651	$20,637	$53,334	$17,958	$46,092	$25,791	$31,942	$41,784	$401,181	$392,557
Corporation income taxes	1,855	1,667	17,748	3,630	975	12,706	12,026	1,613	18,347	1,499	1,461	20,668	94,195	83,926
Social insurance taxes and contributions:														
Employment taxes and contributions	20,791	20,725	22,735	26,920	25,739	25,141	34,464	24,948	27,200	24,964	23,477	27,991	305,093	273,028
Unemployment insurance	956	2,667	170	883	2,399	179	2,477	8,073	352	1,598	4,545	285	24,584	25,575
Other retirement contributions	431	364	457	360	362	356	417	375	415	354	351	418	4,658	4,715
Excise taxes	2,551	2,848	3,832	2,371	2,199	2,885	2,767	3,055	3,136	3,250	3,490	3,158	35,540	32,457
Estate and gift taxes	608	617	540	531	566	622	749	751	644	627	661	678	7,594	7,493
Customs duties	1,340	1,253	1,367	1,217	1,301	1,444	1,204	1,282	1,430	1,343	1,650	1,367	16,198	15,085
Miscellaneous receipts	1,392	1,807	2,141	1,893	1,164	1,760	1,886	1,657	1,590	1,265	1,902	1,454	19,909	19,307
Total—budget receipts this year	**62,354**	**56,987**	**85,525**	**81,791**	**60,355**	**65,730**	**109,323**	**59,711**	**99,205**	**60,690**	**69,479**	**97,803**	**908,953**	.....
(On-budget)	**45,992**	**40,630**	**67,645**	**60,645**	**40,610**	**44,958**	**81,993**	**39,764**	**77,643**	**40,980**	**51,015**	**75,586**	**667,462**	.....
(Off-budget)	**16,362**	**16,357**	**17,880**	**21,146**	**19,745**	**20,772**	**27,330**	**19,947**	**21,562**	**19,710**	**18,464**	**22,217**	**241,491**	.....
Total—budget receipts prior year	*59,012*	*52,967*	*78,035*	*81,771*	*55,463*	*56,515*	*122,897*	*47,691*	*82,945*	*64,223*	*60,213*	*92,410*	......	*854,143*
(On-budget)	*43,865*	*38,158*	*60,694*	*62,981*	*37,919*	*38,469*	*99,083*	*30,205*	*64,222*	*47,880*	*43,510*	*73,755*	......	*640,741*
(Off-budget)	*15,147*	*14,809*	*17,341*	*18,791*	*17,544*	*18,047*	*23,814*	*17,486*	*18,723*	*16,342*	*16,702*	*18,656*	......	*213,402*
Outlays														
Legislative Branch	157	124	182	143	174	141	195	142	130	155	149	161	1,852	1,812
The Judiciary	83	85	90	85	86	222	90	151	92	92	168	93	1,337	1,178
Executive Office of the President	8	15	8	11	9	8	13	10	9	3	18	8	121	109
Funds Appropriated to the President:														
International security assistance	871	584	647	255	501	704	459	600	524	683	304	-1,860	4,273	6,820
International development assistance	464	121	91	371	184	93	386	134	172	493	319	151	2,980	2,673
Other	-82	-523	-416	425	2	-144	517	-25	136	-49	-2	161	-1	913
Department of Agriculture:														
Foreign assistance, special export programs and Commodity Credit Corporation	5,115	3,283	1,543	2,495	426	995	900	304	-509	-475	-250	-545	13,284	23,424
Other	2,530	1,911	2,263	1,933	216	3,363	3,549	3,338	3,061	2,775	2,470	3,309	30,719	26,169
Department of Commerce	153	179	243	194	139	206	181	192	213	165	202	211	2,279	2,156
Department of Defense:														
Military:														
Department of the Army	7,423	5,356	7,990	5,084	6,487	6,814	7,336	5,471	6,908	6,433	6,144	5,870	77,315	73,808
Department of the Navy	8,506	7,183	9,283	6,673	7,307	8,592	9,161	6,728	8,301	8,426	7,918	6,483	94,560	90,813
Department of the Air Force	8,060	7,015	9,172	6,194	7,783	8,627	8,525	6,628	8,096	7,433	8,197	7,331	93,060	91,144
Defense agencies	1,285	1,106	1,913	1,254	1,490	1,723	1,080	1,446	1,284	1,564	1,505	1,353	17,004	18,172
Total Military	25,274	20,660	28,358	19,205	23,067	25,756	26,102	20,273	24,589	23,856	23,764	21,036	281,940	273,938
Civil	1,829	1,814	1,797	1,813	1,806	1,818	1,823	1,853	1,837	1,867	1,877	1,913	22,047	20,659
Department of Education	1,386	2,060	1,420	1,612	1,946	1,545	1,308	1,304	1,424	1,012	1,618	1,611	18,246	16,800
Department of Energy	952	939	941	1,126	815	993	836	1,018	1,037	712	978	813	11,161	10,688
Department of Health and Human Services, except Social Security:														
Public Health Service	970	909	914	876	930	864	981	1,045	1,091	867	992	969	11,408	9,886
Health Care Financing Administration:														
Grants to States for Medicaid	2,444	2,619	2,020	2,398	2,476	2,673	2,606	2,475	2,830	2,328	2,740	2,854	30,462	27,435
Federal hospital ins. trust fund	4,119	3,926	4,479	3,863	4,472	5,245	4,432	4,130	4,906	3,712	4,837	4,607	52,730	50,803
Federal supp. med. ins. trust fund	3,022	2,613	2,856	2,550	2,774	3,168	2,914	2,867	3,045	2,647	3,350	3,140	34,947	30,837
Other	1,775	1,778	4,244	292	2,394	2,359	3,037	2,416	2,431	2,358	2,369	1,063	26,516	21,397
Social Security Administration	2,640	186	2,023	1,120	1,209	1,149	3,941	363	1,295	1,866	1,068	2,173	19,032	17,480
Family Support Administration	950	1,263	817	1,466	1,175	1,311	1,157	1,179	943	1,037	1,042	918	13,256	13,311
Human Development Service	413	434	430	605	617	449	506	535	391	327	702	478	5,886	5,448
Other	-2,324	-2,339	-5,447	-395	-3,189	-3,133	-3,857	-3,117	-3,259	-3,103	-3,179	-1,903	-35,245	-27,703
Department of Health and Human Services, Social Security:														
Federal old-age and survivors ins. trust fund	15,507	15,447	31,907	368	16,258	16,654	16,434	16,411	19,634	16,407	16,422	16,446	197,897	186,780
Federal disability ins. trust fund	1,895	1,731	3,423	284	1,864	1,863	1,920	1,856	1,948	1,879	1,876	1,820	22,360	21,290
Other	-824	-36	-60	-986	-191	-122	-2,026	-137	-249	-1,097	-58	-293	-6,079	-5,648

Table continued on next page.

Table 7. Receipts and Outlays of the U.S. Government by Month, Fiscal Year 1988 (in millions)—Continued

Classification	Oct.	Nov.	Dec.	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Fiscal Year To Date	Comparable Period Prior F.Y.
Outlays—Continued														
Department of Housing and Urban Development	$1,962	$1,421	$1,900	$1,361	$1,396	$1,605	$1,698	$1,327	$1,683	$1,339	$1,681	$1,584	$18,956	$15,464
Department of the Interior	592	406	439	408	336	348	335	356	502	367	339	725	5,152	5,054
Department of Justice	397	340	529	407	431	407	513	445	554	519	455	427	5,426	4,333
Department of Labor:														
Unemployment trust fund	1,012	1,122	1,450	1,488	1,780	1,843	1,427	1,328	1,287	1,158	1,310	3,393	18,598	20,527
Other	-95	574	447	582	395	28	429	591	698	761	794	-1,931	3,272	2,926
Department of State	302	280	479	159	242	221	222	230	321	389	222	356	3,421	2,788
Department of Transportation:														
Highway trust fund	1,276	1,149	1,246	837	945	741	800	1,203	1,257	1,232	1,722	1,505	13,913	12,642
Other	1,024	1,039	954	1,037	1,016	1,049	1,191	1,154	1,061	1,043	916	1,006	12,491	12,789
Department of the Treasury:														
Interest on the public debt	14,115	16,623	30,355	14,674	15,043	14,436	14,856	17,407	31,595	14,534	15,256	15,250	214,145	195,390
Other	-2,318	-711	-1,271	-773	141	-536	-152	-726	-1,524	-1,243	-355	-2,206	-11,673	-15,045
Environmental Protection Agency	393	403	415	391	389	423	392	360	478	394	376	459	4,872	4,903
General Services Administration	-544	293	297	-430	92	143	-434	167	261	-530	144	255	-285	74
National Aeronautics and Space Administration	936	772	843	622	606	804	816	777	863	805	717	530	9,092	7,591
Office of Personnel Management	2,400	2,193	2,324	2,554	2,392	2,510	2,773	2,326	2,492	2,645	2,359	2,222	29,191	26,966
Small Business Administration	241	-34	-45	-45	...	-29	-2	-7	-45	-20	-42	-26	-54	-72
Veterans Administration:														
Compensation and pensions	2,352	44	2,342	44	1,192	1,334	2,422	73	1,243	1,232	1,259	1,792	15,328	14,426
National service life	52	45	51	62	47	79	66	52	55	60	55	51	675	592
Government service life	3	3	3	3	2	4	3	3	4	3	3	3	37	40
Other	1,232	802	1,374	1,102	917	1,138	1,257	1,304	828	1,060	944	1,246	13,204	11,894
Independent agencies:														
Postal Service	355	149	-85	439	-233	347	11	-405	8	-610	35	2,218	2,229	1,593
Tennessee Valley Authority	138	97	104	-289	145	57	167	140	193	139	58	140	1,089	1,091
Other independent agencies	908	2,292	343	1,848	182	2,793	1,411	1,010	27	608	4,053	4,566	20,042	11,582
Undistributed offsetting receipts:														
Employer share, employee retirement	-2,567	-2,528	-2,506	-2,628	-2,367	-2,570	-2,654	-2,687	-2,554	-2,584	-2,682	-4,701	-33,028	-30,559
Interest received by trust funds	-228	-2,109	-16,647	-75	-405	-145	-187	-2,873	-18,252	-69	-476	-356	-41,822	-34,999
Rents and royalties on Outer Continental Shelf lands	-99	-440	-234	8	-468	-195	-208	-584	-657	-121	-359	-190	-3,548	-4,021
Other	-3	....	5	-2	7	-1	-3	4	-28	7	-1	-61	-76	-2,821
Totals this year:														
Total outlays	**93,164**	**84,009**	**109,889**	**65,895**	**84,382**	**95,013**	**95,554**	**82,295**	**90,071**	**83,634**	**92,561**	**87,588**	**[1]1,064,055**	......
(On-budget)	**76,979**	**67,239**	**77,993**	**66,682**	**66,629**	**76,994**	**79,629**	**64,688**	**72,888**	**66,818**	**74,756**	**70,071**	**861,364**	......
(Off-budget)	**16,185**	**16,770**	**31,896**	**-787**	**17,753**	**18,020**	**15,925**	**17,607**	**17,184**	**16,816**	**17,805**	**17,518**	**202,691**	......
Total—surplus (+) or deficit (-)	**-30,810**	**-27,022**	**-24,363**	**+15,896**	**-24,027**	**-29,283**	**+13,769**	**-22,583**	**+9,134**	**-22,944**	**-23,082**	**+10,214**	**[1]-155,102**	......
(On-budget)	**-30,986**	**-26,609**	**-10,347**	**-6,037**	**-26,019**	**-32,036**	**+2,364**	**-24,924**	**+4,756**	**-25,838**	**-23,741**	**+5,515**	**-193,901**	......
(Off-budget)	**+176**	**-414**	**-14,016**	**+21,933**	**+1,992**	**+2,752**	**+11,405**	**+2,340**	**+4,379**	**+2,894**	**+659**	**+4,699**	**+38,800**	......
Totals—outlays prior year	*84,302*	*80,054*	*90,404*	*83,928*	*83,842*	*84,446*	*84,155*	*83,328*	*83,568*	*86,562*	*82,009*	*77,206*	....	*[1]1,003,804*
(On-budget)	*68,815*	*63,721*	*75,915*	*68,162*	*67,152*	*67,791*	*69,130*	*66,282*	*66,423*	*70,877*	*65,140*	*60,563*	....	*809,972*
(Off-budget)	*15,486*	*16,334*	*14,489*	*15,766*	*16,690*	*16,655*	*15,025*	*17,046*	*17,145*	*15,685*	*16,868*	*16,643*	....	*193,832*
Total—surplus (+) or deficit (-) prior year	*-25,290*	*-27,087*	*-12,369*	*-2,157*	*-28,379*	*-27,931*	*+38,742*	*-35,637*	*-623*	*-22,339*	*-21,796*	*+15,204*	....	*[1]-149,661*
(On-budget)	*-24,950*	*-25,563*	*-15,221*	*-5,181*	*-29,233*	*-29,322*	*+29,953*	*-36,077*	*-2,201*	*-22,996*	*-21,630*	*+13,191*	....	*-169,231*
(Off-budget)	*-340*	*-1,524*	*+2,853*	*+3,024*	*+854*	*+1,391*	*+8,790*	*+440*	*+1,578*	*+657*	*-166*	*+2,013*	....	*+19,570*

[1]The outlays by month for FY 1987 have been increased by a net of $737 million to reflect reclassification of the Thrift Savings Fund receipts of $734 million and Federal Retirement Thrift Investment Board (FRTIB) administrative expenses of $6 million to a non-budgetary status. The Federal Retirement Thrift Investment Board outlays by month for FY 1988 have been adjusted by a net of $1,084 million. Data for fiscal years 1987 and 1988 previously reported by Treasury for Federal Savings and Loan Insurance Corporation and FRTIB have been reclassified in consultation with the Office of Management and Budget resulting in revised totals as shown above. Historical tables in the Budget will be changed to agree with Treasury totals with the exception of a difference of $7 million for the Small Business Administration and the administrative expenses for the FRTIB. OMB will continue to reflect the administrative expenses for the FRTIB in budgetary totals.

....No transactions.

(**)Less than $500,000.

Note: Details may not add to totals due to rounding.

Source: Financial Management Service, Department of the Treasury.

Table 8. Trust Fund Impact on Budget Results and Investment Holdings (in millions) as of September 30, 1988

Classification	Current Month			Fiscal Year to Date			Securities held as Investments Current Fiscal Year		
	Receipts	Outlays	Excess	Receipts	Outlays	Excess	Beginning of This Year	Beginning of This Month	Close of This Month
Trust receipts, outlays, and investments held:									
Airport	$373	$306	$67	$4,081	$2,868	$1,214	$9,937	$11,022	$11,132
Black lung disability	55	55	(**)	640	639	1	....	....	....
FDIC	......	433	-433	.....	2,146	-2,146	17,040	16,154	15,565
Federal disability insurance	1,996	1,820	176	22,521	22,360	161	7,193	7,161	7,345
Federal employees life and health	......	-297	297	......	-1,101	1,101	9,287	10,121	10,409
Federal employees retirement	18,757	2,381	16,376	47,063	28,431	18,632	180,516	182,725	199,100
Federal hospital insurance	5,654	4,607	1,047	67,999	52,730	15,270	50,779	65,052	66,078
Federal old-age and survivors insurance	20,969	16,446	4,523	239,386	197,897	41,490	58,356	92,629	97,137
Federal supplementary medical insurance	1,813	3,140	-1,327	35,002	34,947	55	6,166	7,928	6,326
Highways	1,310	1,505	-195	15,307	13,913	1,394	12,691	13,958	13,448
Military advances	542	683	-141	8,964	9,057	-93	....	....	....
Railroad retirement	412	544	-132	4,507	6,435	-1,928	6,688	7,735	7,783
Military retirement	1,590	1,614	-25	33,117	19,009	14,108	30,637	41,816	41,310
Unemployment	326	3,393	-3,067	26,984	18,598	8,386	27,917	37,695	36,197
Veterans life insurance	34	89	-55	1,423	1,058	365	11,440	11,864	11,810
All other trust	424	968	-544	3,863	4,455	-592	2,409	3,373	3,509
Total trust fund receipts and outlays and investments held from Table 6-D	**54,258**	**37,688**	**16,570**	**510,861**	**413,440**	**97,420**	**431,057**	**509,233**	**527,150**
Interfund transactions	-22,228	-22,228	......	-137,338	-137,338	......			
Trust fund receipts and outlays on the basis of tables 4 & 5	32,030	15,460	16,570	373,522	276,102	97,420			
Total federal fund receipts and outlays	**69,604**	**75,959**	**-6,356**	**557,642**	**810,164**	**-252,522**			
Interfund transactions	-2,296	-2,296	......	-2,717	-2,717	......			
Federal fund receipts & outlays on the basis of table 4 & 5	67,308	73,663	-6,356	554,925	807,447	-252,522			
Offsetting proprietary receipts	-1,534	-1,534	......	-19,494	-19,494	.....			
Net budget receipts & outlays	**97,803**	**87,588**	**10,214**	**908,953**	**1,064,055**	**-155,102**			

....No transactions.
(**)Less than $500,000.
Note: Interfund receipts and outlays are transactions between Federal funds and trust funds such as Federal payments and contributions, and interest and profits on investments in Federal securities. They have no net effect on overall budget receipts and outlays since the receipt side of such transactions is offset against budget outlays. In this table, interfund receipts are shown as an adjustment to arrive at total receipts and outlays of trust funds respectively.
Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

Table 9. Summary of Receipts by Source, and Outlays by Function of the U.S. Government, September 1988 and Other Periods (in millions)

Classification	This Month	Fiscal Year To Date	Comparable Period Prior Fiscal Year
RECEIPTS			
Individual income taxes	$41,784	$401,181	$392,557
Corporation income taxes	20,668	94,195	83,926
Social insurance taxes and contributions:			
Employment taxes and contributions	27,991	305,093	273,028
Unemployment insurance	285	24,584	25,575
Other retirement contributions	418	4,658	4,715
Excise taxes	3,158	35,540	32,457
Estate and gift taxes	678	7,594	7,493
Customs	1,367	16,198	15,085
Miscellaneous	1,454	19,909	19,307
Total	**97,803**	**908,953**	**854,143**
NET OUTLAYS			
National defense	21,941	290,349	281,999
International affairs	-691	10,469	11,649
General science, space, and technology	702	10,876	9,216
Energy	116	2,342	4,115
Natural resources and environment	1,625	14,538	13,363
Agriculture	-414	17,210	26,606
Commerce and housing credit	6,076	19,064	6,156
Transportation	2,568	27,196	26,221
Community and regional development	743	5,577	5,051
Education, training, employment and social services	2,588	30,856	29,724
Health	3,823	44,482	39,968
Medicare	6,949	78,798	75,120
Income security	11,226	130,174	123,255
Social security	18,266	219,030	207,353
Veterans benefits and services	3,085	29,248	26,782
Administration of justice	710	9,205	7,548
General government	796	9,506	7,564
Interest	12,371	151,711	138,570
Undistributed offsetting receipts	-4,892	-36,576	-36,455
Total	**87,588**	**1,064,055**	**1,003,804**

Note: Details may not add to totals due to rounding.
Source: Financial Management Service, Department of the Treasury.

GPO 936-211

Explanatory Notes

1. Flow of Data Into Monthly Treasury Statement

The Monthly Treasury Statement (MTS) is assembled from data in the central accounting system. The major sources of data include monthly accounting reports by Federal entities and disbursing officers, and daily reports from the Federal Reserve banks. These reports detail accounting transactions affecting receipts and outlays of the Federal Government and off-budget Federal entities, and their related effect on the assets and liabilities of the U.S. Government. Information is presented in the *MTS* on a modified cash basis.

2. Notes on Receipts

Receipts included in the report are classified into the following major categories: (1) budget receipts and (2) offsetting collections (also called applicable receipts). Budget receipts are collections from the public that result from the exercise of the Government's sovereign or governmental powers, exluding receipts offset against outlays. These collections, also called governmental receipts, consist mainly of tax receipts (including social insurance taxes), receipts from court fines, certain licenses, and deposits of earnings by the Federal Reserve System. Refunds of receipts are treated as deductions from gross receipts.

Offsetting collections are from other Government accounts or the public that are of a business-type or market-oriented nature. They are classified into two major categories: (1) offsetting collections credited to appropriations or fund accounts, and (2) offsetting receipts (i.e., amounts deposited in receipt accounts). Collections credited to appropriation or fund accounts normally can be used without appropriation action by Congress. These occur in two instances: (1) when authorized by law, amounts collected for materials or services are treated as reimbursements to appropriations and (2) in the three types of revolving funds (public enterprise, intragovernmental, and trust); collections are netted against spending, and outlays are reported as the net amount.

Offsetting receipts in receipt accounts cannot be used without being appropriated. They are subdivided into two categories: (1) proprietary receipts—these collections are from the public and they are offset against outlays by agency and by function, and (2) intragovernmental funds—these are payments into receipt accounts from Governmental appropriation or fund accounts. They finance operations within and between Government agencies and are credited with collections from other Government accounts. The transactions may be intrabudgetary when the payment and receipt both occur within the budget or from receipts from off-budget Federal entities in those cases where payment is made by a Federal entity whose budget authority and outlays are excluded from the budget totals.

Intrabudgetary transactions are subdivided into three categories: (1) interfund transactions, where the payments are from one fund group (either Federal funds or trust funds) to a receipt account in the other fund group; (2) Federal intrafund transactions, where the payments and receipts both occur within the Federal fund group; and (3) trust intrafund transactions, where the payments and receipts both occur within the trust fund group.

Offsetting receipts are generally deducted from budget authority and outlays by function, by subfunction, or by agency. There are four types of receipts, however, that are deducted from budget totals as undistributed offsetting receipts. They are: (1) agencies' payments (including payments by off-budget Federal entities) as employers into employees retirement funds, (2) interest received by trust funds, (3) rents and royalties on the Outer Continental Shelf lands, and (4) other interest (i.e., interest collected on Outer Continental Shelf money in deposit funds when such money is transferred into the budget).

3. Notes on Outlays

Outlays are generally accounted for on the basis of checks issued by Government disbursing officers, and cash payments made. Certain intragovernmental outlays do not require issuance of checks. An example would be charges made against appropriations representing a part of employees' salaries which are withheld for individual income taxes, and for savings bond allotments. Outlays are stated net of offsetting collections and refunds representing reimbursements as authorized by law, refunds of money previously expended, and receipts of revolving and management funds. Interest on the public debt (public issues) is recognized on the accrual basis. Outlays of off-budget Federal entities are excluded from budget outlay totals.

4. Processing

The data on payments and collections are reported by account symbol into the central accounting system. In turn, the data are extracted from this system for use in the preparation of the *MTS*.

There are two major checks which are conducted to assure the consistency of the data reported:

1. Verification of payment data. The monthly payment activity reported by Federal entities on their Statements of Transactions is compared to the payment activity of Federal entities as reported by disbursing officers.
2. Verification of collection data. Reported collections appearing on Statements of Transactions are compared to deposits as reported by Federal Reserve banks.

5. Other Sources of Information About Federal Government Financial Activities

- *A Glossary of Terms Used in the Federal Budget Process, March 1981* (Available from the U.S. General Accounting Office, Gaithersburg, Md. 20760). This glossary provides a basic reference document of standardized definitions of terms used by the Federal Government in the budgetmaking process.

- *Daily Treasury Statement* (Available from GPO, Washington, D.C. 20402, on a subscription basis only). *The Daily Treasury Statement* is published each working day of the Federal Government and provides data on the cash and debt operations of the Treasury.

- *Monthly Statement of the Public Debt of the United States* (Available from GPO, Washington, D.C. 20402 on a subscription basis only). This publication provides detailed information concerning the public debt.

- *Treasury Bulletin* (Available from GPO, Washington, D.C. 20402, by subscription or single copy). Quarterly. Contains a mix of narrative, tables, and charts on Treasury issues, Federal financial operations, international statistics, and special reports.

- *Annual Budget Publications* (Available from GPO, Washington, D.C. 20402). There are five annual publications which provide information concerning the budget:

  -The Budget of the United States Government, FY 19__
  -Appendix, The Budget of the United States Government, FY 19__
  -The United States Budget in Brief, FY 19__
  -Special Analyses
  -Historical Tables

- *United States Government Annual Report and Appendix* (Available from Financial Management Service, U.S. Department of the Treasury, Washington, D.C. 20226). This annual report presents budgetary results at the summary level. The appendix presents the individual receipt and appropriation accounts at the detail level.

Scheduled Release

The release date for the October 1988 Statement will be 2:00 p.m. EST November 22, 1988.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402 (202) 783-3238. The subscription price is $22.00 per year (domestic), $27.50 per year (foreign).
No single copies are sold.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 31, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,201 million of 13-week bills and for $ 7,220 million of 26-week bills, both to be issued on November 3, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing February 2, 1989			:	26-week bills maturing May 4, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.33%	7.57%	98.147	:	7.45%	7.85%	96.234
High	7.38%	7.62%	98.135	:	7.49%	7.89%	96.213
Average	7.37%	7.61%	98.137	:	7.48%	7.88%	96.218

Tenders at the high discount rate for the 13-week bills were allotted 9%.
Tenders at the high discount rate for the 26-week bills were allotted 6%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,555	$ 32,555	:	$ 27,835	$ 27,835
New York	24,255,800	5,784,050	:	22,965,220	5,855,455
Philadelphia	27,540	27,540	:	26,475	26,475
Cleveland	51,405	51,405	:	30,465	30,465
Richmond	46,680	46,680	:	36,865	36,865
Atlanta	29,740	29,740	:	29,415	29,405
Chicago	1,228,820	140,370	:	1,436,320	429,620
St. Louis	34,540	34,540	:	20,080	20,080
Minneapolis	12,555	12,555	:	8,910	8,910
Kansas City	46,250	46,250	:	47,275	42,480
Dallas	37,160	27,610	:	36,000	26,300
San Francisco	1,519,050	542,300	:	1,469,990	220,290
Treasury	425,460	425,460	:	466,305	466,305
TOTALS	$27,747,555	$7,201,055	:	$26,601,155	$7,220,485
Type					
Competitive	$24,416,795	$3,870,295	:	$22,089,395	$2,708,725
Noncompetitive	1,180,255	1,180,255	:	1,014,840	1,014,840
Subtotal, Public	$25,597,050	$5,050,550	:	$23,104,235	$3,723,565
Federal Reserve	1,925,925	1,925,925	:	1,850,000	1,850,000
Foreign Official Institutions	224,580	224,580	:	1,646,920	1,646,920
TOTALS	$27,747,555	$7,201,055	:	$26,601,155	$7,220,485

An additional $47,720 thousand of 13-week bills and an additional $328,580 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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.

November 1, 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 $14,400 million, to be issued November 10, 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 $ 13,283 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 Standard time, Monday, November 7, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated August 11, 1988 and to mature February 9, 1989 (CUSIP No. 912794 RF 3), currently outstanding in the amount of $ 7,308 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated May 12, 1988 and to mature May 11, 1989 (CUSIP No. 912794 RX 4), currently outstanding in the amount of $ 8,786 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 November 10, 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 $ 1,649 million as agents for foreign and international monetary authorities, and $ 4,420 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

November 2, 1988

CHARLES H. POWERS TO LEAVE TREASURY

Charles H. Powers, Deputy Assistant Secretary of the Treasury for Public Affairs, will leave the Treasury Department on November 13, 1988 to join the Tobacco Institute as Senior Vice President for Public Affairs.

In announcing Mr. Powers' upcoming departure, Secretary of the Treasury Nicholas F. Brady noted "Charley has been a tremendous asset to the Department. His institutional knowledge and experience have been invaluable and we wish him well in his future endeavors."

Mr. Powers has served as Deputy Assistant Secretary for Public Affairs since March 1986. He rejoined the Treasury Department in 1985 after an association with Ogilvy & Mather Washington. He had previously served with the Treasury Department including the Internal Revenue Service from 1975 to 1978 and from 1980-1985. Mr. Powers was Press Secretary to U.S. Senator Richard S. Schweiker of Pennsylvania from 1978-1980.

His active duty U.S. Air Force service included assignment in Southeast Asia in 1969. He also served as a lieutenant colonel in the U.S. Air Force Reserve. Mr. Powers has worked in television news at WTVJ-TV, Miami, Florida and WMAL-TV, Washington, D.C.

Mr. Powers received his AB degree from the University of Miami (1965) and MA degree from New York University (1967). He resides in Alexandria, Virginia with his wife and two sons.

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TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 2, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY NOVEMBER QUARTERLY FINANCING

The Treasury will raise about $13,250 million of new cash and refund $16,756 million of securities maturing November 15, 1988, by issuing $9,500 million of 3-year notes, $9,500 million of 10-year notes, and $11,000 million of 37-day cash management bills. The $16,756 million of maturing securities are those held by the public, including $1,507 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $30,000 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 $1,896 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.

If Treasury has sufficient bond authority, a $9,000 million bond will be sold later in November or early in December to mature November 15, 2018. In the absence of such authority, Treasury would sell an additional cash management bill for settlement early in December.

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

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HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
NOVEMBER 1988 QUARTERLY FINANCING

November 2, 1988

Amount Offered to the Public.....	$9,500 million	$9,500 million	$11,000 million
Description of Security:			
Term and type of security........	3-year notes	10-year notes	37-day cash management bills
Series and CUSIP designation.....	Series U-1991 (CUSIP No. 912827 WV 0)	Series D-1998 (CUSIP No. 912827 WW 8)	
CUSIP Nos. for STRIPS Components.	Not applicable	Listed in Attachment A of offering circular	(see separate announcement for details)
Issue date	November 15, 1988	November 15, 1988	
Maturity date....................	November 15, 1991	November 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...........	May 15 and November 15	May 15 and November 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, November 8, 1988, prior to 1:00 p.m., EST	Wednesday, November 9, 1988, prior to 1:00 p.m., EST	
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury.....	Tuesday, November 15, 1988	Tuesday, November 15, 1988	
b) readily-collectible check.....	Thursday, November 10, 1988	Thursday, November 10, 1988	

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 2, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $11,000 MILLION
OF 37-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $11,000 million of 37-day Treasury bills to be issued November 15, 1988, representing an additional amount of bills dated December 24, 1987, maturing December 22, 1988 (CUSIP No. 912794 QD 9).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Standard time, Thursday, November 10, 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,

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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 Tuesday, November 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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
November 7, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,202 million of 13-week bills and for $7,225 million of 26-week bills, both to be issued on November 10, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing February 9, 1989			:	26-week bills maturing May 11, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.50%a/	7.75%	98.104	:	7.68%	8.10%	96.117
High	7.55%	7.80%	98.092	:	7.72%	8.15%	96.097
Average	7.54%	7.79%	98.094	:	7.71%	8.13%	96.102

a/ Excepting 2 tenders totaling $2,870,000.

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 57%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 39,370	$ 39,370	:	$ 36,690	$ 36,690
New York	21,157,515	5,908,465	:	21,170,905	6,189,825
Philadelphia	28,815	28,815	:	18,730	18,730
Cleveland	35,910	35,910	:	34,330	34,330
Richmond	56,350	56,350	:	34,450	34,430
Atlanta	35,890	35,890	:	34,420	34,420
Chicago	1,290,885	347,885	:	1,099,865	142,615
St. Louis	51,840	34,690	:	23,660	23,660
Minneapolis	6,600	6,600	:	8,835	8,835
Kansas City	36,445	36,445	:	39,950	39,950
Dallas	35,615	25,615	:	30,920	23,770
San Francisco	1,318,900	222,470	:	1,183,835	197,585
Treasury	423,860	423,860	:	440,460	440,460
TOTALS	$24,517,995	$7,202,365	:	$24,157,050	$7,225,300
Type					
Competitive	$20,550,155	$3,234,525	:	$19,918,475	$2,986,725
Noncompetitive	1,152,220	1,152,220	:	984,880	984,880
Subtotal, Public	$21,702,375	$4,386,745	:	$20,903,355	$3,971,605
Federal Reserve	2,370,415	2,370,415	:	2,050,000	2,050,000
Foreign Official Institutions	445,205	445,205	:	1,203,695	1,203,695
TOTALS	$24,517,995	$7,202,365	:	$24,157,050	$7,225,300

An additional $96,995 thousand of 13-week bills and an additional $287,505 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-54

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.
November 8, 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 $14,400 million, to be issued November 17, 1988. This offering will provide about $ 650 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,758 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 Standard time, Monday, November 14, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated February 18, 1988, and to mature February 16, 1989 (CUSIP No. 912794 RG 1), currently outstanding in the amount of $17,279 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated November 17, 1988, and to mature May 18, 1989 (CUSIP No. 912794 RZ 9).

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

The bills will be issued for cash and in exchange for Treasury bills maturing November 17, 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 $ 1,899 million as agents for foreign and international monetary authorities, and $4,515 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).

NB-55

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
November 8, 1988

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $9,513 million of $28,326 million of tenders received from the public for the 3-year notes, Series U-1991, auctioned today. The notes will be issued November 15, 1988, and mature November 15, 1991.

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

	Yield	Price
Low	8.58%*	99.792
High	8.60%	99.740
Average	8.59%	99.766

*Excepting 1 tender of $5,000.

Tenders at the high yield were allotted 3%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 50,015	$ 50,015
New York	24,366,065	7,948,575
Philadelphia	279,965	279,965
Cleveland	69,150	69,150
Richmond	140,995	78,200
Atlanta	42,820	40,335
Chicago	1,745,285	506,035
St. Louis	79,600	59,600
Minneapolis	56,015	55,515
Kansas City	110,930	110,900
Dallas	19,980	14,980
San Francisco	1,358,350	292,855
Treasury	7,005	7,005
Totals	$28,326,175	$9,513,130

The $9,513 million of accepted tenders includes $1,049 million of noncompetitive tenders and $8,464 million of competitive tenders from the public.

In addition to the $9,513 million of tenders accepted in the auction process, $340 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,596 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
November 9, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 10-YEAR NOTES

The Department of the Treasury has accepted $9,593 million of $28,912 million of tenders received from the public for the 10-year notes, Series D-1998, auctioned today. The notes will be issued November 15, 1988, and mature November 15, 1998.

The interest rate on the notes will be 8-7/8%. 1/ The range of accepted competitive bids, and the corresponding prices at the 8-7/8% interest rate are as follows:

	Yield	Price
Low	8.93%	99.641
High	8.94%	99.576
Average	8.94%	99.576

Tenders at the high yield were allotted 43%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 16,897	$ 16,897
New York	26,408,819	8,798,254
Philadelphia	4,847	4,847
Cleveland	7,752	7,752
Richmond	41,216	16,386
Atlanta	10,379	10,379
Chicago	1,383,604	480,574
St. Louis	25,769	12,762
Minneapolis	5,463	5,463
Kansas City	15,242	15,237
Dallas	11,134	9,564
San Francisco	978,206	212,006
Treasury	2,670	2,670
Totals	$28,911,998	$9,592,791

The $9,593 million of accepted tenders includes $457 million of noncompetitive tenders and $9,136 million of competitive tenders from the public.

In addition to the $9,593 million of tenders accepted in the auction process, $300 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 $ 1,600,000. Larger amounts must be in multiples of that amount.

NB-57

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
November 10, 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 November 25, 1988, and to mature November 24, 1989 (CUSIP No. 912794 SN 5). This issue will result in a paydown for the Treasury of about $ 375 million, as the maturing 52-week bill is outstanding in the amount of $ 9,373 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 Standard time, Thursday, November 17, 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 November 25, 1988. In addition to the maturing 52-week bills, there are $13,481 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 $ 2,222 million as agents for foreign and international monetary authorities, and $7,686 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 $ 279 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.

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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
November 10, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S AUCTION OF 37-DAY CASH MANAGEMENT BILLS

Tenders for $11,025 million of 37-day Treasury bills to be issued on November 15, 1988, and to mature December 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	8.06% a/	8.24%	99.172
High	8.08%	8.26%	99.170
Average	8.07%	8.25%	99.171

a/ Excepting 2 tenders totaling $2,000,000.
Tenders at the high discount rate were allotted 58%.

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

Location	Received	Accepted
Boston	$ --	$ --
New York	44,288,000	10,211,280
Philadelphia	1,000	1,000
Cleveland	--	--
Richmond	95,000	--
Atlanta	--	--
Chicago	1,992,000	534,000
St. Louis	--	--
Minneapolis	3,000	1,580
Kansas City	1,000	--
Dallas	20,000	--
San Francisco	2,260,000	277,240
TOTALS	$48,660,000	$11,025,100

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
November 14, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $9,000 MILLION
OF 30-YEAR BONDS

The Department of the Treasury will auction $9,000 million of 30-year bonds to raise new cash. Additional amounts of the bonds may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

The 30-year bond being offered today will be eligible for the STRIPS program.

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

oOo

Attachment

NB-60

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 30-YEAR BONDS

November 14, 1988

Amount Offered:	
To the Public	$9,000 million
Description of Security:	
Term and type of security	30-year bonds
Loan Title and CUSIP designation ..	Bonds of 2018 (CUSIP No. 912810 EB 0)
CUSIP Nos. for STRIPS Components ..	Listed in Attachment A of offering circular
Issue date	November 22, 1988 (to be dated November 15, 1988)
Maturity date	November 15, 2018
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	May 15 and November 15
Minimum denomination available	$1,000
Amount required for STRIPS	To be determined after auction
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	To be determined after auction
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	Thursday, November 17, 1988, prior to 12:00 noon, EST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury	Tuesday, November 22, 1988
b) readily-collectible check	Friday, November 18, 1988

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

November 14, 1988

Emily Landis Walker
Appointed Deputy Assistant Secretary
(Policy Review and Analysis)

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Emily Landis Walker to serve as Deputy Assistant Secretary of the Treasury for Policy Review and Analysis in the Office of Policy Development, effective Monday, November 7, 1988. Mrs. Walker will be responsible for providing the Assistant Secretary for Policy Development with analysis and briefings on the full range of the Department's policies.

Since 1984, Mrs. Walker served as Assistant to the U.S. Executive Director of the International Monetary Fund (IMF) while he was serving concurrently as Senior Deputy Assistant Secretary of the Treasury for International Economic Policy. Prior to that she worked in the Exchange and Trade Relations Department of the IMF.

Mrs. Walker received her M.A. in 1981 from Johns Hopkins School of Advanced International Studies, attending the Bologna Center in Italy, and a B.A. in International Affairs and French from the University of North Carolina at Chapel Hill in 1978. She also attended the Vanderbilt-in-France program.

Mrs. Walker was born on July 2, 1956 in Clarendon Hills, Illinois to George H. and Jane M. Landis. She resides in Alexandria, Virginia with her husband, William J. Walker and daughter, Sarah Jane.

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
November 14, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,203 million of 13-week bills and for $ 7,204 million of 26-week bills, both to be issued on November 17, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing February 16, 1989			:	26-week bills maturing May 18, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.74% a/	8.00%	98.044	:	7.84% b/	8.28%	96.036
High	7.84%	8.11%	98.018	:	7.88%	8.32%	96.016
Average	7.82%	8.09%	98.023	:	7.87%	8.31%	96.021

a/ Excepting 1 tender of $23,965,000.
b/ Excepting 3 tenders totaling $5,205,000.
Tenders at the high discount rate for the 13-week bills were allotted 73%.
Tenders at the high discount rate for the 26-week bills were allotted 16%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 34,505	$ 34,505	:	$ 27,910	$ 27,910
New York	19,384,375	5,942,125	:	20,524,200	6,167,200
Philadelphia	17,320	17,320	:	16,340	16,340
Cleveland	54,690	54,690	:	34,655	34,655
Richmond	40,675	40,675	:	45,995	45,995
Atlanta	38,900	38,900	:	34,880	34,880
Chicago	1,065,750	375,250	:	838,235	115,435
St. Louis	24,890	24,890	:	16,590	16,590
Minneapolis	3,225	3,225	:	8,050	8,050
Kansas City	38,915	38,915	:	42,985	42,985
Dallas	32,365	31,015	:	26,560	26,560
San Francisco	1,374,080	192,330	:	1,250,280	250,280
Treasury	408,715	408,715	:	417,410	417,410
TOTALS	$22,518,405	$7,202,555	:	$23,284,090	$7,204,290
Type					
Competitive	$18,934,990	$3,619,140	:	$18,406,625	$2,326,825
Noncompetitive	1,105,195	1,105,195	:	947,575	947,575
Subtotal, Public	$20,040,185	$4,724,335	:	$19,354,200	$3,274,400
Federal Reserve	2,364,610	2,364,610	:	2,150,000	2,150,000
Foreign Official Institutions	113,610	113,610	:	1,779,890	1,779,890
TOTALS	$22,518,405	$7,202,555	:	$23,284,090	$7,204,290

An additional $42,190 thousand of 13-week bills and an additional $572,310 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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.

November 15, 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 $14,400 million, to be issued November 25, 1988. This offering will provide about $ 925 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,481 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 Standard time, Monday, November 21, 1988. The two series offered are as follows:

90-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated August 25, 1988, and to mature February 23, 1989 (CUSIP No. 912794 RJ 5), currently outstanding in the amount of $ 7,397 million, the additional and original bills to be freely interchangeable.

181-day bills for approximately $ 7,200 million, to be dated November 25, 1988, and to mature May 25, 1989 (CUSIP No. 912794 SA 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 November 25, 1988. In addition to the maturing 13-week and 26-week bills, there are $ 9,373 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 $ 1,917 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 2,197 million as agents for foreign and international monetary authorities, and $ 7,686 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.

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TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
November 16, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR 2-MONTH NOTES TOTALING $16,500 MILLION

The Treasury will raise about $5,350 million of new cash by issuing $9,000 million of 2-year notes and $7,500 million of 5-year 2-month notes. This offering will also refund $11,140 million of 2-year notes maturing November 30, 1988. The $11,140 million of maturing 2-year notes are those held by the public, including $1,267 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $16,500 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 $495 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

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HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR 2-MONTH NOTES

November 16, 1988

Amount Offered to the Public ...	$9,000 million	$7,500 million
Description of Security:		
Term and type of security	2-year notes	5-year 2-month notes
Series and CUSIP designation ...	Series AH-1990 (CUSIP No. 912827 WX 6)	Series H-1994 (CUSIP No. 912827 WY 4)
Issue date	November 30, 1988	December 1, 1988
Maturity date	November 30, 1990	February 15, 1994
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	May 31 and November 30	August 15 and February 15 (first payment on August 15, 1989)
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	Tuesday, November 22, 1988, prior to 1:00 p.m., EST	Wednesday, November 23, 1988, prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Wednesday, November 30, 1988	Thursday, December 1, 1988
b) readily-collectible check ...	Monday, November 28, 1988	Tuesday, November 29, 1988

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

CORRECTED COPY

FOR IMMEDIATE RELEASE
November 17, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 30-YEAR BONDS

The Department of the Treasury has accepted $ 9,026 million of $ 21,580 million of tenders received from the public for the 30-year Bonds auctioned today. The bonds will be issued November 22, 1988, and mature November 15, 2018.

The interest rate on the bonds will be 9 %. 1/ The range of accepted competitive bids, and the corresponding prices at the 9 % interest rate are as follows:

	Yield	Price 2/
Low	9.09% a/	99.072
High	9.11%	98.869
Average	9.10%	98.970

a/ Excepting 2 tenders totaling $49,000.

Tenders at the high yield were allotted 37%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 2,294	$ 2,294
New York	20,047,235	8,593,805
Philadelphia	585	585
Cleveland	2,543	2,543
Richmond	1,469	839
Atlanta	3,462	3,462
Chicago	926,025	323,925
St. Louis	4,471	4,471
Minneapolis	2,989	2,789
Kansas City	3,967	3,967
Dallas	3,552	2,922
San Francisco	581,127	84,117
Treasury	429	429
Totals	$21,580,148	$9,026,148

The $ 9,026 million of accepted tenders includes $ 413 million of noncompetitive tenders and $ 8,613 million of competitive tenders from the public.

1/ The minimum par amount required for STRIPS is $200,000 Larger amounts must be in multiples of that amount.

2/ In addition to the auction price, accrued interest of $1.74033 per $1,000 for November 15, 1988, to November 22, 1988, must be paid.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

November 17, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $ 9,052 million of 52-week bills to be issued November 25, 1988, and to mature November 24, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.91%	8.54%	92.002
High -	7.93%	8.56%	91.982
Average -	7.92%	8.55%	91.992

Tenders at the high discount rate were allotted 37%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 20,955	$ 20,955
New York	25,896,300	8,215,730
Philadelphia	11,255	11,255
Cleveland	18,670	18,670
Richmond	19,200	19,200
Atlanta	13,140	13,140
Chicago	1,233,135	68,205
St. Louis	30,100	15,950
Minneapolis	7,735	7,735
Kansas City	28,895	28,895
Dallas	17,750	9,600
San Francisco	1,580,935	502,435
Treasury	120,270	120,270
TOTALS	$28,998,340	$9,052,040
Type		
Competitive	$25,276,625	$5,330,325
Noncompetitive	442,415	442,415
Subtotal, Public	$25,719,040	$5,772,740
Federal Reserve	3,000,000	3,000,000
Foreign Official Institutions	279,300	279,300
TOTALS	$28,998,340	$9,052,040

An additional $51,700 thousand of the bills will be issued to foreign official institutions for new cash.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
November 21, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,218 million of 13-week bills and for $7,204 million of 26-week bills, both to be issued on November 25, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing February 23, 1989			:	26-week bills maturing May 25, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.95% a/	8.22%	98.013	:	7.98% b/	8.43%	95.988
High	7.97%	8.24%	98.008	:	7.99%	8.44%	95.983
Average	7.97%	8.24%	98.008	:	7.99%	8.44%	95.983

a/ Excepting 1 tender of $90,000.
b/ Excepting 3 tenders totaling $4,560,000.
Tenders at the high discount rate for the 13-week bills were allotted 98%.
Tenders at the high discount rate for the 26-week bills were allotted 57%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 44,110	$ 44,110	:	$ 29,810	$ 29,810
New York	26,364,160	5,867,720	:	22,074,855	6,253,705
Philadelphia	526,380	526,380	:	21,085	21,085
Cleveland	43,115	43,100	:	45,370	44,370
Richmond	81,215	51,215	:	69,645	44,645
Atlanta	43,620	43,620	:	31,425	31,425
Chicago	1,321,805	56,805	:	1,009,045	98,195
St. Louis	73,990	33,490	:	47,665	21,945
Minneapolis	9,325	9,325	:	11,015	11,015
Kansas City	42,025	42,025	:	48,565	48,565
Dallas	43,860	33,860	:	31,230	21,230
San Francisco	2,060,250	76,250	:	1,571,140	210,640
Treasury	389,700	389,700	:	367,065	367,065
TOTALS	$31,043,555	$7,217,600	:	$25,357,915	$7,203,695
Type					
Competitive	$27,104,110	$3,278,155	:	$20,478,760	$2,324,540
Noncompetitive	1,255,935	1,255,935	:	969,980	969,980
Subtotal, Public	$28,360,045	$4,534,090	:	$21,448,740	$3,294,520
Federal Reserve	2,435,585	2,435,585	:	2,250,000	2,250,000
Foreign Official Institutions	247,925	247,925	:	1,659,175	1,659,175
TOTALS	$31,043,555	$7,217,600	:	$25,357,915	$7,203,695

An additional $74,775 thousand of 13-week bills and an additional $410,325 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 IMMEDIATE RELEASE
November 23, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $7,504 million of $21,793 million of tenders received from the public for the 5-year 2-month notes, Series H-1994, auctioned today. The notes will be issued December 1, 1988, and mature February 15, 1994.

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% rate are as follows:

	Yield	Price
Low	8.95%	99.616
High	8.98%	99.493
Average	8.97%	99.534

Tenders at the high yield were allotted 3%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 33,859	$ 33,859
New York	19,307,995	6,933,425
Philadelphia	13,007	13,007
Cleveland	28,876	28,876
Richmond	40,118	40,118
Atlanta	14,264	14,264
Chicago	1,110,187	241,025
St. Louis	41,976	26,066
Minneapolis	22,632	22,122
Kansas City	48,811	43,961
Dallas	5,714	5,714
San Francisco	1,123,423	99,773
Treasury	2,081	2,081
Totals	$21,792,943	$7,504,291

The $7,504 million of accepted tenders includes $551 million of noncompetitive tenders and $6,953 million of competitive tenders from the public.

In addition to the $7,504 million of tenders accepted in the auction process, $260 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
November 22, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,027 million of $27,081 million of tenders received from the public for the 2-year notes, Series AH-1990, auctioned today. The notes will be issued November 30, 1988, and mature November 30, 1990.

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% rate are as follows:

	Yield	Price
Low	8.86%*	100.027
High	8.89%	99.973
Average	8.88%	99.991

*Excepting 2 tenders totaling $20,000.

Tenders at the high yield were allotted 85%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 61,350	$ 61,350
New York	22,810,330	6,930,400
Philadelphia	417,455	387,455
Cleveland	67,795	67,795
Richmond	117,090	111,190
Atlanta	46,315	45,165
Chicago	1,782,020	711,870
St. Louis	102,155	88,255
Minneapolis	46,700	45,450
Kansas City	144,960	144,960
Dallas	36,535	26,535
San Francisco	1,346,090	304,840
Treasury	102,020	102,020
Totals	$27,080,815	$9,027,285

The $9,027 million of accepted tenders includes $1,275 million of noncompetitive tenders and $7,752 million of competitive tenders from the public.

In addition to the $9,027 million of tenders accepted in the auction process, $970 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $495 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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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.
November 22, 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 $14,400 million, to be issued December 1, 1988. This offering will provide about $75 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,315 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 Standard time, Monday, November 28, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated September 1, 1988, and to mature March 2, 1989 (CUSIP No. 912794 RK 2), currently outstanding in the amount of $7,349 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated December 1, 1988, and to mature June 1, 1989 (CUSIP No. 912794 SB 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 December 1, 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 $2,341 million as agents for foreign and international monetary authorities, and $4,442 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).

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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
November 22, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY AMENDS 2-YEAR AND 5-YEAR 2-MONTH NOTES ANNOUNCEMENT

In an announcement made on November 16, the Treasury offered two new note issues, including the 5-year 2-month note of Series H-1994, to be dated and issued December 1, 1988. The new 5-year 2-month notes will have the same maturity and interest payment dates as the outstanding 9% 15-year 1-month bonds of 1994, issued January 11, 1979.

If, under Treasury's usual operating procedures, the auction of 5-year 2-month notes results in the same interest rate as the outstanding 9% bonds of February 15, 1994, the new notes will be issued with either an 8-7/8% or a 9-1/8% coupon. The 9-1/8% coupon will apply if the auction results in an average accepted yield in a range of 9.05% through 9.22%.

All other particulars of the November 16 announcement remain unchanged.

oOo

Attachment

NB-71

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
November 28, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,210 million of 13-week bills and for $7,227 million of 26-week bills, both to be issued on December 1, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing March 2, 1989			:	26-week bills maturing June 1, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.03%	8.31%	97.970	:	8.12%	8.58%	95.895
High	8.06%	8.34%	97.963	:	8.13%	8.60%	95.890
Average	8.05%	8.33%	97.965	:	8.13%	8.60%	95.890

Tenders at the high discount rate for the 13-week bills were allotted 59%.
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	$ 43,055	$ 41,870	:	$ 31,080	$ 31,080
New York	24,681,655	6,086,830	:	23,352,325	6,419,875
Philadelphia	22,300	22,300	:	17,635	15,635
Cleveland	47,500	46,775	:	32,925	32,790
Richmond	47,590	45,590	:	43,210	42,830
Atlanta	37,340	37,340	:	26,430	26,430
Chicago	1,165,380	107,330	:	926,205	49,305
St. Louis	55,170	41,070	:	30,060	23,680
Minneapolis	9,205	9,205	:	9,255	9,255
Kansas City	54,335	43,335	:	45,390	44,365
Dallas	38,130	31,080	:	25,080	19,130
San Francisco	1,856,815	322,265	:	1,606,225	136,725
Treasury	374,570	374,570	:	375,545	375,545
TOTALS	$28,433,045	$7,209,560	:	$26,521,365	$7,226,645
Type					
Competitive	$24,471,960	$3,248,475	:	$21,718,465	$2,423,745
Noncompetitive	1,124,635	1,124,635	:	879,050	879,050
Subtotal, Public	$25,596,595	$4,373,110	:	$22,597,515	$3,302,795
Federal Reserve	2,306,600	2,306,600	:	2,150,000	2,150,000
Foreign Official Institutions	529,850	529,850	:	1,773,850	1,773,850
TOTALS	$28,433,045	$7,209,560	:	$26,521,365	$7,226,645

An additional $59,750 thousand of 13-week bills and an additional $215,950 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 IMMEDIATE RELEASE
November 29, 1988

CONTACT: Robert Levine
(202)566-2041

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of October 1988.

As indicated in this table, U.S. reserve assets amounted to $50,204 million at the end of October, up from $47,788 million in September.

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					
Sep	47,788	11,062	9,074	18,015	9,637
Oct.	50,204	11,062	9,464	19,603	10,075

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.

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

November 29, 1988

GEORGE D. GOULD
UNDER SECRETARY OF THE TREASURY FOR FINANCE
LEAVES TREASURY

Secretary of the Treasury Nicholas F. Brady announced that George D. Gould, Under Secretary of the Treasury for Finance, has resigned his post at the Treasury Department, effective November 25, 1988.

In announcing his departure, Secretary Brady praised his "dedicated service to President Reagan and the Treasury Department" and noted that Mr. Gould "has truly distinguished himself as one of this Administration's key financial market experts."

Citing Gould's tireless efforts on behalf of the nation's banking and thrift industries and his leadership role in Administration efforts to analyze U.S. financial markets in the wake of the 1987 Stock Market crash, Secretary Brady noted that "George Gould has been one of the moving forces in the Treasury, and I can assure you that he will be missed. He has our sincere best wishes for the future."

Mr. Gould was confirmed as Under Secretary of the Treasury for Finance on November 14, 1985. He has been the Department's chief policymaker in the areas of Banking, Debt Management, and Financial Market Analysis. He served as Chairman of President Reagan's Working Group on Financial Markets, whose interim report was issued in May, 1988.

Before assuming his duties as Under Secretary, Mr. Gould was Chairman and Chief Executive Officer of Madison Resources, Inc. He was also a General Partner in the investment banking firm of Wertheim and Company. He had previously been associated with Donaldson, Lufkin, and Jenrette Securities Corporation, rising to the position of Chairman of that firm.

A 1951 graduate of Yale University, with a Master of Business Administration degree from Harvard University (1955), Mr. Gould has been an advocate for open financial markets and wider choices for American consumers throughout his career in public service.

He has also been active in civic affairs in New York State and in New York City, where he and his wife reside.

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.
November 29, 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 $ 14,400 million, to be issued December 8, 1988. This offering will provide about $ 850 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,545 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 Standard time, Monday, December 5, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated September 8, 1988, and to mature March 9, 1989 (CUSIP No. 912794 RL 0), currently outstanding in the amount of $ 7,604 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated June 9, 1988, and to mature June 8, 1989 (CUSIP No. 912794 SC 9), currently outstanding in the amount of $ 8,801 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 December 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 $ 1,236 million as agents for foreign and international monetary authorities, and $ 4,588 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.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

December 5, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,203 million of 13-week bills and for $7,207 million of 26-week bills, both to be issued on December 8, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing March 9, 1989			:	26-week bills maturing June 8, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.02% a/	8.30%	97.973	:	8.23% b/	8.71%	95.839
High	8.04%	8.32%	97.968	:	8.26%	8.74%	95.824
Average	8.04%	8.32%	97.968	:	8.25%	8.73%	95.829

a/ Excepting 1 tender of $200,000.
b/ Excepting 2 tenders totaling $100,000.
Tenders at the high discount rate for the 13-week bills were allotted 97%.
Tenders at the high discount rate for the 26-week bills were allotted 15%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 49,305	$ 49,305	:	$ 35,670	$ 35,670
New York	24,921,820	5,893,620	:	22,344,230	6,181,480
Philadelphia	44,165	44,165	:	23,415	23,415
Cleveland	52,960	52,930	:	50,220	50,220
Richmond	88,170	53,170	:	49,480	44,080
Atlanta	43,755	43,755	:	39,210	39,210
Chicago	1,076,530	221,565	:	1,217,935	140,185
St. Louis	70,035	30,035	:	57,180	29,480
Minneapolis	11,990	11,990	:	12,345	12,345
Kansas City	40,750	40,750	:	56,445	56,445
Dallas	42,115	36,965	:	31,770	21,670
San Francisco	2,302,300	330,800	:	1,808,245	176,745
Treasury	393,565	393,565	:	395,910	395,910
TOTALS	$29,137.460	$7,202,615	:	$26,122,055	$7,206,855
Type					
Competitive	$25,260,240	$3,325,395	:	$21,825,465	$2,910,265
Noncompetitive	1,269,800	1,269,800	:	1,082,880	1,082,880
Subtotal, Public	$26,530,040	$4,595,195	:	$22,908,345	$3,993,145
Federal Reserve	2,414,330	2,414,330	:	2,200,000	2,200,000
Foreign Official Institutions	193,090	193,090	:	1,013,710	1,013,710
TOTALS	$29,137,460	$7,202,615	:	$26,122,055	$7,206,855

An additional $134,110 thousand of 13-week bills and an additional $ 656,290 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-76

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.

December 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 $14,400 million, to be issued December 15, 1988. This offering will provide about $ 750 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,661 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 Standard time, Monday, December 12, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated March 17, 1988, and to mature March 16, 1989 (CUSIP No. 912794 RM 8), currently outstanding in the amount of $ 16,817 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated December 15, 1988, and to mature June 15, 1989 (CUSIP No. 912794 SE 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 December 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 $ 1,467 million as agents for foreign and international monetary authorities, and $ 4,572 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 12:00 NOON
December 9, 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 December 22, 1988, and to mature December 21, 1989 (CUSIP No. 912794 SP 0). 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 $9,275 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 Standard time, Thursday, December 15, 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 December 22, 1988. In addition to the maturing 52-week bills, there are $13,756 million of maturing 13-week and 26-week bills and $11,025 million of maturing 37-day cash management bills. The disposition of these two latter amounts will be announced next week. Federal Reserve Banks currently hold $3,114 million as agents for foreign and international monetary authorities, and $6,005 million for their own account. These amounts represent the combined holdings of such accounts for the four 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 $358 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.

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
Dec. 12, 1988

Contact: Bob Levine
(202) 566-2041

William E. Barreda Named DAS For Trade and Investment

The Department of the Treasury announced today the appointment of William E. Barreda as Deputy Assistant Secretary for Trade and Investment.

Mr. Barreda assumed this position on Nov. 6, 1988. From 1980 until that date he was Director of the Office of International Trade in the Department of the Treasury. He is also the chief U.S. negotiator for investment matters in the Uruguay Round of international trade negotiations.

In his 23 years of government service Barreda has also held positions in the Commerce and State Departments and the Office of the U.S. Special Trade Representative.

Mr. Barreda holds A.B. and M.A. degrees in economics from the University of California at Berkeley. He was born in Corpus Christi, Texas in 1941.

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TREASURY NEWS

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

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Remarks by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
before the
U.S.-U.S.S.R. Emerging Leaders Summit
December 8, 1988

The U.S. Economy and the Budget Outlook: What's Next?

Introduction

Good afternoon. It is a pleasure to address this important and diverse group of Soviet financial leaders. I visited Moscow and Leningrad for the first time early this year and was treated with great hospitality. I hope your stay in the United States during this conference will be equally enjoyable.

B.N. Chakravarty, in his book, India Speaks to America, described Americans as follows:

> "The Americans are a funny lot; they drink whiskey to keep them warm; then they put some ice in it to make it cool; they put some sugar in it to make it sweet, and then they put a slice of lemon in it to make it sour. Then they say "here's to you" and drink it themselves!"

Sir Winston Churchill vividly portrayed his image of the Soviet Union when he wrote:

> "It is a riddle wrapped in a mystery inside an enigma."

Like all generalizations these quotations contain a certain element of truth, but they also give a somewhat exaggerated and misleading view of America and the Soviet Union. I hope in our discussions today we can cast aside some of the common misconceptions we have about each other and develop a better mutual understanding of our two nations. Toward this end, today I would like to discuss with you briefly (1) the U.S. economy, (2) our near-term economic forecast and (3) the U.S. budget outlook.

But before I get into the details, I'd like to take just a few moments to place America's current economic situation in its policy context. The impressive economic achievements we have produced in recent years didn't simply happen by chance. Our achievements are the fruit of a policy program that broke with the past in important respects, charting a new course for the U.S. economy and, by implication, for the global economy as well.

The basic elements of this new course are not themselves new or technically complicated. Our goal has simply been to enhance the strength and vitality of the free market, and to provide a supportive climate for private initiative and individual enterprise, free from intrusive and excessive government intervention. Our motto has been that the best thing government can do is to get out of the way. And that's precisely what we've tried to do. Our program has:

-- Eliminated suffocating rules and regulations in a wide array of important areas;

-- Reduced the scope of Federal activity and by returning key responsibilities to the state and local levels where they rightly belong;

-- Brought about a fundamental reform of the tax system that has improved the efficiency and equity of a cumbersome tax code and has encouraged innovation and risk taking; and

-- Created a climate of price stability that allows long-term planning.

I recognize that some might be tempted to dismiss this kind of talk as the hyperbole of a Reagan Administration official. To them I would simply say two things:

-- First, these views are not confined to the United States, but rather have an increasingly global appeal. They are being embraced throughout the world, by rich nations and poor, by peoples of every race and by governments of every political stripe; and

-- Second, these views have gained strength because, whether one agrees with the theory or not, the results have been undeniable.

<u>The U.S. Economy</u>

To illustrate, let's take a closer look at our own experience here in the United States. The U.S. economic expansion completed its 72nd month in November. This has been the longest peacetime record by a wide margin. During the current vigorous upswing, real GNP has risen at a 4.2 percent annual rate, impressive by any standard.

And growth has remained solid this year, rising during the first three quarters at a 3.0 percent real annual rate, off from a 5.0 percent increase during 1987. Even so, real growth this year has been substantially stronger than had been estimated by most forecasters, including the Reagan Administration.

One of the reasons for this is that the stock market crash in October 1987 has had a relatively minor impact on the U.S. economy in 1988. There are many explanations for why the crash had such a limited impact, but clearly the flexibility and resiliency of the American economy, produced by the policies I mentioned earlier, had something to do with it.

As an illustration, during 1987 and into 1988 the volume of U.S. exports rose sharply, contributing to gains in industrial production and increases in business capital spending.

- -- Exports of goods and services increased 18-1/2 percent in real terms during 1987 and were up at a strong 15 percent annual rate during the first three quarters of 1988. By contrast, the growth in imports has been substantially slower -- 10-1/2 percent during 1987 and a 4-3/4 percent annual rate so far this year.

- -- There has been a major reduction in the U.S. trade deficit this year, although the deficit remains large. The merchandise trade deficit (on a balance of payments basis) totalled $160 billion in 1987, but fell to $125 billion at an annual rate this year for the first three quarters.

- -- The surge in U.S. exports also contributed to more optimistic spending actions on the part of U.S. businesses. So far this year, business capital spending has risen at a 9 percent annual rate.

Other measures of industrial sector development have also shown improvement over the past year or so. Industrial production rose by 5-1/2 percent over the twelve months of 1987, compared to just over 1 percent during all of 1986. During the first ten months of this year, industrial output has continued to increase at a solid 4-3/4 percent annual rate.

Throughout the expansion, U.S. labor markets have shown striking dynamism and strength. Indeed, it is not an exaggeration to describe the U.S. economy of the 1980s as a "job creating machine." Since November 1982, 18.8 million new jobs have been created. Employment in manufacturing rose by over 460,000 during 1987, after two consecutive yearly declines. More than 370,000 additional factory jobs have been added during the first eleven months of 1988. The percentage of working-age Americans employed has reached new highs and in November was at a level of 62.9 percent. The total unemployment rate was 5.3 percent in November and, along with an October reading of 5.2 percent, was the lowest since 1974.

Here again, these results aren't the product of luck. They reflect a vibrant, flexible labor market coupled with a sound economic environment.

Inflation Prospects

Slashing inflation from the double-digit rates of the 1970s has been one of the key policy achievements of the decade, and we are determined to keep rates low. There is currently little evidence of any market acceleration in inflation. Consumer prices advanced by 4.4 percent during 1987 and rose at a similar 4.6 percent annual rate during the first ten months of 1988. Despite press reports to the contrary, the drought has had relatively little impact on inflation -- this is because food accounts for only 16 percent of the consumer price index.

Several factors suggest that inflation should remain well behaved.

-- Rates of increase in compensation remain in a moderate range of 4 to 5 percent, despite the impressive employment gains.

-- Particular progress in containing costs has been made in the manufacturing sector, due in no small measure to solid productivity gains. Declines in factory unit labor costs in recent years have placed these costs at slightly below their level at the end of 1981.

Why the Expansion is Likely to Continue

So far the economy has not experienced the stresses and imbalances which in the past have been associated with a hard landing. Thus, there is little on the horizon at this point that suggests an end to the current expansion.

-- Utilization of industrial capacity is still well below rates reached in prior economic expansions, and robust investment today ensures greater capacity in the future.

-- Inventories have been held in good balance with no backlogs.

-- With the exception of a few sectors, such as multi-family housing and commercial structures, there have been no excesses in the capital investment sector.

-- Consumer balance sheets appear to be in reasonably good shape.

-- Inflation, as noted above, remains under control.

Near-Term Economic Forecast

These considerations give us great confidence about the future. The Reagan Administration's year-end economic forecast projects that real GNP will grow by 3.5 percent (on a fourth quarter over fourth quarter basis) next year, of which about 0.7 percent will reflect higher farm output following the drought. Growth this year is estimated at 2.6 percent -- or 3.3 percent (again on a fourth quarter over fourth quarter basis) if the effect of the drought were excluded.

The Reagan Administration figure for 1989 is higher than the 2.2 percent contained in the November Blue Chip consensus forecast of some 50 private economists. However, it should be noted that the consensus figure for 1988 was also quite low late last year and has been revised up consistently to 2.7 percent -- virtually the same as the current Administration estimate. This year, it is not clear that the private forecasters have adequately accounted for the phasing out of the drought impact in 1989.

All in all, we believe the U.S. economy is on a solid footing. We have seen a desirable shift in the composition of growth toward net exports and investment. The consumer has rebuilt savings somewhat and the savings rate has risen almost a full percentage point to 4.1 percent in the first three quarters of 1988 from 3.2 percent during all of last year. There are no readily apparent threats to continued growth such as accelerating inflation or inventory imbalances.

The Budget Outlook

President-elect Bush is committed to the same principle of deficit reduction through outlay restraint that characterized the Reagan Administration. This approach has already achieved some important results.

- As a share of GNP the Federal budget deficit has dropped from a high of 6.3 percent in 1983 to 3.2 percent in the 1988 fiscal year just ended.

- In FY-1987 the deficit narrowed by a record $71 billion to $150 billion (3.4 percent of GNP) from $221 billion in FY-1986 -- the largest single-year decline on record.

- The achievements of 1987 were to some extent due to special factors, including one-time asset sales and a jump in revenues as taxpayers chose to take capital gains under the old tax law. Nevertheless, the drop in the 1987 deficit reflected the first decline in real outlays in fourteen years.

- The FY-1988 budget deficit edged up slightly to $155 billion (3.2 percent of GNP), but this should not be viewed as implying that our deficit reduction efforts have stalled out. Adjusting for the special factors affecting FY-1987 that I mentioned above, the deficit declined by some $30 billion in both FY-1987 and FY-1988.

-- I would also note that many observers fail to consider that our state and local governments run substantial budget surpluses. When the combined deficit of all levels of government is considered, the U.S. deficit as a percent of GNP compares favorably with other major economies.

The Reagan Administration is in the process of preparing its budget for FY-1990 which will be submitted to Congress on January 9, 1989. The Gramm-Rudman-Hollings Act mandates reduction of the deficit to $100 billion in FY-1990 (with leeway of $10 billion) and a balanced budget in FY-1993.

The incoming Bush Administration will have the option of laying out a new budget of its own, providing an overall blueprint of any changes in direction it may wish to take, or moving to work directly with the Congress in hammering out an agreement which adheres to the Gramm-Rudman-Hollings path. It is not known which direction the new Administration will take. In any event, President-elect Bush has made it clear that deficit reduction will be a first priority and, as I noted earlier, has also stipulated that the effort must be directed toward the outlay side.

In conclusion, let me thank you for your attention and invite you to ask any questions you may have.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

December 12, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,202 million of 13-week bills and for $ 7,201 million of 26-week bills, both to be issued on December 15, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing March 16, 1989			:	26-week bills maturing June 15, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.95% a/	8.23%	97.990	:	8.19%	8.66%	95.860
High	7.99%	8.27%	97.980	:	8.22%	8.70%	95.844
Average	7.98%	8.26%	97.983	:	8.21%	8.69%	95.849

a/ Excepting 1 tender of $4,000,000.

Tenders at the high discount rate for the 13-week bills were allotted 79%.
Tenders at the high discount rate for the 26-week bills were allotted 59%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,455	$ 36,455	:	$ 38,665	$ 38,665
New York	25,109,815	5,825,650	:	22,878,355	5,988,555
Philadelphia	31,985	31,985	:	34,665	34,665
Cleveland	45,155	45,155	:	30,540	30,540
Richmond	61,820	49,720	:	40,415	40,415
Atlanta	45,205	45,205	:	37,730	37,730
Chicago	1,253,650	329,500	:	1,187,200	354,700
St. Louis	65,995	40,995	:	50,875	28,055
Minneapolis	7,585	7,585	:	10,660	10,660
Kansas City	41,175	41,175	:	43,140	43,140
Dallas	37,725	27,725	:	27,090	17,090
San Francisco	1,725,140	312,480	:	1,712,070	208,470
Treasury	408,190	408,190	:	368,605	368,605
TOTALS	$28,869,895	$7,201,820	:	$26,460,010	$7,201,290
Type					
Competitive	$25,061,170	$3,393,095	:	$22,158,770	$2,900,050
Noncompetitive	1,225,835	1,225,835	:	994,875	994,875
Subtotal, Public	$26,287,005	$4,618,930	:	$23,153,645	$3,894,925
Federal Reserve	2,372,155	2,372,155	:	2,200,000	2,200,000
Foreign Official Institutions	210,735	210,735	:	1,106,365	1,106,365
TOTALS	$28,869,895	$7,201,820	:	$26,460,010	$7,201,290

An additional$101,865 thousand of 13-week bills and an additional $ 567,035 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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
December 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 $14,400 million, to be issued December 22, 1988. This offering will result in a paydown for the Treasury of about $10,375 million, as the maturing bills are outstanding in the amount of $ 24,781 million (including the 37-day cash management bills issued November 15, 1988, in the amount of $11,025 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 Standard time, Monday, December 19, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated September 22, 1988, and to mature March 23, 1989 (CUSIP No. 912794 RP 1), currently outstanding in the amount of $ 7,026 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated December 22, 1988, and to mature June 22, 1989 (CUSIP No. 912794 SF 2).

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 December 22, 1988. In addition to the maturing 13-week, 26-week, and 37-day bills, there are $ 9,275 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 $ 2,443 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 2,801 million as agents for foreign and international monetary authorities, and $ 6,255 million for their own account. These amounts represent the combined holdings of such accounts for the four 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
FOR IMMEDIATE RELEASE

Remarks of the Honorable M. Peter McPherson
Deputy Secretary of the Treasury
Before the
Center for Strategic and International Studies
Washington, D.C.
December 14, 1988

I want to talk today about one of the greatest challenges facing the world: the development of Africa. This is an issue I was personally involved with for many years as Administrator of AID. It is an issue we at Treasury are concerned about because of our involvement in African countries' financial problems and our strong commitment to the efforts of the multilateral development banks and the International Monetary Fund in helping African countries to lay down the foundation for sustainable growth and development.

In the 1980's, Africa drew more focused and dedicated attention from the United States than ever before. U.S. bilateral aid to the continent has increased significantly, so that total aid flows for this decade will tower over those provided in the 1970's. The U.S. has played an important role in addressing the crisis needs of Africa, including leading the international relief effort for the 1984-1985 famine. U.S. diplomatic activities in the region reflected an increased willingness to devote resources and effort to Africa. The President's End Hunger Initiative for Africa in 1987 focused the U.S. effort on reform, resources, and growth. This overall commitment exists both in the U.S. and the international community as a whole.

Because of these efforts, we monitor closely the economic developments in Sub-Saharan Africa. The message I have for you today is that progress is being made in this suffering continent through the combined efforts of Africans and the international community.

Many countries in Africa are starting down the development path with only the most fragile of human resources and institutional structures to support them. Much remains to be accomplished in their struggles to overcome economic adversity and to develop steadily with the help of stable growth. Nevertheless, we can today see progress.

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- o Progress in the growing realization among African countries that they must be responsible for their own future;
- o Progress in the growing commitment and stepped-up actions of African governments to implement difficult but much needed economic reforms;
- o Progress in the actions of the international community to help Africa through an unprecedented cooperative effort -- by committing more net resources and by providing a greater proportion of those resources on a fast disbursing basis.
- o Progress in the actual performance -- for example, in terms of GDP growth and agricultural production -- of Sub-Saharan African economies undertaking serious reform efforts.

African Efforts

A traveller who visited Africa in the early 1980's would be struck upon returning today by the fundamental change in attitude toward the importance of rational economic policies. Ineffective economic policy choices played a large role, along with external fluctuations, in the decline of Sub-Saharan Africa's already fragile economy in recent decades. Today, in contrast, there is a growing consensus in many countries that the key to the resumption of growth is more efficient use of resources through sound macroeconomic and sectoral policies. Such policies are also being recognized as tools for helping to control the impact of external events, such as rising interest rates or fluctuating commodity prices.

Many African countries have therefore altered their approach to their economic problems, and many have committed themselves to policy reform efforts aimed at economic recovery and growth. For example, a number of countries have increased incentives for farmers, by allowing producers to be paid prices that more closely reflect market conditions. Many countries have taken steps to reduce their fiscal deficits, restructure their public sectors, achieve more realistic exchange rates, open up to increased trade, and strengthen their economic management generally.

Reforms are not implemented uniformly and policy changes do not reap the same results in all countries. However, about half the countries in Sub-Saharan Africa have already committed to reforms. Furthermore, those entering serious adjustment programs are generally achieving improved growth and making progress in dealing with economic and financial problems.

Data published in the 1988 World Development Report make the case clear. Average growth in countries studied in Sub-Saharan Africa from 1980-1985 was about 1%. Using economic performance indicators for 14 countries undertaking strong adjustment programs, World Bank data show significant results. Those countries with strong adjustment programs improved their growth rates in 1986-87 to an average of 4%. This compares to virtually no increase in the average growth rate among seven countries identified in the study as having a weak adjustment program or no adjustment at all.

I note that this comparison excludes countries recently affected by strong positive or negative external shocks -- such as Nigeria, which suffered from the sharp drop in oil prices in 1985. However, in addition to improving growth, economies with strong reform programs have also slowed inflation and reduced their fiscal deficits. According to World Bank data, inflation and fiscal deficits have continued to rise in weak or non-reforming countries. I am making available today details about some of these indicators of progress.

In conclusion, the evidence, while preliminary, provides strong indications that adjusting economies today are realizing progress toward recovery that non-reformers have not experienced.

To illustrate the progress that is being made in countries adopting adjustment programs, I would like to be more explicit about the experiences of some specific countries.
In an adjustment program begun in 1979 and renewed in 1984,

Senegal has pursued policies designed to stabilize its financial situation and create a basis for growth, emphasizing increased private sector initiative in agriculture and industry and improved public sector resource allocation. Although delayed by drought and implementation problems, significant progress has been achieved: fiscal and current account deficits narrowed sharply and inflationary pressures have been reduced. The Senegalese economy has grown at an average rate of 4.3 percent in the past three years, and per capita real income has risen modestly as well.

In Tanzania, a 1986 policy reform program changed many inefficient policies in the agricultural, trade, and other sectors. This was a country so often cited as an economic policy failure. As a result of its new effort, Tanzania's economic growth rate rose to 4% in 1987, after an average annual growth rate of only 0.6 percent from 1980-85. Improved growth, reduced inflation, and increased exports signal progress and hope in Tanzania, which is projected to grow about 4 percent again in 1988.

Other countries making major reform efforts include Gambia, Guinea, Ghana, Madagascar, and Mauritius.

Policy reform has also made a clear difference in specific sectors of individual economies. The agricultural sector is one example. In the past few years, incentives to farmers in African countries have improved on average, particularly for export crop producers who were burdened in the late 1970's and early 1980's by unrealistic exchange rates. Conscious price adjustments made through policy reforms have brought real official producer prices in several countries to levels better reflecting market conditions. Again, preliminary World Bank data show that in eleven countries with liberalized pricing policies, food production has grown twice as fast -- by 19% from 1980-87 -- than among twelve countries where food pricing and marketing is controlled -- where food production grew by 10% -- although weather conditions also influence agricultural production.

Because of deeply-rooted structural problems, the response of Sub-Saharan African economies to adjustment and policy reforms is gradual. Lack of education and training, weak institutions, inadequate infrastructure, and lack of appropriate technology are real burdens on growth and can delay the response of African economies to the very best policy changes. Donors must continue to play an important role in helping in some of these areas. Nevertheless, adopting appropriate policies through structural adjustment promotes recovery and growth and can provide the key to resumed healthy development.

Financing Africa's Efforts

Adjustment programs depend in part on adequate external financing for their success. Securing resources to support their efforts has been a challenge for African countries undergoing structural adjustment and policy reform. As I mentioned earlier, the U.S. and other donor countries have taken increasing steps to meet this need. I want to review for you today a variety of initiatives that have received attention on their own, but that as a whole add up to a significant and coherent program of support for economic recovery and growth in Africa.

After closely monitoring Africa's progress early in this decade, the international community concluded that additional resources were needed to sustain African countries' efforts. Individual countries and multilateral organizations began to take action to address this problem. This renewed international commitment was crystallized at a special United Nations conference in 1986 held to address the situation.

In the U.N. agreement titled "The United Nations Program of Action for Africa's Economic Recovery and Development," all parties concurred that the donor community would strive to provide adequate support for adjustment and that African countries would seek to augment or sustain the adjustment effort. In confirming strong international support for Sub-Saharan Africa in its enhanced efforts to achieve recovery and growth through structural adjustment and policy reform, the U.N. session explicitly provided for:

- an international donor community commitment to deliver more resources and a greater proportion of fast-disbursing funds.
- a renewed international community effort to improve coordination of their aid to Africa.

At the close of the special U.N. session, as the U.S. spokesman I outlined how the United States had worked and intended to work in the future with the rest of the donor community to implement the program of action. The U.S. pledged to focus assistance on the highest priorities identified at the session and to find the most effective ways to implement those priorities with the resources at hand.

Since that time, we have committed about $850 million annually in bilateral development assistance and emergency relief in Sub-Saharan Africa. We have also taken significant steps to strengthen the policy framework that guides our aid program. Through one of the initiatives at A.I.D., the Development Fund for Africa, we now have the funding and program flexibility to target our assistance based on actual country performance and to follow up on successful policy dialogues by supporting positive policy reform efforts in specific countries.

A number of international initiatives have also proceeded. The International Development Agency and the African Development Fund have received replenishments; IDA's gross disbursements to Sub-Saharan Africa rose by 52% in 1986 to $1.4 billion and increased again in 1987 to $1.6 billion. The African Development Bank and World Bank have been granted capital increases. The donor countries and agencies have pledged $6.4 billion over three years in support for adjustment programs in heavily-indebted, low-income countries in Africa. New concessional assistance has been facilitated through the IMF Structural Adjustment Facility and Enhanced Structural Adjustment Facility.

We are starting to see the results of these initiatives. Multilateral and bilateral resources are being targeted to countries that are making serious efforts to reform their economies and restore growth. Official Development Assistance to Sub-Saharan Africa grew from $8.1 billion in 1985 to $10.1 billion in 1986 and $11.5 billion in 1987, with an increasing share of that aid going to reforming countries in the latter two years. The quality of resources available has improved since donors are working more closely with each other, recipients, and development institutions to ensure that Africa's problems are being addressed fully and consistently.

Another major multilateral step is the increase in the proportion of funds available on a fast-disbursing basis in support of adjustment. Fast-disbursing funds now compose a greater share of external financing from both bilateral and multilateral sources. A variety of funding mechanisms -- including the International Development Association, the IMF Enhanced Structural Adjustment Facility, cofinancing arrangements with donors in the World Bank's Special Program of Assistance, and World Bank adjustment lending -- have played a role in this expanded role of fast-disbursing financing in support of adjustment programs. For example, the amount of World Bank structural adjustment lending worldwide has increased from 6.2% of Bank commitments in 1980-82 to an expected 25% in 1988 and thereafter; policy-based loans represent an even greater share of World Bank lending to Sub-Saharan Africa. The increased proportion of fast-disbursing funds is designed to support developing countries' adjustment efforts and is targeted to help sustain their policy reforms.

Creditor governments have also been able to support adjustment through rescheduling of official debts. Since 1985, the U.S. and other official creditors have rescheduled in the Pairs Club over $11.5 billion in obligations owed by 18 Sub-Saharan countries. Furthermore, the Paris Club has since 1987 provided special treatment for heavily-indebted, low income countries undertaking adjustment. To date, ten countries have benefitted from the longer grace and repayment periods involved in this special treatment.

Most recently, the United States and other major donors have begun to implement a "differentiated" approach to official debt reschedulings for the poorest countries in the Paris Club. Under this new initiative, creditor countries can choose from a range of options -- forgiveness of a portion of debt service in exchange for shorter repayment periods, longer repayment periods, or more concessional interest rates -- in rescheduling exercises. I am pleased to report that two Sub-Saharan countries, Mali and Madagascar, have already benefitted from this initiative.

In these ways, the donor community has worked hard to meet the needs of African countries undertaking structural adjustment and policy reform. We understand the difficulties associated with economic adjustment. The additional resources serve both to help make the adjustment possible and to help reduce the pain associated with it. According to the World Bank, these recent initiatives should be sufficient upon disbursement to provide adequate external resources to support growth in Sub-Saharan African countries undergoing economic reforms.

Ongoing Partnership

The recent initiatives of the international donor community have been met by renewed vigilance on the part of some African countries to pursue structural adjustment and economic policy reforms. It is through such complementary efforts that progress has been achieved.

The significance of successful implementation and financing of adjustment is great. In our view, there is no more urgent priority than to build on the economic growth of some countries, and, in the long-term, to achieve self-supporting growth. We believe that the achievement of an average 4% growth in adjusting economies is a significant step toward such sustained growth.

A note of caution. These exciting figures are, in fact, preliminary. Africa's progress must still be carefully monitored.

Further success in attaining broad-based and lasting growth will hinge on the freedom of citizens to participate actively in their economies and market incentives for them to do so. The most important resource of any country or area is the willingness of its people to work for something better. The question is whether the economic structure of each country encourages that instinct or burdens it.

Long-term, sustained growth will also rely on forward-looking policies in other areas. For example:

- Economic growth must be targeted toward the increased employment and income levels that Africa desperately needs. Improving these conditions can help lead to improved nutrition, reduced infant mortality, and additional resources needed for education and training.
- Increased attention to environmental conservation in development decision-making will help preserve each country's future potential for economic growth and independence.
- Broad availability of family planning services, which the U.S. continues to support, plays an important role in the health of women and children and, I might point out, tends to reduce the rate of abortion.

The importance of such socio-economic conditions to maintaining progress in the achievement of sustainable growth must not be overlooked.

Implementing and financing structural adjustment programs so that progress toward durable and equitable growth can be achieved is clearly important to both African countries and the international community. Their cooperative efforts have not been easy, and progress signals a strong commitment. Many African countries took the critical steps of recognizing the importance of appropriate economic policies to their pursuit of growth and recovery and then beginning to implement structural adjustment and policy reform. The international donor community has responded with a commitment to support African efforts by making more adequate financial resources available and more responsive to adjustment needs.

It appears that the combined efforts of African countries and the international community have begun a process by which Africa can work toward the goals of feeding its people and helping them achieve a decent quality of life. A many faceted campaign -- based on growth-oriented economic adjustment by African governments, linked to policies and programs that tap Africa's human and natural resources, and supported by external resources targeted at productive endeavors by African economies -- has been generated in pursuit of long-term progress. And the prospect of ongoing partnership -- between Africans devoted to adjusting their economic policies and an international donor community dedicated to making the resources available to promote and sustain individual countries' adjustment efforts -- portends a hopeful future.

INDICATORS	PERIOD	STRONG REFORMERS	WEAK/NON-REFORMERS
GDP Growth	1980-84	0.8	0.7
	1986-87	4.4	0.3
Growth of Export Volume	1980-84	-0.7	-5.7
	1986-87	4.9	-3.3
Fiscal Deficit (% of GDP)	1980-83	12.4	11.2
	1986-87	11.0	12.7
Inflation	1980-85	22%	23%
	1986-87	20%	30%

** These figures exclude countries, reforming or non-reforming, that have recently been affected by strong positive or negative external shocks. The figures represent unweighted averages of individual countries' experiences.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
December 15, 1988

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,040 million of 52-week bills to be issued December 22, 1988, and to mature December 21, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	8.47%a/	9.18%	91.436
High -	8.50%	9.22%	91.406
Average -	8.49%	9.20%	91.416

a/ Excepting 1 tender of $10,000.
Tenders at the high discount rate were allotted 77%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 19,340	$ 19,340
New York	23,751,995	7,810,715
Philadelphia	742,840	742,840
Cleveland	27,280	27,280
Richmond	21,950	21,950
Atlanta	18,655	18,655
Chicago	1,267,125	69,075
St. Louis	18,835	15,605
Minneapolis	9,600	9,600
Kansas City	37,715	37,715
Dallas	19,335	13,185
San Francisco	1,207,460	147,550
Treasury	106,330	106,330
TOTALS	$27,248,460	$9,039,840
Type		
Competitive	$23,955,490	$5,746,870
Noncompetitive	534,870	534,870
Subtotal, Public	$24,490,360	$6,281,740
Federal Reserve	2,400,000	2,400,000
Foreign Official Institutions	358,100	358,100
TOTALS	$27,248,460	$9,039,840

An additional $36,900 thousand of the bills will be issued to foreign official institutions for new cash.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
December 16, 1988

CONTACT: Larry Batdorf
(202) 566-2041

United States and Bermuda Exchange Instruments of Ratification of Treaty Relating to the Taxation of Insurance and Mutual Assistance In Tax Enforcement And Sign Agreement to Exchange Tax Information

The Treasury Department announced today that the United States and the United Kingdom of Great Britain and Northern Ireland (on behalf of Bermuda) exchanged instruments of ratification of a treaty relating to the taxation of insurance and mutual assistance in tax enforcement, thus bringing the Treaty into force. The Treaty was signed in Washington on July 11, 1986. An agreement to exchange tax information that satisfies the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983 was also signed.

At a ceremony held on December 2, 1988, at the Department of State, Bermuda Premier John Swan and Secretary of State George Shultz exchanged instruments of ratification of the Treaty and signed the Agreement. Both the Treaty and the Agreement entered into force immediately.

The principal features of the Treaty include the exemption of Bermudian insurance enterprises from U.S. income and excise taxes on their U.S. premium income in certain instances if they do not have a permanent establishment in the United States. The income and excise tax exemptions are subject to limitations to prevent "treaty shopping," i.e., the use of the Treaty by residents of third countries to obtain treaty benefits from one treaty country by using an entity organized in the other treaty country. In addition, the Treaty would provide for mutual assistance in tax matters, including the sharing of tax information between the United States and Bermuda.

As a result of signing the Agreement, Bermuda will be considered part of the "North American Area" for purposes of determining the deductibility by U.S. taxpayers of expenses incurred in attending conventions, business meetings, and seminars in Bermuda. Therefore, convention expenses incurred by U.S. taxpayers for meetings in Bermuda beginning on or after December 2, 1988 that are otherwise deductible as ordinary and necessary business expenses will be allowed without regard to the additional limitations otherwise applicable to foreign convention deductions.

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In addition, because of the signing of the Agreement, Bermuda qualifies as a foreign country in which a foreign sales corporation may incorporate and maintain an office as provided in the foreign sales corporation provisions of the Tax Reform Act of 1984.

A limited number of copies of the Treaty and the Agreement are available from the Treasury Public Affairs Office, Treasury Department, Room 2315, Washington, D.C. 20220.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
December 19, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,212 million of 13-week bills and for $7,209 million of 26-week bills, both to be issued on December 22, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing March 23, 1989			26-week bills maturing June 22, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	8.10%a/	8.38%	97.953	8.27%	8.75%	95.819
High	8.15%	8.44%	97.940	8.30%	8.78%	95.804
Average	8.14%	8.43%	97.942	8.29%	8.77%	95.809

a/ Excepting 2 tenders totaling $2,850,000.
Tenders at the high discount rate for the 13-week bills were allotted 63%.
Tenders at the high discount rate for the 26-week bills were allotted 53%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 33,935	$ 33,935	$ 34,655	$ 34,655
New York	22,034,240	5,788,240	22,939,580	6,214,580
Philadelphia	16,295	16,295	20,440	19,500
Cleveland	33,325	33,325	35,195	35,195
Richmond	42,025	42,025	32,630	32,630
Atlanta	27,720	27,720	25,950	25,950
Chicago	1,299,620	397,870	1,277,695	254,540
St. Louis	49,075	49,075	33,325	28,385
Minneapolis	6,185	6,185	8,880	8,880
Kansas City	44,645	44,645	48,650	48,650
Dallas	44,415	44,415	36,990	16,990
San Francisco	1,967,460	533,840	1,533,725	216,075
Treasury	194,445	194,445	273,140	273,140
TOTALS	$25,793,385	$7,212,015	$26,300,855	$7,209,170
Type				
Competitive	$22,769,565	$4,188,195	$21,899,135	$2,807,450
Noncompetitive	890,440	890,440	847,520	847,520
Subtotal, Public	$23,660,005	$5,078,635	$22,746,655	$3,654,970
Federal Reserve	1,969,780	1,969,780	1,900,000	1,900,000
Foreign Official Institutions	163,600	163,600	1,654,200	1,654,200
TOTALS	$25,793,385	$7,212,015	$26,300,855	$7,209,170

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M. December 20, 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 $14,400 million, to be issued December 29, 1988. This offering will provide about $ 600 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 13,797 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 Standard time, Tuesday, December 27, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated September 29, 1988, and to mature March 30, 1989 (CUSIP No. 912794 RQ 9), currently outstanding in the amount of $ 7,026 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated December 29, 1988, and to mature June 29, 1989 (CUSIP No. 912794 SG 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 December 29, 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 $ 2,095 million as agents for foreign and international monetary authorities, and $ 3,681 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).

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

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 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
December 20, 1988

CONTACT: LARRY BATDORF
(202) 566-2041

DRAFT INCOME TAX TREATY INITIALLED WITH THE FEDERAL REPUBLIC OF GERMANY

The United States Department of Treasury and the Ministry of Finance of the Federal Republic of Germany today announced that a new draft Income Tax Convention between the two countries has been initialled. The new draft was initialled in Washington on December 16, 1988 by Ministerialdirektor Dr. Adalbert Uelner, on behalf of the Federal Republic of Germany, and by O. Donaldson Chapoton, Assistant Secretary of the Treasury for Tax Policy, on behalf of the United States.

When signed, the new treaty will be subject to ratification by both countries. Upon entry into force, the new treaty will replace the current treaty, which was signed in 1954 and last amended in 1965.

The new treaty will be generally effective on January 1, 1990, although the effective dates for certain provisions will be delayed until 1991 or 1992. A significant change in the current rules for the taxation of income flows between the two countries will be a reciprocal reduction in the withholding tax levied at source on dividends paid by a subsidiary in one country to its parent corporation in the other. The 15 percent rate applicable to such dividends in the present treaty will be reduced to 10 percent for dividends paid in 1990 and 1991, and to 5 percent for dividends paid from 1992 and on. Other significant changes which will be introduced by the new treaty include provision for the imposition of a branch tax and a comprehensive anti-treaty-shopping provision.

It is anticipated that the new treaty will be signed during the first half of 1989. At the initialling, the officials expressed their expectation that the new treaty will be ratified before the end of 1989. The official text of the treaty will be made public at the time of signature.

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

FOR IMMEDIATE RELEASE
DECEMBER 21, 1988

CONTACT: Bob Levine
202/566-2041

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of November 1988.

As indicated in this table, U.S. reserve assets amounted to $48,944 million at the end of November, down from $50,204 million in October.

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					
Oct.	50,204	11,062	9,464	19,603	10,075
Nov.	48,944	11,059	9,785	17,997	10,103

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.

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TREASURY NEWS

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

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

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 4-YEAR NOTES
TOTALING $16,250 MILLION

The Treasury will auction $ 9,000 million of 2-year notes and $ 7,250 million of 4-year notes to refund $ 16,753 million of securities maturing December 31, 1988, and to paydown about $ 500 million. The $ 16,753 million of maturing securities are those held by the public, including $ 1,471 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $ 16,250 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 $1,703 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.

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Attachment

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HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 4-YEAR NOTES TO BE ISSUED JANUARY 3, 1989

December 21, 1988

Amount Offered to the Public ...	$9,000 million	$7,250 million
<u>Description of Security</u>:		
Term and type of security	2-year notes	4-year notes
Series and CUSIP designation ...	Series AJ-1990 (CUSIP No. 912827 WZ 1)	Series Q-1992 (CUSIP No. 912827 XA 5)
Maturity date	December 31, 1990	December 31, 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	June 30 and December 31	June 30 and December 31
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	Wednesday, December 28, 1988, prior to 1:00 p.m., EST	Thursday, December 29, 1988, prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Tuesday, January 3, 1989	Tuesday, January 3, 1989
b) readily-collectible check ...	Thursday, December 29, 1988	Thursday, December 29, 1988

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
December 27, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,207 million of 13-week bills and for $ 7,213 million of 26-week bills, both to be issued on December 29, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing March 30, 1989			:	26-week bills maturing June 29, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.14%	8.43%	97.942	:	8.28%	8.76%	95.814
High	8.25%	8.54%	97.915	:	8.35%	8.84%	95.779
Average	8.22%	8.51%	97.922	:	8.33%	8.82%	95.789

Tenders at the high discount rate for the 13-week bills were allotted 4%.
Tenders at the high discount rate for the 26-week bills were allotted 65%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 42,035	$ 42,035	:	$ 38,860	$ 38,860
New York	20,168,160	6,075,160	:	18,912,755	6,195,255
Philadelphia	28,570	28,570	:	29,330	29,330
Cleveland	73,175	73,175	:	30,155	30,155
Richmond	37,250	37,250	:	33,620	33,620
Atlanta	34,900	34,900	:	29,680	29,680
Chicago	2,181,485	287,485	:	1,366,580	296,580
St. Louis	55,285	50,485	:	38,240	35,540
Minneapolis	9,290	9,290	:	10,665	10,665
Kansas City	46,260	46,260	:	54,165	54,165
Dallas	33,550	33,550	:	21,690	21,690
San Francisco	927,410	136,310	:	902,465	99,115
Treasury	352,175	352,175	:	338,455	338,455
TOTALS	$23,989,545	$7,206,645	:	$21,806,660	$7,213,110
Type					
Competitive	$20,723,610	$3,940,710	:	$17,436,200	$2,842,650
Noncompetitive	1,087,985	1,087,985	:	887,800	887,800
Subtotal, Public	$21,811,595	$5,028,695	:	$18,324,000	$3,730,450
Federal Reserve	1,881,010	1,881,010	:	1,800,000	1,800,000
Foreign Official Institutions	296,940	296,940	:	1,682,660	1,682,660
TOTALS	$23,989,545	$7,206,645	:	$21,806,660	$7,213,110

An additional $27,260 thousand of 13-week bills and an additional $108,340 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 AT 4:00 P.M.
December 27, 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 $ 14,400 million, to be issued January 5, 1989. This offering will result in a paydown for the Treasury of about $ 150 million, as the maturing bills are outstanding in the amount of $14,538 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 Standard time, Tuesday, January 3, 1989. The two series offered are as follows:

91 -day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated October 6, 1988, and to mature April 6, 1989 (CUSIP No. 912794 RR 7), currently outstanding in the amount of $7,792 million, the additional and original bills to be freely interchangeable.

182 -day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated July 7, 1988, and to mature July 6, 1989 (CUSIP No. 912794 SH 8), currently outstanding in the amount of $9,234 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 January 5, 1989. 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 $1,946 million as agents for foreign and international monetary authorities, and $4,621 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
December 28, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $ 9,030 million of $24,243 million of tenders received from the public for the 2-year notes, Series AJ-1990, auctioned today. The notes will be issued January 3, 1989, and mature December 31, 1990.

The interest rate on the notes will be 9-1/8%. The range of accepted competitive bids, and the corresponding prices at the 9-1/8% rate are as follows:

	Yield	Price
Low	9.21% *	99.848
High	9.24%	99.795
Average	9.23%	99.813

*Excepting 3 tenders totaling $60,000.
Tenders at the high yield were allotted 33%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 68,765	$ 68,765
New York	19,890,990	6,538,720
Philadelphia	804,535	803,195
Cleveland	112,105	99,005
Richmond	235,175	142,825
Atlanta	73,590	70,920
Chicago	1,281,050	437,890
St. Louis	96,700	95,030
Minneapolis	54,990	54,990
Kansas City	167,635	164,635
Dallas	35,880	35,880
San Francisco	1,336,620	432,610
Treasury	85,255	85,255
Totals	$24,243,290	$9,029,720

The $9,030 million of accepted tenders includes $ 1,724 million of noncompetitive tenders and $ 7,306 million of competitive tenders from the public.

In addition to the $ 9,030 million of tenders accepted in the auction process, $ 765 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $ 1,100 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.

NB-93

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

FOR IMMEDIATE RELEASE December 29, 1988

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of March 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $149.7 billion on March 31, 1988, posting a decrease of $0.5 billion from the level on February 29, 1988. This net change was the result of decreases in holdings of agency debt of $433.8 million, of agency-guaranteed debt of $22.5 million, and in agency assets of $0.3 million. FFB made 93 disbursements during March.

Attached to this release are tables presenting FFB March loan activity and FFB holdings as of March 31, 1988.

NB-94

FEDERAL FINANCING BANK

MARCH 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 #461	3/1	$ 70,000,000.00	6/1/88	5.935%	
Note #462	3/31	10,000,000.00	4/27/88	6.045%	
TENNESSEE VALLEY AUTHORITY					
Advance #866	3/4	162,000,000.00	3/10/88	5.885%	
Advance #867	3/7	205,000,000.00	3/14/88	5.995%	
Advance #868	3/10	184,000,000.00	3/17/88	6.015%	
Advance #869	3/14	195,000,000.00	3/17/88	6.015%	
Advance #870	3/17	27,000,000.00	3/23/88	5.895%	
Advance #871	3/17	114,000,000.00	3/23/88	5.895%	
Advance #872	3/18	4,000,000.00	3/28/88	5.885%	
Advance #873	3/23	91,000,000.00	3/28/88	6.075%	
Advance #874	3/28	45,000,000.00	4/1/88	5.985%	
Advance #875	3/28	70,000,000.00	4/4/88	5.985%	
Advance #876	3/31	150,000,000.00	4/8/88	6.045%	
Power Bond 1988-A	3/17	200,000,000.00	3/17/04	8.535%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Morocco 13	3/2	539,095.70	5/31/96	7.704%	
Peru 10	3/2	31,978.99	4/10/96	8.095%	
Turkey 18	3/3	1,829,948.72	3/12/14	8.475%	
Philippines 11	3/7	189,500.53	9/12/96	7.475%	
Kenya 10	3/11	995,363.91	5/5/94	8.118%	
Niger 3	3/16	4,186.90	5/5/95	8.185%	
Philippines 11	3/21	45,998.36	9/12/96	7.455%	
Greece 17	3/21	1,731,130.24	8/25/14	8.605%	
Greece 15	3/21	172,879.00	6/15/12	8.775%	
Greece 16	3/22	2,741,421.85	9/1/13	8.773%	
Greece 17	3/23	76,350,000.00	8/25/14	8.683%	
Morocco 13	3/30	354,175.34	5/31/96	8.115%	

+rollover

FEDERAL FINANCING BANK

MARCH 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					
Syracuse, NY	3/1	$ 150,000.00	7/1/88	6.015%	
*Sacramento, CA	3/1	840,000.00	3/1/93	7.561%	7.704% ann.
*Indianapolis, IN	3/1	12,424,571.00	3/1/93	7.569%	7.712% ann.
Indianapolis, IN	3/1	1,626,041.00	3/1/93	6.029%	6.120% ann.
Ponce, PR	3/11	207,332.43	10/1/88	6.315%	6.336% ann.
Alhambra, CA	3/11	1,370,285.00	8/15/88	6.172%	
Lincoln, NE	3/11	40,000.00	11/1/88	6.432%	6.478% ann.
Ponce, PR	3/14	117,502.00	10/1/88	6.285%	6.303% ann.
Toa Baja, PR	3/24	200,000.00	5/1/88	6.125%	
Ponce, PR	3/24	53,822.10	10/1/88	6.455%	6.464% ann.
Florence, SC	3/30	56,739.60	7/1/88	6.035%	
San Juan, PR	3/30	604,688.21	10/1/88	6.455%	6.559% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
So. Miss. Electric Power #330	3/2	1,973,000.00	12/31/19	8.379%	8.293% qtr.
*Soyland Power #165A	3/9	6,593,000.00	12/31/18	8.635%	8.544% qtr.
*Dairyland Power #54	3/9	2,000,000.00	12/31/15	8.607%	8.516% qtr.
*Allegheny Electric #175A	3/10	2,099,000.00	4/2/90	7.347%	7.281% qtr.
*Colorado Ute-Electric 71A	3/10	2,920,000.00	4/2/90	7.347%	7.281% qtr.
*Wolverine Power #182A	3/10	1,223,000.00	12/31/14	8.589%	8.499% qtr.
*Wolverine Power #183A	3/10	1,547,000.00	12/31/14	8.589%	8.499% qtr.
*Wabash Valley Power #104	3/14	7,021,000.00	1/3/17	8.584%	8.494% qtr.
*Wabash Valley Power #206	3/14	524,000.00	1/3/17	8.584%	8.494% qtr.
Old Dominion Electric #267	3/15	1,204,000.00	4/2/90	7.327%	7.261% qtr.
*West Virginia Telephone #17	3/17	32,000.00	1/3/17	8.657%	8.565% qtr.
*Colorado Ute-Electric #203A	3/17	1,030,000.00	4/2/90	7.366%	7.299% qtr.
Washington Electric #269	3/18	119,000.00	4/2/90	7.289%	7.224% qtr.
*Wabash Valley Power #206	3/21	837,000.00	3/21/90	7.355%	7.289% qtr.
Tex-La Electric #329	3/23	450,000.00	1/3/22	8.801%	8.706% qtr.
Oglethorpe Power #320	3/24	19,294,000.00	4/2/90	7.524%	7.455% qtr.
*Colorado Ute-Electric #168A	3/24	290,794.00	4/2/90	7.516%	7.447% qtr.
L&O Power Coop. #302	3/28	1,029,000.00	1/3/17	8.755%	8.661% qtr.
*Colorado Ute-Electric #203	3/28	2,714,000.00	4/2/90	7.526%	7.457% qtr.
*Colorado Ute-Electric #96A	3/28	474,000.00	12/31/15	8.693%	8.601% qtr.
Sho-me Power #324	3/29	650,000.00	4/2/90	7.553%	7.483% qtr.
*Tri-State #89A	3/31	8,303,625.00	4/2/90	7.546%	7.476% qtr.
*Tri-State #89A	3/31	7,375,815.00	4/2/90	7.546%	7.476% qtr.
*Tri-State #89A	3/31	8,663,220.00	4/2/90	7.546%	7.476% qtr.

*maturity extension

FEDERAL FINANCING BANK

MARCH 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd.)					
*Colorado Ute-Electric #78A	3/31	$ 3,858,208.39	4/2/90	7.537%	7.467% qtr.
*Colorado Ute-Electric #78A	3/31	2,859,745.92	4/2/90	7.546%	7.476% qtr.
*Colorado Ute-Electric #78A	3/31	755,333.39	4/2/90	7.537%	7.467% qtr.
*Colorado Ute-Electric #78A	3/31	666,066.61	4/2/90	7.537%	7.467% qtr.
*Colorado Ute-Electric #78A	3/31	2,385,308.39	4/2/90	7.537%	7.467% qtr.
*Colorado Ute-Electric #276	3/31	1,443,781.52	4/2/90	7.539%	7.469% qtr.
*Wolverine Power #101A	3/31	1,839,199.96	1/2/90	7.446%	7.378% qtr.
*Wolverine Power #101A	3/31	1,638,750.03	1/2/90	7.446%	7.378% qtr.
*Wolverine Power #101A	3/31	1,366,099.99	1/2/90	7.446%	7.378% qtr.
*Wolverine Power #101A	3/31	158,649.98	4/2/90	7.545%	7.475% qtr.
*Wolverine Power #101A	3/31	84,550.04	4/2/90	7.545%	7.475% qtr.
*Wolverine Power #183A	3/31	4,039,000.00	1/2/90	7.448%	7.380% qtr.
*Allegheny Electric #175A	3/31	5,804,000.00	4/2/90	7.546%	7.476% qtr.
*Cooperative Power Assoc. #130A	3/31	8,461,785.12	4/2/90	7.540%	7.470% qtr.
*New Hampshire Electric #270	3/31	1,120,000.00	1/2/18	8.876%	8.780% qtr.
*New Hampshire Electric #270	3/31	414,000.00	1/2/18	8.876%	8.780% qtr.
*New Hampshire Electric #270	3/31	286,000.00	1/2/18	8.876%	8.780% qtr.
*Central Power Electric #278	3/31	151,834.16	4/2/90	7.547%	7.477% qtr.
Tex-La Electric #329	3/31	1,739,000.00	1/3/22	8.904%	8.807% qtr.
*Chugach Electric #257	3/31	783,000.00	12/31/18	8.887%	8.790% qtr.
*Chugach Electric #257	3/31	1,096,000.00	12/31/18	8.886%	8.789% qtr.
Plains Electric G&T #300	3/31	716,000.00	1/3/17	8.864%	8.768% qtr.
Plains Electric G&T #215	3/31	530,000.00	1/3/23	8.920%	8.823% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
SEDA-COG Local Dev. Corp.	3/9	88,000.00	3/1/08	8.462%	
Corp. for Bus. Asst. in NJ	3/9	122,000.00	3/1/08	8.462%	
Centl. Upp. Penn. Bus. Dev.	3/9	289,000.00	3/1/08	8.462%	
New Ventures Cap. Dev. Co.	3/9	139,000.00	3/1/13	8.539%	
Ec. Dev. Found. of Sacr. Inc.	3/9	151,000.00	3/1/13	8.539%	
Florida First Cap. Fin. Corp. Inc.	3/9	455,000.00	3/1/13	8.539%	
Central Ozarks Dev., Inc.	3/9	500,000.00	3/1/13	8.539%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-06	3/31	633,441,984.96	6/30/88	6.035%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	March 31, 1988	February 29, 1988	Net Change 3/1/88-3/31/88	FY '88 Net Change 10/1/87-3/31/88
Agency Debt:				
Export-Import Bank	$ 11,488.5	$ 11,971.5	$ -483.0	$ -975.0
NCUA-Central Liquidity Facility	119.4	113.1	6.3	8.0
Tennessee Valley Authority	16,590.0	16,547.0	43.0	204.0
U.S. Postal Service	5,853.4	5,853.4	-0-	1,500.0
U.S. Railway Association +	-0-	-0-	-0-	-0-
sub-total*	34,051.2	34,485.0	-433.8	737.0
Agency Assets:				
Farmer Home Administration	59,674.0	59,674.0	-0-	-5,335.0
DHHS-Health Maintanence Org.	84.0	84.0	-0-	-0-
DHHS-Medical Facilities	102.2	102.2	-0-	-0-
Overseas Private Investment Corp.	-0-	-0-	-0-	-0.7
Rural Electrification Admin.-CBO	4,071.2	4,071.2	-0-	-170.0
Small Business Administration	17.6	17.9	-0.3	-2.0
sub-total*	63,949.0	63,949.3	-0.3	-5,507.7
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,307.2	18,303.0	4.2	-856.8
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DHUD-Community Dev. Block Grant	319.8	316.5	3.3	-4.4
DHUD-New Communities	-0-	29.1	-29.1	-30.6
DHUD-Public Housing Notes +	2,037.0	2,034.9	2.1	-37.3
General Services Administration +	391.6	391.6	-0-	-3.8
DOI-Guam Power Authority	32.6	33.2	-0.5	-0.5
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	1,758.9	-0-	-29.4
Rural Electrification Administration	19,184.2	19,192.9	-8.7	-2,012.7
SBA-Small Business Investment Cos.	711.8	716.4	-4.7	-28.8
SBA-State/Local Development Cos.	891.8	893.1	-1.4	-8.0
TVA-Seven States Energy Corp.	1,941.6	1,927.0	14.5	117.9
DOT-Section 511	51.2	53.5	-2.3	-4.1
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	51,720.9	51,743.4	-22.5	-2,758.3
grand total*	$ 149,721.2	$ 150,177.7	$ -456.6	$ -7,528.9

*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
December 29, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $7,258 million of $23,026 million of tenders received from the public for the 4-year notes, Series Q-1992, auctioned today. The notes will be issued January 3, 1989, and mature December 31, 1992.

The interest rate on the notes will be 9-1/8%. The range of accepted competitive bids, and the corresponding prices at the 9-1/8% rate are as follows:

	Yield	Price
Low	9.19%*	99.787
High	9.22%	99.689
Average	9.22%	99.689

*Excepting 2 tenders totaling $16,000.
Tenders at the high yield were allotted 62%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 46,681	$ 46,681
New York	20,087,311	6,235,460
Philadelphia	18,807	18,807
Cleveland	57,138	57,138
Richmond	320,369	125,969
Atlanta	37,330	37,330
Chicago	1,057,318	348,118
St. Louis	55,329	42,329
Minneapolis	41,375	41,375
Kansas City	108,938	107,938
Dallas	25,042	25,042
San Francisco	1,150,677	151,166
Treasury	20,176	20,176
Totals	$23,026,491	$7,257,529

The $7,258 million of accepted tenders includes $1,042 million of noncompetitive tenders and $6,216 million of competitive tenders from the public.

In addition to the $7,258 million of tenders accepted in the auction process, $ 365 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $ 603 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.

NB-95