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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.
FEBRUARY 6, 1991

**TESTIMONY OF NICHOLAS F. BRADY
BEFORE THE
SENATE BUDGET COMMITTEE
FEBRUARY 6, 1991**

Mr. Chairman and Members of the Committee, I am pleased to meet with you to discuss President Bush's FY 1992 budget and other issues. My comments will concentrate on selected features of the budget. Chairman Boskin will follow with his comments and review the economic forecast.

We meet today at a difficult time. We are at war in the Gulf, the economy is in recession, and problems inherited from the past continue to occupy our attention. We cannot shirk our responsibility to make government a positive and effective force in dealing with the current problems that we are expected to address, while at the same time investing for America's future.

Although economic and budget realities constrain our actions, I believe that this budget achieves the goals of meeting our ongoing responsibilities, addressing problems inherited from the past, and building a base for future economic growth and competitiveness.

The need to restrain government spending and abide by the terms of the budget agreement is an over-arching concern. Over the next five years, the Federal government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the budget agreement. Although a sharp rise in the near-term deficits may obscure our efforts, there is widespread consensus that this budget agreement is an effective effort to deal with the deficit.

Furthermore, important budget process reforms were adopted to ensure that the deficit reduction targets are met. These process reforms are an integral part of the agreement and it is essential that both the letter and spirit of these reforms are adhered to.

President Bush's budget, which increases spending less than inflation, represents a strong commitment to reducing future budget deficits. Deficits have a corrosive effect on economic activity. They crowd private borrowers out of financial markets, and they represent a large diversion of our national savings away from investment in new plant and equipment, research and development, and other uses which would directly enhance productivity and competitiveness and create economic growth. In short, deficits make it more difficult to manage our macroeconomic affairs and ultimately they reduce our economy's growth potential.

Our 1992 budget priorities have been set to keep future budget deficits on a downward path. Our plans for dealing with current problems, as well as the need to improve economic growth and prepare our economy for the international challenges of the future, have been shaped by this necessity. Given the overall budgetary constraint, this necessarily requires a re-ordering of priorities.

Although the pressure to deal with contemporaneous demands is always great, the Bush Administration believes that we must also look to the future. Toward this end, we have made a number of proposals for addressing the economy's long-term growth potential.

Since productivity is <u>the</u> critical element in the long-term well-being of the American economy and the key to our international competitiveness, it must be a central focus of attention. Although many factors affect productivity, three of the most important are education, investment, and technology. And, as I will discuss later, this budget addresses all three of these elements.

Of course, the long-run cannot begin until we get past the short-run. In the near-term there are several uncertainties that affect our budgetary situation. The most important are the depth and duration of the recession and the length of the war in the Gulf.

A further uncertainty is the unpredictable course of the S&L cleanup. The RTC has moved aggressively to deal with this problem and progress has already been made. Quick action by Congress on funding, combined with lower interest rates and an early end to the recession, will help us continue to move ahead on this problem.

The Administration anticipates a recovery from the recession beginning by mid-year and a brisker upturn in the latter part of the year, which should bring the unemployment rate down and put us back on a growth track.

President Bush's budget sets an important marker which we believe must be adhered to--namely, to hold spending growth below the rate of inflation. In other words, the real level of spending must decline. The reason is simple: spending growth is what has fueled the deficit. Unless we can hold the level of spending below the inflation rate, we cannot hope to make the kind of progress on reducing the deficit which the American people expect of us.

To fulfill our responsibility to the economy and make good on the promises made in OBRA, it is essential that we get the deficit down by controlling spending. It will not be easy. We have already done a good deal of the hard first steps and economic recovery can do much of the rest.

Within the context of spending restraint and deficit reduction, this budget shows there is still room for action and initiative. We have just put forward a comprehensive plan for fundamental reform of the banking system. Such a reform is necessary to build capital in the banking industry, protect taxpayers and depositors, and remove archaic restrictions on banking activities. Our goal is to provide the American people with the best quality financial services available, and to provide our banks with the tools to meet the challenge of international competition. I have appended a summary of our reform proposal to my testimony.

In addition, the President has proposed extension of the targeted jobs tax credit, to help deal with the problem of unemployment among the economically disadvantaged, and extension of the low-income housing credit, to encourage private construction of low-income housing. We are also asking for extension of the solar and geothermal energy credits to encourage investment in renewable energy technologies.

Together, these proposals address some of the issues facing us today--problems of financial institutions, unemployment, housing and energy. However, as I mentioned earlier, we also have a responsibility to deal with the long term. Toward this end, President Bush has put forward in this budget initiatives to improve our Nation's educational system by providing opportunities for individual choice, and to improve and expand our Nation's transportation system. In addition, we are asking Congress to support the following initiatives designed to induce long-term economic growth and competitiveness:

1. Family Savings Accounts. Increasing national saving is critical to providing the capital our economy will need to modernize and expand its productive capacity. We believe that providing individuals with a new savings vehicle will help stimulate such saving.

2. A permanent research and experimentation (R&E) credit. Research and experimentation are essential to innovation and growth. We believe that the R&E tax credit is an effective method of promoting private research and development. But it needs to be enacted permanently if we are to derive its maximum benefit.

3. Enterprise Zones. The problems of the inner city demand a new approach. We believe that enterprise zones can be an effective method of targeting private resources to areas that are experiencing economic distress.

4. Permit withdrawals from IRAs for first-time home buyers. Owning a home is part of the American dream. But many younger people increasingly find it beyond their reach. We believe that permitting penalty-free withdrawals from individual retirement accounts for first-time buyers will not only bring home ownership within the means of more people, but also provide a greater incentive for young people to open and contribute to IRAs.

5. A capital gains tax differential. We believe that entrepreneurial activity is the engine that drives the economy in the long run, creating new inventions, products, and services that sustain growth. This is why a reduction in the capital gains tax is important. We are hopeful that Chairman Greenspan, working with Congress, can illuminate and help resolve the disagreements on this issue.

We believe that these incentives will help achieve our economy's long-term growth potential and provide the tools to meet the competitive challenges of the future.

In closing, I would like to turn briefly to the international sphere. It is increasingly clear that we live in an integrated world economy and that the economic health of other nations is essential to our own. The budget reflects this. Funding is provided for President Bush's Enterprise for the Americas Initiative, to help improve trade and investment for our neighbors in the Western Hemisphere. We are also lending a helping hand for economic reform in Eastern Europe, through direct aid and technical assistance. And we continue to support the critical role of the international financial institutions, including the IMF and the World Bank.

Mr. Chairman, I would now be happy to take your questions.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 6, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 10-YEAR NOTES

Tenders for $11,014 million of 10-year notes, Series A-2001, to be issued on February 15, 1991 and mature on February 15, 2001 were accepted today (CUSIP: 912827ZX3).

The interest rate on the notes will be 7 3/4%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.84%	99.384
High	7.85%	99.316
Average	7.85%	99.316

Tenders at the high yield were allotted 67%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	16,965	16,932
New York	27,488,427	10,783,584
Philadelphia	5,818	5,818
Cleveland	10,912	10,897
Richmond	25,860	23,530
Atlanta	10,133	9,118
Chicago	897,267	67,812
St. Louis	15,514	11,514
Minneapolis	7,103	5,938
Kansas City	17,289	17,189
Dallas	4,163	4,163
San Francisco	434,548	54,748
Treasury	2,759	2,759
TOTALS	$28,936,758	$11,014,002

The $11,014 million of accepted tenders includes $380 million of noncompetitive tenders and $10,634 million of competitive tenders from the public.

In addition, $85 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

The minimum par amount required for STRIPS is $800,000. Larger amounts must be in multiples of that amount.

NB-1120

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:OO PM
February 6, 1991

Contact: Peter Hollenbach
(202) 376-4302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR JANUARY 1991

Treasury's Bureau of the Public Debt announced activity figures for the month of January 1991, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$473,539,610
Held in Unstripped Form	$357,379,340
Held in Stripped Form	$116,160,270
Reconstituted in January	$4,270,160

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, JANUARY 31, 1991
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding: Total	Principal Amount Outstanding: Portion Held in Unstripped Form	Principal Amount Outstanding: Portion Held in Stripped Form	Reconstituted This Month[1]
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,591,354	$1,067,200	$24,000
11-1/4% Note A-1995	2/15/95	6,933,861	6,491,461	442,400	41,440
11-1/4% Note B-1995	5/15/95	7,127,086	5,915,886	1,211,200	-0-
10-1/2% Note C-1995	8/15/95	7,955,901	7,283,901	672,000	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,339,750	978,800	25,200
8-7/8% Note A-1996	2/15/96	8,575,199	8,343,199	232,000	8,000
7-3/8% Note C-1996	5/15/96	20,085,643	19,871,243	214,400	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,967,610	291,200	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,848,037	73,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,330,836	32,000	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,792,329	16,000	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,156,188	2,880	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,213,846	128,800	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0-
8-7/8% Note A-1999	2/15/99	9,719,623	9,716,423	3,200	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,178,303	868,800	-0-
8% Note C-1999	8/15/99	10,163,644	10,081,644	82,000	-0-
7-7/8% Note D-1999	11/15/99	10,773,960	10,765,960	8,000	-0-
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0-
8-7/8% Note B-2000	5/15/00	10,496,230	10,461,030	35,200	-0-
8-3/4% Note C-2000	8/15/00	11,080,626	11,080,626	-0-	-0-
8-1/2% Note D-2000	11/15/00	11,519,682	11,519,682	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,666,606	4,635,200	-0-
12% Bond 2005	5/15/05	4,260,758	1,530,808	2,729,950	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	8,344,113	925,600	25,600
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,537,584	4,468,000	138,400
11-1/4% Bond 2015	2/15/15	12,667,799	2,276,599	10,391,200	378,160
10-5/8% Bond 2015	8/15/15	7,149,916	2,102,876	5,047,040	478,400
9-7/8% Bond 2015	11/15/15	6,899,859	2,269,459	4,630,400	150,400
9-1/4% Bond 2016	2/15/16	7,266,854	6,493,254	773,600	415,200
7-1/4% Bond 2016	5/15/16	18,823,551	16,825,951	1,997,600	198,000
7-1/2% Bond 2016	11/15/16	18,864,448	14,539,168	4,325,280	601,280
8-3/4% Bond 2017	5/15/17	18,194,169	5,726,649	12,467,520	167,680
8-7/8% Bond 2017	8/15/17	14,016,858	9,282,458	4,734,400	337,600
9-1/8% Bond 2018	5/15/18	8,708,639	2,868,639	5,840,000	104,000
9% Bond 2018	11/15/18	9,032,870	1,413,670	7,619,200	66,400
8-7/8% Bond 2019	2/15/19	19,250,798	3,909,998	15,340,800	390,400
8-1/8% Bond 2019	8/15/19	20,213,832	11,044,552	9,169,280	102,400
8-1/2% Bond 2020	2/15/20	10,228,868	3,728,468	6,500,400	249,600
8-3/4% Bond 2020	5/15/20	10,158,883	3,739,523	6,419,360	156,000
8-3/4% Bond 2020	8/15/20	21,418,606	19,668,846	1,749,760	216,000
Total		473,539,610	357,379,340	116,160,270	4,270,160

[1]Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
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TREASURY NEWS

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EMBARGOED UNTIL GIVEN
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We meet today at a difficult time. We are at war in the Gulf, the economy is in recession, and problems inherited from the past continue to occupy our attention. We cannot shirk our responsibility to make government a positive and effective force in dealing with the current problems that we are expected to address, while at the same time investing for America's future.

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Mr. Chairman, I would now be happy to take your questions.

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

MODERNIZING THE FINANCIAL SYSTEM:
RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS

FEBRUARY 5, 1991

FACT SHEET

The Need for Reform

It is time to modernize our financial system to make banks safer and more competitive:

- We must modernize our banking system, updating outmoded laws that date back to the 1930s.
- Banks must be sound to protect depositors and taxpayers.
- A strong, internationally competitive banking system is essential to a strong, growing economy.

The Banking System is Under Stress

- Technology has revolutionized the way financial institutions do business, but our banks are hampered by out-of-date rules.
- Weak banks shrink lending when the economy slows, hurting businesses and costing jobs.
- Our banks are falling behind international competitors: Only one of the 30 largest banks in the world is American, compared to nine of 30, including the top three, just 20 years ago.

NB-1112

The Benefits of Reform

A modern, safe and internationally competitive banking industry will protect depositors and taxpayers, serve consumers, benefit workers and businesses, and strengthen our nation.

Protect depositors and taxpayers:

Depositor confidence and taxpayer protection will result from:

-- A safe, competitive, well-capitalized banking system;

-- limitations on taxpayer exposure to losses from bank failures;

-- and a strong, well-capitalized insurance fund.

Serve consumers:

An efficient, integrated financial services system will mean:

-- Consumers will have access to a wider range of services at the least possible cost.

-- Consumers also will enjoy the convenience of nationwide access to services.

Benefit workers and businesses:

A healthy banking system with strong, competitive banks will ensure:

-- Jobs are preserved because loans are not called at the first sign of economic downturn.

-- Small businesses that lack access to securities markets can count on banks in bad times as well as good.

Strengthen the nation:

A world-class financial services system provides a foundation for a world-class economy:

-- International economic leadership in the 21st century will require an internationally competitive financial services system.

The Principles Governing Reform

First, we will preserve deposit insurance for small savers while protecting taxpayers by reducing the overextended deposit insurance system. Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This reform will restore market discipline over risky activities that have increased the possibility of taxpayer exposure to losses in the banking system.

Second, we will make banks stronger and safer by strengthening the role of capital -- not by raising capital standards, but with a plan to attract capital to the banking industry. This will include rewarding well-capitalized banks with new activities that will attract still further capital, and taking prompt corrective action to address under-capitalized banks.

Third, we will make banks more competitive by modernizing outdated laws. Technological advances and other innovations in financial markets have put banks at a competitive disadvantage -- at home and abroad -- that has weakened the system and hurt the economy. Changes will allow banks to engage in a broader range of financial services and to operate nationwide.

Fourth, we will strengthen the banking system by making the regulatory structure more efficient. Currently, overlapping regulatory responsibilities lead to confusion and uneven results.

RECOMMENDATIONS

PART ONE: DEPOSIT INSURANCE AND BANKING REFORM

The Administration's deposit insurance recommendations go well beyond the narrow issue of deposit insurance and encompass the entire range of safety, soundness and competitiveness issues facing the banking system. They form a balanced, integrated package that must be considered as a whole. No single recommendation will be effective by itself, and indeed, could be counterproductive if adopted in isolation.

I. Strengthen the Role of Capital

The single most powerful tool to make banks safer is capital. Capital standards need not be raised, but the role of capital can be strengthened. This will discourage excessive risk-taking, reduce the possibility of bank failure, and provide a cushion to absorb losses ahead of the insurance fund and, ultimately, the taxpayer.

Well-capitalized banks are better able to keep lending, rather than shrinking loans to build capital ratios, during economic declines. And they are better able to meet competitive challenges and to take advantage of new opportunities.

Specific Recommendations:

Capital-based supervision, capital-based deposit insurance premiums and capital-based expanded activities (each described further in other sections of the report) will provide incentives for banks to build and maintain strong capital bases and make bank franchises more attractive. In addition, interest rate risk will be added to credit risk as a criterion for risk-based capital standards.

II. Reduce the Overextended Scope of Deposit Insurance

Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This has increased the exposure of taxpayers to possible losses and decreased market discipline on risky banks.

By returning deposit insurance to its original purpose, we can reduce the possibility that taxpayer funds will be needed to cover depositor losses, while simultaneously reintroducing market discipline that will help curb excessive risk.

Specific Recommendations:

Insured deposits:

"Pass-through" coverage of many types will be eliminated, reducing government protection for large, sophisticated institutional investors.

Brokered insured deposits will be eliminated, ending a practice that has given banks access to large pools of below-market-rate funds that are deposited without concern on the part of the depositor about the safety of the investment.

Individual insurance coverage will be limited to $100,000 per institution after a two-year phase-in period, plus another $100,000 per institution for a retirement account. This change will reduce taxpayer exposure to losses from coverage for wealthier individuals with multiple accounts, including individual, joint and revocable trusts, in a single failed institution.

The FDIC will be required to undertake an 18-month study of the costs and benefits of moving toward a systemwide $100,000 per person insurance limitation. This would more effectively limit taxpayer exposure to losses resulting from coverage of multiple accounts, but should not be implemented until it can be shown that the benefits would outweigh the potentially large administrative costs.

Uninsured deposits:

The government must preserve its ability to protect the banking system and the economy in genuine systemic risk circumstances. But protection of uninsured deposits as a matter of course both expands taxpayer exposure and encourages excessive risk-taking by banks. To limit coverage of uninsured depositors, the FDIC will be permitted to cover uninsured deposits only if that would be the least costly approach. To protect the system in rare instances of systemic risk, the Treasury and Federal Reserve could step in and order that uninsured deposits be covered. This policy would be implemented after three years to allow for an appropriate transition.

Non-deposit creditors:

While protecting uninsured deposits should be the rare exception, coverage of non-deposit creditors should be eliminated.

III. Risk-Based Deposit Insurance

Flat-rate premiums subsidize high-risk, poorly run institutions at the expense of well-run institutions and the taxpayer. There is a perverse incentive to take risks because there is no cost to offset the upside potential.

Specific Recommendations:

First, in the short-term, premiums based on capital levels will reward institutions that build capital to act as a buffer ahead of the insurance fund. In the longer term, a demonstration project may lead to premiums set by private insurance.

IV. Improved Supervision

Even with deposit insurance limits, the insurance fund and the taxpayer remain exposed to possible bank losses. Effective bank supervision can help. Capital standards need not be increased. But because well-capitalized institutions are the safest, regulation should be reoriented towards a system of capital-based supervision that provides rewards and penalties that encourage banks to hold adequate capital.

The rewards of capital-based supervision would be much greater regulatory freedom for well-capitalized banks to expand and engage in new financial activities. The sanctions of capital-based supervision would involve "prompt corrective action" to address problems as capital levels decline, well in advance of insolvency.

Specific Recommendations:

Capital-based supervision would establish five zones for banks based on their capital levels. Those with capital in excess of minimum requirements will be eligible to engage in a broad range of new financial services. Those with less than minimum capital would be subject to increasingly stringent corrective action -- including dividend cuts or even forced sale of the bank -- aimed at preventing failure.

V. Restrictions on Risky Activities

State-chartered banks with federal deposit insurance may be authorized by charter to engage in risky activities that are precluded for national banks. It is important to protect federal taxpayers from such excessive risks while maintaining state regulatory responsibilities under the dual banking system.

Specific Recommendations:

Federal deposit insurance qualifications would prohibit direct investment activities by state banks and limit activities not permitted for national banks.

VI. Nationwide Banking and Branching

Nationwide banking and branching would lead to safer, more efficient and more competitive banks, decreasing taxpayer exposure to losses. The U.S. is the only major industrialized country without a truly national banking system. After 1992, members of the European Community will permit international banking throughout the EC. Not only do we put our banks at an international competitive disadvantage, but we also forego significant safety, efficiency and consumer benefits.

Already, 33 states permit nationwide banking and another 13 permit regional banking. Only four prohibit all interstate banking. So the trend is clearly toward interstate banking. Yet there is almost no authority for interstate branching. Given the cost savings and efficiency arguments for interstate branching, the advantages to consumers and taxpayers of interstate branching are clear.

Specific Recommendations:

Full nationwide banking will be authorized for bank holding companies following a three-year delay. Interstate branching will be authorized for national banks in any state in which the bank's holding company could acquire a bank. Thus, after the three-year delay, full nationwide branching will be permitted.

VII. Modernized Financial Services Regulation

Banks are no longer the protected and steadily profitable businesses they once were. Technological advances and innovations by competing financial services providers have ended their monopoly on transaction accounts and certain types of business credit. They no longer enjoy protected access to low-cost funds from interest rate controls. And old laws that once protected them from competition have become barriers that impede banks from responding to changing market conditions. The result has been declining profitability and increasing bank failures. The losers are not just banks, but also depositors, taxpayers and the overall strength of the economy.

Out-of-date laws must be adapted to permit well-capitalized banks to reclaim the competitive opportunities they have lost to changing markets. Banks with expertise in other financial

services should be allowed to provide them for consumers, and other financial services companies with natural synergies with banking should be allowed to invest in banks. This will provide new sources of capital for the banking system and help promote safe, strong, well-capitalized banks.

The proposed changes will be accompanied by safeguards to prevent exposure of the federal deposit insurance fund to these new activities.

<u>Specific Recommendations</u>:

In order to strengthen the banking system, new rules will <u>permit financial affiliates for well-capitalized banks</u>. A new financial services holding company structure will permit a single company to own affiliates engaging in banking, securities, mutual funds and insurance. The new rules will allow <u>commercial firms to own financial services holding companies</u>.

To protect the deposit insurance fund and the taxpayer, <u>only well-capitalized banks</u> will be permitted to engage in new financial activities. <u>Only the bank will have access to deposit insurance</u>, <u>strict regulation will be focused on the bank</u>, and the new financial activities will be in <u>separately capitalized affiliates</u>.

VIII. <u>Credit Union Reforms</u>

The law required a study of adequacy of capital in the credit union industry and insurance fund and of the regulatory structure governing the credit union industry.

<u>Specific Recommendations</u>:

To ensure adequate capitalization of the credit union insurance fund, the <u>double counting of fund assets will be eliminated</u> over 12 years. To provide Administration accountability for credit union regulation, <u>the federal banking regulator will serve on the National Credit Union Administration Board</u>.

PART TWO -- REGULATORY RESTRUCTURING

The current regulatory structure is complicated, overlapping and confusing. Individual institutions often are supervised by several regulators, and bank holding companies rarely have the same regulator as their subsidiary banks.

A redesigned structure should reduce duplication and improve consistency, accountability and efficiency. It should also separate the insurer from the regulator.

Specific Recommendations:

The present four-regulator model (the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision) will be simplified to two, with the same regulator responsible for a bank holding company and its subsidiary bank.

The Federal Reserve will supervise all state-chartered banks and their holding companies. A new Federal Banking Agency under Treasury will supervise all national banks and their holding companies. When a holding company owns both state-chartered and national banks, jurisdiction over the entire organization will go to the charterer of the largest subsidiary bank. The Federal Banking Agency will take over OTS responsibilities on the date it completes assigning thrifts to the RTC.

The FDIC will be focussed on insurance and resolution of failed institutions.

PART THREE -- RECAPITALIZATION OF THE BANK INSURANCE FUND

The Bank Insurance Fund (BIF) has experienced losses in each of the last three years due to increasing numbers of bank failures. FDIC projects additional losses over the next two years that, under the most pessimistic assumptions, could exhaust the fund's net worth. The FDIC must exercise the authority given to it in the FDIC Assessment Rate Act of 1990 to recapitalize the BIF fund in the near term. Because the FDIC has the authority and because industry participation is essential, a plan to recapitalize the fund ought to be worked out with the industry by the FDIC within the following parameters:

Goals of Recapitalization

1. The plan should provide sufficient resources.

2. It should take into account any impact on the health of the banking system.

3. It should rely on industry funds.

4. It should use generally accepted accounting principles.

TREASURY NEWS

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

Statement of the Honorable
Robert R. Glauber
Under Secretary of the Treasury for Finance
Before the
Senate Committee on Agriculture, Nutrition, and Forestry

February 7, 1991

Chairman Leahy, Senator Lugar, members of the Committee:

I appreciate having this opportunity to present the Administration's views on S. 207, the "Futures Trading Practices Act of 1991."

I want to congratulate the Committee on its thorough work in Titles I and II to update the Commodity Exchange Act. We are generally supportive of Titles I and II and will be glad to submit technical comments on these two titles at a future date.

Rather than elaborating on Titles I and II, I would like to focus my remarks this morning on the crucial issue embodied in Title III -- fragmented regulation of the "one market" of stocks, stock options, and stock index futures. We continue to believe that this issue is so closely related to the CFTC's reauthorization that Congress should consider them only as a legislative package.

Last summer the Administration proposed legislation that we believe is critical to the well-being of the nation's capital markets. Entitled "The Capital Markets Competition, Stability and Fairness Act of 1990," the centerpiece of the bill was a provision designed to unify regulation of stock and stock derivative markets under the Securities and Exchange Commission. As you know, Mr. Chairman, the bill was based substantially on recommendations developed by the 1987 Presidential Task Force on Market Mechanisms, chaired by Secretary Brady.

With the help of your able leadership, Mr. Chairman, key members of this Committee and members of the Senate Banking Committee developed a compromise proposal late in the last Congress that you now have reproposed as Title III of the Futures Trading Practices Act. The compromise deleted our proposal for unified regulation of equity-related markets but preserved other important elements of our bill in modified form. We appreciate the considerable efforts that you and others made to reach this compromise.

NB-1122

Mr. Chairman, I understand that the major futures exchanges oppose even this compromise, as they have other constructive legislation on these issues. While the Administration does not oppose the compromise in concept as far as it goes, we believe it falls short of the comprehensive reform that is needed to reduce the likelihood and consequences of major market disruptions like those we experienced in October 1987 and October 1989. We will be very disappointed if the compromise is all that emerges from Congress on this issue.

We continue to believe that our 1990 proposal is the most appropriate means of resolving the issue crucial to the stability of the capital markets -- regulatory fragmentation. Accordingly, the Administration intends to resubmit its proposal, now entitled "The Capital Markets Competition, Stability, and Fairness Act of 1991," for introduction in the current Congress. We strongly urge the Committee to substitute our proposal for the compromise in Title III.

Let me explain why we believe the need for unified regulation of the markets for stocks and stock derivative products continues to be so compelling. I described many of the reasons when I appeared before this Committee last spring.

We have experienced repeated, violent drops in the stock market in the absence of any significant news events. We have done little to respond, and as a result, we are taking a chance with the very essence of the system, the clearance and settlement process. Perhaps most important, we have damaged the confidence of individual investors. We continue to believe that any market system that disillusions and disenfranchises the individual investor will lose its political standing, and in the end its greatest strength.

Let me be specific.

On Friday, June 22, 1990, in the last few minutes of trading, the stock market plunged 64 points on no significant news. Sell programs kicked in shortly after 3 p.m., and in the last half hour of trading accounted for more than half of S&P 500 trading volume.

On Friday, October 13, 1989, the Dow Jones Industrial Average fell 191 points. Almost 90 percent of the drop occurred in the last 90 minutes of trading, supposedly triggered by news of a failed takeover attempt for a single company. The following Monday, October 16, the market lost 63 points in the first 40 minutes of trading, then sharply rebounded to close 88 points up on the day. A week later, on October 24, 1989, the S&P 500 index dropped 2.7 percent (roughly 90 Dow points) and the price of the S&P index futures contract dropped 3.2 percent in slightly over one hour of trading.

And in October of 1987 the Dow Jones Industrial Average lost almost a third of its value -- $1.0 trillion -- in just four days. This included the one-day drop of 508 points, or 22.5 percent, the largest recorded amount since Dow Jones started computing index numbers in 1885. Moreover, the very real prospect of clearinghouse failures in the wake of this crash led to a crisis of confidence that brought the system to the brink of breakdown. While we all remember these consequences, few can remember what caused them.

Indeed, in each of these episodes, minor, even untraceable, events appear to have triggered precipitous, violent market declines. Each episode occurred in the last four years, when stock index futures have been actively trading in large volumes. And each episode constituted a <u>major market disruption</u>, a period when the markets for stocks and stock index futures disconnect with prices spiraling down.

These major market disruptions create clear and obvious risks to the system. But they also alienate individual investors, who feel the whole system is stacked against them. Those who are in the best position to judge the mood of the individual investor -- the stock exchanges and the large retail brokerage houses -- report a growing disillusionment with the stock market by such investors.

Reported data seem to confirm this trend. From 1965 to 1990 individual ownership of equity securities outstanding declined from 84% to 56%. In 1952, individuals accounted for 70 percent of the volume of public trading, while institutional investors represented only 30 percent. Today, the reverse is true. From 1970 to 1990 the proportion of equities in small investors' portfolios declined from 50% to 28%. Although it is true that individuals have rechannelled many of these investments into mutual funds, the switch to institutional investment has not fully offset the attrition in direct holdings. In 1989, for example, individuals sold $18 billion more on the New York Stock Exchange than they bought, but of these net sales only $11 billion were reinvested in mutual funds.

There are several costs associated with the withdrawal of individual investors from the equity market. One consequence is that smaller capitalization companies, which generally are not favored by institutional investors because of perceived risk, may be forced to pay higher capital costs to compensate for thinner trading by individuals. Moreover, individual investors are passing up opportunities to create wealth for themselves by holding diversified portfolios of individual securities, which in the past has been a very successful method of investment. Finally, the presence of small investors in the market can be a stabilizing influence that offsets some of the volatility caused by the often herd-like trading of institutions.

This disillusionment by small investors is disturbing. Individuals bring to the market a diversity of views, which are a source of stability -- indeed, individuals were net buyers during the October 1989 downdraft and appeared to stop the market from plunging even further. More importantly, political support for our free market system rests on the foundation of broad-based individual ownership. As I said before, when markets operate to disenfranchise the individual investor, they lose that political standing and in the end their greatest strength.

Let me emphasize that when I use the term "major market disruption," I am <u>not</u> talking about increased volatility, an issue so popular with economists. Critics charge that there is no compelling evidence of increased stock market volatility or average price swings. They may be right, but the focus on volatility is a red herring. Our concern is not average price changes, but the episodes of violent market freefalls. During these major market disruptions, pricing relationships between stocks and futures break down; markets in particular stocks experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

These sudden declines unrelated to changes in underlying fundamental information are a new market phenomenon. In the past, large market moves were relatively infrequent and associated with news events that clearly affected fundamental values.

For example, in the 42 years between 1940 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent).

By contrast, with the growth of stock index futures trading, such massive one-day selloffs have occurred four times in less than the last four years:

October 19, 1987	--	22.6 percent
October 26, 1987	--	8.0 percent
January 8, 1988	--	6.9 percent
October 13, 1989	--	6.9 percent

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets flowing over to the stock market.

My point is this. Stocks and stock index futures are "one market," linked together by electronics. Movements in the price of stock index futures are translated almost immediately to stock prices through index arbitrage, and vice versa. This is what we concluded in the President's 1987 Task Force on Market Mechanisms, and essentially no one -- not academics, not people on Wall Street, not politicians -- has disputed that conclusion. The Task Force also concluded that the interaction of trading in stock and stock index futures in the "one market" is a major cause of market disruptions. Yet the Nation's disjointed regulatory system has not kept pace with this reality, preventing us from putting the "one market" tools in place to deal with these market disruptions.

The single most important step Congress can take to reduce both the likelihood of major market disruptions and the severity of their consequences is to unify regulation for the "one market." A single regulator would be able to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. While the problem of major market disruptions would not be magically cured overnight, unified regulation could at least begin to develop and apply the regulatory tools to control what is too often out of control -- the interaction between stock index futures and stocks.

Moreover, we strongly believe that if we fail to come to grips with regulatory fragmentation, the government will have done precious little in the face of clear evidence that we face a problem. As I have said before, minor events are likely to continue to cause major market disruptions -- and major events could cause even worse results. Simply stated, we are accepting too much systemic risk for too little benefit.

The Administration believes that Congress should act by addressing the regulatory structure for stocks and stock index futures. The legislation we intend to resubmit contains three key provisions. First, the bill transfers the authority to regulate stock index futures from the Commodity Futures Trading Commission (CFTC) to the Securities and Exchange Commission (SEC), but in a manner specifically designed to create the least disruption to market participants. Second, it provides federal oversight authority over the ability of futures markets to set margins on stock index futures -- not to prevent volatility, but to safeguard the financial system. Third, the bill modifies the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a "futures contract."

Before I describe the bill in more detail, let me briefly explain the specific problems that we believe require this legislative remedy.

Uncoordinated Intermarket Mechanisms

The first of these is the failure to coordinate key intermarket mechanisms, which would not happen if the "one market" were regulated as one market. These mechanisms include unharmonized margins, disjointed clearance and settlement systems, evasion of short selling restrictions, and uncoordinated circuit breakers.

Unharmonized Margins. As you know, while there is federal oversight of margins on stock, there is virtually none over margins on stock index futures. The futures exchanges and their clearinghouses set these futures margins themselves. The result is a tremendous disparity in margin levels on stocks and stock index futures, even though they are part of one market where margin levels on one instrument can have a direct impact on the trading and price of the other.

The result has been that futures margins, which have no federal oversight, have often dipped to dangerously low levels. Indeed, Chairman Greenspan of the Federal Reserve Board -- the guardian against excessive risk to the financial system -- has expressed his strong concerns about the low level of stock index futures margins prior to the mini-crash in 1989.

Again, those who try to dismiss our proposal by claiming that margins are unrelated to volatility are simply missing the point. We have never said that average volatility has increased. Our concern is major market disruptions and how to slow them down when the tidal wave starts to form -- not volatility.

The Federal Reserve Board agrees with the need for federal oversight of margins on stock index futures to limit systemic risk. Indeed, no credible argument has been advanced against federal oversight -- we must have it where the actions of private market participants in a narrow segment of the market create risks for the financial system as a whole. It is a dangerous practice that's not in the public interest. We ought to address this unjustified anomaly.

Let me elaborate on the link between margins and systemic risk. The fact is that futures traders can control large amounts of stock with little of their own money. Relatively small amounts of capital can concentrate enormous selling pressure on the stock market. For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control roughly $2,000,000 in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash.

Many observers were astounded that, while stock index futures margins were increased temporarily in the wake of the October 1987 break, they were soon again lowered, so that margins were lower in October of 1989 than they were in October of 1987. Futures margins were 3.6 percent at the opening on Monday, October 19, 1987. The futures markets raised them to above 12 percent the following week, but then allowed them to drift back down so that at the opening on October 13, 1989 -- the day the market dropped 190 points -- they were only 2.2 percent.

Today margins on the S&P 500 futures contract are only about 5.8 percent, which means that a market decline of just 5 percent (about 135 Dow Jones points) faces a futures trader with a choice: he either has to virtually double his original margin simply to hold an existing position or sell out, which could put more pressure on a falling market.

A consequence of low futures margins is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through increased margin requirements because margins have been set so low. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity into the system. Indeed, Chairman Greenspan has testified that during the October 1989 mini-crash he was "shaken" at the prospect of increasing margins at a time when liquidity was critical.

Let me mention one related point. Our 1987 Task Force Report showed conclusively that a mere handful of firms created enormous selling pressure in Chicago that swept back to New York markets. For example, on October 19, 1987, three firms in the futures market accounted for the equivalent of $2.8 billion in stock sales. In the futures market the top 10 sellers accounted for sales equivalent to $5 billion, roughly 50 percent of the non-market maker total volume.

Low futures margins contribute to this ability of a small number of traders to concentrate enormous buying and selling pressure on the stock market.

Disjointed Clearance and Settlement Systems. The most disturbing consequence of major market disruptions is the risk they pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over six hours behind its normal payment times, with over $1.5 billion owed to investment houses. Had these funds been missing for any significantly longer time, it could have unleashed a chain reaction of events spreading losses through the payments system.

The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the specter of a full-scale financial system breakdown." To reduce the possibility of financial gridlock, we need to have a single regulator for the "one market" who can facilitate coordination of intermarket clearance and settlement systems. Little effective coordination has occurred in the over three years since the 1987 market break. While the recently-enacted Market Reform Act of 1990 will help address these systems, a single regulator would obviously help accelerate the coordination process.

Evasion of Short Selling Restrictions. For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and leaves the individual investor helpless. However, a concerted selling effort in the futures market can completely undermine the short selling restriction -- and in fact, because of low futures margins, can accelerate the stock market downdraft. Again, it is critical to harmonize these intermarket rules to prevent traders from using one market to evade restrictions in another market.

Uncoordinated Circuit Breakers. Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can and should be done. Fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially towards the harmonized regulation we need to address the problem of major market disruptions. One regulator is what every other country with important trading in these instruments has -- the United Kingdom, Japan, and France.

Ineffective Intermarket Enforcement

Another problem created by regulatory fragmentation involves intermarket enforcement.

With two different regulators, it is sometimes hard to prevent manipulation and fraud in transactions between the stock and futures markets. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context. The current fragmented regulatory system is an open invitation for intermarket manipulation.

Barriers to Innovation

Apart from major market disruptions and intermarket enforcement, regulatory fragmentation also is creating a serious impediment to innovation. This was not always true -- in the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development, while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition can also cause jurisdictional squabbles that can strangle innovation. This is precisely what happened to Index Participation Certificates, which litigation, prompted by the "exclusivity clause" of the Commodity Exchange Act, has prevented from trading in the United States.

With the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business away from U.S. markets.

The Administration's Proposal

To remedy these problems the Administration will resubmit "The Capital Markets Competition, Stability, and Fairness Act of 1991." The bill contains three key provisions. First, it transfers the authority to regulate stock index futures from the CFTC to the SEC. In order to minimize disruptions to market participants, the SEC will operate under the basic framework of the Commodity Exchange Act, augmented with key enforcement and antifraud provisions from the securities laws. In addition, the SEC would have to consider the sufficiency of any existing CFTC rules as well as the views of the CFTC before adopting its own rules regarding stock index futures. Moreover, in designating contract markets for stock index futures, the SEC would have to consider the fair and efficient operation of the stock index futures market and the maintenance of fair and orderly markets in underlying securities.

Taken as a whole, these provisions will unify SEC regulation of the "one market" of stocks, stock options, and stock index futures in the least disruptive manner. This will enhance coordination of key intermarket issues such as margins, circuit breakers, enforcement, and clearance and settlement.

Second, to enhance the safety and soundness of the financial system, the bill gives the SEC oversight authority over the futures exchanges' ability to set margins on stock index futures. The exchanges would still have the flexibility to initiate margin changes, and the statute would not require minimum margins levels, which would be left to regulatory discretion. This is similar to the SEC's current margin authority over stock options.

The result would be that, for the first time since stock index futures began trading in 1982, the federal government would have prudential oversight authority over margins on all stock and stock derivative products. This is crucial to the protection of the integrity of the nation's financial system.

Third, the bill modifies the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a "futures contract." Hybrid equity securities like Index Participation Certificates could trade in both the futures markets (under the framework of the Commodity Exchange Act) and the securities markets (under the securities laws). Institutional swaps would similarly be excepted from exclusive CFTC jurisdiction under limited circumstances. The bill would also allow the CFTC to exempt other financial instruments under certain conditions.

Mr. Chairman, you and others have questioned whether the bill would create regulatory gaps, for example by allowing cash-settled U.S. Treasury bond futures to be traded in casinos. Let me just say that we believe hypothetical problems raised could be cured by SEC enforcement action under existing securities laws. We certainly did not intend to create regulatory gaps, and none were identified by the CFTC when it was given the opportunity to comment on our draft proposal. If any inadvertent gaps are discovered, we would be happy to consider any suggestions for clarifying the appropriate language.

To facilitate transition, the bill does not take effect until 90 days after enactment, leaving time for the SEC, CFTC, and stock index futures markets to adjust. Persons, contract markets and futures associations registered under the Commodity Exchange Act would be deemed to be registered with the SEC on the effective date, and rules and interpretations of the Commodity Exchange Act would continue in effect. To take advantage of economies of scale, the SEC could enter into cooperative agreements with the CFTC to administer reparations proceedings under the Commodity Exchange Act.

Finally, the bill requires the SEC to report to Congress within 18 months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock index futures.

Conclusion

In sum, we believe the Administration's proposal will accomplish the two major purposes we have in mind. The first is to reduce both the likelihood of major market disruptions and the severity of their consequences. The second is to create a market environment that rekindles the interest of the individual investor.

Furthermore, the Administration's proposal is not the proverbial "camel's nose under the tent." The way markets are now functioning makes no further shifts in regulatory jurisdiction necessary -- not Treasury bond futures to the SEC, not a full merger of the SEC and CFTC. Secretary Brady has stated that he will oppose more sweeping changes to CFTC authority if the Administration's bill passes in its present form.

Would the CFTC be rendered a less effective regulatory body if the bill passes? No. The CFTC would be able to concentrate its expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction. Indeed, our proposal would have minimal effect on the CFTC because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction.

In fact, we believe moving jurisdiction over stock index futures to the SEC makes it more likely the CFTC will survive as an independent agency. Further episodes of severe market disruptions could build pressure to merge the CFTC and SEC, as proposed in the Glickman-Eckart bill in the last Congress.

Concerns that our bill would strangle stock index futures also are unfounded. We expect the changes we propose would increase investor confidence in the stock index futures markets and would attract the interest of investors who currently do not use these instruments.

What impact would our proposal have on the individual farmer and the agricultural community in general? None whatsoever. Stock index futures simply have no relation to agricultural products or agricultural futures.

Finally, opponents of the bill have tried to characterize these issues as nothing more than a turf fight between government agencies or congressional committees, or a regional battle between financial centers. Turf is not the issue. Nor is it a geographical battle between Chicago and New York. In fact, some of the largest traders on the futures exchanges are New York investment houses. The Treasury Department comes to this issue with no particular parochial perspective. Our sole objective is sound public policy -- how best to reduce the likelihood of violent market disruptions and position our markets for continued leadership in the face of mounting competition around the world.

Moreover, let me emphasize that the problems I have described do not come from the CFTC or SEC. These regulators are doing a good job under impossible circumstances -- trying to administer a system of regulation that simply is not in concert with the "one market" reality that exists today. It is unfair to expect them to regulate markets effectively without the proper tools to do so. Our concern, as I have explained, is the few but critical intermarket issues that are slipping through the regulatory cracks. Unless properly coordinated through a coherent regulatory structure, these few issues pose a serious risk to the financial system.

For the reasons I have outlined, the Administration believes the need to adopt our legislative proposal is urgent. We strongly urge the Committee to substitute our proposal for the compromise version contained in Title III.

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

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
February 7, 1991

Contact: Robert Levine
202/566-2041

UNITED STATES AND PAKISTAN TO DISCUSS A NEW INCOME TAX TREATY

The Treasury Department announced today that representatives of the United States and Pakistan will meet in Washington, during the week of March 11, 1991, to resume discussions of a possible new bilateral income tax treaty. The income tax treaty currently in force was signed in 1957. Prior discussions, most recently in 1982, were not successful in reaching agreement on a new treaty.

The negotiations will take into account the model income tax treaties published by the Organization for Economic Cooperation and Development, the United Nations, and the U.S. Treasury Department, as well as tax treaties recently concluded by the two countries with other countries, and recent changes in their respective income tax laws.

Income tax treaties provide rules for the taxation of income derived in one of the countries (the "source" country) by residents of the other. They establish when the source country may tax various classes of income and specify maximum rates of tax at source on certain items, such as dividends, interest and royalties. They also provide for administrative cooperation between the tax authorities of the two countries and guarantee non-discriminatory taxation. Treaty benefits are limited to residents of the two countries.

Persons wishing to offer comments or suggestions on the negotiations are invited to write to Philip D. Morrison, International Tax Counsel, Treasury Department, Washington, D.C. 20220.

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NB-1123

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 7, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 30-YEAR BONDS

Tenders for $11,012 million of 30-year bonds to be issued on February 15, 1991 and mature on February 15, 2021 were accepted today (CUSIP: 912810EH7).

The interest rate on the bonds will be 7 7/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.97%	98.922
High	7.98%	98.810
Average	7.98%	98.810

Tenders at the high yield were allotted 87%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	2,631	2,631
New York	21,782,055	10,818,769
Philadelphia	1,636	1,636
Cleveland	2,179	2,179
Richmond	25,162	20,022
Atlanta	3,446	3,416
Chicago	782,945	80,065
St. Louis	8,045	8,045
Minneapolis	7,458	5,678
Kansas City	9,182	9,182
Dallas	2,360	2,360
San Francisco	331,411	57,586
Treasury	450	450
TOTALS	$22,958,960	$11,012,019

The $11,012 million of accepted tenders includes $223 million of noncompetitive tenders and $10,789 million of competitive tenders from the public.

In addition, $100 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

The minimum par amount required for STRIPS is $1,600,000. Larger amounts must be in multiples of that amount.

NB-1124

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 11, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $9,722 million of 13-week bills to be issued on February 14, 1991 and mature on May 16, 1991 were accepted today (CUSIP: 912794WJ9).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.84%	6.01%	98.524
High	5.86%	6.03%	98.519
Average	5.86%	6.03%	98.519

Tenders at the high discount rate were allotted 35%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	51,925	51,925
New York	48,416,095	8,085,230
Philadelphia	20,860	19,145
Cleveland	61,700	61,660
Richmond	107,215	57,215
Atlanta	37,750	35,750
Chicago	2,341,860	151,665
St. Louis	59,875	19,875
Minneapolis	9,025	9,025
Kansas City	37,615	37,615
Dallas	27,830	27,830
San Francisco	1,495,340	197,440
Treasury	967,505	967,505
TOTALS	$53,634,595	$9,721,880
Type		
Competitive	$49,387,510	$5,474,795
Noncompetitive	1,980,730	1,980,730
Subtotal, Public	$51,368,240	$7,455,525
Federal Reserve	2,177,210	2,177,210
Foreign Official Institutions	89,145	89,145
TOTALS	$53,634,595	$9,721,880

An additional $67,955 thousand of bills will be issued to foreign official institutions for new cash.

NB-1125

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 11, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $9,668 million of 26-week bills to be issued on February 14, 1991 and mature on August 15, 1991 were accepted today (CUSIP: 912794XC3).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.83%	6.09%	97.053
High	5.85%	6.11%	97.043
Average	5.85%	6.11%	97.043

Tenders at the high discount rate were allotted 61%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	37,015	37,015
New York	22,742,795	8,127,865
Philadelphia	19,170	19,170
Cleveland	45,870	45,870
Richmond	53,120	53,120
Atlanta	38,660	34,865
Chicago	1,730,715	302,015
St. Louis	43,490	24,540
Minneapolis	9,845	9,845
Kansas City	49,820	49,820
Dallas	20,080	20,080
San Francisco	682,580	250,330
Treasury	693,340	693,340
TOTALS	$26,166,500	$9,667,875
Type		
Competitive	$21,632,380	$5,133,755
Noncompetitive	1,412,865	1,412,865
Subtotal, Public	$23,045,245	$6,546,620
Federal Reserve	2,400,000	2,400,000
Foreign Official Institutions	721,255	721,255
TOTALS	$26,166,500	$9,667,875

An additional $598,745 thousand of bills will be issued to foreign official institutions for new cash.

NB-1126

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
February 11, 1991

CONTACT: BOB LEVINE
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TREASURY RELEASES FIFTH REPORT ON THE
INTERNATIONAL BOYCOTT PROVISIONS OF THE INTERNAL REVENUE CODE

The Treasury Department announced the release of its fifth report on the international boycott provisions, titled "The Operation and Effect of the International Boycott Provisions of the Internal Revenue Code".

The international boycott provisions, added to the Code by the Tax Reform Act of 1976, deny certain tax benefits to persons who participate in or cooperate with an international boycott. The tax benefits affected include the foreign tax credit, the deferral of tax on the earnings of controlled foreign corporations and interest charge Domestic International Sales Corporations as well as the exemptions from tax of certain income of Foreign Sales Corporations.

The Fifth Report broadly covers the tax accounting periods 1983, 1984, 1985 and 1986. The report, which included statistical tables and a description of operations, shows that the number of persons agreeing to participate in boycott operations declined to 44 from 234. For 1986, the tax benefits lost by persons participating in boycott activities was $2,850,000.

Copies are available at the Treasury Press Office, Room 2315, Washington, D.C. 20220, Phone (202) 566-2041.

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NB-1127

TREASURY NEWS

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

FOR IMMEDIATE RELEASE

CONTACT: BARBARA CLAY
202-566-5252

REMARKS BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
AT THE
ANNUAL BANQUET OF THE
VIRGINIA JOURNAL OF INTERNATIONAL LAW
AT THE UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE
FEBRUARY 8, 1991

Thank you for your kind introduction. I am pleased and honored to have been invited to speak to you this evening.

However, I must admit that it was with considerable trepidation that I accepted your invitation to speak to this distinguished gathering. I understand that yours is the oldest student-run international law journal in the United States. I also understand that it is among the best, having won more than its fair share of awards for excellence. The thought of speaking to such a distinguished gathering of law professors and students, reminds me of what Thomas Jefferson once said about Chief Justice John Marshall:

"When conversing with Marshall I never admit anything. ...So great is his sophistry, you must never give him an affirmative answer, or you will be forced to grant his conclusion. Why, if he were to ask me whether it was daylight or not, I'd reply, 'Sir, I don't know. I can't tell.' "

Several weeks ago I discussed with our host the issue of what I might appropriately say here tonight. He suggested several frightening legal subjects, including an analysis of some recent developments in the international economic area in terms of certain contract law concepts.

This caused me to reflect in a new light about how I do my job -- especially the relationships among legally binding and enforceable agreements, agreed rules, pragmatic understandings, and shameless adhocery.

For better or for worse, I am not a lawyer -- though many years ago I did a term at Oxford on the Law of Torts. As I believe most non-practicing lawyers would say, I found the general training valuable. However, the only case I clearly remember -- which might have application to my appearance here tonight -- is Rylands vs. Fletcher -- where, like the water in the reservoir, I might escape from international finance to international law and do mischief, through no particular fault of my own!

Contract law recognizes that parties entering into a contract may make essentially whatever enforcement arrangements they mutually agree upon. Some contractual provisions are clearly intended by the parties to be legally enforceable; that is if one party violates such a provision the other party can go into court and obtain a remedy such as damages or some specified performance. In short, the parties decide that matters covered by such provisions will be settled and absorbed in the context of a formal institutional framework.

On the other hand, parties entering into a contract may also make commitments which, for one reason or another, are not legally enforceable. They might do this for a number of reasons. For example, demanding a strict, airtight clause during negotiations might appear excessively legalistic (a term we often use in talking with our lawyers at the Treasury Department) and thus offend the other party at a time when it may be important to remain in the other party's good graces. Or it may be just too difficult, time consuming and expensive to draft and negotiate a legally enforceable clause.

However, just because a commitment is not legally enforceable does not mean that there are no sanctions for ensuring that it is adhered to. A party might adhere to a commitment that is not legally enforceable because it does not want to have a bad business reputation or because it wants to be able to continue to do business with the other party in the future or because, as is often the case between nations, it <u>must</u> be able to continue business with the other party. Indeed, in the fast-moving and fluid world of international economic and political affairs, such arrangements may be more effective than formal sanctions.

<u>International Monetary Arrangements</u>

The international monetary arrangements established at the end of World War II -- the Bretton Woods agreement -- have been characterized as a rule based system similar in many respects to a contract among the participants. The basic elements of this contract were contained in the Articles of Agreement of the International Monetary Fund (IMF).

> <u>First</u>, countries committed to maintain or fix the price of their currencies -- the exchange rate -- in a narrow range, and these prices could not be changed except in the case of fundamental economic problems and with the prior approval of

the IMF. In practice, these prices were maintained by governments buying and selling their currencies with dollars whenever market forces tended to push the price outside the agreed limit. In the case of the United States, it agreed to convert official dollar holdings into gold at a fixed price to maintain the value of the dollar.

Second, each country had an obligation to pursue the disciplined policies necessary to ensure that large imbalances in supply and demand for its currency did not emerge, thus giving rise to pressures to change the exchange rate.

Third, failure to perform satisfactorily could result in the implementation of specific penalties, including the denial of financing or the imposition of trade sanctions.

The Bretton Woods system was extremely effective in promoting global economic growth and an open, expanding international trading system. However, the system contained the seeds of its own demise and ultimately proved incapable of withstanding the fundamental changes in the world economy which it had made possible.

First, it relied on a continuing supply of dollars to finance international trade and investment. However, as foreign dollar holdings rose dramatically, there was a loss of confidence in the ability or willingness of the United States to convert dollars into gold at the agreed fixed price.

Second, there were no orderly means of adjusting the price of currencies as economic conditions changed. In particular, the ability of the U.S. to change the exchange rate for the dollar was constrained by the central role of the dollar in the system.

Third, the sanctions under the system to encourage changes in economic policy were biased in favor of surplus countries and largely ineffective in promoting adjustment among major countries.

The demise of the Bretton Woods system in the early 1970s produced a sharp reaction in international monetary arrangements which were reflected in the second amendment of the IMF Articles of Agreement. The new rules maintained the obligation of countries to pursue economic policies that would foster stable currencies but eschewed the requirement that countries buy and sell their currencies to maintain its price at agreed levels; the value of currencies was allowed to float in response to market forces. Moreover, the growth of private international capital markets during the 1970s reduced substantially the role of official financing as a constraint on the policies of those major industrial countries with the greatest influence on the functioning of the system. Many, therefore, have criticized the international monetary system of the 1970s and early 1980s as a "non-system."

By the mid-1980s, widespread dissatisfaction had emerged with the floating rate system. In particular, wide fluctuations in the price of currencies, especially the sharp increase in the price of the dollar in the early 1980s, as well as divergent economic conditions, resulted in large trade imbalances among the major industrial countries. For example, the dollar rose around 100 percent against many major European currencies and the U.S. trade position moved from near balance to a deficit of $160 billion, some 3-1/2 percent of GNP. The large U.S. trade deficit that emerged led to the strongest protectionist pressures since the 1930s and threatened to undermine the open trading system which had been a cornerstone of the post-war economic prosperity.

Since the mid-1980s, the major industrial countries have put in place new international monetary arrangements which seek to navigate between the rigidities of the rule-based fixed exchange rate system and the absence of effective constraints under the floating exchange rate system. The economic policy coordination process established by the G-7 countries in recent years has many of the characteristics of an informal contract which relies on a mutuality of interests, peer pressure, and informal sanctions rather than legally enforceable sanctions to achieve effective performance.

The seven countries participating in the G-7 economic policy coordination process -- the United States, Japan, Germany, United Kingdom, France, Canada, Italy -- have continued to affirm their commitment to pursue sound, mutually compatible policies designed to achieve sustainable economic growth with low inflation, reduced trade imbalances, and stable international currency markets. To this end, they meet regularly -- usually with a representative of the IMF -- to review their economic policies and performance. These reviews are based on key economic indicators and understandings regarding general objectives for each country which are mutually compatible. When economic policies and performance diverge significantly from the agreed path, countries are expected to take remedial measures.

There are also informal understandings on exchange rates which are designed to maintain stable currency markets and orderly adjustment of exchange rates in response to changes in fundamental economic conditions. For this purpose, the United States and the other countries cooperate in foreign currency markets through concerted purchases and sales of currency as necessary and appropriate. However, they have avoided any legally binding commitment to maintain the value of currencies at specific levels or within formal zones. This approach in currency markets reflects the lessons of the past and recognizes the great size and strength of global financial markets. In addition, there is recognition that changes in currency values can play an appropriate role in correcting trade imbalances.

There are, however, sanctions of a non-legal nature under the economic policy coordination process. First and foremost, the G-7 countries recognize that the coordination process is mutually beneficial. Each accepts that it has much to gain from an open, growing world economy and stable international monetary system. Moreover, the ability of each country to achieve national economic objectives is influenced considerably by the actions of others in an integrated world economy. This mutuality of interest serves as a strong incentive to seek consensus and compromise in order to avoid creating undesirable instability. In this connection, the public statements released by the group -- G-7 communiques -- are subject to intense scrutiny and judgment both by private financial institutions and the media. This has forced the G-7 to present a common front to the international community at large.

Second, the participants accept that the effectiveness of their joint efforts depends crucially on maintaining the credibility of the process in the eyes of the market. Many attribute the stock market crash of October 1987 in part to the perception that G-7 cooperation had collapsed. Moreover, experience over the last few years has demonstrated that the effectiveness of exchange market operations is enhanced through concerted actions. Such actions at key moments in recent years have helped produce the relatively more stable currency markets that we have enjoyed since 1987. In this regard, it is perhaps worth noting that currency markets in past months have been remarkably stable despite the uncertainties generated by the Gulf war.

Third, peer pressure has been an effective means of assuring that countries take into account international repercussions of domestic policies. This peer pressure takes many forms and at varying levels. The Finance Ministers and Central Bank Governors meet regularly in informal, restricted session for full and frank discussion of key issues. Unlike many other international meetings, these sessions do not include prepared statements, nor are official records of the meeting kept. The unique character of these meetings enhances understanding of each others' views and permits some real horse trading. The Heads of State also meet annually, providing both a political seal of approval and credibility to the process that is essential for its effectiveness. The end result is strong pressure to reach realistic understandings that can be implemented.

The record of success under economic policy coordination has already been considerable. In terms of economic performance, the major countries have achieved the longest expansion in the post war period, inflation has declined significantly, and trade imbalances reduced substantially. The foreign currency markets have become more stable and more orderly adjustment of currency values is taking place in response to changes in underlying economic conditions.

Equally important, we have a process in place that permits the system to evolve gradually in response to changing circumstances without the necessity of large, disruptive upheavals that in the past have proven so costly. This is especially necessary at the present time, when the world economy is undergoing dramatic change as a result of the unification of Western Europe, the political and economic transition in Eastern Europe, the economic decline of the Soviet Union, and the continuing restructuring in the developing countries.

Probably there are now in place fewer sanctions which are legally enforceable to make the system work than there were forty-five years ago when the Bretton Woods system began operating. That is not to say, however, that the replacement of legally enforceable measures by measures which are not legally enforceable has resulted in a crippling of the system. On the contrary, under economic policy coordination there are strong pressures and incentives to achieve the underlying policies necessary for lasting stability.

International Debt

The 1980s also saw a major change in the traditional contractual relations between sovereign borrowers and their lenders, as countries' inability to meet their scheduled payments proved chronic. It became clear that the provisions in the old contracts could not be enforced to the benefit of either side: the borrower could not pay, and the banks knew that they would not gain by enforcing all possible protections in the contracts. A new framework to address this circumstance was required, and the international community has responded to this challenge by adopting a flexible strategy based on mutual needs.

The original loan contracts were straight forward. A bank committed to provide dollars to a country at a rate of interest. The country was obligated to make interest and principal payments on the loan over a certain period. Further, the negative pledge and sharing clauses in the contracts assured that no bank could benefit at the expense of another. Sanctions were also established whereby non-payment could result in the seizure of assets.

As you know, commercial banks and developing countries contracted debt of this nature at a rapid rate during the 1970s. These contracts were established in specific circumstances. Banks were flush with resources due to heavy petrodollar deposits and eager to lend. They could offer loans at negative real interest rates to countries which were enjoying a boom in commodity prices and export earnings yet were also faced with the prospect of maintaining oil imports. Both sides entered into their loan contracts assuming that these circumstances would continue. In these transactions, top international lawyers did their usual thorough job on behalf of their respective clients.

In the early 1980s, however, the situation changed dramatically. Interest rates took a surprise jump upward while export earnings in developing countries fell sharply. And the economic policies pursued by many countries during the period of easy money proved increasingly unsustainable. Countries could not meet their payments, and banks were faced with a situation in which there were insufficient assets in the aggregate for all banks to be paid and sharing clauses precluded payment to less than all the banks.

The absence of an international equivalent to our bankruptcy procedure left debtors, creditors, and governments without a framework for dealing with these new realities. Banks adjusted by accepting the rescheduling of payments and extending new loans. Countries were obligated to undertake broad adjustment and economic reform programs to address problems which had contributed to their payments difficulties.

This process was guided by the need to avoid a breakdown in the international payments system and the imperative of preserving the sanctity of loan contracts in a changing context. To accomplish this, countries and banks had to build on a relationship beyond that formally contained in loan contracts. Creditor governments stepped in to support this new reality in order to protect their own interests, and the international financial institutions such as the IMF and World Bank facilitated this process by helping set the parameters for financing packages and economic reforms.

Ongoing debt problems required continued evolution of the framework. At the outset, preserving the international payments system and commercial bank solvency was the predominant concern of creditor governments. Gradually, however, the international community increasingly focused on means to help countries resume growth.

It became increasingly difficult to assemble rescheduling and new money packages that met countries' needs -- particularly for those countries whose debt did not pose a major systemic risk to the banks. The large syndicates of commercial banks, which were originally seen as spreading and reducing the risks of sovereign lending, soon began to unravel as the disparate exposure and interests of individual banks came to the fore. While providing additional loans remained attractive to those banks seeking to preserve business relationships with and maintain a stake in debtor countries, other banks sought aggressively to reduce their exposure and accept losses.

Banks were withdrawing from new lending and increasing their reserves against potential losses on old loans. At the same time, debtor countries committed to economic reform continued to face serious economic difficulties. This confluence of events shifted the emphasis of the international debt strategy to a broader range of options -- and, in particular, focused on the reduction of debt and debt service as important mechanisms for banks to fulfill their obligations.

This latest stage of the evolution of the debt strategy -- known as the Brady Plan -- recognizes the realities of changing bank interests and ongoing debtor needs. Allowing banks to choose among disparate options puts banks in a better position to act, and facilitating actual reduction in the stock of debt and servicing requirements serves as a greater incentive for countries to pursue reforms. Instead of creating sanctions to enforce these new, flexible agreements, creditor governments -- through the international financial institutions -- have helped debtor countries collateralize the debt and debt service reduction instruments. These "enhancements" have enticed commercial banks to participate by providing short-term coverage of interest payments and ensuring principal payment in the long term.

The system for addressing payment difficulties of developing countries that has evolved is an informal one. Much of the success in gaining banks' commitments to the new forms of financing results from their ability to find market solutions, outside of previous legal restrictions, to their dilemmas. Peer pressure both within the banking community and from creditor governments has also played an important role. The sanctions that existed in original loan contracts have been superseded by a new system of obligations and incentives. The legal agreements that continue to be forged as part of this process form only the basic framework for resolving problems that arise.

The critical point from my perspective, however, is that this informal system is working. Early efforts helped preserve the solvency of the international financial system. And now the

Brady Plan's new emphasis on debt and debt service reduction has produced real results for debtor countries.

- Seven countries have reached agreements with their commercial banks on packages that include debt/debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries.

- The Mexican agreement reduced annual interest payments by $1.5 billion, cut bank debt by the equivalent of $15 billion, and removed the burden of $42 billion in principal payment. The Costa Rican agreement reduced that country's commercial bank debt by 62% and cut annual debt service payments by 74%.

- Chile, Venezuela, Morocco, and Uruguay have also reached agreements that will result in significant reductions in debt burdens, and several other countries are continuing discussions with their banks.

These types of agreements adapt but do not abrogate the commitments and obligations of old loans. They are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

Conclusion

Many of you are interested in becoming international lawyers. Some of you may have taken my remarks this evening about reliance on nonlegal commitments and sanctions to be a prescription for your future unemployment. Before concluding, I want to allay your fears.

I do not share the conclusion reached in a recent study by the Institute for International Economics that economic performance deteriorates the more lawyers there are in a country! There will always be a place in the international economic system for binding rules. Lawyers are continually involved in drafting and helping me negotiate such rules whether they concern the Articles of Agreement of the International Monetary Fund or the multilateral development banks or an agreement on debt reduction with a Latin American government.

Lawyers are also invaluable in helping determine the costs and risks involved in accepting nonlegal commitments rather than legal commitments and making sure that a policymaker has not accepted a non-legal commitment when a legal commitment was intended.

As a distinguished former member of your faculty and former member of the World Court, Hardy Cross Dillard, once said,

> . . .there remains one virtue which law alone possesses. I refer to its capacity to produce a sense of order and, in the long run, a tolerable degree of predictability. . . . In the decentralized international system, law, better than any other method, helps to provide this modicum of order not only by settling fusses but by providing the institutional framework for absorbing them.

I too recognize this virtue. Nevertheless, my experience in international finance increasingly convinces me that in the real world of international economic and political affairs, lawyers will need to have a keener awareness and broader understanding of the role played by informal, non-legal arrangements in the conduct of international economic relations.

Thank you very much.

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

FOR IMMEDIATE RELEASE
February 12, 1991

CONTACT: Barbara Clay
(202) 566-5252

TREASURY ANNOUNCES CENSUS OF BLOCKED IRAQI ASSETS AND U.S. CLAIMS AGAINST IRAQ

Holders of blocked Iraqi property and U.S. nationals wishing to assert claims against the Government of Iraq will be required to report to the Treasury Department's Office of Foreign Assets Control under regulations published in the Federal Register yesterday.

Reports on claims against the Government of Iraq must be submitted by March 1, 1991. The submission of a claims report will not constitute the formal filing of a claim for compensation against the Government of Iraq.

Reports by holders of blocked Iraqi property must be submitted by March 1, 1991, or within 15 days of the acquisition of the property, whichever is later. This information is needed by the U.S. Government to monitor compliance with the asset freeze imposed by President Bush following Iraq's invasion of Kuwait on August 2, 1990.

Copies of the necessary report forms were published in yesterday's Federal Register, or can be obtained by contacting one of the twelve regional Federal Reserve Banks located throughout the country or by calling the Office of Foreign Assets Control at (202) 535-4026. Photocopies of the report forms may be used.

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NB-1129

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

February 12, 1991

ROGER BOLTON
ASSISTANT SECRETARY (PUBLIC AFFAIRS/PUBLIC LIAISON)
TO LEAVE TREASURY

Roger Bolton, Assistant Secretary for Public Affairs and Public Liaison, today announced his resignation, effective March 15, in order to accept a position in the private sector.

Mr. Bolton has served in his present position since 1989. Prior to that, he was Special Assistant to President Reagan for Public Liaison and Assistant U.S. Trade Representative for Public Affairs and Private Sector Liaison. He was Director of Speechwriting for Reagan-Bush '84 and before that worked for nine years on Capitol Hill.

NB-1130

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 12, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $11,811 million of 52-week bills to be issued on February 14, 1991 and mature on February 13, 1992 were accepted today (CUSIP: 912794XZ2).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.83%	6.19%	94.105
High	5.85%	6.21%	94.085
Average	5.85%	6.21%	94.085

Tenders at the high discount rate were allotted 49%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	39,225	39,225
New York	30,156,475	10,523,695
Philadelphia	23,250	23,250
Cleveland	41,805	41,805
Richmond	41,410	41,410
Atlanta	35,995	34,975
Chicago	2,032,345	287,545
St. Louis	31,265	21,225
Minneapolis	14,635	13,635
Kansas City	47,535	47,535
Dallas	23,235	23,235
San Francisco	745,295	254,035
Treasury	459,775	459,750
TOTALS	$33,692,245	$11,811,320
Type		
Competitive	$29,450,700	$7,569,775
Noncompetitive	1,171,445	1,171,445
Subtotal, Public	$30,622,145	$8,741,220
Federal Reserve	2,900,000	2,900,000
Foreign Official Institutions	170,100	170,100
TOTALS	$33,692,245	$11,811,320

An additional $716,900 thousand of bills will be issued to foreign official institutions for new cash.

NB-1131

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
February 12, 1991

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 $19,200 million, to be issued February 21, 1991. This offering will result in a paydown for the Treasury of about $175 million, as the maturing bills are outstanding in the amount of $19,382 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Tuesday, February 19, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $9,600 million, representing an additional amount of bills dated November 23, 1990, and to mature May 23, 1991 (CUSIP No. 912794 WK 6), currently outstanding in the amount of $10,484 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $9,600 million, to be dated February 21, 1991, and to mature August 22, 1991 (CUSIP No. 912794 XD 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 February 21, 1991. 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 $965 million as agents for foreign and international monetary authorities, and $4,813 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 competitive 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.

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.

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.

8/89

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

FOR RELEASE AT 4:00 P.M.
February 13, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $21,000 MILLION

The Treasury will auction $12,000 million of 2-year notes and $9,000 million of 5-year notes to refund $9,962 million of securities maturing February 28, 1991, and to raise about $11,050 million new cash. The $9,962 million of maturing securities are those held by the public, including $696 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $21,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $1,100 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

NB-1133

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED FEBRUARY 28, 1991

February 13, 1991

Amount Offered to the Public ...	$12,000 million	$9,000 million
Description of Security:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series X-1993 (CUSIP No. 912827 ZY 1)	Series L-1996 (CUSIP No. 912827 ZZ 8)
Maturity date	February 28, 1993	February 29, 1996
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	The last calendar day of August and February through February 28, 1993.	The last calendar day of August and February through February 29, 1996.
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
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Receipt of tenders	Wednesday, February 20, 1991	Thursday, February 21, 1991
a) noncompetitive	prior to 12:00 noon, EST	prior to 12:00 noon, EST
b) competitive	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Thursday, February 28, 1991	Thursday, February 28, 1991
b) readily-collectible check ...	Tuesday, February 26, 1991	Tuesday, F[illegible]

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.
FEBRUARY 20, 1991

**TESTIMONY OF NICHOLAS F. BRADY
BEFORE THE
HOUSE APPROPRIATIONS COMMITTEE
FEBRUARY 20, 1991**

Mr. Chairman and Members of the Committee, I am pleased to meet with you to discuss President Bush's FY 1992 budget and other issues. My comments will concentrate on selected features of the budget. Director Darman will discuss the budget in detail and Chairman Boskin will review the economic forecast.

We meet today at a difficult time. We are at war in the Gulf, the economy is in recession, and problems inherited from the past continue to occupy our attention. We cannot shirk our responsibility to make government a positive and effective force in dealing with the current problems that we are expected to address, while at the same time investing for America's future.

Although economic and budget realities constrain our actions, I believe that this budget achieves the goals of meeting our ongoing responsibilities, addressing problems inherited from the past, and building a base for future economic growth and competitiveness.

The need to restrain government spending and abide by the terms of the budget agreement is an over-arching concern. Over the next five years, the Federal government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the budget agreement. Although a sharp rise in the near-term deficits may obscure our efforts, there is widespread consensus that this budget agreement is an effective effort to deal with the deficit.

Furthermore, important budget process reforms were adopted to ensure that the deficit reduction targets are met. These process reforms are an integral part of the agreement and it is essential that both the letter and spirit of these reforms are adhered to.

President Bush's budget, which increases spending less than inflation, represents a strong commitment to reducing future budget deficits. Deficits have a corrosive effect on economic activity. They crowd private borrowers out of financial markets, and they represent a large diversion of our national savings away from investment in new plant and equipment, research and development, and other uses which would directly enhance productivity and competitiveness and create economic growth. In short, deficits make it more difficult to manage our macroeconomic affairs and ultimately they reduce our economy's growth potential.

Our 1992 budget priorities have been set to keep future budget deficits on a downward path. Our plans for dealing with current problems, as well as the need to improve economic growth and prepare our economy for the international challenges of the future, have been shaped by this necessity. Given the overall budgetary constraint, this necessarily requires a re-ordering of priorities.

Although the pressure to deal with contemporaneous demands is always great, the Bush Administration believes that we must also look to the future. Toward this end, we have made a number of proposals for addressing the economy's long-term growth potential.

Since productivity is <u>the</u> critical element in the long-term well-being of the American economy and the key to our international competitiveness, it must be a central focus of attention. Although many factors affect productivity, three of the most important are education, investment, and technology. And, as I will discuss later, this budget addresses all three of these elements.

Of course, the long-run cannot begin until we get past the short-run. In the near-term there are several uncertainties that affect our budgetary situation. The most important are the depth and duration of the recession and the length of the war in the Gulf.

A further uncertainty is the unpredictable course of the S&L cleanup. The RTC has moved aggressively to deal with this problem and progress has already been made. Quick action by Congress on funding, combined with lower interest rates and an early end to the recession, will help us continue to move ahead on this problem.

The Administration anticipates a recovery from the recession beginning by mid-year and a brisker upturn in the latter part of the year, which should bring the unemployment rate down and put us back on a growth track.

President Bush's budget sets an important marker which we believe must be adhered to--namely, to hold spending growth below the rate of inflation. In other words, the real level of spending must decline. The reason is simple: spending growth is what has fueled the deficit. Unless we can hold the level of spending below the inflation rate, we cannot hope to make the kind of progress on reducing the deficit which the American people expect of us.

To fulfill our responsibility to the economy and make good on the promises made in OBRA, it is essential that we get the deficit down by controlling spending. It will not be easy. We have already done a good deal of the hard first steps and economic recovery can do much of the rest.

Within the context of spending restraint and deficit reduction, this budget shows there is still room for action and initiative. We have just put forward a comprehensive plan for fundamental reform of the banking system. Such a reform is necessary to build capital in the banking industry, protect taxpayers and depositors, and remove archaic restrictions on banking activities. Our goal is to provide the American people with the best quality financial services available, and to provide our banks with the tools to meet the challenge of international competition. I have appended a summary of our reform proposal to my testimony.

In addition, the President has proposed extension of the targeted jobs tax credit, to help deal with the problem of unemployment among the economically disadvantaged, and extension of the low-income housing credit, to encourage private construction of low-income housing. We are also asking for extension of the solar and geothermal energy credits to encourage investment in renewable energy technologies.

Together, these proposals address some of the issues facing us today--problems of financial institutions, unemployment, housing and energy. However, as I mentioned earlier, we also have a responsibility to deal with the long term. Toward this end, President Bush has put forward in this budget initiatives to improve our Nation's educational system by providing opportunities for individual choice, and to improve and expand our Nation's transportation system. In addition, we are asking Congress to support the following initiatives designed to induce long-term economic growth and competitiveness:

1. Family Savings Accounts. Increasing national saving is critical to providing the capital our economy will need to modernize and expand its productive capacity. We believe that providing individuals with a new savings vehicle will help stimulate such saving.

2. A permanent research and experimentation (R&E) credit. Research and experimentation are essential to innovation and growth. We believe that the R&E tax credit is an effective method of promoting private

research and development. But it needs to be enacted permanently if we are to derive its maximum benefit.

3. Enterprise Zones. The problems of the inner city and rural America demand a new approach. We believe that enterprise zones can be an effective method of targeting private resources to areas that are experiencing economic distress.

4. Permit withdrawals from IRAs for first-time home buyers. Owning a home is part of the American dream. But many younger people increasingly find it beyond their reach. We believe that permitting penalty-free withdrawals from individual retirement accounts for first-time buyers will not only bring home ownership within the means of more people, but also provide a greater incentive for young people to open and contribute to IRAs.

5. A capital gains tax differential. We believe that entrepreneurial activity is the engine that drives the economy in the long run, creating new inventions, products, and services that sustain growth. This is why a reduction in the capital gains tax is important. We are hopeful that Chairman Greenspan, working with Congress and the Administration, can illuminate and help resolve the disagreements on this issue.

We believe that these incentives will help achieve our economy's long-term growth potential and provide the tools to meet the competitive challenges of the future.

In closing, I would like to turn briefly to the international sphere. It is increasingly clear that we live in an integrated world economy and that the economic health of other nations is essential to our own. The budget reflects this. Funding is provided for President Bush's Enterprise for the Americas Initiative, to help improve trade and investment for our neighbors in the Western Hemisphere. We are also lending a helping hand for economic reform in Eastern Europe, through direct aid and technical assistance. And we continue to support the critical role of the international financial institutions, including the IMF and the World Bank.

Mr. Chairman, I would now be happy to take your questions.

TREASURY NEWS

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TEXT AS PREPARED
FOR IMMEDIATE RELEASE

Contact: Cheryl Crispen
202-566-2041

THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
MT. RUSHMORE COMMEMORATIVE COIN LAUNCH
FEBRUARY 15, 1991
WASHINGTON, D.C.

Thank you, Cathi (Villalpando). And many thanks to Donna Pope and her staff at the U.S. Mint who have done a tremendous job. Finally, I'd like to welcome our honored guests -- all the people who make the U.S. Commemorative Coins Program a success.

Today, we are meeting at a time of international crisis. More than half a million Americans -- and their allies from over 20 nations -- are fighting in the Persian Gulf against aggression and for freedom, decency and humanity. Our hopes and prayers go out to those brave men and women every day. They are the nation's best, and they deserve nothing less than our unstinting support.

Elsewhere in the world, formerly shackled nations are now struggling to solidify their own emerging democracies. Eastern Europe and Latin America are on the threshold of democratic government and free market economies -- proving that ideas of individual and economic freedom are alive and well.

That's why this ceremony is so appropriate. For, we are here to introduce the coins honoring the four great Americans of Mt. Rushmore -- Washington, Jefferson, Lincoln and Theodore Roosevelt -- men whose values, ideas and actions laid the groundwork for, and perpetuated, our nation's commitment to protect freedom, democracy and economic competition here at home and abroad.

But as we honor past greatness, we must also look forward. In his State of the Union Address, President Bush said we must invest in the future. And investing in the future is a central theme in the Commemorative Coin Program.

Since 1982, the Commemorative Coin Program has earned more than $180 million to reduce the national debt. It also has contributed over $190 million to many non-profit programs of national importance.

Clearly, the preservation and improvement of Mt. Rushmore National Monument deserves to be part of that effort. Through your work in the numismatic community, the spectacular Mt. Rushmore monument will be cleaned, restored and ready for its 50th anniversary this summer -- and prepared to inspire millions of visitors well into the 21st century.

We look forward to the 50th Anniversary celebration at Mt. Rushmore in July. It will be the culmination of your dedicated efforts to make this celebration a success.

Thank you for the great work you've done. Our common efforts have contributed significantly to securing in the national consciousness the democratic ideals and principles that keep America free and strong. And if past is prologue, then I know we can continue to depend on your future contributions.

Thank you.

TREASURY NEWS

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FOR IMMEDIATE RELEASE
February 15, 1991

CONTACT: Bob Levine
(202) 566-2041

TAX INFORMATION EXCHANGE AGREEMENT BETWEEN
UNITED STATES AND COSTA RICA ENTERS INTO FORCE

The Treasury Department announced today that the United States and Costa Rica have exchanged diplomatic notes that activate an agreement to exchange tax information (the "Agreement") that satisfies the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983. The Agreement was signed in San Jose on March 15, 1989 and is effective February 12, 1991.

With the Agreement in effect, Costa Rica qualifies as a jurisdiction in which Puerto Rican financial institutions may make certain investments of funds derived from U.S. section 936 companies. Such funds may be used to finance investments in qualifying development projects in Costa Rica.

Another benefit of the Agreement is that Costa Rica will now be considered part of the "North American Area" for purposes of determining whether U.S. taxpayers may deduct expenses incurred in attending conventions, business meetings, and seminars. Therefore, convention expenses incurred by U.S. taxpayers for meetings in Costa Rica that are otherwise deductible as ordinary and necessary business expenses will be allowed without regard to the additional limitations applicable to foreign convention deductions.

Finally, Costa Rica will now qualify 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.

The United States also has Tax Information Exchange Agreements in effect with Barbados, Dominica, The Dominican Republic, Grenada, Jamaica, Trinidad and Tobago, Mexico and Bermuda. All but the final two are Caribbean Basin Initiative countries.

A limited number of copies of the Agreement are available from the Treasury Public Affairs Office, Treasury Department, Room 2315, Washington, D.C. 20220.

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NB-1136

TREASURY NEWS

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STATEMENT OF
THE HONORABLE PETER K. NUNEZ
ASSISTANT SECRETARY OF THE TREASURY FOR ENFORCEMENT
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
SUBCOMMITTEE OF FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
FEBRUARY 19, 1991

Introduction

Mr. Chairman and Members of the Committee, I would like to thank you for this opportunity to testify about H.R. 26, introduced by Chairman Annunzio, and H.R. 950, introduced by Mr. Wylie, legislative proposals relating to money laundering and Bank Secrecy Act enforcement and to international anti-money laundering cooperation.

In recent years Treasury has found this Committee to be an ally in the fight against money laundering. In 1986, in 1988, in 1990, and now, in 1991, this Committee has been willing to tackle legislative solutions to deal with the ever-changing money laundering landscape. We share the commitment to close the doors of legitimate financial institutions to money launderers and to see that banks and other financial institutions are equally committed to being active partners with law enforcement. Treasury also shares the concern that law enforcement needs to be balanced with other legitimate considerations such as the cost to financial institutions. In this difficult time for the banking industry, this issue of balance takes on pressing significance.

Role of the Assistant Secretary for Enforcement

As Assistant Secretary for Enforcement, I have been delegated by the Secretary of the Treasury government-wide responsibility for Bank Secrecy Act enforcement and for coordinating policies affecting Treasury investigatory responsibility for the crime of money laundering. Treasury's Financial Crimes Enforcement Network (FinCEN) reports directly to the Assistant Secretary for Enforcement. Within my office, the Office of Financial Enforcement has primary responsibility for supervision of Bank Secrecy Act enforcement and money laundering activities.

With me today are Brian Bruh, Director of FinCEN and Peter Djinis, Acting Director of the Office of Financial Enforcement. FinCEN, as most of you know, has been established within Treasury

NB-1137

at Secretary Brady's initiative to provide a multi-source data access and financial analysis service to Federal, State, local and foreign law enforcement to assist in the investigation and prosecution of money laundering and other crimes. In performing this analysis function, FinCEN builds on Treasury's experience over the years in analyzing Bank Secrecy Act and other financial data.

The Office of Financial Enforcement is responsible for Bank Secrecy Act enforcement and compliance, including the promulgation of administrative rulings, the assessment of civil penalties, international law enforcement initiatives aimed at combating money laundering, and monitoring a series of delegations to IRS and to the regulatory agencies which examine the various types of financial institutions subject to the currency reporting and recordkeeping provisions of the Bank Secrecy Act.

Treasury has delegated responsibility for examination of compliance with the Bank Secrecy Act to the regulatory agencies according to the types of institutions they examine. For instance, the Federal Reserve Board is responsible for state chartered member banks, the FDIC for state chartered banks that are not Federal Reserve members, and the Comptroller of the Currency for national banks. Compliance responsibility for the various miscellaneous or non-bank financial institutions subject to the Bank Secrecy Act such as transmitters of funds, check cashiers, foreign currency brokers, and casinos rests with the IRS Examination Division.

Charter Revocation

Now, I would like to turn to the bills under consideration by this Committee. Both H.R. 26 and 951 are rooted in and expand upon H.R. 3848, a bill that passed the House overwhelmingly last year, but was not enacted. As I testified last March, the Administration generally supports these initiatives.

Both H.R. 26 and 950 provide that banks, including saving associations and credit unions, convicted of money laundering or Bank Secrecy Act violations could be placed into conservatorship or, if a bank and more than one senior official or director were convicted, the bank could forfeit its national charter or lose its federal deposit insurance. We agree with the objective of these provisions -- to send a loud and clear message to banks and bankers that money laundering and compliance programs that leave institutions vulnerable to money laundering will not be tolerated. We also agree that in egregious cases where banks have, in effect, become criminal enterprises, banks convicted of money laundering should be closed. Furthermore, the bills both provide that relevant factors will be considered and procedural safeguards followed to insure that closing is in no way automatic upon conviction.

Non-Bank Financial Institutions

A number of provisions in the bill deal with the difficult issue of money laundering through businesses such as foreign currency exchanges, casas de cambio, issuers and redeemers of traveler's checks, check cashers, and transmitters of funds. These institutions are among what Treasury refers to as the miscellaneous or non-bank financial institutions subject to the Bank Secrecy Act recordkeeping and reporting requirements.

As I testified last year, it is undisputed that as Bank Secrecy Act compliance by banks has improved, drug money launderers have and will continue to turn to other methods to convert street currency into monetary instruments and even transmit abroad the proceeds of drug sales.

The IRS Examination Division is responsible for examining these institutions. This is an enormously difficult job given the sheer number of institutions, and the fact that the industries are largely unregulated. Simply put, Bank Secrecy Act requirements and IRS compliance review alone cannot turn this situation around. What is needed is state licensing and regulation as set forth in section 10 of H.R. 26 and 951.

The bill provides for development of model state legislation which includes licensing, licensing standards, state penalties for Bank Secrecy Act violations, and criminal penalties for operating without a license. One year after the date of enactment, the Secretary of the Treasury would be required to report to Congress concerning progress made in developing a model statute, the adequacy of the activities of the states to enforce such statutes, and the resources made available to the appropriate state agencies for enforcement. The Secretary would make recommendations in this report on incentives for or sanctions against states that had failed to enact and enforce a statute or to apply adequate resources for enforcement.

We agree that, based on our experience with these institutions Treasury, perhaps through IRS, would be the appropriate Federal agency to undertake this task. However, we are concerned that a one-year time frame may be insufficient for the states to enact and enforce statutes or for Treasury to do an adequate review of the systems of fifty states.

Nevertheless, we believe this is a good proposal that will focus the attention of state governments on this problem, place the emphasis on state licensing and enforcement where we believe it should be, and lead to a regulatory system that will complement Treasury's Bank Secrecy Act enforcement program for these institutions.

Even licensing and regulation, however, are not enough. In addition, non-bank financial institutions must also be required to take affirmative measures to ensure that they are not victimized by money laundering. To this end, they must be required to take anti-money laundering measures comparable to those taken by banks and be subject to sanctions for failure to do so. Therefore, as I will discuss shortly, Treasury seeks authority to require these institutions to report suspicious transactions and have anti-money laundering compliance programs. Failure to take such steps would subject these institutions to the sanctions of the Bank Secrecy Act.

Section 15 - CTR Exemptions

There are a few sections in the bills that Treasury cannot support. For instance, section 15 calls for banks to require that customers on a bank's list of businesses exempt from the Currency Transaction Reporting requirements file a statement with the bank annually regarding entitlement to the exemption. Section 15 also would require that the list of exempt customers, which is required to be kept by Treasury regulations, be filed annually with Treasury.

Treasury already has the ability to effect these measures under current legislative authority, and has considered and rejected such measures in the past. Our conclusion is that annual certification and centralization of exemption lists would be overly burdensome and that the costs would not be justified by the resulting law enforcement benefit.

A provision in the Anti-Drug Abuse Act of 1986 required that prior to being placed on an exempt list customers execute a statement describing why the person is entitled to an exemption. There is no need for bank customers to sign a new statement each year because under Treasury guidelines, banks should annually review the continued appropriateness of exemptions, both with respect to the nature of the customer's business and the exemption amount. Banks must obtain a new exemption statement if the bank discovers that the information to which the customer attested has changed.

With respect to filing of exemption lists centrally, maintaining a centralized automated list would be a very expensive undertaking which Treasury does not believe is justified at this time. FinCEN is currently conducting a thorough review of the entire exemption system. This review should be completed before any decision is made on the need for this provision.

Section 14 - Prosecutorial Guidelines

The provision that gives the Administration the most concern is section 14, which provides that the Secretary of the Treasury, with respect to civil enforcement, and the Attorney General, with respect to criminal enforcement, shall submit their decision whether to issue prosecutorial guidelines on enforcement of the Bank Secrecy Act and the crime of money laundering to public comment. The question to be addressed by the public comment is whether compliance and cooperation with law enforcement would be enhanced by issuance of public prosecutorial guidelines.

The public issuance of prosecutorial guidelines would be unprecedented and plainly and simply is a bad idea. No rulemaking process is necessary to reach this conclusion. Guidelines exist for the civil enforcement of the Bank Secrecy Act. Those guidelines are flexible and do not give rights to third parties. Certainly, the degree to which a financial institution cooperates, makes timely reports of violations, and takes measures to lessen its vulnerability to money laundering, are all factored into a decision whether to proceed against a bank civilly or criminally. Treasury and the Justice Department are not about to issue these guidelines, which also include sensitive information, to be broadcast to potential violators.

The concern underlying this provision appears to be the Administration's opposition to a statutory safe harbor from prosecution for financial institutions that report suspicious transactions. We agree with the Justice Department that whether a bank's suspicious transaction report was timely should not become yet another legal issue in a money laundering case. The financial institutions conduct on the whole will be viewed in assessing whether there was corporate intent. We are confident that absent unusual circumstances, if a bank took appropriate measures to guard against money laundering and nevertheless discovered that it was used by money launderers, it would not be prosecuted following a report of the illegal activity to federal law enforcement.

Right to Financial Privacy Act

A provision that would be helpful to encourage the reporting of suspicious transactions would be an expansion upon the suspicious transaction exception in the Right to Financial Privacy Act.

Since the inception of the Right to Financial Privacy Act, there has been an exception that allows financial institutions to report, in good faith, possible violations of law or regulation to federal authorities without notice to the suspected customer and free from civil liability under the RFPA. At the Administration's request, Congress further clarified this provision in the Anti-Drug Abuse Act of 1986 and 1988 to specify what information a financial institution could give regarding the customer and the suspicious activity, and that the protection pre-empted any state law requiring notice to the customer. These changes were added to ensure that financial institutions would not be inhibited from reporting suspected violations, especially money laundering and Bank Secrecy Act reporting violations.

Nevertheless, there are other concerns beyond liability under privacy laws that may complicate treatment of suspicious transactions. For instance, financial institutions may risk defamation actions or, if they sever relations with a customer, may risk liability under the Fair Credit Reporting Act or for breach of contract. Financial Institutions also should be free to sever relations with a customer based on their suspicions without fear of liability.

The Administration would address these concerns by extending the suspicious transaction protection to a financial institution that severs relations with a customer or refuses to do business because of activities underlying a suspicious transaction report. It should also be specified that the financial institution that acts in good faith in reporting a suspicious transaction is protected from civil liability to the customer under any theory of state or Federal law, not just under financial privacy laws. A similar provision was contained last year in H.R. 3848, but is not in the bills before us now.

The protection should also be extended to the wide range of bank and non-bank institutions subject to the Bank Secrecy Act, 31 U.S.C. 5312. Currently, the protection applies only to financial institutions as defined in the RFPA -- banks, credit unions, savings associations. Nevertheless, non-bank financial institutions may similarly be inhibited from reporting suspicious transactions by fear of civil liability for defamation or breach of contract or under financial or consumer privacy laws.

International Funds Transfers

Both bills require Treasury to have final regulations relating to records maintained by banks and non-bank financial institutions with respect to international funds transfers, particularly by wire, by a certain date -- H.R. 26 by May 1, 1991 and H.R. 951 by October 1, 1991. The section responds to the number of major money laundering schemes involving the wire transfer system in recent years.

In October 1990, Treasury issued a notice of proposed rulemaking setting forth the provisions for enhanced recordkeeping for both domestic and international funds transfers. The comment period on this proposal closed on January 15, 1991, and we are in the process of reviewing over 300 comments received in response to that notice.

In the interim, Treasury has determined that for the foreseeable future, it will not require reporting, as distinct from recordkeeping, of funds transfers, international or domestic. The volume of fund transfer transactions and the difficulty posed of detecting through automated methods a money laundering scheme when it is already in mid-course, led to this decision. FinCEN continues to study the feasibility of developing a suspicious wire transfer profile.

Modifications to the proposed rule are under study. Our goal is to insure that adequate information exists in an accessible form for investigators to follow the trail of funds in money laundering and other financial crimes cases. We hope to develop requirements that will meet this objective at the least possible burden for financial institutions.

Treasury's preference would be for Congress to remove any statutory deadline for this rulemaking, or at a minimum, to adopt the October date for a final rule in H.R. 950. This would give us the latitude to renotice a revised funds transfer regulation for comment, if necessary.

Section 32 - GAO Study

Treasury does not believe that a GAO study on the utility of Bank Secrecy Act reporting, called for in section 32 of H.R. 950, is necessary because, to a large extent, it would duplicate ongoing efforts by Treasury. A section in the Crime Control Act of 1990 signed into law in November, requires Treasury to submit a comprehensive study on the uses of Bank Secrecy Act and 8300 information (cash reports by trades or businesses other than financial institutions) to Congress at the end of May and biannually after that for four years. This study is underway and should obviate the need for a GAO study. FinCEN also has recently completed a report on the utility of Bank Secrecy Act reporting which Treasury will make available to the Committee.

Section 22 - International Discussions

Treasury agrees with the general approach of section 22 of Mr. Wylie's bill to assure that other countries of the world, especially financial center countries, continue to join with us in effecting comprehensive anti-money programs and cooperating in international money laundering cases. The section directs the Secretary of the Treasury to enter discussions with countries whose institutions are engaging in activities involving the proceeds of international narcotics sales to encourage the countries to develop comprehensive anti-money laundering measures and to cooperate with U.S. authorities in drug and money laundering cases. Treasury would report periodically to the Banking Committees on the progress of these discussions and recommend appropriate action to Congress with respect to countries which had made inadequate progress.

This proposal, in effect, directs the Administration to continue what it has been doing in the international arena in recent years. Treasury, Justice and the State Department working together have made an important contribution to the worldwide progress that has been made in addressing the problem of international money laundering.

Section 22 reflects the understanding that this progress starts with persuading countries that international money laundering is a shared problem from which no country is immune; that it is in each country's own best interests to take effective measures to address the problem domestically and to cooperate in international cases.

The section also recognizes that this is an evolutionary process. This progress can be measured concretely in the number of significant international initiatives to address international money laundering, such as the UN Narcotics Convention, which recently came into force, and the ongoing G-7 Financial Action Task Force, the Caribbean Drug Money Laundering Conference, the OAS initiative to draft model legislation, and other initiatives in the European Community and the Council of Europe.

In addition, many individual countries are taking major legislative and regulatory action in response to the FATF and other international commitments -- Switzerland, Canada, France, Italy, Spain, Luxembourg, to name a few. Progress can also be measured by recent international money laundering cases that have been brought to a successful conclusion through the cooperation of foreign law enforcement, such as Operations C-Chase and Polar Cap.

Section 22 would replace section 4702 of the Anti-Drug Abuse Act of 1988, commonly known as the Kerry Amendment. That section requires Treasury to enter agreements with countries to require records of currency transactions over $10,000 in United States dollars and to share those records with U.S. law enforcement agencies upon request in drug cases. The sanction for failure to enter an agreement is that the financial institution of a country would be precluded from the U.S. banking system.

Section 22 would be a significant improvement over section 4702. Section 4702 focuses on what is a very small, although necessary, element of a comprehensive money laundering program, large dollar currency recordkeeping. In addition, sanctions under section 4702 have posed an impediment to reaching 4702 agreements. The statute is perceived by many countries as having an improper extraterritorial effect. Countries that have taken measures that meet and go beyond 4702 will not enter section 4702 agreements because of the perceived extraterritorial principle at stake. Moreover, the sanctions contemplated by section 4702 would be difficult to enforce and, in our view, would have a detrimental effect on U.S. economic interests that may exceed the damage to the sanctioned party.

Treasury suggests that section 22 be recast as a sense of the Congress resolution, in effect expressing a Congressional recommendation rather than a direction to enter these discussions. A direction to enter discussions or negotiations with foreign governments raises the concern of improper interference with the President's foreign policy making authority. The recommendation should be made to the President who in the efficient administration of the Executive Branch will determine the agencies to give effect to the recommendation. Treasury, Justice and State jointly, are the three agencies that are working in tandem in this area.

FATF

I spoke a moment ago of the success of the G-7 Financial Action Task Force on money laundering in furthering the goal of forging a network of countries committed to effective anti-money laundering measures. In Treasury's view the most important legislative amendments in this session of Congress relate to implementation of the recommendations of that group. Treasury has submitted proposed legislative language to this end to the subcommittee staff.

By way of background, the FATF was convened by the 1989 G-7 Summit to study the state of international cooperation on money laundering and measures to improve cooperation in international money laundering cases. The group was composed of fifteen financial center countries and the European Community. After numerous meetings of experts from law enforcement, justice and finance ministries, and bank supervisory authorities, in April 1990, the group issued a comprehensive report with 40 action recommendations for comprehensive domestic anti-money laundering programs and improved international cooperation in money laundering investigations, prosecutions, and forfeiture proceedings. The recommendations of the group have become the world model for effective anti-money laundering measures.

President Bush and the other heads of state and government endorsed the report of the Financial Action Task Force at the Houston Economic Summit in the summer of 1990, and the financial ministries of non-G-7 participants also endorsed the report. The Houston Summit reconvened the Task Force for another year. The mandate of the reconvened Task Force is to study possible complements to the original recommendations, to assess implementation of the recommendations, and to study how to expand the number of countries that subscribe to the recommendations. The reconvened Task Force is currently meeting. The original members have been joined by seven other European countries, and by Hong Kong, New Zealand, and the Gulf Cooperation Council.

By their endorsement, the United States and the other Task Force members are committed to take necessary legislative and regulatory measures to implement the recommendations. Most of the countries are in the process of developing the necessary legislation. As can be expected, most of the recommendations reflect measures already in place in the United States because the United States was among the first countries to recognize the need for a comprehensive regulatory and legislative response to money laundering. Nevertheless, to fully measure up to the recommendations, our program requires some legislative refinements.

First, the Task Force recommendations provide that the same anti-money laundering measures recommended for banks be put in place for non-bank financial institutions, such as the requirement to report suspicious transactions possibly indicative of money laundering and to create anti-money laundering programs. The world experience mirrors the experience in the United States that as banks become more effective in guarding against money laundering, money launderers turn to non-bank financial institutions. As we have discussed, many of these institutions are subject to the recordkeeping and reporting requirements of the Bank Secrecy Act, but unlike banks are not required to report suspicious transactions nor to have compliance programs to guard against money laundering.

Treasury proposes an amendment to the Bank Secrecy Act to authorize the Secretary to require, by regulation, the reporting of suspicious transactions by any financial institution subject to the Bank Secrecy Act. Also in furtherance of the FATF recommendations, a financial institution, bank or non-bank, should be prohibited from warning its customer if it made a suspicious transaction report. As just noted, under the RFPA, a financial institution may report a suspicious transaction free from civil liability for not notifying its customer, but is not specifically prohibited from warning the customer. The FATF concluded that in order for suspicious transactions reporting to be effective there must be a prohibition from notifying the persons involved in the suspicious transaction.

Tracking the language of another FATF recommendation, Treasury also proposes an amendment to the Bank Secrecy Act to authorize the Secretary to require financial institutions subject to the Bank Secrecy Act to have anti-money laundering programs which include, at a minimum, development of internal policies, procedures, and controls, designation of a compliance officer, an ongoing employee training program, and an independent audit function to test the program. The Secretary would be able to promulgate minimum standards for such procedures.

This FATF recommendation was based on the regulations the U.S. bank regulators have in place pursuant to 12 U.S.C. 1818(s) to ensure Bank Secrecy Act compliance. The Secretary already has authority under 31 U.S.C. 5318 to promulgate regulations that require financial institutions to maintain procedures to ensure compliance with requirements of the Bank Secrecy Act. This amendment would eliminate the requirement that the procedures be linked to a Bank Secrecy Act requirement, i.e., currency transaction reporting. The procedures would be directed at money laundering generally, whether or not a customer dealt in cash. For instance, this authority could be used to require that anti-money laundering programs include "know your customer" procedures.

The Department of the Treasury envisions that the proposed authority could be used with respect to any institution subject to the Bank Secrecy Act under 31 U.S.C. 5312 whether or not that institution is required to report currency transactions under the Bank Secrecy Act.

These are important to the U.S. financial enforcement program and enactment will demonstrate the commitment of the Congress to stand behind the United States' endorsement of the report. It will also demonstrate that the United States is not just willing to "teach" effective anti-money laundering measures in international forums, but to learn from the experiences of others.

Conclusion

Finally, I would again like to express the Treasury's appreciation to the Members and staff of this subcommittee who have committed their time and attention to combating money laundering -- an area which is a critical one for law enforcement. Our partnership in the legislative arena has severely restricted the available avenues for drug and other types of money launderers. The pending legislation has the potential to restrict further their ability to operate, and the Treasury Department stands ready to assist in any way as the bill moves through the legislative process.

This concludes my prepared remarks, I will be happy to respond to any question you may have.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 19, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $9,647 million of 13-week bills to be issued on February 21, 1991 and mature on May 23, 1991 were accepted today (CUSIP: 912794WK6).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.92%	6.09%	98.504
High	5.94%	6.11%	98.499
Average	5.94%	6.11%	98.499

$1,000,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 90%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	38,955	38,955
New York	25,831,290	7,989,380
Philadelphia	23,005	23,005
Cleveland	38,840	38,840
Richmond	139,380	39,380
Atlanta	33,430	31,430
Chicago	1,369,375	71,875
St. Louis	11,595	11,595
Minneapolis	8,525	8,525
Kansas City	36,525	36,525
Dallas	22,360	22,260
San Francisco	1,031,035	408,535
Treasury	927,050	927,050
TOTALS	$29,511,365	$9,647,355
Type		
Competitive	$25,133,985	$5,269,975
Noncompetitive	1,721,055	1,721,055
Subtotal, Public	$26,855,040	$6,991,030
Federal Reserve	2,463,385	2,463,385
Foreign Official Institutions	192,940	192,940
TOTALS	$29,511,365	$9,647,355

An additional $26,060 thousand of bills will be issued to foreign official institutions for new cash.

5.89--98.511 5.93--98.501

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
February 19, 1991

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 $18,400 million, to be issued February 28, 1991. This offering will result in a paydown for the Treasury of about $650 million, as the maturing bills are outstanding in the amount of $19,045 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, February 25, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $9,200 million, representing an additional amount of bills dated November 29, 1990, and to mature May 30, 1991 (CUSIP No. 912794 WL4), currently outstanding in the amount of $10,465 million, the additional and original bills to be freely interchangeable.

182 -day bills (to maturity date) for approximately $9,200 million, representing an additional amount of bills dated August 30, 1990 and to mature August 29, 1991 (CUSIP No. 912794 WT7), currently outstanding in the amount of $10,631 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 February 28, 1991. 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 $1,410 million as agents for foreign and international monetary authorities, and $4,333 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-1139

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 competitive 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.

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.

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.

8/89

PUBLIC DEBT NEWS
Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 19, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $9,627 million of 26-week bills to be issued on February 21, 1991 and mature on August 22, 1991 were accepted today (CUSIP: 912794XD1).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.91%	6.18%	97.012
High	5.92%	6.19%	97.007
Average	5.91%	6.18%	97.012

Tenders at the high discount rate were allotted 19%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	31,880	31,880
New York	25,659,770	8,351,805
Philadelphia	16,665	16,665
Cleveland	30,530	30,530
Richmond	37,430	37,430
Atlanta	32,750	32,750
Chicago	1,224,845	236,495
St. Louis	17,040	17,040
Minneapolis	6,420	6,420
Kansas City	44,490	42,640
Dallas	18,795	18,795
San Francisco	686,525	115,025
Treasury	689,165	689,165
TOTALS	$28,496,305	$9,626,640
Type		
Competitive	$24,088,955	$5,219,290
Noncompetitive	1,285,590	1,285,590
Subtotal, Public	$25,374,545	$6,504,880
Federal Reserve	2,350,000	2,350,000
Foreign Official Institutions	771,760	771,760
TOTALS	$28,496,305	$9,626,640

An additional $82,040 thousand of bills will be issued to foreign official institutions for new cash.

NR-1140

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

FOR IMMEDIATE RELEASE

February 19, 1991

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of January 1991.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $181.1 billion on January 31, 1991, posting an increase of $2.0 billion from the level on December 31, 1990. This net change was the result of a decrease in holdings of agency-guaranteed loans of $500.9 million and in holdings of agency assets of $155.1 million, while holdings of agency debt increased by $2,635.2 million. FFB made 21 disbursements during January.

FFB holdings on January 31, 1991, were the highest in the bank's history.

Attached to this release are tables presenting FFB January loan activity and FFB holdings as of January 31, 1991.

NB-1141

FEDERAL FINANCING BANK

JANUARY 1991 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 #539	1/2	$ 15,000,000.00	4/2/91	6.762%	
+Note #540	1/3	8,120,000.00	4/3/91	6.783%	
+Note #541	1/4	2,500,000.00	2/4/91	6.761%	
+Note #542	1/28	15,000,000.00	4/29/91	6.486%	
RESOLUTION TRUST CORPORATION					
Note No. 91-01					
Advance #1	1/2	53,940,651,055.74	4/1/91	6.761%	
Advance #2	1/14	750,000,000.00	4/1/91	6.465%	
Advance #3	1/15	400,000,000.00	4/1/91	6.349%	
Advance #4	1/31	500,000,000.00	4/1/91	6.511%	
TENNESSEE VALLEY AUTHORITY					
Short-term Bond #75	1/8	179,000,000.00	1/21/91	6.852%	
Short-term Bond #76	1/15	187,000,000.00	1/31/91	6.465%	
Short-term Bond #77	1/21	188,000,000.00	2/7/91	6.426%	
Short-term Bond #78	1/31	238,000,000.00	2/16/91	6.532%	
AGENCY ASSETS					
FARMER'S HOME ADMINISTRATION					
RHIF - CBO #57551	1/1	105,000,000.00	1/1/06	8.249%	8.419% ann.
RHIF - CBO #57552	1/30	375,000,000.00	1/30/06	8.202%	8.370% ann.

+rollover

FEDERAL FINANCING BANK

JANUARY 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
GOVERNMENT - GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
U.S. Trust Company of New York					
Advance #5	1/31	$ 1,260,420.35	5/15/91	6.542%	
RURAL ELECTRIFICATION ADMINISTRATION					
*Basin Electric #137	1/3	6,138,514.68	12/31/18	8.178%	8.096% qtr.
Mt. Wheeler Power #326	1/8	1,241,000.00	3/31/93	7.374%	7.307% qtr.
*United Power Assoc. #145A	1/28	4,302,000.00	12/31/19	8.222%	8.139% qtr.
*United Power Assoc. #159A	1/28	1,798,000.00	12/31/19	8.222%	8.139% qtr.
Continental Tele. South #351	1/30	19,000,000.00	12/31/18	8.242%	8.159% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-91-03	1/31	643,474,813.34	4/30/91	6.532%	

*maturity extension

FEDERAL FINANCING BANK
(in millions)

Program	January 31, 1991	December 31, 1990	Net Change 1/1/91-1/31/91	FY '91 Net Change 10/1/90-1/31/91
Agency Debt:				
Export-Import Bank	$ 11,370.2	$ 11,370.2	$ 0.0	$ 30.4
NCUA-Central Liquidity Fund	80.0	81.5	-1.5	23.4
Resolution Trust Corporation	55,590.7	53,000.0	2,590.7	14,109.0
Tennessee Valley Authority	14,101.0	14,055.0	46.0	-281.0
U.S. Postal Service	6,697.8	6,697.8	-0-	-0-
sub-total*	87,839.6	85,204.5	2,635.2	13,881.7
Agency Assets:				
Farmers Home Administration	52,169.0	52,324.0	-155.0	120.0
DHHS-Health Maintenance Org.	69.6	69.6	-0-	-0-
DHHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,407.2	4,407.2	-0-	-0-
Small Business Administration	7.7	7.8	-0.1	-0.7
sub-total*	56,736.2	56,891.3	-155.1	119.3
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,770.3	5,244.1	-473.8	-4,985.3
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.0
DHUD-Community Dev. Block Grant	232.3	233.0	-0.7	-11.7
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.4
General Services Administration +	478.6	477.4	1.3	111.2
DOI-Guam Power Authority	29.7	29.7	-0-	-0-
DOI-Virgin Islands	24.7	25.3	-0.5	-0.5
NASA-Space Communications Co. +	32.7	32.7	-0-	-1,063.2
DON-Ship Lease Financing	1,624.4	1,672.4	-47.9	-47.9
Rural Electrification Administration	18,906.4	18,889.6	16.8	-135.9
SBA-Small Business Investment Cos.	324.4	325.1	-0.8	-58.2
SBA-State/Local Development Cos.	727.3	729.8	-2.5	-14.3
TVA-Seven States Energy Corp.	2,382.3	2,375.0	7.2	26.2
DOT-Section 511	22.9	22.9	-0-	-0.4
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	36,486.3	36,987.2	-500.9	-6,257.4
grand total*	$ 181,062.1	$ 179,083.0	$ 1,979.2	$ 7,743.7

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT, FINANCE, TRADE AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
FEBRUARY 20, 1991

Introduction

Madam Chair and Members of the Committee, it is a great pleasure to testify before you today. In the coming months, this Committee will consider a wide range of issues, including a number of legislative proposals that are critical to the international economic policies of the United States. Many of these issues and much of the legislation will involve issues for which the Treasury has the primary responsibility in the U.S. government.

The full plate which you will have before you reflects the growing importance of the interrelationship between the world economy and our well-being at home. A few vital statistics highlight this essential reality.

- U.S. trade, which equaled roughly 8 percent of GNP in 1970, now accounts for over 16 percent of our national income.
- The external sector accounted for more than 40 percent of our growth in 1990.
- Roughly one out of every four new jobs in the United States is related to merchandise exports.

Let me review with you a number of areas in which the Treasury is engaged that bear on our ability to foster a sound world economy and stable international monetary system that promotes U.S. political and economic interests. I will also inform the Committee of other areas in which Treasury is involved, including the Persian Gulf crisis, efforts to open markets overseas, and the operations of the Exchange Stabilization Fund (ESF).

Before proceeding with this review, however, let me note that during the seven years which I have been Assistant Secretary and Under Secretary of the Treasury I have consulted extensively with this Committee on a number of major policy issues. This has enabled me to learn from you as well as to take account of your views. We have made some important progress on macroeconomic policy issues and international debt. For my part, I certainly hope that this close consultative arrangement that we have established will continue. I am confident that you share this hope.

Economic Policy Coordination

Our economic relations with the major industrialized G-7 nations -- Canada, France, Germany, Italy, Japan, and the United Kingdom -- comprise one pillar in our efforts to maintain growth and stability in the world economy.

In the 1970s through the mid-1980s, the world saw firsthand the consequences of uncoordinated economic policies in the major countries.

- Divergent economic conditions, coupled with wide fluctuations in currency values, including the sharp appreciation of the dollar, resulted in large trade imbalances.

- For example, the dollar rose around 100 percent against many major European currencies in the early 1980's and the U.S. trade position moved from near balance to a deficit of some $160 billion, 3-1/2 percent of our GNP.

- These developments led to unemployment in many important sectors of our economy and a rapid build-up in the external indebtedness of the United States.

Since 1985, however, the G-7 countries have created a mechanism -- the economic policy coordination process -- to establish the consistent policies necessary for sustained growth with low inflation, reduced trade imbalances, and greater stability of exchange markets. As part of this process, the G-7 have intensified their cooperation on exchange markets. The G-7's record of success has been impressive.

- The major countries have achieved the longest postwar expansion on record -- eight consecutive years of sustained growth.

- Exchange rates better reflecting underlying competitiveness are now in place, contributing to greater stability of exchange markets. For example, the annual range in the movement of the deutschemark against the dollar was 25 pfennigs in 1990 (15.5 percent), down from 100 pfennigs in 1985 (35 percent) and 35 pfennigs in 1987 (19.5 percent).

- As a result, trade imbalances have been reduced sharply in the United States and Japan. Also, the long-awaited reduction in Germany's surplus is now occurring, influenced importantly by reunification.

At the same time, we are now in a period where economic conditions in the major industrial countries are diverging. This situation is posing important new challenges to the coordination process. In the months ahead, there will be a need to intensify efforts to develop consistent mutually supportive policies that will sustain global growth with low-inflation, continue the adjustment of trade imbalances and maintain stable international financial and currency markets.

International Monetary Fund (IMF)

The IMF is another critical pillar of our efforts to promote a sound world economy. The Fund's chief mandate in recent years has been to extend its limited resources in support of comprehensive economic reforms in a large number of member countries. In effect, the IMF provides countries with policy advice and seed money, which helps them put in place the appropriate policies to put their economic house in order.

In so doing, the IMF is supporting U.S. foreign economic policy interests throughout the world.

- In Eastern Europe, the IMF is playing the lead role in restructuring Eastern European economies away from central planning towards private markets. Over the past year, IMF support has been critical to the reform efforts of Poland, Czechoslovakia and Hungary, and to unlocking substantial additional resources for them from other contributors. Estimates suggest the IMF may commit up to $10 billion in 1991 in Eastern Europe.

- In response to the Gulf crisis, the IMF quickly adapted its procedures and policies in order to provide timely support to countries adversely affected by Iraq's brutal aggression. To date, the IMF has disbursed $2.2 billion in increased financing to help countries address higher oil import costs.

- In Latin America, in particular, the IMF is providing essential support for economic policy reforms, and for debt and debt service reduction under the U.S.-led international debt strategy.

- In Africa, the IMF is extending concessional resources to help the poorest countries of the world achieve sustained growth and alleviate widespread poverty.

The resource needs of the IMF are periodically reviewed to ensure that the Fund has adequate resources at hand to fulfill its important systemic responsibilities. Last year, the IMF membership concluded negotiations to increase Fund resources from $130 billion to about $195 billion, a 50 percent increase -- the first such increase since 1983. The U.S. share of the increase is some $12 billion, for which we will be seeking Congressional authorization and appropriation as part of the FY 1992 budget.

The IMF is an extremely cost-effective organization. First, no net budgetary outlays are associated with the use of the IMF quota. Each time the IMF uses dollars, we get in return a liquid, interest bearing reserve claim which we can automatically draw. Second, the IMF leverages our resources, which is especially important at this time of budgetary restraint. For every dollar we put in, others put in four. Third, the United States has effective veto power over key IMF decisions, which uniquely positions the United States to influence the policy direction of the IMF in a manner consistent with our interests. Finally, as part of the recent quota negotiations, we secured agreement on a strengthening of the IMF's arrears strategy, in order to ensure that our increased contribution is used wisely.

Madam Chair and Members of the Subcommittee, we look forward to working with you on the IMF quota increase in the months ahead.

The Multilateral Development Banks (MDBS)

U.S. participation in the World Bank Group and the regional MDB groupings is based on the same premise as our participation in the IMF -- to promote a sound world economy and increased prosperity for all countries. In an interdependent world this means furthering an international economic framework that is open and market-oriented to promote the efficiencies in production that trade fosters. These gains from trade make for a world-wide improvement in living standards.

MDB lending supports this general objective by mobilizing private sector and government resources to finance the basic infrastructure and service projects that improve productivity and living standards in developing countries. Loans from the World Bank and the regional MDBs have financed rural electricity, basic health care, agricultural extension, education, water and sewerage, environmental and resource management, telecommunications, private sector investment, and public sector reform projects.

Project viability, however, is determined not only by the rate of return on a specific project, but also is dependent upon the environment in which a particular project exists. Therefore, the MDBs also engage in adjustment lending to support sectoral and macro economic reforms to improve the domestic policy and institutional environment with the goal of moving a national economy toward self-sustaining economic growth.

Stronger, more stable, growing developing country economies directly help the U.S. economy: they contribute to an expansion of employment in the United States through increased exports.

In addition,the business contracts resulting from MDB projects are a direct and tangible benefit of U.S. participation in the MDBs.

These contracts are composed of three related elements. First, there is the procurement stemming directly from MDB provided finance. U.S. businesses secured roughly $2.0 billion in contracts from the MDBs last year. This compares with U.S. budget expenditures for the MDBs averaging about $1.6 billion annually. Secondly, since the MDBs only provide a portion of the finance needed for a project, there are other procurement possibilities generated by non-MDB finance for a project. Finally, the business contacts established through U.S. business participation in bidding on MDB projects lead to follow on business. In sum, MDB projects are an important nexus for the development of U.S. exports and jobs in the export sector, the value of which far exceeds our financial support for these institutions.

Financing the operations of these institutions is shared by all member countries. Consequently, U.S. interests in developing countries can be pursued through these institutions without the United States bearing the full burden. This is particularly important during periods of severe budgetary constraint.

For their market-related lending operations the MDBs leverage the callable capital guarantees of member countries to borrow funds on private capital markets. Hence, the majority of MDB loans are financed with relatively small cash outlays from MDB members, and are cost effective when compared with U.S. bilateral economic assistance.

Periodically we need to increase the capital base of the market-related "hard-loan windows" and replenish the resources of the concessional "soft-loan windows" of these institutions. This year we will be seeking Congressional approval for U.S. participation in a Special Capital Increase (SCI) of the Asian Development Bank (ADB). Depending on the outcome of negotiations, we may also be seeking Congressional authorization to participate in the sixth replenishment of resources for the African Development Fund (AFDF). There have also been serious discussions between the management and executive directors of the International Finance Corporation (IFC) regarding substantive justifications for an IFC capital increase.

<u>The International Debt Strategy</u>

Our work to promote strong developing country economies through the international financial institutions has been profoundly affected over the last decade by external debt problems. The United States has assumed a leadership role in crafting an international strategy for addressing these debt problems. This evolving strategy has produced results. We have protected the international financial system from risks of insolvency while focusing increasingly on supporting economic reform and sustained growth in debtor countries. Most recently, the Brady Plan has proven effective in facilitating financing agreements that recognize the need to reduce debt burdens.

Seven countries have reached agreements with their commercial banks on packages that include debt/debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries. The benefits are substantial.

- The Mexican agreement reduced annual interest payments by 33 percent ($1.5 billion); commercial bank debt was reduced by 32 percent; and the burden of $42 billion in principal payments was removed.

- The Costa Rican agreement reduced that country's commercial bank debt by 62% and cut annual debt service payments by 74%.

Chile, Venezuela, Morocco, and Uruguay have also reached agreements involving significant reductions in debt burdens, and several other countries are continuing discussions with their banks.

These Brady Plan agreements enable debtor countries and commercial banks to address their disparate needs. Furthermore, these agreements are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

Enterprise for the Americas Initiative

In a further effort to strengthen the economies of our neighbors in Latin America and the Caribbean and to improve trade opportunities in the hemisphere, President Bush announced last June the new Enterprise for the Americas Initiative.

This region is of vital interest to the United States. Ten years of slow growth and debt overhang have plagued the economies of Latin America and the Caribbean and thwarted opportunities for the hemisphere as a whole.

The Enterprise for the Americas Initiative aims to address these problems through action in three areas -- trade, investment, and debt. It thereby joins in a single endeavor the three economic issues of greatest importance to the region. It also seizes, in terms of timing and concept, on important developments already underway in the region -- including the spread of democracy and a clear commitment on the part of leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

We are making real progress in implementing the vision laid out in the Initiative. To increase trade and move toward the goal of a hemispheric free trade system, we are pursuing a Free Trade Agreement with Mexico, with Canada as a party. The goal of this agreement is to foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This FTA should expand and lock in recent trade and investment liberalizations achieved by the Salinas Administration.

We are also negotiating framework agreements on trade and investment to establish the basis for progress with other countries in the region. These agreements establish fora for addressing technical issues and beginning to remove barriers to trade and investment. Such framework agreements have been signed since June with five countries -- Colombia, Ecuador, Chile, Honduras, and Costa Rica -- adding to those already in place with Mexico and Bolivia. Negotiations are underway with a number of additional countries, including Jamaica, Venezuela, Peru, Nicaragua, Panama, El Salvador, Guatemala, and a group of countries composed of Argentina, Brazil, Uruguay, and Paraguay.

The dramatic progress we are seeking on trade will take time to develop. The potential for action on investment is more immediate. Latin American and Caribbean countries are competing for scarce capital with other dynamic economies. They need to attract private investment both from abroad and at home, and to reverse capital flight, which in many cases is believed to be as large as their total external debt. The Inter-American Development Bank is developing an investment sector lending program to help countries to open and liberalize their investment regimes. The IDB has begun evaluating the necessary changes to achieve meaningful reform in individual countries, and we hope that the first investment sector loans will be moving forward over the next several months.

The debt reduction proposed under the Initiative will be an important incentive for countries to carry out investment reforms. The IDB has taken action to join the IMF and World Bank in providing support for commercial bank debt reduction. We expect Uruguay to be the first beneficiary. On bilateral debt, we gained authority from Congress during the last session to undertake reduction of concessional PL-480 debt for countries pursuing strong economic reform programs, including liberalization of their investment regimes. We will be discussing such debt reduction with individual countries as they become eligible. We will be seeking comparable legislation permitting the reduction of AID debt this year.

Our initiative will also provide significant benefits for the environment within the Hemisphere. Interest payments on the reduced PL-480 and AID debts will be dedicated by debtor governments to support a broad range of local environmental projects or programs. We expect local non-governmental organizations with expertise in the environment and conservation to play a strong role in determining the use of these environmental funds.

To implement fully the investment and debt elements of the Initiative, we will be seeking additional authority from Congress as a matter of priority.

- Congress must also act to authorize the reduction of concessional AID debt and the sale of a portion of Eximbank and CCC loans. I want to ask for the support of this Committee for action on Eximbank debt. These sales would facilitate debt-for-equity, debt-for-development, and debt-for-nature swaps in eligible countries.

- I want to highlight for this Committee our request that Congress authorize U.S. contributions of $500 million over five years to the Enterprise for the Americas Investment Fund that the President proposed be established in the IDB. We are working with the IDB and other creditor governments to identify productive uses for this Fund. We are also seeking contributions from other countries to meet the goal of a $1.5 billion fund over five years. In sum, we envision that the Fund would make available grants and loans for: technical assistance to help build the expertise needed to undertake privatization and other investment related reforms; worker retraining and relocation necessary due to investment reforms; and enterprise development to assist very small firms in building equity and attracting investors.

I hope we can count on your support for this important Initiative.

Environmental Considerations

The environment has been an extremely important element in our overall approach to economic issues in recent years. Economic progress will be sustainable only in the context of sound environmental practices. Hence, environmental considerations must be integrated more effectively into the on-going operations of the international financial institutions.

This concern led us to negotiate an environmental framework for the IDA 9 Replenishment Agreement in 1990. It is the reason we are now taking such a strong stance on these issues in negotiating replenishments of the Asian Development Fund and the African Development Fund and the establishment of the European Bank for Reconstruction and Development. It underlies the great weight we have given to three key issues: environmental impact assessment, protection of tropical forests, and promotion of energy efficiency and conservation measures.

As a result of our efforts, we believe the World Bank and the Inter-American Development Bank are ready to implement new environmental impact assessment procedures in line with legislation introduced in this sub-committee in the last Congress. The World Bank is reassessing its forest policy and taking a new look at energy efficiency and conservation alternatives. It has created a special unit for energy efficiency and conservation for its operations in Eastern Europe and is restructuring its Energy Sector Management Assistance Program.

These reforms represent a significant strengthening of environmental capability in the MDBs. However, additional effort is still needed to assure their effective implementation. This year we will look for new opportunities to influence energy policy and promote more energy efficiency and conservation projects. We will seek more rapid progress on environmental impact assessment in the Asian and African Development Banks and further improvements and refinements, if they are needed, in the procedures already being adopted by the World Bank and the Inter-American Development Bank. We will continue our efforts to secure greater protection for tropical forests, including reform of the Tropical Forestry Action Plan.

We also want to encourage innovative programs that can be a catalyst for more rapid environmental progress within developing countries. That is why we have encouraged debt-for-nature swaps and put so much emphasis on the environmental element of the Enterprise for the Americas Initiative. In addition, we have offered to provide up to $150 million in parallel financing to the World Bank's Global Environmental Facility over its three life. Our objective in the facility is to foster greater interest in pilot projects that can become part of regular lending programs in future years.

The United States is also at the forefront in encouraging the IMF to enhance its environmental focus. Widespread recognition has emerged that IMF macroeconomic policy advice and prescriptions can have at times an important, though indirect, impact on environmental protection. In particular, the IMF is now discussing the establishment of a group of economists that will serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. Also, most IMF country documents now discuss environmental concerns. The IMF has also strengthened its collaboration with the World Bank with respect to taking into account structural measures for environmental protection into its work.

Treasury Department Role in the Gulf Crisis

The Treasury Department is playing an important role in the efforts of the United States and the international coalition of its allies to enforce the U.N. Security Council's resolutions aimed at obtaining Iraq's unconditional and complete withdrawal from Kuwait.

A key aspect of our contribution is our chairmanship of the Gulf Crisis Financial Coordination Group. This Group was established in September by President Bush to complement the diplomatic and military efforts of the international coalition against Iraq.

The purpose of the Group is to mobilize and channel extraordinary assistance to the front line states, namely Egypt, Turkey, and Jordan. By offsetting the effects of the crisis on their economies, this assistance enables the front line states to continue their effective enforcement of the U.N.-mandated economic sanctions against Iraq.

The Group has met four times, most recently in Washington on February 5. Another meeting is tentatively planned for early March. It now brings together under Treasury Department leadership 26 countries, the European Commission, and the Gulf Cooperation Council. Representatives of the International Monetary Fund and World Bank provide technical and analytical support.

Through this successful initiative, the United States has obtained from other creditors commitments of $14.7 billion for the front line states and other countries whose economies are seriously affected by the crisis. Of this amount, $6.7 billion has already been disbursed, with substantial additional disbursements expected in the coming weeks.

Within the framework of the Gulf Crisis Financial Coordination Group, the Treasury Department is keeping economic developments in the front line states under continuous review to ensure that the economic effects of the crisis are offset to the maximum extent possible. This should help maintain effective enforcement of the economic sanctions against Iraq and facilitate the task of economic recovery and reconstruction in the post war period.

Negotiations to Open Markets Overseas

Treasury is engaged in a number of comprehensive negotiations to open markets overseas for U.S. exports, investment and financial services. Let me briefly discuss our negotiations with Japan, Korea and Taiwan.

With respect to Japan, we are addressing market access problems in the Working Group on Financial Markets (the so-called "Yen/Dollar" talks) and the Structural Impediments Initiative (or "SII"). There has significant progress in liberalizing Japan's financial markets since our talks in this area began in 1984. However, the pace of change has been relatively slow -- particularly compared to liberalization in London and New York -- and U.S. firms continue to face numerous access problems. We will continue to press the Japanese to accelerate their efforts towards true liberalization in order to create a level playing field for U.S. firms in Japan.

We are also in the critical first year of the follow-up process of the SII, which is aimed at addressing the underlying causes of our persistent external imbalances, with the objective of reducing these imbalances further and opening markets. This initiative, which was patterned after the "Yen/Dollar" formula, resulted in a Joint Report last summer, containing commitments by both countries. Japan's commitments include increasing spending on public infrastructure, making the keiretsu system more open and transparent, and increasing the availability of land. If fully implemented, the SII commitments will result in a more open, fair and transparent Japanese economic system. Although there has been progress on implementing these commitments, much more needs to be done.

With respect to Korea and Taiwan, we have made substantial progress on financial policy issues. Negotiations on exchange rates had the desired effect of prompting appreciation in both the Korean won and the Taiwanese dollar to reflect more fully the strength of the two economies. This contributed to substantial declines in the large external surpluses of both countries, and particularly in their bilateral surpluses with the United States. More recently, we have been engaged in discussions with both Korea and Taiwan on a broader range of financial issues. Our objectives are twofold: to encourage liberalization of the Korean and Taiwanese banking, securities, and exchange markets; and to obtain full equality of competitive opportunity for U.S. financial institutions in those markets. We have had some success in these talks -- for example in easing the criteria on bank branching and beginning to open the Korean and Taiwanese capital markets -- but much work remains to be done.

There are clearly limits to what we can achieve bilaterally without additional leverage or a stronger set of international rules than currently exist. Our efforts within the Uruguay Round to negotiate a financial services agreement could complement our bilateral efforts, but only if certain basic conditions are met. Essentially we must be careful not to lock ourselves into a commitment to maintain our open markets without adequate commitments from other countries to open their markets. These arrangements should provide real liberalization, deal effectively with the problem of free riders, and assure that financial experts oversee the operations of the financial services agreement, including dispute settlement. If these fundamental conditions are not met, a financial services agreement would not be in U.S. interests.

Exchange Stabilization Fund

The Treasury Department has a mechanism which enables the Secretary to undertake foreign exchange operations in order to support certain aspects of the international financial policy of the United States outlined above. That entity is the Exchange Stabilization Fund (ESF). It is the only instrument within the U.S. Government which is constituted and empowered to respond rapidly and flexibly to international financial disruptions.

The primary uses of the ESF have been to finance intervention in the foreign exchange market and to extend, under exacting standards, short-term "bridge loans" to assist countries in dealing with problems of indebtedness. In recent years there have been bridge loans to a number of Eastern European countries, including Poland. The Polish arrangement served to support a reform program that incorporated a novel stabilization fund and has led to current efforts to reduce Poland's debt, as provided by Congress.

Secretaries of the Treasury are sensitive to the need to employ judiciously the broad authority provided by statute for use of the resources of the ESF. They are equally sensitive to the need to keep Congress informed of their exercise of this authority and of the financial condition of the ESF, which is extremely sound. I would note in this regard that I provide regular reports to appropriate Congressional bodies, including this Subcommittee.

Conclusion

By now Madam Chair, it should be clear that Treasury is indeed engaged in a number of areas that bear significantly on the ability of the United States to promote a sound, environmentally safe, world economy and stable international monetary system. Treasury relies heavily on the international financial institutions (IFIs) to carry out these objectives, as well as U.S. humanitarian interests. The successful operation of IFI activities makes one additional contribution: the promotion of peace and democracy among nations.

These are important matters, as I am sure you will agree Madam Chair. It is critical that the Executive and Legislative Branches of our government coordinate their activities closely on these issues. That is why I put considerable effort into strengthening the consultation process between this Committee and Treasury. I believe it is essential that this relationship continue.

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 20, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for $12,062 million of 2-year notes, Series X-1993, to be issued on February 28, 1991 and mature on February 28, 1993 were accepted today (CUSIP: 912827ZY1).

The interest rate on the notes will be 6 3/4%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	6.85%	99.816
High	6.87%	99.779
Average	6.87%	99.779

Tenders at the high yield were allotted 71%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	31,580	31,580
New York	37,242,585	11,033,765
Philadelphia	28,650	28,650
Cleveland	33,660	33,660
Richmond	52,380	47,320
Atlanta	43,860	36,410
Chicago	1,519,450	235,020
St. Louis	61,465	56,175
Minneapolis	21,400	21,380
Kansas City	72,705	71,405
Dallas	18,230	18,230
San Francisco	639,395	145,845
Treasury	302,885	302,885
TOTALS	$40,068,245	$12,062,325

The $12,062 million of accepted tenders includes $917 million of noncompetitive tenders and $11,145 million of competitive tenders from the public.

In addition, $725 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $900 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1143

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

FOR IMMEDIATE RELEASE
February 20, 1991

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UNITED STATES RATIFIES CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS

The Treasury Department today announced that the United States has ratified the Convention on Mutual Administrative Assistance in Tax Matters (the Convention). On February 13, 1991, the U. S. Mission to the Organization for Economic Cooperation and Development (OECD), presented the OECD with the instrument of ratification, signed by President Bush on January 30, 1991.

The Convention, developed by the OECD and the Council of Europe, provides for the exchange of tax information between any two parties to the Convention. Exchange of Information under the Convention will be similar to information exchange taking place currently under a network of bilateral tax treaties; similarly, the Convention provides for the protection of the confidentiality of tax information exchanged. The United States will issue an administrative procedure generally providing for notification to a U.S. resident or national before transmitting tax information requested by another country under the Convention.

The United States has entered a reservation on any form of assistance relating to taxes of possessions, political subdivisions, or local authorities; therefore, the United States will not exchange tax information regarding state and local taxes. Also, although the Convention provides for assistance in collection of taxes and in the service of documents, the United States has entered reservations on these forms of assistance and, therefore, will not provide these types of assistance under the Convention.

The Convention will apply only to OECD or Council of Europe member countries that agree to be bound by it. The Convention will be effective for the United States after ratification by four other member countries of the OECD or the Council of Europe.

NB-1144

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

before the

COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION AND COMPETITIVENESS
U.S. HOUSE OF REPRESENTATIVES

February 21, 1991

Economic Sanctions Against Iraq

Madam Chairwoman and members of the subcommittee:

My name is R. Richard Newcomb and I am the Director of the Office of Foreign Assets Control at the United States Department of the Treasury. I am here today to appear before the subcommittee to discuss the Treasury Department's role in formulating, administering, and enforcing the sanctions against Iraq and Kuwait.

The Office of Foreign Assets Control ("FAC") has primary responsibility within the Executive branch for implementing the financial and trade sanctions against Iraq and measures to protect the assets of the legitimate Government of Kuwait. In addition to these programs, FAC also administers economic sanctions programs against Libya, Iran, South Africa, Cuba, Vietnam, Cambodia, and North Korea and administers certain residual World War II asset controls affecting the Baltic Republics. The Office was also responsible for administering the recently-concluded economic sanctions programs against the Sandinista regime in Nicaragua and the Noriega regime in Panama.

This morning I will discuss the objectives, scope, and implementation of the blocking controls affecting Kuwaiti and Iraqi government-owned assets in the U.S. and how we have addressed various problems and issues that have arisen. As you requested, I will also address and discuss (a) whether the authority of the President is adequate to seize U.S. property of the Government of Iraq and to protect fully the U.S. national interest and (b) what the government is doing to identify Iraq's efforts to acquire technology, equipment, and other resources to support its war effort.

NB-1145

Following the Iraqi invasion of Kuwait on August 2, the President, acting under authority of the International Emergency Economic Powers Act ("IEEPA"), declared a national emergency and issued Executive Orders No. 12722 and No. 12723 ("the August 2 Executive Orders"), froze all Iraqi and Kuwaiti government-owned assets within the jurisdiction of the United States or under the control of U.S. persons and imposed an immediate and comprehensive trade embargo against Iraq.

On August 6, the United Nations Security Council, to bring the invasion and occupation of Kuwait to an end and to restore the sovereignty, independence, and territorial integrity of Kuwait, decided that all U.N. member states shall impose sweeping economic sanctions against Iraq and occupied Kuwait. On August 9, the President issued Executive Orders No. 12724 and No. 12725, this time acting under authority of IEEPA and the United Nations Participation Act, which broadened the U.S. sanctions with respect to both Iraq and Kuwait to include a complete prohibition on trade and trade-related activities with any person located within the territories of Iraq or Kuwait, in addition to continuing the freeze of Iraqi and Kuwaiti government-owned assets imposed seven days earlier.

The August 9 Executive order with respect to Iraq:

-- prohibits exports and imports of goods, technology, and services between the United States and Iraq, and any activity that promotes or is intended to promote such exportation and importation;

-- prohibits any dealing by a U.S. person in connection with property of Iraqi origin exported from Iraq after August 6, 1990;

-- prohibits transactions related to travel;

-- prohibits transactions related to transportation to or from Iraq, or the use of vessels or aircraft registered in Iraq by U.S. persons;

-- prohibits the performance by any U.S. person of any contract in support of projects in Iraq;

-- prohibits the commitment or transfer of funds or other financial or economic resources by any U.S. person to the Government of Iraq, or any other person in Iraq; and

-- blocks all property of the Government of Iraq located in the United States or in the possession or control of U.S. persons, including their foreign branches on or after August 2, 1990.

The August 9 Executive Orders were issued to put additional pressure on Iraq and to ensure that the U.S. sanctions program conforms to U.N. Security Council Resolution 661.

The objectives of the Executive Orders are to deprive Iraq of any economic or financial benefits that might result from its illegal invasion and occupation of Kuwait and to preserve and protect the assets of the Government of Kuwait for the benefit of their rightful owner. Iraqi assets blocked in the U.S. and in all U.N. member states may be used as a source of funds to pay claimants and creditors of Iraq when hostilities have ceased.

The August 2 Executive Orders immediately froze, by operation of law, all property and interests in property, of the Governments of Iraq and Kuwait that were in, or thereafter come within, the jurisdiction of the United States or under control of U.S. persons. Any unauthorized transfers of property or interests in property subject to the blocking orders occurring after the effective date are deemed to be null and void. This means that a U.S. financial institution, for example, which transfers blocked funds after the effective date without authorization from FAC can be penalized for violating the sanctions.

The blocking of Iraqi and Kuwaiti assets by Executive Order places the primary legal responsibility of identifying and immobilizing blocked assets upon the persons most knowledgeable concerning the ownership of the property, i.e., upon the holders themselves. This approach obviates the need for the Treasury Department, on an emergency basis, to locate and identify precisely and specifically beforehand each asset subject to the blocking and allows initial enforcement efforts to concentrate on areas where transfers or evasions are most likely to occur. Blocking by Executive Order rather than by individual order permits prompt, orderly, and systematic identification and resolution of the most pressing interpretative questions and ruling requests that inevitably arise immediately after the blocking orders are issued. The need to quickly address these complicated and fact-intensive problems proved especially critical with respect to the Kuwaiti assets since the freeze was intended primarily as a protective measure, and complete immobilization of the Kuwait governmental assets in the U.S. for a prolonged period would have diminished their value and disrupted a number of markets.

On the morning of August 2, immediately after the President signed the blocking orders, FAC began contacting major U.S. money center banks and requested that the Federal Reserve Bank of New York ("the FRBNY") notify Federal Reserve member banks of the blocking. We also began a series of what have since become regular consultations with the FRBNY, and various U.S. Government agencies, including the Departments of State, Commerce, and Defense, the Customs Service, the FBI, the NSC, and members of the intelligence and law enforcement communities. Since the morning of August 2, we have also met with hundreds of U.S. and foreign businesses, official agencies, and individuals affected by the sanctions, in addition to responding to several thousand telephone inquiries and pieces of correspondence. Additionally, we have an ongoing program in place with foreign embassies which enables us to act in concert with all governments worldwide to ensure the uniform application of all U.N. resolutions.

On August 3, we issued a press release announcing the first of a series of general licenses designed to address many of the most immediate and pressing problems relating to the freeze. Most of these licenses addressed the need to safeguard and preserve the value of the frozen assets and investments without causing unnecessary and irreparable harm to the interests of innocent third parties, including those of many U.S. businesses and individuals and of the legitimate Government of Kuwait. These licenses have addressed problems such as: what to do about Iraqi and Kuwaiti oil already en route to the U.S. on the effective date; how to complete or unwind variously affected financial or securities transactions entered into prior to the effective date; what types of transactions or investments by blocked companies or investment portfolios owned or controlled by the Government of Kuwait to allow to continue unimpeded; and what to do about payments due under letters of credit involving U.S. banks for goods or services exported to Iraq or Kuwait prior to the effective date. These general licenses, as well as the specific licenses we have issued on a case-by-case basis, have been carefully crafted to ensure that transactions permitted thereunder are consistent with the objectives of the sanctions and do not confer any realizable benefit on the Government of Iraq. These licenses have been fully incorporated into a comprehensive body of implementing regulations published on November 30, 1990, for Kuwait and on January 18, 1991, for Iraq.

Very early in the program we began meeting regularly with Kuwaiti Embassy officials to begin the process of identifying and clarifying the status of Kuwaiti-owned entities around the world, licensing limited operation of Kuwait entities within U.S. jurisdiction under the effective control of legitimate governmental authorities, and generally coordinating the efforts of our respective governments concerning the sanctions. We have received excellent cooperation from the Kuwaiti authorities. This has proved to be an understandably painstaking and tedious process as the legal, financial, and commercial information required to make these determinations must be precise and accurate. Moreover, it must be obtained from various locations worldwide and some of the records have been destroyed or are under the control of Iraqi authorities.

In the first few weeks our efforts regarding Kuwait focused heavily on identifying and clarifying the status of Kuwaiti-owned banks and financial institutions and communicating this information through the Federal Reserve System. By October 4, we were able to issue a general notice clarifying the status of 94 major banking and non-banking entities or corporate groups operating in the U.S. about which blocking inquiries had been received. We plan to update this list periodically as new information becomes available.

Working closely with the Kuwaiti Ambassador to the U.S., His Excellency Saud Nasir Al-Sabah, and his staff, we have developed a close working relationship with numerous officials of the legitimate Government of Kuwait. The Central Bank of Kuwait has posted a special representative to Washington to serve as a liaison for ongoing sanctions issues. Following coordination with the Bank of England and the French Treasury, we recently issued a license allowing the Central Bank to make use of its U.S. assets and authorizing U.S. persons to conduct normal business with the bank through its temporary London headquarters. The Central Bank has agreed not only to serve as lender-of-last-resort for Kuwait's commercial banks but also to guarantee the payment of their outstanding obligations to creditors and account holders worldwide, with exceptions I will note.

We are currently processing applications from the seven major Kuwaiti banks to allow them to settle their pre-embargo obligations and to manage the investment of their assets subject to U.S. jurisdiction. This should result in the settlement of many millions of dollars in claims of creditors of Kuwait in the U.S. and worldwide. We are hoping to issue licenses late this month allowing a three-week window for claims to be presented to the seven blocked Kuwaiti banks and for the banks to complete preparations to commence settlement of their obligations. The only exceptions will be interbank obligations denominated in Kuwaiti dinars and other deposits originally held on deposit in Iraq or Kuwait. Once licenses have been issued, we will be sending letters to those claimants of whom we are aware, detailing the names and addresses of contacts at each of the banks handling settlement procedures. Settlement dates are being closely coordinated with the Government of Kuwait, our other Gulf coalition partners, and other allies.

The Kuwaiti and Iraqi government-owned assets frozen by the August 2 Executive Orders are substantial. The frozen Kuwaiti investments total in the billions of dollars and consist primarily of bank deposits, debt and equity securities (involving both direct investment and portfolio holdings), and real estate. Most of these assets are owned or controlled by licensed Kuwaiti governmental entities such as the Kuwait Investment Office and the Kuwait Investment Authority. The blocked Iraqi assets may total as much as a billion dollars or more. They are primarily bank deposits and blocked oil payments. On February 11, 1991, we initiated a formal census or inventory of these blocked assets as well as U.S. financial claims against Iraq by publishing in the Federal Register regulations requiring the filing of reports by March 1 by all U.S. holders of Iraqi property and U.S. claimants against Iraq as to the full extent of such assets and claims.

Claims reports must be filed by every U.S. national who had a claim outstanding on January 16, 1991, against the Government of Iraq or an Iraqi government entity. Claims may relate to losses due to expropriation, nationalization, or other measures affecting property rights; losses for breach of contract or debt defaults; compensation for injuries to persons or loss of life; and any other losses or injuries suffered in Iraq, Kuwait or elsewhere, attributable to the Government of Iraq or an Iraqi government entity, whether or not arising from actions relating to Iraq's invasion of Kuwait. Claims may also relate to losses suffered by a foreign partnership, joint venture, corporation or other entity in which U.S. nationals have a significant interest.

The census of blocked property requires all person who since August 2, 1990, have held property subject to Executive Orders No. 12722 and No. 12724 to report (1) the name and address of the Iraqi Government entity which has an interest in the property, and of any other entities or persons, whether Iraqi or non-Iraqi having an interest in the property; (2) the value of the property on August 2, 1990, or on the date of acquisition; (3) a description of the property; (4) for property acquired after August 2, the circumstances of acquisition; (5) the number, total amounts, and nature of all increases and credits or decreases in value of the property; (6) location of the property; and (7) any claims asserted against the property.

In taking the lead in the implementation of U.N. sanctions against Iraq and occupied Kuwait, the United States has utilized a wide array of diplomatic, administrative, and enforcement tools to deter would-be violators of the global trade and financial embargoes. The U.S. sanctions initiatives have been augmented by Treasury and State Department meetings with the United Nations, the Organization of Economic Cooperation and Development, the European Community and member states' central banks through the Bank for International Settlements, and with individual governments. Bilateral approaches to host governments by U.S. embassies worldwide are another facet of this coordinated approach to international sanctions implementation. The State Department has utilized this approach in hundreds of demarches to foreign governments.

The focus on deterring sanctions leakages has been most striking in the financial arena, where Iraq has been denied access to its own funds abroad, and more importantly, to the considerable financial assets of Kuwait. All major banking centers in the world have followed the U.S. lead in freezing Iraqi and Kuwaiti assets in their financial institutions and in permitting the payment of letters of credit in favor of Iraq only into blocked accounts. Iraq's central bank, Markaz, and its two primary international banks, Rafidain and Rasheed, have been effectively cut off from the international financial community, so that Iraqi financial flows have been reduced to a mere trickle of their pre-August levels. Central banks around the world have worked together to monitor all attempted Iraqi banking transactions to reduce this flow even further.

We are working closely with the Federal Reserve Bank of New York and the domestic bank supervisory and regulatory agencies and in close cooperations with the domestic and foreign financial institutions where Iraqi deposits are known to be located to ensure that Iraqi deposits remain blocked and that Iraq is deprived of use of the international banking system and financial resources. We are in routine bilateral and multilateral contact with our counterparts in foreign governments to ensure that the goals of the sanctions program are fully implemented and enforced and that issues are fully coordinated.

With regard to the concern you expressed about the adequacy of the President's authority to seize assets of the Government of Iraq in the United States, the statutes pursuant to which FAC implements and enforces sanctions against Iraq include the International Emergency Economic Powers Act ("IEEPA") and the United Nations Participation Act ("UNPA"). As noted above, the President exercises the authority to block Iraqi governmental property pursuant to IEEPA, which grants the President the authority to

> ...prohibit... transactions in foreign exchange ...transfers of credit or payments ...involv[ing] any interest of a foreign country or a national thereof, [or] the importing or exporting of currency or securities; and ...nullify, void, prevent or prohibit, any acquisition, holding, withholding, use, transfer, withdrawal, transportation, importation or exportation of, or dealing in, or exercising any right, power, or privilege with respect to, or transactions involving, any property in which any foreign country or a national thereof has any interest; by any person, or with respect to any property, subject to the jurisdiction of the United States. (50 U.S.C. 1702(a)(1)(A)-(B).)

This authority provides the President with the ability to restrict or prohibit transactions in property within the jurisdiction of the United States with respect to which a foreign government or its nationals have an interest. Blocking property does not involve any modification of the ownership status of the blocked property.

Blocking authority is exercised by the President pursuant to IEEPA by the issuance of one or more Executive Orders, which declare the existence of a national emergency with respect to a particular country and impose sanctions to deal with the emergency.

Following the Iraqi invasion of Kuwait on August 2, the President imposed an immediate trade embargo against the Government of Iraq and blocked all Iraqi and Kuwaiti government-owned assets within the jurisdiction of the United States or under the control of U.S. persons. The objectives of the blocking orders were to deprive Iraq of any financial or economic benefits as a result of its illegal invasion and occupation of Kuwait and to preserve and protect the assets of the Government of Kuwait for the benefit of their rightful owner.

The term "blocked property" has been defined in the Iraqi Sanctions Regulations (31 C.F.R. 575--"ISR") to mean "any account or property in which the Government of Iraq has an interest, and with respect to which payments, transfers, exportations, withdrawals, or other dealings may not be made or effected except pursuant to an authorization or license from FAC authorizing such action." (31 C.F.R. 575.301.) The property subject to these blocking restrictions, the types of interests in property which trigger blocking, and prohibited transfers have also been broadly defined in the ISR to implement the President's statutory authority. (31 C.F.R. 575.315, 575.308, 575.317.) The Kuwaiti Assets Control Regulations (31 C.F.R. Part 570) impose the same restriction, for protective rather than punitive purposes, on dealings in property in which the Government of Kuwait has an interest.

Property is blocked by action of the President's Executive orders based on the existence of an interest of the Iraqi or Kuwaiti Government, not based on specific action by FAC. Where necessary, FAC enforces the President's blocking order by serving blocking notices and securing blocked property. Activities taken to secure blocked property at the time a blocking notice is served may include padlocking offices, conducting inventories of blocked property, and moving blocked property into storage. These activities are encompassed by the broad statutory authority accorded the President under IEEPA.

Because the sanctions against Iraq and occupied Kuwait are authorized pursuant to the UNPA as well as IEEPA, the President also has the authority granted by UNPA to seek forfeiture of any property involved in a criminal violation of the sanctions (22 U.S.C. 287c(b)). Title to forfeited property passes to the United States.

Blocking, or freezing, foreign-owned assets in the U.S. is fundamentally different from vesting such assets. Vesting involves the actual seizure or confiscation of title to the property. Blocking simply involves immobilizing the property. Questions involving who has, or should have, title to the property then become a separate issue. Such questions are complicated and fact-intensive and frequently must be addressed on a case-by-case basis or ultimately decided in claims settlement proceedings.

If Congress were to declare war against Iraq, the President would receive additional authorities pursuant to the Trading with the Enemy Act ("TWEA"). TWEA provides the President with the authority to vest in the any agency or person "any property or interest of any foreign country or national thereof" and to order the property to be "held, used, administered, liquidated, sold, or otherwise dealt with in the interest of and for the benefit of the United States...." (50 U.S.C. App. 5(b).) Vesting involves a transfer in ownership of property by Presidential action. Thus, TWEA provides authority in a declared war for the vesting of foreign-owned assets in the United States should the President find this in the national interest.

The Administration is not now requesting authority from the Congress to modify the present ownership status of Iraqi governmental property by vesting Iraqi governmental property in the U.S. Government.

Unlike the August 2, 1990 blocking of Iraqi assets, which merely preserved the status quo, vesting would represent an irrevocable, final action terminating Iraqi title to the assets. Vesting Iraqi assets would eliminate a potentially useful bargaining tool in eventual normalization negotiations with Iraq. In addition, absent a consensus on vesting among the cooperating nations implementing U.N. Security Council Resolution 661, the mere specter of a U.S. vesting would weaken unity and threaten to unleash international competition to control Iraqi assets for claims settlement purposes. This would be particularly troublesome where two nations have blocked the same assets.

With regard to the concerns you expressed about the Iraqi efforts to break the embargo and support the war effort, we have undertaken a major initiative to identify front companies and agents used to acquire technology, equipment, and other resources. This is called the Specially Designated Nationals or "SDN" program. As in the case of current sanctions against Cambodia, Cuba, Libya, North Korea, and Vietnam, FAC has the authority to "specially designate"--i.e., to identify publicly and to block--any person, whether an individual or a business who is directly or indirectly owned or controlled by the Government of Iraq, or who acts or purports to act for or on its behalf. The Iraqi SDN program will be modelled after the SDN program used with great effect against former Panamanian dictator Manuel Noriega and his supporters.

The term "specially designated national" is not used in the Iraqi Sanctions Regulations (31 C.F.R. Part 575, 56 Fed. Reg. 2112 (January 18, 1991)). Such designation relies rather on the definition of the Government of Iraq provided by Section 575.306 of the Regulations:

> The term "Government of Iraq" includes:

(a) The state and the Government of Iraq, as well as any political subdivision, agency, or instrumentality thereof, including the Central Bank of Iraq;

(b) Any partnership, association, corporation, or other organization substantially owned or controlled by the foregoing;

(c) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such is, or has been since the effective date [August 2, 1990], acting or purporting to act directly or indirectly on behalf of any of the foregoing; and

(d) Any other person or organization determined by the Director of the Office of Foreign Assets Control to be included in this section.

In practice, a Specially Designated National of the Government of Iraq ("Iraqi SDN") is an Iraqi government body, representative, agent, intermediary, or front (whether open or covert) that is located outside Iraq and functions as an extension of the Government of Iraq. It may be a firm created by the Iraqi government, or it may be a third-country company that otherwise becomes owned or controlled by the Iraqi government, or that operates for or on behalf of the Government of Iraq.

Since the Iraqi government tends to operate its international fronts as interlocking networks of companies and key individuals, it is important to recognize that under this program any identified Iraqi SDN is by definition the "Government of Iraq." Furthermore, another person cannot be owned or controlled by an Iraqi SDN or act for or on the SDN's behalf without also becoming an Iraqi SDN. For example, if "ABC of England" is an Iraqi SDN and "XYZ of Panama" is owned or controlled by or operates for or on behalf of "ABC," then "XYZ" would also be defined as an Iraqi SDN. It is the relationship between entities rather than the country of residence or incorporation that determines SDN status. Thus the same SDN criteria would apply regardless of "XYZ's" location.

The effect of being listed as an Iraqi SDN is four-fold: (1) the SDN is exposed internationally as an Iraqi government front; (2) U.S. persons will be prohibited from any trade or transactions with the SDN; (3) the SDN's property, including financial assets, within U.S. jurisdiction (which includes U.S. banks' corporate branches overseas) will be blocked; and (4) other governments will be urged to take similar steps or other appropriate actions against the SDNs subject to their jurisdiction.

A U.S. company or individual could be designated as an Iraqi SDN and, as such, would have its assets blocked by FAC and, in effect, would be put out of business. Note that, because of the definition of "Government of Iraq" in the ISR, a U.S. firm that has not been designated an SDN, but in which the Government of Iraq holds a controlling interest, is already subject to blocking. For example, in September 1990 FAC served a blocking notice covering all bank accounts and tangible property of the Matrix-Churchill Corporation of Solon, Ohio. Public sources of information demonstrated that the company is owned by Iraqi-controlled companies in England.

For U.S. persons, dealing with an Iraqi SDN is equivalent to doing business with the Government of Iraq--an activity that is prohibited by Executive Orders No. 12722 and No. 12724, and the Iraqi Sanctions Regulations. Such violations are subject to severe penalties. Pursuant to the Iraq Sanctions Act (Pub.L. 101-513, Sec. 586E), civil penalties of up to $250,000 may be imposed administratively. Criminal fines of up to $1,000,000 per violation may be imposed on both individuals and corporate entities, and prison sentences of up to 12 years are authorized for individuals, including officers, directors, and agents of a corporation, who are knowingly involved in a corporate criminal violation.

FAC is conducting and coordinating ongoing investigations of substantive violations of the embargo, such as illegal exportation of U.S.-origin goods via third countries and illegal provision of brokerage services by U.S. persons. FAC's Enforcement Division maintains daily operational liaison with the U.S. Custom Service and the Federal Bureau of Investigation on investigations of mutual interest. Similarly, FAC routinely coordinates it activities with the Departments of State, Defense, Commerce, and Justice, and the intelligence community.

How effective have economic sanctions been?

In his State of the Union message, President Bush said "....these sanctions are working. Iraq is feeling the heat...Iraq's leaders...are cut off from world trade, unable to sell their oil and only a tiny fraction of goods get through."

Thank you. I will be pleased to respond to any questions.

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AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 21, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for $9,040 million of 5-year notes, Series L-1996, to be issued on February 28, 1991 and mature on February 29, 1996 were accepted today (CUSIP: 912827ZZ8).

The interest rate on the notes will be 7 1/2%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.50%	100.000
High	7.51%	99.959
Average	7.51%	99.959

$5,000 was accepted at lower yields.
Tenders at the high yield were allotted 54%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	9,605	9,603
New York	27,614,212	8,770,852
Philadelphia	9,930	9,930
Cleveland	19,462	19,462
Richmond	26,123	25,203
Atlanta	12,187	10,727
Chicago	1,089,868	103,248
St. Louis	17,827	13,827
Minneapolis	7,037	7,037
Kansas City	18,605	18,605
Dallas	5,515	5,515
San Francisco	326,939	16,939
Treasury	28,615	28,615
TOTALS	$29,185,925	$9,039,563

The $9,040 million of accepted tenders includes $344 million of noncompetitive tenders and $8,696 million of competitive tenders from the public.

In addition, $362 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1146

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

FOR IMMEDIATE RELEASE February 22, 1991

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of January 1991.

As indicated in this table, U.S. reserve assets amounted to $85,025 million at the end of January 1991, up from $83,340 million in December 1990.

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/
1990					
December	83,340	11,058	10,989	52,217	9,076
1991					
January	85,025	11,058	10,922	53,577	9,468

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.

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

FOR IMMEDIATE RELEASE
February 25, 1991

CONTACT: Barbara Clay
Phone: 202/566-5252

LICENSED SETTLEMENT OF KUWAITI BANK OBLIGATIONS

The Office of Foreign Assets Control of the Department of the Treasury ("OFAC") announced that, at the request of the Central Bank of Kuwait, it has licensed seven blocked Kuwaiti banks to settle directly most types of obligations arising prior to the August 2, 1990 Iraqi invasion of Kuwait. The licenses were issued pursuant to the Kuwaiti Assets Control Regulations, 31 C.F.R. Part 570, to Al Ahli Bank of Kuwait, The Bank of Kuwait & The Middle East, Burgan Bank, Commercial Bank of Kuwait, The Gulf Bank, The Industrial Bank of Kuwait, and Kuwait Real Estate Bank.

The licensed banks may immediately take preparatory steps toward settling most types of pre-August 2, 1990 obligations, such as gathering information on claims, arranging credit facilities, and liquidating and transferring blocked assets. On March 18, 1991, the banks may begin to use their blocked assets to settle those obligations. Excluded from OFAC's general settlement authorization are obligations denominated in Kuwaiti dinars, and claims related to deposits (except interbank deposits) held in Kuwait or Iraq. As required by U.S. and U.N. sanctions, no transfers may be made to the Government of Iraq, persons in Iraq or occupied Kuwait, or entities operated from Iraq or occupied Kuwait.

The Bank of England has also granted today the approvals necessary in the United Kingdom for implementation of the seven banks' settlement programs in coordination with the Central Bank of Kuwait. The Central Bank of Kuwait has added its payment guarantee for all valid obligations covered by the OFAC licenses, although it has notified OFAC of its belief that the blocked banks will be able to satisfy the licensed settlements directly.

The licenses authorize U.S. persons to engage in all transactions necessary to settlement of the Kuwaiti banks' obligations, although any attachment of, or setoff against, the banks' assets (all of which constitute blocked property) is prohibited without separate OFAC authorization.

Information on the proper bank officials to whom covered claims may be submitted is contained in a Federal Register notice to appear this week, or may be requested from OFAC at (202) 566-2701.

NB-1143

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $9,204 million of 13-week bills to be issued on February 28, 1991 and mature on May 30, 1991 were accepted today (CUSIP: 912794WL4).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.99%	6.17%	98.486
High	6.01%	6.19%	98.481
Average	6.01%	6.19%	98.481

$1,000,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 41%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	42,830	42,830
New York	31,040,890	7,601,600
Philadelphia	17,015	17,015
Cleveland	44,335	44,335
Richmond	150,855	91,855
Atlanta	34,660	34,660
Chicago	1,863,950	255,750
St. Louis	58,280	18,380
Minneapolis	9,480	9,480
Kansas City	37,010	37,010
Dallas	23,140	23,140
San Francisco	1,013,650	211,900
Treasury	815,675	815,675
TOTALS	$35,151,770	$9,203,630
Type		
Competitive	$31,146,975	$5,198,835
Noncompetitive	1,621,695	1,621,695
Subtotal, Public	$32,768,670	$6,820,530
Federal Reserve	2,132,700	2,132,700
Foreign Official Institutions	250,400	250,400
TOTALS	$35,151,770	$9,203,630

NB-1149

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
February 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $9,214 million of 26-week bills to be issued on February 28, 1991 and mature on August 29, 1991 were accepted today (CUSIP: 912794WT7).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	6.00%	6.27%	96.967
High	6.01%	6.28%	96.962
Average	6.01%	6.28%	96.962

$50,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 38%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,285	32,285
New York	26,730,435	8,180,650
Philadelphia	10,575	10,575
Cleveland	32,295	32,295
Richmond	88,270	57,270
Atlanta	31,070	30,450
Chicago	1,796,935	98,935
St. Louis	39,600	17,600
Minneapolis	5,580	5,580
Kansas City	42,705	42,705
Dallas	14,235	14,235
San Francisco	534,225	68,725
Treasury	622,430	622,430
TOTALS	$29,980,640	$9,213,735
Type		
Competitive	$25,690,905	$4,924,000
Noncompetitive	1,187,335	1,187,335
Subtotal, Public	$26,878,240	$6,111,335
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	902,400	902,400
TOTALS	$29,980,640	$9,213,735

NB-1150

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

Embargoed until Given

Expected at 10:00 a.m., February 26, 1991

TESTIMONY OF

THE HONORABLE NICHOLAS F. BRADY

SECRETARY OF THE TREASURY

BEFORE THE SENATE COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

MODERNIZING THE FINANCIAL SYSTEM

February 26, 1991

Chairman Riegle, Senator Garn, and members of the Committee, over 18 months ago the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) asked the Administration to undertake a broad study of our financial system. Congress and the Administration realized that it was time for a fundamental reexamination of the basic laws governing depository institutions and the taxpayer's exposure through deposit insurance.

Earlier this month, we delivered to Congress our final report. The Administration's legislative proposal will be submitted shortly. Today I will describe our recommendations to the Committee. But before doing so, I'd like to describe some of the disturbing conditions I see today in our banking system --

disturbing because they leave taxpayers overexposed, consumers and businesses underserved, and the banking industry uncompetitive and unable to effectively perform its essential role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we had seven. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. Some have suggested that the "Top 25" list does not matter. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? Obviously not.

To start with, we have left antiquated laws on the books that prohibit banks from providing new products in their natural markets, and that even keep them from branching across state lines. Banks in California, Michigan and Utah can open branches in Birmingham, England, but not in Birmingham, Alabama. These laws -- mainly enacted in the 1920s and 30s -- are wholly out of touch with reality, and impose unnecessary costs on banks and consumers, costs that have been estimated at $10 billion annually. Consumers have long since begun to ignore them and conduct their financial affairs their own way, using credit cards, cash machines and the 800 number to effect transactions when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck.

We have a deposit insurance system that has wandered away from its original purpose of protecting only the small depositor, and now covers almost every depositor, large and small, insured and uninsured. This system has protected large, sophisticated investors who don't need the protection, and exposed the taxpayer to potential losses.

Despite the hard lessons we learned from the S&L collapse, we still allow state banks to invest federally insured deposits directly in real estate and other risky investments -- practices we don't allow federally chartered banks to engage in.

Small banks find themselves choking on unnecessary paperwork imposed on them by innumerable state and federal statutes that seem to require multiple reports on every possible subject.

We have an industry that is in the grasp of no less than four separate federal regulators, so that its ability to run its day-to-day affairs and respond quickly to changed conditions -- such as the credit crunch -- is hamstrung by a myriad of Lilliputian restrictions.

We have an industry that is so weakened that, in some regions, it has withdrawn from its crucial role of extending credit to worthy borrowers to finance economic activity and job growth.

What does it all add up to? Bank failures that totalled 198 in the 38 years from 1942 to 1980, but that reached 206 in 1989 alone; higher interest rates and transaction charges due to inefficiency and higher costs; and a bank insurance fund that is under stress.

It's a bleak picture that demands action -- prompt action -- to correct it.

Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized BIF. But we also need interstate branching and broader financial activities so that our banks can become financially strong again. If we leave the job half done -- if we tinker with the problem -- then we'll probably be back again, sooner or later, recapitalizing BIF, perhaps the next time with taxpayer money. I don't relish that prospect any more than you do.

This is not just another round in the biannual, intramural fight among financial services companies over banking reform. This time, the country needs results. Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe to toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to turn this situation around. The laws must be changed to foster a safe and financially strong banking system where the number of costly failures is dramatically reduced. Banking regulation must fit the reality of today. It is time to let the banks catch up with their customers.

Specific Reforms

The Administration's proposal addresses three interrelated problems: first, a banking system with reduced competitiveness and financial strength, caused by outdated legal restrictions that have prevented banking organizations from responding to the evolution of financial markets and technology; second, an overextended deposit insurance system, resulting in excessive exposure for taxpayers and weakened market discipline for banks; and third, a fragmented regulatory system that has created duplicative rules and has often failed to produce timely remedial action.

1. Restored Competitiveness

The competitiveness of the banking industry has been undercut by the erosion of the traditional bank franchise. Banks are no longer the steady, reliable businesses they once were. Old laws designed to assure strong banks have in fact become barriers that impede banks from adapting to changed market circumstances. The result has been financial fragility and loss.

Banks have operated under extremely inefficient and costly restrictions on geographic diversification. Interstate banking was prohibited until recently; interstate branching remains virtually prohibited; and even in-state branching continues to be restricted in a number of states.

While banks have been confined by artificial boundaries, consumers have not. With credit cards, cash machines, and the 800 number, consumers can now "bank" anywhere in the country. The public is not bound by our banking laws. Yet the banks must continue to labor under these antiquated restrictions, which have been estimated to cost $10 billion each year, against a pre-tax industry profit figure of $25 billion for all of 1989. And these costs are passed on to the consumer in higher transaction costs and higher interest rates.

Legal restrictions have denied banks the ability to follow their best traditional customers into new markets. As a result, banks have increased their concentration on the remaining less attractive segments, which in many cases are riskier. The result has been diminished profitability, which has undercut the safety and soundness of the banking system.

How do we reverse this trend? How do we make banks more steadily profitable and competitive, better able to attract capital, and more ready to lend in good times and bad? The answer is plain: we need to overhaul outdated laws to recognize the realities of the current marketplace. I think that Chairman Greenspan captured this need perfectly in earlier testimony, which I'd like to quote. He said that:

> Developments in computer and communications technology have reduced the economic role of commercial banks. These permanent and fundamental changes in the environment cannot be halted by statutory prohibitions, and the longer the law refuses to recognize that fundamental and permanent changes have occurred, the less relevant it will be as a force for stability and competitive fairness in our financial markets. Attempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law which is so critical to a safe and sound financial system.

We should begin by authorizing nationwide banking and branching, which will make banks safer through diversification, and more efficient through substantially reduced operating costs. This is not a radical new idea. A majority of states have already embraced the concept of interstate banking. Thirty-three states -- two-thirds of the country -- have voted to permit nationwide interstate banking, while another 13 states permit regional interstate banking. But the laws on the books impose enormous costs on the system by virtually prohibiting interstate branching. These laws block interstate banking companies from achieving enormous immediate cost savings through such measures as common management and consolidated data processing systems. These savings are directly available to reduce transaction and overhead costs, to lower interest rates and to build both profits and capital.

But well-capitalized banking organizations must also be allowed to use their franchise to participate in the full range of financial services in their natural markets -- but to do so safely outside the bank and outside the federal deposit insurance safety net. The taxpayer should not back these new activities. Neither should the taxpayer bear the cost of a banking system that has been artificially restricted into unprofitability.

And at this time when banks need capital, we should allow strong, well-capitalized financial and commercial firms to own banks as well -- so long as they are willing to adhere to agreements that will maintain well-capitalized banks.

2. Overextended Deposit Insurance

Deposit insurance coverage has expanded well beyond its original purpose of protecting small depositors. Instead, it now guarantees the deposits of wealthier individuals, corporations, and large institutional investors. This broad extension of deposit insurance has dramatically increased taxpayer exposure.

Left to its own workings, the market would have imposed higher funding costs on institutions for excessive risk taking. But our overextended deposit insurance system has undermined the market discipline that should have constrained the increased riskiness of weak banks. With easy access to federally guaranteed funds and little to lose, these weak, undercapitalized banks have had a perverse incentive to take excessive risk with other people's money, exposing the taxpayer to even greater losses.

Reduction in overextended coverage. This proposal would address the problems of overextended deposit insurance by reining in overextended coverage, without reducing the basic protection for small depositors and without losing the benefits of stability in the banking system. It would eliminate coverage for brokered deposits, and for certain pension fund managers with "pass-through" coverage. In addition, it would limit coverage to $100,000 per person per institution, plus a separate $100,000 per institution for retirement savings.

Protection of Uninsured Depositors. We would also curtail the routine practice of protecting virtually all uninsured depositors in bank failures. Protecting uninsured depositors should be the exception, not the rule, and should occur only where there is genuine risk to the financial system. The system that we have proposed would eliminate routine protection of uninsured depositors.

Criticism has come from both sides of this issue. One side charges that we have not totally eliminated the so-called "too big to fail" policy, under which uninsured depositors are fully protected in large bank failures in order to avoid massive damage to the financial system. But no government among the leading industrial nations has deprived itself of the ability to protect uninsured depositors when the system is threatened. None. We should not be the first to try the experiment.

The other side claims that we should protect <u>all</u> deposits in <u>all</u> institutions -- if we are to protect any -- in order to be fair to large depositors in smaller banks. But what about fairness to the taxpayer? It is bad enough that there are times when it is impossible to avoid bailing out large depositors in certain bank failures; but should the taxpayer foot the bill for <u>all</u> large depositors in <u>all</u> bank failures as a result? Extending the safety net to insure all deposits is a backward step.

My point is that the American people should not be asked to choose between a system that offers insufficient protection to the financial system and threatens instability, and one that protects every depositor in every failure at great cost to the taxpayer. Instead, we have proposed a system with strong, well-capitalized banks that are less likely to fail, and a supervisory system that intervenes promptly and decisively before failure can occur.

Much of the heat surrounding this issue is over the question of who should pay for protecting uninsured depositors when they are protected to avoid damage to the system. The practice in some other countries is for the taxpayer to pay because of the fundamental benefits to the financial system and to the entire economy. We recognize that there are arguments for this position. However, our proposal reflects the view that the banking industry should pay because it directly benefits from systemic stability.

Strengthened role of capital and supervision. Reducing overextended coverage by itself cannot resolve our current problems. Deposit insurance will still protect -- and should protect -- a substantial part of each bank's funding base. It is therefore critical to strengthen the role of capital and improve supervision to make deposit insurance safe for the taxpayer. Capital is the single most important protection. It puts the shareholders' own money at risk and thus provides incentives to invest prudently. And it acts as a buffer that absorbs losses ahead of the deposit insurance fund.

The proposal would make bank supervision more effective by creating incentives for banks to build and maintain high levels of capital, and providing swifter and more certain regulatory intervention against banks with too little capital. Indeed, the failure to take prompt corrective action in the past allowed some institutions to fail when they could have been saved, and fostered low capital levels that create incentives for firms to take excessive risk. The proposed new system would address these problems by creating a regime of specific supervisory actions that are triggered by declines to increasingly lower levels of capital.

Risk-based premiums. Assessing risk-based premiums which would vary according to levels of capital would also help. Because capital is a crucial measure of risk, firms would be rewarded with lower premiums for maintaining higher capital. In addition, an FDIC demonstration project would test the feasibility of using private reinsurers to provide market pricing for risk-based premiums.

Risky state activities. Finally, states should no longer have authority to authorize risky activities for state banks that receive federal deposit insurance. A balance was struck in FIRREA for state thrifts between the benefits of the dual banking system and the interest of the federal government. We should strike this same balance for federally insured state banks.

3. Streamlined Regulatory System

Bank regulation and supervision reduces taxpayer exposure to losses created by deposit insurance. But in the face of the problems I've outlined above, our fragmented regulatory system has not been successful in stemming the weakening of the banking industry. In recent years, banks have experienced record loan losses and failures that are rapidly depleting the bank insurance fund. There is not a satisfactory regulatory mechanism for promptly correcting banking problems. Moreover, with as many as four banking regulators involved in the affairs of a single banking organization, no single regulator has had either the full information or the clear authority and responsibility for the decisive, timely action necessary to deal with weak institutions.

Our proposal would streamline the regulatory system in a number of different ways that would further supplement market discipline and apply prompt, decisive corrective action to weak and unsound institutions. First, to improve authority, accountability, and responsibility, there would be a single federal banking regulator for each banking organization. Second, the current system of three federal bank regulators would be reduced to two: national banks would remain under Treasury, and all state banks would go to the Fed. As part of this plan, the FDIC would focus on its primary function as insurer and resolver of failed institutions. This approach parallels that taken in FIRREA, where the thrift regulator and insurer were separated.

Except for receding from its role as the primary federal supervisor for state non-member banks, the FDIC would retain all of its existing examination and enforcement powers.

Finally, the Bank Insurance Fund is at its lowest level in history as a percentage of insured deposits. The Federal Deposit Insurance Corporation (FDIC) has projected that it will decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

The Bank Insurance Fund must therefore be recapitalized. We have said that any plan should satisfy a number of objectives. First, the Fund must have sufficient resources so that the FDIC can do its job of resolving failed institutions. Next, the Fund should be recapitalized with industry funds, but in a way that does not further impair the health of the banking industry. Finally, the plan should rely on GAAP accounting.

Last fall, as part of the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), the FDIC was granted additional legal authority it needed to recapitalize the fund. For the last two months, the FDIC has been working with industry groups to develop a plan. Over last weekend, we have received the outline of a proposal from the FDIC. We are reviewing this proposal, and expect to work with Chairman Seidman to include legislation as appropriate when the FDIC plan is finalized.

Before concluding, I'd like to respond to two criticisms that have been made -- I think with little merit. The first is that we are somehow repeating the mistakes that contributed to the S&L disaster. That is simply not the case. The banks are totally different from the S&Ls. By a wide margin, banks are better capitalized, better managed and better regulated than the S&Ls. To be precise, the banks have over $200 billion in equity capital, plus another $50 billion in reserves. The S&Ls had less than $10 billion in equity in 1987, the year losses mushroomed.

In addition, our approach to reform is distinctly different. The S&Ls were permitted to use federally insured deposits to engage in risky activities inside the institution. In effect, we let S&L owners go to the casino with Uncle Sam's checkbook in hand. By contrast, we have proposed that new financial activities for banking organizations take place only in separately capitalized affiliates, with stringent firewalls and strict supervision. And we've gone even further in limiting new activities only to banks that exceed minimum capital requirements by a substantial amount.

It is important that we do not learn the wrong lesson from the specter of the S&L problem. With the banking system, inaction and procrastination are the enemy. It would be ironic if memories of the S&L cleanup prevent us from making necessary changes -- changes that could save the taxpayer from another costly and unnecessary cleanup.

A second criticism is that we are somehow embarking on a risky "deregulation" of the banking industry, again along the lines of the S&L problem. That just doesn't square with the facts. The proposal represents sound and prudent regulation, with badly needed reforms to protect the taxpayer.

Benefits of Reform

Let me close my remarks with a discussion of the wide range of interests that benefit from the Administration's plan. The first and most obvious group are taxpayers. Strong, well-capitalized banks and a well-capitalized deposit insurance fund are the best protection for the taxpayer -- they result in more profitable banks, fewer failures, and a strong buffer ahead of the taxpayer to absorb whatever losses do occur.

The second group is consumers, both individuals and businesses. Our plan would foster the delivery of a wider range of more convenient services for consumers everywhere in the country, with important protections to prevent confusion between insured and uninsured products. Consumers would also benefit from increased convenience, lower interest rates and lower transaction costs as a result of the enormous savings available.

The third group is businesses and workers, who need to be able to count on bank credit in both good times and bad. Strong, well-capitalized banks can act as shock absorbers in bad times to help customers work through temporary problems. Strong banks can also keep lending in an economic downturn, whereas weak banks are often forced to contract and stop lending in order to continue to meet capital requirements. As a result, loans are called less often, fewer bankruptcies occur, and jobs are preserved.

The fourth group is the banks themselves, including small banks. This is not a "big bank" bill, with nothing in it for small banks. The capital-based nature of the plan particularly benefits smaller banks, which have higher capital levels than larger banks. Let me state again: Well-capitalized firms will be rewarded with lower insurance premiums, greater ability to engage in new activities, and more regulatory freedom. I fully expect that strong, well-managed smaller institutions will continue to more than hold their own against larger rivals. They have done so for many years. For example, the evidence is that, when states such as California and New York enlarged within-state branching powers, smaller banks continued to prosper. To quote Gerry Corrigan of the New York Fed, "I am absolutely confident that literally thousands of small- and medium-sized institutions will continue to flourish." Our proposal does not aim at reducing the number of small banks. Our proposal <u>will</u> lead to earlier resolution of weak banks, many of which are anything but small. The fact is that our plan favors strong banks, not big banks; well-managed banks, not weak banks. Well-capitalized, well-managed smaller banks would prosper under our proposal.

Finally, the Administration's proposal would benefit the nation as a whole. The world's leading economy demands a world-class banking system.

Mr. Chairman, as I said earlier, this is not just another replay of the biannual, intramural fight over banking reform. This time, the country needs results. Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe to toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

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Statement of
The Honorable Charles H. Dallara
Assistant Secretary of the Treasury
for International Affairs
Before the Subcommittee on
Commerce, Consumer Protection, and Competitiveness
of the
Committee on Energy and Commerce
U.S. House of Representatives

February 26, 1991

Madam Chair and Members of the Subcommittee:

I welcome the opportunity to appear before the Subcommittee to discuss U.S. investment policy and issues related to the implementation of the Exon-Florio provision.

Foreign direct investment policy

Decisions with regard to foreign direct investment in the United States are made against the backdrop of an investment policy which has been in place without fundamental change for 200 years. U.S. policy towards foreign direct investment is centered on two key tenets: 1) the United States welcomes foreign direct investment and 2) we seek to liberalize investment regimes abroad. At the same time, it is important that we ensure that our open investment policy does not compromise our national security.

The rationale for our investment policy is plain: It fosters economic efficiency, stimulates economic growth, enhances our international competitiveness, and increases employment. This international investment policy reflects the reliance on market forces which underlies all of the Administration's economic policies. In this regard, the 1990 "Economic Report of the President" said:

> Increases in direct investment by U.S. and foreign firms reflect the increasing integration of the global economy and benefit both host and investor nations.

Foreign investment brings in capital which provides more jobs for American workers. What is important are the jobs and job skills resulting from investment, not the nationality of the investor. For example, Madam Chair, between 1980 and 1987, foreign direct investment in Illinois accounted for roughly one-fourth of the total new jobs generated in Illinois, according to estimates to the Illinois Office of Research and Analysis. In fact as of 1988, Illinois ranked fifth in the United States in terms of foreign investment ($16.2 billion) and fourth in employees of foreign-owned firms (207,000). Foreign-owned firms in the top 14 states provided jobs for 2.5 million American workers.

The complement to our open investment policy is liberalizing the investment regimes of our trading and investment partners. This also can contribute to job creation in the United States. There is no question that we are living in a global economy. Firms compete in a global market place. In 1988, exports of U.S. companies to their foreign subsidiaries accounted for 30 percent of U.S. merchandise exports. In these circumstances, freedom to invest other countries' markets may be a vital contribution to the viability of U.S. companies. As these companies gain greater access to markets abroad, exports from U.S. parents to their foreign subsidiaries translate into more jobs in the United States.

Foreign direct investment: data and trends

As of the third quarter of 1990, the book value of foreign direct investment in the United States was $421 billion, an increase of some $20 billion during 1990. Through the third quarter of 1990, the United Kingdom with investments of $122 billion is the largest investor.

During the first three quarters of 1990, U.S. foreign direct investment increased by nearly $40 billion to $411 billion. Because U.S. foreign direct investment abroad in 1990 has increased faster than foreign direct investment here, the gap in the book value between foreign direct investment here and abroad is narrowing. As of the third quarter, the foreign direct investment gap was $10 billion compared to nearly $30 billion at the end of 1989.

While foreign direct investment in the United States is important in terms of investment and the resulting jobs, technology, and competitiveness it brings to the economy, the presence of foreign direct investment in the U.S. is not overwhelming. And proportionately it has a significantly lesser role in the U.S. economy than in the economies of our major trading partners, with the exception of Japan.

Charts in the appendix provide additional data.

Doubts about open investment

Despite the benefits of foreign investment, the growth of foreign investment in recent years has prompted new doubts in some quarters about the desirability of our open investment policy. Because of the surge of Japanese investment here concentrated in certain sectors and geographic areas, special concern has been expressed over investment from Japan.

Much of the impetus for a change in our investment policy focuses on the absence of a level playing field. I share this concern and, as I will describe below, we are working actively to gain greater access to foreign markets, particularly Japan's. But I believe that it makes little sense for the United States to restrict foreign domestic investment in our market because policies abroad deny U.S. business equivalent access. Instead, our response is to attack restrictive investment regimes and to do all we can to move our investors to a position where have the same rights and opportunities abroad as do the domestic investors. Let me briefly describe our efforts to do so.

Efforts to liberalize foreign restrictive investment practices

- In the General Agreement on Tariffs and Trade (GATT), we are seeking a binding, enforceable, legal obligation to prohibit certain government measures imposed on investment. For example, we are seeking to prohibit measures that require the use of local parts instead of imported parts. Such foreign requirements reduce American exports and harm U.S. workers. This area, known as Trade-Related Investment Measures (TRIMs), is a high priority for us in the Uruguay Round.

- In the Organization for Economic Cooperation and Development (OECD) we are pressing for firmer member country commitments not to discriminate against foreign companies. These commitments are embodied in the OECD's National Treatment Instrument. In current negotiations, we are seeking a standstill of new measures that discriminate against foreign-owned companies and a roll back of existing ones. American companies and their employees will benefit if American companies abroad are not put at a competitive disadvantage merely because they are foreign.

- Bilaterally, we have negotiated a number of investment treaties which provide a framework of agreed principles. An underlying theme of these treaties is to allow U.S. firms to establish businesses and to compete on equal terms with domestic firms. For example, last year we concluded negotiations with Poland of an Economic and Business Relations Agreement. One of the benefits of that agreement is that it enables U.S. firms to compete on a non-discriminatory basis with Polish and other foreign firms. We are negotiating similar agreements with other Eastern European countries, and have entered into negotiations with a number of Latin American countries.

- Through the Structural Impediments Initiative (SII) with Japan, we are seeking removal of barriers to foreign direct investment in that country.

Japan as focus

I would like to expand on the SII discussions. Much of the unease about Japan's direct investment in the United States stems from concerns about a lack of reciprocity -- that Japan's markets are not open to U.S. direct investment. The Administration has made particular efforts to liberalize Japan's investment regime. Our efforts are directed not just at legislative barriers, but in the SII discussions, at internal, structural barriers to foreign direct investment.

In recognition that access to Japan's market was limited by more than the traditional external trade and investment legislative barriers, President Bush and then-Prime Minister Uno launched the Structural Impediments Initiative in July 1989. The talks have been moving ahead despite the extraordinarily complex nature of the issues involved.

In a market as developed and complex as that of Japan, the only really viable way of making a direct investment is through mergers and acquisitions. Although Japan needs to liberalize the legal framework for foreign direct investment, the heart of the problem lies in the relationships among Japanese corporations and their willingness to open up to foreign investors.

In Japan, a web of cross-shareholdings (companies holding each others' equity) and long-term shareholdings is an effective barrier to foreign acquisitions. About 70 percent of all Japanese equities are held off the market in long-term shareholding arrangements. These shareholdings arrangements are a fundamental part of the Japanese keiretsu system of industrial organization. Keiretsu are groups of industrial, commercial, and financial companies joined by formal and informal ties that govern the production, distribution, and sale of a significant portion of goods in the Japan economy. These keiretsu are a significant barrier to the ability of U.S. companies to access the Japanese market through trade and investment.

We have made progress in opening Japan to foreign investors. We obtained commitments from the Japanese government to submit a bill to eliminate the government's current authority to block foreign investment on broad economic grounds. Japan also agreed to make keiretsu more transparent, in particular to improve disclosure which many observers believe is key to a more open investment climate.

But much more is required. In the latest SII talks, we have suggested measures that would lessen the effect of cross-shareholding, improve the proxy voting system, and enhance other shareholders' rights. We believe that these measures, if enacted, will increase the ability of U.S. companies to make strategic investments in Japan.

We are also stressing the importance of limiting Japanese sectoral restrictions on foreign investment only to those sectors that directly affect essential national security interests. Currently, Japan's sectoral restrictions on foreign direct investment cover investments in agriculture, forestry and fisheries, mining, oil, leather and leather products manufacturing.

Investment issues will remain a high priority of the SII talks. We have made Japan negotiators fully aware of the importance we attach to investment, not only in the SII talks, but through other contacts as well. We welcome the support we have received from Congress in this effort.

Exon-Florio provision

The Exon-Florio provision authorized the President, or his designee, to investigate foreign acquisitions to determine their effects on national security. It also authorized the President to take such action as he deems appropriate to prohibit or suspend such acquisitions if he found that:

> There is credible evidence to believe that the foreign investor might take action that threatens to impair the national security; and
>
> Existing laws, other than the International Emergency Economic Powers Act and the Exon-Florio provision, do not provide adequate and appropriate authority to protect the national security.

The President could direct the Attorney General to seek appropriate judicial relief -- including divestment. The President's findings are not subject to judicial review.

By Executive Order 12662 of December 27, 1988, the President designated the Committee on Foreign Investment in the United States (CFIUS) to receive notices and other information, to determine whether investigations should be undertaken, and once an investigation has been completed to prepare a report and a recommendation to the President.

Other Laws

Exon-Florio is by no means the only statute available to protect U.S. national security. Other laws, some of which distinguish between foreign and domestic investment, include:

o Protection of classified information. The Executive orders and Defense Department regulations that constitute the

Industrial Security Program restrict the ability of foreign-controlled companies to obtain security clearances necessary to carry out contracts involving classified information.

o Arms Export Control. Under the Arms Export Control Act, defense firms must provide the U.S. Department of State with written notice 30 days prior to a planned transfer of ownership to a foreign person. A license is required for the transfer of technical data to a foreign person, and can be denied for foreign policy or national security reasons.

o Defense priority. The Defense Production Act, now lapsed, empowered the government to require priority performance of defense-related contracts.

o Export control. The Export Administration Act empowers the government to subject the export of sensitive and high-technology products and information to licensing and other requirements.

<u>CFIUS Operations</u>

Let me now turn to CFIUS operations. As mentioned, the President delegated to CFIUS his authority to receive notices and conduct investigations of foreign acquisitions to determine effects on national security.

CFIUS agencies are Treasury (chair), Defense, State, USTR, Commerce, OMB, CEA, and Justice. Other agencies participate when a transaction falls within their sectors of expertise. For example, if a transaction is in the energy sector, we invite the Department of Energy to participate. And when transactions involve advanced technology, we invite the Office of Science and Technology Policy to augment the expertise of CFIUS agencies in appraising the complexity and importance of the technology in question.

Within CFIUS, Treasury serves as the secretariat. It receives notifications of transactions, decides what Executive Branch agencies other than the eight CFIUS agencies need to be brought in for technical advice, serves as the contact point for the private sector, establishes a calendar for each transaction, and in general supervises the process.

The Exon-Florio provision provides for a 30-day initial review and, if necessary, a 45-day investigation. For those transactions for which an investigation is completed, a Presidential decision must be announced within 15 days. In total, the process does not exceed 90 days.

<u>How notifications are handled</u>

CFIUS review is initiated by receipt of a written notification of a transaction. The proposed regulations provide that notice may be given only by a party to the transaction or by a CFIUS member agency. Notice from third parties is not accepted.

Notification is voluntary. Many foreign acquisitions do not involve issues related to national security and, consequently, parties to the transaction may decide not to notify CFIUS.

In order to perform our review for national security, we have asked that notifications include the following:

- A description of the parties to the transaction;
- Details on the acquisition arrangements;
- Identification of the foreign parent and the ultimate beneficial owner and information on them;
- Other filings with U.S. Government agencies which have been made or are contemplated;
- A list of contracts, both classified and unclassified, with Department of Defense or other U.S. Government agencies;
- The plans of the acquiring company for the U.S. company.

Once a notification is received, Treasury, as a first step, decides if it is complete. If so, the 30-day review period begins. During that period CFIUS agencies evaluate the transaction.

During the 30-day period CFIUS agencies, through Treasury, typically engage in a dialogue with the parties to the transaction regarding issues raised by the notification. This dialogue takes place initially in the form of written questions and answers to clarify or solicit information in addition to that contained in the notice. Subsequently, the dialogue may extend to inviting the parties to the transaction to Treasury to meet with CFIUS staff for clarification and exchange of information. During this time, there is also close coordination and frequent exchanges of information and views among CFIUS agencies.

At the end of the 30 days, any given transaction has been viewed from many national security perspectives. CFIUS at that point has a good sense of the national security aspects of the transaction, and agencies present views on whether to move to the 45-day investigation stage.

If no agencies request an investigation, the parties to the transaction are notified that there are no national security issues sufficient to warrant an investigation and that action under the Exon-Florio provision is concluded with respect to the notified transaction.

If agencies decide to request an investigation, the request is in the form of a letter to Treasury from a Presidential appointee, generally an Assistant Secretary. CFIUS then decides at the Assistant-Secretary level whether to initiate an investigation. A decision to investigate begins the statutory investigation period which is not to exceed 45 days.

At the completion of the investigation, CFIUS must send the President a report and a recommendation. If, however, CFIUS is unable to reach a unanimous recommendation, the Secretary of the Treasury, as chairman, must submit a CFIUS report to the President which sets forth the differing views and presents the issues for decision. The President then has 15 days to announce his decision on the case.

Lapse of Exon-Florio authority

As you know, Exon-Florio authority lapsed with the expiration of portions of the Defense Production Act on October 20, 1990.

We were advised by involved Congressional staff that Exon-Florio authority would, in their view, be renewed. After consultations with Congressional staff, the business and legal communities, and other CFIUS agencies, Treasury announced on November 6, 1990, that CFIUS would continue to operate on an informal basis in accordance with Exon-Florio criteria.

Since the lapse, CFIUS has provided a process of review that is close to that of Exon-Florio. At the end of 30 days, if no agencies believe there are national security concerns that warrant further review, we so advise the parties to the transaction. This allows them to proceed, knowing the transaction does not pose problems from a national security standpoint.

On the other hand, if there are problems, or aspects of the transaction that require greater research, we will initiate the 45-day extended investigation period. Although the President's authority under Exon-Florio is not currently available, parties to transactions have conveyed a willingness to cooperate with CFIUS in the expectation that Exon-Florio authority would be renewed.

However, the longer the period of lapse extends, the more difficult it becomes to continue to operate under interim arrangements. Eventually the Exon-Florio process would be undermined. We believe that it would be unwise to allow the present uncertain situation to continue and we support extension of Exon-Florio in its current form.

Summary of Exon-Florio Operations

We have received over 530 notices since the inception of Exon-Florio. Of that total, twelve transactions have been subject to a 45-day investigation and sent to the President. In seven of those twelve transactions, he chose not to interfere. The President chose to prohibit one transaction. The notifications to CFIUS of the remaining four transactions were withdrawn.

Beginning last fall, there has been a noticeable reduction in the number of notifications to CFIUS of transactions. This reduction has continued into 1991. During last January CFIUS received 25 notifications, while this January CFIUS received 13 notifications. I would not wish to draw firm conclusions at this point, but the drop off may reflect reduced economic activity as well as a reduction in asset values and liquidity in major investing countries, such as Japan.

Criticism of CFIUS

The seemingly small number of transactions subject to the 45-day investigation, and the fact that the President has prohibited only one transaction, have been points of criticism. The argument is made that CFIUS cannot possibly be doing its job if the President has only blocked one deal and CFIUS has only investigated twelve transactions.

I would suggest that this criticism is misdirected, or reflects a misunderstanding of Exon-Florio.

Exon-Florio allows us to assure that foreign direct investment does not pose a threat to national security while sustaining our open investment policy. Indeed, CFIUS's impact goes beyond statistics:

- o Exon-Florio has resulted in greater awareness in the business and legal communities of national security aspects of transactions;

- o CFIUS serves as a mechanism for case-by-case review of transactions designed to confirm that laws to protect security are appropriate and adequate to the task for the transaction under consideration;

- o CFIUS has access to substantial information and data sources and has developed an efficient system for evaluating transactions. When necessary, CFIUS may also ask the parties to a transaction to meet with CFIUS in order to clarify answers to questions raised by CFIUS, to demonstrate and explain technology, and to elaborate upon aspects of the transaction. As a result, CFIUS is able to put transactions through detailed scrutiny in the initial 30-days. This significantly reduces the transactions subject to a 45-day investigation;

o Exon-Florio has also produced a marked improvement in co-ordination and information sharing within the Executive Branch on national security implications of foreign purchases of U.S. businesses. For example, the Defense Investigative Service informs CFIUS of pending transactions brought to its attention because classified information is involved. The CFIUS process has also resulted in other agencies, such the State Department and the Commerce Department, learning of transactions which involve export of munitions and sensitive technology subject to license.

FANUC/Moore Transaction

The most recent withdrawal of a CFIUS notification occurred last week. FANUC, Ltd. and Moore Special Tool Company informed CFIUS that FANUC had decided not to proceed with the proposed acquisition of 40 percent of Moore's stock.

Your letter of invitation to testify asked that I address the FANUC/Moore transaction. I will do so briefly.

Moore is a manufacturer of machine tools and measuring machines in Bridgeport, Connecticut, with annual sales of $40 million. Some 60 percent ($24 million) of Moore's annual sales are to the export market, and 40 percent ($17 million) to the domestic market. At this sales level, Moore is a small but important manufacturer in the U.S. market. Of Moore's total domestic sales, the Department of Energy buys about three machines annually, each valued at $1-1.5 million. Energy purchases from Moore have included jig grinders, coordinate measuring machines, and lathes. These machines are used in the production of nuclear weapons.

Moore approached FANUC after its attempts to find a U.S. investor were unsuccessful. Initially, FANUC sought to lend money to Moore, but this was not a viable alternative from Moore's perspective because it was having difficulty servicing its existing debt. Subsequently, Moore and FANUC agreed that FANUC would purchase an equity share in the company.

From Moore's perspective, approaching FANUC was logical. FANUC has been closely involved with Moore for about two years during which time the two companies have worked together to provide FANUC digital controllers for Moore machines. Digital controllers instruct machine tools to cut, shape, and bore to fine tolerances.

Moore viewed a working relationship with FANUC as a key to developing the next generation of machine tools and maintaining the competitiveness of Moore machines. Moore chose FANUC because it considered FANUC controllers the best in the market and necessary to maintain Moore's excellence.

The Committee carefully scrutinized all aspects of the transaction to determine if the standards for blocking under Exon-Florio were met and forwarded its report to the President.

On February 19, 1991, FANUC and Moore announced that FANUC had decided not to pursue further the investment in Moore. They requested that their notification be withdrawn from CFIUS consideration. That request was granted on February 20.

Conclusion

In concluding, I would like to make two points:

1) an open investment policy is critical to sustaining the ability of our economy to expand, to become more competitive, and to create jobs; and

2) Exon-Florio legislation is needed to continue our national security reviews of transactions. This will be done in the context of our open investment policy.

An investment climate is inherently fragile, and therefore requires a long-term commitment. There are dangers in tampering with such a commitment. We must take care not to signal foreign investors that their investments and their benefits to the economy may not be welcomed in the United States, particularly at a time when competition for capital is intensifying, and our savings rate remains relatively low. It is too early to say whether the fall in the rate of foreign direct investment in the United States is an aberration or an indication of future trends. However, it does suggest that it is not preordained that the United States will be the country of choice for foreign direct investment. It is important to keep this in mind when making decisions with respect to our foreign investment policy.

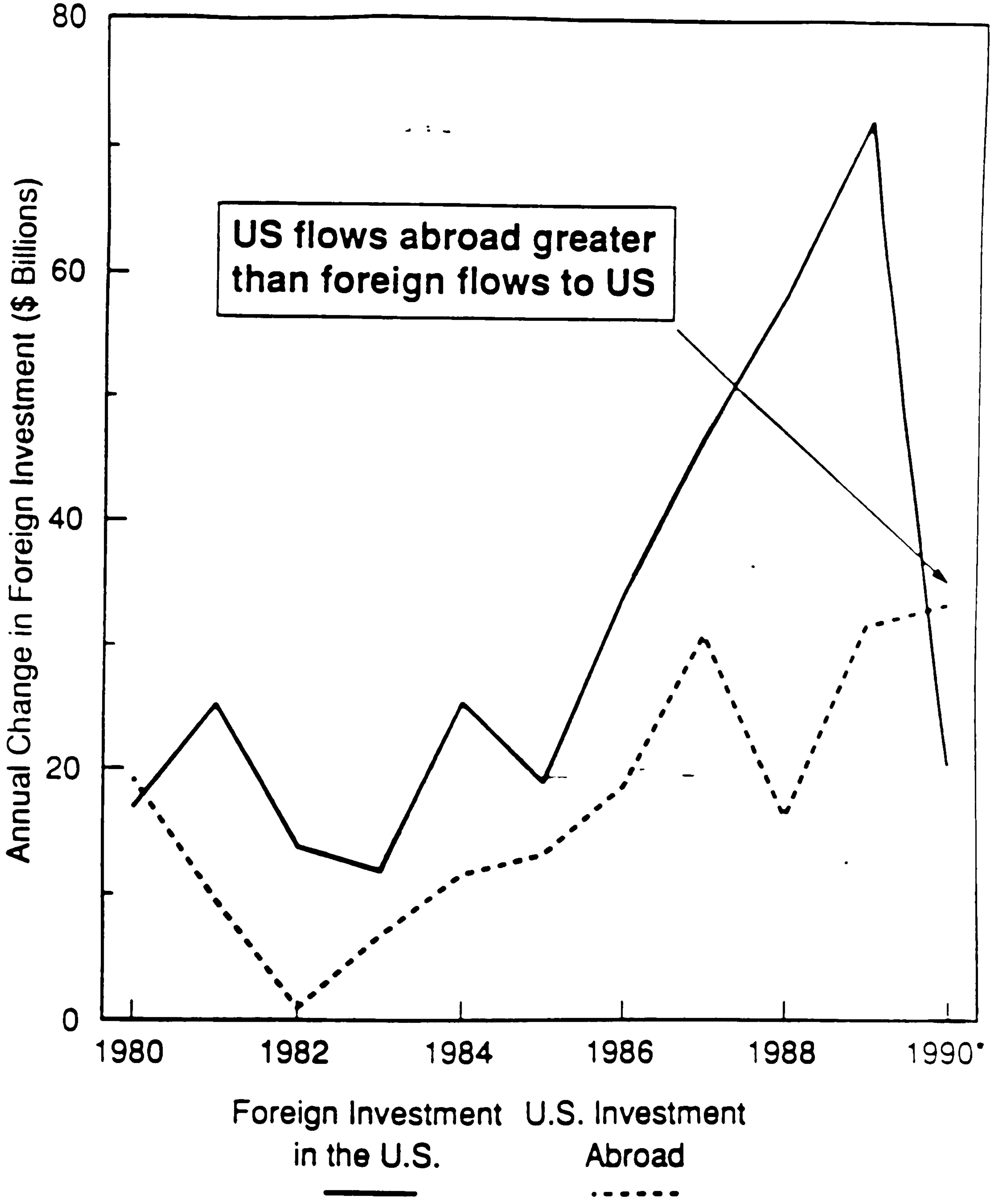
This concludes my statement. I will be happy to take your questions.

APPENDIX

CHARTS ON

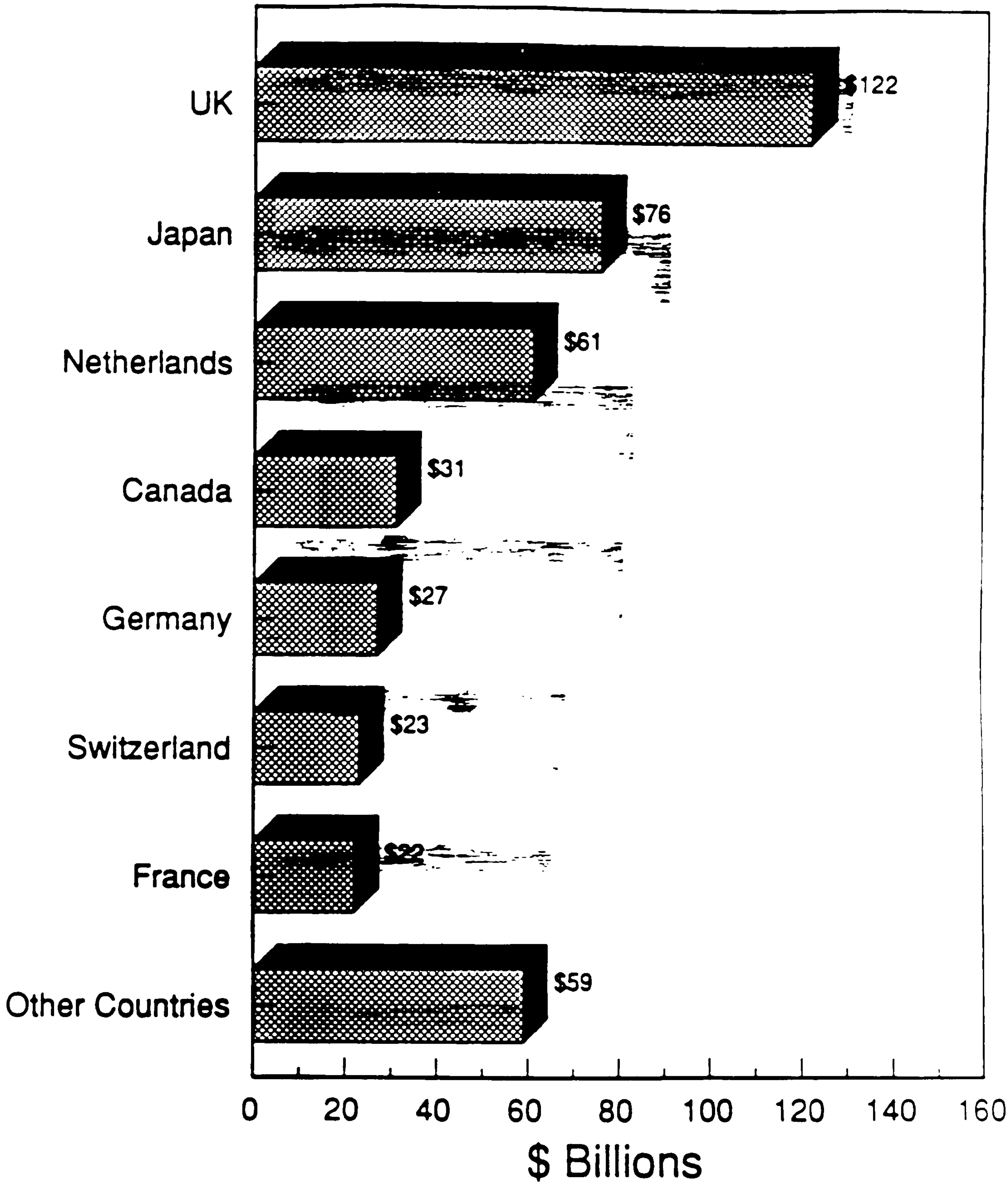
FOREIGN DIRECT INVESTMENT

AFTER INCREASING DURING 1980s, IN 1990 FOREIGN INVESTMENT FLOWS TO U.S. SIGNIFICANTLY DECREASED



1990 data through 3rd quarter only
Source: Survey of Current Business

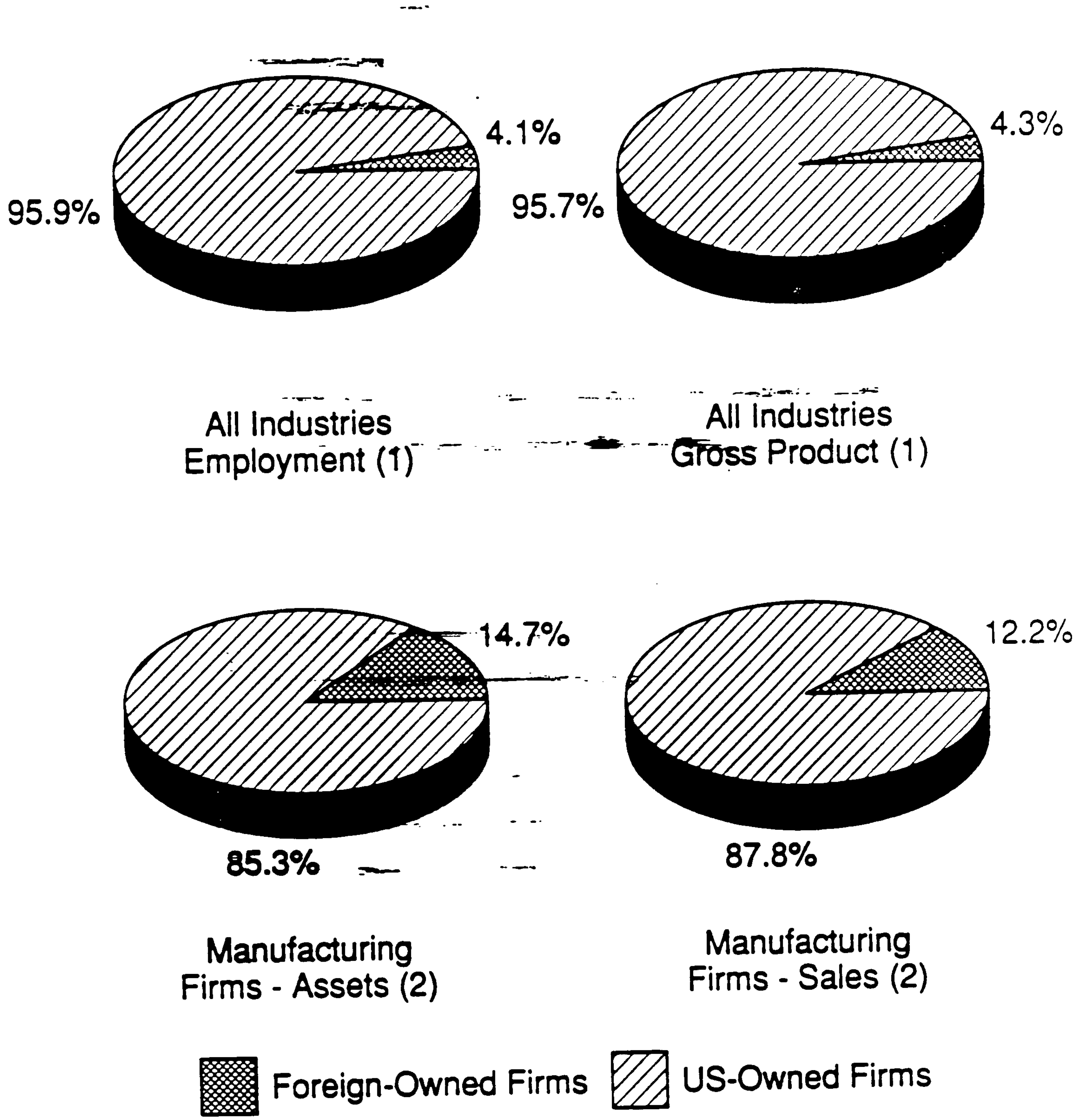
UK, JAPAN, & NETHERLANDS LARGEST FOREIGN INVESTORS IN THE US



FDI position through 3rd Quarter 1990
Source: Bureau of Economic Analysis

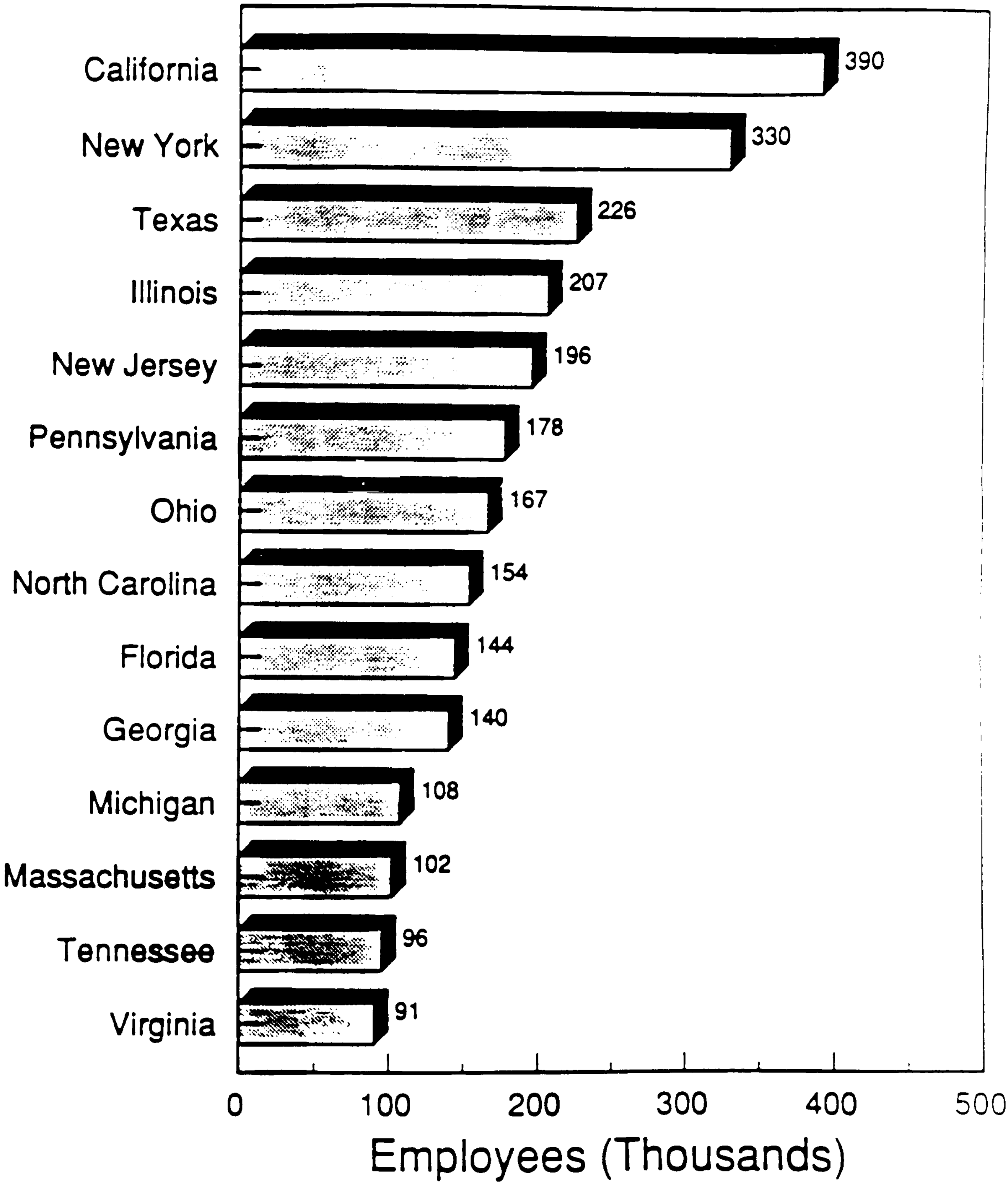
FOREIGN-OWNED FIRMS ACCOUNT FOR ONLY A SMALL PART OF US ECONOMY

1988 Data, Except for Gross Product (1987)



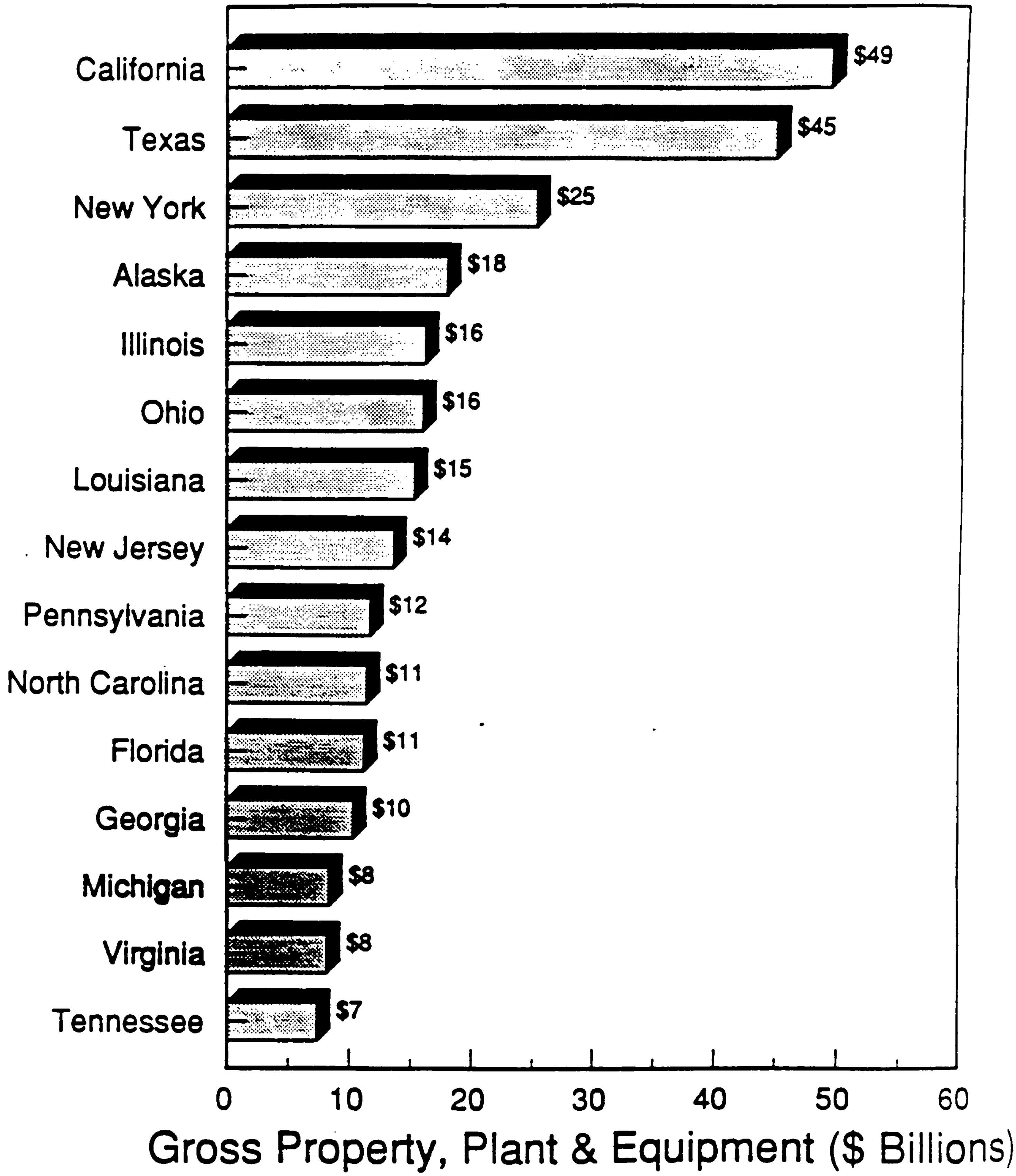
(1) Nonbank US Affiliates/Nonbank US Businesses
(2) US Affiliates/All US Firms (Manufacturing)
Source: Survey of Current Business

IN 1988 FDI ACCOUNTED FOR OVER 2.5 MILLION JOBS IN TOP 14 STATES



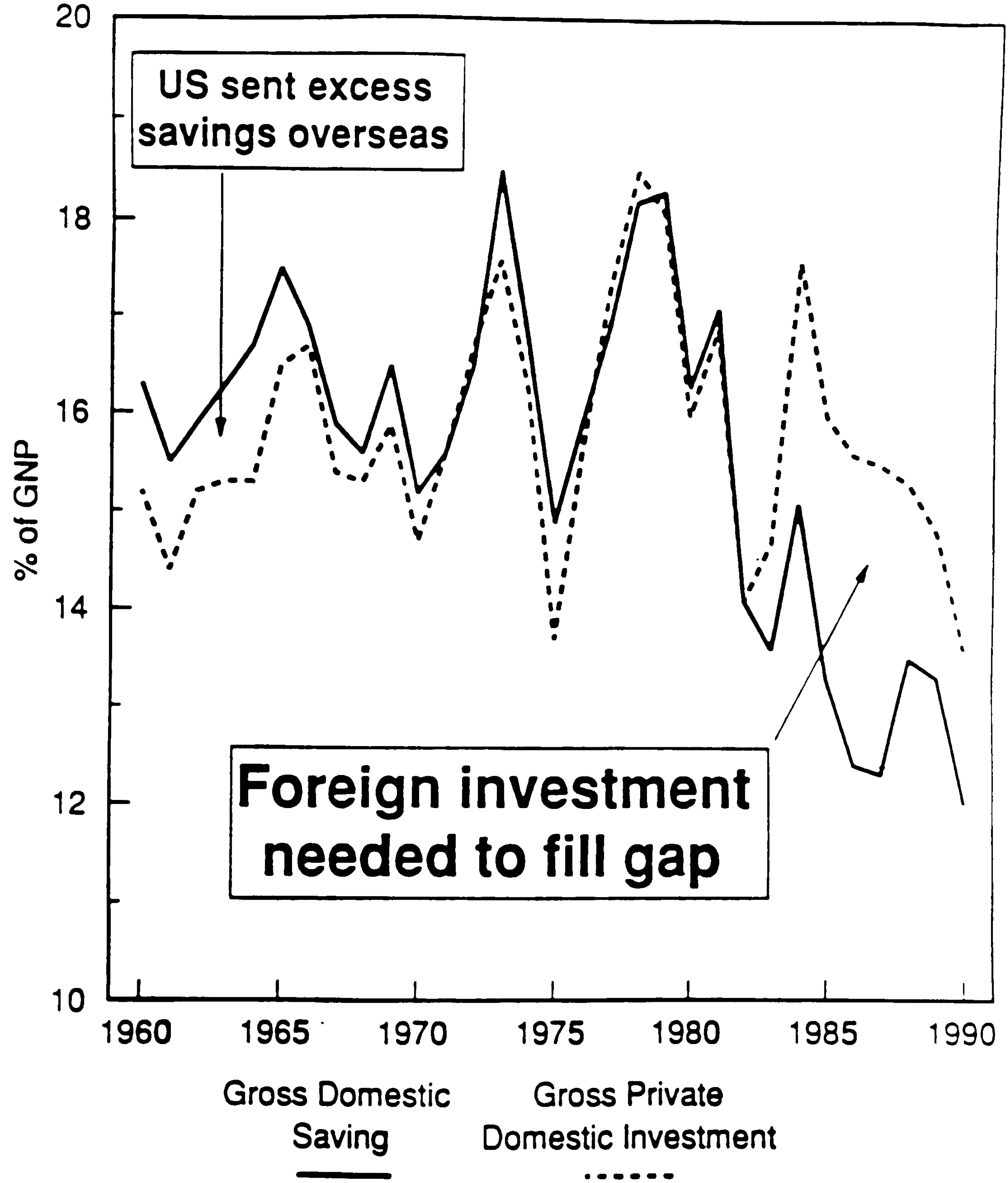
Employment in nonbank US affiliates
Source: Bureau of Economic Analysis

FOREIGN INVESTMENT IN THE US
TOP 14 STATES - 1988



Source: Bureau of Economic Analysis

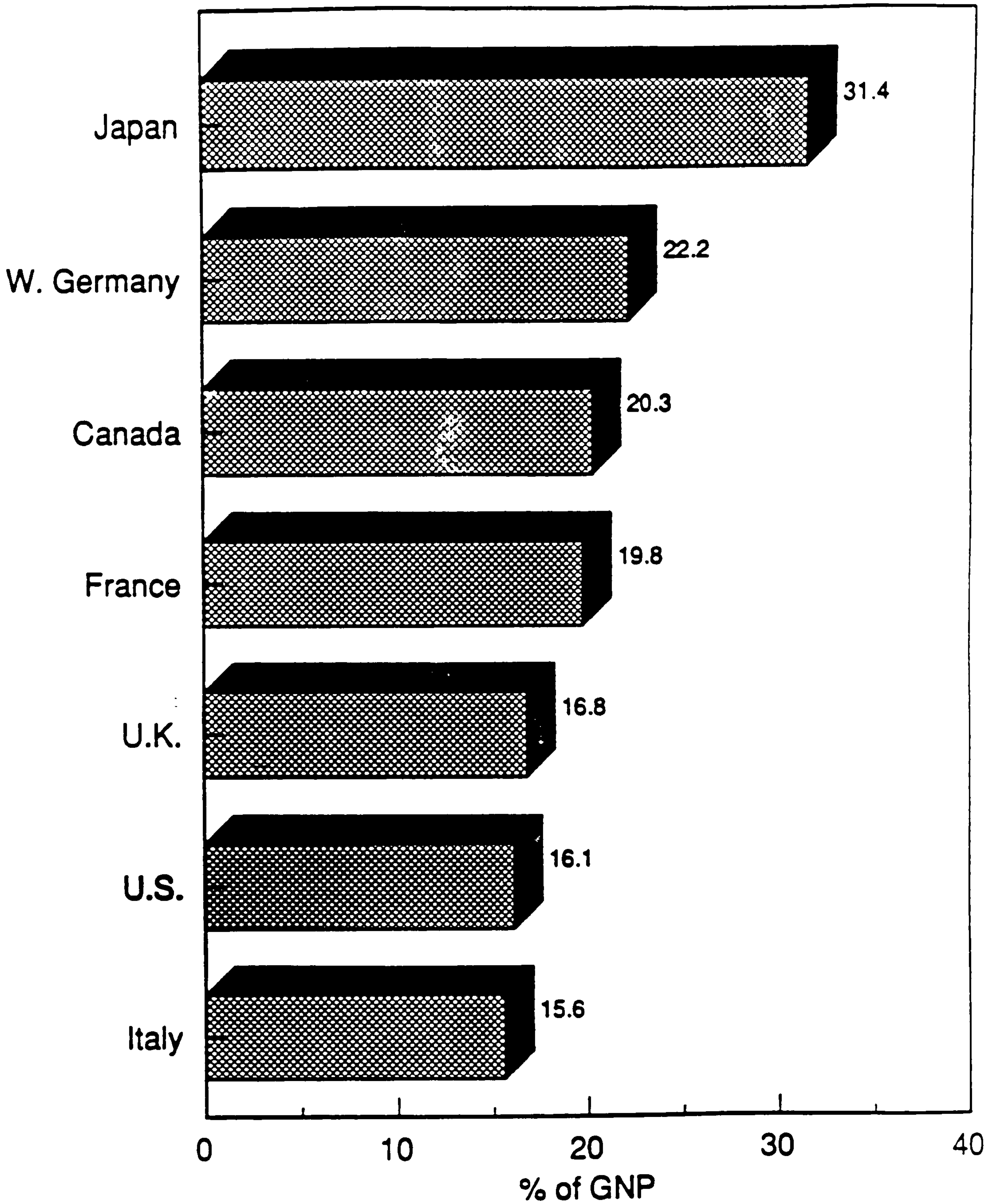
FOREIGN INVESTMENT HELPED US MAINTAIN DOMESTIC INVESTMENT DESPITE DECLINING SAVINGS RATE



Part of difference between Gross Savings & Investment due to statistical discrepancy
Source: 1991 Economic Report of the President

US NEEDS FOREIGN INVESTMENT BECAUSE US SAVINGS RATE SIGNIFICANTLY BELOW MAJOR TRADING PARTNERS

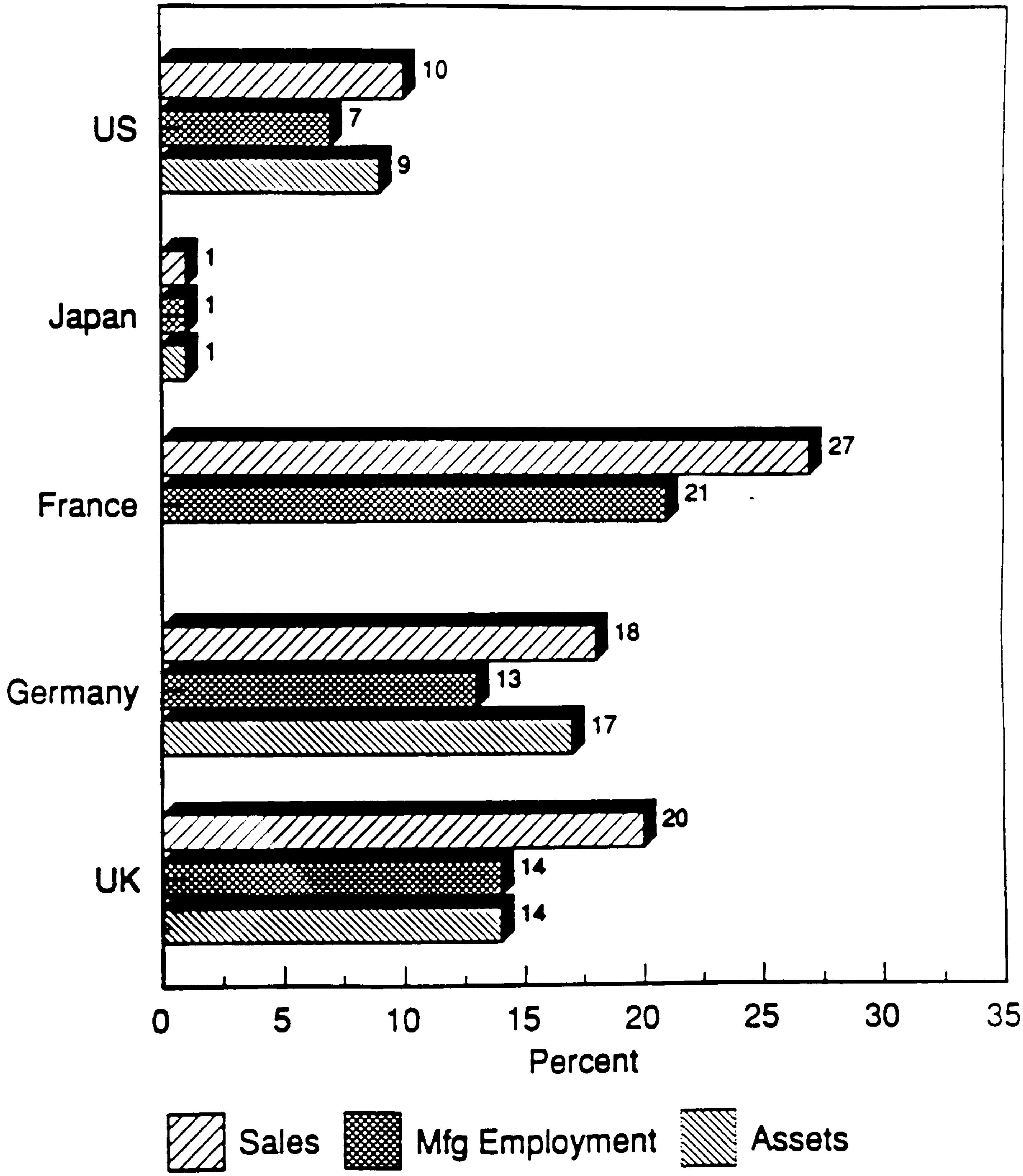
Average Gross Savings Rates 1981-88



Source: OECD

EXCEPT FOR JAPAN, OTHER MAJOR TRADING PARTNERS ACCEPT HIGHER LEVELS OF FOREIGN INVESTMENT

1986 Data (asset data not available for France)



Source: Julius & Thomsen, "Foreign-Owned Firms, Trade & Economic Integration", Tokyo Club Papers 2, Royal Institute for International Affrs, 1988

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
February 26, 1991

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 $17,200 million, to be issued March 7, 1991. This offering will result in a paydown for the Treasury of about $2,150 million, as the maturing bills are outstanding in the amount of $19,360 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, March 4, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,600 million, representing an additional amount of bills dated June 7, 1990, and to mature June 6, 1991 (CUSIP No. 912794 WM 2), currently outstanding in the amount of $20,977 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,600 million, to be dated March 7, 1991, and to mature September 5, 1991 (CUSIP No. 912794 XE 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 March 7, 1991. 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 $1,030 million as agents for foreign and international monetary authorities, and $4,459 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-1153

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 competitive 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.

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.

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.

8/89

TREASURY NEWS

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

Embargoed until Given
Expected at 10:30 a.m., February 27, 1991

TESTIMONY OF

THE HONORABLE NICHOLAS F. BRADY

SECRETARY OF THE TREASURY

BEFORE THE HOUSE COMMITTEE ON

BANKING, FINANCE, AND URBAN AFFAIRS

MODERNIZING THE FINANCIAL SYSTEM

February 27, 1991

Chairman Gonzalez, Congressman Wylie, and members of the Committee, over 18 months ago the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) asked the Administration to undertake a broad study of our financial system. Congress and the Administration realized that it was time for a fundamental reexamination of the basic laws governing depository institutions and the taxpayer's exposure through deposit insurance.

Earlier this month, we delivered to Congress our final report. The Administration's legislative proposal will be submitted shortly. Today I will describe our recommendations to the Committee. But before doing so, I'd like to describe some of the disturbing conditions I see today in our banking system --

disturbing because they leave taxpayers overexposed, consumers and businesses underserved, and the banking industry uncompetitive and unable to effectively perform its essential role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we had seven. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. Some have suggested that the "Top 25" list does not matter. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? Obviously not.

To start with, we have left antiquated laws on the books that prohibit banks from providing new products in their natural markets, and that even keep them from branching across state lines. Banks in Texas, Ohio, and California can open branches in Birmingham, England, but not in Birmingham, Alabama. These laws -- mainly enacted in the 1920s and 30s -- are wholly out of touch with reality, and impose unnecessary costs on banks and consumers, costs that have been estimated at $10 billion annually. Consumers have long since begun to ignore them and conduct their financial affairs their own way, using credit cards, cash machines and the 800 number to effect transactions when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck.

We have a deposit insurance system that has wandered away from its original purpose of protecting only the small depositor, and now covers almost every depositor, large and small, insured and uninsured. This system has protected large, sophisticated investors who don't need the protection, and exposed the taxpayer to potential losses.

Despite the hard lessons we learned from the S&L collapse, we still allow state banks to invest federally insured deposits directly in real estate and other risky investments -- practices we don't allow federally chartered banks to engage in.

Small banks find themselves choking on unnecessary paperwork imposed on them by innumerable state and federal statutes that seem to require multiple reports on every possible subject.

We have an industry that is in the grasp of no less than four separate federal regulators, so that its ability to run its day-to-day affairs and respond quickly to changed conditions -- such as the credit crunch -- is hamstrung by a myriad of Lilliputian restrictions.

We have an industry that is so weakened that, in some regions, it has withdrawn from its crucial role of extending credit to worthy borrowers to finance economic activity and job growth.

What does it all add up to? Bank failures that totalled 198 in the 38 years from 1942 to 1980, but that reached 206 in 1989 alone; higher interest rates and transaction charges due to inefficiency and higher costs; and a bank insurance fund that is under stress.

It's a bleak picture that demands action -- prompt action -- to correct it.

Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized BIF. But we also need interstate branching and broader financial activities so that our banks can become financially strong again. If we leave the job half done -- if we tinker with the problem -- then we'll probably be back again, sooner or later, recapitalizing BIF, perhaps the next time with taxpayer money. I don't relish that prospect any more than you do.

This is not just another round in the biannual, intramural fight among financial services companies over banking reform. This time, the country needs results. Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe to toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to turn this situation around. The laws must be changed to foster a safe and financially strong banking system where the number of costly failures is dramatically reduced. Banking regulation must fit the reality of today. It is time to let the banks catch up with their customers.

Specific Reforms

The Administration's proposal addresses three interrelated problems: first, a banking system with reduced competitiveness and financial strength, caused by outdated legal restrictions that have prevented banking organizations from responding to the evolution of financial markets and technology; second, an overextended deposit insurance system, resulting in excessive exposure for taxpayers and weakened market discipline for banks; and third, a fragmented regulatory system that has created duplicative rules and has often failed to produce timely remedial action.

1. Restored Competitiveness

The competitiveness of the banking industry has been undercut by the erosion of the traditional bank franchise. Banks are no longer the steady, reliable businesses they once were. Old laws designed to assure strong banks have in fact become barriers that impede banks from adapting to changed market circumstances. The result has been financial fragility and loss.

Banks have operated under extremely inefficient and costly restrictions on geographic diversification. Interstate banking was prohibited until recently; interstate branching remains virtually prohibited; and even in-state branching continues to be restricted in a number of states.

While banks have been confined by artificial boundaries, consumers have not. With credit cards, cash machines, and the 800 number, consumers can now "bank" anywhere in the country. The public is not bound by our banking laws. Yet the banks must continue to labor under these antiquated restrictions, which have been estimated to cost $10 billion each year, against a pre-tax industry profit figure of $25 billion for all of 1989. And these costs are passed on to the consumer in higher transaction costs and higher interest rates.

Legal restrictions have denied banks the ability to follow their best traditional customers into new markets. As a result, banks have increased their concentration on the remaining less attractive segments, which in many cases are riskier. The result has been diminished profitability, which has undercut the safety and soundness of the banking system.

How do we reverse this trend? How do we make banks more steadily profitable and competitive, better able to attract capital, and more ready to lend in good times and bad? The answer is plain: we need to overhaul outdated laws to recognize the realities of the current marketplace. I think that Chairman Greenspan captured this need perfectly in earlier testimony, which I'd like to quote. He said that:

Developments in computer and communications technology have reduced the economic role of commercial banks. These permanent and fundamental changes in the environment cannot be halted by statutory prohibitions, and the longer the law refuses to recognize that fundamental and permanent changes have occurred, the less relevant it will be as a force for stability and competitive fairness in our financial markets. Attempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law which is so critical to a safe and sound financial system.

We should begin by authorizing nationwide banking and branching, which will make banks safer through diversification, and more efficient through substantially reduced operating costs. This is not a radical new idea. A majority of states have already embraced the concept of interstate banking. Thirty-three states -- two-thirds of the country -- have voted to permit nationwide interstate banking, while another 13 states permit regional interstate banking. But the laws on the books impose enormous costs on the system by virtually prohibiting interstate branching. These laws block interstate banking companies from achieving enormous immediate cost savings through such measures as common management and consolidated data processing systems. These savings are directly available to reduce transaction and overhead costs, to lower interest rates and to build both profits and capital.

But well-capitalized banking organizations must also be allowed to use their franchise to participate in the full range of financial services in their natural markets -- but to do so safely outside the bank and outside the federal deposit insurance safety net. The taxpayer should not back these new activities. Neither should the taxpayer bear the cost of a banking system that has been artificially restricted into unprofitability.

And at this time when banks need capital, we should allow strong, well-capitalized financial and commercial firms to own banks as well -- so long as they are willing to adhere to agreements that will maintain well-capitalized banks.

2. Overextended Deposit Insurance

Deposit insurance coverage has expanded well beyond its original purpose of protecting small depositors. Instead, it now guarantees the deposits of wealthier individuals, corporations, and large institutional investors. This broad extension of deposit insurance has dramatically increased taxpayer exposure.

Left to its own workings, the market would have imposed higher funding costs on institutions for excessive risk taking. But our overextended deposit insurance system has undermined the market discipline that should have constrained the increased riskiness of weak banks. With easy access to federally guaranteed funds and little to lose, these weak, undercapitalized banks have had a perverse incentive to take excessive risk with other people's money, exposing the taxpayer to even greater losses.

Reduction in overextended coverage. This proposal would address the problems of overextended deposit insurance by reining in overextended coverage, without reducing the basic protection for small depositors and without losing the benefits of stability in the banking system. It would eliminate coverage for brokered deposits, and for certain pension fund managers with "pass-through" coverage. In addition, it would limit coverage to $100,000 per person per institution, plus a separate $100,000 per institution for retirement savings.

Protection of Uninsured Depositors. We would also curtail the routine practice of protecting virtually all uninsured depositors in bank failures. Protecting uninsured depositors should be the exception, not the rule, and should occur only where there is genuine risk to the financial system. The system that we have proposed would eliminate routine protection of uninsured depositors.

Criticism has come from both sides of this issue. One side charges that we have not totally eliminated the so-called "too big to fail" policy, under which uninsured depositors are fully protected in large bank failures in order to avoid massive damage to the financial system. But no government among the leading industrial nations has deprived itself of the ability to protect uninsured depositors when the system is threatened. None. We should not be the first to try the experiment.

The other side claims that we should protect <u>all</u> deposits in <u>all</u> institutions -- if we are to protect any -- in order to be fair to large depositors in smaller banks. But what about fairness to the taxpayer? It is bad enough that there are times when it is impossible to avoid bailing out large depositors in certain bank failures; but should the taxpayer foot the bill for <u>all</u> large depositors in <u>all</u> bank failures as a result? Extending the safety net to insure all deposits is a backward step.

My point is that the American people should not be asked to choose between a policy that puts the financial system at risk and one that puts the taxpayer at risk. Instead, we have proposed a system with strong, well-capitalized banks that are less likely to fail, and a supervisory system that intervenes promptly and decisively before failure can occur.

Much of the heat surrounding this issue is over the question of who should pay for protecting uninsured depositors. The practice in some other countries is for the taxpayer to pay because of the fundamental benefits to the financial system and to the entire economy. We recognize that there are arguments for this position. However, our proposal reflects the view that the banking industry should pay because it directly benefits from systemic stability.

Strengthened role of capital and supervision. Reducing overextended coverage by itself cannot resolve our current problems. Deposit insurance will still protect -- and should protect -- a substantial part of each bank's funding base. It is therefore critical to strengthen the role of capital and improve supervision to make deposit insurance safe for the taxpayer. Capital is the single most important protection. It puts the shareholders' own money at risk and thus provides incentives to invest prudently. And it acts as a buffer that absorbs losses ahead of the deposit insurance fund.

The proposal would make bank supervision more effective by creating incentives for banks to build and maintain high levels of capital, and providing swifter and more certain regulatory intervention against banks with too little capital. Indeed, the failure to take prompt corrective action in the past allowed some institutions to fail when they could have been saved, and fostered low capital levels that create incentives for firms to take excessive risk. The proposed new system would address these problems by creating a regime of specific supervisory actions that are triggered by declines to increasingly lower levels of capital.

Risk-based premiums. Assessing risk-based premiums which would vary according to levels of capital would also help. Because capital is a crucial measure of risk, firms would be rewarded with lower premiums for maintaining higher capital. In addition, an FDIC demonstration project would test the feasibility of using private reinsurers to provide market pricing for risk-based premiums.

Risky state activities. Finally, states should no longer have authority to authorize risky activities for state banks that receive federal deposit insurance. A balance was struck in FIRREA for state thrifts between the benefits of the dual banking system and the interest of the federal government. We should strike this same balance for federally insured state banks.

3. Streamlined Regulatory System

Bank regulation and supervision reduces taxpayer exposure to losses created by deposit insurance. But in the face of the problems I've outlined above, our fragmented regulatory system has not been successful in stemming the weakening of the banking industry. In recent years, banks have experienced record loan losses and failures that are rapidly depleting the bank insurance fund. There is not a satisfactory regulatory mechanism for promptly correcting banking problems. Moreover, with as many as four banking regulators involved in the affairs of a single banking organization, no single regulator has had either the full information or the clear authority and responsibility for the decisive, timely action necessary to deal with weak institutions.

Our proposal would streamline the regulatory system in a number of different ways that would further supplement market discipline and apply prompt, decisive corrective action to weak and unsound institutions. First, to improve authority, accountability, and responsibility, there would be a single federal banking regulator for each banking organization. Second, the current system of three federal bank regulators would be reduced to two: national banks would remain under Treasury, and all state banks would go to the Fed. As part of this plan, the FDIC would focus on its primary function as insurer and resolver of failed institutions. This approach parallels that taken in FIRREA, where the thrift regulator and insurer were separated. Except for receding from its role as the primary federal supervisor for state non-member banks, the FDIC would retain all of its existing examination and enforcement powers.

Finally, the Bank Insurance Fund is at its lowest level in history as a percentage of insured deposits. The Federal Deposit Insurance Corporation (FDIC) has projected that it will decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

The Bank Insurance Fund must therefore be recapitalized. We have said that any plan should satisfy a number of objectives. First, the Fund must have sufficient resources so that the FDIC can do its job of resolving failed institutions. Next, the Fund should be recapitalized with industry funds, but in a way that does not further impair the health of the banking industry. Finally, the plan should rely on GAAP accounting.

Last fall, as part of the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), the FDIC was granted additional legal authority it needed to recapitalize the fund. For the last two months, the FDIC has been working with industry groups to develop a plan. Over last weekend, we have received the outline of a proposal from the FDIC. We are reviewing this proposal, and expect to work with Chairman Seidman to include legislation as appropriate when the FDIC plan is finalized.

Before concluding, I'd like to respond to two criticisms that have been made -- I think with little merit. The first is that we are somehow repeating the mistakes that contributed to the S&L disaster. That is simply not the case. The banks are totally different from the S&Ls. By a wide margin, banks are better capitalized, better managed and better regulated than the S&Ls. To be precise, the banks have over $200 billion in equity capital, plus another $50 billion in reserves. The S&Ls had less than $10 billion in equity in 1987, the year losses mushroomed.

In addition, our approach to reform is distinctly different. The S&Ls were permitted to use federally insured deposits to engage in risky activities inside the institution. In effect, we let S&L owners go to the casino with Uncle Sam's checkbook in hand. By contrast, we have proposed that new financial activities for banking organizations take place only in separately capitalized affiliates, with stringent firewalls and strict supervision. And we've gone even further in limiting new activities only to banks that exceed minimum capital requirements by a substantial amount.

It is important that we do not learn the wrong lesson from the specter of the S&L problem. With the banking system, inaction and procrastination are the enemy. It would be ironic if memories of the S&L cleanup prevent us from making necessary changes -- changes that could save the taxpayer from another costly and unnecessary cleanup.

A second criticism is that we are somehow embarking on a risky "deregulation" of the banking industry, again along the lines of the S&L problem. That just doesn't square with the facts. The proposal represents sound and prudent regulation, with badly needed reforms to protect the taxpayer.

Benefits of Reform

Let me close my remarks with a discussion of the wide range of interests that benefit from the Administration's plan. The first and most obvious group are taxpayers. Strong, well-capitalized banks and a well-capitalized deposit insurance fund are the best protection for the taxpayer -- they result in more profitable banks, fewer failures, and a strong buffer ahead of the taxpayer to absorb whatever losses do occur.

The second group is consumers, both individuals and businesses. Our plan would foster the delivery of a wider range of more convenient services for consumers everywhere in the country, with important protections to prevent confusion between insured and uninsured products. Consumers would also benefit from increased convenience, lower interest rates and lower transaction costs as a result of the enormous savings available.

The third group is businesses and workers, who need to be able to count on bank credit in both good times and bad. Strong, well-capitalized banks can act as shock absorbers in bad times to help customers work through temporary problems. Strong banks can also keep lending in an economic downturn, whereas weak banks are often forced to contract and stop lending in order to continue to meet capital requirements. As a result, loans are called less often, fewer bankruptcies occur, and jobs are preserved.

The fourth group is the banks themselves, including small banks. This is not a "big bank" bill, with nothing in it for small banks. The capital-based nature of the plan particularly benefits smaller banks, which have higher capital levels than larger banks. Let me state again: Well-capitalized firms will be rewarded with lower insurance premiums, greater ability to engage in new activities, and more regulatory freedom. I fully expect that strong, well-managed smaller institutions will continue to more than hold their own against larger rivals. They have done so for many years. For example, the evidence is that, when states such as California and New York enlarged within-state branching powers, smaller banks continued to prosper. To quote Gerry Corrigan of the New York Fed, "I am absolutely confident that literally thousands of small- and medium-sized institutions will continue to flourish." Our proposal does not aim at reducing the number of small banks. Our proposal <u>will</u> lead to earlier resolution of weak banks, many of which are anything but small. The fact is that our plan favors strong banks, not big banks; well-managed banks, not weak banks. Well-capitalized, well-managed smaller banks would prosper under our proposal.

Finally, the Administration's proposal would benefit the nation as a whole. The world's leading economy demands a world-class banking system.

Mr. Chairman, as I said earlier, this is not just another replay of the biannual, intramural fight over banking reform. This time, the country needs results. Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe to toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

TREASURY NEWS
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For Release Upon Delivery
Expected at 10:00 a.m.
February 27, 1991

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

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Administration on a number of proposals to provide tax relief to members of the Armed Services. Most of the proposals listed in the Committee's hearing announcement are specifically designed to benefit military personnel participating in Operation Desert Storm, although some of the proposals would grant tax relief to all military personnel. Before discussing these proposals in detail, I would like to make a few general observations.

DESERT STORM TAX LEGISLATION

In the current crisis in the Persian Gulf area, the President and the Congress have acted quickly to ensure that the tax relief afforded by the Internal Revenue Code is available to the military men and women serving in that area and to expand in some respects the scope of that relief. On January 21, 1991, shortly after the commencement of hostilities, the President signed Executive Order 12744, designating the Persian Gulf area as a combat zone. This triggered the exclusion from taxable income of combat pay under section 112 of the Internal Revenue Code, the postponement under section 7508 of the time for filing tax returns or taking other actions required under the tax laws, and other tax relief that I shall describe below.

Within a few days thereafter, Congress passed and, on January 30, 1991, the President signed into law legislation (P.L.

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102-2) that extended the coverage of section 7508 to include individuals serving in the "Persian Gulf Desert Shield area" (as designated by Executive Order) at any time back to August 2, 1990. This legislation also liberalized prior law by causing interest on overpayments of tax generally to be credited to the taxpayer during the section 7508 suspension period. Finally, this legislation extended the section 7508 suspension period to include periods of hospitalization in the United States with certain limitations. On February 14, the President signed Executive Order 12750, designating the Persian Gulf Desert Shield area.

OVERVIEW OF TAX PROVISIONS APPLICABLE TO DESERT STORM MILITARY PERSONNEL

Over the course of time, Congress has enacted a number of laws to provide tax relief to members of the Armed Forces in time of war. The oldest of these dates from World War I, and most were in place long before the Vietnam War began. Today, the Internal Revenue Code incorporates many of these provisions. The most important follow:

Section 112 excludes from the income of members of the Armed Forces all or a portion of compensation received for active service in a combat zone or while hospitalized as a result of wounds, disease or injury incurred while so serving.

Section 7508 postpones the time for filing returns, paying taxes, claiming refunds, and taking any other action required or permitted under the tax laws by disregarding the period that a member of the Armed Forces serves in a combat zone or is hospitalized as a result of injury incurred while so serving and the next 180 days thereafter.

Section 692(a) eliminates certain income tax liabilities of a member of the Armed Forces who dies while serving in a combat zone or as a result of wounds, disease or injury incurred while so serving. The tax liabilities affected are those for the year of death and any prior year ending on or after the date the member first served in the zone. Uncollected taxes for prior years are also forgiven.

Section 2201 provides that virtually all of the Federal estate tax does not apply to a citizen or resident of the United States if that person was killed in action while serving in a combat zone, or died as a result of wounds, injury, or disease suffered while serving in a combat zone. This provision does not eliminate estate taxes that are credited to the states on account of state death taxes.

Section 3401(a)(1) excludes from the definition of wages for withholding purposes all compensation paid for active service in a month for which the employee is entitled to the benefits of section 112.

Section 6013(f) allows the spouse of a member of the Armed Forces (or of certain civilian employees of the Federal Government) who is in missing status as a result of service in a combat zone to elect to file a joint return under certain circumstances.

Section 134 excludes from income a broad range of military allowances and in-kind benefits, including, for example, the value of quarters, subsistence and a variety of travel expenses, medical benefits and household expenses. The committee report accompanying the adoption of section 134 contains a list of about 30 military benefits that are specifically excluded under this provision.

In addition to the tax relief provisions found in the Internal Revenue Code, the Soldiers' and Sailors' Civil Relief Act of 1940, continued in effect in subsequent legislation and now found in U.S.C. Title 50, Appendix, contains two important provisions affecting the calculation and collection of the tax liabilities of members of the Armed Forces. Section 513 of the Act, 50 U.S.C. app. § 573, defers the collection of income tax from any person in military service for a period extending up to six months after the termination of service if the person's ability to pay the tax is materially impaired by such service. No interest accrues during the period of deferral. Section 206 of the Act, 50 U.S.C. app. § 526, generally sets a limit of six percent on the rate of interest that may be charged to a person in military service during the period of service on liabilities, including tax liabilities, incurred prior to entry into military service.

ANALYSIS OF PROPOSALS

Today, as we turn to address additional proposals for tax relief for military personnel, a ground war is underway in Kuwait. The thoughts of each of us are with the brave men and women serving our country in the Gulf region.

Evenhandedness to our military personnel is generally best served by relying on direct appropriations -- rather than tax benefits -- to compensate our troops for their sacrifices. Tax relief may be discriminatory, with income tax relief generally most benefitting those with higher incomes and with special tax provisions serving only those whose particular circumstances enable them to take advantage of targeted tax relief.

In addition to this cautionary note, our testimony today has also been guided by a number of general principles. First, we believe that relief provisions that materially complicate the ability of the taxpaying public to comply with the tax laws should be avoided. Proposals that would necessarily add lines to the tax forms in widest use, such as the Form 1040, or complicate the instructions to those forms, should be resisted. Second, we should try to avoid placing high compliance burdens on the private sector. Former employers and others who have had an employment or other business relationship with a member of the military should not be unnecessarily burdened in the process of providing tax relief.

We also believe that relief provisions for military personnel should not produce unfair tax advantages relative to similarly situated taxpayers who do not qualify for the relief. Today's gesture of goodwill should not become a permanent source of tax inequities. Historically, military personnel actually serving in a combat zone have received the greatest tax relief. Proposals that offer to extend tax relief to military and other personnel in more usual circumstances deserve close scrutiny. Likewise, we should endeavor to ensure tax fairness between reservists and other military personnel. Even within the combat zone, proposals whose benefits inure mainly to a few individuals are less attractive than those with a wider scope of relief.

Finally, review and modification of benefits available to military personnel serving in the Persian Gulf conflict should be done in a coordinated, rational way and not on a piecemeal basis. Further, modifications to the benefit structure that result in increased costs must fit within the parameters of the 1990 Budget Act. This means that discretionary expenditures (net of offsets) must fit within the spending caps, and revenue losses and mandatory expenditures, must be paid for on a pay-as-you-go basis.

The Administration welcomes the opportunity to participate in a process that reviews benefit proposals comprehensively, applies rational criteria to their assessment, and fits them within the Budget Act. To that end, Administration representatives are currently scheduled to meet with the Republican and Democratic Desert Storm Task Force Chairmen, Senators McCain and Glenn, on Thursday, February 28, 1991.

My comments on legislative proposals being considered by this Committee today are subject to two qualifications:

- these proposals must be considered in the comprehensive context I have described; and

- the Administration reserves the right to withdraw its support for particular measures if the overall package does not meet the tests suggested.

In the remainder of my statement, I will address the specific items listed by the Committee in the hearing announcement. I also understand that the Committee has requested the Administration's position on S. 252, introduced by Senator Warner on January 23. Accordingly, our comments on S. 252 are included in this statement.

Combat Pay Exclusion (Section 112)

Current Law

Enlisted personnel in the Armed Forces may exclude from income all compensation received for active service in a combat zone or while hospitalized as a result of wounds, disease or injury incurred while serving in a combat zone. In the case of hospitalization, this exclusion is unavailable for any month beginning more than two years after the date of termination of combatant activities in the zone. Personnel performing service in direct support of military operations in the combat zone who qualify for hostile fire or imminent danger pay are also entitled to this benefit.

Under current law, commissioned officers are entitled to the exclusion on identical terms as enlisted personnel, but the amount excluded is limited to $500 per month.

Proposal

The proposal would increase the exclusion amount for commissioned officers to $2,000 per month.

Administration Position

Although consideration ought to be given to a direct adjustment to combat pay for commissioned officers in lieu of an expanded income tax exclusion, the Administration supports this proposal so long as appropriate offsets are provided. The exclusion amount for commissioned officers was last increased to $500 in 1966, in connection with the Vietnam War. The increase in military wages and in price levels since that time justifies an increase in the exclusion amount to $2,000, so that the exclusion can once again provide relief comparable in real terms to that which it formerly provided.

Penalty-free Withdrawals from IRAs and Qualified Employer-Sponsored Retirement Plans by Operation Desert Storm Personnel

Current Law

Individuals are permitted to make contributions to IRAs up to the lesser of $2,000 or the individual's compensation for the year. Contributions to IRAs are deductible if the taxpayer does not participate in a qualified retirement plan or has adjusted gross income below a stated threshold amount. Earnings on amounts held in IRAs are tax-deferred.

Retirement plans sponsored by employers are accorded special tax treatment if certain qualification requirements are met. Specifically, contributions to qualified plans are deductible up to specified limits, the participants are not taxable on the contributions or benefits provided until amounts are actually distributed, and earnings on amounts held in trust are tax-exempt.

Withdrawals are permitted from IRAs at any time, but are permitted only from certain types of employer-sponsored plans and then only under circumstances specifically enumerated by the plan. Withdrawals from IRAs, except those from nondeductible contributions, are subject to income tax. Similarly, withdrawals from qualified plans, except those from after-tax employee contributions, are subject to income tax. In general, withdrawals from IRAs and qualified plans prior to age 59-1/2 are also subject to a 10 percent additional tax.

Proposal

The proposal would permit Operation Desert Storm personnel to make penalty-free withdrawals from IRAs and employer-sponsored qualified plans.

Administration Position

There are currently before the Congress a wide variety of proposals to permit penalty-free withdrawals from IRAs for a variety of circumstances, including unemployment, illness or disability, and for such worthwhile expenditures as children's education. The Administration has opposed each of these proposals. In general, the special tax benefits accorded individual retirement accounts and employer-sponsored qualified plans are incentives directed toward retirement savings. Therefore, the Administration does not support any withdrawals from IRAs or qualified plans which would result in premature consumption of retirement savings. The President's FY 1992 Budget proposal which would permit penalty-free IRA withdrawals for first-time home purchases is fully consistent with this position as homeownership constitutes a principal source of retirement savings.

Qualified Veteran's Mortgage Bonds

Current Law

Qualified veterans' mortgage bonds are general obligation bonds of a state, the proceeds of which are used to finance mortgage loans to veterans. The issuance of qualified veterans' mortgage bonds is currently limited to those states that had qualified veterans' mortgage bond programs in effect before June 22, 1984 (Wisconsin, Texas, Oregon, California and Alaska). Loans financed with qualified veterans' mortgage bonds may be made only to veterans who served on active duty before January 1, 1977. The loan must be made with respect to a principal residence and must be applied for before the later of 30 years after the veteran leaves active service or January 31, 1985.

Each state program is subject to an annual volume limitation based on issuance levels between January 1, 1979 and June 22, 1984. In addition, 95 percent of the net proceeds of an issue of qualified veterans' mortgage bonds must be used for the purpose of the issue; i.e., to make mortgage loans to veterans to purchase principal residences.

Proposal

The proposal would permit states to issue qualified veterans' mortgage bonds to veterans of Operation Desert Storm.

Administration Position

The Administration opposes this proposal. When Congress phased out the issuance of veterans' mortgage bonds in 1984, it stated that its reason for doing so was concern about "the increasing volume of veterans' mortgage bonds being issued by a number of States (more than $3.5 billion in the years 1980 through 1982) and the potential for expansion of veterans' mortgage bond programs to states that had not issued those bonds in the past." Congress decided to limit the issuance of these bonds to preexisting state programs, to amounts based on previous volume levels, and to veterans who served in active duty before 1977 to limit the potential Federal revenue loss from expansion of veterans' mortgage bond programs. The Administration believes these concerns are as valid today as they were in 1984 when the restrictions were imposed.

Additionally, the proposed rules for qualified veterans' mortgage bonds impose no limitation on the income of the veteran and no limitation on the purchase price of the residence.

Veterans with substantial family or other wealth would therefore be able to use government subsidized mortgages to purchase expensive homes without any showing of the need for such subsidy on the part of the veteran. Moreover, much of the Federal revenue loss from such a tax-exempt bond program would benefit bondholders and financial intermediaries rather than the intended beneficiaries. The Administration feels this would be an inefficient allocation of government resources.

Further, the Administration believes that this proposal would substantially duplicate an existing direct subsidy entitlement program that more efficiently channels Federal resources to facilitate homeownership by veterans. The VA mortgage guarantee program is already available to veterans (provided that they qualify for a mortgage). It guarantees a portion of the mortgage, effectively allowing veterans to purchase a home with no downpayment, and generally provides an interest rate below the private market rate. The percentage subsidy decreases with the size of the loan.

Income Exclusion for Persian Gulf POWs and MIAs

Current Law

Regulations under section 112 provide that a member of the Armed Forces in active service in a combat zone who there becomes a prisoner of war or missing in action is deemed to continue in active service in the combat zone for the period for which the member is entitled to that status for military pay purposes. In the case of the Vietnam conflict only, section 112(d) adds certain additional relief provisions. Under one of these provisions, the exclusion amount is not limited for commissioned officers who are in missing status (which includes prisoners of war). Under another, an unlimited exclusion is provided to civilian employees of the Federal Government who are in missing status.

Proposal

The proposal would extend additional relief provisions similar to section 112(d) to commissioned officers and civilian employees of the Federal Government in missing status in Operation Desert Storm.

Administration Position

The Administration supports this proposal.

Inclusion of Operation Desert Storm Service in Calculations under Qualified Pension Plans

Current Law

The Internal Revenue Code and ERISA provide rules for determining what years of service are required to be taken into account under a qualified pension plan for participation, vesting and benefit accrual purposes. These rules generally do not require that periods of absence due to military service be taken into account. However, other laws may require periods of military service to be taken into account under an employer's defined benefit pension plan where the reservist is reemployed by the employer following military service (see Alabama Power Co. v. Davis, 431 U.S. 581 (1977) (requiring such periods to be taken into account under a defined benefit pension plan); compare Raypole v. Chemi-trol Chemical Co., Inc., 754 F.2d 169 (6th Cir. 1985) (permitting such periods to be ignored for purposes of determining benefit allocations under a discretionary profit-sharing plan).

Under the Code, annual contributions to a defined contribution plan are limited to the lesser of $30,000 or 25 percent of compensation for the year. This limit could preclude or reduce significantly contributions to an employer's qualified plan during a period of military service where the reservist is no longer receiving the same compensation from the employer as he or she was receiving before being called up to military service.

Proposal

The proposal would permit an employer to take into account under qualified pension plans periods of absence due to military service.

Administration Position

The Administration supports permitting employers to take periods of absence due to military service into account under an employer's qualified pension plan and otherwise to facilitate continuing participation in qualified plans during such periods.

In the case of defined contribution plans, the proposal would require a modification of the present law limitation imposed on such plans to permit an employer to impute compensation at the pre-military service level during the period of military service. In that regard, a similar provision (Section 415(c)(3)(C)) exists under present law which applies in cases of periods of absence due to permanent and total disability.

Above-the-Line Deductions for Reservists

Current Law

Employees are generally allowed to deduct trade or business expenses "above the line" (i.e., in arriving at adjusted gross income) only under a reimbursement arrangement with the employer which requires the employee to substantiate the expenses. Otherwise, virtually all unreimbursed employee trade or business expenses as well as any expenses that are reimbursed under a nonaccountable plan must be treated as miscellaneous itemized deductions, deductible only to the extent that the taxpayer's total miscellaneous itemized deductions exceeds two percent of adjusted gross income. In addition, generally only 80 percent of the otherwise allowable cost of food, beverages and entertainment is allowable as a miscellaneous itemized deduction.

Proposal

The proposal would allow an above-the-line deduction to all military reservists for expenses, such as the cost of uniforms, and travel and meals while away from home, in connection with their reservist duties.

Administration Position

The Administration opposes this proposal. The proposal would not benefit reservists who have been called to duty stations in the Persian Gulf area because they are not generally incurring expenses of the type addressed by the proposal. Instead, the proposal primarily would benefit reservists in the United States in peacetime as well as during the current conflict. It would complicate the administration of the tax laws and taxpayers' attempts to comply by adding provisions to both the individual income tax form and its instructions. The limitations on deductions of employee business expenses were enacted to simplify tax reporting and reduce recordkeeping requirements. We do not believe that exempting reservists from tax rules that apply to other employees, including other government employees and members of the military, would promote equity in the tax laws. Direct appropriations are a better method of insuring a strong and effective reserve force.

Extend EITC to Military Personnel Stationed Overseas

Current Law

Current law provides a refundable earned income tax credit (EITC) to certain low-income workers. Low-income workers with qualifying children may be eligible for an EITC of up to 17.3 percent of the first $7,140 in earned income. The maximum amount of the EITC is $1,235 for 1991. The EITC is reduced by an amount equal to 12.36 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over $11,250. The EITC is not available to taxpayers with AGI over $21,245.

Families eligible for the EITC may also qualify for two supplemental credits. The eligibility criteria, income and phaseout requirements are the same as those for the EITC. An additional credit is provided for qualifying children under the age of one, as of the close of the taxable year of the taxpayer. The maximum credit for 1991 is $357. A credit is also available to taxpayers for qualified health insurance expenses that include coverage for a qualifying child. The credit percentage is six percent of earned income and the phaseout rate is 4.285 percent. For 1991, the maximum credit is $428.

In order to be eligible for the EITC, qualifying children must have the same principal place of abode as the taxpayer for more than one-half of the taxable year and such abode must be in the United States. Thus, military families stationed overseas are not eligible for the EITC.

Proposal

The proposal would extend eligibility for the EITC to military personnel stationed overseas.

Administration Position

The Administration supports this proposal, subject to offsetting the revenue loss involved. In this connection, the Defense Department and the Treasury Department have identified certain potential improvements in reporting of relevant information to military personnel. Such reporting would serve to notify military employees that certain items excluded from gross income, such as combat zone compensation, quarters and subsistence (whether provided in-kind or by basic allowances in lieu of these in-kind benefits), are included in the computation of earned income for EITC eligibility purposes. Such amounts would also be reported to the Internal Revenue Service.

Extension of the Period of Unemployment Compensation for Individuals Involuntarily Separated from the Armed Forces

Current Law

Separated military personnel who are unemployed for 4 weeks after being separated from military service are eligible for up to 13 weeks of unemployment compensation.

Proposal

The proposal would conform the military unemployment compensation regime to the civilian regime; i.e., former service members would qualify for unemployment compensation one week after separation from active military service and the maximum period of unemployment compensation would be extended from 13 weeks to 26 weeks.

Administration Position

The Administration supports this proposal provided that appropriate offsets are provided and the enhanced benefits are limited to the following three categories of separated service members: activated reservists, involuntarily separated personnel, and personnel extended beyond their regular release date.

Rollovers of Military Separation Pay into Eligible Retirement Plans (S.252)

Current Law

Generally, current income tax and, if otherwise applicable, early distribution penalties may be avoided on distributions from qualified pension plans and other tax-preferred retirement programs (including IRAs) if these distributions are "rolled over" to another retirement plan. There are a number of technical requirements that must be satisfied under current law in order to qualify for rollover treatment.

Proposal

S. 252 would exclude military separation pay from current income tax to the extent the pay is rolled over to a tax-preferred retirement program. The severance pay rollover generally would be required to satisfy the requirements of existing law for pension rollovers, and the penalties for early withdrawal from retirement programs under existing law would apply.

Administration Position

The Administration does not support this proposal. As we understand it, military severance pay is awarded to those who have been involuntarily denied a military career in recognition of the Federal Government's responsibility to help military men and women ease their transition into civilian life. To permit deferral of current income tax on this pay would benefit those individuals who could afford to satisfy their transition expenses with other funds.

INTERNAL REVENUE SERVICE ACTIVITY

In conclusion, I would like to mention certain efforts by the Internal Revenue Service to respond to tax questions raised by Operation Desert Storm. Since August of 1990, the Service has endeavored to develop procedures and guidance designed to ease the tax burdens of our troops in the Persian Gulf area and their families, as well as others affected by the crisis. To date, this has resulted in the completion of several important projects including the issuance of guidance in the form of answers to frequently-asked questions arising from the Persian Gulf crisis, guidance to enable military personnel and others serving in Operation Desert Storm to file early for tax refunds, and the announcement of a special procedure that will ensure that applications for federal tax exemption of organizations set up to help participants in Operation Desert Storm are reviewed and processed quickly. The Service has also made available free electronic filing to families of individuals serving in Operation Desert Storm. In addition, the Service is nearing completion of several other important projects, including a pamphlet containing a series of questions and answers and proposed regulations relating to the combat zone compensation exclusion and section 7508. The Internal Revenue Service is committed to continuation of its policy of addressing tax matters affecting Armed Forces personnel in the Persian Gulf fairly and expeditiously.

* * *

This concludes my prepared remarks. I will be pleased to answer any questions the Committee may have.

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STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEES ON THE WESTERN HEMISPHERE AND
INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittees:

I want to thank you for the opportunity to discuss the status of the Enterprise for the Americas Initiative. I have found my previous appearances on the Initiative before these Subcommittees very valuable, and I look forward to similarly useful exchanges today.

Announced by President Bush last June, the Enterprise for the Americas Initiative (EAI) focuses on building more productive relations with our neighbors in Latin America and the Caribbean. The President cited the Initiative in his State of the Union address and will be submitting to Congress very shortly legislation providing for implementation of all of its elements. To underscore the importance the President places on this legislation, I want to quote what he said to President Gaviria of Colombia in their meetings on February 26: "I am absolutely committed to its passage."

The priority placed by the President on gaining necessary authorities and moving forward on full implementation of the Initiative is well founded. The United States economy is linked to these countries through a wide array of trade and investment ties, which the President's Initiative is uniquely positioned to deepen and expand for our mutual benefit. This is a region with which we share a common cultural heritage, and whose many new leaders have shown a strong commitment to democratic values, market-based economic reforms and measures to attract investment.

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These new leaders will help drive the successful implementation of the proposals contained in the Initiative. In his recent trips to Mexico and South America, President Bush was impressed with the commitment on the part of leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital. To respond to this determination, we are committed to pressing forward on every front to make the President's vision for the hemisphere a reality.

The Initiative proposes action in three areas -- trade, investment, and debt -- thereby joining in a single endeavor the three economic issues of greatest importance to the region. I want to review these fundamental pillars with you briefly.

- Trade: The President set the goal of a hemispheric free trade system to increase trade and boost the economic potential of countries in the hemisphere. To work towards this goal, we are negotiating a series of trade and investment framework agreements with individual countries and groups of countries in the region. Successful conclusion of the Uruguay Round will also make an important contribution to this process.

- Investment: To help countries attract needed capital for growth, the President suggested that the Inter-American Development Bank (IDB) develop an investment sector lending program to encourage countries to liberalize their investment regimes. In addition, the President proposed the creation of a $1.5 billion multilateral investment fund, managed by the IDB, to provide additional support for countries undertaking investment reforms.

- Debt: The President recommended that the IDB join the IMF and World Bank in providing support for commercial bank debt reduction. He also proposed to reduce the bilateral debt owed to the U.S. Government by countries in the region which meet certain eligibility requirements. The stock of concessional AID and PL-480 debt would be substantially reduced, and remaining dollar payments would be applied directly to retire principal. Interest payments on this reduced debt would be made in local currency to support environmental projects in each country. A portion of non-concessional Eximbank loans and CCC assets would be sold, reduced or cancelled as part of an overall effort to facilitate debt-for-equity, debt-for-nature, and debt-for-development swaps.

Efforts to implement the trade, investment, and debt pillars of the Initiative began immediately after its announcement. Significant progress has been made to date.

Advancing Free Trade

We are engaged in discussions with countries throughout the region to liberalize trade and investment and move toward the goal of a hemispheric free trade system.

President Bush stated when he announced the Initiative that the United States stands ready to enter into free trade agreements (FTAs) with Latin American countries, in particular with groups of countries that have associated for the purpose of trade liberalization. Our long term goal is to establish a hemispheric free trade area. The first step in this process will be an FTA with Mexico and Canada. FTAs will progressively eliminate obstacles to the flow of goods, services and investment, provide for the protection of intellectual property rights, and establish fair and expeditious dispute settlement mechanisms.

Eventual free trade agreements will bring substantial benefits to the United States as well as the other countries involved. FTAs will result in increased U.S. exports, both in the short and long term. The U.S. labor force will experience significant job growth as a result of increased productivity and output of the U.S. economy. U.S. consumers will also benefit from improved access to low cost foreign imports, and U.S. producers will benefit from reductions in the cost of intermediate inputs. Our trading partners will experience a rise in real wages, increased investment, and increased export opportunities as a result of FTAs with the United States.

Presidents Bush and Salinas announced last June 11th that Mexico would be the first country in this process. Two weeks ago, Canada joined us in these trade talks, to negotiate a trilateral agreement. Such an agreement would foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. I should note that in order to achieve this agreement, we will need fast-track authority. Without such authority, our ability to negotiate such an agreement under the Initiative will be severely undermined.

Meanwhile, to advance towards our goal of hemispheric free trade, the Administration is negotiating framework agreements with individual countries and groups of countries in the region. Framework agreements establish fora for addressing and consulting on bilateral trade and investment issues. They contain immediate action agendas listing specific trade and investment issues of concern to both parties and areas in which liberalization is needed. Through these agreements, we can discuss the requirements for free trade agreements and facilitate negotiations when the appropriate time arrives. Chile has expressed an interest in FTA negotiations and we are using the framework agreement to explore this possibility.

Framework agreements have been signed since June with five countries -- Colombia, Ecuador, Chile, Honduras, and Costa Rica -- adding to those already in place with Mexico and Bolivia. Negotiations are underway with a number of other countries, including Jamaica, Venezuela, Peru, Nicaragua, Panama, El Salvador, Guatemala, and a group of countries composed of Argentina, Brazil, Uruguay, and Paraguay.

A successful conclusion of the Uruguay Round will make an important contribution to our goals of trade and investment liberalization under the Initiative. We continue to work with Latin American and Caribbean countries towards this end. We have made a special effort to propose tariff cuts on products of interest to Latin America in the context of Uruguay Round tariff negotiations.

Creating a Better Climate for Investment

While it will take time to open borders and extend free trade throughout the hemisphere, the potential for increasing investment flows to the hemisphere is more immediate. Latin American and Caribbean countries are already competing for capital with other dynamic economies, and they need to move quickly to attract private investment both from abroad and at home. The Inter-American Development Bank is developing an investment sector lending program to encourage countries to liberalize their investment regimes. The IDB has begun evaluating the need for reform in individual countries, and we anticipate the first investment sector loans moving forward in the next few months.

As an additional means to support investment policy reform efforts, the President outlined his proposal for a multilateral investment fund in his June statement. This proposal is under discussion with the IDB and other creditor governments. We see the fund supporting investment policy reform efforts, by making technical assistance grants for privatization and other investment-related reforms.

The fund should spur human capital development through grants for worker retraining and education in support of investment reforms. To combat micro and small-sized enterprises' lack of access to capital, the fund also could provide them with credit and equity financing channelled through arrangements to be developed with local non-governmental organizations and other financial intermediaries. We would envision the fund placing special emphasis on smaller countries in the region such as those in Central America and in the Caribbean.

Accordingly, we are asking that Congress authorize a U.S. contribution of $500 million, to be made available in five annual installments of $100 million each, beginning in fiscal year 1992. We expect other countries to contribute two-thirds of the fund's capital, to meet the goal of a $1.5 billion fund over five years.

Reducing Debt Burdens

Debt reduction is an important tool for encouraging countries in the region to sustain their efforts to reform their economies. The overhang of external debt has constrained the resources available for growth and tested the resolve of nearly every government in the region. By easing the burden of debt on their economies, we can help them attract new investment capital and make the rewards of reform more immediate.

The reduction of official bilateral debt proposed under the Initiative complements the international efforts under the Brady Plan to address countries' commercial bank debt problems. Bilateral debt reduction under the Initiative will be particularly important for the relatively small countries that owe a substantial portion of their external debt to official creditors, rather than to commercial banks.

The reduction of concessional debt under the Initiative aims to change dramatically the current situation in which countries must seek repeated Paris Club reschedulings to adjust their debt service payments to their ability to pay. The stock of concessional debt will be substantially reduced at the outset, depending on the individual circumstances of each country. Moreover, new dollar payments on this reduced debt will be applied to retire principal. As a result, a country's concessional debt will be eliminated within a designated and shorter period.

This new approach would result in significant benefits for debtor countries by making debt burdens more manageable, eliminating the debt overhang, and improving investor confidence. As a creditor, the U.S. Government would also be assured of repayment of a realistic sum, thereby maximizing its return in the medium term.

As you know, last year's Farm Bill provided the authority to reduce PL-480 (food assistance) debt for countries pursuing strong economic and investment reform programs, and to establish the mechanisms for channelling local currency interest payments to support environmental projects. The President will soon sign an Executive Order establishing the inter-agency procedures through which the Administration will implement this authority. Pursuant to this order, we will be discussing PL-480 debt reduction with individual countries as they become eligible.

We believe that Chile, Jamaica and Bolivia could qualify for debt reduction in the next few months. Given their good standing with the IMF and World Bank, and their agreements with commercial banks, these countries' current eligibility depends primarily on their implementation of investment reforms. All three have liberal investment regimes and are discussing possible additional measures with the IDB. Other countries could also move to qualify for PL-480 debt reduction in the near future.

To implement fully the debt reduction elements of the Initiative, we need authority from Congress to reduce foreign economic assistance obligations to AID in the same manner as provided for PL-480 assistance in the 1990 Farm Bill. PL-480 debt constitutes only about one-fourth of the concessional debt owed to the U.S. Government by Latin American and Caribbean countries. A far larger share of this debt (some $5 billion) is owed to AID. Substantial debt relief for these countries, therefore, will need to involve action on AID debts as well.

We will also be seeking authority to sell, reduce or cancel a portion of assets held by CCC as a result of its credit guarantee programs and a portion of Eximbank loans to facilitate debt/equity, debt-for-nature and debt-for-development swaps in eligible countries. The Administration will propose legislation in the coming days to accomplish these objectives.

Support for the Environment:

In addition to substantial reduction of their concessional debt, and possible swaps of their Exim and CCC obligations, countries will benefit from U.S. willingness to direct local currency denominated interest payments on the reduced PL-480 and AID debt instruments to support environmental projects. These interest payments will be deposited in an environmental fund in the debtor country, created under the environmental framework agreement negotiated with the country. Local committees composed of debtor country and U.S. government representatives and local non-governmental representatives (who should be in the majority) will determine the use of these environmental funds.

By creating a dedicated stream of payments to support environmental projects, the Initiative will provide the continuity essential for sustained environmental progress. The absolute amounts provided to environmental projects under the Initiative will be significant in relation to current levels of environmental funding in most Latin American countries. If more creditor countries decide to provide comparable support, the total amount of environmental funds will increase substantially.

The Initiative will also play a crucial role in strengthening institutional development in the environmental area, by supporting local organizations active in the field.

One of our key objectives here is to encourage grassroots efforts within Latin America to protect and preserve the environment. The active involvement of local non-governmental organizations (NGOs) therefore is an essential component of this initiative.

We will also create an Environment for the Americas Board in Washington. This Board -- composed of U.S. Government representatives and non-governmental representatives -- will advise the President on negotiations of the environmental framework agreements, ensure that local administering bodies are properly constituted and review countries' annual programs for use of the funds.

We worked closely with this Committee on the legislation passed into law last fall to authorize PL-480 debt reduction -- and on the authorization passed by the House on AID debt. We were pleased with the results of that process and look forward to working closely with you on new legislation. I think we agree on the importance of reducing the debt burdens of Latin American and Caribbean countries which are pursuing strong economic policies, while we also provide critical support for grassroots environmental projects in these countries.

Advancing Our Vision for the Hemisphere

While we have made significant progress in recent months in moving the Initiative forward, we cannot pause in our efforts. Expectations in Latin America and the Caribbean are high: they welcome U.S. recognition of the importance of its neighbors and the need to address their pressing problems. President Bush delivered this message directly to key Latin heads of state during his December trip to the region, vowing that the implementation of this initiative will not be tied up in bureaucratic red tape on our part. At the same time, he was impressed by the commitment of Latin American leaders to implement economic policies that will help them compete for scarce capital and achieve growth. Latin American and Caribbean leaders welcomed the Initiative, and I would like to submit their statements for the record.

Continued dedication of this kind in Latin America and the Caribbean is absolutely fundamental to the success of the Initiative. We, too, must follow through on our commitments and move together with countries in the region and the IDB to undertake the substantive work that must be done. We look to Congress to support this historic effort for the Americas by enacting the legislation necessary to implement the remaining debt and investment provisions, and as I noted earlier, fast-track authority will also be critical.

I value our continuing dialogue on these issues and hope I can count on your timely support for this important Initiative.

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

AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 10:00 a.m.

Contact: Barbara Clay
202-566-5252

**THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
WELCOMING REMARKS
THE CONFERENCE AT THE WHITE HOUSE
WEDNESDAY, FEBRUARY 27, 1991**

Thank you, Secretary Eagleburger, and thank you to our distinguished guests who have come from throughout the nation -- and the world -- to join us for this conference.

Abraham Lincoln once said education is the most important subject the American people can be engaged in. And that is the central purpose of this Conference at the White House -- to see if the people of the United States can engage more broadly and aggressively in providing management training, business education, and economics education for the people of Central and Eastern Europe.

We see this initiative as a continuation of the commitment this country has already made to assisting the emergence of democracy and free market economies in the region -- a commitment marked by very tangible contributions by our government and by the involvement of many of you in this room.

But the path to the free market, after a half-century under command economies, is a long and difficult journey.

That is why we are here. That is why we must find ways today, and after this conference, to bring to bear the great American resources in management training and economics education for the benefit of the people of Central and Eastern Europe.

We are blessed in this country with splendid institutions, immense resources, and diverse skills with which to teach others how to operate in a competitive free market economy -- all the way from basic accounting and inventory management to sophisticated concepts in advanced economics.

Now is time for us to get to work and find new ways to use these considerable assets.

NB-1157

We have designed this Conference to be concrete and practical. We intend to define the needs for management training and market economics education of Central and Eastern Europe and identify some specific ways to meet those needs.

We are looking for results. And one way to accomplish results is to set specific goals. Thirty years ago, President Kennedy motivated the nation by setting the specific goal of putting a man on the moon by the end of the decade. That goal was accomplished.

So, we, too, have set some specific goals in management training and economics education to be accomplished over a three-year period:

1. Expose at least 10 million citizens of Central and Eastern Europe to television and other media programs that explain the workings of a free market economy;

2. Train or retrain at least 50,000 managers, workers and entrepreneurs;

3. Educate 10,000 college-age students in the fundamentals of management and economics; and

4. Train at least 200 teachers in management and economics, so that they can go back to become the core faculties of the future.

The accomplishment of these goals will not be easy, but we are confident that the resources and the commitment are here to do the job. And we must recognize, too, that our goals can only be achieved if the governments and people of the beneficiary countries contribute substantially to their accomplishment.

So now is the time for us take the first steps to push this initiative forward. It's time to knit together the resources and the energies necessary to accomplish the education and training goals we have set.

I look forward to working with all of you to attain these goals, and I am confident we will do it.

Now I would like to introduce my colleague and another of the three coordinators for East European Assistance, Michael Boskin, the Chairman of the Council of Economic Advisors, who will act as the host of the first morning panel session.

Ladies and gentlemen, Michael Boskin.

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 9:30 A.M.
FEBRUARY 27, 1991

STATEMENT BY JAMES H. FALL, III
DEPUTY ASSISTANT SECRETARY FOR DEVELOPING NATIONS
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE BUDGET COMMITTEE
February 27, 1991

Mr. Chairman and members of the Committee, it is a pleasure to have the opportunity to comment on the Treasury Department's role in encouraging and facilitating financial support for Operations Desert Shield and Desert Storm. As recent events have underscored, the strong support of our allies has been crucial in reaching the objectives of dislodging the Iraqi military from Kuwait, restoring the legitimate government of that country, and laying the groundwork for greater regional stability in the future.

The financial support from our allies has sharply reduced the budgetary cost to the American people of our efforts. This is an important objective of the U.S. government and, as you have heard from others today, we have been remarkably successful in generating strong financial support -- both in level of commitments and pace of disbursements to date.

There have been intensive interagency consultations aimed at maximizing foreign contributions for Operations Desert Shield and Desert Storm. The Treasury Department has played an active part in these efforts, along with the State Department, the Defense Department, NSC, and OMB. Treasury has also used the regular G-7 Finance Ministers' Meetings and other international fora to attain USG objectives.

In September, Treasury Secretary Brady visited several of our allies in Europe and Asia to encourage financial and economic support for the U.S. military presence in the Gulf and for those countries severely affected by the crisis, particularly through their support for the U.N. sanctions. At the same time, Secretary of State Baker traveled to Europe and several Gulf states with a similar message. These meetings accomplished much in confirming the support of our major allies and in producing the initial commitments of military and economic assistance.

NB-1158

As noted in the recent press release from the White House, these approaches and subsequent contacts resulted in 1990 commitments of $9.74 billion by our allies for incremental costs incurred by Operation Desert Shield. This represents about 88 percent of estimated total incremental costs for that period. Additional commitments for the first three months of 1991 have reached $43.8 billion, bringing the total for the period August through March to approximately $53 billion.

Secretary Brady used the opportunity of a visit by Finance Minister Hashimoto of Japan to New York during the most recent G-7 Finance Ministers' Meeting in late January to consult with the Japanese authorities on additional commitments. The government of Japan responded by offering $9 billion to support Desert Storm in the first quarter of this year. This amount represents a part of the $43.8 billion committed so far for the period through March.

Let me address some technical issues. The Treasury Department's system of accounts is normally the initial recipient of all foreign cash contributions for U.S. military activities during Operations Desert Shield and Desert Storm. Under a law passed last year, the Defense Cooperation Account has been established at the Treasury to receive monetary contributions and proceeds for Operations Desert Shield and Desert Storm. Using the same interagency consultation process mentioned earlier, we actively coordinate with the Department of State, Defense, and OMB to ensure that those monies received from foreign contributors are credited against their commitments to the United States for 1990 and for 1991.

Aside from the military component, the Treasury Department is also actively engaged in a complementary effort with the State Department to assist those countries whose economies are most seriously affected by the crisis. Key economies in the region, such as Egypt, Turkey, and Jordan, were particularly hard hit by Saddam Hussein's attack on Kuwait and the imposition by the U.N. of economic sanctions against Iraq. To complement the military and diplomatic leadership of the United States, President Bush announced on September 25 the creation of the Gulf Crisis Financial Coordination Group to: 1) maintain and support effective implementation of U.N. economic sanctions against Iraq; 2) demonstrate international resolve in mobilizing financial assistance for the front line states; and, 3) establish an informal coordination process to secure appropriate responsibility-sharing among creditors and donors for those countries hardest hit by the crisis.

The Coordination Group has met four times, most recently in Washington on February 5. The next meeting will take place on March 11. Participants include 26 countries, the European Commission, and the Gulf Coordination Council. Representatives of the International Monetary Fund and the World Bank also attend to provide technical and analytical support.

The Coordination Group assists in quantifying the financial needs of those countries most seriously affected by the crisis, generating international resources to meet these needs and encouraging the creditors and donors to direct these resources in a balanced manner to the individual countries. The Group relies on traditional bilateral channels between donors and recipients, and does not pool or centralize resources for further distribution.

To date the Coordination Group has secured $14.7 billion in commitments. Of this amount, $11.4 billion has been pledged to the front line states of Egypt, Turkey, and Jordan. Close to two-thirds of the assistance for which terms have been determined are being made available in the form of cash or in-kind grants. Moreover, $7.3 billion of the total commitments have already been disbursed, $4.9 billion of which has gone to the front line states.

Also in response to suggestions made by President Bush and Treasury Secretary Brady at the time of the Annual Meetings of the World Bank and IMF, these institutions have taken rapid and concrete action to adapt their lending procedures to permit them to counter more effectively the economic effects of the crisis on a broad range of countries.

Specifically, an oil import element has been incorporated into the IMF's Compensatory and Contingency Financing Facility (CCFF), traditionally used to compensate member countries for external shocks which reduce their foreign exchange earnings. New potential financing is estimated at up to $5 billion, depending on recipient countries having satisfactory energy policies and an IMF program

For its part, the World Bank estimates that its commitments to countries most affected by the crisis will increase by $4 billion over a two year period. Priority is being given to helping second-tier countries develop and promptly implement adjustment policies to strengthen their economies over the longer run. As part of this effort, the Bank plans to increase its concessional lending to lower middle-income countries. Increased World Bank and IDA lending can be accommodated with the Bank's current financial resources. The Bank is in the middle of a capital increase approved in 1988 and, therefore, has resources sufficient to meet increased demands.

In sum, our success in meeting the objectives of the Coordination Group has been notable. U.N. sanctions against Iraq have been imposed with significant success. Our ability to support key economies in their efforts to enforce the sanctions is contributing to fulfillment of the U.N. mandates for Iraq to withdraw from Kuwait and has helped to prepare the basis for stability in the region at the conclusion of the war.

"Economies in Transition: Management Training and Market Economics Education in Central and Eastern Europe" Conference at The White House February 26 - 27, 1991

FOR IMMEDIATE RELEASE
FEBRUARY 28, 1991

CONTACT: BARBARA CLAY
U.S. TREASURY
202-566-5252

CONFERENCE HELD AT THE WHITE HOUSE ON MANAGEMENT TRAINING AND MARKET ECONOMICS EDUCATION IN CENTRAL AND EASTERN EUROPE

A Conference at the White House yesterday addressed specific goals for management training for the emerging democracies of Eastern and Central Europe.

Those goals included exposing millions of people in that region via television to the basic concepts of market economics; training and retraining managers, workers, and entrepreneurs; and training teachers and students in management and economics.

The Conference assessed urgent and long-term management training needs and recommended a mechanism for information-sharing and coordination of management training needs and resources. The conferees also agreed that the broad participation of American industry would be the key to the success of this initiative.

The Conference was an initiative by the Bush Administration to expose as many East Europeans as possible to American management training and market economics education. It brought together approximately 200 leaders, including presidents and deans from major American universities, CEOs and other high-level corporate representatives, foundation presidents and representatives of non-profit organizations, as well as leaders from the U.S. government and from Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia.

Leaders in the region are on record as favoring more widespread training in the basic principles of market economics to accelerate the pace of economic reforms and reduce the chances of retrogression once reforms are in place. Since business management training and market economics education are two areas in which the United States has a strong comparative advantage relative to other countries, the United States is uniquely equipped to play a pivotal role.

Conference participants noted that the initiative could include: providing support for the development of television materials that introduce the basics of market economics and management; teaching courses and workshops to students and workers in Central and Eastern Europe; bringing teachers and students to the United States for internships and academic programs; and providing multilingual curricula, texts and other materials.

The Conference was hosted by the President's Coordinators for East European Assistance -- Deputy Secretary of State Lawrence S. Eagleburger, Deputy Secretary of the Treasury John E. Robson, and Chairman of the President's Council of Economic Advisers Michael J. Boskin -- as well as Administrator of the Agency for International Development Ronald W. Roskens, and Director of the U.S. Information Agency Bruce S. Gelb.

Among the speakers at the Conference were President Bush; Treasury Secretary Nicholas F. Brady; John Brademas, President of New York University; Drew Lewis, Chairman of the Citizens Democracy Corps and Chairman of Union Pacific; George Varga, President and CEO of Tungsram; Rand Araskog, Chairman and Chief Executive of ITT; and Thomas Langfitt, President and CEO of Pew Charitable Trusts. The Conference was moderated by David Gergen, editor-at-large of U.S. News and World Report, and former White House Director of Communications.

The United States is committed to continuing to help move reform forward. President Bush has visited Central and Eastern Europe twice in the past 18 months to highlight our strong support for reform. Since 1989, the Bush Administration has:

- Supported democratic reform through, for example, support in monitoring elections; assistance to national legislatures and an independent media; help in drafting constitutions and laws; and programs of English language and educational reform.

- Supported economic reform through, for example, major bilateral commitments involving about $1.5 billion in grants and other assistance to Central and Eastern Europe; creation of Enterprise Funds in Poland, Hungary and Czechoslovakia to nurture the development of a healthy, competitive private sector; technical assistance for management training and market economic education; privatization and restructuring of enterprises; and development of agriculture, business, financial, and housing sectors.

- Mobilized multilateral support by initiating the "Group of 24" to support economic reform in Eastern Europe. The Group of 24 has resulted in many billions of dollars in bilateral financial pledges to Eastern Europe from other bilateral donors, as well as strong support from the IMF, the World Bank, and other multilateral economic organizations.

- Provided, through trade and investment agreements, GSP, OPIC, Eximbank and other means, humanitarian assistance, particularly food and medical supplies where needed.

- Supported an expansion of trade and investment opportunities, and sponsored programs in the areas of energy and the environment.

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

FOR RELEASE AT 12:00 NOON
March 1, 1991

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 $10,750 million of 364-day Treasury bills to be dated March 14, 1991, and to mature March 12, 1992 (CUSIP No. 912794 YD 0). This issue will provide about $ 850 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $9,910 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Thursday, March 7, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. 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 March 14, 1991. In addition to the maturing 52-week bills, there are $19,871 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 $1,657 million as agents for foreign and international monetary authorities, and $6,633 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 $354 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 competitive 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.

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.

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.

8/89

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

FOR IMMEDIATE RELEASE
March 1, 1991

Contact: Desiree Tucker-Sorini
202-566-8773

Statement by
Nicholas F. Brady
Secretary of the Treasury

I am pleased with today's timely announcement by the regulators on guidelines to clarify certain regulatory and accounting policies. For the past several months, Treasury has been meeting with the regulators, business leaders and bankers on credit availability to find a coordinated and sensible approach to the credit crunch.

We hope that the actions taken today will encourage lenders to make prudent loans and assure that examiners perform their reviews in a balanced, sensible way.

I commend and stress the importance of the regulators' commitment to promptly communicate these policies to the nearly 7,000 bank examiners in the field. Confidence and understanding between banks and their regulatory examiners are essential to sound lending practices and to prudent, evenhanded, common-sense implementation of supervisory practices.

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NB-1160

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 4, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,699 million of 13-week bills to be issued on March 7, 1991 and mature on June 6, 1991 were accepted today (CUSIP: 912794WM2).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	6.08%	6.28%	98.463
High	6.09%	6.29%	98.461
Average	6.09%	6.29%	98.461

$1,010,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 20%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,715	32,715
New York	40,767,875	7,413,225
Philadelphia	27,800	25,945
Cleveland	42,665	42,665
Richmond	50,665	50,665
Atlanta	32,925	28,925
Chicago	2,395,330	60,330
St. Louis	62,930	19,930
Minneapolis	10,235	10,235
Kansas City	49,200	49,200
Dallas	31,110	31,110
San Francisco	766,190	76,190
Treasury	858,000	858,000
TOTALS	$45,127,640	$8,699,135
Type		
Competitive	$40,992,165	$4,563,660
Noncompetitive	1,708,190	1,708,190
Subtotal, Public	$42,700,355	$6,271,850
Federal Reserve	2,326,930	2,326,930
Foreign Official Institutions	100,355	100,355
TOTALS	$45,127,640	$8,699,135

An additional $25,845 thousand of bills will be issued to foreign official institutions for new cash.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 4, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,623 million of 26-week bills to be issued on March 7, 1991 and mature on September 5, 1991 were accepted today (CUSIP: 912794XE9).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	6.05%	6.35%	96.941
High	6.06%	6.36%	96.936
Average	6.06%	6.36%	96.936

$10,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 88%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	28,510	28,510
New York	28,595,460	7,641,600
Philadelphia	12,420	12,420
Cleveland	34,650	34,650
Richmond	40,375	40,375
Atlanta	30,575	28,575
Chicago	1,212,870	37,870
St. Louis	35,965	15,965
Minneapolis	6,120	6,120
Kansas City	45,360	37,360
Dallas	17,880	17,880
San Francisco	749,425	49,425
Treasury	672,515	672,515
TOTALS	$31,482,125	$8,623,265
Type		
Competitive	$27,299,485	$4,440,625
Noncompetitive	1,220,695	1,220,695
Subtotal, Public	$28,520,180	$5,661,320
Federal Reserve	2,150,000	2,150,000
Foreign Official Institutions	811,945	811,945
TOTALS	$31,482,125	$8,623,265

An additional $234,055 thousand of bills will be issued to foreign official institutions for new cash.

NB-1162

TREASURY NEWS

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

STATEMENT BY
THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
U.S. HOUSE OF REPRESENTATIVES
MARCH 5, 1991

Mr. Chairman and Members of the Committee:

It is a pleasure to testify before you today on the critical role of the international financial institutions (IFIs) as instruments to achieve U.S. economic policy objectives in the world economy, and international and bilateral efforts underway to support economic reform.

Today, the world community finds itself at the dawn of a new order of multilateral cooperation. This order, emerging from the fundamental economic and political changes underway throughout the world, holds forth the prospect for durable global peace and prosperity.

Many East European and Latin American leaders are rejecting statist approaches to organizing economic development. A revolution of thought is sweeping these countries, as well as those in Africa and Asia. People throughout the world are beginning to recognize that market economies are the best means to secure prosperity and freedom.

Interdependence amongst our economies is growing, and no longer can any one country -- not even the United States -- achieve its economic policy objectives in isolation. Economic issues increasingly dominate the international agenda.

These developments confront us with both unique opportunities and challenges. We will all need to work together as we approach the future to secure the gains of the new order. In so doing, we will also need to call increasingly upon the IFIs to play a continuing central leadership role in helping to manage the world economy and implement U.S. policy objectives.

Multilateral efforts are critical to supporting strong economic policies and sustained growth throughout the world. Our close relationship with Latin America and the Caribbean, however, also warrants a distinct bilateral approach on the part of the United States to advance hemispheric prosperity. We are pushing ahead on the President's Enterprise for the Americas

Initiative announced in June 1990. This Initiative will respond to difficulties faced by Latin America and the Caribbean over the past decade and support the commitments of many of the region's new leaders to undertake economic reforms.

The political and economic evolution now underway throughout the world is still young. Our support -- both multilateral and bilateral -- for the process of economic reform will be an important determinant in the success and longevity of the new world order.

Global Role of the International Financial Institutions (IFIs)

We are fortunate to be able to rely on the international financial institutions as vehicles for pooling multilateral efforts. Over the years, these institutions have served U.S. policy well. They have helped us to reconstruct the world from the ashes of World War II, reform the international monetary system, address the problems of external indebtedness in the developing countries, and tackle poverty. They have done so in every corner of the world by promoting sound market-oriented economic policies, consistent with U.S. foreign economic policy interests.

Through their essential support for a sound world economy, these institutions have strengthened U.S. growth, which supports our economic well being. In 1990 alone, the external sector accounted for more than 40 percent of the U.S. growth. Estimates suggest that roughly one out of every four new jobs in the United States is related to merchandise exports.

More recently, the international financial institutions have demonstrated anew the vital contribution they are making to promote a sound world economy and to support U.S. foreign economic and national security objectives.

These institutions have been at the front of international efforts to address the serious economic consequences of the Gulf crisis, and stand ready to assist the region in the aftermath of the war. In response to U.S. proposals, the International Monetary Fund (IMF) adapted its procedures to provide fast-disbursing assistance, and has already committed $2.8 billion of increased financing to help countries offset higher oil costs. The World Bank has intensified its lending plans for the front line states such as Turkey and Egypt, as well as other countries seriously affected by the crisis such as the Philippines and Bangladesh.

The IFIs are playing a leading role in Eastern Europe's bold and dramatic effort to restructure economic and political life. The IMF is currently backing sweeping reforms in Poland, Hungary, and Czechoslovakia; and support for Bulgaria and Romania should soon be in place. Most recently, the IMF has completed negotiations on a new $2 billion three year program for Poland to support structural reforms. Final approval by the IMF Executive Board is expected soon. In Eastern Europe overall, the IMF may commit $8 billion in 1991. Moreover, the World Bank is planning to lend $9 billion to Eastern Europe over three years, and the IFC will play a key privatization role. In addition, the European Bank for Reconstruction and Development (EBRD) will be ready to assist the region later this year.

These institutions are also providing essential support for economic policy reforms and development in Latin America and the Caribbean -- particularly in the context of the international debt strategy and the President's Initiative. The IMF serves as the primary catalyst for establishing the broad basis for sound economic policies designed to mobilize savings and investment and to reverse capital flight. The IMF has committed $12.5 billion to support economic policy reform in the region. The World Bank and the Inter-American Development Bank (IDB) are important agents in mobilizing private sector and government resources to finance the basic infrastructure and service projects that improve productivity and living standards. Last year the World Bank Group provided $6.0 billion and the IDB $3.8 billion to support policy reforms and projects for the region. The IMF, World Bank, and Inter-American Development Bank will be critical to our efforts to encourage further reforms, creating a productive environment for the success of the President's Enterprise for the Americas Initiative (EAI).

In Africa, the IFIs are at the center of a concerted international strategy designed to provide concessional resources to help the poorest countries of the world achieve sustainable growth, meet basic human needs, and alleviate widespread suffering. Total IMF commitments to these countries under the concessional Enhanced Structural Adjustment Facility (ESAF), and its predecessor facility, exceed $3.5 billion. Last year, the World Bank Group and African Development Bank Group made total commitments of $7.2 billion to the region.

If the institutions are to meet the global challenges of the 1990s in a manner that serves our foreign economic policy interests, we must stand squarely behind them and ensure that they have adequate resources to do their job.

The International Monetary Fund (IMF)

The resource needs of the IMF are reviewed periodically to ensure that the Fund has sufficient financing to fulfill its global responsibilities. Last year, the IMF concluded negotiations on a 50 percent increase in its resources from $130 to $195 billion. The U.S. share of the increase is some $12 billion at current exchange rates, for which we will be seeking Congressional appropriations and authorization as part of the FY 1992 budget.

Passage of this legislation is essential. The increase in IMF resources is vital if the Fund is to provide financial assistance throughout the world and to secure U.S. objectives in the new order of multilateral cooperation. As I have already observed, the IMF is providing vast amounts of resources in Eastern Europe, Latin America, Africa, and Asia, to promote comprehensive market-oriented reforms and to address the costs of the Gulf crisis. Overall Fund lending is expected to more than double in 1991 to $16 billion in disbursements and remain high in subsequent years. In addition to bolstering Fund liquidity to meet these near-term financing demands, the quota increase will provide for adequate Fund resources over the medium term.

The quota increase will also help the Fund to keep pace with the growth in the world economy. Over time, the size of the Fund's quotas has fallen significantly to roughly 4 percent of world imports. If the Fund is to be an effective lender of last resort, it must be perceived as being of a meaningful size relative to the problems at hand in the world economy in order for countries to adopt appropriate adjustment measures and to catalyze resources from other lenders.

Furthermore, the United States, as the leading and largest member of the IMF, has a special responsibility to do its part in the organization. Failure of the United States to support the quota legislation would seriously erode the effectiveness and credibility of the IMF.

In this context, the United States, with some 19 percent of the IMF's voting power, has effective veto over key IMF decisions, such as quota increases and amendments to the IMF's Articles, requiring an 85 percent majority. This veto power has often proven essential to ensure that the Fund operated in a manner consistent with overall U.S. interests.

The IMF is also extremely cost-effective in supporting U.S. interests. First, the transfer of dollars to the IMF is like putting money into a checking account which is interest-bearing and can be drawn automatically. In recognition of this unique monetary character of the IMF, Congress has agreed repeatedly over the years that use of the U.S. quota involves no net budgetary outlays. Under the recent budget summit agreement, a specific provision was made to account for the unique budgetary treatment of the quota increase. While use by the IMF of the U.S. quota will increase Treasury's borrowing requirements, the interest earned on our position in the Fund offsets this cost. Furthermore, the IMF leverages our scarce resources, which is particularly important at this time of budget restraint. For every dollar we put in, others put in four.

During the quota negotiations, a number of steps were taken to ensure that U.S. resources would be used far more effectively by the IMF. Thus, at U.S. insistence, as an integral part of the quota negotiations, the United States gained agreement on a strengthened strategy to tackle the large and growing problems of arrears in payments to the Fund. In recent years, arrears to the

Fund have grown to some $5 billion, roughly twice the level of IMF reserves.

The strengthened arrears strategy is designed to protect the Fund's financial position and to ensure that additional contributions are wisely spent. This strategy is well balanced, combining incentives for countries to clear their overdue obligations with disincentives to deter new arrears cases.

Mr. Chairman and Members of the Committee, the IMF is serving vital U.S. interests throughout the world. It is an extremely cost-effective organization. To ensure continued strong U.S. leadership in this critical global organization, I urge you to support the proposed increase in the U.S. quota share in the IMF.

<u>The Multilateral Development Banks (MDBs)</u>

Mr. Chairman, as you know supporting the MDBs requires appropriating U.S. financial resources annually. This year the Administration is requesting $1,685 million for U.S. paid-in contributions to the MDBs:

- $1,286.8 million to meet previously agreed scheduled payments to the MDBs;

$70.1 million	World Bank
$1,060.0 million	International Development Association
$57.3 million	Inter-American Development Bank (IDB)
$20.5 million	IDB Fund for Special Operations
$8.9 million	African Development Bank
$70.0 million	European Bank for Reconstruction and Development

- $25.5 million for the first installment to a Special Capital Increase (SCI) for the Asian Development Bank (ADB);

- $187.5 million to cover U.S. funding shortfalls in the agreed payments schedules to the Asian Development Fund ($175 million) and the Inter-American Investment Corporation ($12.5 million); and

- $185 million for "other" MDBs.

Of special note among previously authorized MDB programs, the $70 million funding request for the European Bank for Reconstruction and Development (EBRD) represents the second installment of the U.S. contribution to this new institution.

The Bank will hold its inaugural meeting next month -- April 15 -- and is expected to begin operations by early summer. We expect the Bank to make a significant contribution to the unprecedented transformation of the countries of the region to a market economy. The U.S. contribution to the Bank will not only promote economic and political stabilization in a region of the world that is very important to us, it will also help promote U.S. business interests in the region.

The Special Capital Increase for the ADB, in which Japan, Sweden, and the United States participated, was approved by the ADB Board of Governors in 1988. Japan sought the increase to make up for the decrease in its percentage ownership that resulted from the entry of China in the Bank and a previous SCI for several European countries. The United States joined in the increase to maintain parity with Japan.

When the ADB was established in 1966, the United States and Japan, as the two pre-eminent economic powers in the region, each subscribed to the same number of shares in the Bank's capital stock. The presumption was that equal ownership would be reflected in equal influence in the policies and operations of the Bank.

Although the situation has changed since then -- most notably with Japan's rapid growth and the expansion of its influence in Asia -- the United States' involvement and stake in the economic and political development of the region remains strong. Keeping our relative share in the ownership of the Bank's capital will enable us to maintain our influence in the ADB. We will thus avoid ceding a measure of our influence in Asia in general, the world's most rapidly growing region.

Mr. Chairman, I want to thank you and your Committee for your leadership last year in reducing significantly the U.S. shortfall in providing scheduled payments to the MDBs. I believe it is important that we clear up our remaining funding shortfall this year.

It is true that because of exchange rate changes and lower-than-expected lending levels in the past the Asian Development Fund (ADF) has managed to mount a credible lending program despite U.S. funding shortfalls. The ADF has now reached the point, however, where it must receive the U.S. funding shortfall in full near the beginning of FY 1992, or cease its lending operations early in calendar year 1992. This must not happen because the ADF provides financing on concessional terms to its developing member countries, which are among the poorest in the world. We have a strong stake in encouraging their economic growth and development, and the ADF makes a major contribution to achieving this objective.

The $12.5 million funding request for the Inter-American Investment Corporation (IIC) represents the fourth and final installment for the institution's initial capitalization. The U.S. payment can be invested in equity operations, and, as part of the capital base, can be borrowed against to fund additional IIC activities. The IIC is helping to meet the capital needs of the region by mobilizing from private sources up to an average of four times the amount of IIC commitments. IIC operations also help fulfill the U.S. economic policy objective of expanding the size of the private sector as the engine of sustained growth.

In late February, the U.S. met all of its major policy objectives for the sixth replenishment of the African Development Fund (AfDF), and as a result, agreed to support a 3.5 percent real increase in the resources of this institution. In the near future, the Administration will submit a budget amendment requesting that $135 million be transferred from the MDB "other" category to the AfDF to provide for U.S. participation in AfDF-6. Full implementation of the agreement will result in a fundamental improvement in the quality of this institution's operations and signals a new commitment by the donor community and management to make the AfDF a more effective and productive development institution.

The bulk of the Fund's resources will now be allocated to countries that are providing the economic environment conducive to development and growth. Countries not pursuing sound economic policies will be restricted to core operations that can be implemented successfully even in the face of adverse economic circumstances and policies. To improve loan quality, donors agreed on new Board procedures allowing executive directors with economic or technical concerns on a loan to return it to the Loan Committee so that these concerns may be addressed. We also reached agreement to strengthen the Fund's environmental staff, and increase emphasis on protection of forests and promotion of energy efficiency and conservation.

Up to $50 million remaining in the MDB other category could be allocated to the International Finance Corporation (IFC) for a capital increase. No decision has been made at this time about U.S. participation, however.

The IFC serves our policy goals in promoting the private sector. Nevertheless, the IFC could be more effective in both promoting needed developing country policy changes, and in encouraging the rest of the World Bank group to give higher priority to the private sector. The United States is, therefore, reviewing the IFC capital increase proposal in the broader context of the need for the entire World Bank group to give significantly greater priority to private sector developments in the 1990s. The World Bank's private sector activities should be strengthened and enhanced, and there should be better coordination between the World Bank and the IFC on key policy issues regarding private sector development. We also want the IFC to be more selective in the countries and sectors in which it operates.

The International Debt Strategy

The international community has called on the IMF and World Bank to assume pivotal roles in its efforts to address external debt problems of developing countries.

The international debt strategy, which has been shaped in large part through U.S. leadership, has proven effective. Under the debt strategy, we have seen real progress in reducing the debt burdens of countries with strong economic reform programs. Seven countries have reached agreements with their commercial banks on packages that include debt and/or debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries. The benefits are substantial. For example:

- The Mexican agreement reduced annual interest payments by 33 percent ($1.5 billion); commercial bank debt was reduced by 38 percent; and the burden of $42 billion in principal payments was removed.

- The Costa Rican agreement reduced that country's commercial bank debt by 62 percent and cut annual debt service payments by 74 percent.

Chile, Venezuela, Morocco, the Philippines, and Uruguay have also reached agreements involving significant reductions in debt burdens, and several other countries are continuing discussions with their banks.

These debt reduction agreements enable debtor countries and commercial banks to address their disparate needs. Furthermore, these agreements are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

The support of the IMF and World Bank is vital to achieving these agreements. The economic reform programs countries undertake with these institutions enable countries to gain credibility with their creditors and to proceed with negotiations. The IMF has committed $2.8 billion and the World Bank $2.7 billion to support specific debt and debt service reduction instruments in countries that have reached agreements with their commercial banks under the strengthened debt strategy. Under the President's new Enterprise for the Americas Initiative, the Inter-American Development Bank is joining the IMF and World Bank in providing support for these commercial bank packages.

The ongoing support of these institutions will help debtor countries achieve real gains through economic reform and commercial bank debt reduction.

The United States is also leading the effort to reach a consensus with other major creditors to reduce Poland's official debt. Reduction of Poland's large debt overhang is essential to support the dramatic economic reforms Poland is undertaking. The United States has favored a substantial reduction of Poland's debt, and we have been encouraged by recent progress with other key creditor governments, although the final components of a package and the extent of debt relief have not yet been determined.

Enterprise for the Americas Initiative

In a further effort to strengthen the economies of our neighbors in Latin America and the Caribbean and to improve trade opportunities in the hemisphere, President Bush announced last June the new Enterprise for the Americas Initiative (EAI).

This region is of vital interest to the United States. Ten years of slow growth and debt overhang have plagued the economies of Latin America and the Caribbean and thwarted opportunities for the hemisphere as a whole.

The Enterprise for the Americas Initiative aims to address these problems through action in three areas -- trade, investment, and debt. It thereby joins in a single endeavor the three economic issues of greatest importance to the region. It also seizes, in terms of timing and concept, on important developments already underway in the region -- including the spread of democracy and a clear commitment on the part of many leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

We are making real progress in implementing the vision laid out in the Initiative. To increase trade and move toward the goal of a hemispheric free trade system, we are pursuing a Free Trade Agreement (FTA) with Mexico and Canada. The goal of this agreement is to foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This FTA should expand and lock in recent trade and investment liberalizations achieved by the Salinas Administration. As you know, the President has just sent a formal request to Congress seeking an extension of fast track authority, which will enable us to negotiate effectively such an FTA agreement.

In announcing the Initiative, the President also indicated our willingness to enter into an FTA with countries or groups of countries throughout the region. We are negotiating framework agreements on trade and investment to establish the basis for progress with a range of countries. These agreements establish the context for addressing technical issues and beginning to remove barriers to trade and investment. We are using the framework agreement with Chile to explore their interest in an FTA.

Rapid progress can also be made on the investment front. Latin American and Caribbean countries are competing for scarce capital with other dynamic economies. They need to attract private investment both from abroad and at home, and to reverse capital flight, which in many cases is believed to be as large as their total external debt. The Inter-American Development Bank is developing an investment sector lending program to help countries to open and liberalize their investment regimes. The IDB has begun evaluating the necessary changes to achieve meaningful reform in individual countries, and we expect that the first investment sector loans will be moving forward over the next several months.

The debt reduction proposed under the Initiative will be an important incentive for countries to carry out investment reforms. We gained authority from Congress during the last session to undertake reduction of concessional PL-480 debt for countries pursuing strong economic reform programs, including liberalization of their investment regimes. We will be discussing such debt reduction with individual countries as they become eligible.

The Initiative will also provide significant benefits for the environment within the hemisphere pursuant to EAI Environmental Framework Agreements negotiated with each eligible country. Interest payments made in local currency on the reduced PL-480 and, eventually, AID debts will remain in the country to support a broad range of environmental projects. We expect local non-governmental organizations with expertise in the environment and conservation to play a strong role in determining the use of these environmental funds.

The President transmitted to the Congress last week legislation seeking authority from Congress to implement fully the investment and debt elements of the Initiative. The Administration is also requesting funding for implementation of debt reductions and the creation of a multilateral investment fund to support policy reform.

The bulk of these resources -- $309.7 million -- would cover the cost under the new credit reform budget procedures of reducing PL-480 and AID debt, and selling Eximbank loans and CCC assets in FY 1992.

The remaining $100 million is the first installment of the U.S. contribution to the multilateral investment fund which the President proposed be established in the Inter-America Development Bank (IDB). We have been discussing in detail this proposal with the IDB and other creditor governments. The Fund would make technical assistance grants to implement investment reforms, build privatization expertise, and develop human capital. It could also provide micro and small-sized enterprises with credit and equity financing, addressing their lack of access to capital in the region. We envision the Fund placing special emphasis on smaller countries in the region, such as those in Central America and the Caribbean. We will be seeking $500 million in total over a five year period.

Protecting the Environment

In recent years the issues of protecting the environment has taken on added importance. Treasury has taken an active role in championing this important U.S. policy goal in the IFIs.

Our objective has been to improve the environmental performance of these institutions and make them more effective agents of environmental reform. Our focus is on: establishment of environmental impact assessment (EIA) procedures, protection of tropical forests, and promotion of energy conservation and efficiency, including integrated least-cost planning and renewables. We have pressed hard to mobilize more support for these issues over the past year: at the annual meetings of the MDBs, in the Joint World Bank/IMF Development Committee, and at the Economic Summit in Houston last July.

The EIA process is particularly important. We have a legislative mandate to bring about a fundamental reform in this area by the end of this year. Significant progress has been made in implementing the EIA process in both the World Bank and the Inter-American Development Bank. Our overall assessment is that effectively functioning EIA systems should be in place by the end of this year.

The Asian Development Bank has upgraded its environmental unit and made budgetary provision for increases in environmental staff. It has said it will seek to strengthen its procedures for appraising environmental issues. At this point, however, we are not yet certain that the Bank will have in place by the end of the year an EIA system that meets our criteria.

EIA was highlighted as a key element of the African Development Fund Replenishment Agreement concluded in Rome last month. Our judgment, however, is that it will be extremely difficult for the AFDB to meet our criteria by the end of this year. We intend to work more closely with both the African and Asian banks over the next year to help them improve their capability in this area.

Energy efficiency and conservation is another area in which we have an important legislative mandate. In response to our efforts over the past year, the World Bank has restructured its Energy Sector Management Assistance Program (ESMAP) and created a special unit for energy efficiency and conservation for its operations in Eastern Europe. It is reassessing the approach it has taken to energy issues in the past.

We have also continued our efforts to encourage greater protection for tropical forests. This has included our effort to reform forest policies in both the World Bank and the Inter-American Development Bank and an initiative to reform and strengthen the Tropical Forestry Action Plan (TFAP). A meeting designed to broaden public participation in TFAP is scheduled for later this month in Geneva. We hope this meeting will produce a more open process and provide the international impetus that is needed to help preserve large areas of primary tropical moist forests.

Significant progress is being made on these issues, although more progress is needed. We still have problems with specific loans, and the MDBs need to place more emphasis on energy efficiency and conservation. I believe, however, that we are at the point of institutionalizing fundamental changes in the way the MDBs address environmental issues. What we are able to accomplish over the next year and a half will be critical in that respect. We will look for new opportunities to influence policies and procedures and promote specific projects, particularly in energy efficiency and conservation and in forest programs.

We have also offered to provide up to $150 million in parallel financing to the World Bank's Global Environmental Facility over the three year life of the facility. This is meant to foster greater interest in pilot projects that can become part of the regular lending program in future years.

The United States is also at the forefront in encouraging the IMF to enhance its environmental focus. Widespread recognition has emerged that IMF macroeconomic policy advice and prescriptions can have at times an important, though indirect, impact on environmental protection. In particular, the IMF has decided to establish a group of economists that will serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. Also, most IMF country documents now discuss environmental concerns. The IMF has also strengthened its collaboration with the World Bank with respect to taking into account structural measures for environmental protection into its work.

Reducing Poverty

The alleviation of poverty has long been a driving force in the work of the IFIs. Many developing countries face macroeconomic and structural imbalances requiring the adoption of comprehensive adjustment measures. In this context, the U.S. is working to ensure that IFI programs both protect and designed to help the poorest segments of the population. In the IMF, with our urging, there is now a heightened emphasis of incorporating measures to establish social safety nets to mitigate the affects of poverty on the poorest and to help countries meet basic human needs.

The World Bank, consistent with the objectives of U.S. legislation, is embarking on an effort to design assistance strategies that will contribute more effectively to the reduction of poverty. In negotiating the ninth replenishment of resources for the International Development Association (IDA-9), the United States and other donors agreed that a borrower country's economic performance, including efforts to alleviate poverty, will receive greater weight as criteria for allocation of resources.

The World Bank's 1990 "World Development Report" (WDR) focussed on identifying the key factors associated with reducing poverty. Bank management -- in response to a request from the U.S. and other executive directors -- prepared a paper elaborating the operational implications of the 1990 WDR. We generally endorse the recommendations enunciated in the Bank paper, particularly the recommendation that borrowing countries formulate their own "National Strategy for Development and Poverty Elimination" with the support and encouragement of the Bank. However, we have expressed concern to the Bank that these measures can only be implemented if the Bank addresses seriously the issues of adequate incentives for Bank staff and the implications of the staff-intensity of the proposed recommendations. This is an issue that we will be monitoring closely, Mr. Chairman.

Conclusion

Mr. Chairman, I have briefly reviewed the role of the international financial institutions (IFIs) in promoting U.S. national security interests -- from their financial support to regions of the world such as the Persian Gulf, Africa, and Latin America, to their involvement in functional issues like protecting the global environment and alleviating poverty. I have also presented an overview of President Bush's Enterprise for the Americas Initiative. I have also discussed their important role in promoting a stronger economy in which U.S. jobs and exports can thrive.

The relationships between U.S. national interests and the activities of the IFIs are inextricably linked. Your strong leadership, Mr. Chairman, and that of your Committee, has been and will continue to be vital to the success of these programs.

TREASURY NEWS

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

The Honorable John E. Robson

Deputy Secretary of the

U. S. Department of the Treasury

Before the Committee on Small Business

U. S. House of Representatives

March 5, 1991

Mr. Chairman, members of the Committee, I am pleased to appear before you today to address issues relating to the availability of bank credit.

During the last several months there has been considerable discussion about the credit crunch and its impact on the economy. As we all know, accessible, affordable bank credit is important to all businesses, large and small. And a safe and financially strong banking system is the best assurance for the availability of credit.

Mr. Chairman, you and the Committee are to be commended for your work during the last Congress in researching the factors that promote a sound, financially strong and competitive banking system. Your Task Force report on "The International Competitiveness of U.S. Financial Institutions" was very helpful to us in the preparation of the analysis and recommendations contained in our study, "Modernizing the Financial System," on which Secretary Brady testified before the House Banking Committee last week.

Strong, competitive institutions are necessary for the banking system to play the critically important role as a "shock absorber" in our economy. When the economic needs of industry expand, the banks are there to provide the credit necessary for growth and capital investment. And, when the economy contracts, our banks are needed to patiently work with borrowers on their working capital needs and to absorb some of the shock from falling sales and property values.

Today, I would like to give some opening comments and then my colleagues representing the four bank and thrift regulatory agencies -- the Federal Reserve, the FDIC, the Comptroller of the Currency, and the Office of Thrift Supervision -- (the "Regulatory Agencies") will discuss more fully the specific recommendations and proposals. My comments are in the spirit of the Treasury's role in this effort. We served as a "catalyst" in working with the Regulatory Agencies who actually developed the united set of recommendations and are now acting to implement them promptly and effectively.

Factors Contributing to the Credit Crunch

For the last several months our country has experienced a declining economy and our citizens have been preoccupied with our service men and women in the Persian Gulf. This has had a deleterious effect on consumer confidence and has negatively impacted many borrowing decisions including home and automobile sales and corporate capital expenditure plans. Thus, demands for credit have fallen. Likewise, with a softening economy, real estate markets are experiencing increasing vacancy rates and falling rents. Commercial banks, as in all downturns, have seen a rise in non-performing assets and the need for greater loan loss reserves -- while at the same time they are working diligently to raise capital to meet international standards.

Recognizing these trends, the Federal Reserve has responded by moving to lower short-term interest rates and reduce the reserves that banks are required to maintain on deposit at the Federal Reserve. These steps are meant to address both credit demand by lowering rates and credit supply by freeing up reserves that banks can then lend to sound borrowers.

Regulation's Impact on the Supply of Credit

However, even before the invasion of Kuwait, businesses and banks perceived a more stringent regulatory approach. It must be said first that this approach was in substantial measure due to the application of prudent regulation in more severe economic conditions, where the creditworthiness of borrowers and the values of real estate and loans had in fact deteriorated, necessitating larger loan loss reserves. Praise, not criticism, should be given to the bank regulators for vigilance in difficult economic conditions. No one wants a return to the dangerous laxity that marked the savings and loan collapse.

However, the application of prudent regulation also requires balance, common sense, and a recognition that banks, borrowers, and economic sectors experiencing temporary difficulties may need some flexibility to work through their problems -- and that regulatory judgment should and can be quite responsibly exercised in those situations.

It is in these areas of permissible and appropriate regulatory judgment where the perception has been created among banks and businesses that examiners are inflexible and overly harsh. This perception -- right or wrong -- began to create an atmosphere of risk-adversity, apprehension and hesitation among lenders, and has resulted in the constraint of bank credit even to sound borrowers. This undesirable atmosphere appears to have been created in a number of areas of the country and seems to be largely traceable to the examiners' overly pessimistic and rigid application of regulatory guidelines in areas where supervisory latitude exists and judgment can be properly employed.

For example, in the past, examiners reviewed appraisal information and also looked to the income generating capability of a real property in order to determine adequate reserves. However, regulators and bankers have recently reported a trend toward using only worst case, liquidation-type of valuations. Another instance might be the case where an examiner has instructed bank management to make a significant reduction in a loan concentration over a short period of time. Under that circumstance, many bankers will cease making or renewing any loans -- even sound ones -- in that concentration area.

Certainly, it was not the intention of the Regulatory Agencies to create a repressive lending climate. However, these perceptions are not facilitating the proper atmosphere to encourage bankers to work with borrowers experiencing problems and to avoid shutting off credit to sound borrowers, especially those in sectors of the economy experiencing temporary problems. And, commendably, in their statement released last Friday, the Regulatory Agencies stated that they "do not want the availability of credit for sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings of them."

Improving the Credit Climate

Following President Bush's State of the Union Address urging "sound banks to make sound loans," Secretary Brady suggested to the leadership of the Regulatory Agencies that they get their heads together and sort through the many recommendations from the Regulatory Agencies themselves, the business community and the bankers to address these issues.

On Friday, March 1, 1991, the Agencies announced a package of proposals to address the credit crunch. The package is the result of several weeks of work to determine what existing supervisory and examination policies and guidelines should be reassessed and clarified.

The proposals address a number of the areas of concern raised by both the regulatory community and the private sector. This includes guidance on the use of appraisals by examiners and other valuation issues -- especially in troubled real estate markets; broader disclosure to inform the investment community as to the true earning power of loans which have been technically placed in the non-performing assets category; continued prudent lending by institutions operating under a capital plan or with a loan concentration; clarification on the disclosure of credits in Highly Leveraged Transactions (HLTs); and, the need for clear and effective communication between bankers and their regulators. Furthermore, the Regulatory Agencies will continue to review their supervisory practices to determine what other policies may require modification.

These Proposals are not "Forbearance"

It is important to properly characterize the actions undertaken by the Regulatory Agencies last week and to address the concerns expressed by some that this is a kind of improper and risky forbearance. Such concerns have no foundation in fact. In no part of this package of recommendations from the Regulatory Agencies is there any -- I repeat -- any proposal to create fictitious capital, permit accounting practices not in accord with generally accepted accounting standards, or otherwise encourage "toying" with the books. This package encourages the application of common sense and judgment in supervisory actions and promotes lending to sound borrowers. To condone an approach of discredited forbearance would not be in keeping with the reforms implemented under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) or that we are now asking the Congress to consider as a part of our recommendations to modernize the financial services industry. Furthermore, it would ignore the disciplines of the market place and protect institutions which operate in an unsafe and unsound manner. That is not the case here.

Importance of Communication

Mr. Chairman, in the past, I have served as head of a federal regulatory agency and as chief executive officer of a company operating in a regulated industry. Thus, I believe I can speak with some perspective on the dynamics of the regulatory process. In order to achieve policy goals it takes clear communication and a great deal of management effort to achieve the desired policy objective.

I cannot emphasize enough that the encouragement of prudent lending activities rests on the shared confidence and understanding among both examiners and those whom they regulate. The guidance released last Friday must be clearly communicated to the more than 6,700 field examiners and to the financial institutions, and implemented in an even-handed, common sense manner. I am pleased that each Regulatory Agency has committed to make a special effort in disseminating these initiatives.

These steps alone will not end the credit crunch. However, they should have a very positive impact on the regulatory environment -- giving greater confidence to lenders that extending credit to sound borrowers will not result in regulatory retribution -- giving greater assurance to examiners that their exercise of appropriate judgment, balance and recognition of economic reality will not result in criticism from their superiors -- and giving greater confidence to borrowers to come forward in the expectation that sound projects will be funded. So, it is my hope that when combined with steps already taken by the Federal Reserve to lower interest rates and reduce bank reserve requirements, these efforts will result in greater credit availability to sound borrowers.

I would be pleased to respond to the Committee's questions.

TREASURY NEWS

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

STATEMENT BY
THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE
MARCH 5, 1991

Mr. Chairman and Members of the Committee:

It is a pleasure to testify before you today on the critical role of the international financial institutions (IFIs) as instruments to achieve U.S. economic policy objectives in the world economy, and international and bilateral efforts underway to support economic reform.

Today, the world community finds itself at the dawn of a new order of multilateral cooperation. This order, emerging from the fundamental economic and political changes underway throughout the world, holds forth the prospect for durable global peace and prosperity.

Many East European and Latin American leaders are rejecting statist approaches to organizing economic development. A revolution of thought is sweeping these countries, as well as those in Africa and Asia. People throughout the world are beginning to recognize that market economies are the best means to secure prosperity and freedom.

Interdependence amongst our economies is growing, and no longer can any one country -- not even the United States -- achieve its economic policy objectives in isolation. Economic issues increasingly dominate the international agenda.

These developments confront us with both unique opportunities and challenges. We will all need to work together as we approach the future to secure the gains of the new order. In so doing, we will also need to call increasingly upon the IFIs to play a continuing central leadership role in helping to manage the world economy and implement U.S. policy objectives.

Multilateral efforts are critical to supporting strong economic policies and sustained growth throughout the world. Our close relationship with Latin America and the Caribbean, however, also warrants a distinct bilateral approach on the part of the United States to advance hemispheric prosperity. We are pushing ahead on the President's Enterprise for the Americas

NB-1165

Initiative announced in June 1990. This Initiative will respond to difficulties faced by Latin America and the Caribbean over the past decade and support the commitments of many of the region's new leaders to undertake economic reforms.

The political and economic evolution now underway throughout the world is still young. Our support -- both multilateral and bilateral -- for the process of economic reform will be an important determinant in the success and longevity of the new world order.

Global Role of the International Financial Institutions (IFIs)

We are fortunate to be able to rely on the international financial institutions as vehicles for pooling multilateral efforts. Over the years, these institutions have served U.S. policy well. They have helped us to reconstruct the world from the ashes of World War II, reform the international monetary system, address the problems of external indebtedness in the developing countries, and tackle poverty. They have done so in every corner of the world by promoting sound market-oriented economic policies, consistent with U.S. foreign economic policy interests.

Through their essential support for a sound world economy, these institutions have strengthened U.S. growth, which supports our economic well being. In 1990 alone, the external sector accounted for more than 40 percent of the U.S. growth. Estimates suggest that roughly one out of every four new jobs in the United States is related to merchandise exports.

More recently, the international financial institutions have demonstrated anew the vital contribution they are making to promote a sound world economy and to support U.S. foreign economic and national security objectives.

These institutions have been at the front of international efforts to address the serious economic consequences of the Gulf crisis, and stand ready to assist the region in the aftermath of the war. In response to U.S. proposals, the International Monetary Fund (IMF) adapted its procedures to provide fast-disbursing assistance, and has already committed $2.8 billion of increased financing to help countries offset higher oil costs. The World Bank has intensified its lending plans for the front line states such as Turkey and Egypt, as well as other countries seriously affected by the crisis such as the Philippines and Bangladesh.

The IFIs are playing a leading role in Eastern Europe's bold and dramatic effort to restructure economic and political life. The IMF is currently backing sweeping reforms in Poland, Hungary, and Czechoslovakia; and support for Bulgaria and Romania should soon be in place. Most recently, the IMF has completed negotiations on a new $2 billion three year program for Poland to support structural reforms. Final approval by the IMF Executive Board is expected soon. In Eastern Europe overall, the IMF may commit $8 billion in 1991. Moreover, the World Bank is planning to lend $9 billion to Eastern Europe over three years, and the IFC will play a key privatization role. In addition, the European Bank for Reconstruction and Development (EBRD) will be ready to assist the region later this year.

These institutions are also providing essential support for economic policy reforms and development in Latin America and the Caribbean -- particularly in the context of the international debt strategy and the President's Initiative. The IMF serves as the primary catalyst for establishing the broad basis for sound economic policies designed to mobilize savings and investment and to reverse capital flight. The IMF has committed $12.5 billion to support economic policy reform in the region. The World Bank and the Inter-American Development Bank (IDB) are important agents in mobilizing private sector and government resources to finance the basic infrastructure and service projects that improve productivity and living standards. Last year the World Bank Group provided $6.0 billion and the IDB $3.8 billion to support policy reforms and projects for the region. The IMF, World Bank, and Inter-American Development Bank will be critical to our efforts to encourage further reforms, creating a productive environment for the success of the President's Enterprise for the Americas Initiative (EAI).

In Africa, the IFIs are at the center of a concerted international strategy designed to provide concessional resources to help the poorest countries of the world achieve sustainable growth, meet basic human needs, and alleviate widespread suffering. Total IMF commitments to these countries under the concessional Enhanced Structural Adjustment Facility (ESAF), and its predecessor facility, exceed $3.5 billion. Last year, the World Bank Group and African Development Bank Group made total commitments of $7.2 billion to the region.

If the institutions are to meet the global challenges of the 1990s in a manner that serves our foreign economic policy interests, we must stand squarely behind them and ensure that they have adequate resources to do their job.

The International Monetary Fund (IMF)

The resource needs of the IMF are reviewed periodically to ensure that the Fund has sufficient financing to fulfill its global responsibilities. Last year, the IMF concluded negotiations on a 50 percent increase in its resources from $130 to $195 billion. The U.S. share of the increase is some $12 billion at current exchange rates, for which we will be seeking Congressional appropriations and authorization as part of the FY 1992 budget.

Passage of this legislation is essential. The increase in IMF resources is vital if the Fund is to provide financial assistance throughout the world and to secure U.S. objectives in the new order of multilateral cooperation. As I have already observed, the IMF is providing vast amounts of resources in Eastern Europe, Latin America, Africa, and Asia, to promote comprehensive market-oriented reforms and to address the costs of the Gulf crisis. Overall Fund lending is expected to more than double in 1991 to $16 billion in disbursements and remain high in subsequent years. In addition to bolstering Fund liquidity to meet these near-term financing demands, the quota increase will provide for adequate Fund resources over the medium term.

The quota increase will also help the Fund to keep pace with the growth in the world economy. Over time, the size of the Fund's quotas has fallen significantly to roughly 4 percent of world imports. If the Fund is to be an effective lender of last resort, it must be perceived as being of a meaningful size relative to the problems at hand in the world economy in order for countries to adopt appropriate adjustment measures and to catalyze resources from other lenders.

Furthermore, the United States, as the leading and largest member of the IMF, has a special responsibility to do its part in the organization. Failure of the United States to support the quota legislation would seriously erode the effectiveness and credibility of the IMF.

In this context, the United States, with some 19 percent of the IMF's voting power, has effective veto over key IMF decisions, such as quota increases and amendments to the IMF's Articles, requiring an 85 percent majority. This veto power has often proven essential to ensure that the Fund operated in a manner consistent with overall U.S. interests.

The IMF is also extremely cost-effective in supporting U.S. interests. First, the transfer of dollars to the IMF is like putting money into a checking account which is interest-bearing and can be drawn automatically. In recognition of this unique monetary character of the IMF, Congress has agreed repeatedly over the years that use of the U.S. quota involves no net budgetary outlays. Under the recent budget summit agreement, a specific provision was made to account for the unique budgetary treatment of the quota increase. While use by the IMF of the U.S. quota will increase Treasury's borrowing requirements, the interest earned on our position in the Fund offsets this cost. Furthermore, the IMF leverages our scarce resources, which is particularly important at this time of budget restraint. For every dollar we put in, others put in four.

During the quota negotiations, a number of steps were taken to ensure that U.S. resources would be used far more effectively by the IMF. Thus, at U.S. insistence, as an integral part of the quota negotiations, the United States gained agreement on a strengthened strategy to tackle the large and growing problems of arrears in payments to the Fund. In recent years, arrears to the

Fund have grown to some $5 billion, roughly twice the level of IMF reserves.

The strengthened arrears strategy is designed to protect the Fund's financial position and to ensure that additional contributions are wisely spent. This strategy is well balanced, combining incentives for countries to clear their overdue obligations with disincentives to deter new arrears cases.

Mr. Chairman and Members of the Committee, the IMF is serving vital U.S. interests throughout the world. It is an extremely cost-effective organization. To ensure continued strong U.S. leadership in this critical global organization, I urge you to support the proposed increase in the U.S. quota share in the IMF.

<u>The Multilateral Development Banks (MDBs)</u>

Mr. Chairman, as you know supporting the MDBs requires appropriating U.S. financial resources annually. This year the Administration is requesting $1,685 million for U.S. paid-in contributions to the MDBs:

- $1,286.8 million to meet previously agreed scheduled payments to the MDBs;

$70.1 million	World Bank
$1,060.0 million	International Development Association
$57.3 million	Inter-American Development Bank (IDB)
$20.5 million	IDB Fund for Special Operations
$8.9 million	African Development Bank
$70.0 million	European Bank for Reconstruction and Development

- $25.5 million for the first installment to a Special Capital Increase (SCI) for the Asian Development Bank (ADB);

- $187.5 million to cover U.S. funding shortfalls in the agreed payments schedules to the Asian Development Fund ($175 million) and the Inter-American Investment Corporation ($12.5 million); and

- $185 million for "other" MDBs.

Of special note among previously authorized MDB programs, the $70 million funding request for the European Bank for Reconstruction and Development (EBRD) represents the second installment of the U.S. contribution to this new institution.

The Bank will hold its inaugural meeting next month -- April 15 -- and is expected to begin operations by early summer. We expect the Bank to make a significant contribution to the unprecedented transformation of the countries of the region to a market economy. The U.S. contribution to the Bank will not only promote economic and political stabilization in a region of the world that is very important to us, it will also help promote U.S. business interests in the region.

The Special Capital Increase for the ADB, in which Japan, Sweden, and the United States participated, was approved by the ADB Board of Governors in 1988. Japan sought the increase to make up for the decrease in its percentage ownership that resulted from the entry of China in the Bank and a previous SCI for several European countries. The United States joined in the increase to maintain parity with Japan.

When the ADB was established in 1966, the United States and Japan, as the two pre-eminent economic powers in the region, each subscribed to the same number of shares in the Bank's capital stock. The presumption was that equal ownership would be reflected in equal influence in the policies and operations of the Bank.

Although the situation has changed since then -- most notably with Japan's rapid growth and the expansion of its influence in Asia -- the United States' involvement and stake in the economic and political development of the region remains strong. Keeping our relative share in the ownership of the Bank's capital will enable us to maintain our influence in the ADB. We will thus avoid ceding a measure of our influence in Asia in general, the world's most rapidly growing region.

Mr. Chairman, I want to thank you and your Committee for your leadership last year in reducing significantly the U.S. shortfall in providing scheduled payments to the MDBs. I believe it is important that we clear up our remaining funding shortfall this year.

It is true that because of exchange rate changes and lower-than-expected lending levels in the past the Asian Development Fund (ADF) has managed to mount a credible lending program despite U.S. funding shortfalls. The ADF has now reached the point, however, where it must receive the U.S. funding shortfall in full near the beginning of FY 1992, or cease its lending operations early in calendar year 1992. This must not happen because the ADF provides financing on concessional terms to its developing member countries, which are among the poorest in the world. We have a strong stake in encouraging their economic growth and development, and the ADF makes a major contribution to achieving this objective.

The $12.5 million funding request for the Inter-American Investment Corporation (IIC) represents the fourth and final installment for the institution's initial capitalization. The U.S. payment can be invested in equity operations, and, as part of the capital base, can be borrowed against to fund additional IIC activities. The IIC is helping to meet the capital needs of the region by mobilizing from private sources up to an average of four times the amount of IIC commitments. IIC operations also help fulfill the U.S. economic policy objective of expanding the size of the private sector as the engine of sustained growth.

In late February, the U.S. met all of its major policy objectives for the sixth replenishment of the African Development Fund (AfDF), and as a result, agreed to support a 3.5 percent real increase in the resources of this institution. In the near future, the Administration will submit a budget amendment requesting that $135 million be transferred from the MDB "other" category to the AfDF to provide for U.S. participation in AfDF-6. Full implementation of the agreement will result in a fundamental improvement in the quality of this institution's operations and signals a new commitment by the donor community and management to make the AfDF a more effective and productive development institution.

The bulk of the Fund's resources will now be allocated to countries that are providing the economic environment conducive to development and growth. Countries not pursuing sound economic policies will be restricted to core operations that can be implemented successfully even in the face of adverse economic circumstances and policies. To improve loan quality, donors agreed on new Board procedures allowing executive directors with economic or technical concerns on a loan to return it to the Loan Committee so that these concerns may be addressed. We also reached agreement to strengthen the Fund's environmental staff, and increase emphasis on protection of forests and promotion of energy efficiency and conservation.

Up to $50 million remaining in the MDB other category could be allocated to the International Finance Corporation (IFC) for a capital increase. No decision has been made at this time about U.S. participation, however.

The IFC serves our policy goals in promoting the private sector. Nevertheless, the IFC could be more effective in both promoting needed developing country policy changes, and in encouraging the rest of the World Bank group to give higher priority to the private sector. The United States is, therefore, reviewing the IFC capital increase proposal in the broader context of the need for the entire World Bank group to give significantly greater priority to private sector developments in the 1990s. The World Bank's private sector activities should be strengthened and enhanced, and there should be better coordination between the World Bank and the IFC on key policy issues regarding private sector development. We also want the IFC to be more selective in the countries and sectors in which it operates.

The International Debt Strategy

The international community has called on the IMF and World Bank to assume pivotal roles in its efforts to address external debt problems of developing countries.

The international debt strategy, which has been shaped in large part through U.S. leadership, has proven effective. Under the debt strategy, we have seen real progress in reducing the debt burdens of countries with strong economic reform programs. Seven countries have reached agreements with their commercial banks on packages that include debt and/or debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries. The benefits are substantial. For example:

- The Mexican agreement reduced annual interest payments by 33 percent ($1.5 billion); commercial bank debt was reduced by 38 percent; and the burden of $42 billion in principal payments was removed.

- The Costa Rican agreement reduced that country's commercial bank debt by 62 percent and cut annual debt service payments by 74 percent.

Chile, Venezuela, Morocco, the Philippines, and Uruguay have also reached agreements involving significant reductions in debt burdens, and several other countries are continuing discussions with their banks.

These debt reduction agreements enable debtor countries and commercial banks to address their disparate needs. Furthermore, these agreements are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

The support of the IMF and World Bank is vital to achieving these agreements. The economic reform programs countries undertake with these institutions enable countries to gain credibility with their creditors and to proceed with negotiations. The IMF has committed $2.8 billion and the World Bank $2.7 billion to support specific debt and debt service reduction instruments in countries that have reached agreements with their commercial banks under the strengthened debt strategy. Under the President's new Enterprise for the Americas Initiative, the Inter-American Development Bank is joining the IMF and World Bank in providing support for these commercial bank packages.

The ongoing support of these institutions will help debtor countries achieve real gains through economic reform and commercial bank debt reduction.

The United States is also leading the effort to reach a consensus with other major creditors to reduce Poland's official debt. Reduction of Poland's large debt overhang is essential to support the dramatic economic reforms Poland is undertaking. The United States has favored a substantial reduction of Poland's debt, and we have been encouraged by recent progress with other key creditor governments, although the final components of a package and the extent of debt relief have not yet been determined.

Enterprise for the Americas Initiative

In a further effort to strengthen the economies of our neighbors in Latin America and the Caribbean and to improve trade opportunities in the hemisphere, President Bush announced last June the new Enterprise for the Americas Initiative (EAI).

This region is of vital interest to the United States. Ten years of slow growth and debt overhang have plagued the economies of Latin America and the Caribbean and thwarted opportunities for the hemisphere as a whole.

The Enterprise for the Americas Initiative aims to address these problems through action in three areas -- trade, investment, and debt. It thereby joins in a single endeavor the three economic issues of greatest importance to the region. It also seizes, in terms of timing and concept, on important developments already underway in the region -- including the spread of democracy and a clear commitment on the part of many leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

We are making real progress in implementing the vision laid out in the Initiative. To increase trade and move toward the goal of a hemispheric free trade system, we are pursuing a Free Trade Agreement (FTA) with Mexico and Canada. The goal of this agreement is to foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This FTA should expand and lock in recent trade and investment liberalizations achieved by the Salinas Administration. As you know, the President has just sent a formal request to Congress seeking an extension of fast track authority, which will enable us to negotiate effectively such an FTA agreement.

In announcing the Initiative, the President also indicated our willingness to enter into an FTA with countries or groups of countries throughout the region. We are negotiating framework agreements on trade and investment to establish the basis for progress with a range of countries. These agreements establish the context for addressing technical issues and beginning to remove barriers to trade and investment. We are using the framework agreement with Chile to explore their interest in an FTA.

Rapid progress can also be made on the investment front. Latin American and Caribbean countries are competing for scarce capital with other dynamic economies. They need to attract private investment both from abroad and at home, and to reverse capital flight, which in many cases is believed to be as large as their total external debt. The Inter-American Development Bank is developing an investment sector lending program to help countries to open and liberalize their investment regimes. The IDB has begun evaluating the necessary changes to achieve meaningful reform in individual countries, and we expect that the first investment sector loans will be moving forward over the next several months.

The debt reduction proposed under the Initiative will be an important incentive for countries to carry out investment reforms. We gained authority from Congress during the last session to undertake reduction of concessional PL-480 debt for countries pursuing strong economic reform programs, including liberalization of their investment regimes. We will be discussing such debt reduction with individual countries as they become eligible.

The Initiative will also provide significant benefits for the environment within the hemisphere pursuant to EAI Environmental Framework Agreements negotiated with each eligible country. Interest payments made in local currency on the reduced PL-480 and, eventually, AID debts will remain in the country to support a broad range of environmental projects. We expect local non-governmental organizations with expertise in the environment and conservation to play a strong role in determining the use of these environmental funds.

The President transmitted to the Congress last week legislation seeking authority from Congress to implement fully the investment and debt elements of the Initiative. The Administration is also requesting funding for implementation of debt reductions and the creation of a multilateral investment fund to support policy reform.

The bulk of these resources -- $309.7 million -- would cover the cost under the new credit reform budget procedures of reducing PL-480 and AID debt, and selling Eximbank loans and CCC assets in FY 1992.

The remaining $100 million is the first installment of the U.S. contribution to the multilateral investment fund which the President proposed be established in the Inter-America Development Bank (IDB). We have been discussing in detail this proposal with the IDB and other creditor governments. The Fund would make technical assistance grants to implement investment reforms, build privatization expertise, and develop human capital. It could also provide micro and small-sized enterprises with credit and equity financing, addressing their lack of access to capital in the region. We envision the Fund placing special emphasis on smaller countries in the region, such as those in Central America and the Caribbean. We will be seeking $500 million in total over a five year period.

Protecting the Environment

In recent years the issues of protecting the environment has taken on added importance. Treasury has taken an active role in championing this important U.S. policy goal in the IFIs.

Our objective has been to improve the environmental performance of these institutions and make them more effective agents of environmental reform. Our focus is on: establishment of environmental impact assessment (EIA) procedures, protection of tropical forests, and promotion of energy conservation and efficiency, including integrated least-cost planning and renewables. We have pressed hard to mobilize more support for these issues over the past year: at the annual meetings of the MDBs, in the Joint World Bank/IMF Development Committee, and at the Economic Summit in Houston last July.

The EIA process is particularly important. We have a legislative mandate to bring about a fundamental reform in this area by the end of this year. Significant progress has been made in implementing the EIA process in both the World Bank and the Inter-American Development Bank. Our overall assessment is that effectively functioning EIA systems should be in place by the end of this year.

The Asian Development Bank has upgraded its environmental unit and made budgetary provision for increases in environmental staff. It has said it will seek to strengthen its procedures for appraising environmental issues. At this point, however, we are not yet certain that the Bank will have in place by the end of the year an EIA system that meets our criteria.

EIA was highlighted as a key element of the African Development Fund Replenishment Agreement concluded in Rome last month. Our judgment, however, is that it will be extremely difficult for the AFDB to meet our criteria by the end of this year. We intend to work more closely with both the African and Asian banks over the next year to help them improve their capability in this area.

Energy efficiency and conservation is another area in which we have an important legislative mandate. In response to our efforts over the past year, the World Bank has restructured its Energy Sector Management Assistance Program (ESMAP) and created a special unit for energy efficiency and conservation for its operations in Eastern Europe. It is reassessing the approach it has taken to energy issues in the past.

We have also continued our efforts to encourage greater protection for tropical forests. This has included our effort to reform forest policies in both the World Bank and the Inter-American Development Bank and an initiative to reform and strengthen the Tropical Forestry Action Plan (TFAP). A meeting designed to broaden public participation in TFAP is scheduled for later this month in Geneva. We hope this meeting will produce a more open process and provide the international impetus that is needed to help preserve large areas of primary tropical moist forests.

Significant progress is being made on these issues, although more progress is needed. We still have problems with specific loans, and the MDBs need to place more emphasis on energy efficiency and conservation. I believe, however, that we are at the point of institutionalizing fundamental changes in the way the MDBs address environmental issues. What we are able to accomplish over the next year and a half will be critical in that respect. We will look for new opportunities to influence policies and procedures and promote specific projects, particularly in energy efficiency and conservation and in forest programs.

We have also offered to provide up to $150 million in parallel financing to the World Bank's Global Environmental Facility over the three year life of the facility. This is meant to foster greater interest in pilot projects that can become part of the regular lending program in future years.

The United States is also at the forefront in encouraging the IMF to enhance its environmental focus. Widespread recognition has emerged that IMF macroeconomic policy advice and prescriptions can have at times an important, though indirect, impact on environmental protection. In particular, the IMF has decided to establish a group of economists that will serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. Also, most IMF country documents now discuss environmental concerns. The IMF has also strengthened its collaboration with the World Bank with respect to taking into account structural measures for environmental protection into its work.

Reducing Poverty

The alleviation of poverty has long been a driving force in the work of the IFIs. Many developing countries face macroeconomic and structural imbalances requiring the adoption of comprehensive adjustment measures. In this context, the U.S. is working to ensure that IFI programs both protect and designed to help the poorest segments of the population. In the IMF, with our urging, there is now a heightened emphasis of incorporating measures to establish social safety nets to mitigate the affects of poverty on the poorest and to help countries meet basic human needs.

The World Bank, consistent with the objectives of U.S. legislation, is embarking on an effort to design assistance strategies that will contribute more effectively to the reduction of poverty. In negotiating the ninth replenishment of resources for the International Development Association (IDA-9), the United States and other donors agreed that a borrower country's economic performance, including efforts to alleviate poverty, will receive greater weight as criteria for allocation of resources.

The World Bank's 1990 "World Development Report" (WDR) focussed on identifying the key factors associated with reducing poverty. Bank management -- in response to a request from the U.S. and other executive directors -- prepared a paper elaborating the operational implications of the 1990 WDR. We generally endorse the recommendations enunciated in the Bank paper, particularly the recommendation that borrowing countries formulate their own "National Strategy for Development and Poverty Elimination" with the support and encouragement of the Bank. However, we have expressed concern to the Bank that these measures can only be implemented if the Bank addresses seriously the issues of adequate incentives for Bank staff and the implications of the staff-intensity of the proposed recommendations. This is an issue that we will be monitoring closely, Mr. Chairman.

Conclusion

Mr. Chairman, I have briefly reviewed the role of the international financial institutions (IFIs) in promoting U.S. national security interests -- from their financial support to regions of the world such as the Persian Gulf, Africa, and Latin America, to their involvement in functional issues like protecting the global environment and alleviating poverty. I have also presented an overview of President Bush's Enterprise for the Americas Initiative. I have also discussed their important role in promoting a stronger economy in which U.S. jobs and exports can thrive.

The relationships between U.S. national interests and the activities of the IFIs are inextricably linked. Your strong leadership, Mr. Chairman, and that of your Committee, has been and will continue to be vital to the success of these programs.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
March 5, 1991

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 $ 17,200 million, to be issued March 14, 1991. This offering will result in a paydown for the Treasury of about $ 2,675 million, as the maturing bills are outstanding in the amount of $ 19,871 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, March 11, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 8,600 million, representing an additional amount of bills dated December 13, 1990, and to mature June 13, 1991 (CUSIP No. 912794 WN 0), currently outstanding in the amount of $ 10,056 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 8,600 million, to be dated March 14, 1991, and to mature September 12, 1991 (CUSIP No. 912794 XF 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 March 14, 1991. In addition to the maturing 13-week and 26-week bills, there are $9,910 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 $ 1,168 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,522 million as agents for foreign and international monetary authorities, and $ 6,708 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 competitive 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.

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.

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.

8/89

Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions

Department of the Treasury
March 1991

Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions

On September 18, 1990, the Resolution Trust Corporation (RTC), in accordance with the requirements of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), issued a report to the Congress and the Oversight Board of the RTC on the 1988/89 Federal Savings and Loan Insurance Corporation (FSLIC) transactions.[1] The RTC Report recommended further study of certain tax issues relating to the 1988/89 FSLIC transactions. The Treasury Department has examined whether legislation or other action is appropriate to address the tax issues raised by the RTC Report. This report analyzes the tax issues raised by the RTC Report and provides the Treasury Department's views on those issues.

I. INTRODUCTION

Until it was abolished by FIRREA, FSLIC insured the deposits of its member savings and loan associations and was responsible for insolvent member institutions. During 1988 and 1989, FSLIC resolved 199 insolvent financial institutions in 96 assisted transactions. The assistance agreements with respect to the 1988/89 transactions obligated FSLIC to make ongoing assistance payments to the 91 institutions remaining after the restructuring of the insolvent financial institutions that were involved in those transactions.

FIRREA abolished FSLIC and established the FSLIC Resolution Fund (FRF) to assume all of the assets and liabilities of FSLIC (other than those expressly assumed by or transferred to RTC). FRF is administered exclusively by the Federal Deposit Insurance Corporation (FDIC). Thus, under FIRREA, the FDIC (through FRF) has assumed responsibility for FSLIC's obligations under the 1988/89 assistance agreements.

It is estimated that the cost of assistance with respect to the 1988/89 transactions will exceed $69 billion without considering the tax benefits involved in those transactions.[2] In structuring the 1988/89 assisted transactions, FSLIC increased its reliance on long-term assistance. As a result,

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[1] *See Report to the Oversight Board of the Resolution Trust Corporation and the Congress on the 1988/89 Federal Savings and Loan Insurance Corporation Assistance Agreements* (RTC Report).

[2] *See* RTC Report (vol. I) at 9 and 68.

only a portion of the total estimated assistance with respect to these transactions has been paid thus far (approximately $14.6 billion as of January 1, 1991).

The most significant forms of continuing assistance provided in the 1988/89 transactions are described below.[3]

1. Promissory notes. Promissory notes were provided to offset negative net worth and generally bear interest at a specified cost of funds index plus a spread.

2. Capital loss protection. In virtually all of the larger 1988/89 transactions, FSLIC agreed to pay acquirers assistance in an amount equal to the difference between the book value of "covered assets" and the proceeds received upon disposition of the assets. This type of assistance is designed to protect the acquirer from losses incurred with respect to covered assets. The assistance agreements generally grant FSLIC the right to purchase covered assets at market or book value. In addition, many of the assistance agreements permit FSLIC to order the assisted institution to write down the value of covered assets on their books to fair market value in exchange for a payment in the amount of the write-down. Some assistance agreements limit the amount of such a write-down to a percentage of book value or by other factors.

Typically, covered assets are assets that were owned by the acquired institution and that were classified as nonperforming or troubled at the time of the assisted transaction. In some cases, covered assets include assets that were expected to become troubled within a relatively short period of time. Some assistance agreements specifically identify the covered assets and others identify these assets by category. Covered assets usually include some combination of real estate, loans in various stages of default, delinquent loans (*i.e.*, usually loans at least 90 days past due), noninvestment grade securities, and investments in subsidiaries. Most agreements also permit or require the assisted institution to provide financing to facilitate the sale of a covered asset. In some cases the assistance agreements provide for these purchase money loans to become covered assets.

3. Guaranteed yield maintenance. FSLIC generally guaranteed the acquirer a minimum return or yield on the book value of covered assets. This type of assistance is designed to ensure that the acquirer would earn a minimum return over a base rate on covered assets. Any reduction in the amount of covered assets, whether by way of a write-down, purchase by FSLIC (now the FDIC), or other disposition, reduces the base on which yield maintenance payments are determined. In general, guaranteed yields exceed the amount of market yield that the institution could otherwise earn on the assets.

4. Indemnification and reimbursement from losses. The assistance agreements generally obligate FSLIC to reimburse acquiring institutions for amounts incurred and paid in connection with the satisfaction, settlement or compromise of certain claims and for reasonable costs and expenses related to such claims. These claims include unreserved claims, challenges to the transaction, and claims involving unassumed or undisclosed liabilities and nonexistent assets. The agreements also

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[3] For a more detailed discussion of the assistance provided in the 1988/89 transactions *see* RTC Report (vol. I) at 30-49.

require FSLIC to reimburse acquiring institutions for reasonable costs and expenses incurred by the institutions in pursuing related claims (*e.g.*, counterclaims) undertaken with FSLIC approval.

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The timing and structure of the 1988/89 assisted transactions can be attributed to two factors. First, FSLIC did not have the financial resources required to liquidate insolvent institutions even where liquidation would have minimized the cost of resolving the institutions. Consequently, in order to resolve insolvent institutions, FSLIC resorted to long-term assistance. Second, the special tax benefits provided to troubled financial institutions were due to expire on December 31, 1988. This resulted in an increase in the number of assisted transactions completed in 1988.[4] The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) postponed the expiration of these special tax benefits, but significantly reduced the amount of tax benefits available to assisted transactions occurring after 1988.

II. OVERVIEW OF SPECIAL TAX BENEFITS AVAILABLE IN CONNECTION WITH THE 1988/89 ASSISTED TRANSACTIONS

Prior to their repeal by FIRREA, the following three provisions of the Internal Revenue Code (the Code) provided the special tax benefits available in the 1988/89 transactions:

- Under old section 597 of the Code, qualifying assistance payments to a financial institution acquired in an assisted transaction prior to January 1, 1989, are excluded from the institution's income, and the institution is not required to reduce the tax basis of its property or other tax attributes on account of the receipt of such assistance. In addition, the general rule disallowing deductions for expenses and interest relating to tax-exempt income (section 265) does not apply to deductions allocable to amounts excluded from gross income pursuant to old section 597. Generally, in the case of any assisted transaction after December 31, 1988, and before May 10, 1989 (the effective date of the repeal of tax benefits available to troubled financial institutions), the assisted institution is required to reduce its net operating losses, built-in losses, and interest expense deductions by 50 percent of any assistance paid to the institution.

- Under section 368(a)(3)(D) of the Code, the acquisition of a troubled financial institution in a FSLIC-assisted transaction could qualify as a tax-free transaction without regard to the generally applicable requirement that the shareholders of an acquired corporation have a meaningful ownership interest in the acquiring corporation for the acquisition to qualify for tax-free reorganization treatment.

- Under section 382(l)(5)(F) of the Code, a corporation could acquire a troubled financial institution in a tax-free reorganization under section 368(a)(3)(D) without triggering the limitations that would otherwise apply to the net operating losses, built-in losses, and excess credits of the troubled financial institution.

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[4] *See* RTC Report (vol. I) at 3-4.

Prior to the enactment of old section 597 in 1981[5], the tax treatment of a payment from FSLIC to a financial institution was unclear. The payment could be treated as gross income or as a contribution to the capital of the institution. If treated as a contribution to capital, the payment was not included in gross income, but the institution was required to reduce the basis of its property by the amount of the contribution. After the enactment of old section 597, however, financial assistance payments made by FSLIC to certain troubled financial institutions were not included in the gross income of the institutions, and the institutions were not required to reduce the tax basis of property on account of the receipt of those payments.

The tax benefits available in 1988/89 assisted transactions represent a significant portion of the total cost of those transactions to the fisc. FSLIC estimated in early 1989 that the tax benefits attributable to the 1988/89 assisted transactions would equal $8.5 billion. After reducing this amount by FSLIC's estimate of the portion of those tax benefits that will accrue to its benefit under tax sharing agreements, FSLIC's total estimated cost to the Treasury of the tax benefits attributable to the 1988/89 assisted transactions is $4.2 billion in foregone revenues.[6]

III. TAX ISSUES RAISED BY RTC REPORT

The special tax provisions that applied to assisted transactions prior to FIRREA raise numerous tax issues. While many of these tax issues are not free from doubt, the resolution of most of them has not been controversial. The RTC Report, however, identifies a select set of tax-related issues that, depending on how they are resolved, may materially affect the cost of the 1988/89 transactions, most importantly:

1. The extent to which an assisted institution should be allowed to deduct losses and expenses even though the FDIC compensates or reimburses the institution for the losses or expenses; and

2. The extent to which the earnings on assets covered by yield maintenance guarantees are exempt from tax.

The remainder of this report analyzes these issues and provides the Treasury Department's views thereon.[7]

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[5] Old section 597 was enacted pursuant to the Economic Recovery Tax Act of 1981.

[6] *See Report to the Congress: Thrift Resolutions*, United States General Accounting Office (September 1990). For a more detailed discussion of the tax rules applicable to troubled financial institutions *see* Staff of the Joint Committee on Taxation, *Current Tax Rules relating to Financially Troubled Savings and Loan Associations* (February 16, 1989).

[7] In the 1988/89 transactions, the assistance agreements generally require the assisted institutions to share a portion of their tax benefits with FSLIC. *See* RTC Report (vol. I), at 6, 47-49. Many assisted institutions that have entered into tax sharing arrangements with FSLIC are members of an affiliated group of corporations that files consolidated federal income tax returns. In many of those cases, the tax benefits that are subject to sharing are used by an affiliate of the assisted institution,

IV. DEDUCTIBILITY OF REIMBURSED LOSSES AND EXPENSES

The critical tax issue raised by the RTC Report is the extent to which financial institutions may deduct losses and expenses even though they receive assistance payments from the FDIC as compensation for those losses or expenses. In considering this issue, first this report provides an overview of the federal income tax considerations relating to the deductibility of covered losses and expenses, describing briefly the types of transactions in which covered losses and expenses arise. Second, the report considers the incentive effects of the deduction of covered losses and expenses on assisted institutions. Third, the report analyzes the arguments for and against the deductibility of covered losses and expenses. Finally, the report presents the Treasury Department's views on the appropriate response to this issue and considers potential legislative clarification.

A. Overview of Federal Income Tax Considerations

1. Sale or other disposition of covered assets

Generally, a taxpayer incurs a loss for tax purposes on the sale or other disposition of property to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition.[8] When an institution sells a covered asset, the question arises whether it is entitled to claim a tax loss to the extent the tax basis of the covered asset exceeds the proceeds from the sale even though it receives assistance payments to compensate for that loss. The following two types of transactions are at issue:

(i) Sale to third party. If an institution sells a covered asset to a third party, the question is whether it may claim a tax loss even though it receives tax-free assistance payments from the FDIC to compensate for that loss and therefore experiences no economic loss. Assume, for example, that an institution sells a covered asset with a book value and tax basis of $100 to a third party for $40. Under the 1988/89 assistance agreement, the FDIC pays the institution $60 in tax-free assistance as compensation for the loss. The institution might nonetheless claim a $60 loss for tax purposes. Although, as this report discusses in detail, the issue is not free of doubt, the IRS has issued one unpublished ruling allowing the tax loss. The rationale for allowing the loss is that, under the law applicable to the 1988/89 transactions, assistance payments are excluded from income. The allowance of tax losses in such cases, even though the institution has experienced no economic loss, produces unintended and disadvantageous effects, which are described in the next section.

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rather than by the institution itself. In some cases, the other members of the affiliated group are not reimbursing the assisted institution for their use of its tax benefits. The RTC Report expressed concerns regarding these tax sharing arrangements and recommended that the FDIC and the Office of Thrift Supervision review the tax sharing arrangements to ensure that they are consistent with sound banking practices. *See* RTC Report (vol. I), at 118-120. As this does not raise issues of tax policy, this report does not address the issue.

[8] *See* I.R.C. § 1001.

(ii) Sale to the FDIC. Because it may be argued that all payments made with respect to covered assets constitute "assistance" provided under the 1988/89 agreements, institutions may claim that they are entitled to a tax loss equal to the entire tax basis of the covered assets if they sell the assets to the FDIC for market value or their book value. Assume, for example, that an institution owns a covered asset with a fair market value of $90 and a book value and tax basis of $100, and that the FDIC purchases that asset from the institution for its $100 book value pursuant to one of the 1988/89 agreements. The institution may argue for a $100 tax loss even though the institution receives $100 from the FDIC for the asset. The rationale for this view is that the entire amount paid by the FDIC should be treated as federal financial assistance and therefore disregarded in determining the institution's tax loss from the transaction. If this argument prevails, the covered asset would be treated as having been sold for $0 and the institution would be entitled to a loss equal to its entire tax basis in the asset. Alternatively, the institution might claim a $10 loss, on the ground that it would claim a loss in this amount had it sold the asset to a third party for its $90 fair market value and received $10 in assistance payments from the FDIC. In most cases, the FDIC's contractual rights to repurchase covered assets are at fair market value ($90 in the example), but in some cases the FDIC has a contractual right to repurchase covered assets at book value.

2. *Write-down of covered assets*

When an institution is ordered to write down a covered asset, the FDIC is generally required to make an assistance payment to the institution in the amount of the write-down. If the covered asset is a loan ("covered loan"), the issue is whether the institution must take the assistance payment into account in applying its method of accounting for bad debts. If an institution uses the reserve method of accounting for bad debts and the assistance payment made on account of the write-down is ignored for tax purposes, the institution may be entitled to charge the write-down against its reserve as a bad debt loss, potentially increasing the institution's addition to its reserve for bad debts and the deduction it may claim therefor.[9] If an institution uses the specific charge-off method of accounting for bad debts and the assistance payment made on account of the write-down is ignored for tax purposes, the institution may be entitled to claim a bad debt deduction on the write-down of a covered loan.[10]

In the case of covered assets other than loans or covered loans with respect to which bad debt losses may not be claimed on the write-down, the issue is whether the assistance payment made in connection with the write-down must be taken into account in determining whether the institution is entitled to claim a loss on the subsequent disposition of the asset. As a result, in the case of an asset other than a loan, the tax considerations implicated by a write-down of the asset are similar to those raised above in cases where contemporaneous assistance payments are made to compensate for a loss on the sale or other disposition of a covered asset, although the legal analysis of the two transactions might diverge.

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[9] *See* I.R.C. § 593 and Treas. Reg. § 1.593-7(b)(2).

[10] *See* I.R.C. § 166.

3. *Reimbursed expenses*

There is also an argument that expenses incurred but reimbursed by the FDIC should be deductible for tax purposes. Assume, for example, that an institution incurs legal expenses of $100 in connection with defending a claim relating to a covered asset and that these expenses are reimbursed by the FDIC. The institution has not, in reality, borne any expense in connection with defending the claim, but may nevertheless claim a deduction for the legal expense if the reimbursement is ignored for tax purposes.

In terms of the potential cost to the government, the deductibility of losses on the disposition of covered assets is much more important than the deductibility of reimbursed expenses. The policy considerations raised by the two issues, however, are quite similar.

B. Incentives

To the extent that tax deductions are allowed for losses on covered assets that are compensated by FDIC payments, institutions have a perverse incentive to ***hold*** covered assets and to ***minimize*** their value when sold. In the typical case, as long as an institution holds a covered asset, the yield guarantee protects the institution from any loss of income and on disposition the institution is guaranteed to receive book value through a combination of sales proceeds and FDIC payments. The FDIC, and not the institution, bears the economic burden corresponding to any reduction in value. Indeed, the institution and its affiliated corporations will tend to benefit as tax losses are enhanced. The institution, therefore, has an incentive to minimize the value of covered assets in order to maximize its tax loss and the attendant tax savings. Similarly, to the extent that tax deductions are allowed for expenses that are reimbursed with FDIC payments, institutions have an incentive to maximize, rather than minimize, those expenses. Unless the tax rules are clarified to provide that covered losses and expenses are not deductible or such incentives effectively are reversed through renegotiations, only the exercise of the FDIC's contractual rights to repurchase covered assets can stop the potential waste.

C. Current Law: Arguments For and Against Deductibility

In the case of the sale or write-down of a covered asset, the assisted institution generally receives compensation from the FDIC for any loss. Similarly, the FDIC generally is required under the assistance agreements to reimburse institutions for a variety of expenses. The deductibility of these losses and expenses turns on the appropriate tax treatment of the financial assistance paid by the FDIC. However, the tax law is not clear.[11]

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[11] Many of the legal arguments discussed below are raised in one of the consultant's reports prepared and submitted to the RTC in connection with the preparation of the RTC Report. *See* RTC Report (vol. I), Appendix V. Contrary arguments have been presented by the law firms Skadden, Arps, Slate, Meagher & Flom and Johnson & Gibbs, which represent taxpayers who acquired thrift institutions in 1988. *See* letter dated November 6, 1990, from Skadden, Arps, Slate, Meagher & Flom to Kenneth W. Gideon, Assistant Secretary (Tax Policy); letter dated December 18, 1990, from Johnson & Gibbs to Michael J. Graetz, Deputy Assistant Secretary (Tax Policy).

1. *Considerations generally applicable to covered losses and expenses*

Legislative background

The question whether covered losses and expenses reimbursed by the FDIC are nevertheless deductible for tax purposes depends upon a construction of the provisions of old section 597, enacted in 1981. Under old section 597, money or property received from FSLIC pursuant to section 406(f) of the National Housing Act is excluded from the gross income of a domestic building and loan association.[12] A companion rule in old section 597(b) prohibits a reduction in the tax basis of the assets of an assisted institution on account of the receipt of exempt assistance. Prior to the enactment of old section 597, the tax treatment of a payment from FSLIC to a financial institution was unclear. The payment could be treated as gross income or as a nonshareholder contribution to the capital of the institution. If treated as a nonshareholder contribution to capital, the payment was not included in gross income,[13] but the institution was required to reduce the basis of its property by the amount of the contribution.[14]

When Congress enacted old section 597, it decided that assistance payments should be excluded from gross income and should not be subject to the basis reduction rules applicable to nonshareholder contributions to capital. The statutory rule prohibiting basis adjustments apparently was intended to ensure that the exclusion from gross income provided by old section 597 would be permanent rather than temporary. It also appears that the special tax rules that applied to the acquisition of troubled financial institutions were designed to make the net operating losses of those institutions available to acquirers in assisted transactions.[15]

In enacting the special tax rules applicable to the acquisition of troubled financial institutions, Congress intended to facilitate the provision of financial assistance by FSLIC and to encourage the merger of troubled financial institutions into stronger institutions. The legislative history, however, does not suggest that Congress explicitly considered the implications of the basis adjustment prohibition beyond this point.[16]

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[12] This exemption was extended to FDIC assistance to banks in 1988. *See* § 4012(b)(2) of TAMRA.

[13] *See* I.R.C. § 118.

[14] *See* I.R.C. § 362(c).

[15] First, the exclusion of assistance payments from income without requiring a reduction in the acquired institution's net operating losses prevents those losses from being absorbed or otherwise reduced as a result of the assistance payments. Second, the special reorganization rules that were applicable to the acquisition of a troubled domestic building and loan association in an assisted transaction allowed the limitations of section 382 to be avoided in cases where it would have been impossible to do so otherwise.

[16] *See* H.R. Rep. No. 215, 97th Cong., 1st Sess. 283-4 (1981). *See also* Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* 151-3 (December 29, 1981).

The fundamental goal of the exclusion of income and the elimination of basis adjustments found in old section 597 was to ensure that FSLIC (and subsequently FDIC) assistance would not be reduced by the imposition of income taxes. There is no indication that Congress believed that the deductibility of covered losses and expenses was necessary either to fulfill this purpose or to facilitate the resolution of troubled financial institutions. Moreover, we suspect that Congress would have expressed a contrary view if it had explicitly considered the deductibility of covered losses and expenses and the perverse incentives associated with the deductibility of those losses and expenses. At the time of their enactment, old section 597 and the accompanying legislation to facilitate mergers and acquisitions of savings and loan institutions were estimated to produce an annual revenue loss of approximately $5 million. Old section 597 and its legislative background fail to provide conclusive authority for the deduction of covered losses and expenses.

Deductibility of Losses: The amount realized

Under current law, a taxpayer is generally required to overcome two hurdles in order to claim a deduction for a loss on the sale of an asset. The first hurdle requires the taxpayer to establish that a loss was realized on the sale. As a general rule, a taxpayer realizes a loss on the sale or other disposition of property to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the sale or other disposition.[17] A taxpayer's adjusted basis for an asset is generally determined by the cost of the asset.[18] A taxpayer's amount realized from the sale or other disposition of an asset generally equals the amount of money received plus the fair market value of any other property received on the disposition.[19] Therefore, an assisted institution would not be entitled to claim a tax loss on the sale or other disposition of a covered asset if assistance payments made to the institution as compensation for that loss are included in the amount realized from the sale. This treatment arguably is the most reasonable as it characterizes the transaction for tax purposes in accordance with its economic substance by denying the selling institution a deduction for a loss that it does not bear economically.

Upon any acquisition of covered assets, the acquiring institution acquired both the asset and FSLIC's agreement to provide compensation for any loss on the disposition of those assets. Consequently, the right of an institution to receive assistance on the disposition of a covered asset may be considered an integral part of that asset. Indeed, this view is consistent with private rulings that the IRS has issued holding that the right to receive assistance with respect to covered assets is taken into account in valuing those assets for purposes of determining whether the built-in deduction limitation of the consolidated return regulations applies to those assets.[20]

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[17] I.R.C. § 1001.

[18] I.R.C. § 1012.

[19] I.R.C. § 1001(b).

[20] *See, e.g.*, private letter rulings 8914021 (December 29, 1988) and 8914020 (December 29, 1988). There is little doubt that a payment received from the FDIC to purchase a covered asset constitutes an amount realized on the sale of the asset, at a minimum to the extent of the fair market value of the asset. As noted previously, because all FDIC payments with respect to covered assets arguably

Old section 597 does not appear to prohibit the inclusion of assistance in amounts realized. By its terms, old section 597 only excludes from gross income amounts that would be gross income but for the exclusion. The amount realized on the sale of an asset is included in gross income only to the extent it exceeds the basis of the asset sold.[21] Therefore, old section 597 can reasonably be read to exclude only amounts of assistance that otherwise would produce taxable gain on the disposition of covered assets. In addition, the basis adjustment prohibition of old section 597 applies only to assistance that is excluded from gross income under old section 597. Thus, if assistance paid as compensation for a loss on the sale of a covered asset were treated as an amount realized on the sale, old section 597 would not apply to the assistance to the extent that it merely reduced the tax loss from the sale.

Perhaps the strongest argument of the proponents of deductibility is that disallowing a deduction for covered losses and expenses is tantamount to taxing the assistance, thereby denying the permanent exclusion that Congress intended. Under this argument, the basis adjustment prohibition of old section 597 is viewed as a prohibition of any reduction of tax attributes that would have the effect of taxing FSLIC assistance. Assume, for example, that an assisted institution sells an asset with a book value and an adjusted basis of $100 for $60, and that the FDIC pays the institution $40 of assistance to compensate for the loss. If a deduction for the $40 loss reimbursed by the FDIC is disallowed on account of the assistance payment, the institution is in the same position that it would have been in if it had realized $40 of taxable income from the assistance payment and recognized a $40 taxable loss on the sale of the property. Notwithstanding the superficial appeal of this argument, we do not believe that Congress intended the provisions of old section 597 to require deductibility of the reimbursed loss in such a case. It is quite reasonable to view that provision as prohibiting the reduction of FSLIC or FDIC assistance through taxation without, at the same time, reading the provision to create tax incentives for increasing losses and minimizing value in assisted transactions.

General principles governing the treatment of compensated losses and reimbursed expenses

If, contrary to the above analysis, assistance received from the FDIC as compensation for a covered loss is not treated as an amount realized, the selling institution will be treated as realizing a loss from the sale for tax purposes. The fact that the institution has realized a loss for tax purposes does not, however, necessarily mean that a deduction for the loss will be allowed. In order to claim a deduction, the institution must clear a second legal hurdle. Under section 165(a) of the Code, a deduction is allowed for any loss sustained during the year only if the loss is not

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constitute "assistance" for purposes of old section 597, institutions may take the position that they are entitled to claim a tax loss equal to the entire tax basis of a covered asset when they sell the asset to the FDIC. The portion of the payment that does not exceed the fair market value of the covered asset, however, clearly represents consideration paid for the asset and must be treated as an amount realized for tax purposes.

[21] Under section 61(a)(3) of the Code, gross income includes gains derived from dealings in property. Under section 1001(a) of the Code, a taxpayer recognizes gain on the sale or other disposition of property only to the extent that the amount realized from the sale exceeds the basis of the property sold.

compensated for by insurance or otherwise. In other contexts, this rule has been interpreted to bar a deduction for a loss that is compensated for by tax-free assistance.[22]

Similar principles apply to the deductibility of covered expenses. Generally, the Code allows taxpayers to claim a deduction for the ordinary and necessary expenses incurred in carrying on a trade or business.[23] It is well established, however, that ordinary and necessary business expenses are not deductible to the extent that they are reimbursed, even if the reimbursement payments are excludable, under specific provisions of the Code, from the recipient's income.[24] Amounts that are subject to reimbursement are in the nature of advances on the credit of the party responsible for making the reimbursement.[25]

Therefore, unless the provisions of old section 597 are interpreted to require that assistance payments be ignored in applying the principles that generally govern the deductibility of losses and expenses, the better view is that no deduction should be allowed for covered losses and expenses because those losses and expenses are compensated for or reimbursed with assistance payments. The proponents of deductibility, however, argue that assistance payments made with respect to covered losses do not represent compensation "by insurance or otherwise" within the meaning of section 165(a) of the Code because the assistance payments are not payments in the nature of insurance, but rather are part of an arm's length bargain that induced the acquirer to enter into the assisted transaction.[26]

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[22] *See* Rev. Rul. 76-144, 1976-1 C.B. 17 (disaster losses compensated for by tax-exempt disaster relief payments were not deductible). *See also Shanahan v. Commissioner*, 63 T.C. 21 (1974); Treas. Reg. § 1.165-1(d)(2)(i). In addition, *see* note 24, below, for analogous authority regarding the deductibility of reimbursed business expenses under section 162 of the Code.

[23] *See* I.R.C. § 162.

[24] *See, e.g., Manocchio v. Commissioner*, 710 F.2d 1400 (9th Cir. 1983) (flight training expenses were not deductible to the extent reimbursed by tax-free veterans assistance); Rev. Rul. 80-173, 1980-2 C.B. 60, 61 (similar facts, but stressing that in such a case a taxpayer "suffers no economic detriment and incurs no expense"); *Wolfers v. Commissioner*, 69 T.C. 975 (1978) (expenses for increased rent, moving costs and professional fees were not deductible to the extent reimbursed by tax-free relocation assistance); Rev. Rul. 78-388, 1978-2 C.B. 110 (moving expenses were not deductible where taxpayer had a fixed right to reimbursement with tax-free relocation assistance).

[25] *See, e.g., Manocchio, id.* at 1402, quoting *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, 952 (2d Cir. 1932).

[26] This argument relies, in part, on *Idaho First National Bank v. Commissioner*, 95 T.C. 185 (1990), where the Tax Court stated that "[t]he FDIC insures depositors, not banks, and an FDIC assistance payment is not an insurance payment." Two points should be noted when considering the quoted passage. First, the passage appears in the opinion's findings of fact without any legal analysis and does not appear to be a finding that was required for the court to reach its decision. Second, the assisted transaction at issue in that case did not require the FDIC to reimburse or otherwise compensate the assisted institution for any losses incurred on the disposition of its assets. The FDIC

While it is indisputable that the capital loss coverage provided in many of the 1988/89 transactions was part of an agreed package of consideration, that fact is not dispositive. First, loss reimbursements paid by the FDIC may qualify as compensation for purposes of section 165(a) even if the payments are not in the nature of insurance.[27] Second, even if the payments must resemble insurance, the assistance that FSLIC agreed to pay under the 1988/89 assistance agreements with respect to covered losses shifted the risk of those losses to FSLIC and, as such, bears a striking resemblance to insurance.[28] If, as part of one of the 1988/89 transactions, FSLIC had agreed to pay a third party to insure the assisted institution against some risk, would the fact that the insurance represented part of the consideration provided in connection with the acquisition of the assisted institution cause the insurance to be characterized as something other than insurance for tax purposes? We think not and cannot readily distinguish such a fact pattern from the one at hand.

Other considerations

The only existing administrative guidance explicitly addressing the deductibility of covered losses and expenses is an IRS technical advice memorandum.[29] This memorandum concludes that the assisted institution may deduct losses and expenses that are reimbursed with assistance payments from FSLIC. A technical advice memorandum, however, generally is not considered authoritative guidance.[30] Nonetheless, this ruling provides some support for the position of those arguing that covered losses and expenses are deductible.

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assistance provided in that transaction took the form of a contribution to the assisted institution immediately prior to its acquisition. Under these circumstances, we do not believe that the Tax Court's decision in *Idaho First National Bank* should be accorded any precedential value with respect to the issue under consideration.

[27] *Compare Forward Communications Corp. v. United States*, 608 F.2d 485, 501 (Ct. Cl. 1979) (insurance is merely "one example" of the forms of compensation that will prohibit a deduction for a loss under section 165(a)) *with Shanahan v. Commissioner, supra* (the only form of compensation that will prohibit a section 165(a) deduction is compensation that is similar to insurance).

[28] The resemblance should be sufficient for capital loss coverage to be considered similar to insurance for purposes of section 165(a). *See, e.g., Estate of Bryan v. Commissioner*, 74 T.C. 725 (1980) (reimbursement of amounts embezzled from client out of trust fund maintained through annual contributions required of all practicing attorneys treated as compensation similar to insurance for purposes of the estate tax counterpart to section 165(a)).

[29] *See* technical advice memorandum 8637005 (May 30, 1986). We also understand that the deduction of reimbursed covered losses was permitted in one closing agreement entered into by a taxpayer and the IRS.

[30] Generally, a technical advice memorandum (or private ruling) is not precedent and may be relied upon only by the taxpayer to whom it is issued. *See* I.R.C. § 6110(j)(3); Treas. Reg. § 301.6110-7(b).

Assisted institutions may also argue that the deduction of covered losses and expenses is supported by legislation enacted subsequent to the enactment of old section 597. For example, Congress enacted legislation in 1986 providing that an otherwise allowable deduction would not be disallowed under section 265(a)(1) solely because it is allocable to income that is exempt from tax under old section 597.[31] Generally, section 265 of the Code disallows a deduction for any expense that is allocable to exempt income. The purpose of section 265 in disallowing deductions for expenses incurred to earn exempt income is to prevent taxpayers from deriving a double tax benefit from an exclusion from income.[32] It may be argued that the legislative decision to exclude assistance exempt under old section 597 from the ambit of section 265 represents a decision to approve a double benefit analogous to the allowance of a deduction for covered losses and expenses, and that this decision supports the conclusion that Congress had a similar result in mind when it enacted old section 597.

As a matter of statutory interpretation, however, the situations in which postenactment expressions of intent by a subsequent Congress are relevant in ascertaining the intent of a prior Congress are limited. We believe that, in this case, the actions or intent of the 99th Congress in enacting statutory provisions related to old section 597 should not be accorded any weight in assessing the intent of the 97th Congress, when it enacted old section 597, regarding the treatment of covered losses and expenses since the 99th Congress did not directly consider the treatment of those losses and expenses.

Similarly, in 1988, Congress amended old section 597 to reduce the tax benefits associated with the exclusion of assistance payments from income.[33] This legislation, in general, required that certain tax attributes of an assisted institution be reduced to the extent of 50 percent of any assistance that is received by the institution and is excluded from gross income under old section 597 (the "attribute reduction rule"). Proponents of the deductibility of covered losses assert that this legislation indicates that Congress believed that covered losses and expenses are deductible because otherwise the attribute reduction rule would have the effect of reducing an assisted institution's tax attributes for assistance payments that provided the institution with no tax benefits. This argument, of course, assumes that the attribute reduction rule would apply to reimbursements of covered losses and expenses. The rule would apply, however, only if those reimbursements represent gross income that is exempt from tax under old section 597. If those reimbursements are treated either as an amount realized on the sale of an asset or as compensation for a loss, they would not be treated as gross income that is subject to exemption under old section 597.

In sum, while the subsequent legislative developments involving old section 597 do provide some measure of support to those asserting the deductibility of covered losses and expenses, that support is not determinative because Congress, when it enacted the subsequent legislation, did not

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[31] *See* § 904(c)(2)(B) of the Tax Reform Act of 1986. Congress subsequently amended section 904(c)(2)(B) by striking out "Section 265(a)(1)" and inserting in its place "Section 265," thereby providing that the provision applied to all of section 265. *See* § 4012(c)(2) of TAMRA.

[32] *See, e.g.*, Rev. Rul. 83-3, 1983-1 C.B. 72, modified by Rev. Rul. 87-32, 1987-1 C.B. 131.

[33] *See* old section 597(c), as amended by TAMRA.

provide a specific and official expression of its intent regarding the treatment of covered losses and expenses. Furthermore, we are impelled, once again, to state that, in our view, it seems likely that if Congress had specifically considered the issue, it would have expressed a contrary view.

2. *Special considerations applicable to write down of covered assets*

When an institution is ordered to write down a covered asset, the FDIC is generally required to make an assistance payment to the institution in the amount of the write-down. If the covered asset is a loan (*i.e.*, a covered loan), the issue is whether the institution may claim a bad debt loss on the write-down of the loan.[34]

Under the Code, a taxpayer is allowed a deduction for any debt that has become wholly or, to the extent provided in regulations, partially worthless during the year.[35] It is likely that assisted institutions will argue that they are entitled to claim a bad debt loss when they are ordered to write down covered loans. Under Treasury regulations, loans made by a bank or other regulated financial institution are conclusively presumed to be worthless to the extent that they are written off on the institution's books in response to an order of the institution's supervisory authority.[36] Arguably, the order to write down a covered loan represents an order that triggers a conclusive presumption under Treasury regulations that the debt is worthless to the extent of the write-down.

It does not appear, however, that a write-down ordered pursuant to rights granted under an assistance agreement should trigger the conclusive presumption of worthlessness. The purpose of the conclusive presumption is to conform tax and regulatory standards to the extent possible.[37] When an institution is ordered to write down a covered loan in accordance with the requirements of an assistance agreement, the write-down does not reflect an exercise of regulatory standards by the institution's supervisory authority in its capacity as such. Rather, the write-down is a product of rights and obligations created pursuant to an arm's length transaction between the institution and FSLIC.

If the conclusive presumption of worthlessness does not apply, all "pertinent evidence," including the value of the collateral and the condition of the debtor, are taken into account in

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[34] In the case of covered assets other than loans or covered loans with respect to which bad debt losses may not be claimed on the write-down, the issue is whether the assistance payment made in connection with the write-down is taken into account in determining whether the institution is entitled to claim a loss on the subsequent disposition of the asset. Therefore, in those cases, the tax considerations implicated by a write-down of the asset are similar to those raised where contemporaneous assistance payments are made to compensate for a loss on the sale or other disposition of a covered asset.

[35] I.R.C. § 166.

[36] *See* Treas. Reg. § 1.166-2(d)(1).

[37] *See* Rev. Rul. 80-180, 1980-2 C.B. 66.

determining worthlessness.[38] A taxpayer is not entitled to claim a deduction for a bad debt loss if the taxpayer has a reasonable prospect of being made whole for the loss.[39] Accordingly, it is appropriate in valuing a covered loan to take into account the institution's right to receive assistance compensating it for any loss on the disposition or write-down of the loan.[40]

D. Clarifying the Tax Treatment of Reimbursed Losses and Expenses

The RTC Report identified the acceleration of covered asset dispositions as one of the best options available for reducing the overall cost of the 1988/89 transactions.[41] The RTC Report also recognized the severe adverse impact that the deduction of covered losses and expenses could have on the cost of the 1988/89 transactions, stating that clarification of this issue is "vital."[42]

From the point of view of sound tax and financial policy, taking into account both the costs to the government and the appropriate economic incentives for assisted institutions, it is clear that assisted institutions should not be allowed to deduct losses or expenses that are reimbursed by the FDIC. Unfortunately, as a legal matter, the deductibility of covered losses and expenses under existing law is less clear. Although the IRS has never taken a published position allowing these losses, it has issued at least one technical advice memorandum holding that the covered losses and expenses are deductible. In addition, IRS personnel apparently conveyed informally both to FSLIC and to potential acquirers that covered losses and expenses would be deductible. Material provided by FSLIC to prospective acquirers explicitly indicated that such losses would be deductible, although that same material indicated that the economic benefits of such deductions would flow to FSLIC and

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[38] *See* Treas. Reg. § 1.166-2(a).

[39] *See, e.g., Aerotron Grantor and Stockholder Trust v. Commissioner*, 56 T.C.M. 789 (1988); *Exxon Corporation v. United States*, 7 Cl. Ct. 347 (1985), *rev'd and remanded on other grounds*, 785 F.2d 277 (Fed. Cir. 1986). *See also* Treas. Reg. 1.166-2(b). *But see* Rev. Rul. 80-24, 1980-1 C.B. 47, 48 (which relies on *Zeeman v. United States*, 275 F.Supp. 235 (S.D.N.Y. 1967), *remanded on other grounds*, 395 F.2d 861 (2d Cir. 1968)), for the proposition that a creditor may deduct a bad debt loss on a note, regardless of whether the creditor has a reasonable prospect of succeeding in a suit against the seller of the note for rescission of the sales contract, where the rescission suit does not deal with "the debt owed by the debtor to the creditor or with collateral, guarantees or indemnity contracts directly related to the debt as such". The FDIC's obligation to reimburse an institution for any loss on a covered loan, however, effectively constitutes a guarantee of that loan and, as such, should be taken into account in determining whether the loan is worthless.

[40] The IRS has taken into account an institution's right to assistance in valuing covered assets for other purposes. *See* authority cited at note 20, above.

[41] *See* RTC Report (vol. I), at 72.

[42] *See* RTC Report (vol. I), at 117-118.

not the acquirers.[43] Under these circumstances, acquirers in the 1988/89 transactions regard the deductibility of covered losses as part of the consideration they received in connection with the acquisition of the troubled financial institutions involved in those transactions.[44] We are cognizant that denying institutions deductions for losses and expenses that are reimbursed by the FDIC will be perceived by some as a repudiation of the government's agreements.

Nonetheless, the Treasury Department has concluded that assisted institutions should not be allowed to deduct losses and expenses that are reimbursed by the FDIC. In reaching this conclusion, the Treasury Department has carefully weighed the costs to the government of allowing institutions to deduct reimbursed losses and expenses against the costs of creating a perception that the government is not adhering to its bargain. The costs to the government of allowing assisted institutions to deduct covered losses and expenses is considerable. The costs of the perverse incentives that would accompany the deductibility of covered losses and expenses would likely dwarf the cost of the tax benefits associated with those deductions. Such perverse incentives are not only financially costly, but they also create the perception that the government is incapable of soundly managing the savings and loan failures. That the government may be perceived as reneging on its deal is unfortunate, but the costs of avoiding that perception are unacceptable.

Under these circumstances, the Treasury Department does not and should not feel bound by one technical advice memorandum and informal advice conveyed to acquirers by government personnel. The acquirers in the 1988/89 transactions were generally represented by sophisticated counsel who know well that they are not entitled to rely on informal advice either from the IRS or other government agencies or on technical advice memorandums or on private letter rulings issued by the IRS to other taxpayers. The failure of acquirers, for whatever reason, to obtain private rulings or closing agreements confirming the deductibility of their covered losses and expenses represents an assumption of the risk that the government might someday challenge those deductions. The Treasury Department does not believe that the American people should bear the burden of exculpating those taxpayers from their assumption of this risk. The IRS is prepared to challenge and litigate, if necessary, the deductibility of covered losses and expenses.

While the Treasury Department has determined that assisted institutions should not be allowed to deduct covered losses and expenses reimbursed by the FDIC, our decision does not settle the issue. Our view will surely be challenged in the courts and that litigation could drag on for a number of years. The uncertainty that this environment creates will make it very difficult for the RTC to implement measures to reduce the cost of the 1988/89 transactions. Therefore, congressional clarification of this issue is extremely desirable, if not essential. We do not believe

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[43] *See Information and Instructions for the Preparation and Submission of Proposals for the Acquisition of one or more Savings Institutions in the Southwest* (prepared by the Federal Home Loan Bank Board and FSLIC).

[44] Acquirers of troubled thrifts also take comfort from a statement by the Joint Committee on Taxation suggesting that such losses are deductible, even though that statement was made in February 1989 and therefore obviously not relied upon by taxpayers. *See* Staff of the Joint Committee on Taxation, *Current Tax Rules Relating to Financially Troubled Savings and Loan Associations* 38-39 (February 16, 1989).

that Congress, when it enacted the special tax benefits that were available in the 1988/89 transactions, intended to sanction the deductibility of covered losses and expenses. But, if so, Congress should tell us now so we can avoid costly litigation. Otherwise, Congress should enact clarifying legislation disallowing deductions for covered losses and expenses.

V. TREATMENT OF YIELD MAINTENANCE

A. Overview

In the 1988/89 transactions, FSLIC generally guaranteed the acquirer a minimum return or yield on the book value of covered assets. FSLIC agreed to pay yield maintenance to induce acquirers to purchase the assets (and thereby avoid the burden of purchasing those assets itself) because it believed that the acquiring institutions were better positioned to manage the assets properly. The guaranteed yields are based on a specified base rate (*e.g.*, the Texas Cost of Funds) plus additional amounts ranging up to 275 basis points. In most transactions, the additional basis points decline over the term of the assistance agreement. The guaranteed yield was set so as to provide the acquiring institution with sufficient income to cover high funding and operating costs, including the costs of managing the covered asset portfolio. In most cases, the guaranteed yield is significantly higher than the yield the institution would receive on a market investment of an amount equal to the book value of the covered assets.[45]

B. Clarifying Tax Treatment of Yield Maintenance

Guaranteed yield maintenance has created incentives for institutions to engage in behavior that will tend to increase the costs to the government of the 1988/89 transactions.[46] First, yield maintenance gives the assisted institution an incentive to delay disposition of covered assets since the institution cannot readily replace the high tax-free guaranteed yields with comparable taxable yields. Second, the assisted institution has an incentive to minimize actual yield on these assets. This results in larger tax-free yield maintenance payments, thereby minimizing the taxable income of the institution or increasing tax losses that may be used to offset its other income or income of affiliated entities.[47] Apparently, the adverse incentives attributable to yield maintenance are being compounded by the fact that some assisted institutions are taking the position that actual yield on covered assets is not taxable to the assisted institutions, on the ground that these institutions collect actual yield as agents of the FDIC.[48] This view, which in substance treats actual yield as if it were tax-free assistance, is at odds with both the language and purpose of old section 597(a). That

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[45] *See* RTC Report (vol. I), at 33-34 and 72-73, for a more detailed discussion of yield maintenance.

[46] *See* RTC Report (vol. I), at 73-74.

[47] Although assistance agreements provide for a declining yield spread over time, this has not yet materially reduced yield maintenance payments, and, therefore, has not thus far tended to mitigate the adverse incentives. *See* RTC Report (vol. I), at 74.

[48] *See* RTC Report (vol. I), at 116-117.

provision defines assistance as amounts received from FSLIC (or the FDIC) pursuant to section 406(f) of the National Housing Act. The actual yield earned by an institution from its investments is not "received" from the FDIC and is therefore not received "pursuant to" section 406(f) of the National Housing Act.[49] The RTC Report recommends that appropriate authorities clarify that only the net difference between guaranteed and actual yield constitutes tax-free assistance income.[50] The Treasury Department will issue an administrative pronouncement holding that the actual yield on assets covered by a yield maintenance guarantee is taxable to the assisted institution. This result is sufficiently clear under present law that confirming legislation is not necessary.

[49] *See, e.g.*, § 406(f)(1) and (2) of the National Housing Act, 12 U.S.C. § 1729(f)(1) and (2) (FSLIC is responsible for determining the terms and conditions of assistance received pursuant to section 406(f)).

[50] *See* RTC Report (vol. I), at 116-117.

Department of the Treasury
Washington, D.C. 20220

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THE SECRETARY OF THE TREASURY

WASHINGTON

March 4, 1991

Dear

On September 18, 1990, the Resolution Trust Corporation ("RTC") issued a report to the Congress and the Oversight Board of the RTC on the 1988/89 FSLIC transactions. The RTC Report recommended further study and clarification of certain tax issues relating to the 1988/89 FSLIC transactions.

The Treasury Department has examined whether legislation or other action is appropriate to address the tax issues raised by the RTC Report. Enclosed for your consideration is a report that analyzes and provides our views on those issues.

The critical tax issue raised by the RTC Report is the extent to which financial institutions involved in the 1988/89 transactions may deduct losses and expenses even though they receive assistance payments from the FDIC as compensation for those losses or expenses. To the extent that tax deductions are allowed for losses that are compensated by FDIC payments, institutions have a perverse incentive to hold covered assets and to minimize their value when sold. From the point of view of sound tax and financial policy, taking into account both the costs to the government and the appropriate economic incentives for assisted institutions, it is clear that assisted institutions should not be allowed a tax deduction for losses or expenses that are reimbursed by the FDIC. Unfortunately, as a legal matter, the deductibility of covered losses and expenses under existing law is less clear.

The Treasury Department has concluded that assisted institutions should not be allowed to deduct losses and expenses that are reimbursed by the FDIC. Some of these institutions will argue that our decision is contrary to their expectations regarding the 1988/89 transactions. We felt, however, that, absent a clear congressional directive to the contrary, in order to protect the general taxpayer, we could not sanction the deductibility of covered losses and expenses and the perverse economic incentives that follow from such deductibility.

Certain financial institutions seem likely to challenge our conclusion, and, as a result, the Treasury Department's decision regarding the deductibility of covered losses and expenses does not settle the issue. The IRS is prepared to challenge and litigate the deductibility of covered losses and expenses. However, the uncertainty of years of litigation can and should be avoided.

Congressional clarification of this issue seems not only desirable but essential. If Congress did intend in 1981 when it enacted the special tax benefits available in the 1988/89 transactions or desires now to sanction the deductibility of covered losses and expenses, prompt legislative clarification should be enacted so that we may avoid embarking on a course of costly litigation. Otherwise, I urge Congress to enact clarifying legislation disallowing deductions for covered losses and expenses.

Sincerely,

Nicholas F. Brady

Enclosure

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:00 PM
March 6, 1991

Contact: Peter Hollenbach
(202) 376-4302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR FEBRUARY 1991

Treasury's Bureau of the Public Debt announced activity figures for the month of February 1991, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$495,965,885
Held in Unstripped Form	$375,643,135
Held in Stripped Form	$120,322,750
Reconstituted in February	$5,774,680

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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PA-46

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, FEBRUARY 28, 1991
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,591,354	$1,067,200	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,491,461	442,400	-0-
11-1/4% Note B-1995	5/15/95	7,127,086	5,811,886	1,315,200	$39,040
10-1/2% Note C-1995	8/15/95	7,955,901	7,233,901	722,000	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,387,350	931,200	50,400
8-7/8% Note A-1996	2/15/96	8,575,199	8,351,199	224,000	8,000
7-3/8% Note C-1996	5/15/96	20,085,643	19,871,243	214,400	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,967,610	291,200	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,848,037	73,200	2,000
8-5/8% Note B-1997	8/15/97	9,362,836	9,330,836	32,000	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,792,329	16,000	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,156,188	2,880	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,213,846	128,800	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0-
8-7/8% Note A-1999	2/15/99	9,719,623	9,716,423	3,200	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,178,303	868,800	-0-
8% Note C-1999	8/15/99	10,163,644	10,081,644	82,000	-0-
7-7/8% Note D-1999	11/15/99	10,773,960	10,765,960	8,000	-0-
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0-
8-7/8% Note B-2000	5/15/00	10,496,230	10,454,630	41,600	-0-
8-3/4% Note C-2000	8/15/00	11,080,646	11,080,646	-0-	-0-
8-1/2% Note D-2000	11/15/00	11,519,682	11,519,682	-0-	-0-
7-3/4% Note A-2001	2/15/01	11,312,802	11,312,802	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,703,406	4,598,400	36,800
12% Bond 2005	5/15/05	4,260,758	1,654,808	2,605,950	164,000
10-3/4% Bond 2005	8/15/05	9,269,713	8,329,713	940,000	40,800
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,676,784	4,328,800	269,600
11-1/4% Bond 2015	2/15/15	12,667,799	2,078,359	10,589,440	156,800
10-5/8% Bond 2015	8/15/15	7,149,916	1,725,276	5,424,640	62,080
9-7/8% Bond 2015	11/15/15	6,899,859	2,149,459	4,750,400	19,200
9-1/4% Bond 2016	2/15/16	7,266,854	6,782,054	484,800	472,800
7-1/4% Bond 2016	5/15/16	18,823,551	16,825,951	1,997,600	-0-
7-1/2% Bond 2016	11/15/16	18,864,448	14,641,168	4,223,280	482,400
8-3/4% Bond 2017	5/15/17	18,194,169	6,273,209	11,920,960	630,560
8-7/8% Bond 2017	8/15/17	14,016,858	9,320,858	4,696,000	488,000
9-1/8% Bond 2018	5/15/18	8,708,639	2,587,039	6,121,600	49,600
9% Bond 2018	11/15/18	9,032,870	1,428,070	7,604,800	187,400
8-7/8% Bond 2019	2/15/19	19,250,798	5,221,998	14,028,800	1,531,200
8-1/8% Bond 2019	8/15/19	20,213,832	10,819,912	9,393,920	153,600
8-1/2% Bond 2020	2/15/20	10,228,868	3,474,868	6,754,000	312,800
8-3/4% Bond 2020	5/15/20	10,158,883	3,729,763	6,429,120	504,000
8-3/4% Bond 2020	8/15/20	21,418,606	14,581,646	6,836,960	113,600
7-7/8% Bond 2021	2/15/21	11,113,453	11,020,653	92,800	-0-
Total		495,965,885	375,643,135	120,322,750	5,774,680

[1]Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

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

TEXT AS PREPARED
EMBARGOED UNTIL 6:00 p.m.
March 6, 1991

Contact: Cheryl Crispen
202-566-2041

REMARKS BY THE
HONORABLE NICHOLAS F. BRADY
TO THE
NEW YORK STOCK EXCHANGE BOARD OF DIRECTORS
WASHINGTON, D.C.
MARCH 6, 1991

Thank you, Bill, and welcome to the Treasury Department's Cash Room. This magnificent room is one of the most historic in the Treasury Department. For more than a century, the Cash Room was Treasury's bank lobby, where the public redeemed silver and gold certificates and cashed government checks until 1976.

President Ulysses S. Grant held his Inaugural Ball in this room on March 4, 1869. Two thousand tickets were sold to men only, and each gentleman was permitted to bring two ladies.

The six thousand guests apparently created quite a crush here in the Cash Room, and afterwards there was a slight problem in the cloak room. Some celebrants went home without their coats; others waited until 4 a.m. to retrieve their coats; and the most successful climbed over a transom from an adjacent room, and using the principle of first-come, best-dressed, ended their evening by moving up the fashion scale. Well, we won't have that problem tonight, and I know all of you want to be in your appointed places for the President's speech about one hour from now.

Accordingly, I'll be brief. But I do want to take a few minutes to address one of the most important economic issues facing our nation: the need for fundamental reform of the laws governing financial services in our country.

Following an extensive study, the Administration last month delivered the Treasury's report to the Congress recommending important reforms to our 40- and 50-year old banking laws.

NB-1167

These recommendations are important not just for the financial services sector, but also for the economy as a whole. Businesses must be able to count on our financial services firms, particularly banks, in bad times as well as good.

As we have seen in the current economic downturn, weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of trouble, jobs are imperiled. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in our country.

Some have questioned whether this is the time for fundamental reform: Are we taking on too much? Shouldn't we hear the winds of politics and make sure we don't offend established interests? This reaction reminds me of the reception given the recommendations in the report of the President's Task Force on Market Mechanisms following the market break in October 1987.

Many of you will remember that the immediate conventional wisdom was that the recommendations were too radical -- that they wouldn't be adopted. However, the central finding of that report has never been challenged: What had been seen traditionally as separate markets -- the markets for stocks, stock index futures, and stock options -- were in fact one market.

But our recommendations, once seen as too challenging of the powers that be, have in fact largely been put in place. Let's think back. There were four major proposals:

First, circuit breakers should be implemented to protect the market system. The exchanges themselves -- led by the New York Stock Exchange -- have established circuit breakers that have proven themselves to be an effective mechanism in subsequent market disruptions. The public has been protected.

Second, clearance and settlement systems should be improved, and third, large trader information in the stock markets should be reported. These two recommendations were the central provisions of the Market Reform Act of 1990 that was signed by President Bush last year.

Finally, we recommended that margins should be harmonized across geographical marketplaces that were in fact one market. The Bush Administration has been working to address this issue, and just today a compromise has emerged which, if enacted, would achieve this objective.

Under the compromise, which was passed by the Senate Agriculture Committee today, the Federal Reserve will be given new oversight over stock index futures, just as we recommended in the 1987 report. The Fed is specifically charged to take systemic risk into account, which means it can consider the need for consistency between stock and stock index futures margins. Day-to-day margin-setting will still be conducted by the futures exchanges.

My point is this: I am confident that we will achieve fundamental reform of financial services laws because our proposals for financial services reform, like those for financial market reform, address the reality of the modern marketplace. Increasingly, the financial services market is, in fact, one market, and our laws must be modernized to deal with this reality.

Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe-to-toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

For those who chart the future of our financial services industry, there is much to worry about in the banking world. The state of banking in the U.S. leaves taxpayers overexposed, consumers and businesses underserved, and the industry increasingly uncompetitive. As a result, banks are unable to effectively perform their important role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we had seven. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? A national stock exchange that didn't stack up? Obviously not.

In addition, we have left out-of-date laws on the books that prohibit banks from getting into new financial markets, and even keep them from branching across state lines. Banks in California, Michigan and Utah can open branches in Birmingham, England, but not in Birmingham, Alabama. These laws are totally out of touch with reality. And they impose unnecessary expenses on banks and consumers that have been estimated to cost $10 billion annually.

Consumers have long since begun to ignore these artificial restrictions, using credit cards, cash machines, and the 800 number to handle their financial affairs when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck.

We have a deposit insurance system that has wandered away from its original purpose of protecting only the small depositor. This safety net now covers almost every depositor, large and small, sophisticated and trusting, insured and uninsured. The system has bailed out large, money-wise investors who don't need the protection, and exposed the taxpayer to potential losses.

We have an industry that is in the grasp of no less than four separate federal regulators. Its ability to run day-to-day affairs and respond quickly to changed conditions -- such as the credit crunch -- is hamstrung by a myriad of Lilliputian restrictions.

What does this all add up to? Bank failures totalled 198 in the 38 years from 1942 to 1980, but reached 206 in 1989 alone. Interest rates are higher for consumers due to inefficiency and higher costs. And the bank insurance fund is under stress.

How do we reverse this trend? How do we help make banks more steadily profitable and competitive, better able to attract capital, and more ready to lend in good times and bad? The answer is plain: We need to overhaul outdated laws to recognize the modern marketplace.

Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized Bank Insurance Fund. But we also need interstate branching and broader financial activities so that our banks can become financially strong again.

If we leave the job half done -- if we only tinker with the problem -- then we'll probably be back again, sooner rather than later, recapitalizing the Bank Insurance Fund again, perhaps the next time with taxpayer money. That's a prospect no one could relish.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to put this country's financial services system back where it belongs: number one in the world.

The timing is right. By facing up to the reality of the marketplace today, we can help to ensure financial security for the future. We can create a modern financial system that is internationally competitive, that will protect depositors and taxpayers, serve consumers and strengthen the economy. This is a goal worthy of all our efforts, and with your help, we will get it done.

Thank you.

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

TEXT AS PREPARED
EMBARGOED UNTIL DELIVERY
Expected 1:30 p.m.

Contact: Cheryl Crispen
202-566-2041

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
GREATER NEW YORK SAVINGS BONDS KICKOFF
THURSDAY, MARCH 7, 1991
NEW YORK, NEW YORK

Thank you, Walter (Shipley). It's a pleasure to be in New York to help launch the nation's largest geographic campaign for Unites States Savings Bonds.

We can always count on the Greater New York Campaign for success. Last year, you really came through with 110,000 new or increased savers and 800 contributing companies. That's a real victory for the Savings Bonds Program, and it proves that our message of thrift and fiscal responsibility still hits home with the American people.

This year, a new campaign is underway -- with ambitious new goals and an aggressive plan to achieve them. And there is a new national campaign team, under Ed Hennessy's leadership, to make 1991 the 50th successful year for U.S. Savings Bonds.

When President Roosevelt bought the first Savings Bond in 1941, it was the beginning of a great tradition. Over the last 50 years, Americans have turned to bonds for safe and competitive investments to guard their future.

Today, the tradition continues, and President Bush is behind the Savings Bonds program 100 percent. The President appreciates all you're doing to make the 50th anniversary a success.

Americans have over $125 billion invested in Savings Bonds, and their investments are secure. Throughout the nation, Americans are using Savings Bonds to set their money aside for homes and education and retirement funds.-- all the while increasing financial stability for the United States.

Savings Bonds help the nation save hundreds of millions of dollars in debt costs every year. That means direct savings for U.S. taxpayers, as well as lower budget deficits.

And most importantly, Savings Bonds are a significant part of the nation's saving ethic. A saving economy is a strong economy, and Savings Bonds can help Americans attain a savings rate that will buttress our economic strength.

That's why the Greater New York Savings Bonds Committee is so important. Through your leadership and commitment, Savings Bonds have become an integral part of the savings and investment fabric of our nation.

Now, I'd like to turn to another issue of paramount importance to the nation's economic future: the need for fundamental reform of the laws governing financial services in our country.

As President Bush indicated in his address to a Joint Session of Congress last night, we are committed to working just as hard on domestic issues as we have worked to secure peace in the Persian Gulf region. And one of the President's top domestic priorities is to ensure a sound financial services system.

Following an extensive study, the Administration last month delivered the Treasury's report to the Congress recommending important reforms to our 40- and 50-year old banking laws.

These recommendations are important not just for the financial services sector, but also for the economy as a whole. Businesses must be able to count on our financial services firms, particularly banks, in bad times as well as good.

As we have seen in the current economic downturn, weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of trouble, jobs are imperiled. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in our country.

Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in good times and bad. The nation needs a banking system that is strong enough to compete toe-to-toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

For those who chart the future of our financial services industry, there is much to worry about in the banking world. The state of banking in the U.S. leaves taxpayers overexposed, consumers and businesses underserved, and the industry increasingly uncompetitive. As a result, banks are unable to effectively perform their important role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we had seven. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? A national stock exchange that didn't stack up? Obviously not.

In addition, we have left out-of-date laws on the books that prohibit banks from getting into new financial markets, and even keep them from branching across state lines. Banks in California, Michigan and Utah can open branches in Birmingham, England, but not in Birmingham, Alabama. These laws are totally out of touch with reality. And they impose unnecessary expenses on banks and consumers that have been estimated to cost $10 billion annually.

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Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized Bank Insurance Fund. But we also need interstate branching and broader financial activities so that our banks can become financially strong again.

Some have questioned whether this is the time for fundamental reform: Are we taking on too much? Shouldn't we hear the winds of politics and make sure we don't offend established interests?

I am confident that we will achieve fundamental reform of financial services laws because our proposals for financial services reform address the reality of the modern marketplace. Increasingly, the financial services market is, in fact, one market, and our laws must be modernized to deal with this reality.

If we leave the job half done -- if we only tinker with the problem -- then we'll probably be back again, sooner rather than later, recapitalizing the Bank Insurance Fund again, perhaps the next time with taxpayer money. That's a prospect no one could relish.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to put this country's financial services system back where it belongs: number one in the world.

The timing is right. By facing up to the reality of the marketplace today, we can help to ensure financial security for the future. We can create a modern financial system that is internationally competitive, that will protect depositors and taxpayers, serve consumers and strengthen the economy. This is a goal worthy of all our efforts, and with your help, we will get it done.

In closing, let me thank you again for all of the time and effort that you put into the Savings Bond program. The success of the program depends on you, and we're very grateful for all that you do. Thank you.

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 7, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $10,833 million of 52-week bills to be issued on March 14, 1991 and mature on March 12, 1992 were accepted today (CUSIP: 912794YD0).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	6.05%	6.45%	93.883
High	6.07%	6.47%	93.863
Average	6.06%	6.46%	93.873

Tenders at the high discount rate were allotted 31%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	24,035	24,035
New York	28,613,205	9,546,305
Philadelphia	15,420	15,420
Cleveland	25,640	25,640
Richmond	32,695	29,935
Atlanta	20,655	20,655
Chicago	2,064,870	660,920
St. Louis	28,935	20,175
Minneapolis	7,740	7,740
Kansas City	33,280	33,280
Dallas	9,300	9,300
San Francisco	589,420	70,420
Treasury	369,335	369,335
TOTALS	$31,834,530	$10,833,160

Type		
Competitive	$28,167,500	$7,166,130
Noncompetitive	812,730	812,730
Subtotal, Public	$28,980,230	$7,978,860
Federal Reserve	2,500,000	2,500,000
Foreign Official Institutions	354,300	354,300
TOTALS	$31,834,530	$10,833,160

An additional $375,700 thousand of bills will be issued to foreign official institutions for new cash.

NB-1169

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

FOR IMMEDIATE RELEASE
March 7, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY PARTICIPATING IN BRIDGE LOAN FOR ROMANIA

The Treasury Department announced today its participation in a short-term multilateral bridge loan for Romania. The multilateral arrangement, coordinated by the Bank for International Settlements, will total up to $300 million, with the U.S. share $40 million.

U.S. participation in this arrangement reflects support for Romania's economic reform program. The Treasury loan will be repaid from disbursements from the International Monetary Fund.

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B-1170

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

FOR IMMEDIATE RELEASE
March 7, 1991

Contact: Desiree Tucker-Sorini
(202) 566-8773

Statement by
Nicholas F. Brady
Secretary of the Treasury

The Senate is to be commended for its bipartisan vote to provide $30 billion in funding for the Resolution Trust Corporation (RTC). We appreciate the leadership of Chairman Riegle and Senator Garn in guiding this bill through the Banking Committee and the full Senate. Costs resulting from delays in providing RTC funding are mounting at the rate of $8 million per day, and we urge the House to act swiftly to avoid further unnecessary cost to the taxpayer.

# # #

NB-1171

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

FOR IMMEDIATE RELEASE
March 8, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY LIFTS KUWAIT TRADE AND TRAVEL RESTRICTIONS

Kuwaiti trade and travel restrictions have been eased by the U.S. Treasury Department in light of a March 2nd U.N. Security Council resolution calling for cooperation in Kuwait's reconstruction.

At the request of the Government of Kuwait, Treasury's Office of Foreign Assets Control (OFAC) amended its Kuwaiti Assets Control Regulations today, authorizing by general license transactions involving import, export, contracting, travel, and transportation. The transfer of blocked Kuwaiti government assets continues to require a license. Assets were frozen by the President's August 2nd executive order at Kuwait's request to protect them during Iraq's invasion and occupation.

The unblocking of the funds and other assets of the Government of Kuwait will soon follow. Prior to unblocking, such assets remain subject to the Kuwaiti Assets Control Regulations and the licenses issued thereunder.

In that connection, the settlement process involving certain payments by blocked Kuwaiti banks, previously licensed by OFAC, remains unaffected. The licensing of these banks allows the orderly settlement of certain pre-embargo banking transactions.

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NB-1172

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 11, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,602 million of 13-week bills to be issued on March 14, 1991 and mature on June 13, 1991 were accepted today (CUSIP: 912794WN0).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.84%	6.03%	98.524
High	5.86%	6.05%	98.519
Average	5.85%	6.04%	98.521

Tenders at the high discount rate were allotted 37%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	30,885	30,885
New York	24,435,035	7,130,770
Philadelphia	23,195	23,195
Cleveland	53,535	53,410
Richmond	58,105	58,105
Atlanta	29,940	28,940
Chicago	1,455,590	154,790
St. Louis	64,980	27,420
Minneapolis	12,100	12,100
Kansas City	51,940	48,940
Dallas	27,415	27,415
San Francisco	652,755	125,865
Treasury	880,430	880,430
TOTALS	$27,775,905	$8,602,265
Type		
Competitive	$23,583,495	$4,409,855
Noncompetitive	1,810,825	1,810,825
Subtotal, Public	$25,394,320	$6,220,680
Federal Reserve	2,221,355	2,221,355
Foreign Official Institutions	160,230	160,230
TOTALS	$27,775,905	$8,602,265

An additional $10,770 thousand of bills will be issued to foreign official institutions for new cash.

NB-1173

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 11, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,616 million of 26-week bills to be issued on March 14, 1991 and mature on September 12, 1991 were accepted today (CUSIP: 912794XF6).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.90%	6.18%	97.017
High	5.91%	6.19%	97.012
Average	5.91%	6.19%	97.012

Tenders at the high discount rate were allotted 68%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	35,775	35,775
New York	22,413,800	7,061,040
Philadelphia	18,070	18,070
Cleveland	38,780	38,780
Richmond	44,270	42,670
Atlanta	38,060	37,740
Chicago	1,836,190	466,590
St. Louis	41,340	22,100
Minneapolis	9,210	9,210
Kansas City	58,970	58,970
Dallas	23,965	23,965
San Francisco	685,155	153,155
Treasury	647,770	647,770
TOTALS	$25,891,355	$8,615,835
Type		
Competitive	$21,558,110	$4,282,590
Noncompetitive	1,348,975	1,348,975
Subtotal, Public	$22,907,085	$5,631,565
Federal Reserve	2,000,000	2,000,000
Foreign Official Institutions	984,270	984,270
TOTALS	$25,891,355	$8,615,835

An additional $108,830 thousand of bills will be issued to foreign official institutions for new cash.

NB-1174

TABLE A

GULF CRISIS FINANCIAL ASSISTANCE *

($ Billions – as of 3/11/91)

Donor/Creditor	Commitments
GULF STATES	9.8
EUROPEAN COMMUNITY	3.2
JAPAN	2.2
OTHER	0.5
TOTAL	**15.7**

* Includes all commitments to date for extraordinary economic assistance in 1990 and 1991. Does not include contributions to the multinational force, existing bilateral assistance, or funds made available by the IMF and World Bank.

TABLE B

GULF CRISIS FINANCIAL ASSISTANCE *

($ Billions - as of 3/11/91)

Donor/Creditor	Total Commitments	1990-91 Commitments Egypt/Turkey/Jordan	1990-91 Commitments Humanitarian**	Other States
GULF STATES	9.8	6.2	0.0	3.6
EUROPEAN COMMUNITY	3.2	2.3	0.7	0.2
JAPAN	2.2	2.0	0.1	0.1
OTHER	0.5	0.3	0.1	0.1
TOTAL	**15.7**	**10.8**	**0.9**	**4.0**

* Includes all commitments to date for extraordinary economic assistance in 1990 and 1991. Does not include contributions to the multinational force, existing bilateral assistance, or funds made available by the IMF and World Bank.

** Includes both unallocated commitments and multilateral humanitarian assistance.

TABLE C

GULF CRISIS FINANCIAL ASSISTANCE *

($ Billions - as of 3/11/91)

Donor/Creditor	Commitments	Disbursements
GULF STATES	9.8	6.2
EUROPEAN COMMUNITY	3.2	1.1
JAPAN	2.2	0.8
OTHER	0.5	0.2
TOTAL	**15.7**	**8.3**

* Includes all commitments to date for extraordinary economic assistance in 1990 and 1991. Does not include contributions to the multinational force, existing bilateral assistance, or funds made available by the IMF and World Bank.

Table 1

GULF CRISIS FINANCIAL ASSISTANCE *
COMMITMENTS FOR 1990–91
DISBURSEMENTS THROUGH 3/11/91

(US$ Millions)

Donor/Creditor	Egypt/Turkey/Jordan Commitments	Egypt/Turkey/Jordan Disbursements	Other States 1/ Commitments	Other States 1/ Disbursements	TOTAL Commitments	TOTAL Disbursements
GCC STATES	6168	3463	3576	2785	9744	6248
Saudi Arabia	2848	1788	1773	1403	4621	3191
Kuwait	2500	855	1184	763	3684	1618
UAE	820	820	619	619	1439	1439
EC	3034	1123	184	1	3218	1124
EC Budget:	805	624	0	0	805	624
Bilateral:	2229	499	184	1	2413	500
France	200	0	30	0	230	0
Germany	1190	360	144	0	1334	360
Italy	650	37	9	0	659	37
Other EC 2/	189	102	1	1	190	103
JAPAN	2126	800	100	0	2226	800
ALL OTHERS	413	96	99	62	512	158
Korea	98	5	17	2	115	7
Norway	24	7	82	60	106	67
Switzerland	120	16	0	0	120	16
Other 3/	171	68	0	0	171	68
TOTAL COMMITMENTS	11741	5482	3959	2848	15700	8330

* All commitments and disbursements are bilateral economic assistance and do not include contributions to the multinational force. Totals may not equal sum of components due to rounding. Based on data submitted to the Gulf Crisis Financial Coordination Group

1/ For Bangladesh, Djibouti, Lebanon, Morocco, Pakistan, Somalia, and Syria

TREASURY NEWS
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EMBARGOED UNTIL GIVEN
EXPECTED AT 2:00 P.M.
MARCH 12, 1991

TESTIMONY OF NICHOLAS F. BRADY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MARCH 12, 1991

Mr. Chairman and Members of the Committee, I am pleased to meet with you to discuss the economy, President Bush's FY 1992 budget and the revenue proposals contained therein.

Our work and thinking on the 1992 Budget has been guided by the need to restrain government spending and abide by the terms of the budget agreement hammered out by Congress and the Bush Administration last October. Over the next five years, the Federal government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the budget agreement. And, although a sharp rise in the near-term deficits may tend to obscure the significance of this achievement, there is widespread consensus, both here and abroad, that this budget agreement is an effective force for fiscal stability.

Furthermore, important budget process reforms, particularly the so-called "pay-as-you-go" provisions, were adopted to ensure that the deficit reduction targets adopted in the budget agreement are met. These process reforms are an integral part of the agreement and it is essential that Congress and the Administration adhere to both the letter and spirit of these reforms. They have received a positive reaction from the markets and have contributed to the lowering of interest rates.

ECONOMIC POLICY GOALS AND THE BUDGET

President Bush's budget, in which spending increases at less than the inflation rate, sets an important standard to which we must adhere. In other words, the real level of spending must decline. The reason is simple: spending growth is what has fueled the deficit. Deficits have a corrosive effect on economic activity. They crowd private borrowers out of financial markets and divert our national savings away from investment in new plants and equipment, research and development, and other uses which would directly enhance productivity and create economic growth.

With this in mind, our 1992 budget priorities have been set to keep future budget deficits on a downward path. Our plans for dealing with current problems, as well as the need to improve economic growth and prepare our economy for the challenges of the future, have been shaped by this necessity.

Most economists anticipate an end to the current recession by mid-year and a resumption of moderate growth as the year progresses. The return to positive growth will be based on strong exports, a resumption of consumer and business spending as confidence is gradually restored following the victory in the Gulf, and the stimulative effect of this year's deficit. Lower interest rates and improving inflation results will contribute to this turnaround.

Nevertheless, there will be proposals for various programs which have, in the past, been suggested to "jump start" the return to growth. While such suggestions have an important goal, the resumption of strong economic growth, they tend to be inefficient and often take effect long after the recovery phase is underway. Moreover, in the current budgetary setting, they would trigger the mandatory pay-as-you-go provisions enacted in OBRA 90.

This does not mean we should rest on our oars. And steps now are under way which will have a definite impact on the turnaround. First, the Federal Reserve has lowered the Federal funds rate seven times in the last four and one-half months. Some pundits have said this 200 basis-point reduction will have no effect, that it is merely "pushing on a string". They are dead wrong. Americans who have received downward adjustments in their variable rate mortgages and home equity credit lines or who now can buy a car or a house with substantially lower monthly payments understand. Lower interest rates and monthly payments have made a difference before and they will now. And for American businesses, lower interest rates mean lower capital costs and a greater incentive to invest.

Second, we have undertaken a review of the regulations covering bank lending with a view toward making sure these regulations are based on common sense. The results of this review, which included senior officials of the OCC, the Federal Reserve and the FDIC, have resulted in a number of regulatory policy clarifications which will have an effect on the so-called credit crunch. A copy of these clarifications is attached to my testimony.

These changes create the climate in which commercial banks ought to be making loans to sound borrowers.

I would now like to take a few minutes to discuss how President Bush's budget deals with longer term growth.

PROPOSALS ADDRESSING LONG-TERM INVESTMENT AND GROWTH

With respect to problems facing the Nation's financial institutions, we have just put forward a comprehensive plan for fundamental reform of the banking system. These reforms will update archaic laws which place costly and unneeded restrictions on banking activities, will make banks safer and sounder to protect depositors and taxpayers, and will restore international competitiveness of our financial firms. Our goal is to provide top quality, convenient financial services to the American people and capital for U.S. corporations to compete in global markets.

In addition, President Bush has proposed in his budget initiatives to improve our Nation's educational system by providing opportunities for individual choice, and to improve and expand our Nation's transportation system.

We are asking Congress and this Committee to support the following initiatives designed to induce long-term economic growth and enhance our Nation's competitiveness: a permanent research and experimentation credit, family savings accounts, enterprise zones, the allowance of withdrawals from individual retirement accounts for first-time home buyers, and a capital gains tax rate reduction for individuals.

Incentives for Research and Experimentation

Technological change plays a central role in economic growth. The Government has an important function in promoting innovation and basic research. In order to do so, we believe that the twenty percent research and experimentation (R&E) tax credit, which is set to expire after 1991, should be extended permanently. Research is inherently a long-term process. Extending the R&E tax credit permanently will permit businesses to begin projects without having to worry that the credit will be withdrawn in the future. In addition, the current allocation rules for R&E under section 861 should be extended for another year.

Family Savings Accounts

An important goal for the 1990s is to increase the rate of savings in the U.S. Savings finance investment and growth which means more jobs. We believe that the Federal Government should foster an environment that is conducive to saving, and we propose the creation of the Family Savings Account (FSA) to allow nondeductible contributions of up to $2,500 per taxpayer with a maximum of two accounts per family. After meeting the required seven-year holding period, all savings, including the accumulated earnings, can be withdrawn tax-free.

The new FSAs will provide a simple and understandable program for Americans to save. The time limit is short enough to focus attention on specific personal goals -- saving to buy a home, preparing for eduction costs or for building a financial reserve to protect against unexpected events. This is a program that Americans can understand and in which they can participate without having to wait for long periods to have access to their savings. It will work.

Enterprise Zones

To help economically distressed areas share in the benefits of economic growth, we propose to designate up to fifty Federal enterprise zones which will benefit from targeted tax incentives and Federal, state, and local regulatory relief. The incentives are: (1) a wage credit of up to $525 per worker; (2) elimination of capital gains taxes for tangible property used in an enterprise zone business; and (3) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses.

Penalty-Free IRA Withdrawals for First-Time Home Buyers

Owning a home is part of the American dream. However, many younger people increasingly find home ownership beyond their reach. We propose allowing individuals to withdraw amounts of up to $10,000 from their individual retirement accounts for a "first-time" home purchase. The 10-percent additional tax on early withdrawals imposed under current law would be waived for eligible individuals. Our proposal is designed to enhance the attractiveness of IRAs by making them more flexible.

Capital Gains Tax Rate Reduction for Individuals

Reducing the capital gains tax rate for individuals is important to restore economic growth and competitive strength by promoting savings, entrepreneurial activity, and investment in new products, processes and industries. At the same time, investors should be encouraged to extend their horizons and search for investments with longer term growth potential. To encourage Americans to invest for longer periods of time, we believe that the tax rate for capital gains on real estate, timber, homes, farms, land and corporate stock should be reduced based on the length of time an asset has been held.

In his State of the Union address, President Bush acknowledged the existence of divergent opinions on the impact of a capital gains tax rate reduction on economic growth and revenues. The President requested Federal Reserve Board Chairman Alan Greenspan to study these matters. We are hopeful that Chairman Greenspan, working with Congress and the Administration, can illuminate and resolve the disagreements surrounding a reduction in the capital gains tax rate.

Mr. Chairman, I would now be happy to take your questions.

Joint Agency News Release

Washington, DC

REGULATORS ISSUE JOINT SUPERVISORY POLICIES

The four federal regulators of banks and thrift institutions today issued joint statements and guidelines to clarify certain regulatory and accounting policies. The agencies said the intent of this effort is to contribute to a climate in which banks and thrifts will make loans to credit-worthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. The policies encourage increased disclosure about the condition of financial institutions' loan portfolios, facilitate extensions of credit to sound borrowers and the workout of problem loans, and better assure sound assessments of the value of real estate that secures loans.

The four regulatory agencies that issued today's statements are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,400 thrift institutions.

The joint policy statements cover a wide range of issues, including the following specific points:

- <u>Recognition of income for certain non-performing loans</u>. The agencies are considering the merits of proposed guidelines addressing the accrual of income on loans that have been partially charged off. The agencies and the Securities and Exchange Commission will both solicit public comment on the proposed guidelines.

- <u>Valuation of real estate loans in examinations</u>. The joint statement clarifies that the supervisory evaluation of real estate loans is based on the ability of the collateral to generate cash flow over time, not upon its liquidation value.

(more)

- <u>Guidance on other issues relating to nonaccrual assets and formally restructured debt</u>. This guidance covers a range of accounting issues, including cash basis income recognition on nonperforming loans, treatment of multiple loans to one borrower, and acquisition of nonaccrual assets.

The four agencies also issued a general statement that stressed the importance of financial institutions working with borrowers who may be experiencing temporary difficulties. The general statement discusses previously released policies that deal with increased disclosure on nonaccrual loans and guidance on the application of the definition of Highly Leveraged Transactions (HLTs). The statement also addresses regulatory policies on capital levels and loan concentrations, as they relate to institutions' ability to make loans to credit-worthy borrowers.

The agencies will send the clarifications and statements to field examiners and depository institutions. The agencies may also issue more detailed guidance on the issues covered in today's joint statements. Copies of the general statement and the joint policy guidelines released today are available from the OCC, FDIC, FRB, and OTS.

# # # #

GENERAL STATEMENT

Recent credit problems have underscored the importance of prudent lending practices to the overall safety and soundness of the nation's financial system. The emergence of credit problems in a number of sectors of the economy has prompted many depository institutions to review their lending practices as well as their capacity to meet credit demands. Many institutions have wisely tightened credit standards where such standards had become too loose. Others have reduced the pace of lending in response to the need to shore up their capital positions and strengthen their balance sheets.

It is possible, however, that some depository institutions may have become overly cautious in their lending practices. In some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examination standards.

The Federal banking and thrift regulators do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them. As a result, the agencies today are issuing a series of guidelines and statements that are intended to clarify regulatory policies in a number of areas and reduce concerns depository institutions may have about extensions of credit to sound borrowers. Specifically, the guidelines and statements released today: (1) encourage enhanced disclosure to the public, (2) facilitate extensions of credit to sound borrowers and the workout of problem loans, and (3) better assure sound assessments of the value of real estate by depository institutions and Federal examiners.

Recent concerns related to a tightening of credit have focused the agencies' attention on regulatory policies and their effects on institutions' willingness to extend new credit and to work with troubled borrowers. The guidelines and statements released today, which have been under development for some time, are not intended, nor are they expected, to "solve" all credit availability problems. When combined with other steps that have been taken (such as lower money market interest rates and changes in reserve requirements), these initiatives should help facilitate prudent credit extensions to sound borrowers.

Enhanced disclosure will help to ensure that the public is better informed about the nature of institutions' portfolios. The new guidance recently issued by the Office of the Comptroller of the Currency (OCC) on suggested disclosures of more detailed information about nonaccrual loans in public financial statements, and recent banking agency guidelines on Highly Leveraged Transactions, should help by differentiating among broad groups of assets with varying degrees of risk.

Depository institutions have traditionally worked with their borrowers who are experiencing problems. In the current economic environment, it is especially important for institutions to avoid shutting off credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems.

Consistent with sound banking practices, depository institutions, including those with low capital positions, should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties. Such efforts may include reasonable workout arrangements or prudent steps to restructure extensions of credit. Institutions that have in place effective internal controls to manage and reduce excessive concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers because of the borrower's particular industry or geographic location.

The documents released today by the Federal bank and thrift regulatory agencies aim to facilitate the workout of problem loans by addressing the income accrual treatment of formally restructured debt and acquired nonaccrual loans consistent with generally accepted accounting principles. Further, there is a clarification of the accounting treatment of multiple loans to a single borrower when some, but not all, of the loans to the borrower are troubled.

The agencies have also clarified when payments may be recognized as income on a cash basis for loans that have been partially charged-off. In addition, the agencies are developing guidelines that address how institutions can accrue income on loans that have been partially charged-off.

Finally, the agencies are also clarifying their policies on the supervisory valuation of real estate. The policies provide that the evaluation of loan loss reserves or net carrying values for real estate loans should reflect a realistic market analysis and not be based solely on liquidation values.

1. <u>Enhanced Disclosure to the Public</u>

<u>A. Disclosure of Nonaccrual Loans</u> Nonaccrual loans vary widely with respect to their quality and cash generating capacity. Consequently, the simple total of such

loans on an institution's books may not be a good indicator of the institution's financial position. One method to address this is to provide more information to the public on these assets. For example, useful supplemental disclosures might include information on the amount of charge-offs taken on nonaccrual loans, the amount of cash payments received on these assets, and the portion of these loans that generate substantial cash flow.

OCC recently issued a Banking Bulletin that contains suggestions for the voluntary disclosure of additional information on nonaccrual loans. The Federal regulatory agencies fully support the voluntary disclosures of the type suggested by the OCC and described in the attached statement.

B. Disclosure of Highly Leveraged Transactions (HLTs)

The Federal banking agencies have previously developed a uniform supervisory definition for HLTs. The purpose of the definition is to provide a consistent means to monitor loans to HLT borrowers. The agencies have recently provided the attached additional guidance to examiners and bankers on the application of this definition. This guidance stresses that the HLT designation does not imply a supervisory criticism of the credit.

The guidance also makes clear that certain extensions of credit, such as loans to debtors-in-possession (DIPs), do not fit the definition of HLT loans and should not be so reported. The criteria for the removal of a loan from HLT status have been expanded in the attached document. The agencies will continue to review these criteria to determine if other steps are warranted in view of the characteristics and performance of HLT credits, including the quality and reliability of the borrower's cash flow.

2. Other Lending Issues

There appears to be some concern that any new lending by institutions that fail to meet minimum capital requirements will result in supervisory criticism. While it is essential that depository institutions that fail to meet minimum capital standards take effective and timely steps to address this deficiency, such institutions are not necessarily required to cease prudent, low-risk lending activities. Institutions should attain capital compliance in a prudent manner that strengthens their financial conditions. Institutions that seek to improve their capital-to-assets ratios through shrinking their balance sheets should avoid actions that raise their risk exposure, such as the sale of all high-quality assets or of core deposits. Such actions by themselves, or the refusal to lend to sound borrowers, fail to achieve the important objective of improving the quality of under-capitalized institutions' portfolios.

The agencies share common procedures to address capital deficiencies at depository institutions. In general, each agency requires such institutions to prepare a plan that details the steps they will take to attain the minimum capital levels. Approved plans generally do not preclude a continuation of sound lending activities, including prudent steps to work with borrowers encountering financial difficulties.

Similarly, there appears to be some concern that institutions with loan concentrations are automatically turning down good loans. The benefits of adequate portfolio diversification are well recognized by depository institutions and their regulators. Although the regulatory agencies have not established rigid rules on asset concentrations, they are in agreement that, as a matter of sound operating policy, depository institutions should establish and adhere to policies that control "concentration risk."

Institutions that have in place effective internal controls to manage and reduce undue concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers. The purpose of institutions' policies should be to improve the overall quality of their portfolios. The replacement of unsound loans with sound loans can enhance the quality of a depository institution's portfolio, even when concentration levels are not reduced.

3. <u>Recognition of Income on Certain Nonperforming Loans</u>

Questions have been raised regarding the recognition of income on loans that have been partially charged-off. This subject is not explicitly addressed in the agencies' regulatory reporting requirements. The agencies wish to clarify that payments can be recognized as income on a <u>cash basis</u> for loans that have been partially charged-off, without requiring that the prior charge-off first be recovered, so long as the remaining book balance is deemed fully collectible.

The agencies, along with the Securities and Exchange Commission (SEC), each plan to solicit public comment on proposed guidelines which would allow certain nonperforming loans to be placed back on accrual status once the loans are reduced to an appropriate level through charge-offs. Any formal guidance issued will be based on the comments received from the public and on-going discussions between the agencies and the SEC.

The agencies have released today supervisory guidance on a variety of other issues related to nonaccrual assets and formally restructured debt. These guidelines include a discussion of regulatory requirements related to cash basis income recognition, multiple loans to one borrower, and the acquisition of nonaccrual assets.

4. Valuation of Real Estate Loans

In recent months, there have been significant declines in real estate values in certain markets. In response to these declines, examiners have reviewed the adequacy of institutions' loan loss reserves and, where they believed it appropriate, have required additional reserves based on, in part, their estimates of real estate values.

These actions have focused attention on the techniques used to assess the value of real estate, especially commercial real estate. It is important that valuation techniques reflect not only existing market conditions, but also reasonable expectations of the property's performance in the market over time. The Federal regulatory agencies are reiterating their policy on the assessment of real estate values and the establishment of loan loss reserves.

The basic thrust of this guidance is to ensure that income property loans not be assessed solely on the basis of liquidation values but also on the income-producing capacity of the properties over time. Supervisory evaluations should take into account the lack of liquidity and cyclical nature of real estate markets and the temporary imbalances in the supply and demand for real estate that may occur.

5. Review of Supervisory Findings

The agencies want to make clear their policy that any institution may request a review of any major decision reached as part of the supervisory process, including those related to asset classification and required reserve levels.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
March 12, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY AMENDS IRANIAN TRANSACTION REGULATIONS

The Treasury Department's Office of Foreign Assets Control today amended its Iranian Transactions Regulations to clarify the circumstances under which Iranian oil may be imported into the United States. Specific licenses will be issued on a case-by-case basis for these imports.

Iranian oil imports are now permitted under license from the U.S. Treasury Department in settlement of cases before the Iran-U.S. Claims Tribunal or if all payments due to Iran go to the Tribunal's Security Account at The Hague. The unlicensed importation of Iranian-origin oil into the United States has been prohibited since October, 1987.

The Security Account was established in 1981 after the signing of the Algiers Accords. The Accords freed American hostages and provided for the settlement of claims between the two countries. Tribunal awards are paid to U.S. claimants using funds from the Security Account. In selling oil for importation into the United States, Iran would produce revenues to satisfy a Tribunal award or replenish the Security Account against future awards.

Prohibitions on the unauthorized importation of Iranian-origin goods and services contained in the Regulations remain in effect. For more information about the sanctions program contact the Office of Foreign Assets Control at (202) 535-2071.

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NB-1176

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

FOR RELEASE AT 4:00 P.M.
March 12, 1991

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 $ 16,800 million, to be issued March 21, 1991. This offering will result in a paydown for the Treasury of about $ 2,575 million, as the maturing bills are outstanding in the amount of $ 19,386 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, March 18, 1991 prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 8,400 million, representing an additional amount of bills dated December 20, 1990 and to mature June 20, 1991 (CUSIP No. 912794 WP 5), currently outstanding in the amount of $ 10,521 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 8,400 million, to be dated March 21, 1991 and to mature September 19, 1991 (CUSIP No. 912794 XG 4).

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

The bills will be issued for cash and in exchange for Treasury bills maturing March 21, 1991. 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 $ 1,936 million as agents for foreign and international monetary authorities, and $ 4,205 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 competitive 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.

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.

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.

8/89

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
MARCH 14, 1991

STATEMENT TESTIMONY OF NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
March 14, 1991

Mr. Chairman and Members of the Committee, it is my pleasure to appear before this Subcommittee to discuss the operating budget request for the Department of the Treasury for FY 1992.

Since we met a year ago, significant events have taken place in both the international and domestic arenas. As part of the international coalition, we have addressed the situation in the Persian Gulf. We have taken a positive step toward responsibly managing Government by forging a budget agreement that adds discipline to Government spending. Seeking peace, stimulating economic growth, and responsibly managing Government spending are challenges for our nation.

The Department has supported Operation Desert Storm by enforcing economic sanctions against Iraq, by assessing the economic impact of the conflict on the "front line" countries and by coordinating, processing and investing foreign contributions for Operation Desert Storm. These efforts which helped win the war must be continued in new ways for us to win the peace.

The Administration anticipates a short-lived recession with recovery beginning at mid-year and the economic pace picking up later in the year. This should bring unemployment down and enhance growth.

Last month, I testified before the Senate and House Budget Committees and the House Appropriations Committee on the need to restrain Government spending and abide by the budget agreement so that future budget deficits can be controlled. The Treasury budget request presents an honest approach to responsible spending. More importantly, we are targeting every opportunity available to promote fiscal responsibility and provide innovative responses to today's problems.

We know that the savings and loan cleanup and the safety and soundness of our banking system are near the top of everyone's list of domestic issues which require thoughtful, responsible analysis and workable solutions. In that regard, we have recently proposed a comprehensive plan for banking reform that preserves deposit insurance for small savers, strengthens banks by attracting capital, increases competition by modernizing outdated laws, and streamlines the regulatory structure.

In addition to the banking reforms, we have asked Congress to support initiatives to stimulate growth and competition that include: family savings accounts to increase national saving; a permanent research and experimentation tax credit to promote private research and development; first-time home buyer withdrawal from IRAs; and reduction in the capital gains tax.

The Department of the Treasury's functions are broad and critical to the Nation's economic well being. These critical activities include:

- developing international monetary, financial and trade policies;
- developing economic policies that consider the economic effects of tax and budget policy;
- borrowing money needed to operate the Federal Government and accounting for the resulting public debt;
- collecting the proper amount of tax revenue, at the least cost to the public and with the highest degree of public confidence;
- improving Federal cash management and debt collection practices governmentwide;
- producing currency and coin for the Nation's commerce;
- carrying out activities that include collecting revenue from imports; collecting excise taxes on alcoholic beverages and tobacco products;
- controlling the sale and registration of firearms and prosecuting their illegal possession and use; oversight of drug interdiction programs and prevention of money laundering; oversight of strategic exports programs; preventing counterfeiting; training Federal law enforcement officers and protecting the President and Vice President;
- administering embargoes and economic sanctions against foreign countries to further U.S. foreign policy and national security goals; and
- regulating national banks and Federal and State chartered thrifts.

To continue to carry out these essential Government functions, we are requesting a total FY 1992 budget of $9.6 billion and 162,999 full time equivalent positions.

The Fiscal Year 1992 budget request has the following major objectives:

- Modernize Information Systems. Treasury plans to aggressively upgrade and integrate our existing systems to ensure they will perform in the electronic environment of the next century. For example, this budget requests funds to continue our commitment to completely overhaul and modernize the IRS' tax administration system. The goal of Tax System Modernization (TSM) is to place IRS on par with the highest financial processing standards in American business. We undertake this while recognizing that no other organization anywhere has the same complexity, volume and statutory environment of financial transactions. Ultimately, we expect TSM to relieve IRS of its manual processes so that we can dedicate our personnel to even higher standards of service quality.

- Improve Management of the Nation's Finances. The proposed budget for the Financial Management Service (FMS) includes funding to determine the best approach to merge governmentwide budget and asset and liability data bases, to enlarge current efforts to establish financial management evaluation criteria and improve data standards. Funds are also requested to implement the Credit Reform Act of 1990 to more accurately account for the costs of direct and guaranteed loans, and to comply with the Cash Management Improvement Act of 1990 which requires payment of interest when the Federal Government does not provide, or the States do not disburse, Federal funds in a timely and efficient manner.

- Improve Internal Controls. Funds are requested to strengthen Treasury's internal controls and fully meet the requirements of the Federal Managers' Financial Integrity Act. These funds include continued development of financial systems at IRS and Customs to enhance resource allocation. Further, these funds also support the completion of a new public debt accounting system that will improve automated controls and management information.

- Increase Enforcement of the Tax Laws. In an orderly and thoughtful way, we want our service coverage and operations to keep pace with the economy. As more returns are filed, more follow-up is required in every service and enforcement function so that we maintain a high level of voluntary compliance with the tax laws. We continue to give special emphasis to Accounts Receivable, the collecting of back taxes. We also must be responsive to growing requests from business organizations to help them determine what is proper compliance with a variety of tax code provisions. Internally, the IRS must support higher Government standards for financial systems accountability, and continue to address the higher threat of narcotics crime to the integrity of tax administration. We consider all of this proposed spending to be a wise and necessary investment.

- <u>Law Enforcement and the War on Drugs</u>. The War on Drugs will continue as a national priority in FY 1992. Treasury is a major participant in the War on Drugs and is committed to working with the Office of National Drug Control Policy. In support of key priorities of the National Drug Control Strategy, Treasury continues as a major participant in the Organized Crime Drug Enforcement Task Force (OCDETF) and the High Intensity Drug Trafficking Area (HIDTA) Programs. The Customs Service will continue to strengthen the President's War on Drugs through its narcotics interdiction efforts. Part of this strategy is the successful cross designation of 1,000 Customs special agents with the Drug Enforcement Administration (DEA). Funds are requested to enable Customs to fly the air assets that will come on-line in FY 1992, to expand the Canine Training Center and to provide service to the importing community.

Funds are also requested for the Bureau of Alcohol, Tobacco and Firearms (ATF) to combat violent crimes by preventing armed career criminals from obtaining firearms to commit drug related crimes. Funding for ATF also will provide for the collection of an estimated $13.5 billion in excise taxes on alcohol and tobacco.

The Department continues its commitment to consolidated law enforcement training at the Federal Law Enforcement Training Center (FLETC) facilities. Our FY 1992 FLETC request provides the resources to continue facility expansion initiated in previous years.

The Financial Crimes Enforcement Network (FinCEN) budget request provides funding for the operation and improvement of the FinCEN intelligence information system providing financial intelligence to deter money laundering and other financial crimes.

The Secret Service budget request provides protection for the President, Vice President and their families, as well as candidates and nominees for the 1992 Presidential Campaign. In addition, the Secret Service will be aggressively utilizing manpower and resources to combat fraud against financial institutions as a direct result of new authority provided by the Appropriations Committee this past year.

- <u>Meet the Nation's Demand for Currency and Coinage</u>. The budget for the U.S. Mint will provide for production of sufficient coinage to meet expected demand. The Bureau of Engraving and Printing (BEP), which does not require annual appropriation, will meet the demand for currency.

- <u>Policy Formulation and Management Oversight of Departmental Operations</u>. The Departmental Offices budget request will permit the Department to carry out economic, financial and tax policies.

In summary, the Department's budget request of $9.6 billion represents a commitment to:

- modernize the administration of the tax laws, collection of revenues and responsiveness to the public;

- improve the management of the Nation's finances;

- strengthen internal controls to facilitate the responsible management of the Nation's financial resources;

- enhance the war on drugs; and

- manage essential Government services.

Mr. Chairman, that concludes my opening remarks. I will be happy to answer any questions that you or the other Subcommittee members may have.

PUBLIC DEBT NEWS
Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 18, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,438 million of 13-week bills to be issued on March 21, 1991 and mature on June 20, 1991 were accepted today (CUSIP: 912794WP5).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.80%	5.98%	98.534
High	5.83%	6.02%	98.526
Average	5.83%	6.02%	98.526

Tenders at the high discount rate were allotted 38%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	42,295	42,295
New York	27,752,690	7,322,720
Philadelphia	26,985	26,985
Cleveland	45,405	45,405
Richmond	48,600	48,600
Atlanta	32,300	30,680
Chicago	1,357,965	158,465
St. Louis	60,670	17,430
Minneapolis	10,420	10,420
Kansas City	41,505	41,505
Dallas	24,695	24,695
San Francisco	611,425	61,425
Treasury	607,745	607,745
TOTALS	$30,662,700	$8,438,370
Type		
Competitive	$26,674,040	$4,449,710
Noncompetitive	1,386,510	1,386,510
Subtotal, Public	$28,060,550	$5,836,220
Federal Reserve	2,204,780	2,204,780
Foreign Official Institutions	397,370	397,370
TOTALS	$30,662,700	$8,438,370

An additional $6,530 thousand of bills will be issued to foreign official institutions for new cash.

NB-1179

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

Text as prepared
for release upon delivery
expected at 2:00 p.m.
March 14, 1991

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE
MARCH 14, 1991

Thank you for the opportunity to discuss the proposed negotiation of a free trade agreement (FTA) between the United States, Mexico and Canada. I would also like to take this opportunity to place our discussion today in the broader perspective of the Administration's Enterprise for the Americas Initiative. We look forward to more consultations with you as you review both these efforts.

The FTA proposal reflects an emerging global recognition that open markets for trade in goods and services and investment are a powerful impetus for growth and stability. We must not underestimate the magnitude of this change in perception. Just a few years ago there was no such consensus. FTAs and other ambitious trade and investment agreements seemed beyond our reach.

The new awareness of the importance of open markets creates an unprecedented opportunity to convert sound economic principles into reality. To do this, the Administration needs your support for an extension of the fast track authority for the implementation of trade agreements. This authority is essential for the President to maximize the Administration's negotiating leverage and credibility and to exert U.S. leadership in the world economy. An extension will allow the Administration and Congress to work together to seize the opportunity to fashion a new, more open trade environment through the Uruguay Round, a free trade agreement with the United States, Mexico, and Canada, and the Enterprise for the Americas Initiative.

NB-1180

Mexico is at the forefront of the shift toward more open, market-oriented development strategies. Its courageous steps to stabilize the economy through its structural reform program and the negotiation of a financing package with its commercial bank creditors under the Brady Plan have put Mexico firmly on the path toward long-term sustainable growth. A successful FTA would be a complement to these measures and strengthen Mexico's potential as an economic partner of the United States. Now is the time for the United States to create a permanent economic relationship based on open markets between our countries.

A North American free trade agreement would create an open market encompassing some 360 million consumers and $6 trillion in output. Mutual liberalization of trade and investment restrictions between the United States, Mexico, and Canada will help our firms become more competitive internationally and stimulate economic growth and productivity across North America.

Benefits for the United States

An FTA which reduces or eliminates trade and investment restrictions can make an important contribution to economic growth. Since Mexico initiated a policy of lowering trade barriers in connection with World Bank loans and joining the General Agreement on Tariffs and Trade (GATT) in 1986, U.S. exports to Mexico have more than doubled, growing from $12.4 billion to $28.2 billion in 1990. Reducing tariffs further would generate additional gains: currently our exporters face a trade weighted tariff of ten percent in Mexico; ours is four percent.

As Mexican economic growth accelerates, Mexico's demand for capital goods and machinery should respond quickly. U.S. industry is in a good position to fill much of this demand with increased exports thereby creating more U.S. jobs. In addition to the increased demand for goods, the overall demand for services should rise. The FTA can be an effective vehicle for ensuring that U.S. firms can compete on an equal basis in this growing market.

An important area in a comprehensive FTA is financial services, an issue for which Treasury will have lead responsibility. U.S. financial service firms could gain significant benefits given the diversity and scope of their products. Therefore we will seek improved access, national treatment and equivalent competitive opportunities for U.S. banks and securities firms in the Mexican market. Greater openness in this sector will enhance financial intermediation in North America and increase the overall efficiency of all markets concerned.

An FTA would also help U.S. industry maintain global competitiveness. The two countries already engage in a considerable amount of complementary intra-industry trade and investment particularly through the special maquiladora program.

Lower trade and investment barriers through an FTA can make U.S. industries more competitive by promoting further intra-industry specialization, capitalizing on each country's comparative advantage.

Foreign investment is an important issue for us to consider. Unfortunately the debate has often centered on the notion that foreign investment means the export of jobs. This is not the case. Our trade interests are closely linked to our investment interests.

Foreign investment not only strengthens the host country's economy, but also strengthens U.S. businesses' ability to compete globally. Therefore foreign investment can actually serve to protect and generate jobs for U.S. firms. This is particularly the case with U.S. investment in Mexico in part because Mexico spends 70 cents of each dollar of imports on U.S. goods. More broadly, one of the main goals of the Enterprise for the Americas Initiative, which I will discuss later, is to encourage open investment regimes throughout all of Latin America.

Finally, an FTA would also increase overall economic efficiency through the economies of scale provided by a larger market. U.S., Canadian, and Mexican consumers will enjoy lower-priced products and wider diversity.

Benefits for Mexico

An FTA will complement the economic reforms Mexico has already accomplished and will solidify growing confidence in the Mexican economy. This confidence, combined with improved export opportunities and a more open investment environment, will lead to substantial inflows of foreign capital, including reflows of flight capital. We estimate that since the June, 1990 announcement of the two Presidents of their intent to negotiate an FTA, Mexico has attracted about $5 billion in foreign direct investment and other net private capital inflows (about half for each).

In the longer term, an FTA would help institutionalize the market-opening policies that Mexico has been implementing. The FTA would also provide important incentives for Mexico to maintain sound macroeconomic policies and strengthen its ability to finance its balance of payments position. Increased capital inflows should offset any short term deterioration in the trade balance. Increased imports and direct investment would contribute to expanded production capacity and strengthened international competitiveness.

Finally, an FTA and other open market policies Mexico has implemented would increase job opportunities and real wages for Mexican workers. Such a growth stimulus would contribute to higher real income levels and improved standards of living.

Why an FTA?

Why is an FTA the optimal arrangement for our future trade and investment relations with Mexico? Compared to more limited trade agreements, pursuit of a comprehensive FTA is the best means to ensure maximum benefits from negotiations.

First, comprehensive FTA negotiations would produce a balanced agreement with commitments on all sides for mutually beneficial liberalization.

Second, the FTA negotiations would not only meet the trade objectives sought in the multilateral Uruguay Round negotiations, but also go beyond those objectives. For example, we will seek gradual elimination of tariffs rather than just a reduction; and on investment we will seek the greatest possible liberalization such as right of establishment and national treatment, well beyond the Round's narrower focus on trade-related investment measures.

Third, an FTA is the most effective strategy for encouraging continued liberalization in Mexico and encouraging other developing nations in Latin America to follow Mexico's example. Mexico is an important cornerstone for our comprehensive Western Hemisphere policy. Mexico's trade barriers are already low by developing country standards, and it has taken many of the preliminary necessary steps to liberalize foreign investment regulations and stabilize macroeconomic policies that we would look for before considering a trade agreement.

Link with the Enterprise for Americas Initiative

Having a firm commitment to appropriate economic policies is essential for any country to achieve sustainable economic growth and enjoy the full benefits of an FTA. Encouraging Latin American countries to adopt such policies is a key objective of the President's Enterprise for the Americas Initiative. That Initiative, which has been enthusiastically greeted throughout Latin America, joins in a single endeavor the three economic issues of greatest importance to Latin America: trade, investment, and debt.

On trade, the ultimate goal of the Initiative is to establish a free trade system which links the entire Western Hemisphere. FTA negotiations with Mexico are a major first step. To move forward in this process, we are establishing Trade and Investment Councils with many Latin American and Caribbean countries to discuss trade problems and explore liberalization.

On investment, the Initiative includes two specific proposals to help countries compete for capital in a world of scarce resources. First, the Inter-American Development Bank is developing an investment sector lending program to encourage countries to liberalize their investment regimes.

Second, the President proposed the creation of a Multilateral Investment Fund in the IDB to provide additional support for investment reforms. The Fund would make technical assistance grants for privatization and other investment-related reforms, support human capital development through grants for worker retraining and education, and improve micro and small-sized enterprises' access to capital by providing them with credit and equity financing. The Administration has asked Congress to authorize U.S. contributions to this Fund. As part of the fiscal year 1992 budget, we have requested $100 million. We will be seeking $500 million in total over a five year period. We believe that this fund will prove critical to the ability of goverments in the region to take meaningful steps to reform their investment regimes and attract needed capital for growth. We expect other countries to contribute two-thirds of the Fund's capital, to meet the goal of a $1.5 billion fund over five years.

With regard to debt, the Initiative would involve the reduction of debt owed to the U.S. government of countries pursuing strong economic reform programs, including measures to open their investment regimes. We gained authority from Congress last year to undertake reduction of concessional PL-480 debt. Under this program, the United States would significantly reduce the stock of PL-480 debt of eligible countries. Continued dollar payments would be applied directly to retire the new, reduced debt.

The Initiative will also provide significant benefits for the environment within the hemisphere pursuant to Environmental Framework Agreements negotiated with each eligible country. Interest payments made in local currency on the reduced debt will remain in the country to support a broad range of environmental projects.

The President recently transmitted to Congress a legislative proposal authorizing the reduction of AID debt and the channelling of local currency interest payments to support the environment in a manner similar to that conceived for PL-480 debt. PL-480 debt constitutes only about one-fourth of the concessional debt owed to the U.S. Government by Latin American and Caribbean countries. Substantial debt relief for these countries, therefore, will need to involve action on AID debts as well.

In addition, this proposal would provide authority to sell, reduce, or cancel a portion of assets held by the Commodity Credit Corporation as a result of its credit guarantee programs and a portion of Eximbank loans to facilitate debt/equity, debt-for-nature, and debt-for-development swaps in eligible countries.

Conclusion

In concluding, I would like to emphasize the importance of seizing this moment in our economic relations with Latin America. We have the opportunity to lay the basis for greater U.S. trade and investment with Mexico while at the same time helping Mexico move away from decades of closed, state-controlled stagnation to open market-oriented development. This will benefit all three of our countries. Mexico has taken the all-important first steps itself. But the central question is: Would the United States be better off a decade from now with an FTA or by sitting back and hoping Mexico continues to liberalize and takes into account U.S. economic interests? In my view, the answer is clear. With your support, and your support for extension of fast track negotiating authority, we can actively set the course for improved prosperity across the Hemisphere.

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**"Rebirth of a Nation:
The Difficulties of Transition in Eastern and Central Europe"**

Presented By

**J. French Hill
Deputy Assistant Secretary
U.S. Department of the Treasury**
before

**The Vanderbilt University School of Law
March 15, 1991
Nashville, Tennessee**

It is a thrill for me to address this distinguished group gathered on the campus of my alma mater. It was here at Vanderbilt that I developed my abiding interest in foreign policy and economics. Needless to say, our assemblage today to discuss eastern Europe and the Soviet Union is an indication of the rapidly changing syllabus for the undergraduate comparative economics course probably underway just a few yards away. My remarks will deal with the economic transition of Europe's emerging economies -- but the lessons are equally applicable to reform efforts in the Soviet Union. These observations are based upon my travel throughout the region over the last few months.

The 1980's will go down in history as the Decade of Democracy. Latin America, Europe and even parts of Africa saw remarkable gains in political pluralism and individual freedoms -- but nowhere was this more pronounced than in central and eastern Europe and the Balkans.

As Timothy Garton Ash chronicled in his inspiring essays, The Magic Lantern -- The Revolution of '89, the movements of a people from totalitarianism to freedom were remarkably peaceful. Once started, the speed was breathtaking. This dash toward freedom is epitomized in Ash's quip made famous by playwright, turned President, Vaclav Havel: "In Poland it took ten years, in Hungary ten months, in East Germany ten weeks: perhaps in Czechoslovakia it will take ten days!"[1] It actually took twenty-four days from meetings in the smoke-filled basement of

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[1]Timothy Garton Ash, The Magic Lantern - The Revolution of '89 Witnessed in Warsaw, Budapest, Berlin and Prague (New York: Random House, 1990), p. 78.

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the Magic Lantern Theater (which served as the Civic Forum's headquarters) to the Presidency.

The decade of democracy began with a Polish Pope making his first visit to Poland in June 1979, which inspired the courage necessary to form Solidarity in 1980. The decade ended with people poking their heads out from beneath the weight of the Iron Curtain. From the Baltic to the Adriatic, once again people breathed the air of freedom -- the freedoms we take for granted: of association, thought, prayer, and to own private property.

Today, I would like to reflect on the first year or two of freedom for the emerging economies of east central Europe and the Balkans, and specifically highlight the important role of the financial sector for their future success.

Rebirth of a Nation

Like our forefathers in the coffeehouses of Boston or Philadelphia, the Poles in the Lenin Shipyard, those gathered in Heroes Square in Budapest, the journalists, artisans, and actors in The Magic Lantern all began with a political debate about self-determination.[2] The formation of political parties and the drafting of resolutions and platforms all came first and in a fury. Interestingly, each of these movements cautiously projected a gradual transition to actual democratic power -- to the running of a government chosen by the people and responsible for an economic program. However, once started, an avalanche thundered downhill. Solidarity was first with its overwhelming Parliamentary victory on the June 4, 1989 -- sadly, the same day that another vibrant group of democrats were crushed on the other side of the globe -- the Tiananmen Square Massacre. On the thirty-third anniversary of the 1956 Revolution, Hungarians adopted a slate of anti-communist amendments and moved rapidly toward national elections in March 1990. And so it went -- Romania in May, followed by Czechoslovakia and Bulgaria in June.

These first months of freedom and self-government have been exhilarating and frustrating as these countries continue the exorcism that started with their peaceful revolutions. Many eastern Europeans describe themselves as Cain and Abel -- Jekyll and Hyde, both as a people and individually. The new democrats pass private property statutes, declare and construct independent judiciaries, move to end central planning, and price controls; but the old nomenklatura ask, "who sells the property, decides the cases, plans the production and sets the prices, if not a

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[2] I have not dealt with East Germany as a result of her reunification with West Germany on October 3, 1990 -- less than one year after the first breach of the Berlin Wall.

ministry?" In short, many would argue that the eastern and central Europeans are attempting to "plan" their market economy! Czechoslovak Finance Minister Vaclav Klaus described his personal rejection of this philosophy in Reason Magazine in June 1990:

> We want a market economy without any adjectives. Any compromise will only fuzzy up the problems we have. To pursue a so-called third way is foolish. We had our experience with this in the 1960s when we looked for socialism with a human face. It did not work, and we must be explicit when we say that we are not aiming for a more efficient version of a system that has failed. The market is indivisible; it cannot be an instrument in the hands of central planners.[3]

Another seeming contradiction is a rejection of all things "central." This manifests itself in often mindlessly moving authority to state and local officials. What will be the authority of the central governments and what will be reserved for state and local governments? This debate is especially pronounced where old duchies and kingdoms and ethnic populations have spoken up for the first time since World War II, especially in Czechoslovakia and Yugoslavia -- and, of course, in the Soviet Union.

Doesn't this debate sound more than familiar? After 200 years in the U.S. we still have a vigorous and useful debate over Federalism. As eastern European union members, authors, and actors turned-politicians have learned, democracy is hard work. They are often so quick to reject "central" government solutions, that approaches to national debts, fiscal and monetary policy and other "national" problems are mired in as many solutions as there are states or republics or ethnic groups. Our forefathers struggled through seven long years of confederation before we had our endearing and timeless Constitution. We fought a Civil War -- more costly in American lives than all combined wars before and since -- to make the notion of one country a permanent fixture of our national character. As Shelby Foote noted in the PBS television series on the Civil War, only after the War was our country referred to as "The" United States, rather than "These" United States.

But, in today's world of interdependence, International Monetary Fund (IMF) and World Bank-supported reform programs, and with an eye toward future membership in the economic powerhouse, the European Community, none of these countries want to do too much fighting or experimenting. Thus, they are trying to become

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[3]Kevin Acker, "Poisoning of the Soul, New Leaders of Russia and Central Europe Talk about the Evil Empire," Policy Review, Number 55 (Winter 1991), pp. 63-64.

democracies and free market economies simultaneously and as quickly as possible.

In my view, we must practice patience. The rebirth of a nation is as difficult, if not more so, than our own birth as a nation. Forty years of communism and propaganda and fear is bad; forty years of "you will do as you are told" combined with a driving desire to escape centralized direction and "do it our way" in Slovenia, Slovakia, Croatia, or Lithuania make for difficult transitions. As Alexander Hamilton wrote to a friend in 1782, "Quit your sword, my friend; put on the toga. Come to Congress, we have fought side-by-side to make America free; let us hand-in-hand struggle to make her happy."[4] That's where each of the countries is today.

To make their people happy, following the assurance of the basic rights of property, self-determination, freedom of association, speech, and religion, one must have an economy that prospers. This is proving to be even more complex than the aforementioned political reforms. Here the challenges of maintaining international creditworthiness, freeing the market of state controls, and raising living standards come together in a din of conflicting economic exigencies and prescriptions.

Let me cite a few colorful examples of government officials' propensity to become "Hyde" and seek to "plan" their market economy.

- Despite no doubt countless hours of reading or studying comparable economics, one Finance Ministry official requested a meeting with the appropriate U.S. official responsible for the setting of commodity prices.

- Another official asked which U.S. government agency determined credit quality for corporate bonds to be issued.

- One group was disturbed about a large number of "stock exchanges" spontaneously starting outside the capital city and not waiting for a central exchange to be established.

- Yet another official voiced concern about shares being sold in a state enterprise before a securities law was enacted.

While there are many anecdotes about the transition, the point is that these great countries with their rich heritage are

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[4]Richard B. Morris, ed., Alexander Hamilton and The Founding of the Nation (New York: Dial Press, 1957), p. 86.

attempting to skip over decades of economic and financial development. Unfortunately, while often beautifully educated, much of the business and entrepreneurial talent in these countries possess little or no practical knowledge about business or market economies. Thus, what is desperately needed on the part of business and government leaders are the basics. Let me use the financial sector to illustrate some needs and to offer some possible ways to satisfy them.

Analysis of the Financial Sector

Fiscal Policy - All of these emerging economies are seeking to adopt a Value Added Tax (VAT) like their EC neighbors. Each desires a tax system which encourages capital formation, savings and investment. Most currently have tax contribution systems whereby the most profitable state or socially-owned enterprises turn over most of their income (often over 100%) to the government. These funds are funneled into the state for subsidies for the industrial, public, defense sectors and to local authorities for housing, education, and the like. Incentives to encourage efficiency, productivity, and entrepreneurship are non-existent. Indeed, the incentive structure is such that it tends to encourage waste, inefficiency, and stagnation. The countries are not moving rapidly enough to adopt necessary tax reform measures. Unraveling the byzantine web of confiscatory taxes and subsidies is a complex and politically difficult task, but it is critical to the restoration of a credible government. As Hamilton said, in 1791, "Power without revenue, in a political society, is a name."[5]

The design of a tax system must carefully balance revenue needs, resulting economic incentives, fairness, and the overall burden of its administration. Revenues should be geared toward fundamental needs and ideally should be as low as possible. This is especially challenging in a transition from a bloated, subsidy budget to a market economy. But, it is important that a slim, balanced budget be crafted so as not to exacerbate inflationary pressures.

These economies are in critical need of savings and investment. As significant revenue could be collected from efficient, consumption-oriented taxes like a VAT, the tax burden on entrepreneurial effort and savings and investment should be light. For example, in my view, these countries should adopt a low flat rate tax -- no more than 15% -- and no taxes on capital gains, interest and dividend income. This would likely be a powerful inducement for savings and capital formation. Likewise,

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[5] Ibid., p. 84.

taxes should not burden the export sector of the economy which brings in badly needed foreign exchange.

This brief outline of a tax policy may strike you as "unfair" in its simple, regressive structure. However, one only need study the economic record of the developing countries which have adopted low tax, pro-growth policies compared with those developing nations who have endorsed a strategy of high taxes with the resulting stagnation.

Hong Kong is a good example. The colony's low, flat rate tax structure has generated unprecedented economic growth. Economic growth produces increasing standards of living for all citizens and allows for necessary expansion of the public sector. High tax, redistribution strategies have resulted in stagnating economic growth, a reduced standard of living and negative growth in public services. Per capita income in 1990 was $10,916 in Hong Kong compared with $340 in India and $315 in the People's Republic of China. The last time Hong Kong had a per capita income level near $300 was in <u>1960</u>.

Opponents of the growth model assert that one cannot duplicate a "Hong Kong" in Europe due to different cultural backgrounds. I disagree. Why is it that Chinese living just a few miles away produce barely 3% per capita of their Hong Kong neighbors or that Indians in business outside of India are some of the world's most industrious and successful business people. The answer lies in proper economic policies, not in people's heritage. When a proponent of welfare statism queried pro-growth economist Melvyn B. Krauss, "But, how many Hong Kongs can the world have?", Dr. Krauss replied, "As many as the world will allow itself."[6]

The large state indebtedness accrued over the past forty years of inefficient and counterproductive action should be shifted from the bankrupt enterprise sector to the new national governments. Subsidies should be phased out and assets should be transferred to private hands. A credible fiscal policy will foster confidence, economic growth, and eventual discharge of accumulated national debts.

<u>Monetary Policy</u> - The critical long-term success of the eastern and central European economies depends on having money that is a true store of value, that serves effectively as a medium of exchange, and that acts as a meaningful unit of account. For example, Poland's action to give the zloty these three functions

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[6]Melvyn B. Krauss, <u>Development Without Aid</u>: <u>Growth, Poverty, and Government</u> (New York: New Press, McGraw Hill Book Company, 1983) p. ix.

has been rewarded with availability of ample goods, few shortages, no lines, and the zloty's new found convertibility.

By contrast, Yugoslavia, rich with advantages in a skilled labor force, foreign exchange reserves, and a much greater decentralization of the enterprise sector, is utterly debilitated by an overvalued dinar and a complete lack of an enforceable monetary policy. While inflation appears lower (annual rates of 140% in 1990 versus 2665% in 1989) and banks are complaining that credit is tight, nothing could be further from the truth.

In fact, the National Bank of Yugoslavia continues to guarantee bank domestic and foreign exchange liabilities. This, combined with the socially-owned enterprises not collecting their receivables nor paying their payables, allows the country to avert economic reality and generate huge underground inflation by running what some have termed "one of the largest check kiting schemes in the world." This manifests itself in an official rate of 10.4 dinars per dollar compared with a street or black market rate 30% greater, a hoarding of consumer durables, and a drop in the country's large foreign exchange reserves.

In formulating monetary policy, the parallel goals of political reform and economic reform can be in conflict. It takes courage to create a truly independent central bank which can achieve monetary policy objectives in the face of resulting unemployment and fear of the unknown. But, the benefits are not to be feared, but, rather welcomed -- price stability, ample goods, and a credible currency.

Banking System - Unfortunately, the most ignored link in the reform chain is the banking system. It has never functioned in any of these countries as an efficient allocator of credit to worthy investment projects. Instead, it was an arm of the central bank, which simply printed money to support state-owned businesses, collectivized agriculture and the overhead of military and Communist Party technocrats. In several countries where efforts have been made over the years to separate commercial banks from the central bank (by the creation of a so-called "two-tiered" banking system), one is left with "banks" which were often created and managed by their largest borrowers. The borrowers then received subsidies in the form of "loans" guaranteed by the state and further loans to pay the interest. Thus, the lack of independent credit analysis and improper corporate governance have littered the landscape with financial dinosaurs. These dinosaur banks effectively have no capital, no credibility, no expertise, and are tightly linked with failing state-owned enterprises.

It is fundamental that each of these governments adopt strict, enforceable prudential standards for capital adequacy, incentives for responsible management, and market-based lending standards. Private banks started by local residents, by foreigners, or by joint ventures, should not be delayed. These banks should be allowed -- even encouraged -- to become full service depository institutions. There are few branches, no credit cards, no checking accounts (in Poland and Hungary), no automated tellers, and customer service is a "thing of the future." Nonetheless in each country there are a few brave souls attempting to computerize, introduce new products and begin marketing.

The countries of eastern and central Europe will see their political reforms significantly weakened without access to capital. Without a thriving, private enterprise sector, there will be no alternative employment for the millions of displaced workers. The small entrepreneur needs capital to expand, to finance a shop or store, to purchase a privatized state asset and to start anew. Coherent investment decisions will not be made until projects are evaluated on the basis of financial merit rather than political connections. In my view, this will simply not happen with the existing state banks. New banks and foreign banks must be rapidly integrated into these economies, to foster competition and provide debt and equity finance.

What about the dinosaurs, the state banks? They cannot be considered in isolation from the privatization of the enterprise sector. Here is where the World Bank can be helpful. Structural and financial sector adjustment loans can be used to restructure state enterprises, thus improving a bank's prospect for repayment. World Bank loans can also facilitate the restructuring of bank balance sheets. Also, these loans can be used to help modernize bank data processing and record keeping systems, and to support fundamental workforce training.

Privatization Efforts - Because state-controlled banks are inextricably linked to other state-controlled enterprises, it is necessary to make some observations about plans for privatization.

First, the emerging governments appear too obsessed with the privatization of the large, state monopolies. Assessing their potential, valuing the assets, and attempting to privatize by way of a public offering like the British model is made immensely cumbersome and complex by lack of skilled management; few accounting standards or trained accounting professionals; the absence of an operating market economy with a convertible currency within which one might even try to judge future performance; a bureaucracy trying to plan a capital market with ambiguous notions of a "fair" distribution; and, the simple fact that most of these entities are hopelessly bankrupt and effectively "owned" by the state banks -- which, in turn, have negative net worth.

Instead, the focus should be on prompt development of "private enterprise" by the following:

First, small shops and stores -- viable without state subsidies -- should simply be given to their current managers and employees. (It should be noted that some countries are attempting to give pre-World War II owners a chance to "claim" their prior possessions). Forcing these businesses to have new owners by way of an auction is bureaucratic and counter-productive. Nor does it in any way improve a small shop's potential success. Better to have happy, motivated new "owners," producing revenues, paying taxes, and feeding, housing, and clothing their families.

Next, the innate entrepreneurship of the eastern and central Europeans should not be discouraged by imposing heavy taxes, excessive regulations, permits, and redtape. I was shocked when President Gorbachev condemned the so-called "black marketeers" in the Soviet Union. These entrepreneurs are his private sector, who are the only ones who can distribute goods effectively and employ the growing number of displaced workers.

Third, while some of the large-scale state enterprises will be competitive in the global marketplace, most should simply be dissolved. It is important to let market forces work. Take the case of the "State Crop Dusting Company" in Hungary: it has 260 employees -- 12 pilots, 10 co-pilots, 6 mechanics, 4 ground crew, and 228 administrative people, including 4 economists.[7] Can you imagine almost 90% of your employees as non-productive overhead -- and four economists in a crop dusting business! This kind of gross over-staffing is common throughout east and central Europe. In my view, if a pilot and a mechanic want to leave and start their own business, just let them go, and give them a chance to purchase or lease a plane. In other words, one should be flexible and not attempt to program a sale of an entire company, if it has no hope for a successful future as an ongoing entity.

For those state companies with some hope of building successful domestic and export businesses, one should encourage access to foreign capital and technology. Foreign expertise and ownership should not be burdened with so many hurdles that no one dare jump. Flexible structures should be developed to accomplish long-term goals: in my view, the state, as "seller", should be willing to receive non-voting equity shares (or, some kind of deferred instrument) instead of demanding all cash. The cash is desperately needed by these companies and their managements --

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[7]Conversation with Mr. Peter Rona, a member of the board of directors of the First Hungary Fund, and former president and chief executive officer of IBJ Schroder Bank and Trust Company.

foreign, domestic or joint -- to improve production and workforce training. The state is far better off having productive companies employing people, exporting products, paying taxes, and thus improving the standard of living of its citizens. Capping foreign ownership and taking all of the working capital will not produce a long-term success or attract badly needed foreign capital and expertise.

Certain sectors -- airline, railway, steel, oil -- inevitably may obtain more sustained state support. However, each government should carefully reevaluate the reasons for such continued state assistance. The companies should be restructured and commercialized, possibly with financial assistance from the World Bank and their restructuring should be coordinated with the effort to privatize the state banks. Of course, truly unproductive operations should be put into bankruptcy.

Capital Markets - Every one of the emerging countries is out to reclaim a page from its past -- its stock exchange. To the citizens, the stock exchange stands as a symbol that capitalism has returned. However, exchanges should serve a role greater than mere symbolism.

While each country is in a whirlwind to form a regulatory commission, trading rules, clearing houses, purchase electronic trading computers and to reclaim their pre-war building, it is important to remember the basics: that stock markets help companies raise capital, secondary trading affords liquidity and attractive opportunities for savers, and these markets perform the role of efficient allocator of resources. However, before these functions can come into play, one must have private companies to have stock listings and one must have capital for there to be investment.

While stock exchanges can be conduits for foreign and domestic capital and serve the important liquidity and asset valuing function of markets, I caution that they are not essential to a privatization program, nor are they the perfect device to impose an "equal" or "fair" distribution of state assets. In fact, to the contrary, illiquid markets dominated by new issues of dubious quality and no track record can "backfire" to the political detriment of the economic reforms. Instead, one should initially encourage domestic and foreign capital to support both private enterprise and privatization through a transparent and efficient investment and tax system. Further, each government should develop and implement prudential accounting standards and work to minimize unnecessary regulation or other legacies from the past.

For former state enterprises, the result will be new private joint stock companies owned in some combination by the state, (either directly or through convertible instruments such as shares, warrants or options), direct foreign capital, foreign banks (resulting from debt-for-equity swaps), and employees. Then, as a company develops a track record under new management and in the hard reality of a market economy, the government can register its shares and sell them pro rata to the owners or to management and the employees. The result will be more successful and more frequent public offerings. Disclosure and accounting standards will have been in practice and understood. Only then can the benefits of liquidity and capital-raising functions of public markets really be fulfilled.

Role of the United States

The U. S. government has a clear objective: To help the people in these emerging economies help themselves. At the end of World War II, the U. S. created the Marshall Plan in Europe and sent General McArthur to Japan. The goal in the countries of both the vanquished and the victorious was to rebuild from the vast rubble that remained, and in the case of Germany and Japan, to foster the permanent institutions of democracy. These objectives were carried out by the one nation rich enough to shoulder the task, the United States.

Today, our world is distinctly different. The end of the Cold War calls for a "Marshall Plan of Ideas," not of construction. We are not rebuilding in Europe the physical destruction of a hot war, but the psychological destruction of a cold one. As President Havel said in his New Year's address in 1990, "We are living in a decayed moral environment. We have become morally ill, because we have become accustomed to saying one thing and thinking another."[8]

Today, this burden does not fall solely to the United States as the lone wealthy nation. Instead, the European Community (plus others in the Group of 24 industrial countries) join the United States in this effort. The G-24 has already mobilized approximately $20 billion in grants, credits, guarantees, and technical assistance for the region.[9] These resources combined with those of the World Bank and International Monetary Fund and the private sector are many times greater than those available for reconstruction efforts in the immediate post-World War II period.

In every conceivable area -- customs, environment, civil aviation, law, agriculture, infrastructure, and the financial sector, the U.S. Government is providing professional advice and

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[8]Policy Review, p. 62.

[9]Economic Report of the President (Washington: Council of Economic Advisers, 1991), p. 229.

counsel to newly elected and appointed government officials in these aspiring market economies. In fiscal year 1990, Congress appropriated $418 million to assist Poland and Hungary. In this fiscal year 1991, Congress authorized $369 million for Poland, Hungary, Czechoslovakia, Bulgaria, Romania, and Yugoslavia. Additionally, $70 million was approved for our initial capital subscription to the new European Bank for Reconstruction and Development (EBRD) to be headquartered in London. The Bush Administration's budget for fiscal 1992 released last month calls for an additional $400 million to be made available for assistance to the region.

Using our assistance to the financial sector as an example, I will highlight both the efforts of the U.S. public and private sectors.

Fiscal Policy - To assist these governments in designing and implementing new tax policies, the U.S. Treasury is forming a regional tax policy advisory team. With legal, accounting, and economic expertise, this team will be on call to finance ministries and legislative committees for policy and technical expertise. Likewise, we have Treasury professionals from the Internal Revenue Service (IRS) and the Financial Management Service to assist in the improvement and design of tax collection systems and the design and issuance of public debt, respectively.

Long-Term Financial Advisors - To directly aid the key financial institutions, the Treasury is engaging experienced financial advisors who will live in the eastern European capitals as policy advisors to the ministries of finance, central banks, commercial banks. At the invitation of the governments, these long-term advisors will help guide policy direction, provide common sense approach to market economics, and will provide advice in the critical area of policy execution.

Additionally, the Treasury is considering engaging bank restructuring specialists to work full time with the World Bank and a country's finance ministry and central bank to more expeditiously facilitate private capital being invested in the banking sector. This will include advice on resolving the largest bankrupt state banks, updating technology and accounting systems, and breaking up the incestuous links between borrowers and bank management.

Financial Workforce Training - We are supporting critically needed workforce training of all types for the tens of thousands of bank employees in these countries. This training includes short-term courses in specialty areas like company valuation and support for newly created, private institutes of banking and finance to be located in Katowice (Poland), Budapest, Prague, and Belgrade.

As I have said, we consider financial sector reform of fundamental importance to these emerging economies. Working with the World Bank and IMF, we are providing experts to assist in the design of bank supervision and examination policies and in training.

Securities and Capital Market - The U. S. government is providing extensive legal and management training to assist in the creation and implementation of stock exchanges in Warsaw, Prague, Bratislava, Budapest, Sofia, Ljubljana, Zagreb, and Belgrade. The Securities and Exchange Commission (SEC) has contributed a great deal of energy in supporting these efforts. For example, in April, the Commission is hosting a conference in Washington, D.C. for developing market officials. This training session will be accompanied by internship programs in brokerage firms, stock exchanges, and at the SEC.

Contribution by the U.S. Private Sector - The U.S. Treasury, as the coordinator of financial sector assistance, has developed a program where we believe government expertise makes sense and adds value: tax policy and administration, customs, and basic banking and securities laws and supervisory procedures. But, our objective is also to bridge the Atlantic for private American firms and educators to participate in the economic transformation and development of the former eastern bloc. Only through sustainable, long-term economic relationships in the private sector will market forces take root and produce lasting results.

The long-term financial advisors I described in financial policy, bank credit, accounting, and privatization are all being obtained from the U.S. private sector. Likewise, the advice and assistance in bank and finance training will be "hands-on" and will be provided by professional bank training experts.

In addition to the engagement of U.S. private experts in law, accounting, mergers and acquisitions, banking, corporate finance, I would like to highlight three volunteer organizations which are providing incalculable expertise to the eastern Europeans.

First, the Financial Services Volunteer Corps (FSVC) which was created by the U.S. Agency for International Development (US AID). Chaired by former Secretary of State Cyrus Vance, now a senior partner at Simpson, Thacher & Bartlett and John Whitehead, a former Deputy Secretary of State and partner at Goldman Sachs, the FSVC takes teams of bankers, lawyers, and accounting professionals to foreign countries and addresses reform issues in the financial sector. They have had successful trips to Poland, Hungary, Yugoslavia and, this week, they are in Czechoslovakia.

Next, at the direction of Chairman Richard Breeden, the Securities and Exchange Commission established its Emerging

Markets Advisory Committee (EMAC). With a particular focus on stock exchange and securities development, this committee of bankers, academics, and accountants has been very active in designing market regulation, underwriting and disclosure standards, and clearance and settlement systems.

Finally, I would like to mention the Citizens Democracy Corps (CDC). Chaired by former Secretary of Transportation and current Union Pacific chief executive, Drew Lewis, the CDC is to foster voluntary efforts in improving business management and economics education. Just last month, President Bush hosted a White House conference in business management and economics education, which drew together 200 university, foundation and corporate leaders to exchange views on how they could make a difference in central and eastern Europe. The conference set ambitious goals through our private sector efforts. They are: exposing at least ten million citizens to television and other media programs explaining the working of a free market economy; training or retraining at lest 50,000 managers, workers and entrepreneurs; educating 10,000 college-age students in the fundamentals of management and economics; and training at least 200 teachers in management and economics, so that they can go back to become the core faculties of the future.

Conclusion

In closing, the challenges are great. Creating democracies and free market economies simultaneously present unique circumstances and difficult choices for legislators and government ministers. To jump in a short span of months from a system of "you pretend to pay me, and I'll pretend to work" to the untidy world of capitalism at work is a shock.

But, with patience and perseverance these countries can become enterprising members of the greater world market. I am a short-term pessimist and a long-term optimist. With luck, political stamina, and the right policy choices, perhaps one or more of these budding economies could well become a model of free market success, achieving standards of living equal to the finest on earth. It is in the realm of possibility. We may read in ten or twenty years of "the Hungarian Miracle or the Polish Miracle" or how these countries have become a European equivalent of the "Asian Tigers." I urge each of you to go and experience the change. You will return filled with admiration for their courage and patriotism. See what freedom can do. You will never take yours for granted again.

Report On The Taxation of Social Security and Railroad Retirement Benefits in Calendar Years 1987 and 1988

Report to the Congress,
the Secretary of Health and Human Services
and the Railroad Retirement Board

Department of the Treasury
March 1991

THE SECRETARY OF THE TREASURY
WASHINGTON

March 1, 1991

The Honorable Thomas S. Foley
Speaker of the House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

Subsection (e) of Section 121 of Public Law 98-21, the Social Security Amendments of 1983, provides that "the Secretary of the Treasury shall submit annual reports to the Congress and to the Secretary of Health and Human Services and the Railroad Retirement Board on:

(A) the transfers made under this subsection during the year, and the methodology used in determining the amount of such transfers and the funds or account to which made, and

(B) the anticipated operation of this subsection during the next five years."

Pursuant to that section, I hereby submit the "Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Years 1987 and 1988."

Copies of the report are being sent to the President of the Senate, Secretary Louis W. Sullivan of the Department of Health and Human Services, and Chairman Glen Bower of the Railroad Retirement Board.

Sincerely,

Nicholas F. Brady

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

March 1, 1991

The Honorable J. Danforth Quayle
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

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Copies of the report are being sent to the Speaker of the House, Secretary Louis W. Sullivan of the Department of Health and Human Services, and Chairman Glen Bower of the Railroad Retirement Board.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

Enclosure

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CHAPTER 1: INTRODUCTION AND SUMMARY

I. INTRODUCTION

Beginning in January 1984, social security and railroad social security equivalent benefits have been partially taxable for high-income taxpayers. The Treasury Department is required to estimate the individual income tax liabilities attributable to the benefits payable during each calendar quarter and transfer these amounts to the Federal Old-Age and Survivors Insurance (FOASI), Federal Disability Insurance (FDI), and Social Security Equivalent Benefit Account (SSEBA) trust funds at the beginning of the quarter. Both the taxation of benefits and the transfers of taxes to the trust funds are required by the Social Security Amendments of 1983 (P.L. 98-21), as amended by the Railroad Retirement Solvency Act of 1983 (P.L. 98-76) and the Consolidated Budget Reconciliation Act of 1985 (P.L. 99-272). Further, the 1983 Act required adjustments in the amounts transferred to the trust funds in the event that the estimates of the tax liability attributable to the benefits, made before the year's tax returns become available, are subsequently shown to be incorrect.

The 1983 Act also required the Treasury Department to submit annual reports to the Congress, the Secretary of Health and Human Services, and the Railroad Retirement Board containing a description of the methodology used to estimate the transfers of income tax to the trust funds and a forecast of transfers over the five subsequent years. The Treasury Department's Office of Tax Analysis (OTA) is responsible for preparing these annual reports, as well as for estimating transfers to the trust funds and making adjustments to the transfers based on actual tax return data. This report describes the methodology used to determine the transfers to the trust funds of calendar year 1987 and 1988 income tax liabilities, adjustments to the transfers for those and prior years, and a forecast of transfers between 1989 and 1993.

The amounts transferred to the three trust funds are calculated as the difference between tax liabilities with and without the inclusion of benefits in taxable income for returns with taxable social security or railroad social security equivalent benefits. To determine if any benefits are taxable, a taxpayer must complete a separate worksheet contained in the instructions to the tax return. The taxpayer adds both tax-exempt interest income and one-half of social security and railroad social security equivalent benefits to adjusted gross income (AGI). If this sum exceeds $25,000 ($32,000 for joint filers), then the taxpayer must include in AGI the lesser of one-half of the benefits <u>or</u> one-half of the excess. Thus, a maximum of 50 percent of the social security and railroad social security equivalent benefits are includable in AGI. For taxpayers with incomes slightly above the threshold amounts or with relatively large benefits, the percentage of such benefits includable in AGI can be lower than the 50 percent maximum.

II. SUMMARY

The initial transfers to the three trust funds of income tax liabilities attributable to the Social Security Amendments of 1983 were based on estimates derived from the OTA's Individual Income Tax Model. The Tax Model contains information from a stratified random sample of tax returns, various imputations of data not available from tax returns, and a tax calculator which computes changes in tax liabilities attributable to changes in the tax laws. For both 1987 and 1988 liabilities, estimates were made at the end of the preceding calendar year and were modified as new information was obtained. At the beginning of each quarter, the trust funds received amounts equal to one-fourth of the estimated change in calendar year income tax liabilities due to taxation of benefits. Chapter 2 contains a description of the methodology used to derive estimates of benefit taxation for the initial calendar year 1987 and 1988 trust fund transfers.

Tax return data from 1987 were received from the Internal Revenue Service (IRS) by the OTA in 1989[1] The initial calendar year 1987 transfers of $3,291 million to the three trust funds were $139 million higher than the amount of tax liability calculated from actual 1987 tax return data. Transfers to the FOASI, FDI, and SSEBA trust funds were initially overstated by $82 million, $39 million, and $18 million, respectively Correcting adjustments were made in the July 1989 trust fund transfers.

During 1988, $3,498 million was transferred to the three trust funds, based on OTA's estimates. Data from the 1988 tax returns became available in 1990. The 1988 tax returns showed that the initial transfers to the trust funds fell short of the actual income tax liability by $275 million. This shortfall chiefly reflected an underpayment to the FOASI trust fund of $326 million. Transfers to the FDI and SSEBA trust funds were initially overstated by $42 million and $9 million, respectively Correcting adjustments were made in the October 1990 trust fund transfers. The 1987 and 1988 adjustments are described in Chapter 3.

Adjustments were made in October 1989 to correct for overpayments of $1,363 million to the trust funds which had occurred during prior reconciliations. Because of a processing error, reconciliations for 1984 through 1986 inadvertently credited the three trust funds with certain additional income tax receipts, largely attributable to lump-sum distributions from pensions. These adjustments are described in Chapter 4.

Transfers to the three trust funds for calendar years 1989 through 1993, including the adjustments already made for previous years and an anticipated adjustment for 1989, are estimated to be $24,732 million. The forecasts for 1989 through 1993 are described in Chapter 5

Chapter 6 presents the distribution by income class of taxpayers who include social security or railroad social security equivalent benefits in taxable income. When returns are classified according to AGI, nearly half of the tax liability attributed to the inclusion of benefits is paid by filers with AGI less than $50,000. However, the proportion of benefits includable in AGI varies among taxpayers. Two-thirds of taxpayers with taxable benefits (generally, those with higher incomes) include the statutory maximum -- 50 percent of benefits -- in AGI. Among the remaining taxpayers with taxable benefits (generally, those with lower incomes), the rate of inclusion averages about 22 percent. Thus, the average rate of inclusion for those taxpayers with AGI less than $50.000 is about 33 percent, whereas it is about 50 percent for those with AGI greater than or equal to $50,000. When the income classifier is expanded to include the non-taxable portion of benefits, only about one-third of the tax liability resulting from the taxation of benefits is paid by filers with AGI plus non-taxable benefits of less than $50,000.

CHAPTER 2: METHODOLOGY AND ESTIMATES OF BENEFIT TAXATION FOR THE INITIAL CALENDAR YEARS 1987 AND 1988 TRUST FUND TRANSFERS

I. METHODOLOGY

The Treasury Department's Office of Tax Analysis (OTA) is responsible for estimating the tax liability attributable to the social security and railroad social security equivalent benefits received by high-income beneficiaries.[2] The OTA provides the information to the Treasury Department's Office of Finance and Planning, which has the authority to transfer funds from general revenue to the trust funds.

The OTA estimated the 1987 and 1988 tax liability effects attributable to the inclusion of benefits in adjusted gross income (AGI) using the Office's Individual Income Tax Model.[3] This Tax Model contains information from a stratified random sample of 75,000 returns selected from the IRS's Statistics of Income file for 1985, various imputations of data not available from tax returns, and a tax calculator which computes changes in tax liabilities attributable to changes in the tax code. Records on the Tax Model file are extrapolated to future years. Computations based on the Tax Model are weighted to produce results that are representative of the entire population of taxpayers.

Because returns do not provide sufficient data to estimate the revenue effects of the partial inclusion of social security and railroad retirement benefits in AGI, imputations were added to the Tax Model to compensate for the missing items. First, the Tax Model was modified to include data on social security and railroad retirement benefits. The Social Security Administration and the Railroad Retirement Board provided information on the total amounts of benefits. These amounts were distributed among appropriate taxpayers, using the most recent Current Population Survey data from the Census Bureau as a guide. Second, an imputation was made for tax-exempt interest on state and local obligations because it is included in the benefit inclusion formula but was not tabulated by the IRS prior to tax year 1987.

The data items on the Tax Model were adjusted for three types of growth. First, total expenditures on social security and railroad social security equivalent benefits were projected to grow according to the most recent forecast provided by the Social Security Administration and the Railroad Retirement Board.[4] Second, an adjustment was made to capture the maturing of the beneficiary population. The current structure of the social security system ensures that for the near future new beneficiaries subject to tax have both greater benefits and higher incomes than prior entrants. Finally, the thresholds were adjusted to reflect the effect of inflation on their real value. The thresholds which trigger taxation of social security and railroad social security equivalent benefits are not adjusted for inflation. As the real value of the thresholds erode, the number of filers who must include benefits in AGI increases.

The tax calculator then utilizes the information (including the imputations and extrapolations discussed above) from each potential filing unit to calculate the Federal income tax liability. For purposes of making the initial 1987 and 1988 transfers, the Tax Model was used to estimate tax liabilities with and without social security and railroad social security equivalent benefits included in AGI. The Tax Model takes account of changes in other tax provisions indirectly affected by the inclusion of these benefits in AGI. Usage of deductions and credits, as well as calculations of alternative minimum tax liabilities, can be affected by the inclusion of benefits in AGI. These effects can be in opposing directions. Thus, as AGI increases it becomes more difficult to meet the criteria for deducting medical, casualty and certain miscellaneous expenses. But the increased tax liability resulting from the inclusion of benefits in AGI enables some taxpayers to use credits which otherwise might not be usable in that year. The Tax Model calculates both the percentage of total benefits included in AGI as a result of the special benefit inclusion formula and the marginal tax rates applicable to the taxable benefits.

II. ESTIMATES OF BENEFIT TAXATION IN 1987 AND 1988

Estimates of the additional tax liability from the partial taxation of social security and railroad retirement benefits for calendar year 1987 were made in late 1986 and were adjusted as new information was obtained. Similarly, estimates of calendar year 1988 liability were initially made in late 1987 and were adjusted during the year to reflect new information. The amounts transferred to the trust funds each quarter equaled one-fourth of the estimated change in calendar year tax liability as a result of the Social Security Amendments of 1983, plus adjustments for prior transfers. The transfers were allocated to the following trust funds based on OTA estimates:

- Federal Old-Age and Survivors Insurance (FOASI);
- Federal Disability Insurance (FDI); and
- Social Security Equivalent Benefit Account (SSEBA).

Table 1 compares the assumptions used to estimate the initial transfers for calendar year 1987 with the actual results. The top section of the table indicates that for FOASI, it was initially estimated that 6.3 percent of the $182,838 million of benefits paid out in 1987 would be included in AGI at a marginal tax rate of 26.8

TABLE 1

Comparison of Assumptions Used to Estimate Initial Trust Fund Transfers for Calendar Year 1987 with Actual Results 1/

Trust Fund	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable In AGI (%)	Transfer Amount ($millions)
	Initial Transfer Assumptions 2/			
Federal Old-Age and Survivors Insurance (FOASI)	182,838	6.3	26.8	3,088
Federal Disability Insurance (FDI)	20,138	3.0	26.0	156
Railroad Social Security Equivalent Benefits (SSEBA)	3,823	4.6	26.7	47
Total	206,799	5.9	26.8	3,291
	Actual Results 3/			
Federal Old-Age and Survivors Insurance (FOASI)	183,140	6.7	24.6	3,006
Federal Disability Insurance (FDI)	20,499	2.5	22.9	117
Railroad Social Security Equivalent Benefits (SSEBA)	3,729	3.6	21.8	29
Total	207,368	6.2	24.5	3,152

Department of the Treasury
Office of Tax Analysis

1/ Different assumptions were used for each quarterly transfer. This table presents a weighted average of these quarterly transfer assumptions. Rounding of results may prevent exact matching of total. Benefits paid to non-resident aliens are not included in the total benefits paid.

2/ Source: The total benefits paid data were estimates provided by the Social Security Administration and the Railroad Retirement Board, the other data came from the Individual Income Tax Model of the Office of Tax Analysis.

3/ Source: The total benefits paid data are from the 1989 Annual Statistical Supplement to the Social Security Bulletin, the Social Security Administration and the Railroad Retirement Board; the other data come from the Internal Revenue Service's Individual Master File data.

percent, yielding an initial transfer of $3,088 million. The estimates assumed that railroad retirees would include a smaller proportion of benefits in AGI: 4.6 percent of the $3,823 million paid out in railroad social security equivalent benefits were estimated to be included in AGI at a 26.7 percent marginal tax rate, yielding a $47 million transfer to the SSEBA trust fund. Relative to retirees, recipients of social security disability insurance benefits have lower incomes. As a result, smaller tax parameters were used in the estimation of the initial transfer of disability benefits: 3.0 percent of the $20,138 million in FDI benefits were included at a 26.0 percent marginal tax rate resulting in a transfer of $156 million.

The parameters used to estimate the initial transfers for calendar year 1988 are shown in the top section of Table 2. The percentage of total benefits includable in AGI was increased from its 1987 level, while the marginal tax rate applicable to benefits was estimated to decline. The thresholds for taxation of benefits are fixed in nominal terms, but certain other tax parameters (notably the tax rate structure) are indexed for inflation. As a result, more benefits become subject to tax each year at a lower marginal rate. Marginal tax rates were also estimated to decline between 1987 and 1988 in response to the continued implementation of the Tax Reform Act of 1986, It was estimated that 6.9 percent of the $194,659 million in FOASI benefits payable in 1988 would be includable in AGI at a marginal tax rate of 24.6 percent, and that 3.5 percent of the $21,467 million in FDI benefits would be includable in AGI at a marginal tax rate of 23.5 percent. Thus, in 1988, $3,285 million was transferred to the FOASI account, and the FDI account received $173 million.

The tax parameters applied to railroad social security equivalent benefits were adjusted primarily to reflect data from 1984 and 1985 tax returns indicating that railroad retirees paid less taxes on benefits than had been previously estimated. As a result, the percent of railroad social security equivalent benefits includable in income was not changed from its 1987 level of 4.6 percent, and for the first time, the marginal tax rate estimated to be applicable to railroad social security equivalent benefits was reduced to a level (23 percent) below the rate applied to other benefit types. As a result, $40 million was transferred to the SSEBA trust fund in 1988.

TABLE 2

Comparison of Assumptions Used to Estimate Initial Trust Fund Transfers for Calendar Year 1988 with Actual Results 1/

Trust Fund	Total Benefits Paid ($million)	Benefits Includable in AGI(%)	Tax Rate on Benefits Includable in AGI(%)	Transfer Amount ($million)
	Initial Transfer Assumptions 2/			
Federal Old-Age and Survivors Insurance (FOASI)	194,659	6.9	24.6	3,285
Federal Disability Insurance (FDI)	21,467	3.5	23.5	173
Railroad Social Security Equivalent Benefits (SSEBA)	3,934	4.6	23.0	40
Total	220,060	6.5	24.5	3,498
	Actual Results 3/			
Federal Old-Age and Survivors Insurance (FOASI)	194,984	7.2	25.8	3,611
Federal Disability Insurance (FDI)	21,671	2.8	21.7	131
Railroad Social Security Equivalent Benefits (SSEBA)	3,889	3.7	21.5	31
Total	220,544	6.7	25.6	3,773

Department of the Treasury
Office of Tax Analysis

1/ Different assumptions were used for each quarterly transfer. This table presents a weighted average of these quarterly transfer assumptions. Rounding of results may prevent exact matching of totals. Benefits paid to non-residents have been subtracted from the total benefits paid.

2/ Source: The total benefits paid data were estimates provided by the Social Security Administration and the Railroad Retirement Board; the other data came from the Individual Income Tax Model of the Office of Tax Analysis.

3/ Source: The total benefits paid data are from the 1989 Annual Statistical Supplement to the Social Security Bulletin, the Social Security Administration and the Railroad Retirement Board; the other data come from the Internal Revenue Service's Individual Master File data.

CHAPTER 3: ADJUSTMENTS TO TRANSFERS FOR ACTUAL 1987 AND 1988 TAX RETURN INFORMATION

I. TAX RETURN DATA

The Social Security Amendments of 1983 require adjustments to the trust funds if actual tax return data subsequently reveal errors in the initial transfers. To calculate the additional tax liability for calendar year 1987 and 1988 resulting from partial taxation of social security and railroad social security equivalent benefits, the IRS created a data file based on Form 1040 records. All filers who reported taxable social security or railroad social security equivalent benefits on their Form 1040 in 1987 or 1988 are included in this data file. While the Form 1040 provides information on the total amount of benefits includable in taxable income, it does not indicate whether the filer received FOASI, FDI or railroad social security equivalent benefits. Such information is necessary for the appropriate allocation of revenues among the trust funds. To obtain this information, the Form 1040 records belonging to those beneficiaries who reported taxable benefits were matched to the Form 1099 records provided by the Social Security Administration and the Railroad Retirement Board. (While the actual Forms 1099-SSA sent to taxpayers do not disclose whether the amounts shown are for retirement or disability benefits, the Form 1099 records provided by the Social Security Administration to the IRS do include the source of benefits.)

Using this matched file of Form 1040 and Form 1099 records, the IRS calculated for each benefit type the number of tax returns with benefits which might be includable in adjusted gross income (AGI), the gross dollar amount of benefits paid to beneficiaries who filed tax returns, and the amount of benefits included in AGI. Next, for each taxpayer on the file, taxable income was computed with benefits excluded from AGI. Using the new measure of taxable income, the tax liability was recalculated. The difference between the filers' actual tax liabilities and their liabilities re-estimated with taxable benefits excluded from taxable income represents the amount of revenue attributable to the taxation of benefits.

The special IRS file of social security and railroad retirement beneficiaries was expanded in 1987 to include information from Schedule D on long-term capital gains income. This information was necessary because the maximum tax rate on long-term capital gains income was limited to 28 percent in 1987. In order to take advantage of this provision, taxpayers with long-term capital gains income had the option of computing their tax liability on Schedule D, without reference to the normal tax tables. Approximately 25 percent of returns with taxable social security or railroad social security equivalent benefits computed their tax liability on Schedule D. (In contrast, only 3 percent of all tax filers used this option.) Failure to account for this treatment would have resulted in an understatement of the taxes attributable to the inclusion of benefits in AGI in 1987. In 1988, capital gains income was taxed at the same rates as ordinary income, and the additional information from Schedule D was no longer necessary.

II. ACTUAL INCOME TAX LIABILITIES IN 1987 AND 1988

The lower section of Table 1 shows the additional tax liability attributable to partial inclusion of social security and railroad social security equivalent benefits calculated from actual 1987 tax returns. In 1987, the Social Security Administration and the Railroad Retirement Board paid out $207,368 million in FOASI, FDI, and railroad social security equivalent benefits. As a result of the Social Security Amendments of 1983, $12,844 million in benefits (6.2 percent of the total) were added to AGI for calendar year 1987. On average, these benefits were taxed at a marginal rate of 24.5 percent, yielding $3,152 million in additional revenues. For all trust funds, initial transfers exceeded these actual receipts by $139 million.

As a result of the reconciliation of estimated and actual 1987 tax liability, the July 1, 1989 transfer included a total downward adjustment of $139 million to the FOASI, FDI, and SSEBA trust funds. The adjustments to the FOASI, FDI, trust funds were $82 million, $39 million, and $18 million, respectively (see Table 3).

Actual results from the 1988 tax return data are shown in the lower section of Table 2. In 1988, the Social Security Administration and the Railroad Retirement Board paid out $220,544 million in FOASI, FDI, and railroad social security equivalent benefits. While total expenditures on benefits increased by 6 percent between 1987 and 1988, the amount of benefits includable in AGI increased by 15 percent to $14,734 million (6.7 percent of the total). On average, these benefits were taxed at a marginal rate of 25.6 percent, yielding $3,773 million in additional revenues. In total, revenues to the trust fund were understated by $275 million. A sizable underpayment to the FOASI account was partially offset by overpayments to the other two trust funds.

The initial transfers to the FOASI account fell short of actual liabilities by $326 million because the marginal tax rate applicable to social security retirement benefits was underestimated. The actual marginal tax rate was 25.8 percent, exceeding both the estimated tax rate for 1988 and the actual 1987 level by 1.2 percentage points. Although counter to initial expectations, the increase in the marginal tax rate between 1987 and 1988 probably reflects timing effects caused by the delayed implementation of certain provisions in the Tax Reform Act (for example, rate increases on capital gains income) which were of particular importance to high-income elderly.

TABLE 3

Adjustments to Trust Funds for Calendar Year 1987 Based on Comparison of the Initial Transfers With Actual Results

($ millions)

Trust Fund	Initial Transfer	Actual Amount	Adjustment (Change from Initial Transfer)
Federal Old-Age and Survivors Insurance (FOASI)	3,088	3,006	-82
Federal Disability Insurance (FDI)	156	117	-39
Railroad Social Security Equivalent Benefits (SSEBA)	47	29	-18
Total	3,291	3,152	-139

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TABLE 4

Adjustments to Trust Funds for Calendar Year 1988 Based on Comparison of the Initial Transfers With Actual Results

($ millions)

Trust Fund	Initial Transfer	Actual Amount	Adjustment (Change from Initial Transfer)
Federal Old-Age and Survivors Insurance (FOASI)	3,285	3,611	326
Federal Disability Insurance (FDI)	173	131	-42
Railroad Social Security Equivalent Benefits (SSEBA)	40	31	-9
Total	3,498	3,773	275

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CHAPTER 4: ADJUSTMENTS TO TRANSFERS FOR ACTUAL 1984-1986 TAX RETURN INFORMATION

During the spring of 1989, the Office of Tax Analysis and IRS initiated a comprehensive review of the methodology used in the reconciliation process. This review revealed an error in the calculation of actual tax liabilities, beginning with the first reconciliation of 1984 tax liabilities. As a consequence, certain additional taxes attributable to the treatment of lump-sum distributions of pensions and accumulation distributions of trusts were erroneously transferred into the trust funds at the time of the reconciliations for tax liabilities in 1984, 1985, and 1986. These additional taxes, although included as a separate line entry on the Form 1040, do not affect the calculation of adjusted gross income, taxable income, or the taxation of benefits. Thus, they should not be included in measures of the tax liabilities attributable to the inclusion of benefits in adjusted gross income. The additional taxes represent a very small share of total individual income tax receipts. However, because of their nature a sizable proportion of these additional taxes are paid by filers with taxable social security or railroad social security equivalent benefits. In 1987, recipients with taxable social security or railroad social security equivalent benefits paid $244 million in additional taxes -- or about 8 percent of the total amount of income taxes transferred to the trust funds.

The error was discovered in sufficient time to correct the 1987 reconciliation. However, a review of the computer programs for 1984 through 1986 verified that the error had occurred, undetected, in those years. Based on data from the Statistics of Income (SOI) stratified random samples of individual income tax returns for 1984 through 1986, the trust funds received overpayments of $1,363 million -- or about 14 percent of the total amount of income taxes transferred during this period. The additional taxes were larger in the pre-1987 period because of the treatment of lump-sum pension income prior to the passage of the Tax Reform Act of 1986.

Adjustments were made to the trust funds in October 1989 to correct for these overpayments. The adjustments were based on the SOI stratified random samples of tax returns for 1984 through 1986. The SOI files identify the total amount of additional taxes paid by filers who also reported a tax on social security or railroad social security equivalent benefits. These totals were allocated among the trust funds using parameters derived from the 1987 IRS file of tax returns of social security and railroad retirement beneficiaries.[5]

The third column of Table 5 shows the adjustments to the trust funds for the erroneous crediting of additional income taxes. The adjustments to the FOASI and FDI accounts were, respectively, -$1,319 million and -$40 million. The adjustments to the railroad retirement accounts were significantly smaller: -$4 million from the SSEBA and -$1 million from the Railroad Retirement Account.[6] The railroad retirement adjustments were small because railroad retirees are not entitled to lump-sum pension distributions. Any additional taxes

TABLE 5

Adjustments to Trust Funds for Calendar Years 1984 Through 1986 for Overpayments of Individual Income Taxes to Trust Funds

Trust Fund	Initial Transfers	Adjustments: Annual Correcting Adjustments	Adjustments: Overpayments of Additional Taxes	Final Transfers
Federal Old-Age and Survivors Insurance (FOASI)				
1984	2,754	-43	-372	2,339
1985	3,133	145	-481	2,797
1986	3,353	29	-466	2,916
Subtotal	9,240	131	-1,319	8,052
Federal Disability Insurance (FDI)				
1984	186	-81	-11	94
1985	218	-114	-14	90
1986	234	-116	-14	104
Subtotal	638	-311	-40	288
Railroad Retirement Tier 1 1/				
1984	68	-33	-1	34
1985	77	-43	-2	32
1986	69	-39	-2	28
Subtotal	214	-115	-5	94
Total, All Trust Funds				
1984	3,008	-157	-384	2,467
1985	3,428	-12	-497	2,919
1986	3,656	-126	-482	3,048
Total	10,092	-295	-1,363	8,434

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1/ Includes transfers and adjustments to both the Railroad Retirement Account and the Social Security Equivalent Benefit Account (SSEBA).

paid by railroad retirees were most likely attributable to trust income or pension lump-sum distributions from other jobs or the employment of their spouses.

Previous reports have contained tables showing the tax liabilities and the tax parameters associated with the inclusion of benefits in adjusted gross income for 1984, 1985, and 1986. On the basis of this new information, the marginal tax rates applicable to benefits have been revised downward for these three years. Appendix Tables A-1 through A-3 compare the revisions with the results shown in previous reports. The marginal tax rate applicable to social security retirement benefits is reduced by between 4 to 5 percentage points for these years. The marginal tax rates for disability and railroad social security equivalent benefits decline by between 1 and 3 percentage points as a consequence of the new information.

CHAPTER 5: FORECAST OF TRANSFERS TO TRUST FUNDS FOR 1989-1993

The Social Security Amendments of 1983 required that the annual report include a forecast of transfers to the trust funds for the next five years. The forecast is produced by the Office of Tax Analysis using the methodology described in Chapter 2. Forecasts of social security and railroad social security equivalent benefits are obtained from the respective agencies, and the percent of aggregate retirement benefit includable in adjusted gross income (AGI) and marginal tax rates are obtained by extrapolating the Individual Income Tax Model in accordance with the Administration's budget forecasts. In addition, the estimates of future transfers reflect the information obtained from the IRS computation of marginal tax rates and benefits includable in AGI reported on tax returns for calendar years 1987 and 1988.

The estimated transfers for calendar years 1989-1993 are presented in Table 6. The net transfer is significantly smaller in 1989 than in subsequent years due to two negative correcting adjustments which occurred in that year: the 1987 adjustment (-\$139 million) and the corrections for overpayments in 1984 through 1986 (-\$1,363 million). In 1990, total transfers of current-year liabilities are augmented by the positive adjustment for 1988 (\$275 million). The projected transfer for 1991 includes an estimate that small adjustments will be necessary when 1989 tax return data become available. It is estimated that the 1983 Act will result in \$24,732 million being transferred to the FOASI, FDI, and SSEBA trust funds in calendar years 1989-1993.

TABLE 6

Forecast of the Net Transfers for Calendar Years 1989-1993
Due to the Social Security Amendments of 1983 1/

($ millions)

Trust Fund	Initial Transfers Already Made 1989	1990	Estimated Transfers 1991	1992	1993	Total Transfers 1989-1993
Federal Old-Age and Survivors Insurance (FOASI)	2,366	4,772	5,115	5,490	5,959	23,702
Federal Disability Insurance (FDI)	91	140	181	204	226	842
Railroad Retirement Tier 1:						
Railroad Social Security Equivalent Benefits (SSEBA)	13	29	47	47	51	187
Railroad Retirement Account	-1	0	2	0	0	1
	2,469	4,941	5,345	5,741	6,236	24,732

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1/ Transfers for 1989 and 1990 have already been made and include adjustments to prior year transfers for actual tax return data. The estimates for 1991-1993 include anticipated adjustments. Includes Office of Tax Analysis' estimates of taxes attributable to railroad social security equivalent benefits received by non-resident aliens.

CHAPTER 6: DISTRIBUTION OF TAXABLE BENEFITS AND TAX LIABILITY ATTRIBUTABLE TO TAXATION OF BENEFITS IN 1988

I. USING THE INDIVIDUAL INCOME TAX MODEL FOR DISTRIBUTIONAL ANALYSIS OF SOCIAL SECURITY BENEFICIARIES

This chapter contains an analysis of the distribution by income class of returns with taxable social security or railroad social security equivalent benefits in 1988. The analysis is based on the Office of Tax Analysis' Individual Income Tax Model. Because of sampling error in the underlying Statistics of Income data file, the Tax Model provides a less precise measure of taxable benefits than the special IRS data base which contains the returns of all taxpayers with taxable benefits.[7] However, the Tax Model utilizes more extensive data from tax returns, as well as data from the Current Population Survey, permitting comprehensive distributional analyses. Using the Tax Model, it is possible to analyze all potential tax filing units with social security or railroad retirement benefits, including units who did not file a tax return in 1988 because they had no tax liability.

II. DISTRIBUTION OF TOTAL AND TAXABLE BENEFITS BY ADJUSTED GROSS INCOME CLASS

As shown in Table 7, 29 million "potential" tax filing units received social security or railroad retirement benefits in 1988. About 4 million filing units, or 14 percent of the total, reported taxable benefits. Two thirds of all potential filing units with benefits had adjusted gross incomes (AGIs) less than $10,000 and thus were generally not subject to tax on benefits. As explained, the income test for the taxation of benefits includes tax-exempt interest, so it is possible for some taxpayers with AGIs significantly below the income thresholds to be liable for taxes on benefits. However, this number is small, as shown in Table 7. Fewer than 20,000 tax filers with taxable benefits have AGIs below $10,000. One-third of the filing units with AGIs between $20,000 and $30,000 and nearly all these filing units with AGIs greater than $30,000 were subject to some tax on benefits.

Since each filing unit may contain more than one beneficiary, the number of beneficiaries paying income tax on their benefits cannot be determined precisely. Because joint returns of married couples constitute about two-thirds of the 4 million returns with taxable benefits, it is reasonable to assume that no more than about 6.6 million beneficiaries are taxable on their benefits. In 1988, about 40 million persons (including those living in institutional settings) received retirement or disability benefits, suggesting that between 10 and 16.5 percent of beneficiaries paid taxes on their benefits.

TABLE 7

Distribution of Total and Taxable Social Security and Railroad Retirement Benefits in 1988 By Adjusted Gross Income Class

Adjusted Gross Income Class ($000)	All Returns with Benefits 1/ Number of Returns (000)	All Returns with Benefits 1/ Amount of Benefits ($millions)	Returns with Taxable Benefits Number of Returns (000)	Returns with Taxable Benefits Amount of Benefits Total ($millions)	Returns with Taxable Benefits Amount of Benefits Taxable ($millions)
Under 10	19,259	117,563	18	100	32
10-20	4,861	42,941	79	692	222
20-30	2,069	17,029	705	6,279	934
30-50	1,867	16,130	1,859	16,123	6,369
50-75	743	6,893	743	6,893	3,435
75-100	264	2,700	264	2,700	1,349
100-200	243	2,611	243	2,611	1,306
200 and over	113	1,427	113	1,427	714
Total	29,419	207,294	4,024	36,825	14,361

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1/ Figures cover individuals, other than those living in institutional settings, who did not actually file tax returns because their taxable incomes were too low.

Source: Office of Tax Analysis' Individual Income Tax Model.

As Table 7 shows, fewer than 100,000 tax filers with taxable benefits have AGIs below \$20,000. In contrast, 705,000 filers with taxable benefits, or 18 percent of all recipients with taxable benefits, have AGIs between \$20,000 and \$30,000. An additional 1.9 million filers with taxable benefits report AGI between \$30,000 and \$50,000. Combining these income classes, two-thirds of recipients with taxable benefits have AGIs below \$50,000.

Table 8 covers only those returns with taxable benefits. Taxable benefits are divided by total benefits received to derive inclusion rates, shown in the fifth column of Table 8. On average, taxpayers with taxable benefits include 39 percent of benefits in AGI. Taxpayers whose AGIs exceed \$50,000 generally include 50 percent of benefits in AGI. At 33 percent, the inclusion rate is lower for those with AGIs below \$50,000, indicating that they tend to be in the phase-in region for taxation of benefits. One-third of all taxpayers with taxable benefits are in the phase-in region for the taxation of benefits. Among these taxpayers, the rate of inclusion of benefits averages about 22 percent. The other two-thirds of taxpayers with taxable benefits (generally, those with higher incomes) include the statutory maximum 50 percent of benefits in AGI.

In general, taxable social security and railroad social security equivalent benefits represent a relatively small proportion of any taxpayer's AGI, regardless of how close the income of the beneficiary is to the income thresholds. On average, taxable benefits constitute about 6 percent of AGI, with the greater share of taxable income derived from interest, dividends, capital gains, earnings and pensions. For recipients with taxable benefits, about half of AGI consists of interest, dividends, and capital gains. The importance of labor income in AGI varies according to marital status, ranging from 8 percent among single filers to 22 percent among married filers.

III. DISTRIBUTION OF TOTAL AND TAXABLE BENEFITS BY EXPANDED ADJUSTED GROSS INCOME CLASS

In Tables 9 and 10, returns of beneficiaries are distributed according to an expanded AGI classifier, which adds non-taxable social security and railroad social security equivalent benefits to AGI. The inclusion of all benefits in the income classifier shifts the distribution upward. As Table 9 demonstrates, among those with expanded AGIs between \$20,000 and \$30,000, only 6 percent paid taxes on benefits. In the \$30,000 to \$50,000 class, 62 percent of filing units were subject to taxes on benefits.

With AGI as the classifier, filers with AGIs below \$50,000 pay 46 percent of the tax attributable to the Social Security Amendments of 1983 (see Table 8). With the expanded AGI classifier, this proportion falls to 33 percent, as demonstrated in Table 10. Note that the expanded AGI classifier used in Tables 9 and 10 still excludes certain income items, such as tax-exempt interest income, which affect the relative well-being of the higher-income elderly

TABLE 8

Distribution of Taxable Social Security and Railroad Retirement Benefits and Resulting Tax Liability for Tax Returns with Taxable Benefits In 1988 by Adjusted Gross Income Class

Adjusted Gross Income Class ($000)	Number of Returns (000)	Adjusted Gross Income ($millions)	Benefits: Total Amount ($millions)	Benefits: Taxable Amount ($millions)	Benefits: Inclusion Rate (percent)	Additional Tax on Benefits: Amount ($millions)	Additional Tax on Benefits: Tax Rate (percent)
Under 20	97	1,190	792	254	32	40	18
20-30	705	18,454	6,279	934	15	201	22
30-50	1,859	72,387	16,123	6,369	40	1,466	23
50-75	743	44,440	6,893	3,435	50	985	29
75-100	264	22,379	2,700	1,349	50	405	30
100-200	243	32,964	2,611	1,306	50	423	32
200 and over	113	67,139	1,427	714	50	201	28
Total	4,024	258,953	36,825	14,361	39	3,721	26

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1/ Source: Office of Tax Analysis' Individual Income Tax Model.

TABLE 9

Distribution of Total and Taxable Social Security and Railroad Retirement Benefits in 1988 By Expanded Adjusted Gross Income Class 1/

Expanded Adjusted Gross Income Class 1/ ($000)	All Returns with Benefits 2/ Number of Returns (000)	All Returns with Benefits 2/ Amount of Benefits ($millions)	Returns with Taxable Benefits Number of Returns (000)	Returns with Taxable Benefits Amount of Benefits Total ($millions)	Returns with Taxable Benefits Amount of Benefits Taxable ($millions)
Under 10	14,006	71,213	13	58	24
10-20	6,558	49,434	34	165	57
20-30	3,900	36,416	247	1,547	368
30-50	3,247	32,124	2,022	16,948	5,114
50-75	1,003	10,224	1,003	10,224	4,867
75-100	314	3,364	314	3,364	1,671
100-200	269	2,961	269	2,961	1,481
200 and over	122	1,558	122	1,558	779
Total	29,419	207,294	4,024	36,825	14,361

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1/ Expanded Adjusted Gross Income is AGI plus the untaxed portion of benefits.

2/ Figures cover individuals, other than those living in institutional settings, who did not actually file tax returns because their taxable incomes were too low.

Source: Office of Tax Analysis' Individual Income Tax Model

TABLE 10

Distribution of Taxable Social Security and Railroad Retirement Benefits and Resulting Tax Liability for Tax Returns with Taxable Benefits In 1988 by Expanded Adjusted Gross Income Class 1/

Expanded Adjusted Gross Income Class 1/ (000)	Number of Returns (000)	Adjusted Gross Income ($millions)	Benefits: Total Amount ($millions)	Benefits: Taxable Amount ($millions)	Benefits: Inclusion Rate (percent)	Additional Tax on Benefits: Amount ($millions)	Additional Tax on Benefits: Tax Rate (percent)
Under 20	47	310	223	81	37	*	N/A
20-30	247	5,628	1,547	368	24	77	21
30-50	2,022	70,107	16,948	5,114	30	1,133	22
50-75	1,003	54,372	10,224	4,867	48	1,332	27
75-100	314	25,120	3,364	1,671	50	482	29
100-200	269	34,634	2,961	1,481	50	476	32
200 and over	122	68,782	1,558	779	50	220	28
Total	4,024	258,953	36,825	14,361	39	3,721	26

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* Less than $10 million

1/ Expanded Adjusted Gross Income is AGI plus the untaxed portion of benefits.

Source: Office of Tax Analysis' Individual Income Tax Model runs

APPENDIX

COMPARISON OF TAX PARAMETERS SHOWN IN PRIOR REPORTS WITH REVISED RESULTS FOR 1984, 1985, and 1986

TABLE A-1

Comparison of Tax Parameters Shown in Report on Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1984 With Revised Results

Trust Fund	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable in AGI (%)	Transfer Amount ($millions)
	Tax Parameters Shown in 1984 Report 1/			
Federal Old-Age and Survivors Insurance (FOASI)	157,301	5.0	34.1	2,711
Federal Disability Insurance (FDI)	17,871	1.9	30.5	105
Railroad Retirement Tier 1 2/	4,024	2.8	31.1	35
Total	179,196	4.7	33.9	2,851
	Revised Tax Parameters			
Federal Old-Age and Survivors Insurance (FOASI)	157,301	5.0	29.4	2,339
Federal Disability Insurance (FDI)	17,871	1.9	27.5	94
Railroad Retirement Tier 1 2/	4,024	2.8	30.4	34
Total	179,196	4.7	29.4	2,467

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Office of Tax Analysis

1/ Source: U.S. Department of the Treasury, Office of Tax Analysis, Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1984, March 1987, Table 1. Revised tax data from Internal Revenue Service's Individual Master File and Statistics of Income – 1984 Individual Income Tax Returns. Benefits paid to non-residents have been subtracted from the total benefits paid. Data on non-resident benefits from the Social Security Administration and the Railroad Retirement Board.

2/ Includes transfers to both the Railroad Retirement Account and the Railroad Social Security Equivalent Benefit Account (SSEBA).

Comparison of Tax Parameters Shown in Report on Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1985 With Revised Results

Trust Fund	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable in AGI (%)	Transfers Amount ($millions)
	Tax Parameters Shown in 1985 Report 1/			
Federal Old-Age and Survivors Insurance (FOASI)	166,748	5.6	35.2	3,278
Federal Disability Insurance (FDI)	18,800	2.0	27.9	104
Railroad Retirement Tier 1 2/	4,186	3.0	27.4	34
Total	189,734	5.2	34.8	3,416
	Revised Tax Parameters			
Federal Old-Age and Survivors Insurance (FOASI)	166,748	5.6	30.0	2,797
Federal Disability Insurance (FDI)	18,800	2.0	24.1	90
Railroad Retirement Tier 1 2/	4,186	3.0	25.8	32
Total	189,734	5.2	29.7	2,919

Department of the Treasury
Office of Tax Analysis

1/ Source: U.S. Department of the Treasury, Office of Tax Analysis, Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1985, August 1987, Table 1. Revised tax data from Internal Revenue Service's Individual Master File and Statistics of Income - 1985 Individual Income Tax Returns. Benefits paid to non-residents have been subtracted from the total benefits paid. Data on non-resident benefits from the Social Security Administration and the Railroad Retirement Board.

2/ Includes transfers to both the Railroad Retirement Account and the Railroad Social Security Equivalent Benefit Account (SSEBA).

TABLE A-3

Comparison of Tax Parameters Shown in Report on Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1986 With Revised Results

Trust Fund	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable in AGI (%)	Initial ransfers millions)
		Results Shown in 1986 Report 1/		
Federal Old-Age and Survivors Insurance (FOASI)	176,340	6.1	31.2	3,382
Federal Disability Insurance (FDI)	19,826	2.6	22.6	118
Railroad Social Security Equivalent Benefits (SSEBA)	3,672	3.0	27.5	30
Total	199,838	5.7	30.8	3,530
		Revised Results 1/		
Federal Old-Age and Survivors Insurance (FOASI)	176,340	6.1	26.9	2,916
Federal Disability Insurance (FDI)	19,826	2.6	20.0	104
Railroad Social Security Equivalent Benefits (SSEBA)	3,672	3.0	25.7	28
Total	199,838	5.7	26.6	3,048

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Office of Tax Analysis

1/ Source: U.S. Department of the Treasury, Office of Tax Analysis, Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1986, February 1989, Table 1. Revised tax data from Internal Revenue Service's Individual Master File and Statistics of Income -1986 Individual Income Tax Returns. Benefits paid to non-residents have been subtracted from total benefits paid. Data on non-resident benefits from the Social Security Administration and the Railroad Retirement Board.

ENDNOTES

1. The IRS data are not available until approximately one and one-half years after the close of the applicable calendar year due to the normal lags in tax return filing, processing, transcription, and analysis.

2. OTA does not estimate the liability attributable to the receipt of social security benefits by non-resident aliens. One-half of any social security benefit received by a non-resident alien is subject to a 30 percent tax rate, and this amount is automatically withheld by the Social Security Administration. Each month, the Social Security Administration sends a certification of the amount withheld to the Treasury Department's Office of Finance and Planning, and the transfer of the withheld amount from the FOASI and FDI trust funds to general revenues and back again to the FOASI and FDI trust funds is effected. (In practice, the monies never leave the trust fund.) Since the Social Security Administration has information on the actual amounts withheld, OTA does not estimate these withheld amounts.

   Similarly, the Railroad Retirement Board automatically withholds taxes on railroad social security equivalent benefits received by non-resident aliens. However, a different procedure is used to transfer these amounts to the SSEBA. OTA includes an estimate of the withheld amounts in its initial transfers to the trust funds and subsequently verifies these estimates by reference to the Form 1042 filed by the Railroad Retirement Board. In 1987 and again in 1988, $1 million in withheld taxes was transferred to the SSEBA.

   With one exception, the tables in the report do not include benefits received by non-resident aliens or the taxes attributable to these benefits. Table 6, showing the 5-year OTA projections of estimates of transfers to the trust funds, includes a forecast of the taxes attributable to railroad social security equivalent benefits received by non-resident aliens.

3. A detailed description of the Individual Income Tax Model can be found in Cilke and Wyscarver (1987).

4. These forecasts do not include benefits received by non-resident aliens.

5. These parameters do not appear to be sensitive to changes in pension laws, following the passage of the 1986 Act.

6. Prior to 1986, the non-SSEBA portion of railroad retirement Tier 1 benefits was taxed in the same manner as social security benefits. The taxes attributable to the non-SSEBA portion of Tier 1 were transferred to the Railroad Retirement Account.

Further, the SSEBA trust fund was not established until October 1984. The tax liability attributable to all Tier 1 benefits was transferred to the Railroad Retirement Account for the first nine months of 1984. Subsequent adjustments to the trust funds reflect the account to which transfers were originally made.

7. A comparison of Tables 2 and 7 shows that the Tax Model underestimates the amount of taxable benefits by $373 million. However, the marginal tax rates estimated by the Tax Model are slightly higher than those from the special IRS data base, thus reducing the differences in the computation of the 1988 tax liability due to taxation of benefits.

This study was prepared by Janet Holtzblatt of the Office of Tax Analysis under the direction of James R. Nunns. Typing assistance was provided by Connie Haftman and Dolores Perticari.

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Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986

A Report to The Congress

Department of the Treasury
March 1991

Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986

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March 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington D. C. 20515

Dear Mr. Chairman:

Section 6072 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury shall conduct a study of the treatment provided by section 1706 of the Tax Reform Act of 1986 (relating to treatment of certain technical personnel).

Pursuant to that section, I hereby submit the "Taxation of Technical Services Personnel: Report on Section 1706 of the Tax Reform Act of 1986."

I am sending a similar letter to Senator Lloyd Bentsen, Chairman of the Committee on Finance.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ISTANT SECRETARY

March 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington D. C. 20510

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Sincerely,

Kenneth W. Gideon

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Assistant Secretary
(Tax Policy)

Enclosure

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PART ONE

EXECUTIVE SUMMARY

CHAPTER 1: EXECUTIVE SUMMARY

I. BACKGROUND OF REPORT

Despite the wide variety of relationships between workers and firms, there are generally only two classifications of workers for Federal tax purposes: self-employed workers (sometimes called independent contractors) and employees. The proper classification is self-evident for many workers; for others, it is ambiguous. When the proper classification is ambiguous, the potential for worker misclassification increases. Inadvertent misclassification may occur if employers lack sufficiently detailed guidance to determine the correct classification. In addition, the various legal, economic, and tax consequences of the alternate classifications may provide incentives for deliberate misclassification.

Historically, misclassification of employees as independent contractors was a concern because self-employed workers faced significantly lower Social Security and Medicare tax rates than the combined rate for employers and employees. Misclassification was perceived as producing large losses of employment tax revenues. Now that self-employed workers face Social Security and Medicare tax rates comparable to the combined rate for employees and employers, concern about misclassification has shifted to potential losses of all tax revenues. Income and employment tax revenues may be lower due to differences in the income and employment tax bases and differences in compliance between employees and the self-employed.

In the late 1960s, when significant employment tax rate differentials still existed, the Internal Revenue Service (IRS) began to increase its employment tax enforcement activities, which previously had been sporadic, to address the misclassification of workers. Classification of a worker directly affects employment tax obligations and indirectly affects a worker's income tax treatment. As a result of the IRS' actions, the number of reclassifications increased substantially. Many reclassifications resulted in large retroactive assessments against employers.

Congress subsequently took several actions to address taxpayer concerns about worker reclassification. In section 530 of the Revenue Act of 1978 (section 530), it provided statutory relief from reclassification for certain employers involved in employment tax controversies with the IRS. Section 530 generally prohibited the IRS from challenging an employer's erroneous treatment of an employee as an independent contractor for employment tax purposes if the employer had a reasonable basis for such treatment and certain other requirements were met. It also generally prohibited the IRS from issuing regulations or publishing revenue rulings addressing the status of workers as employees or independent contractors for employment tax purposes. Section 530 was initially intended as an interim measure. In 1982, Congress extended it indefinitely, and also limited employer liabilities in certain cases of retroactive reclassification.

Section 1706 of the Tax Reform Act of 1986 (section 1706) removed the statutory relief of section 530, but only for taxpayers that broker the services of technical services workers, *i.e.*, engineers, designers, drafters, computer programmers, systems analysts and other similarly-skilled workers engaged in a similar line of work. Thus, section 1706 only applies in multi-party situations involving (1) technical services workers, (2) companies that use the workers, and (3) firms that supply or broker the services of the workers.

Section 1706 does not change the rules for classifying workers as employees or independent contractors, nor does it change the legal status of anyone covered by the provision. It only permits the IRS to interpret and enforce the underlying rules for employment tax purposes for the covered technical services workers without regard to section 530. However, in practice the worker's employment tax classification generally determines whether the worker is treated as an employee or independent contractor for Federal income tax purposes.

II. REPORT MANDATE

This report was prepared in response to a congressional mandate in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Section 6072 of TAMRA directed the Secretary of the Treasury or his delegate to conduct a study of the treatment provided by section 1706 of the Tax Reform Act of 1986 (TRA 1986).

III. EVALUATION OF ISSUES

According to the Conference Report on TAMRA,[1] the Treasury report was to include an evaluation of five issues. These issues, and the general findings of the report with respect to each, are described below.

[1] H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 167-68 (1988).

Administrability of section 1706. The Conference Report questioned whether there were difficulties in the administration of the provisions of section 1706. The report finds that:

- Section 1706 itself presents few administrative problems, particularly in comparison with section 530;
- Section 1706 actually improves the administrability of the present-law rules for classifying individuals as employees or independent contractors by partially repealing the prohibition in section 530 against the issuance of guidance; but
- The occupations covered by section 1706 could be clarified (*see* Chapter 6, section II).

Abuses in the reporting of income by independent contractors. The Conference Report questioned whether there were any abuses in the reporting of income by independent contractors that would justify the adoption of section 1706, including any evidence of greater noncompliance by independent contractors when compared to employees. The report finds that:

- Existing IRS data suggest that there are errors in the classification of employees as independent contractors and in the reporting of income by such individuals, which may call for legislative or administrative changes--
  - Underreporting of income by such individuals, and the more favorable treatment of independent contractor trade or business expenses, reduce tax revenue;
  - Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by such individuals, because direct compensation to independent contractors is substituted for tax-favored employee fringe benefits;
- Evidence suggests that compliance is somewhat better for technical services workers who are classified as independent contractors than for workers in general who are classified as independent contractors (*see* Chapter 5).

Chilling effect of section 1706 on the ability of technical services personnel to get work. The Conference Report questioned the effect of section 1706 on the ability of technical services personnel to get work. The report concludes that:

- Section 1706 does not affect the cost to firms of technical services workers relative to other workers, and does not affect the demand for firms' products; it is unlikely, therefore, that section 1706 affects the overall ability of technical services workers to get work;

- Section 1706 may, however, have had some transitory effects on the ability of some workers to find work in their accustomed classification (*see* Chapter 4).

Administrability of the present-law standards for classifying individuals as employees or independent contractors. The Conference Report questioned whether the present law standards for distinguishing between employees and independent contractors were administrable. The report finds that:

- The task of classifying workers as employees or independent contractors under the 20-factor common law tests generally used under present law can be difficult, in particular in the multi-party situations affected by section 1706;
- Section 530 has exacerbated this problem by preventing the IRS from issuing guidance in this area for over ten years; and
- Section 1706 may have improved tax administration by permitting the IRS to issue guidance with respect to certain workers and by denying the section 530 safe harbors to certain employers (*see* Chapter 6, section III).

Equity of distinguishing between independent contractors who work through brokers and those who do not. The Conference Report questioned the equity of providing rules that distinguish between independent contractors who work through brokers and those who do not. The report finds that:

- This distinction unnecessarily limits the beneficial effects of section 1706, and may have an adverse effect on the efficiency of the labor markets for such workers;
- Data are not available, however, to determine whether the distinction can be justified on the basis of differences in compliance rates between the two groups (*see* Chapter 4).

IV. OPTIONS FOR FURTHER CONSIDERATION

The significance of the effects of section 1706 must be viewed in the context of existing substantive tax differences between independent contractors and employees, especially with respect to the exclusion of fringe benefits from gross income, the deductibility of employee business expenses, and differences in the Social Security and Medicare tax base. In that context, and based on the findings of this report, the following options are presented for further consideration and analysis:

- Eliminate the difference in treatment under section 1706 between technical services workers working through brokers and those not working through brokers. This difference is difficult to justify on equity or other policy grounds. (*See* Chapter 4.)
- Clarify the occupations covered by section 1706. Difficulties in determining the occupations covered by section 1706 present an administrative problem. (*See* Chapter 6.)
- Repeal the prohibition in section 530 against the issuance of guidance by the IRS concerning employee status. This prohibition has significantly reduced taxpayers' ability to classify workers correctly as employees or independent contractors and has exacerbated the difficulty of applying the 20-factor common law standards. (*See* Chapter 6.)

PART TWO

BACKGROUND INFORMATION

CHAPTER 2: SOURCES OF EMPLOYEE MISCLASSIFICATION

I. OVERVIEW

A wide variety of relationships between service-providers and service-recipients exists in the modern economy. They differ with respect to the degree of control exercised by the service-recipient, whether the services are full-time or part-time, the method of compensation (*e.g.*, salaried versus hourly), the level of material support provided by the service-recipient, and many other factors. Despite this diversity, service-providers are generally grouped into one of two broad categories for Federal tax purposes: employees and independent contractors.

Misclassification of individuals as employees or independent contractors results when service-recipients and service-providers misapply the tests used to distinguish employees from independent contractors under the Code. Deliberate misclassification of employees as independent contractors results in part from the fact that there are numerous differences under the Internal Revenue Code (Code) between the treatment of employers and employees, on the one hand, and independent contractors and their clients, on the other, and from the perception that these differences systematically favor the second group.

Differences in treatment between employers and employees, on the one hand, and independent contractors and their clients, on the other, also occur under a number of other Federal and State laws, primarily those dealing with workers' compensation and unemployment insurance, labor-management relations, employment discrimination, and other labor issues. Misclassification designed to benefit from these differences in non-tax treatment can also contribute to misclassification for Federal tax purposes, since inconsistent treatment of an individual under these laws and Federal tax laws might invite scrutiny.

Misclassification of individuals as employees or independent contractors is problematic to the extent that it circumvents a policy decision to limit certain tax benefits or burdens to one group or the other, or results in a loss of revenue through noncompliance.

This chapter provides a general description of the factors used to distinguish employees from independent contractors under Federal tax and other laws, and of the differences in the treatment of employees and independent contractors that may encourage misclassification under each. A more detailed description of these issues is provided in Appendix A.

II. DETERMINATION OF EMPLOYEE STATUS

The status of an individual as an employee or independent contractor for purposes of Federal employment, income and other tax laws is, with few exceptions, determined under the common law tests for determining whether an employment relationship exists. These tests focus on whether the service-recipient has the right to *direct and control* the service-provider, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. Over the years, the IRS has identified 20 important factors useful in determining whether the common law tests have been satisfied. These factors are listed in Appendix B.

The status of an individual as an employee or independent contractor for purposes of Federal and State labor and related laws is generally determined under standards that resemble the control-based common law standards applied under the Code. Depending on the purpose of the law involved, however, different factors are often emphasized in making this determination. Thus, IRS determinations of employee status based on the common law tests are generally persuasive but not determinative in other areas, and it is possible for an individual to be classified as an employee for some purposes and as an independent contractor for others.

III. DIFFERENCES IN TAX TREATMENT BETWEEN EMPLOYEES AND INDEPENDENT CONTRACTORS

Current law does not consistently favor status as either an employee or an independent contractor. Employers and employees are treated differently than independent contractors and their clients under a number of Federal and State laws, however. Thus, depending on individual circumstances, misclassification may sometimes be advantageous to the service-provider, the service-recipient, or both.

A. Differences Favoring Independent Contractor Status

Federal Tax Law. Prior to 1982, compensation earned by independent contractors was taxed at substantially lower rates under the Social Security and Medicare tax provisions of the Code than wage income, apparently creating a significant incentive for misclassification.[2] Subsequent legislation has essentially eliminated this important difference. The Social Security,

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[2] To some extent, however, the rate differential may have been offset by differences in the compensation base to which the taxes applied.

Medicare, and income tax provisions of the Code may still favor classification as an independent contractor, however, where an individual has a small or unpredictable cash flow or significant employee business expenses. This is primarily because:

(1) Independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees. In particular, employees generally may not deduct their trade or business expenses unless they "itemize" their deductions on their tax returns, and then only to the extent the expenses exceed two percent of their adjusted gross incomes from all sources. They must also satisfy additional requirements before they may deduct their automobile depreciation, home office, home computer and certain other expenses. These requirements are difficult for many employees to meet and in some cases constitute an effective barrier to a deduction.

(2) The estimated tax system used to collect Social Security, Medicare, and income taxes from independent contractors largely avoids the problem of over-withholding that can result when an employee incurs large business expenses, has net income that fluctuates during a year, or is employed for only part of a year. It also generally permits later and less frequent payments than the withholding system used to collect such taxes from employees.

As an essentially voluntary reporting system, the estimated tax system also provides fewer checks against underreporting of income and taxes than the withholding system and may, therefore, be favored by service-providers and service-recipients willing to violate the law and risk detection on audit; it also does not ensure the collectability of taxes to the same extent as the withholding system. Finally, the withholding system involves overhead costs, which employers may seek to shift to employees by classifying them as independent contractors.

The unemployment insurance tax provisions of the Code (and corresponding State laws) may in some cases also favor classification as an independent contractor. Independent contractors and their clients generally are not subject to unemployment insurance taxes. On the other hand, independent contractors generally are not eligible for unemployment insurance benefits. Other things being equal, employers will have an incentive to classify a worker as an independent contractor in order to avoid unemployment insurance taxes on an employee's wages (and the administrative costs of remitting such taxes and complying with other associated statutory requirements). Workers may prefer to be classified as independent contractors if they are not (or perceive that they are not) dependent on a single employer for their income.

Other Laws. State and Federal labor and related laws may in some cases also favor classification as an independent contractor. Such laws typically do not apply to independent contractors, providing protection only to employees. This is generally beneficial to clients of independent contractors, since it may allow them to avoid the direct costs of providing additional benefits and protections to the independent contractors, as well as the administrative cost of explaining the benefits and assuring that various other statutory requirements have been met. Thus, the difference in treatment may provide an incentive for employers to misclassify employees as independent contractors. Employees may also prefer to be misclassified as independent contractors in order to avoid coverage under these laws, if they are not willing to pay the indirect cost for the specific protection provided.

B. Differences Favoring Employee Status

The Social Security, Medicare, and income tax provisions of the Code may, on the other hand, favor classification as an employee in cases where an individual prefers to receive some of her compensation in the form of fringe benefits rather than cash. This is because, under the Code, an employer may provide fringe benefits, such as pensions, accident and health and group-term life insurance, on a tax-favored basis to its employees but not to its independent contractors. Such benefits are generally excluded from employees' gross incomes subject to income tax as well as wages subject to Social Security and Medicare taxes. While independent contractors can generally establish their own fringe benefit plans, amounts used to purchase such benefits generally cannot be deducted or excluded from gross income subject to income tax, or from compensation subject to Social Security and Medicare taxes. Limited exceptions are provided for certain of the most significant benefits, including pensions and accident and health insurance; amounts used to purchase these benefits can to some extent be deducted or excluded from gross income subject to income tax by independent contractors, although they cannot be deducted or excluded from compensation subject to Social Security and Medicare taxes.

An employer may be reluctant to allow an independent contractor to participate in a plan as an employee, however, since that might involve additional costs to the employer. This is particularly true if the independent contractor is highly compensated, in which case her participation might require the employer to provide additional benefits to its non-highly compensated employees under the minimum coverage and nondiscrimination requirements of the Code. Also, short-service independent contractors may not derive any significant benefits from participation, and may therefore prefer to receive additional cash compensation, instead.

The various differences in tax treatment between employees and independent contractors discussed above are summarized in Table 2-1.

C. Five Hypothetical Examples of Differential Tax Treatment

The preceding discussion indicates that Federal and State tax, labor and related laws do not systematically favor classification of an individual as an employee or independent contractor. The most beneficial classification for a particular individual depends instead on her circumstances, preferences, and negotiating skills. This section illustrates the effects of these differences using five hypothetical examples.

Each example begins with $1,000 which an employer or service-recipient could spend on worker compensation. In the employee situation, most of the $1,000 is used to pay the employee her normal salary plus holiday, vacation and sick pay. The remainder is used to pay employment taxes (including Social Security and Medicare taxes, and State and Federal unemployment insurance taxes) and to provide statutorily-required or voluntarily-provided fringe benefits (including contributions to retirement plans, health insurance premiums, and workers' compensation premiums). The employee pays any Federal and State income taxes and the employee share of the Social Security and Medicare taxes due on her salary, and also pays any work-related expenses (for tools, etc.).[3]

In the independent contractor situation, the $1,000 spent for worker compensation by the client is generally assumed to be paid to the independent contractor, although, depending on the knowledge and relative negotiating skills of the two parties, some might be retained by the client. The amount, if any, retained by the client is assumed to pass directly to the client's "bottom line" and, therefore, to be subject to Federal and State corporate income taxes.

In order to maintain the comparison between the employee and the independent contractor, the independent contractor is assumed to incur the same costs as the employee (although the tax treatment may be different) and is assumed to purchase directly the same

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[3] Since the examples show the impact of *additional* income to the employee or independent contractor, a 28 percent Federal income tax rate and a 7.5 percent State income tax rate are assumed to apply to the additional taxable income. The assumed Federal corporate income tax rate is 34 percent, and the assumed State rate is eight percent. The various tax rates are based on those that would be paid by or for a middle-income worker.

Table 2-1

Major Differences in Treatment of Employees and Independent Contractors for Federal Tax and Other Purposes

Employees	Independent Contractors
Fringe Benefits[1]	
Value of many employer-provided fringe benefits excluded from income and employment tax bases	Qualified retirement plan contributions excluded from income but not self-employment tax base
	25 percent of health insurance costs deducted from income but not self-employment tax base
	Few other fringe benefits excluded from income or self-employment tax bases
Trade or Business Expenses	
May be deducted from income tax base only by itemizers and only to the extent expenses exceed two percent of adjusted gross income	May be deducted from income tax base
May not be excluded from employment tax base	May be excluded from self-employment tax base
Certain expenses subject to additional business purpose requirements	
Administrative Costs	
Withholding involves more administrative costs for employer but less for employee	Estimated tax system involves more administrative costs for independent contractor but less for client
	Estimated tax system allows modest delay in tax payments relative to withholding
Compliance	
	Somewhat more ability to be noncompliant due to lack of withholding, larger trade or business expenses, and somewhat more limited business purpose requirements with respect to such expenses
Non-Tax Differences[2]	
Less flexibility in choosing among fringe benefits; value of employer contributions to retirement plan may be lost if worker changes jobs frequently	May be unable to obtain fringe benefits, including statutory fringe benefits such as unemployment insurance and workers' compensation
Administrative (and other) costs associated with Federal and State laws applicable to employees, *e.g.*, minimum wage	May be unable to negotiate worker protections such as minimum wage and overtime

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1. For a detailed comparison of the tax treatment of fringe benefits and business expenses, *see* Appendix A. Employer-provided fringe benefits may be subject to nondiscrimination requirements and other limits.

2. Some of the non-tax differences, such as minimum wage laws, may be more applicable to less advantaged workers than to occupations covered by section 1706.

benefits that the employee would receive as employer-paid fringe benefits.[4] It is further assumed that the independent contractor can purchase these benefits at the same cost an employer could when purchasing for all of its employees as a group.[5]

Example 1--Typical Mix of Fringe Benefits. Example 1 (Table 2-2) shows a situation in which an employee receives a typical mix of fringe benefits but does not incur any deductible trade or business expenses. The employer pays the employer share of Social Security and Medicare taxes, as well as the total cost of workers' compensation premiums and Federal and State unemployment insurance taxes. The employer also makes contributions to retirement and medical insurance plans for the employee, each costing six percent of total compensation. The employee receives regular, vacation, holiday and sick pay of $806, out of which the employee's share of Social Security and Medicare taxes, as well as Federal and State income taxes, are paid. The independent contractor receives the entire $1,000 in cash. Out of that, she pays Federal and State income taxes, Social Security and Medicare taxes, buys health insurance, and contributes to a tax-favored "Keogh" retirement plan. As shown in Table 2-2, the independent contractor pays $12 more in Federal income tax, $4 more in State income tax, and $18 more in Social Security and Medicare tax.

Taxes are higher for the independent contractor in Example 1 because the part of her cash income that was used to provide fringe benefits in the case of the employee is subject to Social Security and Medicare taxes, and some is also subject to income taxes. Current Federal law attempts to equate the tax rate for employees and self-employed persons for Social Security and Medicare tax purposes. Nevertheless, there are differences in the tax base. Self-employed persons may not exclude the value of fringe benefits they purchase for themselves from the Social Security and Medicare tax base (other than the employer portion of Social Security and Medicare taxes), while the value of employer-provided fringe benefits is typically excluded from that base in the case of employees. Hence, in Example 1, the Social Security tax is $18, or 15 percent, higher for the independent contractor than for the employee. The income tax system does provide deductions for self-employed persons for contributions to retirement plans (and for the equivalent to the employer portion of Social Security and Medicare taxes), but it only

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[4] In practice, the lower after-tax price for voluntarily-provided fringe benefits would likely result in greater expenditures for these items in the employee case. Conversely, the lower after-tax price of certain trade or business expenses for independent contractors would likely result in higher trade or business expenses for such individuals.

[5] This assumption is made for simplicity and may be approximately correct for small employers. For large employers, economies of scale are probably important.

Table 2-2

EXAMPLE 1: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS AND NO WORKER EXPENSES

	Employer/Employee			Independent Contractor		
	Employer	Employee	Combined	Service Recipient	Worker	Combined
Money Payment or Regular Salary..................................		733	733		1,000	1,000
Holiday/Vacation/Sick Pay..		73	73			
MONEY PAYMENT OR TOTAL SALARY.....................		806	806		1,000	1,000
Employer-Paid Taxes and Benefits..................................	194		194			
TOTAL COMPENSATION TO WORKER.......................			1,000			1,000
Retained by Service Recipient..				0		
TOTAL COMPENSATION..			- 1,000			1,000
TAXES AND STATUTORY BENEFITS, TOTAL.............	74	331	405	0	427	427
Federal Income Tax 1/ 2/		209	209	0	221	221
State Income Tax 1/ 3/		60	60	0	64	64
Social Security (FICA/SECA) 4/	62	62	123		141	141
Unemployment Insurance (FUTA and State) 5/	4		4			
Workers' Compensation 6/	8		8			
VOLUNTARY FRINGE BENEFITS, TOTAL...................	120	0	120	0	120	120
Retirement/Keogh Contribution	60		60		60	60
Health Insurance Premiums	60		60		60	60
WORKER EXPENSES (DEDUCTIBLE), TOTAL.............		0		0	0	
Income and Social Security Tax Compliance Rate................			100.0%			100.0%
For Worker						
Total Compensation less Taxes and Statutory Benefits.....................................			595			573
Money Income less Worker Taxes...			475			573
Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses.................			475			453
For Employer (Service Recipient)						
Retained by Service Recipient less Taxes..........................			0			0

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Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

permits a deduction for 25 percent of medical insurance costs (and then only in some circumstances), and it does not permit a deduction for the cash equivalent of other fringe benefits, which in this example only consist of the costs of unemployment insurance and workers' compensation.

Example 2--Noncompliance. Independent contractors may have greater opportunity than employees to be less than fully compliant with tax laws. Employees are subject to withholding, and the amount of their wage income is reported with great precision to the IRS. Independent contractors may be able to omit some of their income on their tax returns, although that becomes more difficult when their gross income is reported to IRS on information returns (generally Forms 1099-MISC). Even if independent contractors report 100 percent of their income, however, they may be able to lower their reported tax liability by overstating expenses. Since the workers in Example 2 do not have trade or business expenses, the noncompliance consists solely of the failure to report all of gross income. Example 2 (Table 2-3) illustrates the effect of a lower compliance rate on the independent contractor's tax liabilities. Example 2 is the same as Example 1, except that the independent contractor is assumed to report only 95 percent of her net income from self-employment. As a result of this underreporting by five percent, the independent contractor's Federal and State income taxes are now virtually the same as for the employee, although the Social Security tax is still $11, or nine percent, higher.[6] At greater levels of noncompliance, the taxes of the independent contractors would be lower than those of the fully compliant employee.[7]

Example 3--Trade or Business Expenses. Employee business expenses can also differentially affect the tax treatment of employees and independent contractors. Example 3 (Table 2-4) is similar to Example 1, except that the worker is now assumed to have expenses equivalent to ten percent of total compensation. The independent contractor is able to deduct all of these expenses in calculating income subject to both income and Social Security and Medicare taxes. In contrast, the employee's Social Security and Medicare taxes are not adjusted at all to reflect these expenses. For income tax purposes, these expenses may be reflected if the worker itemizes deductions on her income tax return, but, even then, they are only deductible to the extent that they, together with other miscellaneous deductions, exceed two percent of her

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[6] *See* Table 5-3 for a summary of the compliance rates found in one recent IRS study.

[7] *See* Table 5-2 for a summary of compliance rates actually found in one IRS study. For technical services workers in that study, reporting of gross receipts was 97.0 percent, and reporting of net income (*i.e.*, gross receipts minus business expenses) was 83.4 percent.

Table 2-3

EXAMPLE 2: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS, NO WORKER EXPENSES, AND 5 PERCENT NON-COMPLIANCE BY THE INDEPENDENT CONTRACTOR

	Employer/Employee			Independent Contractor		
	Employer	Employee	Combined	Service Recipient	Worker	Combined
Money Payment or Regular Salary		733	733		1,000	1,000
Holiday/Vacation/Sick Pay		73	73			
MONEY PAYMENT OR TOTAL SALARY		806	806		1,000	1,000
Employer-Paid Taxes and Benefits						
TOTAL COMPENSATION TO WORKER			1,000			1,000
Retained by Service Recipient						
TOTAL COMPENSATION			1,000			1,000
TAXES AND STATUTORY BENEFITS, TOTAL	74	331	405	0	404	404
Federal Income Tax 1/ 2/		209	209	0	209	209
State Income Tax 1/ 3/		60	60	0	61	61
Social Security (FICA/SECA) 4/	62	62	123		134	134
Unemployment Insurance (FUTA and State) 5/	4		4			
Workers' Compensation 6/	8		8			
VOLUNTARY FRINGE BENEFITS, TOTAL	120	0	120	0	120	120
Retirement/Keogh Contribution	60		60		60	60
Health Insurance Premiums	60		60		60	60
WORKER EXPENSES (DEDUCTIBLE), TOTAL	0	0		0	0	
Income and Social Security Tax Compliance Rate			100.0%			95.0%
For Worker						
Total Compensation less Taxes and Statutory Benefits			595			596
Money Income less Worker Taxes			475			596
Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses			475			476
For Employer (Service Recipient)						
Retained by Service Recipient less taxes			0			0

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Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

Table 2-4

EXAMPLE 3: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS AND WORKER EXPENSES OF 10 PERCENT

	Employer/Employee			Independent Contractor		
	Employer	Employee	Combined	Service Recipient	Worker	Combined
Money Payment or Regular Salary		733	733		1,000	1,000
Holiday/Vacation/Sick Pay		73	73			
MONEY PAYMENT OR TOTAL SALARY		806	806		1,000	1,000
Employer-Paid Taxes and Benefits	194		194			
TOTAL COMPENSATION TO WORKER			1,000			1,000
Retained by Service Recipient				0		
TOTAL COMPENSATION			1,000			1,000
TAXES AND STATUTORY BENEFITS, TOTAL	74	308	382	0	381	381
Federal Income Tax 1/ 2/		191	191	0	197	197
State Income Tax 1/ 3/		55	55	0	57	57
Social Security (FICA/SECA) 4/	62	62	123		127	127
Unemployment Insurance (FUTA and State) 5/	4		4			
Workers' Compensation 6/	8		8			
VOLUNTARY FRINGE BENEFITS, TOTAL	120	0	120	0	120	120
Retirement/Keogh Contribution	60		60		60	60
Health Insurance Premiums	60		60		60	60
WORKER EXPENSES (DEDUCTIBLE), TOTAL	0	100	100	0	100	100
Income and Social Security Tax Compliance Rate			100.0%			100.0%
For Worker						
Total Compensation less Taxes and Statutory Benefits			618			619
Money Income less Worker Taxes			498			619
Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses			398			399
For Employer (Service Recipient)						
Retained by Service Recipient less Taxes			0			0

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Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

adjusted gross income from all sources. In Example 3, it is assumed that the effective deduction floor is equivalent to four percent of total compensation, so that only the excess over that level is deductible. As a result of the differential treatment of these trade or business expenses, the extra Federal income tax paid by the independent contractor has been reduced from $12 to $6, and the extra State income tax has been reduced from $4 to $2. The extra Social Security tax has been reduced from $18 to $4, however.

Effect of Expenses on Noncompliance Rates. The noncompliance rate for net income generally does not equal the noncompliance rate for gross income. The rates are equal only when gross income and net income are equal because the worker has no trade or business expenses. When the worker has such expenses, the noncompliance rate for net income exceeds the noncompliance rate for gross income. The higher the level of expenses, the greater the difference between noncompliance rates becomes. Consider a worker with gross income of $1,000 and expenses of $400; net income is $600. If the worker understates gross income by ten percent, net income will be understated by 16.7 percent.[8]

The noncompliance rate for net income and the difference between the gross and net income compliance rates will be greater if the worker can use the existence of trade or business expenses to understate net income further by overstating expenses. In the example above, if the worker both understates gross income by ten percent and overstates expenses by ten percent, net income will be understated by 23.3 percent.[9]

Example 4--Statutorily-Required Fringe Benefits Only. In Example 4 (Table 2-5), the employer is assumed not to provide any voluntary fringe benefits. In addition to salary, the employer pays only for the employer portion of Social Security and Medicare taxes, the Federal and State unemployment taxes, and workers' compensation insurance premiums. Since fringe benefits, which cause the disparity between Social Security and Medicare tax levels for employees and independent contractors, have been greatly reduced, there is only a $1 difference in Social Security and Medicare taxes between the employee and the independent contractor. The additional Federal income tax paid by the independent contractor is $4, and the additional

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[8] Net and gross income are both understated by $100. The noncompliance rate on gross income is $100/$1,000; the noncompliance rate on net income is $100/$600.

[9] Gross income is understated by $100. Expenses are overstated by ten percent, or $40. Net income is understated by $140. The noncompliance rate on net income is $140/$600.

Table 2-5

EXAMPLE 4: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH ONLY STATUTORY BENEFITS AND NO WORKER EXPENSES

	Employer/Employee			Independent Contractor		
	Employer	Employee	Combined	Service Recipient	Worker	Combined
Money Payment or Regular Salary		916	916		1,000	1,000
Holiday/Vacation/Sick Pay		0				
MONEY PAYMENT OR TOTAL SALARY		916	916		1,000	1,000
Employer-Paid Taxes and Benefits	84		84			
TOTAL COMPENSATION TO WORKER			1,000			1,000
Retained by Service Recipient				0		
TOTAL COMPENSATION			1,000			1,000
TAXES AND STATUTORY BENEFITS, TOTAL	84	376	460	0	452	452
Federal Income Tax 1/ 2/		237	237	0	241	241
State Income Tax 1/ 3/		69	69	0	70	70
Social Security (FICA/SECA) 4/	70	70	140		141	141
Unemployment Insurance (FUTA and State) 5/	5		5			
Workers' Compensation 6/	9		9			
VOLUNTARY FRINGE BENEFITS, TOTAL	0	0		0	0	
Retirement/Keogh Contribution	0				0	
Health Insurance Premiums	0				0	
WORKER EXPENSES (DEDUCTIBLE), TOTAL	0	0		0	0	
Income and Social Security Tax Compliance Rate			100.0%			100.0%
For Worker						
Total Compensation less Taxes and Statutory Benefits			540			548
Money Income less Worker Taxes			540			548
Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses			540			548
For Employer (Service Recipient)						
Retained by Service Recipient less Taxes			0			0

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Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

State income tax is $1. The situation illustrated in Example 4 is typical of many temporary employees, whose fringe benefits are often restricted to those required by law.[10]

Note that in Example 4, as a result of higher cash wages exactly offsetting the reduction in fringe benefits, both workers' total current tax bills have increased compared with the workers in Example 1. For the employee, the sum of the Federal and State income taxes and the combined employer-employee Social Security and Medicare taxes has increased by $53, or 13 percent. For the independent contractor, the combined bill has increased by $25, or six percent.

Example 5--Lower Independent Contractor Compensation. Example 5 (Table 2-6) is similar to Example 4, except that the independent contractor's compensation is slightly lower because she has been unable to negotiate from her client the equivalent of the value of the employer's costs for workers' compensation and unemployment insurance (*i.e.*, her bargaining power is lower than in Example 4). Since this wedge between total employee compensation and total payments to the independent contractor is small, the resulting tax differences are also small. Because the independent contractor now has less income, her Social Security and Medicare taxes are now slightly lower ($1) than those paid by the employer and the employee. Also, the independent contractor's Federal and State income taxes are now the same as those of the employee. However, because the client must pay income tax on the funds it has retained, the combined income taxes of the independent contractor and her client are still $6, or two percent, higher than those of the employee.[11]

Summary. These examples illustrate that the difference in income, Social Security and Medicare taxes paid by employers and employees, on the one hand, and independent contractors and their clients, on the other, on the same amount of total compensation depends on the proportion of compensation the individual takes as fringe benefits, the extent of the individual's work-related expenses, and the relative compliance of employees and independent contractors. With typical patterns of fringe benefits and worker expenses, independent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than

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[10] U.S. Department of Labor, Bureau of Labor Statistics, *BLS Reports on its First Survey of Pay and Employee Benefits in the Temporary Help Supply Industry*, 88-260, page 8 (1988).

[11] Employees with substantial trade or business expenses and sufficient bargaining power may be able to negotiate with their employers to structure computer and auto expenses as required business expenses. In such a situation, the worker would still be subject to the two-percent floor, but would be able to deduct expenses that would normally not be deductible.

Table 2-6

EXAMPLE 5: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH ONLY STATUTORY BENEFITS, NO WORKER EXPENSES, AND A "WEDGE" BETWEEN EMPLOYEE AND INDEPENDENT CONTRACTOR TOTAL COMPENSATION

	Employer/Employee			Independent Contractor		
	Employer	Employee	Combined	Service Recipient	Worker	Combined
Money Payment or Regular Salary		916	916		986	986
Holiday/Vacation/Sick Pay		0				
MONEY PAYMENT OR TOTAL SALARY		916	916		986	986
Employer-Paid Taxes and Benefits	84		84			
TOTAL COMPENSATION TO WORKER			1,000			986
Retained by Service Recipient				14		14
TOTAL COMPENSATION			1,000			1,000
TAXES AND STATUTORY BENEFITS, TOTAL	84	376	460	6	445	451
Federal Income Tax 1/ 2/		237	237	4	237	242
State Income Tax 1/ 3/		69	69	1	69	70
Social Security (FICA/SECA) 4/	70	70	140		139	139
Unemployment Insurance (FUTA and State) 5/	5		5			
Workers' Compensation 6/	9		9			
VOLUNTARY FRINGE BENEFITS, TOTAL	0	0		0	0	
Retirement/Keogh Contribution	0				0	
Health Insurance Premiums	0				0	
WORKER EXPENSES (DEDUCTIBLE), TOTAL	0	0		0	0	
Income and Social Security Tax Compliance Rate			100.0%			100.0%
For Worker						
Total Compensation less Taxes and Statutory Benefits			540			541
Money Income less Worker Taxes			540			541
Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses			540			541
For Employer (Service Recipient)						
Retained by Service Recipient less Taxes			0			9

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

employees and employers, provided that the income and expenses are reported correctly.[12] When independent contractors receive few fringe benefits that are not statutorily-required (as is typical for temporary workers), however, and have few or no trade or business expenses, they and their clients may pay about the same level of taxes as employees and employers, provided that the income and expenses are reported correctly.

D. Validity of Differences

It is evident from the preceding discussion that a mere change in classification of an individual as an employee or independent contractor can result in differences in the total tax liability of the individual and the service-recipient, regardless of whether there has been any change in their economic circumstances. While such differences may seem arbitrary or unfair in the case of individuals whose relationship with a service-recipient places them close to the line between employee and independent contractor status, these differences can generally be justified for more "typical" employees and independent contractors. For example, withholding, the partial disallowance of trade or business expense deductions, and the imposition of additional business purpose requirements on those deductions, may be more administratively appropriate for employees than independent contractors, on the assumption that independent contractors typically have more volatile net incomes and larger trade or business expenses, and typically change jobs more frequently than employees. Similarly, the special treatment accorded to employee fringe benefits under the Code, and the special protections for employees found in Federal and State labor laws, may be justified if employees typically have less bargaining power than independent contractors and are more dependent on a single business for their livelihoods.

Even if these assumptions regarding "typical" employees and independent contractors are correct, the fact that a single broad distinction is drawn under the Code between employees and independent contractors means that some "atypical" individuals may not be treated properly. For example, withholding and the partial disallowance of trade or business expense deductions may not be appropriate (except as a compliance measure) for an employee who regularly incurs large expenses and changes jobs frequently: in such situations it might be preferable to treat the individual as an employee for one purpose and an independent contractor for another. Similarly, independent contractors who lack significant bargaining power or financial sophistication may be better off being treated as employees under the fringe benefit provisions of the Code and under Federal and State labor laws. Nevertheless, the costs of such inappropriate results in

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[12] The higher levels of Social Security taxes may in some cases result in a comparable increase in Social Security benefits.

some cases must be balanced against the benefits of maintaining a single standard that applies for all purposes.

Of course, it may be that these assumptions regarding the characteristics of "typical" employees and independent contractors are not generally correct. If this is the case, and the current scheme therefore results in inappropriate results in *too many* cases, it may be desirable to develop new definitions of employee or even to reexamine the need for the current-law distinctions between employees and independent contractors. For example, if most independent contractors lack the means or the foresight to provide for their own retirement income or health insurance coverage, there may be no reason to limit the fringe benefit provisions of the Code to employees, except perhaps in the case of wealthier or more sophisticated individuals. Similarly, there may be no reason for the differences in treatment of employees and independent contractors with respect to the excludability of fringe benefits from the Social Security and Medicare tax base, which arose at a time when fringe benefits made up only a small portion of total income.

CHAPTER 3: ORIGINS OF SECTION 1706

I. SECTION 530

In the late 1960s, the IRS began to increase its employment tax enforcement activities, which had previously been sporadic, to address the misclassification of employees as independent contractors. Since, as noted above, independent contractors and their clients at that time faced significantly lower Social Security and Medicare tax rates than employers and employees, such misclassification was perceived to produce large revenue losses. As a result of the IRS' action, the number of reclassifications increased substantially.[13] Many of these reclassifications resulted in large assessments against the employers involved for employer Social Security, Medicare, and Federal unemployment insurance taxes, and unwithheld employee Social Security, Medicare, and income taxes.

Taxpayers complained to Congress that the reclassifications amounted to a change of position by the IRS in how it was applying the common law tests for determining an individual's status as an employee or an independent contractor.[14] House and Senate conferees reporting on the Tax Reform Act of 1976 urged the IRS "not to apply any changed position or any newly stated position which is inconsistent with a prior general audit position in this general area to past, as opposed to future[,] taxable years" until the completion of a study by the Joint Committee on Taxation on the independent contractor issue.[15]

The Joint Committee asked the General Accounting Office (GAO) to examine the IRS administration of employment taxes. This study was completed by the GAO in 1977.[16] The study recommended that a safe harbor test of independent contractor status dealing with situations where an individual carries her own trade or business be added to Code, and that

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[13] *See IRS Annual Reports* for 1971-1978.

[14] *See* Staff of the Joint Committee on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978*, 300-01 (Comm. Print 1979); H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 271 (1978); H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5-6 (1978); S. Rep. No. 938, 94th Cong., 2d Sess. 604 (1976).

[15] H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 489 (1976).

[16] GAO, *Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions*, GGD-77-88 (1977).

certain other changes be made to reduce the financial burden of retroactive employment tax assessments. The study also found that employees misclassified as independent contractors on average reported 96 percent of their wages. This finding, however, was based on payments by a sample of only five employers involved in employment tax audits.[17] Noting limitations in the GAO sample, the IRS undertook its own study. Based on payments by a sample of 2,600 employers to 7,109 individuals that it had previously proposed to reclassify as wages, the IRS found an average income tax reporting compliance rate of 76.2 percent and an average employment tax reporting compliance rate of 70.0 percent.[18] It also found that compliance rates varied less by industry than by the size of payment and other factors, with small payments and those likely to have been made in cash much less likely to be reported.

In the Revenue Act of 1978, Congress, without mentioning the GAO study, provided statutory relief for certain taxpayers involved in employment tax controversies with the IRS. Section 530 of the Act prohibits the IRS from challenging an employer's treatment of an individual as an independent contractor for employment tax purposes if the employer (1) has a reasonable basis for such treatment and (2) consistently treats the individual, and any other individual holding a substantially similar position, as an independent contractor.[19] Section 530 does not merely provide relief from retroactive assessments: as long as these requirements are met with respect to an individual, the IRS is prevented from correcting an erroneous classification of that individual. Section 530 applies solely for purposes of the employment tax provisions of the Code (*e.g.*, Social Security, Medicare, unemployment insurance taxes, and income tax withholding). It does not affect an individual's classification as an employee for income tax purposes; treatment of an individual as an employee for income tax purposes may, however, violate the consistency requirement noted above and thereby cause the employer to lose

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[17] *Id.* at 25 and 71. A larger sample showed compliance rates of only 87 percent. *Id.* at 25.

[18] *See id.*, Appendix V; Hearings Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, 96th Cong., 1st Sess. (June 20, 1979) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy)).

[19] Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885 (1978). These requirements must be met *before* the commencement of any IRS compliance procedures with respect to an individual. Rev. Proc. 85-18, § 3.03(C), 1985-1 C.B. 518.

protection under section 530. Section 530 treats reasonable reliance on any of the following as a reasonable basis for treating an individual as an independent contractor:

(1) judicial precedent, published rulings, or letter rulings or technical advice memoranda issued to or with respect to the taxpayer;
(2) a past IRS audit in which there was no assessment attributable to the employment tax treatment of the individual or of individuals holding positions substantially similar to that of the individual; or
(3) a long-standing recognized practice of a significant segment of the industry in which the individual was engaged.

The IRS has issued a series of revenue procedures since 1978 explaining the application of section 530.[20]

Section 530 was originally described as an interim measure to provide relief until "Congress ha[d] adequate time to resolve the many complex issues involved in this area",[21] and was scheduled to expire after 1979. It was instead extended through a series of public laws, and was made permanent in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[22]

II. SECTION 3509

In TEFRA, Congress added section 3509 to the Code to mitigate the problem of large retroactive employment tax assessments faced by employers who were *not* entitled to relief under section 530.[23] Under prior law, in the event of a misclassification an employer could be held liable for the full amount of unwithheld income taxes and the unwithheld employee share of Social Security and Medicare taxes. In addition, the employer remained liable for Federal unemployment insurance tax and the employer share of Social Security and Medicare taxes.

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[20] Rev. Proc. 78-35, 1978-2 C.B. 536, was issued soon after enactment. The current version is Rev. Proc. 85-18, 1985-1 C.B. 518.

[21] Staff of the Joint Committee on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978*, 300-01 (Comm. Print 1979).

[22] Pub. L. No. 96-167, § 9(d), 93 Stat. 1275, 1278 (1979); Pub. L. No. 96-541, § 1, 94 Stat. 3204 (1980); Pub. L. No. 97-248, § 269(c), 96 Stat. 325, 552-53 (1982).

[23] Pub. L. No. 97-248, § 270(a), 96 Stat. 325, 553 (1982).

Penalties and interest could also be assessed. The employer bore the burden of proving that the employee had paid income and Social Security and Medicare taxes on the wages in order to abate any liability.[24]

Section 3509 generally limits an employer's liability for failure to withhold income, Social Security or Medicare taxes on payments made to an individual whom it misclassified as an independent contractor to 1.5 percent of the wages paid to the individual plus 20 percent of the employee portion of Social Security and Medicare taxes on those wages.[25] Section 3509 has no effect on an employer's own liability for Federal unemployment insurance taxes or the employer portion of Social Security and Medicare taxes; it also does not apply in cases of intentional disregard of the withholding requirements.[26] As a *quid pro quo* for limiting the employer's liability for failure to withhold employee taxes, section 3509 prohibits the employer from reducing its liability by recovering any tax determined under the section from the employee, and gives the employer no credit for any income taxes ultimately paid the employee.[27]

III. SECTION 1706

Section 530 affects different taxpayers differently, depending on whether they satisfy the conditions for relief contained therein. In particular, some taxpayers that have consistently misclassified their employees as independent contractors are entitled to relief under section 530, while other taxpayers in the same industry (that, for example, have sometimes taken more

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[24] In many cases, the misclassified employee had paid SECA taxes on the wages. The employer could not require the employee to provide evidence of this payment, however.

[25] If the employer did not comply with the information reporting requirements associated with the treatment of an individual as an independent contractor, these percentages are doubled to 3.0 and 40 percent, respectively.

[26] If an employer's liability is determined under section 3509, the employee is liable for the entire amount of unwithheld Social Security and Medicare taxes, unreduced by any amount paid by the employer. Rev. Rul. 86-111, 1986-2 C.B. 176.

[27] Code § 3509(d)(1). In some instances, an employer would be better off under the old rules, *e.g.*, if it can establish that its workers have paid their income taxes in full despite its failure to withhold, and therefore have its liability abated. Section 3509 is a mandatory provision, however.

conservative positions on classification issues) are not, because they cannot satisfy the consistency requirements of the section.

In the mid-1980s, some employers in the technical services industry complained that this difference in treatment under section 530 created an unfair advantage for certain of their competitors. According to the staff of the Joint Committee on Taxation,

> Congress was informed that many employers in the technical services industry that did not qualify for relief under section 530 nonetheless had claimed that their workers were independent contractors, despite the fact that such workers would be classified as employees under the common-law test. It is further contended that some of these employers were relying on erroneous interpretations of section 530, while others simply perceived that the IRS would not aggressively enforce employment tax issues.[28]

The dispute was primarily between two groups of taxpayers, both of which were engaged in the business of arranging for the provision of services by technical services personnel to other companies. One group (sometimes called "technical service firms") generally treated the service-providers as their employees, and they argued that the other group (sometimes called "brokerage firms" or "job-shops") achieved unfair cost savings by treating the service-providers as independent contractors.[29] As explained in Chapter 2, however, misclassification of an employee as an independent contractor does not necessarily result in any cost savings unless the misclassification is accompanied by underreporting of income or similar compliance problems by the independent contractors, or unless the client is able to pay the independent contractor less than the sum of the cash compensation and fringe benefits it would have paid to an employee.

As a result of these complaints, Congress in TRA 1986 excluded taxpayers that broker the services of engineers, designers, drafters, computer programmers, systems analysts and "other similarly skilled workers engaged in a similar line of work" from the safe harbor

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[28] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1344 (Comm. Print 1987).

[29] The first group is represented in part by two trade associations, ADAPSO and the National Technical Services Association (NTSA). The second group is represented in part by the National Association of Computer Consultant Businesses (NACCB).

provided by section 530, effective for payments made after December 31, 1986.[30] Section 1706 applies exclusively to multi-party situations, *i.e.*, those involving (1) technical services workers, (2) a company that uses the workers, and (3) a firm that supplies the workers. The effect of section 1706 is to deny relief solely to the firm that supplies the workers. Section 1706 did not affect the application of section 3509 to such firms.

Congress may have believed that the denial of section 530 relief to this group of taxpayers would cause most or all technical services workers to be reclassified as employees.[31] Section 1706 does not, however, actually require that the individuals listed in the provision be treated as employees: it merely requires them to be classified as employees or independent contractors for employment tax purposes under the usual common law tests, and permits the IRS to issue guidance with respect to such classification.[32]

Since the enactment of section 1706, the IRS has increased its enforcement activity in the employment tax area across the board, including the technical services industry. It has also issued guidance on the proper classification of technical services workers as employees or independent contractors.[33]

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[30] Pub. L. No. 99-514, § 1706, 100 Stat. 2095, 2781 (1986).

[31] *See* H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-834 (1986); 132 Cong. Rec. S8088-89 (June 20, 1986) (floor Statement by Sen. Moynihan introducing predecessor to section 1706).

[32] Notice 87-19, 1987-1 C.B. 455. As described in footnote 57, however, there was some initial confusion over this point after the enactment of section 1706.

[33] Rev. Rul. 87-41, 1987-1 C.B. 296.

PART THREE

DISCUSSION OF ISSUES

CHAPTER 4: GENERAL POLICY ISSUES

I. OVERVIEW

Differences in treatment between employees and independent contractors under Federal and State tax and other laws were described in Chapter 2. This chapter addresses the policy issues underlying these differences in treatment. This report proceeds from the assumption that the government's basic role is to maintain the efficiency of labor markets by not interfering in the natural diversity of firm/worker arrangements unless specific policy goals require intervention. The source of this diversity and its importance to the efficient functioning of labor markets is discussed in Section II of this chapter. Neutrality in the tax treatment of employees and independent contractors, addressed in Section III, in most circumstances is necessary to maintain the efficiency of labor markets and is required to insure tax equity between the two groups of workers. These tax policy issues are illustrated using the examples presented in Chapter 2. An additional goal of tax policy, addressed in Section IV, is to minimize tax compliance costs for firms, workers, and tax administration agencies while maximizing taxpayer compliance. Finally, the non-tax policies of the Federal and State governments affecting labor markets are described in Section V.

II. EFFICIENCY OF LABOR MARKETS

Well-functioning labor markets have a diversity of arrangements between workers and firms. The diversity arises naturally from differences in workers' skills and preferences and differences in firms' organizations and production processes. Workers search out firms that offer arrangements that best match the worker's skills and preferences. Likewise, firms search out workers whose skills and preferences best match the firms' needs. Searching by workers and firms is accomplished through labor markets, which may be informal or well organized. However organized, the more efficiently labor markets work--that is, the more closely workers' skills and preferences are matched to firms' needs--the greater will be workers' real income and firms' productivity.

A. Arrangements Between Workers and Firms

<u>Workers' Skills and Preferences</u>. The significant differences in the level and range of workers' skills are important determinants of the occupations and industries that workers enter, as well as the particular firms for which they choose to work. There are also significant differences in preferences across workers. For example, some workers prefer a stable

relationship with a firm, with a low risk of being laid off, while other workers prefer greater variety in their work or greater autonomy over their work, than could normally be provided by a single employer. Other things being the same, workers with the first set of preferences are more likely to enter long-term employer/employee arrangements with firms. Workers with the second set of preferences, in contrast, are more likely to work as independent contractors for a number of firms (service-recipients), perhaps working for none of the firms for any extended period of time, and perhaps working for more than one simultaneously. It is important to recognize that these differences in arrangements between workers and firms would arise in a well-functioning labor market even in the absence of any government policies that affect the labor market. The different arrangements exist because they are to the mutual benefit of workers and firms.

Workers' preferences vary in many other respects. Workers may differ in their preferences about the timing of work. For example, some workers may want to alternate between long periods of intense work effort and leisure rather than working conventional 40-hour weeks.

Workers may also have different preferences over the form of compensation they receive. Workers may prefer cash compensation because they place a low value on the fringe benefits supplied by the employer, or because employers provide more of the fringe benefits than workers prefer. For example, some workers may consider themselves unlikely to need medical care, so place little value on employer-paid health insurance. Other workers may already have health insurance coverage through a spouse's employer and as an employee be unable to decline the coverage and receive the employer's savings in the form of cash compensation. Workers may also value pensions quite differently. A worker who knows she will change employers before eligibility for pension benefits becomes vested would place no value on the employer's pension contributions. Each of these preferences increases the likelihood that a worker would prefer to be an independent contractor.[34]

Finally, workers may differ in their aversion to possible health and safety risks associated with certain jobs. Since the insurability of such risks are quite different for employees and independent contractors, workers who are risk-averse are more likely to be employees.

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[34] Note that cafeteria plans blur the distinction between the benefit flexibility of employees and independent contractors.

Firms' Organization and Production Processes. Just as individuals have preferences about the characteristics of firms, firms have preferences about the characteristics of workers. These preferences are determined by a firm's organization and production processes and therefore vary widely across firms. A firm's preference for workers determines the mix of worker skills and preferences best suited to the firm.

Firms may differ in the amount of firm-specific knowledge they require of their workers. Firms that require relatively little firm-specific knowledge may be less willing to make long-term employment commitments to their workers than firms that require relatively high levels. Firms may also have different costs of providing fringe benefits to their employees; larger firms generally can provide benefits at lower costs.

Variability in the demand for their product may also differ among firms. Firms experiencing greater variability may be less willing to make long-term employment commitments to their workers, or at least to some of their workers, than firms with relatively more stable product demand. Firms may differ in the production processes they use to produce similar goods, leading to differences in the most suitable skill levels of their workers. Differences in the way that firms organize themselves also can result in differences in the firms' abilities to determine whether their workers actually accomplish the tasks for which they are paid. Firms with higher monitoring costs may hire those workers they believe will require less monitoring and supervision, or workers who are more willing to be monitored.

Arrangements Between Workers and Firms. The differences in workers' skills and preferences and in firms' organization and production processes will lead to a diversity of arrangements between workers and firms. These differences in workers and firms are found in numerous combinations, so that a simple characterization of the diversity in firm/worker arrangements is not possible.

Generally, firms that demand a high degree of control over their production process or require workers to have a high level of firm-specific knowledge are more likely to enter into long-term employer/employee arrangements with workers. Such arrangements are also more likely for firms that have a sufficient scale to provide fringe benefits to workers at a lower cost than the worker faces purchasing similar benefits directly. The workers who enter such arrangements are likely to be more risk-averse, or to have higher preferences for fringe benefits. Conversely, firms that can provide fringe benefits only at high costs or that have high costs of monitoring and supervising workers are more likely to prefer independent contractor arrangements with workers. Firms are also more likely to enter independent contractor arrangements in circumstances where they have a high degree of variability over time in their need for workers with specific skills. The workers who enter such arrangements generally prefer more variety and autonomy, greater flexibility in scheduling work, and more cash compensation than they would receive as employees.

Although firms generally enter into arrangements with workers directly, third parties may be involved in certain circumstances. For example, short-term arrangements for experienced or higher-skilled workers are often a small segment of these labor markets, so the cost to firms and workers of locating each other and making matches may be quite high. Third parties such as temporary worker organizations and brokers reduce such costs by gathering the necessary information and making it available to firms and workers.

B. Government Policy

The diversity of arrangements between workers and firms reflects the outcome of well functioning labor markets. This report proceeds from the assumption that a fundamental goal of government policy should be to maintain the efficiency of labor markets, which generally requires noninterference with diversity. Government intervention in labor markets is warranted only in those relatively narrow and well-defined instances in which imperfections in the markets result in inefficiencies or in which overriding social goals can be achieved, cost effectively, through such intervention. Section V of this chapter briefly discusses such government interventions.

III. NEUTRALITY IN TAX TREATMENT

A. Maintaining Labor Market Efficiency

Tax treatment that is neutral between employee and independent contractor status is necessary to maintain labor market efficiency. Tax treatment that is not neutral creates artificial incentives for workers to be classified as employees rather than independent contractors, or *vice versa*. Although particular firms and workers may gain by responding to such artificial incentives, the economy as a whole does not; aggregate labor market efficiency is reduced, as are aggregate worker real income and firm production.

Determining the efficiency effects of section 1706 on the market for technical services workers is difficult because the underlying efficiency of the market to which section 1706 applies is unknown, and because that market had already been affected by prior legislation by the time section 1706 was enacted.[35] Thus, the previous efficiency of the market could not be taken for granted.

Determining the efficiency effect of section 1706 is also complicated by the fact that section 1706 is limited to situations involving a third-party broker. The limitation creates a separate category of workers for employment tax purposes; depending on the effect of prior legislation, the limitation could cause a non-neutrality in the market.

Section 1706 may also have indirectly affected worker classification. Publicity surrounding section 1706 made workers and firms aware of the common law tests and the correct interpretation of section 530. Workers and firms that had incorrectly believed that section 530 required certain workers to be classified as independent contractors learned that it did not. At the same time, by removing the relief in section 530 from employer penalties for misclassifying technical services workers as independent contractors, section 1706 increased the risk to some employers of misclassification.

It is reasonably certain that section 1706 reduced efficiency in some cases and increased it in others. There is not enough information, however, to reach any conclusions about the overall effect of section 1706 on labor market efficiency.

The TAMRA conferees requested an evaluation of the extent to which Section 1706 has had a chilling effect on the ability of technical services personnel to get work. Assuming that, prior to the enactment of section 1706, the compensation level of technical services workers did not depend on their worker classification (although the compensation mix may have varied), section 1706 should not have affected the total demand for technical services workers. As long as the total compensation of independent contractors and employees is the same (although perhaps paid in different forms), there is no reason to expect the total demand for technical services workers to decline.

Although section 1706 probably did not reduce the overall demand for technical services workers, it may have resulted in some workers being unable to find work with their accustomed form of compensation and working conditions. Removing the safe harbor provision of section

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[35] The prior legislation includes income and employment tax and labor law, section 530 restrictions on issuing guidance about classification under employment laws, and section 3509 reductions in employer costs for misclassification. Each of these pieces of legislation may have reduced or increased the underlying market efficiency.

530 for technical services workers focused employers' attention on the need to classify workers correctly. Some independent contractors may have been able to continue their current work only as employees. If the classification change required the workers to accept a package of fringe benefits in lieu of some amount of cash compensation, the value to them of their entire compensation package may have changed. They would have been better off to the extent that they considered the fringe benefit package and its accompanying tax-preferred benefits more valuable than the loss in cash income. For example, workers who would previously have preferred to be classified as employees, but were not because of resistance from service-recipients, would be better off. Conversely, workers who did not find the substituted fringe benefit package more valuable may have found the value of their income reduced. Similarly, workers who would not have preferred to be classified as employees include those with considerable trade or business expenses, whose opportunity to deduct these expenses would have become constrained, and those who tended to understate receipts or overstate deductions. In addition, workers whose classification was questionable and who were used to working through brokers may have found that work as independent contractors could no longer be secured through a broker; these workers may have been able to continue work as independent contractors by contacting service-recipients directly.

B. Tax Equity

Equitable tax treatment requires that taxpayers in equivalent situations, with the same incomes, be taxed equally. Thus, providing equivalent tax treatment to employees and independent contractors is required to insure tax equity between the two groups of workers. The examples presented in Chapter 2 can be used to illustrate potential inequities in the tax treatment of employees and independent contractors.[36] As the discussion in Chapter 2 concluded, section 1706 does not systematically favor either status.

Worker with Typical Mix of Fringe Benefits. Example 1, which is summarized in Table 2-2 in Chapter 2, shows the situation of an employee who receives total compensation of $1,000, consisting of wages and a typical mix of fringe benefits. The worker does not have any potentially deductible work-related expenses, such as union dues, home office expenses, or travel expenses. The independent contractor receives the entire $1,000 in cash, out of which Federal and State income taxes and the Social Security and Medicare taxes for self-employed workers

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[36] *See* Section III.C of Chapter 2 for a description of the approach taken in developing these examples.

are paid, health insurance is purchased, and contributions to a tax-favored "Keogh" retirement plan are made.

As shown in the bottom portion of Table 2-2, the money income of the self-employed worker, after paying taxes and purchasing medical and retirement benefits, is $22 or about five percent ($22/$475) lower than that of the employee. The $22 is the net of $34 of additional taxes less $12 saved by not purchasing unemployment insurance and workers' compensation. Thus, the self-employed worker' has $22 less money income despite not having the protection of either unemployment insurance or workers' compensation. As explained in Chapter 2, taxes are higher for the self-employed worker because that part of cash income which would have purchased employer-paid fringe benefits is subject to Social Security and Medicare taxes and some is also subject to income taxes. Thus, in Example 1, the differential treatment of certain fringe benefits for tax purposes, especially for Social Security and Medicare taxes, causes an inequitable distribution of taxes between employees and independent contractors.[37]

Noncompliance. The administrative rules governing the form and timing of tax payments and where income is reported on tax returns differ for employees and independent contractors, with stricter rules generally applying to employees (*see* Chapter 2 and Appendix A). Thus, independent contractors may have greater opportunity than employees to be less than fully compliant with tax laws. If the situation in Example 1 is maintained, except that the independent contractor understates net income from self-employment by five percent, the after-tax money income of the independent contractor and the employee would be equal. That situation is illustrated in Example 2 (Table 2-3). If the underreporting of net income were to exceed five percent, the independent contractor would have a higher after-tax money income than the employee.

Worker Expenses. Because worker expenses are treated more favorably for independent contractors than for employees, workers who have such expenses are not taxed equally. Example 3 (Table 2-4) illustrates the same situation as Example 1, except that the worker has work-related expenses equal to ten percent of gross compensation. This level of worker expenses is just sufficient to make the money income net of taxes and worker expenses of the independent contractor equal to that of the employee. At higher levels of worker expenses, the independent contractor would have a higher after-tax income.

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[37] Note, however that because the independent contractor's Social Security taxes are being paid on a higher level of income, his or her future Social Security benefits might also be slightly higher.

No Voluntary Fringe Benefits. In Example 4 (Table 2-5), the employer provides only those fringe benefits mandated by Federal or State law: Social Security and Medicare; unemployment insurance, and workers' compensation. Otherwise, the facts are the same as in Example 1. In Example 1, the net after-tax income of the independent contractor was $22, or about five percent, lower than that of the employee. In Example 4, with no voluntary fringe benefits, the results are reversed; the independent contractor's money income is $8, or 1 percent, greater than the income of the employee. The independent contractor's greater after-tax income is due to the cost of the employee's coverage under unemployment insurance and workers' compensation and the income tax treatment of the employer's payments for that coverage. Inequity does not arise directly from the difference in income stemming from the cost of unemployment insurance and workers' compensation. Although the independent contractor has a higher after-tax income because she does not make payments for such coverage, the independent contractor also is not eligible for the benefits from these programs. The inequity is due to the exclusion from the employee's taxable income of the employer payments for unemployment insurance and workers' compensation.

Summary. The examples indicate that the difference in after-tax income between employees and independent contractors would typically be quite small, if firms classify workers correctly. The differences may be significant, however, for certain sets of worker preferences. Thus, a worker who has substantial business expenses and no desire for employee benefits may have much higher after-tax income as an independent contractor. Conversely, a worker who has few business expenses and a strong desire for all the employee benefits that a firm offers may have much higher after-tax income as an employee.

While it is possible for one set of tax differentials to offset another exactly, as Examples 2 and 3 illustrate, such exact offsets are unlikely in practice. The typical situation is for the combined effects of the various differentials in tax treatment not to leave employees and independent contractors treated exactly equally, and, therefore, to create inequities.

Even in cases where differences in the after-tax income of the worker are small, the consequences of a retroactive IRS determination of misclassification may be significant for the firm. Because the firm did not provide employee benefits to the independent contractor, the cash compensation to the independent contractor generally had equalled the sum of the wage payment which would have been received by an employee and the amount the employer would have spent for employee benefits. With reclassification, the entire amount of cash compensation paid to the independent contractor is deemed to have been wages that the firm would have paid to the worker as an employee, and the employer's liability for Social Security and Medicare taxes and for the withholding of income taxes is larger than if the firm had treated the worker as an employee and divided the worker's compensation into taxable wages and non-taxable fringe benefits.

Classifying workers as employees nominally shifts much of the tax compliance burden to employers and permits tax collection through withholding, which is extremely efficient. Similarly, employers incur the direct compliance costs of supplying legally-required as well as voluntary, but somewhat regulated, fringe benefits. However, the extent to which such compliance burdens are shifted to employees through reduced levels of compensation is not known.

IV. ADMINISTRATIVE COSTS

Although compliance with tax laws is necessary, the administrative costs of compliance divert resources from other uses. A goal of tax policy is, therefore, to minimize tax compliance costs while achieving the desired level of efficiency and equity in the tax system. While the principles are clear, implementing them can be difficult. The inherent tradeoffs between low compliance costs, efficiency, and equity help explain some of the differentials in the tax treatment of employees and independent contractors.

For example, the Federal Social Security and Medicare system generally taxes employees on their stated salaries; it does not permit adjustments for various work-related expenses which employees may incur. As a result of this simplification, the income to which the Social Security and Medicare taxes are applied in the case of employees may be mismeasured: that is, it may differ from their economic incomes. The mismeasurement may be significant in a small percentage of cases, and both the tax liability and the effective tax rate may be higher than if employees were taxed, as independent contractors are, on their net income from employment. In this situation, the compliance burdens of employees are greatly reduced as a result of the simplification, but at the cost of a certain degree of equity.[38]

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[38] However, the benefits of excluding employer-paid fringe benefits from Social Security and Medicare income bases for employees but not completely for independent contractors may reduce or even outweigh the extra tax burden on employees from the failure to exclude employees' work-related expenses from the employee's Social Security, Medicare, and income tax bases. Moreover, workers' eventual disability or retirement benefits may be increased as the result of the differential in Social Security tax treatment, thus partially offsetting any potential equity loss.

Similarly, for income tax purposes, an employee cannot deduct any employment-related expenses unless she itemizes deductions on her income tax return and unless these expenses exceed two percent of income from all sources. Moreover, there are classes of expenses for which a deduction is further limited or effectively prohibited. In contrast, an independent contractor has much greater freedom to take such deductions for income (and Social Security and Medicare) tax purposes. There are, however, compliance costs to the independent contractor associated with this freedom. The costs include the burden of maintaining complete sets of records which might not otherwise have to be maintained, the burdens and expense of filing more complicated tax returns, and the costs of being excluded from using the highly efficient payment system provided by the withholding of taxes by, and payment through, an employer. In addition, the costs to the government of assuring compliance with tax laws through examination of a sample of workers' tax returns and matching information from various information documents against the information reported on workers' tax returns is usually higher for self-employed taxpayers.

V. NON-TAX POLICIES

Federal and State governments have a number of non-tax policy objectives which affect labor markets. Some of these may increase the efficiency of labor markets by reducing or removing imperfections, and others may achieve various politically-determined goals. While these policies may have important effects on workers' choices of arrangements with firms, because this report focuses on specific tax policies, these non-tax policies are merely listed here. The policies are: retirement security; access to health care; protection of workers (occupational health and safety); unemployment security; employment standards (minimum wage and hours); and nondiscrimination in employment practices.[39]

Much of the legislation implementing non-tax policies applies only to employees, not to independent contractors or other self-employed workers. The definition of an employee may vary under different legislation, however, so that, for example, a limited number of workers might be deemed independent contractors for tax purposes, while being deemed employees under wage and hours legislation. Such differences may be warranted by the differences in policies of the various legislation, but they do impose additional compliance costs on both firms and workers. Much of the additional cost stems from the confusion caused by seemingly inconsistent treatment, as Examples 2 and 3 illustrate.

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[39] Legislation implementing these policies is summarized in Chapter 2 and Appendix A.

CHAPTER 5: TAX COMPLIANCE ISSUES

I. OVERVIEW

The TAMRA conferees questioned whether there were abuses in the reporting of income by independent contractors (as compared to employees) that justified the adoption of section 1706. This question has been evaluated in terms of whether there was a significant revenue loss attributable to noncompliance that section 1706 could have been expected to reduce.[40] Whether this is true depends in part on (1) the extent of the misclassification of technical services workers covered by section 1706 and (2) the noncompliance rate of such misclassified employees relative to the rate that would be expected if they were properly classified. This chapter provides data relevant to these questions.[41]

II. RATE OF MISCLASSIFICATION

IRS studies suggest that misclassification of employees as independent contractors is significant.[42] Recent studies of this problem include the IRS' Strategic Initiative on Withholding Noncompliance (SVC-1).

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[40] The revenue effect also depends on the existence of other differences in the level of tax paid by employees and independent contractors, *e.g.*, the proportionately larger tax expenditures associated with employee fringe benefits. These differences are discussed in Chapter 2 and Appendix A to this report. They are not taken into account here, however, because their use is not considered abusive within the meaning of the TAMRA conferees.

[41] At the initial stage of this study, it was determined that existing IRS data would be used in addressing these questions, and that no new surveys would be undertaken to measure the compliance of technical services workers or the population of those who had been affected by section 1706.

[42] *See also* GAO, *Information Returns Can Be Used to Identify Employers Who Misclassify Workers* Appendix II, GGD-89-107 (1989). In that study, individuals receiving more than $10,000 in income reportable on Form 1099 from one payor were identified. A random sample of 408 of the payors was interviewed. The interviews indicated that 157 (138-176 at a 95 percent confidence level), or 38 percent, misclassified at least some of their employees as independent contractors.

The employer portion of SVC-1 examined employment tax and withholding compliance for tax year 1984 for a sample of 3,331 employers.[43] It includes an estimate of the percentage of employers that misclassified at least some of their employees as independent contractors.[44] Some of the results for different sectors are shown in Table 5-1. For purposes of the table, employees were considered misclassified if they were determined to be employees under the common law tests (regardless of whether section 530 applied), but had been treated as independent contractors by their employers. Employers were considered to have misclassified employees if they misclassified one or more of their employees, regardless of the total number they misclassified.

Table 5-1 does not provide definitive proof that misclassification is a bigger problem among employers subject to section 1706 than among other employers. The table indicates that misclassification rates among employers in the service sector were not much higher than among employers in other sectors in the sample population.[45] It is difficult to estimate the percentage of misclassified employees in each sector reliably because the SVC-1 survey was designed to determine the frequency of employ*ers* that misclassify, rather than the frequency of misclassified employ*ees*. It appears, however, that the percentage of service sector employees who were misclassified was higher than in other sectors in the sample population, suggesting that employers in the service sector that had misclassified employees tended to misclassify a larger

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[43] The employers were selected at random from employers with previous employment tax records (Form 940 or 941E) listed on the business master file (BMF) for 1984. Form 941 is the Employer's Quarterly Federal Tax Return. State and local governments and other employers that generally only withhold income taxes and do not pay FICA or FUTA taxes instead file Form 941E, Quarterly Return of Withheld Federal Income Tax. Thus, the employer sample does not include organizations with no employees or those that were legally required to file a Form 941 or 941E for 1984, but had no previous records on the BMF.

[44] The employer portion of SVC-1 also measured compliance with reporting requirements with respect to employment tax returns and W-4 submittals, and compliance of U.S. citizens claiming exemption from withholding on foreign-source income.

[45] Misclassification rates were not separately calculated for the section 1706 group because the SVC-1 sample contained very few workers in technical fields (only about 0.4 percent), and because the SVC-1 survey did not gather sufficient data to identify employers in these fields that were actually subject to section 1706.

Table 5-1

Percentage of Employers with Some Misclassified Employees, by Industry

Industry	Number of Employers in Sample	Number of Employers, Weighted to Represent Total Population	Number of Employers with Misclassified Employees, Weighted to Represent Total Population	Percentage of Employers in Total Population with Misclassified Employees
Agriculture	286	36,435	6,080	16.7%
Mining, Oil, Gas	260	16,819	3,324	19.8%
Mining, Other	276	7,624	1,228	16.1%
Construction, Heavy	288	13,247	1,571	11.9%
Construction, Other	205	249,409	50,446	20.2%
Manufacturing	261	235,593	37,154	15.8%
Transport, Air	272	2,662	529	19.9%
Transport, Other and Public Utilities	264	79,995	8,700	10.9%
Wholesale and Retail Trade	121	781,123	74,855	9.6%
Finance, Insurance and Real Estate	255	241,665	46,629	19.3%
Services	124	848,514	130,828	15.4%
Government	282	68,521	6,595	9.6%
Not Elsewhere Classified	437	2,569,958	324,550	12.6%
TOTAL	3,331	5,151,525	692,489	13.4%

Department of the Treasury

Source: Strategic Initiative on Withholding Noncompliance (SVC-1) Employer Survey.

percentage of their employees.[46] This may reflect the fact that the service sector contains a disproportionate number of smaller employers, and studies suggest that smaller employers misclassify a larger percentage of their employees. (It may also reflect somewhat greater difficulty in applying the common law tests of employee status in the service sector.)

For several reasons, no strong conclusions can be drawn from the SVC-1 data regarding current misclassification patterns among employers subject to section 1706. First, there have been significant changes in the tax laws and IRS enforcement activity since 1984, which may have affected employers' abilities and incentives to misclassify workers.[47] Second, the SVC-1 survey covered a relatively small sample of employers and has a relatively high sampling error for small populations. Third, the population from which the sample was drawn included mainly service-recipients that reported having at least some employees, and did not include service-recipients that treated all of their workers as independent contractors.

Finally, misclassification rates for employers subject to section 1706 could not be specifically determined from the data. The service sector misclassification rate may be indicative of the rate for employers subject to section 1706, since service brokers would tend to be classified in the service sector. The service-recipients may be in any industry, however, including manufacturing or government. There may be reason to believe that, regardless of the sector to which they are allocated, the relatively independent nature of the work done by employees covered by section 1706, and the frequently temporary nature of the employment relationship, may create a misleading appearance of independent contractor status under the common law tests. In addition, the particular importance of computers in this area, and the greater ease with which independent contractors can deduct their legitimate computer-related expenses, may create an incentive to misclassify such employees as independent contractors.

III. RATE OF NONCOMPLIANCE

Misclassification can cause compliance problems if misclassified employees have a greater tendency to underpay their taxes, whether due to underreporting of income, overstate-

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[46] Service firms in the SVC-1 sample accounted for about 19 percent of reclassified workers but only ten percent of W-2 forms. In contrast, the percentage of employers in the service sector that had at least one misclassified employee was only slightly higher than for all employers in the survey (Table 5-1).

[47] *See generally* Appendix A.

ment of deductions, nonpayment of reported liabilities, or other factors. In fact, IRS studies consistently find lower compliance rates for non-wage compensation income than for wage income.[48] Recent studies include the 1985 Tax Compliance Measurement Program (TCMP) and the employee portion of the 1984 SVC-1 survey. The 1985 TCMP is more comprehensive, but is less useful for the specific purposes of this report than the 1984 SVC-1 survey because the former covers all workers rather than just misclassified employees--the only group actually affected by section 1706.

A. 1985 TCMP

The 1985 TCMP measured wages, Schedule C gross profit, and other categories of income and deduction reported by a randomly-selected sample of 50,000 individual taxpayers, compared them to the correct amounts (determined after an examinations of the taxpayers' returns), and expressed the ratios as voluntary reporting percentages (VRP).[49] Data from the survey were then used to estimate the values for the entire population of taxpayers from which the sample was selected. The results are shown in Table 5-2. For purposes of this table, the sample data have been divided between employees and independent contractors,[50] and between technical services workers and other workers.[51]

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[48] In addition to the IRS and GAO studies cited above, these include IRS studies of (1) 1975 and 1976 information returns (covering filers receiving commissions or fees); (2) 1979 Forms 1099-NEC (covering filers receiving nonemployee compensation); and (3) 1977 delinquent Forms 1099-MISC (follow-up study covering U.S. residents required to file Form 1040).

[49] *See generally* Fratanduono & Bucci, *Trends in the Voluntary Compliance of Taxpayers Who File Individual Income Tax Returns*, in Department of the Treasury, Internal Revenue Service, 1989 Update, *Trend Analyses and Related Statistics*, Document 6011 (1989).

[50] For this purpose, employees are defined as individuals with over $10,000 in wage income (as examined), *and* more wages than Schedule C income, while independent contractors are defined as those with over $10,000 in Schedule C income (as examined), more Schedule C income than wage income, *and* less than $5,000 in wage payments. Using this definition, approximately three percent of the taxpayers in the entire weighted TCMP sample were independent contractors, 55 percent were employees, and 41 percent did not fall into either category. For technical services workers, two percent of the sample were independent contractors, 92 percent were employees, and six percent did not fall into either category.

[51] See Appendix C for a definition of technical services worker used for this purpose.

Table 5-2

Reporting of Income and Expenses by Employees and Independent Contractors

	Technical Services Workers			Other Workers		
	As Reported ($billions)	As Examined ($billions)	Voluntary Reporting Percentage	As Reported ($billions)	As Examined ($billions)	Voluntary Reporting Percentage
Employees						
Wages, Salaries and Tips	171.1	171.1	100.0%	1521.9	1534.1	99.2%
Schedule C Gross Receipts	3.0	3.1	95.2%	37.9	39.2	96.5%
Schedule C Gross Profit	2.2	2.4	94.3%	23.9	25.4	94.1%
Schedule C Total Deductions	1.9	1.6	117.3%	22.1	18.9	116.9%
Schedule C Net Profit	0.4	0.9	50.6%	3.0	7.8	38.7%
Adjusted Gross Income	170.9	173.0	98.8%	1,566.9	1,592.0	98.4%
Total Taxable Income	178.6	180.4	99.0%	1,638.4	1,660.0	98.7%
Independent Contractors						
Wages, Salaries and Tips	1.1	1.1	100.4%	17.2	16.9	101.0%
Schedule C Gross Receipts	4.4	4.5	97.0%	190.2	202.0	94.2%
Schedule C Gross Profit	3.8	4.0	95.9%	113.4	124.9	90.8%
Schedule C Total Deductions	2.0	1.8	113.4%	72.1	65.5	110.0%
Schedule C Net Profit	2.1	2.5	83.4%	47.3	65.6	72.1%
Adjusted Gross Income	3.1	3.7	83.9%	74.0	95.0	77.3%
Total Taxable Income	3.4	4.0	85.1%	79.1	100.2	79.0%

Department of the Treasury

Source: Taxpayer Compliance Measurement Program (TCMP) for Tax Year 1985.

Table 5-2 shows that the VRPs for the Schedule C income (and total taxable income) of the independent contractors included in the 1985 TCMP were generally worse than the comparable VRPs for the wages (and total taxable income) of employees, but that both measures were generally better for technical services workers than for other workers. It also shows that underreporting of income was not the only reason for the independent contractors' low VRPs: in particular, the low VRPs for their net Schedule C income also resulted from the overstatement of the cost of goods sold and/or operations (resulting in underreporting of Schedule C gross profit), and the overstatement of other Schedule C deductions (resulting in underreporting of Schedule C net profit). The overstatement of Schedule C deductions contributes about two-thirds of the total understatement of net profit shown for technical services independent contractors. Some of the reported overstatement of deductions may have been attributable to inadequate record-keeping.

For independent contractors, the actual reporting of Schedule C income may have been slightly better than indicated. Table 5-2 shows that wages and salaries tend to be slightly overreported by independent contractors, whereas Schedule C gross receipts tend to be slightly underreported. Some of the wage and salary overreporting may be due to Schedule C income being reported incorrectly as wage or salary income, however, which may lead to failure to collect any Social security or Medicare tax on that income. Thus, actual Schedule C VRPs may be somewhat higher than shown on Table 5-2. Also, it may be particularly hard for IRS examiners to detect wage and salary underreporting when the underreporting is due to collusion between employers and employees. Thus, actual wage and salary VRPs may not be as high as reported as shown on Table 5-2.

General conclusions drawn from the TCMP data with respect to workers actually covered by section 1706 are subject to several reservations. First, it was impossible to calculate separate VRPs for such workers, so a broader group of technical services workers was used a proxy.[52] The compliance patterns in the two groups may have been different. Second, there have been significant changes in the tax laws and IRS enforcement activity since 1985 that may have affected individuals' incentive and ability to underreport their income or overstate their deductions. Specifically, the tightening of the requirements for certain business deductions in TRA 1986 may have reduced the extent to which itemized deductions and Schedule C deductions

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[52] See Appendix C for a description of the occupations included in this group.

are overstated.[53] Third, the population from which the sample was drawn includes only individuals for whom a return was filed, and thus the data do not measure compliance in the so-called "underground" economy. Fourth, as indicated above, it was not possible to distinguish misclassified workers from other workers in the TCMP sample. Therefore, the data relates to the relative compliance of independent contractors generally, rather than the narrower group of misclassified employees actually affected by section 1706. Finally, the VRPs are not adjusted to reflect TCMP audit sustension rates and, therefore, may not indicate the actual revenue potential from legislative or administrative changes affecting compliance.

B. 1984 SVC-1 Employee Survey

As explained above, the SVC-1 survey examined employment tax and withholding compliance for a sample of businesses for tax year 1984. The employer portion of the survey identified employees who were misclassified (by their employers) as independent contractors. A follow-up survey of 3,260 misclassified employees was also conducted to determine their level of individual reporting compliance. Data covering the 2,406 employees for whom a Form 1099 had been filed were then weighted to represent values for the entire population of misclassified employees.[54] Misclassified technical services workers were found to have reported 92.6 percent of their misclassified compensation. For other workers, the VRP was 77 percent of misclassified compensation. Other data from the employee portion of the SVC-1 survey suggest that information reporting may also play a substantial role in subsequent compliance by misclassified employees.[55]

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[53] *See, e.g.*, the discussion of the two-percent floor on itemized deductions and sections 280A and 280F in Appendix A.

[54] Forms 1099 had been filed for 37 of the 43 technical services workers and 2,369 of the 3,217 other workers in the misclassified employee sample. The sub-sample used to generate the estimates in the table was limited to employees for whom a Form 1099 had been filed because these are the only employees covered by section 530, and the issue for resolution is whether section 530 protection for misclassified workers has permitted significant compliance problems to develop.

[55] The survey found that information returns were filed for 84 percent of misclassified employees in the sample whose payments exceeded $600. While 77.2 percent of the misclassified compensation for which a Form 1099 was filed was reported, only 28.8 percent of the misclassified compensation for which no Form 1099 was filed was reported. This contrasts with the results of a 1977 study, in which misclassification was *not* an issue, which

The data from the employee portion of the SVC-1 generally suffer from the same problems as the TCMP data described above. In addition, the small number of technical services workers covered by the survey means that any differences found between them and other workers have a high sampling error. The TCMP data also indicate that Schedule C reporting of both income and deductions for workers whose primary source of income is Schedule C income is superior to that of workers who have only occasional Schedule C income. This is true for both technical services workers and other workers. There is no way to determine from the data whether there are differences in Schedule C reporting for correctly classified independent contractors and those who are incorrectly classified. Furthermore, workers covered by section 1706 may have more than one job during a year, and may be misclassified in one job but not another. Thus, correct classification may not result in correct reporting of the entire Schedule C amount.

C. Summary

The 1985 TCMP and the 1984 SVC-1 misclassified employee survey suggest that there is more underreporting of income by independent contractors than by employees. They do not, however, support assertions that technical services workers are less compliant than other workers. Taken together, the 1985 TCMP and 1984 SVC-1 data suggest that the reporting of non-wage income by workers covered by section 1706 is at least as good as, and perhaps superior to, reporting by other misclassified workers, but not as good as the reporting of wage and salary income. The 1985 TCMP also indicates that overstatement of deductions is responsible for much of the understatement of net profit for independent contractors in technical services (and independent contractors in general).

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found that 83.2 percent of the compensation for which no Form 1099 MISC was filed was reported.

CHAPTER 6: TAX ADMINISTRATION ISSUES

I. OVERVIEW

The TAMRA conferees questioned whether there were problems with the administration of section 1706 itself, or with the common law tests that employers subject to section 1706 must generally use in classifying workers as employees or independent contractors. This chapter addresses these issues and concludes that both the scope of section 1706 and the common law tests could be further clarified.

II. ADMINISTRATIVE PROBLEMS WITH SECTION 1706

Compared to section 530, section 1706 raises few administrative or interpretive issues. Those that have arisen concern primarily its effect (including its relationship to the common law tests for determining employee status) and its scope (including the occupations covered under it).

Many taxpayers were initially confused about the effect of section 1706, believing that it *required* that the individuals covered by the provision be treated as employees. Apparently, some service-recipients reacted by treating all their technical services workers as employees, even though that was sometimes contrary to the results under the common law tests. This misconception probably sprang from some imprecise language in the legislative history of the provision[56] and an IRS publication issued soon after enactment,[57] plus the common misconception that section 530 had previously *required* that these individuals be treated as independent contractors regardless of whether there was a basis for doing so. This misconception has been largely corrected through a combination of industry education and IRS guidance, which

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[56] *See* footnote 31 above.

[57] In January, 1987, the IRS published a revised Publication 15 (Circular E) which discussed section 530 and Stated that "[i]f you have any reason for treating a worker other than as an employee you will not be liable for employment taxes on payments to the worker. This relief is not available, however, for any arrangement you may have for services provided to you by certain technical personnel, such as engineers, computer programmers, and systems analysts." In *Resource Technical Consultants (U.S.A.), Inc. v. Baker*, 88-1 U.S.T.C. ¶ 9111 at 83,033 (S.D.N.Y. 1987), the district court found that "the Circular makes no misstatements and is at worst confusing."

explained that technical services workers would "be classified as independent contractors or employees under generally applicable common law standards."[58]

Many taxpayers are still confused about the scope of section 1706, in particular about the occupations it covers. The provision mentions "engineers, designers, drafters, computer programmers, systems analysts and other similarly skilled workers engaged in a similar line of work." These terms are not defined in the legislative history, however, and are not well defined in other sources.[59] Nor do they correspond well to industry usage or to the occupational categories used by the IRS for Schedule C purposes. The phrase "similarly skilled workers engaged in a similar line of work" is particularly vague, since it is not clear how much similarity is required. For example, are scientists included if they are engaged in engineering-type activities, such as oil exploration, or are they excluded because they do not have similar skills to engineers? Are architects included because they often perform drafting, or was the term "drafting" meant to be read more narrowly for purposes of section 1706? These problems have made it difficult in some cases for employers to identify covered workers and for the IRS systematically to target such workers for enforcement or even to gather sufficient data on their levels of compliance.

III. ADMINISTRATIVE PROBLEMS WITH COMMON LAW TESTS OF EMPLOYEE STATUS

As explained in Chapter 2, whether an individual is an employee for Federal tax purposes is generally determined under the common law tests for determining whether an employment relationship exists. As explained in Chapter 3, section 530 allows employers to rely on their own erroneous classification under some circumstances. Section 1706 denies this relief to certain employers in the technical services field, and thus requires these employers to apply the common law tests in all cases. In a sense, section 1706 restores pre-section 530 law for these employers.

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[58] Notice 87-19, 1987-1 C.B. 455; News Release IR-87-8 (January 21, 1987); News Release IR-87-68 (May 21, 1987). This guidance also clarified that section 1706 applies only to brokers or job-shops, and does not apply to service-recipients generally.

[59] *See, e.g.*, U.S. Department of Labor, Employment & Training Administration, *Dictionary of Occupational Titles* (4th ed. 1977 & Supp. 1986).

The common law tests, like most facts-and-circumstances tests, lack precision and predictability. Since they were developed in an entirely different context from Federal tax law (primarily the law of employer liability for employee torts), they may also produce inappropriate results for some tax purposes. As then-Assistant Secretary (Tax Policy) John Chapoton stated in 1982, "[i]n many cases, applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers[,] and reasonable persons may differ as to the correct classification."[60]

Although the subjectivity of the common law tests is no doubt one problem,[61] a bigger problem may be the large number of factors with which taxpayers and the IRS must contend, and the consequent difficulty in determining the relative weight of any one factor.[62] Thus, an important feature of many proposed legislative solutions has been to limit the number of factors to be taken into account.[63]

The common law tests may be particularly difficult to apply in the multi-party contract situations, which are the only situations covered by section 1706. This is because the service-broker and the service-recipient often share control over the service-provider's performance of

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[60] Hearings Before the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, 97th Cong., 2d Sess. (April 26, 1982). *See also* Hearings Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations, 101st Cong., 1st Sess. (May 16, 1989) (acting Commissioner of Internal Revenue stating that "[o]ne of the most difficult and controversial issues in the employment tax area is the definition of 'employee' under the so-called 'common law rules' . . . . IRS' preference has been and continues to be for a legislative solution.").

[61] *See, e.g.*, GAO, *Information Returns Can Be Used to Identify Employers Who Misclassify Workers* 3, GGD-89-107 (1989).

[62] In an August 5, 1987 letter to Lawrence B. Gibbs, Commissioner of Internal Revenue, Frank S. Swain, the U.S. Small Business Administration Chief Counsel for Advocacy, requested that the IRS clarify which factors are important, and which are not important, in determining employee status in the technical services area.

[63] *See, e.g.*, the proposals described in Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 97th Cong., 2d Sess. (June 11, 1982) (joint Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), and Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

services, as well as sharing other incidents of employment.[64] In some cases, both may legitimately be considered the individual's employer. While the parties may request a determination letter from the IRS, this may be too difficult and time-consuming to be practical.[65] Moreover, even if the service-recipient is considered the individual's sole employer, the broker may have sufficient control over payments made to the individual to be treated as her "imputed employer" and be subject to a withholding requirement.[66] Finally, even if the broker is considered the sole employer, the client may be treated as the employer for certain employee fringe benefit purposes under the leased employee rules.[67]

Problems with the common law tests have been exacerbated by the fact that labor markets have undergone significant changes--including the proliferation of multi-party arrangements--since the enactment of section 530 in 1978, during which period section 530 has virtually prevented the IRS from issuing any general guidance reflecting its interpretation of the common law tests. This has made it very difficult for taxpayers and IRS personnel alike to analyze employment relationships consistently, and has greatly reduced employers' ability to predict when the common law tests require a particular worker to be treated as an employee or independent contractor. The enactment of section 1706 has permitted the IRS to issue guidance[68] in some very narrow circumstances, only, and significant gaps therefore remain.

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[64] The situation becomes even more complicated when the individual operates through a corporation. *See* Appendix A for a discussion of the relevance of incorporation in this context.

[65] For a third-party broker with dozens of independent contractors at many different clients, the number of determination letter requests (Form SS-8) to be completed--even if a sampling is used--can be very large if the firm wants to cover all typical factual settings. Moreover, client projects often last only weeks or months, making it difficult to obtain a ruling before the independent contractor changes job settings.

[66] Code § 3401(d)(1); Treas. Reg. § 31.3401(d)-1(f). *See Otte v. United States*, 419 U.S. 43 (1974).

[67] *See* Code § 414(n). Section 1706 does not affect the application of section 414(n). Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1345 (Comm. Print 1987).

[68] *See, e.g.*, Rev. Rul. 87-41, 1987-1 C.B. 296.

PART FOUR

APPENDICES

APPENDIX A

DIFFERENCES IN TREATMENT OF EMPLOYEES AND INDEPENDENT CONTRACTORS--DETAILED ANALYSIS

I. OVERVIEW

Employees and employers face significantly different treatment from independent contractors and their clients under a wide range of laws, including Federal and State employment tax, income tax and labor laws. Differences that significantly favor one group over the other may encourage deliberate misclassification of an individual as an employee or independent contractor. This appendix describes the major differences in treatment between employees and employers on the one hand and independent contractors and their clients on the other, and the factors used to distinguish between them. It also compares the relative advantages of both types of treatment and attempts to determine whether current law creates unnecessary incentives for misclassification. It concludes that current law does not consistently favor one classification over the other.

II. FEDERAL TAX LAW

A. Employment Taxes

Social Security and Medicare. Wages paid to employees are generally subject to Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA). Compensation paid to independent contractors, by contrast, is generally subject to Social Security and Medicare taxes under the Self-Employment Contributions Act (SECA).[69]

Since 1990, the combined tax rates on employees and their employers on the one hand and independent contractors and their clients on the other have been virtually identical under both FICA and SECA.[70] Prior to 1983, the tax rates on independent contractors were

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[69] *See* Code Subtitle A, Chapter 2, and Subtitle C, Chapter 21.

[70] The combined Social Security and Medicare tax rate for 1991 is the same (15.3 percent) under both. Code §§ 1401, 3101 and 3111. Under both, only the first $53,400 of compensation is subject to Social Security tax, while the first $125,000 is subject to Medicare tax. Code §§ 1402(k) and 3121(x), as added by the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), Pub. L. No. 101-508, 104 Stat. 1388 (1990); Notice, 55 Fed. Reg. 45856 (October 31,

significantly lower, even though they were generally eligible for the same Social Security and Medicare benefits as employees.[71] In 1982 testimony, Treasury recommended that the rate differential be reduced to "help neutralize the decision whether to hire an independent contractor or an employee, and relieve pressure on the question of employment status."[72] 1983 legislation mostly eliminated the rate differential effective in 1984, and made other conforming changes that became fully effective in 1990.[73]

Some differences still remain, however. In some cases they can be significant. While the gross tax base is generally the same under FICA and SECA,[74] items that reduce FICA wages generally do not reduce compensation subject to SECA tax unless they are deductible on Schedule C for income tax purposes. In particular, contributions to a qualified pension plan or an accident and health plan generally are not includible in employee FICA wages, but are subject to SECA tax.[75] Contributions to certain nonqualified plans may also receive more favorable

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1990). While, technically, the employer pays half of the FICA taxes imposed on an employee's wages, the economic effect is the same as if the employee paid the entire amount. Special deductions are also provided to self-employed individuals subject to SECA, which produce nearly the same effect as the fact that employees are not subject to income or FICA taxes on the employer's share of FICA. Code §§ 164(f) and 1402(a)(12).

[71] In 1980, for example, the combined FICA tax rate (employer and employee) was 12.26 percent, while the combined SECA tax rate was 8.1 percent.

[72] Hearings Before the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, 97th Cong., 2d Sess. (April 26, 1982) (Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy)).

[73] Social Security Amendments of 1983, Pub. L. No. 98-21, § 124, 97 Stat. 65, 89 (1983). *See also* H.R. Conf. Rep. No. 47, 98th Cong., 1st Sess. 125-26 (1983).

[74] *Commissioner v. Braddock*, 95 T.C. No. 45 (1990).

[75] *Compare* Code §§ 1402(a) and 3121(a)(5); *see* Code § 62(a)(6). Health and accident plan contributions are included in SECA compensation even though they are partially deductible for income tax purposes. *See* Code §§ 162(l)(4). The treatment of pension plan contributions may be explained by viewing contributions by self-employed persons as essentially elective. Employee elective contributions are includible in FICA wages. Code § 3121(v)(1). This explanation does not apply to accident and health plan contributions, however, since these may be excluded from FICA wages even when provided under an elective arrangement. Code § 3121(a)(5)(G).

treatment under FICA.[76] These advantages are to a limited extent offset, however, by the fact that trade or business expenses may be deducted from compensation before SECA compensation is calculated, but cannot be so deducted for FICA purposes, and that excess FICA taxes may be imposed on the employer when an employee changes jobs in mid-year.[77] Finally, unlike employees, independent contractors who are eligible for Social Security benefits can sometimes avoid application of the Social Security earnings test through the use of deferred compensation.[78]

Unemployment Insurance. The first $7,000 of wages paid to an employee is generally subject to tax under the Federal Unemployment Tax Act (FUTA).[79] Under the integrated Federal/State system, part of the tax is ordinarily paid to the State of employment, while part is paid to the Federal government; the combined rate averaged approximately 2.8 percent in

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[76] There is no analogue to section 3121(v)(2) in SECA. OBRA 1990 deleted an analogous rule for corporate directors in section 1402(a) for tax purposes; however, a similar rule still exists for purposes of the Social Security earnings test. *See* Social Security Act § 211(a), 42 U.S.C. § 411(a).

[77] This results from the fact that, in computing FICA taxes on a new employee's wages, an employer generally may not take into account the fact that the employee has already earned wages in excess of the taxable wage base. Treas. Reg. § 31.3121(a)(1)-1(a)(3). If this results in an overpayment, the employee may be entitled to a refund, but *not* the employer. Code § 6413(b); Treas. Reg. § 31.6413(c)-1; Rev. Rul. 55-584, 1955-2 C.B. 394. SECA taxes are also considered income taxes, which are collected through the estimated tax system. Thus, while FICA taxes are generally collected and deposited with the Federal government every pay period, SECA taxes are generally paid quarterly. *Compare* Treas. Reg. §§ 1.1401-1(a) and 31.6302(c)-1. Similarly, SECA taxes may be contested in the Tax Court, while FICA taxes may not.

[78] Under the Social Security earnings test, benefits through age 69 are reduced by a fraction of the payee's other earnings in excess of an exemption amount. Social Security Act § 203, 42 U.S.C. § 403. In the case of an independent contractor, deferred compensation is generally taken into account for this purpose when it is received, whereas, in the case of an employee, deferred compensation is generally taken into account when earned. *Compare* Social Security Act §§ 209 and 211, 42 U.S.C. §§ 409 and 411 (as noted above, an exception is provided for deferred directors' fees). Therefore, some independent contractors defer receipt of compensation that would otherwise reduce their Social Security benefits until after age 70.

[79] *See generally* Code Subtitle C, Chapter 23.

1990. The Federal portion of the tax is paid quarterly. Independent contractors are not subject to FUTA tax, but likewise generally are not eligible to receive any unemployment benefits.[80]

B. Income Taxes

Collection Mechanisms. Income taxes on employees are collected mainly through the withholding system, whereas income taxes on independent contractors are collected mainly through the estimated tax system. Both systems are backed up by information reporting requirements imposed on service-recipients.

Employers are generally required to withhold a portion of their employees' wages as they are paid and remit it to the Federal government as payment of the employees' income taxes.[81] Withholding rates are specified in tables and procedures published by the IRS, and are calculated to collect approximately the same amount of tax as the employees will ultimately owe with respect to the wages if they work all year at the same wage level.[82] Withholding must generally be done at the same rate each pay period,[83] and the amounts withheld must generally be deposited, along with FICA taxes, soon thereafter in a Federal depositary.[84] Withholding can generate significant overhead expenses.[85] Independent contractors and their clients

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[80] Eligibility is a matter of State rather than Federal law. *See* footnotes 140 and 143 below for a discussion of State eligibility standards.

[81] *See generally* Code § 31 and Subtitle C, Chapter 24.

[82] *See generally* Code § 3402; IRS Publication 15 (Circular E), *Employer's Tax Guide* (Rev. January, 1991). Withholding rates are generally based on the employee's rate of compensation, marital status, and the number of allowances claimed on Form W-4. Withholding rates may be increased if an employee anticipates receiving additional income during a taxable year that is not subject to withholding, or reduced if large deductions are anticipated.

[83] *But see, e.g.*, Announcement 85-113, 1985-31 I.R.B. 31 (special accounting rule for fringe benefits); *cf.* Code § 3501(b).

[84] The actual schedule depends on the size of the payroll. *See* Treas. Reg. § 31.6302(c)-1.

[85] Some argue that the government is the main beneficiary of withholding, in that it enables tax authorities to shift a large portion of the collection burden to the private sector. On the other hand, it is not clear that withholding is any more burdensome on employers than increased estimated tax payments (which would be necessary without withholding) would be on employees. Withholding may also provide benefits to some employers because they have the use of withheld funds for a short period of time before they must remit them to the government. Moreover,

generally are not subject to a withholding requirement with respect to their compensation income.

Unless certain exceptions apply, both employees and independent contractors must pay their estimated income tax liabilities for the current year in quarterly installments throughout the year.[86] The installments are due on April 15, June 15, September 15, and January 15 of the following year. The amount of each installment is generally one quarter of the lesser of the taxpayer's income tax liability for the prior year, or 90 percent of her liability for the current year. Because of withholding, however, employees generally do not have to make any estimated tax payments. This is because withholding generally requires earlier payments than would be necessary under the estimated tax system, and these amounts are credited towards employees' estimated tax obligations.[87] Thus, employees are generally only required to make estimated tax payments if they have significant non-wage income.

Employers generally must report all wages paid to an employee annually on Forms W-2.[88] Similarly, clients must generally report all compensation paid to independent contractors annually on Form 1099-MISC; no Form 1099-MISC is generally required, however, for payments to a corporation, payments that are not made by a business (*e.g.*, homeowners' payments to a house painter), or payments to a service-provider aggregate less than $600 in a calendar year.[89] The administrative burden is about the same for each.

Copies of Form W-2 must be sent to the employee and to the Social Security Administration.[90] The Social Security Administration subsequently sends information from the forms to the IRS. Also, the employee is required to attach any copies she receives to her income tax return. Using this information, the IRS can determine whether wages have been

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employers may be able to shift some of their administrative costs of withholding to the worker in the form of lower compensation.

[86] *See generally* Code §§ 6315 and 6654.

[87] Code § 6654(g).

[88] Code § 6041A; Treas. Reg. §§ 1.6041-1(a) and 1.6041-2.

[89] Code § 6041; Treas. Reg. §§ 1.6041-1 and 1.6041-3.

[90] Code § 6051; Treas. Reg. §§ 31.6051-1 and 31.6051-2.

underreported. While 1099s must be sent to the independent contractor and the IRS, there is no requirement that they be attached to an individual's return.

Trade or Business Expense Deductions. Under current law, independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees. In particular, employees (but not independent contractors) generally may not deduct their trade or business expenses unless they itemize their deductions on their Federal income tax returns, and even then only to the extent they exceed two percent of their adjusted gross income from all sources. Also, they must satisfy additional requirements before they may deduct their automobile, home office and certain other expenses.

Independent contractors' trade or business expenses are generally deductible "above-the-line", *i.e.*, as a direct reduction in their business income reported on Schedule C. Employees' trade or business expenses, by contrast, are generally only deductible "below-the-line", *i.e.*, as itemized expenses.[91] Especially for lower-income employees, use of the standard deduction is often more favorable than itemization of expenses; such individuals effectively get no tax benefit from their trade or business expenses.[92] In addition, since 1986, employees' trade or business expenses have generally been deductible only to the extent they (plus any other miscellaneous itemized deductions) exceed two percent of the employee's adjusted gross income from all sources.[93]

The two-percent floor generally does not apply to an employee's trade or business expenses to the extent they are reimbursed by her employer: in such case, generally no deduction is necessary, because the reimbursement is not included in the employee's taxable income in the first place. Only reimbursement arrangements that require the employee to account to the employer for any expenditures are eligible for this treatment, however.[94] This

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[91] Code § 62(a).

[92] *See* Rev. Proc. 90-64, 1990-53 I.R.B. 27, for the standard deductions in effect for 1991.

[93] Code § 67. This requirement reversed the earlier trend to conform the treatment of employees and self-employed persons as much as possible.

[94] Code § 62(c); Treas. Reg. § 1.62-2; *cf.* Treas. Reg. § 1.132-5(a)(1)(v) (similar rules for working-condition fringe benefits). Somewhat different accounting rules apply depending on whether the expense is subject to the substantiation requirements of section 274(d), and whether the arrangement is a *per diem* or mileage plan. *See* Code § 62(c); Treas. Reg. §§ 1.62-2(e) and 1.274-5T(g) and (j).

prevents employees from excluding from income amounts greater than that which they could have deducted.[95] Client reimbursements are always included in an independent contractor's gross income, and the expenses for which they are made must be deducted. Inadequate accounting by the independent contractor to the client is therefore generally irrelevant in this context.[96]

Unlike independent contractors, employees may not deduct interest expenses incurred in their trade or business of being an employee: such interest is considered a personal expense.[97]

Entertainment expenses generally may not be deducted unless they satisfy the business purpose requirements of section 274(a). The rules applicable to employees and their employers on the one hand and independent contractors and their clients on the other are about the same for this purpose.[98] Special exemptions are provided, however, for food or beverages furnished on an employer's business premises primarily for its own employees, and for recreational or

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[95] Excess reimbursements must be returned to the employer. If the accounting requirements are not met, the employee may still be able to deduct the underlying expenses. They will, however, be subject to the two-percent floor. In addition, failure to account will shift the burden of complying with various requirements of section 274, including the business purpose requirement of section 274(a), the substantiation requirement of section 274(d), and the 80-percent deduction limit of section 274(n), from the employer to the employee. Code § 274(e)(2), (e)(3)(A) and (n)(2)(A); Treas. Reg. §§ 1.274-2(f)(iv), 1.274-5T(f)(2) and 31.3401(a)-4.

[96] As with employees, however, if an independent contractor does not adequately account to her client, the burden of complying with various requirements of section 274 will shift from the client to her. Code § 274(e)(3)(B) and (e)(9); Treas. Reg. § 1.274-2(f)(2)(iv); *see* Treas. Reg. § 1.274-5T(h)(3) for the definition of an adequate accounting for this purpose; *see also* Treas. Reg. § 1.274-2(f)(2)(iv)(a) and (c)(1) (definitions of adequate accounting and reimbursement arrangement). The substantiation requirements of section 274(d) are an exception; an independent contractor continues to be subject to these requirements even if she makes an adequate accounting to her client. *See* Treas. Reg. § 1.274-5T(h)(2); Rev. Proc. 63-4, Q&A-28 and 29, 1963-1 C.B. 474; *Smith v. Commissioner*, 80 T.C. 1165 (1983). This distinction presumably reflects the fact that, while employees generally need not deduct reimbursed expenses because the reimbursements are simply excluded from their gross income, independent contractors must generally deduct the amounts.

[97] Code § 163(h)(2)(A).

[98] *See* footnotes 95 and 96 above for rules relating to the allocation of the burden of substantiation in the case of reimbursed expenses.

social activities primarily for their benefit.[99] Independent contractors may, however, benefit from both as long as they are not provided primarily for the contractors' benefit.

Travel and entertainment expenses, business gifts, and expenses associated with "listed property" (including automobiles, computers, cellular telephones and property used for entertainment) also may not be deducted unless the taxpayer has adequate records or other evidence to substantiate their amount and business purpose, within the meaning of section 274(d).[100] Again, the rules applicable to employees and their employers on the one hand and independent contractors and their clients on the other are about the same. Employers may use certain simplified substantiation methods that are unavailable to clients of independent contractors, however. In particular, they may rely on records maintained by their employees with respect to the use of listed property, and they can avoid any substantiation requirements with respect to the use of vehicles by adopting a policy statement prohibiting personal use and meeting certain other requirements.[101] Presumably, these methods are denied to clients of independent contractors because clients generally do not provide them with the property necessary to perform their jobs, and, in any event, cannot supervise their use of the property very closely.

Finally, business meal expenses generally may not be deducted unless the taxpayer or one of its employees is present. Independent contractors may be treated as employees for this purpose only if they render "significant services" to the taxpayer.[102]

Home office expenses and rental and depreciation expenses associated with listed property (as described above) may be subject to special deduction limits unless they meet certain business

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[99] Code § 274(e)(1) and (e)(4).

[100] *See* footnotes 95 and 96.

[101] Treas. Reg. §§ 1.274-5T(e)(2) and 1.274-6T. The latter rule applies to both employees and sole-proprietors. Treas. Reg. § 1.274-6T(e)(2)(i). The employer can also shift the burden of compliance to its employees by treating the use of listed property as personal use and including it in the employees' incomes without regard to the working condition fringe benefit rules of section 132.

[102] Code § 274(k); Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 69 (Comm. Print 1987).

use requirements.[103] These limits were significantly tightened in TRA 1986. The limits for employees and independent contractors are generally the same except that, in the case of home office expenses, the employee's business use must also be "for the convenience of the employer",[104] and, in the case of listed property such as home computers, such use must be "for the convenience of the employer and required as a condition of employment."[105] These standards are difficult for many employees to meet.[106]

Fringe Benefits. Independent contractors are generally not taken into account under the employee fringe benefit provisions of the Code. On the one hand, this means that independent contractors' clients generally are not required to include them in any pension or welfare benefit plans they provide for their employees in order to maintain the plans' tax-qualified status, and the independent contractors have correspondingly greater freedom to structure their own benefit arrangements. On the other hand, this means that independent contractors may be unable to participate in such plans even if they want to (and their clients agree), and some of the benefit arrangements they establish for themselves as sole proprietors or partners may not be tax-favored. (Such arrangements may also be more costly, since they usually cannot benefit from the economies that some employers able to achieve through group purchase arrangements.)

The Code provides tax-favored treatment for a wide range of common employee fringe benefits, including pension plans, life insurance and health and accident plans. In many cases, such treatment is not available for benefits provided to highly compensated workers unless the employer also provides comparable benefits to a minimum number of its nonhighly compensated workers. Generally, only an employer's common law employees (and individuals treated as such

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[103] *See generally* Code §§ 280A and 280F. Generally, in the case of a home office, the space must be used exclusively on a regular basis as the taxpayer's principal place of business. In the case of listed property, the property must be used predominantly (*i.e.*, more than 50 percent of the time) in the taxpayer's trade or business.

[104] *See* Code § 280A(c)(1).

[105] *See* § 280F(d)(3)(A); Treas. Reg. § 1.280F-6T(a)(2).

[106] *See, e.g.*, Rev. Rul. 86-129, 1986-2 C.B. 48. On the other hand, the Tax Court's "focal point" test has made it difficult for independent contractors to establish their home office as their principal place of business if they render services elsewhere. *E.g.*, *Baie v. Commissioner*, 74 T.C. 105 (1980); *but see Soliman v. Commissioner*, 94 T.C. 20 (1990) (apparent abandonment of "focal point" test).

under the Code)[107] are taken into account for this purpose. In addition, these same provisions generally prohibit an employer from offering tax-favored benefits to its independent contractors. A list of tax-favored benefits, and the conditions under which they may be offered to employees and independent contractors, are shown in Table A-1.[108] (The table does not include statutorily-required benefits such as workers' compensation.)

Taken together, these rules tend to encourage employers to admit a new worker into an existing fringe benefit plan if she is classified as an employee, and to discourage (if not actually prohibit) them from doing so if she is classified as an independent contractor. Classification as an independent contractor may, therefore, be beneficial to the client; in cases where the worker would prefer additional cash or a different benefit package to the fringe benefits offered under the employer's plan and can negotiate to receive some or all of the compensation the client would otherwise have spent on the benefits, classification as an independent contractor may also be beneficial to the worker.

An independent contractor who is unable to participate in her client's plans generally can establish her own benefit arrangements in her capacity as a sole proprietor (or as a partner, if she is in business with other individuals).[109] As indicated in Table A-1, the most significant types of fringe benefits may be available on a tax-favored basis. For example, sole proprietors can generally establish their own pension plans, subject to essentially the same rules as

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[107] These include leased employees subject to section 414(n) and so-called "statutory employees" treated under sections 3121(d) and 7701(a)(20) as employees for purposes of FICA and certain employee benefit provisions of the Code. *Cf.* Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1345 (Comm. Print 1987) (section 1706 not to affect application of section 414(n)). Note that, in some cases employees may also be deemed to be self-employed. *See, e.g.*, Code § 1372 (certain S corporation shareholders treated as partners).

[108] Provisions that merely specify the accounting treatment of benefits provided to employees, and do not grant tax-favored treatment, generally also apply to independent contractors. *E.g.*, Code §§ 83, 280G and 457; Treas. Reg. §§ 1.83-1(a)(1) and 1.457-2(d); Prop. Treas. Reg. § 1.280G-1, Q&A-15.

[109] Sole proprietors and partners are proprietors of unincorporated businesses. The treatment of proprietors of incorporated businesses is discussed in section II.C. below.

Table A-1

Tax-Favored Benefits Available to Employees and Independent Contractors

Benefits	Availability: To Employee in Employer's Plan	To Independent Contractor in Client's Plan	To Independent Contractor in Own Plan
Employee achievement awards[a]	May be required		
Group-term life insurance[b]	May be required		
Death benefits[c]	Generally optional		
Accident and health insurance[d]	Generally optional		Limited deduction only
Tuition remission[e]	May be required		
Meals and lodging[f]	Optional		
Group legal services[g]	May be required		Optional
Cafeteria plans[h]	May be required		
Educational assistance[i]	May be required		Optional
Dependent care[j]	May be required		Optional
No-additional-cost fringes[k]	May be required		Optional
Qualified employee discounts[l]	May be required		Optional
Working condition fringes[m]	Optional	Optional	Optional
De minimis fringes[n]	Generally optional	Optional	Optional
Free parking[o]	Optional		Optional
On-premises athletic facilities[p]	Optional		Optional
New-product testing[q]	Optional		Optional
Qualified pensions and annuities[r]	May be required		Optional
Tax-sheltered annuities[s]	May be required		
Qualified and incentive stock options[t]	Optional		
Employee stock purchase plans[u]	May be required		
Voluntary employees' beneficiary associations[v]	May be required		

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In this table, "optional" means that the benefit is not required to be provided under any minimum coverage or nondiscrimination rules, while "may be required" means that it may have to be provided.

Notes

a. Code §§ 74(c) and 274(j)(3)(B).

b. Code § 79(d); Treas. Reg. § 1.79-0(b).

c. Code § 101(b)(3)(A); Treas Reg. § 1.101-2(f)(1). Discrimination rules may apply if the benefits are provided under a qualified pension plan, however.

d. Code §§ 105(g), 106, and 162(1)(1); Treas. Reg. § 1.105-1(a). Coverage and discrimination requirements may apply if the plan is self-funded. Code § 105(h).

e. Code § 117(d)(2)(A).

f. Code § 119.

g. Code § 120(c)(1), (c)(2) and (d)(1).

h. Code § 125(b)(1) and (d)(1)(A); Prop. Treas. Reg. § 1.125-1, Q&A-4.

i. Code § 127(b)(2) and (c)(2); Treas. Reg. § 1.127-2(h)(1)(iii).

j. Code § 129(d)(2), (d)(3), (d)(8) and (e)(3).

k. Code § 132(b), (f) and (h)(1); Treas. Reg. § 1.132-1(b)(1) and (3).

l. Code § 132(c), (f) and (h)(1); Treas. Reg. § 1.132-1(b)(1) and (3).

m. Code § 132(d); Treas. Reg. § 1.132-1(b)(2) and (4).

n. Code § 132(e); Treas. Reg. § 1.132-1(b)(2) and (4). Certain nondiscrimination rules apply to eating facilities, however.

o. Code § 132(h)(4); Treas. Reg. § 1.132-(b)(2) (flush language).

p. Code § 132(h)(5); Treas. Reg. § 1.132-1(b)(1) and (3).

q. Treas. Reg. §§ 1.132-1(b)(2) (flush language) and 1.132-5(n).

r. Code §§ 401(a)(4), 401(c) and 410(b); Treas. Reg. §§ 1.72-17(a) and 1.401-10(b).

s. Code § 403(b); Treas. Reg. § 1.403(b)-1(a)(1).

t. Code §§ 421-22A; Treas. Reg. § 1.421-7(h).

u. Code § 423; Treas. Reg. § 1.423-2(e)(2).

v. Code § 501(c)(9); Treas. Reg. § 1.501(c)(9)-2(b).

employer-sponsored plans.[110] In lieu of the exclusion from income for employer-provided accident and health insurance, they can often deduct up to one-quarter of their medical insurance expenses, without regard to the 7.5 percent floor in section 213 (unless they are covered under an employer-sponsored plan directly or through their spouse).[111] They can also provide themselves certain fringe benefits, including working condition and *de minimis* fringes, on a pre-tax basis. Other benefits must generally be purchased out of after-tax income. In addition, as explained in Section II above, the tax benefits for sole proprietor and partnership plans are generally limited to the income tax provisions of the Code, and do not apply for Social Security and Medicare tax purposes.

C. Determination of Employee Status

The status of an individual as an employee or independent contractor for purposes of the Federal tax laws is, with few exceptions, determined under the common law tests for determining whether a master-servant (employment) relationship exists.

Background. The common law tests first assumed importance under the employment tax provisions of the Code. The original Social Security Act simply defined an "employee" as including "an officer of a corporation".[112] Treasury regulations issued in 1936 used common law standards to determine employee status.[113] The lower courts, however, applied a variety of different standards, some relying less than others on common law precedents.[114] In 1947

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[110] In a sense these rules are more favorable: plans of sole proprietors who have no nonhighly compensated employees resemble elective arrangements like IRAs and section 401(k) plans, but are subject to higher dollar limits on contributions.

[111] Code § 162(l)(6), as amended by OBRA 1990 § 11410. This provision is due to expire December 31, 1991, however.

[112] Social Security Act § 1101(a)(6), Pub. L. No. 74-271, 49 Stat. 620, 647 (1935). FICA was in Title VIII of the original act. SECA was enacted on August 28, 1950.

[113] Reg. 91, article 3, 1 Fed. Reg. 2049, 2052 (Nov. 11, 1936). The regulations state, *inter alia*, that "[i]n general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor. An individual performing services as an independent contractor is not as to such services an employee." This closely resembles the language in the current regulations.

[114] *See United States v. Webb*, 397 U.S. 179 (1969), for a description of this case law.

the Supreme Court issued a pair of opinions that attempted to clarify the governing standards.[115] In them, the Court applied an "economic reality" test that resembled the common law tests, under which "employees are those who as a matter of economic reality are dependent on the business to which they render services."[116]

The IRS (and the Social Security Administration) proposed amendments to their regulations to incorporate the Court's new economic reality test, but these never took effect: Congress reacted immediately by passing (over President Truman's veto) the so-called Gearhart Resolution, endorsing the use of common law tests.[117]

Current Rules. Current Treasury regulations provide that an individual is generally an employee if, under the usual common law tests, the relationship between the individual and the person for whom she performs services is the legal relationship of employer and employee. Such a relationship generally exists if the person for whom the services are performed

> has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but [also] how it shall be done.[118]

Over the years, the IRS has identified 20 important factors for determining when the common law tests are satisfied.[119] These factors, which are listed in Appendix B, are used in resolving issues raised in rulings and other guidance, including guidance on the status of technical services

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[115] *Bartles v. Birmingham*, 332 U.S. 126 (1947), and *United States v. Silk*, 331 U.S. 704 (1947). *See also Harrison v. Greyvan Lines*, 331 U.S. 126 (1947).

[116] *Bartles*, 332 U.S. at 130.

[117] H.R.J. Res. 296, Pub. L. No. 642, 62 Stat. 438 (1948).

[118] Treas. Reg. §§ 31.3121(d)-1(a)(2), 31.3306(i)-1(b) and 31.3401(c)-1(b).

[119] Internal Revenue Manual 4600 (Employment Tax Procedures), Exhibit 4640-1; *see also* Rev. Rul. 87-41, 1987-1 C.B. 296. These factors were originally compiled by the Social Security Administration in determining entitlement to benefits.

workers issued after the enactment of section 1706.[120] No one factor on this list is determinative, though some are more important than others.

Congress and the courts have overridden the common law tests in some situations. For example, certain occupations generally performed by employees are nevertheless treated as performed by independent contractors under the Code; these include certain door-to-door salesmen and real estate agents.[121] Conversely, certain occupations generally performed by independent contractors are nevertheless treated as performed by employees for employment tax purposes. These "statutory employees" include certain full-time life insurance salesmen, agent-drivers and commission-drivers engaged in the distribution of specific kinds of products, homeworkers and traveling or city salesmen.[122]

Relevance of Incorporation. An employee generally cannot change her status for Federal tax purposes to that of an independent contractor via incorporation. The common law tests focus on the relationship between the individual performing the services and the service-recipient; if an employment relationship exists, it is generally irrelevant whether payments are made directly or through a corporation controlled by the individual.[123] The legislative history of section 1706 reiterates this point.[124]

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[120] *See* Rev. Rul. 87-41, 1987-1 C.B. 296. *See also* Moore, *Defining the Employee: Common-Law Rules*, Direction, February, 1988, at 13. Mr. Moore is the technical assistant for Federal employment tax in the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) of the IRS. *See generally* Annotation, *Determination of Employer-Employee Relationship for Social Security Contribution and Unemployment Tax Purposes*, 37 A.L.R. Fed. 95 (1978), and Annotation, *What Constitutes Employer-Employee Relationship for Purposes of Federal Income Tax Withholding*, 51 A.L.R. Fed. 59 (1981).

[121] *See* Code § 3508; *see also* Code § 1372.

[122] *See* Code § 3121(d); Treas. Reg. § 31.3121(d)-1(d); Rev. Rul. 90-93, 1990-45 I.R.B. 4. Full-time life insurance salesmen may also be treated as employees for certain fringe benefit purposes. Code § 7701(a)(20).

[123] *E.g.*, *Sargent v. Commissioner*, 93 T.C. 572 (1989); Rev. Rul. 87-41, 1987-1 C.B. 296; and Rev. Rul. 74-330, 1974-2 C.B. 278 (examples (1) and (2)).

[124] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-835 (1986); 132 Cong. Rec. S8088-89 (June 20, 1986); *see* Rev. Rul. 87-41, 1987-1 C.B. 296; and Private Letter Ruling 9002017 (October 12, 1989).

An independent contractor also generally cannot change her status for Federal tax purposes to that of an employee *of her client* via incorporation; she may, however, be treated as an employee of her own personal service corporation for certain purposes, and derive certain tax benefits as a result. The effect depends on whether the personal service corporation elects to be taxed as a Subchapter S corporation under section 1362 of the Code. If it does not, the individual will generally be treated as an employee of the corporation for tax purposes, and can thus take advantage, *inter alia*, of various employee benefit provisions of the Code. She will, moreover, not be subject to the two-percent floor on itemized deductions or other limits on employee trade or business expense deductions to the extent she causes such expenses to be deducted at the corporate level. Although any income received and retained by the corporation will be taxed at (usually higher) corporate rates, in practice this problem can be minimized by distributing as much income as possible in the form of compensation.

If the personal service corporation *does* elect to be taxed as an S corporation, the individual will also generally be treated as an employee of the corporation for tax purposes,[125] but with one important exception: assuming her ownership interest exceeds two percent, she will not be treated as a employee for purposes of the employee benefit provisions of the Code.[126] The treatment of trade or business expenses is roughly the same as for a C corporation.[127]

III. OTHER LAWS

A. Federal Labor Laws

Most Federal labor laws apply only to employees and do not protect independent contractors. This is generally beneficial to the independent contractors' clients, who may save the direct costs of providing additional benefits to the individuals plus any associated administrative costs, but may not be beneficial to the independent contractors unless they do not need the protection and can share in their clients' cost savings.

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[125] *See Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990).

[126] Code § 1372.

[127] Code § 67(c); Temp. Treas. Reg. § 1.67-2T(b).

COBRA. Employers must generally give their employees and the employees' beneficiaries the right to continue coverage under an employer-sponsored health plan after their coverage has ceased, if coverage ceases on account of certain qualifying events.[128] This requirement applies to employees and independent contractors (provided the plan covers at least some common law employees).[129]

ERISA. Pension and welfare benefit plans are subject to various coverage, funding, fiduciary, reporting, and other requirements under the Employee Retirement Income Security Act of 1974.[130] These labor provisions of ERISA do not apply to plans benefiting self-employed individuals (including independent contractors) unless they also cover employees, and many of the specific protections provided under ERISA extend only to employee-participants.[131] The tax provisions of ERISA are included in the Code.

Other Labor Laws. Independent contractors are generally not covered by the National Labor Relations Act, and therefore generally may not engage in collective bargaining or similar protected activities.[132] They also receive no protection under the nondiscrimination requirements of the Age Discrimination in Employment Act[133] or Title VII of the Civil Rights Act

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[128] Code § 4980B, as added by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Pub. L. No. 99-272, Title X, 100 Stat. 222 (1986), and amended by TAMRA § 3011.

[129] Code § 4980B(f)(7); Prop. Treas. Reg. § 1.162-26, Q&A-16(b).

[130] Pub. L. No. 93-406, 88 Stat. 829 (1974), *codified at* 29 U.S.C. §§ 1001 *et seq.*

[131] ERISA §§ 3(3) and (6), 4(a) and 4021(a), 29 U.S.C. §§ 1002(3) and (6), 1003(a) and 1321(a); 29 C.F.R. § 2510.3-3.

[132] NLRA § 7, 29 U.S.C. § 157. *See North American Van Lines, Inc. v. NLRB*, 869 F.2d 596 (2d Cir. 1989).

[133] ADEA §§ 4(a) and (11), 29 U.S.C. §§ 623(a) and 630(f). *See Hyland v. New Haven Radiology Assocs., P.C.*, 794 F.2d 793 (2d Cir. 1986).

of 1964,[134] the safety requirements of the Occupational Safety and Health Act,[135] or the minimum wage and overtime requirements of the Fair Labor Standards Act,[136] among others.

B. Patent and Copyright Laws

An employer is generally considered the author of any work prepared during the course of an employee's employment for purposes of the Federal copyright laws; no such presumption exists with respect to work prepared by independent contractors.[137] By contrast, generally no legal distinction is drawn between employees and independent contractors under the Federal patent laws.[138] In practice, however, independent contractors may find it somewhat easier to secure patent protection for on-the-job creations than employees, since this issue often turns on a court's analysis of the implicit bargain struck between the parties.[139]

C. State Laws

Many State laws also impose different requirements on employers and employees on the one hand and independent contractors and their clients on the other. In particular, employers are generally required to contribute a portion of the wages paid to each of their employees to

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[134] Civil Rights Act (1964) § 701(f), 42 U.S.C. §§ 2000e(f). *See Wheeler v. Hurdman*, 825 F.2d 257 (10th Cir.), *cert. denied*, 484 U.S. 986 (1987).

[135] OSHA §§ 3(6) and 5(a)(1), 29 U.S.C. §§ 652(6) and 654(a)(1).

[136] FLSA §§ 3(e)(1), 6 and 7, 29 U.S.C. §§ 203(e)(1), 206 and 207. *See Walling v. Portland Terminal Co.*, 330 U.S. 148 (1947). Recent legislation has created an exemption from FLSA for technical services workers who are employees. Pub. L. No. 101-583, 104 Stat. 2781 (1990).

[137] Copyright Act §§ 101 and 201(b), 17 U.S.C. §§ 101 and 201(b) (work-for-hire). *See, e.g., CCNV v. Reid*, 104 L.Ed.2d 831 (1989); and *Aldon Accessories Ltd. v. Speigel, Inc.*, 738 F.2d 548, 552 (2d Cir.), *cert. denied*, 469 U.S. 982 (1984).

[138] *See, e.g., Francklyn v. Guilford Packing Co.*, 695 F.2d 1158, 1160-61 (9th Cir. 1983); and *B.F. Gladding & Co. v. Scientific Anglers, Inc.*, 248 F.2d 483 (6th Cir. 1957).

[139] This is especially true of the so-called "shop right" doctrine, under which an employer or client may claim royalty-free use of an invention. *See, e.g., Hobbs v. United States*, 376 F.2d 488, 495 (5th Cir. 1967), and *Crom v. Cement Gun Co.*, 46 F. Supp. 403, 404 (D. Del. 1942).

State workers' compensation and unemployment funds.[140] Clients of independent contractors generally are not required to do so, and, as a consequence, independent contractors generally are not eligible for benefits under these systems. Employee wages may also be protected under State wage payment laws, while payments to independent contractors are not.[141] As with Federal labor laws, this exclusion is generally beneficial to the clients of independent contractors, but may not be beneficial to the independent contractors themselves unless they do not need the protection and can share in their clients' cost savings.

D. Determination of Employee Status

The status of an individual as an employee or independent contractor for purposes of Federal and State labor and other laws is generally determined under standards that resemble the control-based common law standards applied under the Code.[142] Depending on the purpose of the law involved, however, different factors are often emphasized in making this determination.[143] Thus, IRS determinations of employee status are generally persuasive but not

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[140] *See, e.g.*, N.Y. Workmen's Compensation Law § 210 (McKinney 1965), and N.Y. Labor Law §§ 560 and 570 (McKinney 1988) (unemployment insurance). *See also* text accompanying footnote 80 above.

[141] *See, e.g.*, N.Y. Workmen's Compensation Law § 50 (McKinney 1965) (requirement that employer provide security for payment of wage compensation).

[142] *See generally* Annotation, *Trucker as Independent Contractor or Employee Under § 2(3) of the National Labor Relations Act (29 U.S.C.S. § 152(3))*, 55 A.L.R. Fed. 20 (1990); Annotation, *Determination of "Independent Contractor" and "Employee" Status for Purposes of § 3(e)(1) of the Fair Labor Standards Act (29 U.S.C.S. § 203(e)(1))*, 51 A.L.R. Fed. 702 (1990); Annotation, *Who is "Employee" Within the Meaning of Age Discrimination in Employment Act (29 U.S.C.S. §§ 621-634)*, 69 A.L.R. Fed. 700 (1990); Annotation, *Who is "Employee" as Defined in § 701(f) of the Civil Rights Act of 1964, 42 U.S.C.S. § 2000e(f)*, 72 A.L.R. Fed. 522 (1990); and Annotation, *Right to unemployment compensation or social security of one working on his own projects or activities*, 65 A.L.R.2d 1182 (1990).

[143] Federal law: *see, e.g., Darden v. Nationwide Mutual Ins. Co.*, 796 F.2d 701 (4th Cir. 1986) (ERISA); *Weisel v. Singapore Joint Venture, Inc.*, 602 F.2d 1185 (5th Cir. 1979); *Dunlop v. Dr. Pepper-Pepsi Cola Bottling Co.*, 529 F.2d 298 (6th Cir. 1976) (NLRA); *Brennan v. Gilles & Cotting, Inc.*, 504 F.2d 1255 (4th Cir. 1974) (OSHA); *Spirides v. Reinhardt*, 613 F.2d 826 (D.C. Cir. 1979) (Title VII); and *EEOC v. Zippo Mfg. Co.*, 713 F.2d 32 (3d Cir. 1983) (ADEA).

State law: *see, e.g., Taylor v. Employment Division*, 597 P.2d 780 (Or. 1978); *Starinieri, v. Unemployment Compensation Board of Review*, 289 A.2d 726 (Pa. 1972); and determinative, and, in some cases, a worker can simultaneously be an employee for some purposes and an independent contractor for others.

IV. SUMMARY

Current law does not consistently favor employee or independent contractor status. Independent contractors and their clients are treated somewhat more favorably with respect to employment taxes, and significantly more favorably with respect to their trade or business expense deductions. On the other hand, employees and employers are treated more favorably with respect to the taxation of some fringe benefits. Similarly, clients of independent contractors do not bear as great a burden as employers under Federal and State labor laws, but independent contractors also do not enjoy the same benefits or protections under those laws as do employees.

Laeng v. Workmen's Compensation Appeals Board, 494 P.2d 1100 (Cal. 1972); *cf. Cumming v. District Unemployment Compensation Board*, 382 A.2d 1010 (D.C. 1977) (self-employed status does not *per se* disqualify claimant).

APPENDIX B

COMMON LAW FACTORS USED TO DETERMINE EMPLOYEE STATUS

Workers are generally considered employees for Federal tax purposes if they:

1. Must comply with employer's instructions about the work.
2. Receive training from or at the direction of the employer.
3. Provide services that are integrated into the business.
4. Provide services that must be rendered personally.
5. Hire, supervise, and pay assistants for the employer.
6. Have a continuing working relationship with the employer.
7. Must follow set hours of work.
8. Work full-time for an employer.
9. Do their work on the employer's premises.
10. Must do their work in a sequence set by the employer.
11. Must submit regular reports to the employer.
12. Receive payments of regular amounts at set intervals.
13. Receive payments for business and/or travelling expenses.
14. Rely on the employer to furnish tools and materials.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from their services.
17. Work for one employer at a time.
18. Do not offer their services to the general public.
19. Can be fired by the employer.
20. May quit work at any time without incurring liability.

Source: Exhibit 4640-1, Internal Revenue Manual 4600 (Employment Tax Procedures), and Rev. Rul. 87-41, 1987-1 C.B. 296.

APPENDIX C

ADDITIONAL BACKGROUND TO TCMP AND SVC-1

I. TCMP

The definition of "technical services worker" for purposes of Table 5-2 is based on the occupation of the primary taxpayer determined in the course of the TCMP audit. Unweighted frequencies for the occupations included in the analysis are as follows:

Frequency	Occupation
102	Architects
1,327	Engineers
27	Surveyors and Mapping Scientists
79	Computer Scientists
204	Operations and Systems Researchers and Analysts
8	Mathematical Scientists
182	Physical Scientists
27	Life Scientists
176	Engineering Technologists and Technicians
94	Drafting Occupations
11	Survey and Mapping Technicians
8	Biological Technologists and Technicians (Except Health)
39	Chemical and Nuclear Technologists and Technicians
4	Mathematical Technicians
47	Science Technologists and Technicians, Not Elsewhere Classified
12	Air Traffic Controllers
13	Radio and Related Operators
6	Legal Technicians
98	Programmers
4	Technical Writers
216	Technicians, Not Elsewhere Classified
2,684	Total

II. SVC-1

Unweighted frequencies for the "technical services" occupations included in the SVC-1 survey are as follows:

Frequency	Occupation
1	Architects
8	Engineers
4	Physical Scientists
10	Engineering Technologists and Technicians
5	Air and Ship Officers and Technicians
15	Technicians, *e.g.*, Embalmer/Morticians, Radio Operator, Computer Programmer
43	Total

The following occupations were included in the TCMP analysis, but did not appear in the SVC-1 sample of misclassified employees:

Computer Scientists and Specialists;
Operations and System Researchers and Analysts;
Mathematical Scientists including Mathematicians, Actuaries and Statisticians,
Life Scientists;
Science Technologists and Mathematical Technicians.

Department of the Treasury
Washington, D.C. 20220

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Study of the Effect of the Minimum Participation Requirements on Government Contractors

Department of the Treasury
March 1991

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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington D. C. 20510

Dear Mr. Chairman:

Section 6056 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury shall conduct a study on the application of section 401(a)(26) of the Internal Revenue Code of 1986 to Government contractors that are subject to Federal prevailing wage requirements.

Pursuant to that mandate, I hereby submit the "Study of the Effect of the Minimum Participation Requirements on Government Contractors."

I am sending a similar letter to Representative Dan Rostenkowski, Chairman of the Committee on Ways and Means.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1991

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Chairman
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Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

STUDY OF THE EFFECT OF THE MINIMUM PARTICIPATION REQUIREMENTS ON GOVERNMENT CONTRACTORS

I. INTRODUCTION

Under the minimum participation requirements of section 401(a)(26),[1] a qualified retirement plan must cover at least 50 employees or, if fewer, at least 40 percent of all employees of the employer. Under the Davis-Bacon Act and the McNamara-O'Hara Service Contract Act (as well as under other related Federal statutes), a government contractor is required to pay certain of its employees at least the wage that prevails in the locale where the employees perform their services for the contractor. The required prevailing wage may be determined in part by reference to a contribution to fund fringe benefits, including retirement benefits under a qualified plan.

As part of the Technical and Miscellaneous Revenue Act of 1988, the Congress directed the Department of the Treasury to study the effects on government contractors of the minimum participation requirements of section 401(a)(26). Specifically, the Treasury was directed to consider the employee benefit aspects of the Federal prevailing wage requirements, the need (if any) for special treatment of prevailing wage employees in applying the minimum participation requirements, and possible methods for modifying plans to satisfy the minimum participation requirements in the absence of such special treatment.

The specific issue to be considered is whether present law provides government contractors sufficient flexibility to satisfy both the Federal prevailing wage requirements and the minimum participation requirements of section 401(a)(26). In the past, it has been common for government contractors to maintain multiple plans, with at least one plan that covers office and supervisory staff and another plan that covers prevailing wage employees. In addition, several multiple employer plans exist that cover solely prevailing wage employees subject to the Davis-Bacon Act.

Some have raised the concern that certain government contractors may have difficulty satisfying section 401(a)(26) in the common situation where the contractor maintains a separate plan for office and supervisory staff, as described above. This separate plan may fail minimum participation if the office and supervisory staff plan does not cover 50 employees or 40 percent of the employer's workforce (including both office and supervisory staff and prevailing wage employees). It is this concern, in particular, that the Congress asked the Department of the Treasury to explore in its study.

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[1]Unless otherwise specified, all statutory references are to the Internal Revenue Code of 1986, as amended (the Code).

II. FEDERAL PREVAILING WAGE REQUIREMENTS

There are two Federal statutes that impose prevailing wage requirements on government contractors, the Davis-Bacon Act and the McNamara-O'Hara Service Contract Act of 1965.[2]

A. Davis-Bacon Act

The Davis-Bacon Act was enacted in 1931. It imposes certain standards with respect to any contract in excess of 2,000 dollars[3] that is entered into for the actual construction, alteration, or repair of a public building or a public work, and that is financed in whole or in part with Federal funds (whether directly, by guarantee, or otherwise).[4]

In general, the statute requires that prevailing wages be paid to laborers and mechanics under covered contracts. The Department of Labor (DOL) issues prevailing wage determinations by geographic locale and by class of laborer. The prevailing wage may include a basic wage rate and a fringe benefit amount.

The prevailing wage determinations set the minimum level of wages that must be paid by any bidder on a particular contract. Under the Davis-Bacon Act, the Congress sought to ensure wage protection and equity for local contractors, laborers, and mechanics involved in Federal construction activity. The intent is to protect local contractors from outside contractors that secure Federal contracts solely because their bids are based on wage levels lower than those prevailing in the locale where construction occurs. The Act is also intended to protect the wage standards of local craftsmen because government contractors might deny them work by recruiting labor from distant labor areas with lower wage standards.

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[2]Other Federal statutes may apply to government contractors as well. For example, the Fair Labor Standards Act (FLSA) generally applies to all government contractors. In addition, while not discussed in the text of this study, the Walsh-Healey Public Contracts Act (41 U.S.C. § 35 *et seq.*) sets basic labor standards for workers performing on contracts in excess of $10,000 for the manufacture and furnishing of goods to the Federal government. However, the Walsh-Healey Act requires only that the minimum wage generally required under the FLSA be met and does not require a prevailing wage or fringe benefit.

[3]The President's budget for fiscal year 1992 generally would raise the minimum threshold to 250,000 dollars. Executive Office of the President, Budget of the United States Government for Fiscal Year 1992, at II-319 (1991).

[4]*See* 40 U.S.C. § 276a *et seq.* (1989). While the statute itself applies to directly funded Federal projects, numerous other laws require contractors to comply with its provisions. *See* 29 C.F.R. § 5.1 (1990) for a list of some of these related statutes.

The definition of prevailing wage was amended in 1964 to include fringe benefit payments. Permissible fringe benefits include medical and hospital benefits, pensions on retirement or death, compensation for injuries or illness resulting from occupational activity, insurance to provide any of the foregoing, unemployment benefits, life insurance, disability and sickness insurance, accident and holiday pay, costs of apprenticeship and other similar programs, and any other bona fide fringe benefits.

Thus, a contractor may offset its prevailing wage obligation through the payment of certain fringe benefits, as long as such benefits are not otherwise required under Federal or state statute (*e.g.*, the employer share of the tax imposed under the Federal Insurance Contribution Act (FICA)).

The modified definition of prevailing wage was adopted in order to modernize the Act by recognizing that certain fringe benefits had become an integral part of the wages of employees.[5] The Congress determined that if fringe benefits were not considered, an unfair advantage would be conferred on those contractors that do not provide such benefits in locales where the benefits prevailed as a part of the compensation package.

1. Mechanics of prevailing wage determinations

As indicated above, the DOL has jurisdiction over matters pertaining to the Davis-Bacon Act and thus is responsible for determining a prevailing wage for each classification of laborer or mechanic in a particular locale. In addition, the amount of the prevailing wage will vary depending on the type of construction (*i.e.*, residential, building, highway, or heavy). Thus, for example, in area 1 of state X, the prevailing wage for a carpenter performing residential construction could be expressed as a \$15 basic hourly rate and a \$4 fringe benefit rate. The type of fringe benefit is not designated. Notwithstanding the separate components used by DOL in arriving at a total prevailing wage, the controlling figure is the total of \$19. While a contract will specify that prevailing wages will be paid, there is generally nothing in the contract, and nothing in the Act itself, that requires the \$4 to be paid in fringe benefits. Thus, a contractor would be permitted to pay the entire \$19 in cash wages.[6] Alternatively, the contractor could reduce the cash portion and increase the portion of the prevailing wage attributable to fringe benefits, provided that the contractor complies with the requirements of the statute with respect to such benefits.[7]

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[5] *See* 1964 U.S. Code Cong. & Admin. News 2339, 2340.

[6] Regardless of what the contractor decides to pay in fringe benefits and cash wages, overtime pay generally is calculated based upon the DOL-specified cash portion of the prevailing wage.

[7] The provision of the prevailing wage in the form of fringe benefits that are excluded from the definition of "wages" for employment tax purposes may have the effect of reducing the

2. Requirements applicable to fringe benefit contributions

The DOL requires that certain standards be met for a contractor to be able to claim credit against the prevailing wage for employer contributions made on behalf of an employee to a fringe benefit plan. No prior approval from DOL is required for fringe benefit plans that provide "bona fide" benefits and that are funded under a trust or insurance program. Except as specified below, these requirements apply to all fringe benefit plans and not just qualified retirement plans.[8]

a. Conformance with ERISA

In order to be a bona fide plan, the plan must meet all applicable requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

b. Permissible eligibility rules

A plan is bona fide notwithstanding the fact that it contains eligibility rules that exclude certain employees (*e.g.*, restrictions relating to age, length of service, or union membership). However, no credit is given with respect to contributions on behalf of a laborer or mechanic unless the contractor makes payments or incurs costs with respect to such employee. Similarly, if a plan requires a participant to be employed on the allocation date under the plan in order to be entitled to a benefit, no credit is given unless the laborer or mechanic is employed on such date.

c. Timing of contributions

A contractor must contribute on a regular basis to a plan in order for the plan to be bona fide. The DOL requires that contributions be made no less frequently than quarterly.

The DOL allows a profit-sharing plan to be a bona fide fringe benefit plan notwithstanding the fact that the amount of the contribution to such plan is based solely on the

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employer's employment tax liabilities with respect to prevailing wage employees. The Department of the Treasury is aware that some government contractors have attempted to increase the portion of the prevailing wage provided in the form of such excludable fringe benefits in order to escape employment tax liabilities with respect to nonunion prevailing wage employees. Nothing in the above discussion is intended to imply that such practices are permissible.

[8]The regulations relating to fringe benefit plans under the statute are found at 29 C.F.R. § 5.2 *et seq.*

discretion of the employer. Such a plan is permitted if the contractor regularly and irrevocably contributes to an escrow account during the period of covered work. The amount contributed must be adequate to meet the anticipated rate of contributions to the plan at the end of the year. Upon the annual determination of profits or contributions, the funds in escrow may be transferred to the plan as an offset against the employer's obligation to contribute. However, such amounts may only be used to the extent they do not exceed the obligation related to that portion of the total hours worked by the employee during the year attributable to covered work. If excess amounts exist, they must be paid to the laborer in cash if they are to be credited against the prevailing wage.

d. Individual accounting

A contractor must meet its prevailing wage obligations with respect to each laborer and mechanic employed on the project. Therefore, the DOL requires the contractor separately to determine the amount contributed for each laborer and mechanic (*e.g.*, no averaging of contributions is allowed). The amount contributed must represent the actual rate of costs or contributions required to provide benefits for a particular laborer.

e. Annualization

Except with respect to certain defined contribution plans discussed below, the DOL allows credit for contributions to a plan based on the effective annual rate of contributions for all hours worked for the contractor during the year. For example, a contractor may not claim a $4-per-hour contribution to a pension plan unless that same $4 rate is paid for all hours worked during the year with respect to that employee (regardless of whether the work is covered under the statute). If the $4 is not paid on this basis, the creditable amount of the contribution rate is reduced. This requirement ensures that covered wages do not subsidize fringe benefits provided during periods when the employee is not performing covered work.

The following example illustrates this requirement. Assume a contractor's contribution with respect to a particular employee for a pension benefit is $4 per hour and is paid only for work covered under the Davis-Bacon Act. The employee works 400 hours for the contractor during the year. If the employee was employed for 100 hours on work covered under the statute, only $1 per hour may be credited.

An exception to the annualization requirement is provided for contributions to certain defined contribution plans. The DOL permits a contractor to take full credit at the specified hourly rate for contributions to defined contribution plans with certain vesting schedules. A plan meets this vesting requirement if it provides for the full vesting of a participant's benefit after an employee works 500 or fewer hours for the contributing employer. The rationale for this exception is that this type of plan will provide workers with a greater likelihood of vested benefits. Under a plan meeting these requirements, the DOL does not permit a contribution rate in excess of the maximum permitted under the Code.

f. Irrevocability of contributions

In order to offset the obligation to provide a prevailing wage, contributions to fringe benefit plans must be irrevocably contributed by the contractor. Thus, for example, amounts in escrow in excess of those necessary to fund a discretionary profit-sharing plan may not be returned to the employer.[9]

B. McNamara-O'Hara Service Contract Act

The McNamara-O'Hara Service Contract Act (the McNamara-O'Hara Act) was enacted in 1965 and imposes prevailing wage requirements with respect to any Federal contract in excess of $2,500, the principal purpose of which is to furnish services through the use of service employees.[10] The purpose of the Act is to prevent the Federal government's purchasing power from being used to unfairly depress wages and other standards of employment.[11]

1. Mechanics of prevailing wage determinations

Like the Davis-Bacon Act, the McNamara-O'Hara Act is administered by the DOL. The McNamara-O'Hara Act requires that affected contractors comply with DOL prevailing wage determinations when performing work on Federal service contracts. There are two types of prevailing wage determinations under the Act. The first is a prevailing wage determination based on wages paid to classes of service employees in a particular locale. These are determined by the DOL after due consideration of the rates applicable to such service employees if directly hired by the Federal government.

The second type of prevailing wage determination is the collective bargaining agreement or successorship determination. These determinations set forth the wage rates and fringe benefits, including accrued and prospective increases, contained in a collective bargaining agreement that applied to service employees who performed services on a predecessor contract in the same locale. Thus, contractors performing contracts subject to the McNamara-O'Hara Act generally are obliged to pay service employees wages and fringe benefits not less than those to which such employees would have been entitled under a collective bargaining agreement if they were employed on like work under a predecessor contract in the same locale.

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[9]Credit is not lost if a prevailing wage employee forfeits his or her benefit under a fringe benefit plan. However, the amount of the forfeiture must be used to fund future contributions for which the contractor is not permitted to take credit.

[10]*See* 41 U.S.C. § 350 *et seq.*

[11]*See* H.R. Rep. No. 948, 89th Cong., 1st Sess. 2-3 (1965); S. Rep. No. 798, 89th Cong., 1st Sess. 3-4 (1965).

A prevailing wage determination contains a cash amount and an amount representing the cost to the contractor with respect to a specific type of fringe benefit. Thus, the McNamara-O'Hara Act may require that an ambulance driver in a particular locale receive a wage of $10 an hour in cash and $2 an hour in health coverage. The types of fringe benefits permitted under the McNamara-O'Hara Act generally are the same as those permitted under the Davis-Bacon Act (*e.g.*, pension benefits). Similarly, the fringe benefit may not otherwise be required under Federal or state law.

The manner in which a contractor gains credit under the McNamara-O'Hara Act differs in one major respect from the Davis-Bacon Act in that the contractor is not permitted to substitute fringe benefit payments for the cash portion of the prevailing wage. That is, if the wage determination requires a $10 an hour cash wage and a $2 an hour contribution for health coverage, the contractor is not permitted to pay less than $10 in cash to the service employee. However, the contractor may pay the remaining $2 to the employee entirely in cash, entirely in fringe benefits, or in some combination of the two.

2. Requirements applicable to fringe benefit contributions

As under the Davis-Bacon Act, certain requirements must be met in order for the contractor to take credit against the required prevailing wage for contributions to a fringe benefit plan.[12] In general, the requirements are similar to those under the Davis-Bacon Act. Thus, the contribution generally must be irrevocably made to a bona fide fringe benefit plan, fund, or program. Such a plan must be in writing and must be communicated to employees. It must also contain a definite formula for determining the amount to be contributed by the contractor and a definite formula for determining the benefits of each covered employee.

In order to be a bona fide plan, a plan providing pension benefits must meet ERISA requirements and be qualified under the Code. Contributions to individual retirement accounts are permitted.

The eligibility rules generally are the same as the rules under the Davis-Bacon Act. Similarly, contributions must be made no less frequently than quarterly. In this regard, however, no specific rules relating to discretionary profit-sharing plans are set forth.

If during the contract period, a contractor employs an employee part of the time on service contract work and part of the time on other work, the contractor may only credit against the hourly amount required for the hours spent on the contract work, the corresponding proportionate part of a weekly, monthly, or other amount contributed by the contractor for such fringe benefits. For example, if an employee works on service contract work 30 hours per week and on other work 10 hours per week, and a pension contribution of $40 is made on a weekly

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[12] *See* 29 C.F.R. § 4.170 (1990) for an extensive discussion of these requirements.

basis for such employee, the creditable amount of the contribution would be the proportionate amount of such contribution (*i.e.*, \$30 out of the total \$40). No exceptions are specified to this rule.

III. MINIMUM PARTICIPATION REQUIREMENTS

The minimum participation requirements of section 401(a)(26) were enacted as part of the Tax Reform Act of 1986. Under these requirements, a retirement plan maintained by an employer is not entitled to tax-favored treatment unless the plan benefits at least 50 employees or, if fewer, 40 percent of all employees of the employer. Section 401(a)(26) generally is effective for plan years beginning after December 31, 1988.

Each qualified plan of an employer must separately satisfy section 401(a)(26). Thus, if an employer maintains two qualified plans, each plan must meet the minimum participation requirements without regard to those employees benefitting under the other plan. Assume, for example, that an employer with 100 employees maintains two plans, one covering 50 employees and the other covering 20 employees. The plan covering 20 employees does not meet the minimum participation requirements notwithstanding the fact that when considered together, the two plans cover more than 50 employees and, indeed, more than 40 percent of the employer's workforce.

The proposed regulations under section 401(a)(26) contain a definition of what constitutes a separate plan. Under this definition, a plan (or portion thereof) is treated as a separate plan if plan assets are segregated to benefit a particular employee or class of employees.[13] For example, if only a portion of the assets under a defined benefit plan is available on an ongoing basis to provide the benefits of certain employees and the remaining assets are only available in limited cases (but are available to provide benefits for another group of participants), there are two separate plans each of which must meet the minimum participation requirements.

In addition, section 401(a)(26)(I) grants the Secretary of the Treasury authority to treat each separate benefit structure under a plan as itself a separate plan for purposes of applying the minimum participation requirements. In the Conference Report to the Tax Reform Act of 1986, Congress explained, "Thus, for example, a plan that provides two different formulas for calculating participants' benefits or contributions may be treated as at least two plans."[14] Under such an approach, a plan that satisfied minimum participation as a whole nonetheless could fail to satisfy section 401(a)(26) if it included any separate benefit structure that covered fewer than 50 employees or 40 percent of the employer's workforce.

The potential application of the minimum participation requirements to separate benefit structures as envisioned in the statute and legislative history caused particular concern to government contractors. A plan covering office and supervisory staff in most cases provides for different contributions and benefits from those provided under a plan covering prevailing wage

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[13]Prop. Treas. Reg. § 1.401(a)(26)-2(c).

[14]H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-422 (1986).

employees. Thus, if either plan failed minimum participation, the contractor could not remedy this failure by merging the two plans, because each plan would continue to be a separate benefit structure that itself would have to satisfy minimum participation.

As currently proposed, the regulations under section 401(a)(26), however, decline to exercise the authority granted the Secretary under the statute to treat separate benefit structures as separate plans for purposes of applying the minimum participation requirements. The Department of the Treasury has determined that the potential abuses of separate benefit structures that concerned the Congress are adequately addressed in the Treasury's proposed regulations under section 401(a)(4) governing nondiscrimination in qualified retirement plans.[15]

Thus, under the proposed regulations, a plan does not cease to be treated as a single separate plan merely because it includes two or more separate benefit structures, for example, where the plan provides different rates of contribution to different employees under the plan. In addition, a defined contribution plan (*i.e.*, a plan that maintains a separate account for each participant) does not constitute separate plans merely because it includes more than one trust, provides for separate accounts, permits employees to direct the investment of amounts allocated to their accounts, or permits distributions in kind.[16] As a result, a defined contribution plan that is a money purchase pension plan may be tested as a single plan for purposes of the minimum participation requirements notwithstanding the fact that the employer varies its contribution rate by class of laborer (*e.g.*, carpenters versus bricklayers), and each laborer's benefit under the plan is maintained in a separate account.

If a plan benefits employees of more than one unrelated employer and those employees are not included in a unit of employees covered by one or more collective bargaining agreements, the plan is a multiple employer plan. A multiple employer plan is treated as separate plans, each of which is maintained by a separate unrelated employer. Each such plan must separately satisfy the minimum participation requirements by reference solely to that employer's employees.[17]

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[15]Although as originally proposed the regulations under section 401(a)(26) had previously accepted Congress's invitation to subject separate benefit structures to minimum participation requirements, these proposed regulations were withdrawn and reissued in substantially modified form in conjunction with Treasury's issuance of proposed regulations under section 401(a)(4). *See* 55 Fed. Reg. 19935 (May 14, 1990).

[16]Prop. Treas. Reg. § 1.401(a)(26)-2(c)(2).

[17]Prop. Treas. Reg. § 1.401(a)(26)-2(d)(4).

Certain plans are excepted from the application of the minimum participation requirements.[18] These plans include those not benefitting highly compensated employees and certain underfunded defined benefit plans. In addition, a plan generally is excepted from the minimum participation requirements if it is a multiemployer plan (*i.e.*, a plan covering union employees that is maintained by more than one employer pursuant to one or more collective bargaining agreements).

In general, all employees of the employer must be considered when determining whether a plan meets the minimum participation requirements. However, an employee may be excluded from consideration if the employee is described in one or more of the following categories: (1) employees who have not met the plan's minimum age or service requirements, (2) nonresident aliens with no United States source earned income, and (3) certain employees who are air pilots.[19]

In addition, in applying the minimum participation requirements to a collectively bargained plan (*i.e.*, a plan covering union employees that is not otherwise exempt by reason of being a multiemployer plan), employees not covered by the collective bargaining agreement may be disregarded at the employer's option.[20] Likewise at the employer's option, employees covered by a collective bargaining agreement are not taken into account in applying the minimum participation requirements to plans covering nonunion employees.[21] The effect of these provisions are illustrated by the following example. If an employer with 100 employees maintains two plans, one covering 20 employees and the other covering 50 employees, the 20-participant plan ordinarily does not satisfy the minimum participation requirements. However, if the 20-participant plan covers union employees and no more than 50 union employees are covered under the collective bargaining agreement, the plan will satisfy minimum participation if the employer elects to exclude nonunion employees from consideration. This result occurs because the 50 employees who are not covered under the collective bargaining agreement may be disregarded in determining whether that plan satisfies minimum participation (*i.e.*, 20 is 40 percent of the 50 remaining employees who are covered under the collective bargaining agreement).

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[18]Prop. Treas. Reg. § 1.401(a)(26)-1(b).

[19]Prop. Treas. Reg. § 1.401(a)(26)-6(b)(1) to (3). In addition, under certain conditions an employer may exclude from consideration employees who have not satisfied the highest minimum age and service conditions permitted under section 410(a)(1). Prop. Treas. Reg. § 1.401(a)(26)-6(b)(1)(ii).

[20]Prop. Treas. Reg. § 1.401(a)(26)-6(b)(5).

[21]Prop. Treas. Reg. § 1.401(a)(26)-6(b)(4).

IV. DISCUSSION AND CONCLUSION

It is the conclusion of the Department of the Treasury that no change in current law is warranted. Current law and regulations grant government contractors broad latitude to structure their qualified retirement plans in a manner that simultaneously satisfies both the minimum participation requirements of Code section 401(a)(26) and the prevailing wage requirements of the Davis-Bacon and McNamara-O'Hara Acts. As discussed earlier, the regulations under section 401(a)(26) as currently proposed do not prevent an employer from maintaining separate benefit structures--including different levels of contributions or benefits--under a single plan. Likewise, the Davis-Bacon and McNamara-O'Hara Acts do not require that the portion of the prevailing wage determined by reference to fringe benefits be provided in a separate plan, or even that such portion actually be provided in the form of fringe benefits as opposed to cash. Thus, there are no irreconcilable differences between the minimum participation requirements of Code section 401(a)(26), on the one hand, and the prevailing wage requirements of the Davis-Bacon and McNamara-O'Hara Acts, on the other hand, that would prevent a government contractor from complying with both sets of requirements.

A. Prevailing Wage Employees Covered Under a Collective Bargaining Agreement

In the case of prevailing wage employees covered under a collective bargaining agreement, the minimum participation requirements impose virtually no restrictions on an employer's ability to use qualified plan contributions to satisfy its prevailing wage obligations. A qualified plan that covers only such employees should automatically satisfy section 401(a)(26) because employees not covered under the collective bargaining agreement may, at the employer's option, be disregarded in applying the minimum participation requirements. In addition, if the plan is a multiemployer plan, it generally is exempted from the minimum participation requirements altogether.

B. Prevailing Wage Employees Not Covered Under a Collective Bargaining Agreement

In the case of prevailing wage employees who are not covered under a collective bargaining agreement, the employer is free to structure its qualified retirement plans in a manner that satisfies the minimum participation requirements without sacrificing the ability simultaneously to satisfy the prevailing wage requirements. For example, if the employer has different classes of prevailing wage employees and each class separately constitutes fewer than 50 employees or 40 percent of the employer's workforce, section 401(a)(26) still permits the employer to establish a single plan that covers all its prevailing wage employees, even though different levels of contributions or benefits are provided to each class of prevailing wage employees under the plan.[22] Similarly, if an employer's prevailing wage employees as a group

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[22]The fact that the plan must also satisfy the minimum coverage and nondiscrimination requirements of sections 410(b) and 401(a)(4) should not prevent the employer from meeting its

constitute fewer than 50 employees or 40 percent of the employer's workforce, section 401(a)(26) still permits the employer to cover the prevailing wage employees under the same plan with its other employees whose compensation is not subject to prevailing wage requirements, even though different levels of contributions or benefits are provided to prevailing wage and non-prevailing wage employees under the plan.[23]

C. Non-Prevailing Wage Employees

A similar analysis applies in the case of non-prevailing wage employees. If an employer maintains a separate plan for its office and supervisory staff who constitute fewer than 50 employees or 40 percent of the employer's workforce, section 401(a)(26) still permits the employer to merge that plan with a plan covering the employer's prevailing wage employees, even though separate benefit structures, including different levels of contributions or benefits, are maintained for each group of employees under the plan. The resulting merged plan covering both prevailing wage and non-prevailing wage employees generally would be treated as a single plan under section 401(a)(26) and, as a result, should satisfy the minimum participation requirements.[24]

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prevailing wage obligations with respect to each class of prevailing wage employees. If none of the prevailing wage employees were highly compensated employees within the meaning of section 414(q), the plan would automatically satisfy minimum coverage and nondiscrimination. If the prevailing wage employees included one or more highly compensated employees who otherwise might cause the plan to fail minimum coverage under section 410(b), the employer could exclude those employees from the plan and instead meet its prevailing wage obligation by providing them with an additional cash payment. Similarly, if the prevailing wage employees included one or more highly compensated employees who otherwise might cause the plan to fail nondiscrimination under section 401(a)(4), the employer could set the contributions or benefits of those employees at a lower level under the plan and instead provide them with an additional cash payment.

[23]*See supra* note 22 and *infra* note 24.

[24]*See supra* note 22. As explained in that footnote, a plan covering prevailing wage employees can satisfy the minimum coverage and nondiscrimination requirements of sections 410(b) and 401(a)(4) without impairing the employer's ability to meet its prevailing wage obligations. The same analysis applies in the case of a merged plan that covers both prevailing wage and non-prevailing wage employees. It should be noted, however, that any difficulty in satisfying minimum coverage or nondiscrimination on account of a highly compensated non-prevailing wage employee would have predated the merger and thus would not have been occasioned by either the minimum participation rules of section 401(a)(26) or the prevailing wage requirements of the Davis-Bacon or McNamara-O'Hara Act.

Department of the Treasury
Washington, D.C. 20220

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 18, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,404 million of 26-week bills to be issued on March 21, 1991 and mature on September 19, 1991 were accepted today (CUSIP: 912794XG4).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.81%	6.08%	97.063
High	5.82%	6.10%	97.058
Average	5.82%	6.10%	97.058

$3,000,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 59%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,410	32,410
New York	23,151,710	7,343,715
Philadelphia	18,015	18,015
Cleveland	27,425	27,425
Richmond	37,430	36,430
Atlanta	29,620	27,620
Chicago	1,500,375	274,325
St. Louis	35,110	18,060
Minneapolis	6,370	6,370
Kansas City	41,890	41,890
Dallas	15,335	15,335
San Francisco	720,975	134,475
Treasury	428,370	428,370
TOTALS	$26,045,035	$8,404,440
Type		
Competitive	$21,746,330	$4,105,735
Noncompetitive	968,375	968,375
Subtotal, Public	$22,714,705	$5,074,110
Federal Reserve	2,000,000	2,000,000
Foreign Official Institutions	1,330,330	1,330,330
TOTALS	$26,045,035	$8,404,440

An additional $43,470 thousand of bills will be issued to foreign official institutions for new cash.

NB-1182

TREASURY NEWS
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PREPARED FOR DELIVERY
EMBARGOED UNTIL 12:30 P.M. (P.S.T.)
March 18, 1991

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
REMARKS TO THE COMMONWEALTH CLUB
SAN FRANCISCO, CALIFORNIA
MARCH 18, 1991

Thank you, Vickie (Jenkins). Secretary Shultz, members of the Commonwealth Club and honored guests -- thank you for your generous welcome. I am pleased to have this opportunity to discuss our nation's economic priorities with such a distinguished audience.

This is a time when all Americans can share in the renewed pride we feel as we welcome our men and women home from the Persian Gulf. It is not only a very proud moment for the United States -- a moment of renewed patriotism -- but also a time of restored confidence in our ability to meet the challenges that we will face as America prepares for the next century.

Now that the Gulf War is behind us, we can turn our attention to other priorities, both international and domestic. Much of our effort must be focussed on the need to encourage economic growth -- both at home and around the world.

The broad cooperation forged in the Gulf Crisis bodes well for the world economy. The United States has joined with the allies to encourage the emergence of democracy and market-oriented economic systems all over the world, but particularly in Eastern Europe and Latin America. These developments will mean not only better prospects for the citizens of developing nations, but also new markets for American exports, creating growth opportunities for our own economy.

At home, as the President said when he recently addressed the Joint Session of Congress, "Our first priority is to get this economy rolling again." Most economists anticipate an end to the current recession by mid-year, and a resumption of moderate growth as the year progresses. The return to positive growth will be based on strong exports, lower and more stable oil prices, increased credit availability and lower interest rates. In addition, the success of Desert Storm and the President's leadership have renewed consumer and business confidence.

But the most important economic development is the President's budget agreement with Congress which has reformed Federal government spending and created the framework for future economic growth.

Think about it. The 1990 budget agreement mandates a $492 billion reduction in federal borrowing over the next five years and dictates that federal spending shall be governed by the principle of pay-as-you-go. Since these reforms, the Federal Funds rate has fallen from 8% in October 1990 to 6% today. This was not an accident. This was President Bush's plan. Remember, prior to the budget agreement, the Chairman of the Federal Reserve, Alan Greenspan, said a "credible, enforceable reduction in the budget deficit" would result in lower interest rates. The President forged just such an enforceable reduction package and interest rates have dramatically declined.

Over the next five years, the Federal government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the 1990 budget agreement. The interest rate decline that followed, makes it clear that the budget agreement has received a positive reaction from the markets.

Those who don't think this will help stimulate economic growth are dead wrong. Americans who have received downward adjustments in their variable rate mortgages and home equity credit lines certainly understand what it means. Those who can buy a car or a house with substantially lower monthly payments know what it means. Lower interest rates and monthly payments have always made a difference before and they will now.

And for American businesses, lower interest rates mean lower capital costs and a greater incentive to invest. And that means more jobs and more economic activity.

Although these developments are encouraging, this does not mean we have rested on our oars. And, we are taking additional steps which will strengthen the economy both in the short-run and the long-term.

President Bush submitted to Congress a 1992 budget that maintains spending at less than the inflation rate, meaning that the real level of spending will decline. The President has reaffirmed his commitment to restrain government spending and stick to the pay-as-you-go provisions of the 1990 budget act. Now Congress must also adhere to these provisions.

In addition to controlling the deficit, we will continue to press for initiatives that will induce long-term economic growth and enhance this country's competitiveness. We are again asking Congress to support the following initiatives as part of the budget: a permanent research and experimentation credit, family savings accounts, enterprise zones, the allowance of withdrawals from individual retirement accounts for first-time home buyers, and a capital gains tax rate reduction for individuals. These priorities can be met while still keeping future budget deficits on a downward path.

As a further step toward encouraging the economic turnaround, the Administration has taken steps to alleviate the credit crunch. Together with the Federal Reserve, the FDIC, the Comptroller of the Currency and the Office of Thrift Supervision, we initiated a review of the regulations covering bank lending. Our goal has been to ensure that key regulations are truly based on common sense. As the President said in the State of the Union address, "Sound banks should be making sound loans, now." We should not foster an atmosphere of risk-adversity, apprehension and hesitation among lending institutions.

The application of prudent regulation requires balance and common sense. There needs to be a recognition that banks, borrowers, and economic sectors experiencing temporary difficulties may need some flexibility to work through their problems -- and that regulatory judgment should and can be quite responsibly exercised in those situations. Our review has resulted in a number of regulatory policy clarifications that were announced on March 1.

These steps alone will not end the credit crunch. However, common sense bank regulations combined with strict adherence to the pay-as-you-go provision of the 1990 budget agreement, and the Fed's action to lower interest rates and reduce bank reserves, should contribute to a renewal of U.S. consumer and industrial activity.

Although the plan to ease the credit crunch addresses a short-term problem in the economy, we must also come to terms with longer range problems. One of the Administration's top domestic priorities is to modernize our antiquated 40- and 50-year old banking laws. This is important not just for the financial services sector, but for the economy as a whole. Businesses must be able to count on our financial services firms, particularly banks, in bad times as well as good.

As we have seen in the current economic downturn, weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of trouble, jobs are imperiled. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in our country. Right here in the United States.

Some have questioned whether this is the time for fundamental reform: Are we taking on too much? Shouldn't we listen to the winds of politics and make sure we don't offend established interests? This reaction reminds me of the reception given the recommendations in the report of the President's Task Force on Market Mechanisms following the stock market break in October 1987.

Many of you will remember that the immediate conventional wisdom was that the recommendations were too radical -- that they wouldn't be adopted. However, the central finding of that report has never been challenged: What had been seen traditionally as separate markets -- the markets for stocks and stock index futures -- were in fact one market. Those recommendations, once seen as too challenging to the vested interests, have in fact largely been put in place.

My point is this: I am confident that we will achieve fundamental reform of financial services laws. Our proposals for banking reform are based on the same principles that governed the financial market reform. They address the reality of the modern marketplace. Increasingly, the financial services market is in fact one market, and our laws must be modernized to deal with this reality.

Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in economic downturns. The nation needs a banking system that is strong enough to compete toe-to-toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

As we chart the future of our financial services industry, there is much to worry about in the banking world. The state of banking in the U.S. leaves taxpayers overexposed, consumers and businesses underserved, and the industry increasingly uncompetitive. As a result, banks are unable to effectively perform their important role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we led the standings with the top three and had seven banks in the top 25. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? Of course not.

This is not a size issue, but a competitiveness issue. Foreign banks are increasing lending in the United States as American banks lose market share here at home. Even U.S. investors are not rushing to invest in U.S. banks. Our country's largest bank recently turned to foreign sources for a capital infusion.

The simple fact is, our banks -- large and small -- are being asked to compete in a highly competitive world financial services market with one hand tied behind their backs. For example, we have out-of-date laws on the books that prohibit banks from getting into new financial markets, and even keep them from branching across state lines. Banks in California, Michigan and Utah can open branches in Birmingham, England, but not in Birmingham, Alabama.

These laws are totally out of touch with reality. And they impose unnecessary expenses on banks and consumers that have been estimated to cost $10 billion annually, compared to total industry pre-tax profits of just $25 billion. Taking the simple step of permitting interstate branching would significantly improve the soundness of our banking system and could lead to lower interest rates for American borrowers and lower transaction costs for depositors.

Consumers have long since begun to ignore the artificial restrictions on banking practices, using credit cards, cash machines, and the 800 number to handle their financial affairs when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck.

We also have a deposit insurance system that has wandered away from its original purpose of protecting only the small depositor. This safety net now covers almost every depositor, large and small, sophisticated and trusting, insured and uninsured. The system has bailed out large, money-wise investors who don't need the protection, and exposed the taxpayer to potential losses.

And finally, we have an industry that is in the grasp of no less than four separate federal regulators. Its ability to run day-to-day affairs and respond quickly to changed conditions -- such as the credit crunch -- is hamstrung by a myriad of competing restrictions.

What does this all add up to? Bank failures totalled 198 in the 38 years from 1942 to 1980, but reached 206 in 1989 alone. Interest rates and transactions costs are higher than they need to be, due to inefficiency and higher costs. And the bank insurance fund is under stress.

How do we reverse this trend? How do we help banks provide better and less expensive services to the consumer, attract capital, and lend when the economy is weak? The answer is plain: We need to overhaul our outdated laws which hinder the banks ability to provide consumers with better services, lower costs, and the funds necessary to stimulate economic growth. As we strengthen our banking system, we strengthen the ability of banks to raise capital and compete internationally.

Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized Bank Insurance Fund. But we also need interstate branching and broader financial activities so that our banks can finance economic growth.

Well-capitalized banks should be allowed to participate in the full range of financial services in their natural markets -- but to do so safely, outside the bank and outside the federal deposit insurance safety net. The taxpayer should not back these new activities. Neither should the taxpayer bear the cost of a banking system that has been artificially restricted by outmoded, outdated laws.

Deposit insurance coverage has expanded well beyond its original purpose of protecting small depositors. Our legislation will address the problems of overextended deposit insurance yet continue protection for small depositors, without losing the benefits of stability in the banking system. It would eliminate coverage for brokered deposits, and for large sophisticated fund managers who use "pass-through" coverage.

We would also curtail the routine practice of protecting virtually all uninsured depositors in bank failures. Protecting uninsured depositors should be the exception, not the rule, and should occur only where there is a genuine risk to the financial system. The system we have proposed would eliminate routine protection of uninsured depositors. But it would still allow the monetary authorities to respond to a banking crisis.

Many have asked about the too big to fail doctrine. They are concerned that big bank depositors are favored over small bank depositors. Let me be very clear, under our plan all insured depositors will be safe and the banking system will be sound. The best way to treat large and small banks fairly is to greatly reduce failures of all banks and particularly those which would threaten systemic stability. That is precisely the aim of our banking legislation.

The changes the Administration is proposing favor strong, well-capitalized banks, not necessarily large banks. Most regional and community banks are the best-capitalized in the country, and win in head-to-head competition with the money center banks in states that have within state branch banking.

Our legislation would make bank supervision more effective by creating incentives for banks to build and maintain high levels of capital. It will also provide swift and certain sanctions against banks with too little capital by creating a regime of specific supervisory actions that are triggered by declines in capital levels.

Finally, the Bank Insurance Fund (BIF) is at its lowest level in history as a percentage of insured deposits. The Federal Deposit Insurance Corporation (FDIC) has projected that it will decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer. The Bank Insurance Fund must therefore be recapitalized with industry funds.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to put this country's financial services industry back where it belongs: number one in the world.

If we leave the job half done -- if we only tinker with the problem -- then we'll probably be back again, sooner rather than later, recapitalizing the Bank Insurance Fund again, perhaps the next time with taxpayer money. That's a prospect no one could relish.

The timing is right. By facing up to the reality of the marketplace today, we can help to ensure financial security for the future. We can create a modern financial system that is internationally competitive, that will protect depositors, save taxpayers money, serve consumers and strengthen the economy.

Modernizing our financial services industry, encouraging sound lending practices, holding down the Federal Governments' spending, pushing for lower U.S. interest rates and encouraging the winds of freedom and free markets around the world will contribute to the strength of our economy. With President Bush's leadership we can achieve these policy objectives and provide for a secure economic future, not only for all Americans, but for all nations. With your help we'll get it done.

Thank you.

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TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
March 19, 1991

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 $16,000 million, to be issued March 28, 1991. This offering will result in a paydown for the Treasury of about $3,250 million, as the maturing bills are outstanding in the amount of $19,259 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, March 25, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,000 million, representing an additional amount of bills dated December 27, 1990, and to mature June 27, 1991 (CUSIP No. 912794 WQ 3), currently outstanding in the amount of $9,970 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $8,000 million, representing an additional amount of bills dated September 27, 1990, and to mature September 26, 1991 (CUSIP No. 912794 WU 4), currently outstanding in the amount of $10,630 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 March 28, 1991. 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 $2,146 million as agents for foreign and international monetary authorities, and $3,405 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 competitive 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.

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.

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.

8/89

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:00 A.M.
MARCH 20, 1991

TESTIMONY OF KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee, I am pleased to discuss with you today the revenue proposals contained in President Bush's FY 1992 budget.

The Administration's 1992 Budget abides by the terms of the budget agreement developed last year. We view the budget process reforms, particularly the "pay-as-you-go" provisions, as an integral part of the agreement. It is essential that Congress and the Administration adhere to both the letter and spirit of these reforms.

The revenue proposals in the budget which I will discuss today address the need to promote long-term economic growth as well as addressing current problems. These proposals are financed through a combination of initiatives which raise revenues and decrease spending.

Incentives for Research and Experimentation

We recommend that the 20 percent research and experimentation (R&E) tax credit, which is set to expire after 1991, be extended permanently. Research is inherently a long-term process. To obtain full value for this incentive, it must be reliable and dependable -- not subject to the uncertainties of an annual debate on renewal. In addition, the current allocation rules for R&E under section 861 should be extended for another year.

Family Savings Accounts

We hope to improve our country's low rate of personal savings by creating a new savings vehicle, the Family Savings

Account (FSA). Nondeductible contributions to an FSA of up to $2,500 per taxpayer would be permitted with a maximum of two accounts per family. After meeting the required 7 year holding period, all savings, including the accumulated earnings, can be withdrawn tax free. Withdrawals of savings within 3 years of the time the contribution was made will result in a 10 percent excise tax penalty and an income tax on the accumulated earnings. Earnings on funds withdrawn between 3 and 7 years after contribution will be subject only to income tax with no excise tax penalty.

FSAs are explicitly a savings -- not a retirement -- program. The time limit to obtain full benefits is short enough to focus attention on specific personal goals -- saving to buy a home, preparing for education costs, building a financial reserve to protect against unexpected events, or any high-priority objectives. FSAs will not undermine the basic retirement focus of existing IRAs and pension plans; they will supplement those long-term savings plans with a vehicle suitable for shorter term needs.

From the Government's perspective, the FSA does not cause large revenue losses at the beginning of the program because the contributions are not tax deductible. Instead, the earnings created by the contributions to FSAs will be exempt from taxes. This approach is prudent because we can evaluate the impact on revenues and savings as we proceed without incurring large front-end revenue losses.

Enterprise Zones

To help economically distressed areas enjoy the benefits of economic growth, we recommend designation of up to 50 Federal enterprise zones which will benefit from targeted tax incentives and Federal, state, and local regulatory relief. The Federal tax incentives would be: (i) a wage credit of up to $525 per worker; (ii) elimination of capital gains taxes for tangible property used in an enterprise zone business; and (iii) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses. The willingness of states and localities to "match" Federal incentives will be considered in selecting the enterprise zones to receive these additional Federal incentives.

Penalty-Free IRA Withdrawals for First-Time Home Buyers

We propose to allow individuals to withdraw amounts of up to $10,000 from their IRAs for a "first-time" home purchase. The 10 percent additional tax on early withdrawals imposed under current law would be waived for eligible individuals. Our proposal is designed to enhance the attractiveness of deductible IRAs by making them more flexible. Since home equity is itself a significant form of retirement saving for many Americans, we do not believe that allowing withdrawals for this purpose undermines the retirement saving objectives of IRAs.

Proposals on Expiring Provisions

The budget contains proposals to extend for one year the following programs that would otherwise expire at the end of fiscal 1991:

1. The low-income housing credit encourages the private sector to construct and rehabilitate the Nation's housing stock and makes it available to low-income families. In addition to tenant-based housing vouchers and certificates, the credit is a mechanism for providing Federal assistance to rental households.

2. Geothermal and solar energy credits are intended to encourage investment in renewable energy technologies. Increased use of solar and geothermal energy would reduce our Nation's reliance on imported oil and other fossil fuels and would improve our long-term energy security, while also reducing air pollution.

3. The targeted jobs tax credit is intended to encourage employers to hire disadvantaged workers who otherwise might be unable to find employment. We do not believe job creation incentives should be reduced in the current economic climate.

4. The 25 percent deduction for health insurance costs of self-employed individuals reduces the disparity in the tax treatment of such costs between self-employed individuals and owners of incorporated businesses.

Special Needs Adoption

We again urge the enactment of an income tax deduction (up to a maximum of $3,000 per child) for expenses incurred in connection with the adoption of special needs children. When combined with the current outlay program under the Adoption Assistance Program, the proposal would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents.

Capital Gains Tax Rate Reduction for Individuals

Reducing the capital gains tax rate for individuals is important to restore economic growth and competitive strength by promoting savings, entrepreneurial activity, and risky investment in new products, processes and industries. At the same time, investors should be encouraged to extend their horizons and search for investments with longer term growth potential. To encourage Americans to invest for longer periods of time, we believe that the tax rate for capital gains on assets such as real estate, timber, homes, farms, land and corporate stock should be reduced based on the length of time an asset has been held.

Under our proposals, the capital gains tax rate would be reduced by means of a sliding-scale exclusion. Individuals would be allowed to exclude a percentage of the capital gain realized upon the disposition of all assets qualifying as capital assets under current law, except for collectibles. Individuals would apply their current marginal rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. The amount of the exclusion would depend on the holding period of the assets. Assets held 3 years or more would qualify for an exclusion of 30 percent. Assets held at least 2 years but less than 3 years would qualify for a 20 percent exclusion. Assets held at least 1 year but less than 2 years would qualify for a 10 percent exclusion.

For example, individuals subject to a 28 percent tax on capital gains (i.e., taxpayers in the 28 and 31 percent tax brackets for ordinary income) would pay rates of 25.2, 22.4 and 19.6 percent for assets held 1, 2, or 3 years, respectively. The corresponding figures for individuals subject to a 15 percent rate would be 13.5, 12.0 and 10.5 percent.

For the balance of 1991, the 30 percent exclusion would apply to all qualified capital assets held at least 1 year. For assets disposed of in 1992, the 30 percent exclusion would apply to assets held at least 2 years, and the 20 percent exclusion would apply to assets held at least 1 year but less than 2 years. The general rule would apply in 1993 and all years thereafter. The excluded gains would be subject to the alternative minimum tax. Prior depreciation deductions would be recaptured.

The Administration believes that this capital gains proposal would lower the cost of capital and stimulate investment, reduce the lock-in effect, and lower the double tax on corporate stock investment. Given that there are divergent opinions on the relative strength of these effects, however, President Bush requested Federal Reserve Board Chairman Alan Greenspan to study these matters. We hope that the Congress will work with Chairman Greenspan and the Administration to illuminate and resolve the disagreements surrounding the revenue, distributional and macroeconomic effects of a capital gains tax rate cut.

The President's budget contains several additional proposals to increase revenues. I would like to mention three today. Other proposals not discussed in my written statement are described in the Treasury's "General Explanations of the

President's Budget Proposals Affecting Receipts" which was released with the Budget in February.

Additional Internal Revenue Service Funding

The budget calls for an increase in Internal Revenue Service funding for tax law enforcement. Two initiatives -- one in the area of field examinations and the other in the area of collection of accounts receivable -- are expected to add $700 million to receipts over the budget period.

Medicare Hospital Insurance (HI) for State and Local Employees

We propose extending coverage by Medicare Hospital Insurance (HI) to all State and local government employees. State and local government employees are the only major group of employees not assured Medicare coverage. One out of six State and local government employees are not covered by voluntary agreements or by law. However, an estimated 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Over their working lives, they contribute on average only half as much tax as paid by workers in the private sector. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without contributing fully. The addition of two million State and local government employees as contributors to Medicare would increase revenues by $7.3 billion over the budget period.

Special Occupation Taxes

To increase compliance rates and revenues, distributors of alcoholic beverages would be required to verify prior to sale that their retail customers pay the special taxes in connection with liquor occupations. It is expected that this measure will increase revenues by about $100 million over the budget period. The proposal would be effective beginning October 1, 1991.

Conclusion

Recognizing the controversy which has surrounded capital gains estimates, the budget has been formulated to meet "pay-as-you-go" requirements without relying on the revenues which we believe would be generated by our capital gains proposal. The reductions in mandatory program outlays outlined in the budget together with the proposals increasing revenues which I have described are more than sufficient to fund the items which reduce receipts, even if revenues from capital gains are disregarded.

Mr. Chairman, we look forward to working with the Congress and this Committee to enact a budget which fully complies with last year's budget agreement. We believe that our budget proposals meet that goal and urge the Committee to report legislation embodying those proposals.

Mr. Chairman, I would be pleased to answer any questions which you and other members of the Committee may have.

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

EMBARGOED UNTIL GIVEN
MARCH 20, 1991

STATEMENT TESTIMONY OF NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
March 20, 1991

Mr. Chairman and Members of the Committee, it is my pleasure to appear before this Subcommittee to discuss the operating budget request for the Department of the Treasury for FY 1992.

Since we met a year ago, significant events have taken place in both the international and domestic arenas. As part of the international coalition, we have addressed the situation in the Persian Gulf. We have taken a positive step toward responsibly managing Government by forging a budget agreement that adds discipline to Government spending. Seeking peace, stimulating economic growth, and responsibly managing Government spending are challenges for our nation.

The Department has supported Operation Desert Storm by enforcing economic sanctions against Iraq, by assessing the economic impact of the conflict on the "front line" countries and by coordinating, processing and investing foreign contributions for Operation Desert Storm. These efforts which helped win the war must be continued in new ways for us to win the peace.

The Administration anticipates a short-lived recession with recovery beginning at mid-year and the economic pace picking up later in the year. This should bring unemployment down and enhance growth.

Last month, I testified before the Senate and House Budget Committees and the House Appropriations Committee on the need to restrain Government spending and abide by the budget agreement so that future budget deficits can be controlled. The Treasury budget request presents an honest approach to responsible spending. More importantly, we are targeting every opportunity available to promote fiscal responsibility and provide innovative responses to today's problems.

We know that the savings and loan cleanup and the safety and soundness of our banking system are near the top of everyone's list of domestic issues which require thoughtful, responsible analysis and workable solutions. In that regard, we have recently proposed a comprehensive plan for banking reform that preserves deposit insurance for small savers, strengthens banks by attracting capital, increases competition by modernizing outdated laws, and streamlines the regulatory structure.

In addition to the banking reforms, we have asked Congress to support initiatives to stimulate growth and competition that include: family savings accounts to increase national saving; a permanent research and experimentation tax credit to promote private research and development; first-time home buyer withdrawal from IRAs; and reduction in the capital gains tax.

The Department of the Treasury's functions are broad and critical to the Nation's economic well being. These critical activities include:

- developing international monetary, financial and trade policies;
- developing economic policies that consider the economic effects of tax and budget policy;
- borrowing money needed to operate the Federal Government and accounting for the resulting public debt;
- collecting the proper amount of tax revenue, at the least cost to the public and with the highest degree of public confidence;
- improving Federal cash management and debt collection practices governmentwide;
- producing currency and coin for the Nation's commerce;
- carrying out activities that include collecting revenue from imports; collecting excise taxes on alcoholic beverages and tobacco products;
- controlling the sale and registration of firearms and prosecuting their illegal possession and use; oversight of drug interdiction programs and prevention of money laundering; oversight of strategic exports programs; preventing counterfeiting; training Federal law enforcement officers and protecting the President and Vice President;
- administering embargoes and economic sanctions against foreign countries to further U.S. foreign policy and national security goals; and
- regulating national banks and Federal and State chartered thrifts.

To continue to carry out these essential Government functions, we are requesting a total FY 1992 budget of $9.6 billion and 162,999 full time equivalent positions.

The Fiscal Year 1992 budget request has the following major objectives:

- <u>Modernize Information Systems</u>. Treasury plans to aggressively upgrade and integrate our existing systems to ensure they will perform in the electronic environment of the next century. For example, this budget requests funds to continue our commitment to completely overhaul and modernize the IRS' tax administration system. The goal of Tax System Modernization (TSM) is to place IRS on par with the highest financial processing standards in American business. We undertake this while recognizing that no other organization anywhere has the same complexity, volume and statutory environment of financial transactions. Ultimately, we expect TSM to relieve IRS of its manual processes so that we can dedicate our personnel to even higher standards of service quality.

- <u>Improve Management of the Nation's Finances</u>. The proposed budget for the Financial Management Service (FMS) includes funding to determine the best approach to merge governmentwide budget and asset and liability data bases, to enlarge current efforts to establish financial management evaluation criteria and improve data standards. Funds are also requested to implement the Credit Reform Act of 1990 to more accurately account for the costs of direct and guaranteed loans, and to comply with the Cash Management Improvement Act of 1990 which requires payment of interest when the Federal Government does not provide, or the States do not disburse, Federal funds in a timely and efficient manner.

- <u>Improve Internal Controls</u>. Funds are requested to strengthen Treasury's internal controls and fully meet the requirements of the Federal Managers' Financial Integrity Act. These funds include continued development of financial systems at IRS and Customs to enhance resource allocation. Further, these funds also support the completion of a new public debt accounting system that will improve automated controls and management information.

- <u>Increase Enforcement of the Tax Laws</u>. In an orderly and thoughtful way, we want our service coverage and operations to keep pace with the economy. As more returns are filed, more follow-up is required in every service and enforcement function so that we maintain a high level of voluntary compliance with the tax laws. We continue to give special emphasis to Accounts Receivable, the collecting of back taxes. We also must be responsive to growing requests from business organizations to help them determine what is proper compliance with a variety of tax code provisions. Internally, the IRS must support higher Government standards for financial systems accountability, and continue to address the higher threat of narcotics crime to the integrity of tax administration. We consider all of this proposed spending to be a wise and necessary investment.

- Law Enforcement and the War on Drugs. The War on Drugs will continue as a national priority in FY 1992. Treasury is a major participant in the War on Drugs and is committed to working with the Office of National Drug Control Policy. In support of key priorities of the National Drug Control Strategy, Treasury continues as a major participant in the Organized Crime Drug Enforcement Task Force (OCDETF) and the High Intensity Drug Trafficking Area (HIDTA) Programs. The Customs Service will continue to strengthen the President's War on Drugs through its narcotics interdiction efforts. Part of this strategy is the successful cross designation of 1,000 Customs special agents with the Drug Enforcement Administration (DEA). Funds are requested to enable Customs to fly the air assets that will come on-line in FY 1992, to expand the Canine Training Center and to provide service to the importing community.

  Funds are also requested for the Bureau of Alcohol, Tobacco and Firearms (ATF) to combat violent crimes by preventing armed career criminals from obtaining firearms to commit drug related crimes. Funding for ATF also will provide for the collection of an estimated $13.5 billion in excise taxes on alcohol and tobacco.

  The Department continues its commitment to consolidated law enforcement training at the Federal Law Enforcement Training Center (FLETC) facilities. Our FY 1992 FLETC request provides the resources to continue facility expansion initiated in previous years.

The Financial Crimes Enforcement Network (FinCEN) budget request provides funding for the operation and improvement of the FinCEN intelligence information system providing financial intelligence to deter money laundering and other financial crimes.

The Secret Service budget request provides protection for the President, Vice President and their families, as well as candidates and nominees for the 1992 Presidential Campaign. In addition, the Secret Service will be aggressively utilizing manpower and resources to combat fraud against financial institutions as a direct result of new authority provided by the Appropriations Committee this past year.

- <u>Meet the Nation's Demand for Currency and Coinage</u>. The budget for the U.S. Mint will provide for production of sufficient coinage to meet expected demand. The Bureau of Engraving and Printing (BEP), which does not require annual appropriation, will meet the demand for currency.

- <u>Policy Formulation and Management Oversight of Departmental Operations</u>. The Departmental Offices budget request will permit the Department to carry out economic, financial and tax policies.

In summary, the Department's budget request of $9.6 billion represents a commitment to:

- modernize the administration of the tax laws, collection of revenues and responsiveness to the public;

- improve the management of the Nation's finances;

- strengthen internal controls to facilitate the responsible management of the Nation's financial resources;

- enhance the war on drugs; and

- manage essential Government services.

Mr. Chairman, that concludes my opening remarks. I will be happy to answer any questions that you or the other Subcommittee members may have.

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

THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT OF 1991

MARCH 20, 1991

FACT SHEET

The Need for Reform

It is time to modernize our financial system to make banks safer and more competitive:

- We must modernize our banking system, updating outmoded laws that date back to the 1930s.
- Banks must be sound to protect depositors and taxpayers.
- A strong, internationally competitive banking system is essential to a strong, growing economy.

The Banking System is Under Stress

- Technology has revolutionized the way financial institutions do business, but our banks are hampered by out-of-date rules.
- Weak banks shrink lending when the economy slows, hurting businesses and costing jobs.
- Our banks are falling behind international competitors: Not one of the 25 largest banks in the world is American, compared to seven of 25, including the top three, just 20 years ago.

NB-1187

The Benefits of Reform

A modern, safe and internationally competitive banking industry will protect depositors and taxpayers, serve consumers, benefit workers and businesses, and strengthen our nation.

Protect depositors and taxpayers:

Depositor confidence and taxpayer protection will result from:

-- A safe, competitive, well-capitalized banking system;

-- limitations on taxpayer exposure to losses from bank failures;

-- and a strong, well-capitalized insurance fund.

Serve consumers:

An efficient, integrated financial services system will mean:

-- Consumers will have access to a wider range of services at the least possible cost.

-- Consumers also will enjoy the convenience of nationwide access to services.

Benefit workers and businesses:

A healthy banking system with strong, competitive banks will ensure:

-- Jobs are preserved because loans are not called at the first sign of economic downturn.

-- Small businesses that lack access to securities markets can count on banks in bad times as well as good.

Strengthen the nation:

A world-class financial services system provides a foundation for a world-class economy:

-- International economic leadership in the 21st century will require an internationally competitive financial services system.

The Principles Governing Reform

First, we will preserve deposit insurance for small savers while protecting taxpayers by reducing the overextended deposit insurance system. Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This reform will restore market discipline over risky activities that have increased the possibility of taxpayer exposure to losses in the banking system.

Second, we will make banks stronger and safer by strengthening the role of capital -- not by raising capital standards, but with a plan to attract capital to the banking industry. This will include rewarding well-capitalized banks with new activities that will attract still further capital, and taking prompt corrective action to address under-capitalized banks.

Third, we will make banks more competitive by modernizing outdated laws. Technological advances and other innovations in financial markets have put banks at a competitive disadvantage -- at home and abroad -- that has weakened the system and hurt the economy. Changes will allow banks to engage in a broader range of financial services and to operate nationwide.

Fourth, we will strengthen the banking system by making the regulatory structure more efficient. Currently, overlapping regulatory responsibilities lead to confusion and uneven results.

KEY ELEMENTS OF THE LEGISLATION

I. DEPOSIT INSURANCE COVERAGE

- o Preserves deposit insurance coverage for small savers.
  - -- $100,000 per person per institution
  - -- Plus, $100,000 for retirement savings per person per institution
  - -- Two year phase-in period.
  - -- Example: A husband and wife will be able to have as much as $400,000 in insured deposits in any one institution ($200,000 each). While this reduces the amount of deposit insurance available at any one bank, if the couple needs more than $400,000 coverage, they can still go to another bank to get an additional $400,000 insured coverage.
- o No change in current treatment of corporate accounts.
- o Eliminates coverage for "brokered deposits".
- o Reduces deposit insurance for professionally managed pension plans.
  - -- Eliminates coverage for bank investment contracts (BICs).
  - -- Eliminates "pass-through" coverage for deposits of most professionally managed pension plans.
  - -- Exceptions:
    - oo Continues deposit insurance coverage for state and local government pension plans
    - oo Continues deposit insurance coverage for escrow and similar types of accounts
    - oo Continues coverage for self-directed pension plans (such as IRAs and small company Keoghs).

- FDIC to perform 18 month study of feasibility, costs and benefits of implementing system-wide limitation of coverage for every depositor; Fed to undertake survey to gather data on ownership of deposits and report in one year.
- Pilot program for private reinsurance coverage.

II. TOO BIG TO FAIL

- Eliminates current policy of routinely protecting all insured and uninsured depositors in every case.
- FDIC permitted to cover uninsured depositors only if that would be the least costly approach to resolving a failed institution.
- Maintains ability to intervene in cases where there is a threat to our financial system (same power afforded to governments of every other industrialized nation).
- Treasury and the Fed could order coverage of uninsured deposits in rare cases of systemic risk, in consultation with OMB and FDIC.
- Three year phase-in period.

III. RISK BASED ASSESSMENTS

- Requires establishment of a risk-based system for setting insurance premiums.
- Effective two years after enactment.
- Risk categories must use ratio of capital to risk weighted assets as fundamental measure.

IV. <u>RESTRICTIONS ON FEDERALLY INSURED STATE BANK ACTIVITIES</u>

- o Maintains dual banking system, but limits taxpayer exposure.
- o Limits the states' ability to authorize risky activities for federally insured state banks.
- o Federally insured state-chartered banks and their subsidiaries will not be able to undertake principal activities which are not permissible for federally insured national banks, unless they meet their capital requirements and obtain permission from the FDIC.
- o <u>Taxpayers should not be on the hook</u> for risky state-chartered bank activities that are covered by federal deposit insurance.

V. <u>IMPROVED SUPERVISION</u>

- o Banks that fall <u>below minimum capital standards are subject to prompt corrective action</u> - including, for example, dividend cuts - aimed at preventing failure.
- o Generally, requires <u>annual on site examinations</u> for banks.
  - -- Smaller banks (less than $1 billion in assets) that maintain required capital need only have exams once every 18 months.
- o Capital standards must reflect interest rate risk.

VI. <u>CREDIT UNIONS</u>

- o Recognizes <u>independence of credit unions</u>.
- o National Credit Union Administration (NCUA) remains as insurer and regulator.
- o Protects taxpayer by <u>eliminating double counting</u> of insurance fund assets over 12 year period.

o Revises the Board of Directors of NCUA to include the Director of the Office of Depository Institutions Supervision as a Board member.

VII. FINANCIAL SERVICES MODERNIZATION

o Permits new financial services to be conducted only in separately capitalized financial affiliates and only for well-capitalized banks.

o Only banks have access to deposit insurance fund coverage.

o Requires appropriate firewalls to ensure that new activities are not conducted under the federal deposit insurance safety net.

o Creates "Financial Services Holding Company" (FSHC) structure which will permit a single company to own affiliates engaging in banking, securities, and insurance.

o Allows commercial firms to own FSHCs (if FSHC's banks are well-capitalized) through a "Diversified Holding Company" (DHC).

o Firewalls

-- Tighter limits on lending inside FSHCs (23a & 23b). Banks cannot put deposit insurance funds at risk in non-bank financial services.

-- Broad regulatory authority to prevent unfair competition, conflicts of interest, and unfair banking practices. Banks cannot use deposit insurance funds to gain an unfair competitive advantage in other financial services activities.

-- Strict disclosure laws to ensure that customers do not confuse insured products with uninsured products.

-- Regulatory authority to limit disclosure of non-public customer information.

- -- No lending by a bank, or its FSHC, to any affiliated commercial company.

- o Imposes capital restoration requirements on FSHCs that fail to maintain specified levels of capital in banks they own. They must either build up the capital of the bank to the required level, sell the bank, divest themselves of non-bank financial activities, or become subject to holding company capital requirements and much greater regulation.

- o Similar prompt corrective action applies to commercial firms that own FSHCs that fail to maintain specified capital levels in banks they own.

- o Provides for functional regulation of new activities allowed in subsidiaries.

- o Requires insured depository institutions and affiliates to prominently disclose in writing to each of their customers that any securities or insurance products offered, recommended, or sold by the institutions or affiliates are not deposits and therefore are not covered by federal deposit insurance.

- o Insurance

  - -- Banks and insurance companies can affiliate on a full two-way street.

  - -- Insurance affiliates of banks continue to sell insurance in any state, but banks themselves can only sell insurance in states where state-chartered banks can sell insurance.

  - -- National banks can sell insurance wherever state banks are allowed to sell insurance, but interstate authority to sell insurance in towns of 5,000 or less would be eliminated.

- o Securities

  - -- Banks and securities companies could affiliate on a full two-way street.

  - -- Certain securities activities are moved out of banks into subsidiaries or affiliates.

- Real Estate

  -- No real estate development by state or national banks. Real estate development and brokerage cannot be financial activities in new FSHC. Existing real estate brokerage activities of state-chartered banks are left undisturbed.

VIII. NATIONWIDE BANKING

- Authorizes full nationwide banking for bank holding companies following a three year phase-in period.
- Authorizes interstate branching for national banks in any state in which the financial services holding company in the same state could acquire a bank.
- Removes barriers to interstate branching by state banks.

IX. STATE REGULATION

- Generally, preempts state anti-affiliation provision, but continues policy of having states determine limitations on direct bank marketing of real estate and insurance products.
- Preserves procedures for enforcing the Community Reinvestment Act (CRA).
- States may tax interstate branches to the same extent they tax interstate banks.

X. REGULATORY RESTRUCTURING

- Simplifies and consolidates current four-regulator model (the Federal Reserve, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision) into two regulators, with the same regulator responsible for a bank holding company and its principal subsidiary bank.

- Creates a new federal banking agency -- the Office of Depository Institution Supervision -- as a bureau of the Treasury which replaces the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

- State-chartered banks (including savings banks) will be regulated by the Federal Reserve.

- National banks will be regulated by a new federal banking agency -- the Office of Depository Institution Supervision.

- Thrifts and their holding companies will be regulated by the Office of Depository Institution Supervision.

- There is no reduction of FDIC examination authority as the insurer.

XI. RECAPITALIZATION OF BANK INSURANCE FUND (BIF)

- Includes necessary legislative language to implement FDIC proposal for industry financed recapitalization of BIF.

- FDIC will be authorized to borrow up to a maximum of $25 billion from the Federal Reserve banks.

- FDIC will pay interest on any such borrowings at a rate equal to the Treasury rate for borrowings of comparable maturity.

- Any borrowing under this new authority will be secured by the FDIC's dedication of insurance premiums in amounts sufficient to service and retire the debt in accordance with its terms.

- Annual premiums paid by the BIF insured institutions will be capped at an aggregate of 30 basis points.

- FDIC's existing authority to borrow from the Treasury and the Federal Financing Bank will not be affected.

XII. PROVISIONS FOR SMALLER INSTITUTIONS

- Increases the exemption in the Home Mortgage Disclosure Act for small depository institutions from $10 million to $50 million and eliminates duplicative reporting.

- Treasury, and the appropriate federal banking agencies to review whether it is feasible to reduce the number of reporting requirements for institutions with assets less than $50 million.

XIII. FOREIGN BANKS IN THE U.S.

- Foreign banks are provided national treatment under Treasury's proposed reforms.

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

FOR RELEASE AT 4:00 P.M.
March 20, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $20,000 MILLION

The Treasury will auction $11,500 million of 2-year notes and $8,500 million of 5-year notes to refund $18,826 million of securities maturing March 31, 1991, and to raise about $1,175 million new cash. The $18,826 million of maturing securities are those held by the public, including $2,014 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $20,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $1,876 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

NB-1188

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED APRIL 1, 1991

March 20, 1991

Amount Offered to the Public ...	$11,500 million	$8,500 million
Description of Security:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series Y-1993 (CUSIP No. 912827 A2 8)	Series M-1996 (CUSIP No. 912827 A3 6)
Maturity date	March 31, 1993	March 31, 1996
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	September 30 and March 31	September 30 and March 31
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
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Receipt of tenders	Tuesday, March 26, 1991	Wednesday, March 27, 1991
a) noncompetitive	prior to 12:00 noon, EST	prior to 12:00 noon, EST
b) competitive	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Monday, April 1, 1991	Monday, April 1, 1991
b) readily-collectible check ...	Thursday, March 28, 1991	Thursday, March 28, 1991

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

FOR IMMEDIATE RELEASE
March 20, 1991

CONTACT: Barbara Clay
202-566-5252

FACT SHEET

Addendum: The Reduction of Poland's Debt

- Poland owes approximately $33 billion to Paris Club creditor governments, including roughly $3.8 billion to the United States.1/

- The Paris Club of creditor countries has agreed to reduce the value of Poland's debt obligations by 50 percent in two stages, or the equivalent of $16.5 billion on a net present value basis.2/

- The Paris Club agreement permits creditor governments to choose from a number of equivalent options: principal reduction, interest reduction, and capitalization of interest at low interest rates.

  - As a result, the value of the debt will be reduced by 50 percent on a net present value basis, even though the nominal stock of debt will not be reduced by as much.

  - During the first three critical years, all creditors have agreed to reduce Poland's interest payments by 80 percent.

- The United States will increase its debt relief for Poland to 70 percent on a net present value basis through:

  - A write-off of 10 percent of Poland's debt to the United States to enable the Government of Poland to fund a Polish environmental foundation, and

  - Bilateral debt reduction equivalent to 60 percent of the original debt, within the two-stage Paris Club operation.3/

- This additional United States action will reduce Poland's debt to the United States from $3.8 billion to $1.14 billion on a net present value basis.

  - The nominal stock of Poland's debt to the United States will be reduced only to about $1.4 billion.

- o The additional U.S. action will increase the total debt reduction under the multilateral agreement to 52 percent in real terms.

  -- The President is encouraging other creditors to take similar additional action to move the level of debt reduction beyond that level.

NOTES

1/ Previous estimates of Poland's debt to the United States ($2.9 billion) were provided by USG agencies and did not include the interest capitalized under an earlier Paris Club agreement.

2/ "Present value" calculates the value of future payments in today's dollars. The value of future payments after the Paris Club action will be 50 percent of the value of the today's scheduled payments.

3/ After accounting for the 10 percent write-off, the remaining 90 percent of the debt will be reduced by two-thirds on a net present value basis, within the two-stage Paris Club process (the equivalent of a 60% reduction of the original stock). The result of these two actions produces the 70 percent reduction on a net present value basis.

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 2:00 P.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

March 21, 1991

Chairman Riegle, Senator Garn and members of the Committee, thank you for the opportunity to provide the Administration's views on our comprehensive legislative proposal to reform the banking laws, "The Financial Institutions Safety and Consumer Choice Act of 1991" (FISCC). As you know, Secretary Brady recently testified before the full Banking Committee to set forth the fundamental reasons requiring the enactment of this legislation. I will not repeat the details of his testimony today, but I would like to reiterate some of the key reasons why we believe this legislation is essential. I would also like to discuss several important aspects of the legislation that were not described in detail in previous testimony, particularly the recapitalization of the Bank Insurance Fund. Finally, I would like to lay to rest several misconceptions that have arisen since our recommendations were released to the public.

<u>Time to Fix the System</u>

Mr. Chairman, I want to stress that we have a fundamental problem on our hands that demands a comprehensive solution. The picture we see is not a pretty one. The Bank Insurance Fund is at its lowest level in history as a percentage of insured deposits, and the 206 bank failures in 1989 alone were more than the total number of failures in the thirty-eight year period between 1942 and 1980.

At the same time, banks have become less competitive as traditional banking business has migrated to new products in the securities industry and other parts of the financial services industry -- products that are off limits for banks due to outdated laws. Our international competitive position has declined to the point where we have no banks among the top 25 in the world. And as the economy has slowed, some regions have experienced "credit crunches" -- weak banks have not been able to lend even to good customers, hampering a speedy recovery.

NB-1190

The time has come to fix these fundamental problems across the board. A piecemeal approach such as merely recapitalizing the Bank Insurance Fund will not work, because it cannot eliminate the massive taxpayer exposure we now face. Put another way, with over $2 trillion in insured deposits, there is no deposit insurance fund large enough to cover the losses inherent in a banking system that we allow to become weak, inefficient, and uncompetitive.

Fundamental Reforms

We believe comprehensive reform must accomplish three fundamantal objectives. First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors in this country. It also means a well capitalized bank insurance fund.

Second, it is time to modernize archaic laws to let banks catch up with their customers and deliver more efficient products to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for customers, and more bank capital.

Third, we need to restore the preeminent international position of our banking industry. Our economy is twice the size of our nearest competitor, and a world class economy demands a world class banking system.

As outlined in previous testimony, we believe our legislation will help accomplish each of these objectives. Let me focus today on several aspects of the legislation that require more detailed explanation. The place to begin is improved supervision.

Prompt Corrective Action

The regulatory system must be better designed to catch problems early, before they mushroom into costly failures. The legislation's proposed system of Prompt Corrective Action will do just that, and we urge the Subcommittee to study these provisions carefully. The combination of rules and flexibility will help foster two desirable results: regulators will be able to take action much more swiftly as capital declines, and there will be more pressure to take such swift action because of the presumptions built into the statute. More important, banks will be much more likely to maintain strong levels of capital if they face the certainty of decisive regulatory action as their capital declines.

Not everyone will like this system, because it will be argued that statutory presumptions will reduce regulatory "flexibility." But that is in part its purpose -- open-ended flexibility can be the enemy of decisive corrective action.

Critics will also claim that capital is not a good leading indicator of problems, and that prompt corrective action relies exclusively on capital. Both allegations are false. Numerous studies have shown that capital is an excellent leading indicator of problems in banks, and a simple one to measure. But it is not a perfect early warning system, and our legislation specifically recognizes its limits -- even a well-capitalized bank will trigger prompt corrective actions under the new system if it is in an unsafe and unsound condition due to loan concentrations or other supervisory problems. Prompt corrective action does not rely exclusively on capital.

Reduction of Overextended Deposit Insurance

The legislation recognizes the importance of stopping the creeping expansion of deposit insurance coverage to large, sophisticated depositors. For example, we have eliminated insurance coverage for brokered deposits and have carefully tried to eliminate so-called "pass through" coverage for depositors that are least in need of protection. Defined benefit pension plans with professional management, employer liability, and guarantees from the Pension Benefit Guaranty Corporation are hardly in need of deposit insurance protection as well. At the same time, however, the legislation would preserve pass-through protection for self-directed defined contribution plans, where individuals individuals choose their own investments and bear the risk of any loss.

Likewise, banks' use of multiple insured accounts has gotten out of hand. It is time to impose limits, and ours is $100,000 per depositor per bank for most accounts, with a separate $100,000 in coverage for retirement savings. While this limit is important, it is obviously not radical -- a couple can still get up to $400,000 in insurance coverage in each bank, which is hardly a small sum. Insurance for business accounts would not change. Those who suggest that such clearly reasonable limits would destroy the banking system or deprive the elderly of safe places to invest are just plain wrong -- and worse, are irresponsibly and needlessly stirring up depositor fears.

Finally, the FDIC's current "too big to fail" policy must be changed. The legislation would therefore essentially eliminate the FDIC's discretion to protect uninsured depositors in bank failures. But it would also preserve the government's ability to protect the financial system when necessary, even if that requires the rare protection of uninsured depositors.

We believe that this balance struck between direct taxpayer exposure and the stability of the financial system is the correct one. Nevertheless, our recommendations have been criticized for not going far enough to prevent taxpayer exposure through deposit insurance -- that the government should never protect uninsured depositors. But it would be foolhardy for the government to give up its ability to protect the financial system, a restriction that no other governmnent has embraced.

Others argue that we should simply expand the safety net to cover all deposits in all banks in order to create "fairness" for uninsured depositors. That would be equally foolhardy -- what about fairness to the taxpayer? Why should the taxpayer have to pick up the tab to protect an uninsured depositor who knows his or her deposits are uninsured when deposited in a bank?

The best way to address this problem is to stop banks from failing so frequently, which is exactly what other parts of this legislation would do. The next best way is to reduce the systemic risk that creates the need for extraordinary government action to protect uninsured depositors. Our legislation includes technical changes to laws governing the clearing system that are a step in the right direction.

Restored Competitiveness

Let me turn now to the need to restore the competitiveness of our banking system. Our banking laws are archaic. They simply do not reflect the way that banks now do business, and they impose substantial and unnecessary costs. The system needs an overhaul, which the proposed legislation would accomplish.

Nationwide banking and branching. Interstate branching is a perfect example. The geographical debate is essentially over because states have already broken down most of the barriers to interstate banking. Yet interstate branching is still virtually prohibited, imposing totally unnecessary costs on banks.

The legislation would end these artificial barriers, but in a way that recognizes the legitimate interests of state governments. A state would still be able to restrict intrastate branching of all state and national banks operating within its borders. It would also have the ability to establish activities restrictions for all of its own state banks and all in-state branches of banks chartered in another state. States would be encouraged to enter into reciprocal arrangements to examine the out-of-state branches of each other's banks. The Community Reinvestment Act would continue to apply, and states could continue to apply state consumer protection laws to branches of all out-of-state banks. Finally, states could tax branches of all banks, state or national, to avoid any adverse revenue impact resulting from changes in the law.

Critics argue that these proposed changes will end the need for small banks and will draw funds out of local communities and deprive rural areas of much needed sources of credit. There is no credible evidence to support these hypothetical fears. The trend towards interstate banking and statewide branching have had not restricted credit availability in smaller communities. Smaller banks have continued to compete extremely effectively with larger banks, and in states like New York, larger banks have actually decreased the number of their branches in recent years in the face of stiff competition from community banks. We believe that a more efficient banking system will mean more efficient banks of all sizes.

Financial Services Holding Companies. The legislation repeals key elements of the Glass-Steagall Act and modernizes the Bank Holding Company Act of 1956 to become the Financial Services Holding Company Act of 1991. Again, these changes reflect the reality of the way that banking organizations already do business. Banks are already in many aspects of the securities and insurance businesses through a patchwork system created by changes to state laws, exceptions in federal laws, and legitimate regulatory interpretations. But this hodgepodge system is costly and burdensome, with numerous Lilliputian restrictions that keep our financial companies from competing fairly and effectively.

The new Financial Services Holding Company Act would require all bank holding companies to become financial services holding companies. These new companies could engage in all of their present financial services activities, and those who maintained well capitalized banks could engage in a broad range of new financial activities through affiliates -- securities activities, insurance activities, and any new activities that are determined to be "of a financial nature" over time.

But important safeguards would be in place to protect banks from risks associated with new activities and to prevent unfair competition. Any new activities would be carried out in separately capitalized affiliates whose capital could not be double counted as capital of the bank. As mentioned above, only companies with well-capitalized banks could take advantage of these new activities, and only if their banks were not in an unsafe or unsound condition and were not engaging in unsafe or unsound practices. If the bank's capital level should decline or if it otherwise falls into an unsafe or unsound condition, the holding company would have to fix the problem or face the prospect of strong remedial action. This could include divestiture of either the new financial activities or the bank itself, or, if that did not occur, holding company capital requirements, dividend restrictions, and much closer supervision.

In addition, a number of strict firewalls would exist between the bank and its new affiliates. A strengthened version of Section 23A of the Federal Reserve Act expands the type of transactions subject to its provisions. It also amends the definition of affiliate to cover other companies such as subsidiaries of banks that are owned less than 80 percent by the bank. In addition, banks would have to give prior notice to the regulator of any loan exceeding 5 percent of capital. At the same time, under revised Section 23B of the Federal Reserve Act, bank loans to <u>customers</u> of affiliates would also have to be conducted on an arms length basis.

Strict disclosure rules would apply to sales of non-deposit products not only by banks, but by affiliates of banks -- customers would have to sign plainly worded forms acknowledging that such products were <u>not</u> covered by federal deposit insurance. Regulators would have the explicit authority to limit the disclosure by banks of nonpublic customer information to customers. And most important, they would have broad regulatory authority to impose limits on transactions between banks and affiliates to prevent conflicts of interest, unfair competition, and unsafe and unsound banking practices.

<u>Diversified Holding Companies</u>. The bill would also allow diversified holding companies to own financial services holding companies. These diversified holding companies would have no limits on the types of activities in which they could engage. They would provide a critical new source of capital for banks, since 80 percent of the capital in this country is in commercial companies. But these companies must be prepared to put up this capital if they want to own banks -- again, their ownership of banks would be contingent on maintaining high bank capital levels, and they would be subject to similar prompt corrective action penalties if bank capital should ever drop and the holding company was unwilling to restore capital.

All of the firewalls that apply to bank transactions within the financial services holding company would apply to bank transactions with affiliates in the diversified holding company -- with one crucial difference. No bank, and no bank affiliate within a financial services holding company, could provide loans of any kind to the diversified holding company or its subsidiaries. The bank simply could not become a commercial company's "piggy bank" for private sources of credit. We believe that this prohibition along with the other safeguards described above will be more than adequate to protect against abusive lending practices.

Regulatory Restructuring

As we have outlined in previous testimony, the legislation will also propose a streamlining of the regulatory structure. A bank and its holding company would generally be regulated by one federal regulator that would have full supervisory responsibility and accountability for that organization. At the same time, the number of bank regulators would be reduced from four regulators to two, with the Board of Governors of the Federal Reserve regulating state banking organizations, and the the new Office of Depository Institutions under Treasury regulating all Federal banking organizations and all thrifts.

The Federal Deposit Insurance Corporation would refocus its resources on its primary role of insuring banks and resolving failed institutions. While its day-to-day role in regulating certain state banks would end, it would maintain its current authority to examine all banks and their affiliates for insurance purposes. There would be no cutback in FDIC regulatory authority, and indeed, there would be expanded FDIC authority to check the riskiness of state-chartered banks that maintain federal deposit insurance.

Recapitalization of the Bank Insurance Fund

Finally, I would like to discuss the FDIC proposal to recapitalize the Bank Insurance Fund (BIF), which is included in the legislation. As the Committee is well aware, the BIF is at its lowest level in history as a percentage of insured deposits, and is projected to decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

Since last fall, the FDIC and the banking industry have been engaged in discussions over how best to recapitalize the BIF. As these discussions proceeded, we set out four objectives that we believe a BIF recapitalization plan should meet. These objectives are:

First, the plan should provide sufficient resources for the FDIC to do its job.

Second, the plan should be financed by the industry.

Third, the plan should be structured to avoid further impairing the health of the banking industry. And

Fourth, the plan should rely on generally accepted accounting principles.

Several weeks ago, the FDIC circulated an outline of a recapitalization proposal. This outline contained a broad range of funding options, including authority to borrow from, and to sell stock to, the Federal Reserve, the Treasury, the banking industry, and the public. Following receipt of this outline, we worked with the FDIC to narrow the range of funding options. The result is the proposal incorporated in the legislation. This plan has the full support of the FDIC Chairman and the FDIC board, and the full support of the Administration. We believe that it satisfies the four objectives I just described -- perhaps most importantly, the plan relies on industry funds, not taxpayer funds.

The plan would give the FDIC authority to borrow up to $25 billion from the Federal Reserve banks, for use as loss funds. These borrowings would bear interest at Treasury rates. The FDIC would be required to increase premiums and dedicate them -- that is, to set them aside -- in amounts sufficient to assure the payment of interest and principal on any such borrowings. Thus, the Federal Reserve would be assured of repayment.

The plan would also modify the FDIC's current borrowing limitation in two ways, in order to permit the FDIC to use the new Federal Reserve borrowing authority to pay for losses, as intended. First, the legislation would exclude any new borrowing from the Federal Reserve from the existing limitation on obligations. Without this provision, the FDIC would not have access to the funds. Second, the legislation would allow the FDIC to count the unused portion of its existing $5 billion line of credit for purposes of calculating compliance with the obligation limitation. Without this provision, the FDIC would be unable to continue to use its existing authority to borrow for working capital purposes from the Federal Financing Bank.

Finally, the legislation would impose an aggregate ceiling on insurance premiums for BIF-insured institutions of 30 basis points. Since the new risk-based premium authority discussed above would allow the FDIC to vary premiums depending on the riskiness of the institution, the FDIC would retain the authority to assess individual institutions more than 30 basis points. The ceiling would apply in the aggregate to all BIF-insured institutions.

The Committee will recall that the ceiling on premiums was lifted just last fall, as part of the Omnibus Budget Reconciliation Act of 1990. The reasons for reimposing the ceiling are two. First, there is widespread agreement among the bank regulators, including Chairman Seidman, that a cap on premiums is important to allow the industry to continue to attract capital. Moreover, it is the FDIC's view that raising premiums to more than 30 basis points could cause substantially more bank failures, and thus be counterproductive. Second, the old ceiling was lifted in order to permit the FDIC to craft a recapitalization plan. Now that such a plan is in place, we join the FDIC in urging the Congress to reimpose a ceiling of 30 basis points.

Mr. Chairman, I would also like to address the specific questions raised in your letter of invitation. As you know, the Administration's projections are that the BIF will decline substantially over the next five years, reaching a negative net worth of over $22 billion by the end of 1996. These projections are based on a computer model that applies historical failure and loss rates to banks according to their capital levels. This projection assumes a modest recession roughly 6 months in duration.

As you are also aware, in addition to the Administration's projections, there are a number of other projections for BIF, which reach widely disparate conclusions. This only proves what Chairman Seidman of the FDIC often says -- there can be little certainty in projecting BIF losses, particularly more than two years out. Attached as Exhibit A to my testimony, you will find summarized the results of BIF projections made by the Congressional Budget Office, the FDIC, and the Administration, as well as a description of the methodology used by the Administration. I would point out that the plan included in our legislation is adequate to deal with each of these scenarios.

Conclusion

The time has come to address the urgent problems facing the banking industry. We strongly urge Congress to adopt the "Financial Institutions Safety and Consumer Choice Act of 1991."

EXHIBIT A

COMPARISON OF BIF ESTIMATES

($ in billions)

	1991	1992	1993	1994	1995	1996
Fund Net Worth						
OMB	4.4	(2.2)	(9.1)	(15.5)	(19.3)	(22.2)
CBO	1.4	(2.8)	(2.6)	(1.0)	0.9	4.2
FDIC - base	3.9	2.4	n/a	n/a	n/a	n/a
FDIC - pessimistic	0.0	(5.8)	n/a	n/a	n/a	n/a
Assets of Failed Banks						
OMB	62.4	62.4	62.4	56.1	40.6	40.6
CBO\1	96.6	66.9	44.6	37.2	37.2	29.7
FDIC - base	65.0	30.0	n/a	n/a	n/a	n/a
FDIC - pessimistic	90.0	70.0	n/a	n/a	n/a	n/a
Losses on Failed Banks						
OMB	12.0	12.0	12.0	11.5	8.8	8.5
CBO	13.0	9.0	6.0	5.0	5.0	4.0
FDIC - base	10.0	6.5	n/a	n/a	n/a	n/a
FDIC - pessimistic	13.9	10.8	n/a	n/a	n/a	n/a
Net Outlays (excl. FFB interest)						
OMB	15.9	9.2	6.7	5.0	(1.3)	(1.5)
CBO	12.4	3.9	(2.7)	(3.9)	(4.0)	(5.7)
FDIC	n/a	n/a	n/a	n/a	n/a	n/a
Premium Assessments						
OMB	21.25	23	23	23	23	23
CBO	21.25	27	30	30	30	30
FDIC	19.5	19.5	19.5	19.5	19.5	19.5
Deposit Base Growth						
OMB	3.9%	6.6%	7.3%	7.0%	6.7%	6.5%
CBO	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
FDIC	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%

\1 *Estimate based upon data supplied in CBO testimony of January 29, 1991.*

METHODOLOGY FOR BIF ESTIMATES IN 1992 BUDGET

- Estimates in the President's budget were derived from actual call report data on commercial banks.

- A bank failure model adjusted the capital levels of individual banks by predicting loan loss rates and earnings through 1993.

- This model assumed a continuation of recent patterns, with the following exceptions (to simulate a moderate recession):

  - Nonperforming loan rates double (on average); and

  - Loss rates and time required to dispose of assets are greater than the FDIC's historical experience, reflecting weaker real estate markets.

- Banks were put into groups according to their size (large, medium, small, and savings banks) and capital ratio (i.e., banks with capital < 0%, 0-3%, 3-6%, > 6%).

- The failure rate for banks in each of these groups during 1987 to 1990 was applied.

- The timing of failures was smoothed out over the period between 1991 and mid-95. Failures assumed to decrease significantly thereafter (by over 40 percent).

- A loss rate was applied to each of the groups of failed banks; this loss rate averaged 20 percent.

- Using recent experience as a guide, assumptions were made regarding types of bank resolutions, marketable vs. illiquid assets, and the pace of asset sales to estimate the FDIC's working capital needs resulting from failures occurring between 1991 and 1996.

- Premium assessments were assumed to rise to 23 basis points in mid-1991, and remain at that level through 1996.

- All of these assumptions were then incorporated into the presentation that appears in the President's budget.

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

March 21, 1991

Chairman Annunzio, Congressman Wylie, and members of the Subcommittee, thank you for the opportunity to provide the Administration's views on our comprehensive legislative proposal to reform the banking laws, "The Financial Institutions Safety and Consumer Choice Act of 1991" (FISCC). As you know, Secretary Brady recently testified before the full Banking Committee to set forth the fundamental reasons requiring the enactment of this legislation. I will not repeat the details of his testimony today, but I would like to reiterate some of the key reasons why we believe this legislation is essential. I would also like to discuss several important aspects of the legislation that were not described in detail in previous testimony, particularly the recapitalization of the Bank Insurance Fund. Finally, I would like to lay to rest several misconceptions that have arisen since our recommendations were released to the public.

Time to Fix the System

Mr. Chairman, I want to stress that we have a fundamental problem on our hands that demands a comprehensive solution. The picture we see is not a pretty one. The Bank Insurance Fund is at its lowest level in history as a percentage of insured deposits, and the 206 bank failures in 1989 alone were more than the total number of failures in the thirty-eight year period between 1942 and 1980.

At the same time, banks have become less competitive as traditional banking business has migrated to new products in the securities industry and other parts of the financial services industry -- products that are off limits for banks due to outdated laws. Our international competitive position has declined to the point where we have no banks among the top 25 in the world. And as the economy has slowed, some regions have experienced "credit crunches" -- weak banks have not been able to lend even to good customers, hampering a speedy recovery.

The time has come to fix these fundamental problems across the board. A piecemeal approach such as merely recapitalizing the Bank Insurance Fund will not work, because it cannot eliminate the massive taxpayer exposure we now face. Put another way, with over $2 trillion in insured deposits, there is no deposit insurance fund large enough to cover the losses inherent in a banking system that we allow to become weak, inefficient, and uncompetitive.

Fundamental Reforms

We believe comprehensive reform must accomplish three fundamantal objectives. First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors in this country. It also means a well capitalized bank insurance fund.

Second, it is time to modernize archaic laws to let banks catch up with their customers and deliver more efficient products to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for customers, and more bank capital.

Third, we need to restore the preeminent international position of our banking industry. Our economy is twice the size of our nearest competitor, and a world class economy demands a world class banking system.

As outlined in previous testimony, we believe our legislation will help accomplish each of these objectives. Let me focus today on several aspects of the legislation that require more detailed explanation. The place to begin is improved supervision.

Prompt Corrective Action

The regulatory system must be better designed to catch problems early, before they mushroom into costly failures. The legislation's proposed system of Prompt Corrective Action will do just that, and we urge the Subcommittee to study these provisions carefully. The combination of rules and flexibility will help foster two desirable results: regulators will be able to take action much more swiftly as capital declines, and there will be more pressure to take such swift action because of the presumptions built into the statute. More important, banks will be much more likely to maintain strong levels of capital if they face the certainty of decisive regulatory action as their capital declines.

Not everyone will like this system, because it will be argued that statutory presumptions will reduce regulatory "flexibility." But that is in part its purpose -- open-ended flexibility can be the enemy of decisive corrective action.

Critics will also claim that capital is not a good leading indicator of problems, and that prompt corrective action relies exclusively on capital. Both allegations are false. Numerous studies have shown that capital is an excellent leading indicator of problems in banks, and a simple one to measure. But it is not a perfect early warning system, and our legislation specifically recognizes its limits -- even a well-capitalized bank will trigger prompt corrective actions under the new system if it is in an unsafe and unsound condition due to loan concentrations or other supervisory problems. Prompt corrective action does not rely exclusively on capital.

Reduction of Overextended Deposit Insurance

The legislation recognizes the importance of stopping the creeping expansion of deposit insurance coverage to large, sophisticated depositors. For example, we have eliminated insurance coverage for brokered deposits and have carefully tried to eliminate so-called "pass through" coverage for depositors that are least in need of protection. Defined benefit pension plans with professional management, employer liability, and guarantees from the Pension Benefit Guaranty Corporation are hardly in need of deposit insurance protection as well. At the same time, however, the legislation would preserve pass-through protection for self-directed defined contribution plans, where individuals individuals choose their own investments and bear the risk of any loss.

Likewise, banks' use of multiple insured accounts has gotten out of hand. It is time to impose limits, and ours is $100,000 per depositor per bank for most accounts, with a separate $100,000 in coverage for retirement savings. While this limit is important, it is obviously not radical -- a couple can still get up to $400,000 in insurance coverage in each bank, which is hardly a small sum. Insurance for business accounts would not change. Those who suggest that such clearly reasonable limits would destroy the banking system or deprive the elderly of safe places to invest are just plain wrong -- and worse, are irresponsibly and needlessly stirring up depositor fears.

Finally, the FDIC's current "too big to fail" policy must be changed. The legislation would therefore essentially eliminate the FDIC's discretion to protect uninsured depositors in bank failures. But it would also preserve the government's ability to protect the financial system when necessary, even if that requires the rare protection of uninsured depositors.

We believe that this balance struck between direct taxpayer exposure and the stability of the financial system is the correct one. Nevertheless, our recommendations have been criticized for not going far enough to prevent taxpayer exposure through deposit insurance -- that the government should never protect uninsured depositors. But it would be foolhardy for the government to give up its ability to protect the financial system, a restriction that no other governmnent has embraced.

Others argue that we should simply expand the safety net to cover <u>all</u> deposits in all banks in order to create "fairness" for uninsured depositors. That would be equally foolhardy -- what about fairness to the taxpayer? Why should the taxpayer have to pick up the tab to protect an uninsured depositor who knows his or her deposits are uninsured when deposited in a bank?

The best way to address this problem is to stop banks from failing so frequently, which is exactly what other parts of this legislation would do. The next best way is to reduce the systemic risk that creates the need for extraordinary government action to protect uninsured depositors. Our legislation includes technical changes to laws governing the clearing system that are a step in the right direction.

<u>Restored Competitiveness</u>

Let me turn now to the need to restore the competitiveness of our banking system. Our banking laws are archaic. They simply do not reflect the way that banks now do business, and they impose substantial and unnecessary costs. The system needs an overhaul, which the proposed legislation would accomplish.

<u>Nationwide banking and branching</u>. Interstate branching is a perfect example. The geographical debate is essentially over because states have already broken down most of the barriers to interstate banking. Yet interstate branching is still virtually prohibited, imposing totally unnecessary costs on banks.

The legislation would end these artificial barriers, but in a way that recognizes the legitimate interests of state governments. A state would still be able to restrict <u>intra</u>state branching of all state and national banks operating within its borders. It would also have the ability to establish activities restrictions for all of its own state banks and all in-state branches of banks chartered in another state. States would be encouraged to enter into reciprocal arrangements to examine the out-of-state branches of each other's banks. The Community Reinvestment Act would continue to apply, and states could continue to apply state consumer protection laws to branches of all out-of-state banks. Finally, states could tax branches of all banks, state or national, to avoid any adverse revenue impact resulting from changes in the law.

Critics argue that these proposed changes will end the need for small banks and will draw funds out of local communities and deprive rural areas of much needed sources of credit. There is no credible evidence to support these hypothetical fears. The trend towards interstate banking and statewide branching have had not restricted credit availability in smaller communities. Smaller banks have continued to compete extremely effectively with larger banks, and in states like New York, larger banks have actually decreased the number of their branches in recent years in the face of stiff competition from community banks. We believe that a more efficient banking system will mean more efficient banks of all sizes.

Financial Services Holding Companies. The legislation repeals key elements of the Glass-Steagall Act and modernizes the Bank Holding Company Act of 1956 to become the Financial Services Holding Company Act of 1991. Again, these changes reflect the reality of the way that banking organizations already do business. Banks are already in many aspects of the securities and insurance businesses through a patchwork system created by changes to state laws, exceptions in federal laws, and legitimate regulatory interpretations. But this hodgepodge system is costly and burdensome, with numerous Lilliputian restrictions that keep our financial companies from competing fairly and effectively.

The new Financial Services Holding Company Act would require all bank holding companies to become financial services holding companies. These new companies could engage in all of their present financial services activities, and those who maintained well capitalized banks could engage in a broad range of new financial activities through affiliates -- securities activities, insurance activities, and any new activities that are determined to be "of a financial nature" over time.

But important safeguards would be in place to protect banks from risks associated with new activities and to prevent unfair competition. Any new activities would be carried out in separately capitalized affiliates whose capital could not be double counted as capital of the bank. As mentioned above, only companies with well-capitalized banks could take advantage of these new activities, and only if their banks were not in an unsafe or unsound condition and were not engaging in unsafe or unsound practices. If the bank's capital level should decline or if it otherwise falls into an unsafe or unsound condition, the holding company would have to fix the problem or face the prospect of strong remedial action. This could include divestiture of either the new financial activities or the bank itself, or, if that did not occur, holding company capital requirements, dividend restrictions, and much closer supervision.

In addition, a number of strict firewalls would exist between the bank and its new affiliates. A strengthened version of Section 23A of the Federal Reserve Act expands the type of transactions subject to its provisions. It also amends the definition of affiliate to cover other companies such as subsidiaries of banks that are owned less than 80 percent by the bank. In addition, banks would have to give prior notice to the regulator of any loan exceeding 5 percent of capital. At the same time, under revised Section 23B of the Federal Reserve Act, bank loans to customers of affiliates would also have to be conducted on an arms length basis.

Strict disclosure rules would apply to sales of non-deposit products not only by banks, but by affiliates of banks -- customers would have to sign plainly worded forms acknowledging that such products were not covered by federal deposit insurance. Regulators would have the explicit authority to limit the disclosure by banks of nonpublic customer information to customers. And most important, they would have broad regulatory authority to impose limits on transactions between banks and affiliates to prevent conflicts of interest, unfair competition, and unsafe and unsound banking practices.

Diversified Holding Companies. The bill would also allow diversified holding companies to own financial services holding companies. These diversified holding companies would have no limits on the types of activities in which they could engage. They would provide a critical new source of capital for banks, since 80 percent of the capital in this country is in commercial companies. But these companies must be prepared to put up this capital if they want to own banks -- again, their ownership of banks would be contingent on maintaining high bank capital levels, and they would be subject to similar prompt corrective action penalties if bank capital should ever drop and the holding company was unwilling to restore capital.

All of the firewalls that apply to bank transactions within the financial services holding company would apply to bank transactions with affiliates in the diversified holding company -- with one crucial difference. No bank, and no bank affiliate within a financial services holding company, could provide loans of any kind to the diversified holding company or its subsidiaries. The bank simply could not become a commercial company's "piggy bank" for private sources of credit. We believe that this prohibition along with the other safeguards described above will be more than adequate to protect against abusive lending practices.

Regulatory Restructuring

As we have outlined in previous testimony, the legislation will also propose a streamlining of the regulatory structure. A bank and its holding company would generally be regulated by one federal regulator that would have full supervisory responsibility and accountability for that organization. At the same time, the number of bank regulators would be reduced from four regulators to two, with the Board of Governors of the Federal Reserve regulating state banking organizations, and the the new Office of Depository Institutions under Treasury regulating all Federal banking organizations and all thrifts.

The Federal Deposit Insurance Corporation would refocus its resources on its primary role of insuring banks and resolving failed institutions. While its day-to-day role in regulating certain state banks would end, it would maintain its current authority to examine all banks and their affiliates for insurance purposes. There would be no cutback in FDIC regulatory authority, and indeed, there would be expanded FDIC authority to check the riskiness of state-chartered banks that maintain federal deposit insurance.

Recapitalization of the Bank Insurance Fund

Finally, I would like to discuss the FDIC proposal to recapitalize the Bank Insurance Fund (BIF), which is included in the legislation. As the Committee is well aware, the BIF is at its lowest level in history as a percentage of insured deposits, and is projected to decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

Since last fall, the FDIC and the banking industry have been engaged in discussions over how best to recapitalize the BIF. As these discussions proceeded, we set out four objectives that we believe a BIF recapitalization plan should meet. These objectives are:

First, the plan should provide sufficient resources for the FDIC to do its job.

Second, the plan should be financed by the industry.

Third, the plan should be structured to avoid further impairing the health of the banking industry. And

Fourth, the plan should rely on generally accepted accounting principles.

Several weeks ago, the FDIC circulated an outline of a recapitalization proposal. This outline contained a broad range of funding options, including authority to borrow from, and to sell stock to, the Federal Reserve, the Treasury, the banking industry, and the public. Following receipt of this outline, we worked with the FDIC to narrow the range of funding options. The result is the proposal incorporated in the legislation. This plan has the full support of the FDIC Chairman and the FDIC board, and the full support of the Administration. We believe that it satisfies the four objectives I just described -- perhaps most importantly, the plan relies on industry funds, not taxpayer funds.

The plan would give the FDIC authority to borrow up to $25 billion from the Federal Reserve banks, for use as loss funds. These borrowings would bear interest at Treasury rates. The FDIC would be required to increase premiums and dedicate them -- that is, to set them aside -- in amounts sufficient to assure the payment of interest and principal on any such borrowings. Thus, the Federal Reserve would be assured of repayment.

The plan would also modify the FDIC's current borrowing limitation in two ways, in order to permit the FDIC to use the new Federal Reserve borrowing authority to pay for losses, as intended. First, the legislation would exclude any new borrowing from the Federal Reserve from the existing limitation on obligations. Without this provision, the FDIC would not have access to the funds. Second, the legislation would allow the FDIC to count the unused portion of its existing $5 billion line of credit for purposes of calculating compliance with the obligation limitation. Without this provision, the FDIC would be unable to continue to use its existing authority to borrow for working capital purposes from the Federal Financing Bank.

Finally, the legislation would impose an aggregate ceiling on insurance premiums for BIF-insured institutions of 30 basis points. Since the new risk-based premium authority discussed above would allow the FDIC to vary premiums depending on the riskiness of the institution, the FDIC would retain the authority to assess individual institutions more than 30 basis points. The ceiling would apply in the aggregate to all BIF-insured institutions.

The Committee will recall that the ceiling on premiums was lifted just last fall, as part of the Omnibus Budget Reconciliation Act of 1990. The reasons for reimposing the ceiling are two. First, there is widespread agreement among the bank regulators, including Chairman Seidman, that a cap on premiums is important to allow the industry to continue to attract capital. Moreover, it is the FDIC's view that raising premiums to more than 30 basis points could cause substantially more bank failures, and thus be counterproductive. Second, the old ceiling was lifted in order to permit the FDIC to craft a recapitalization plan. Now that such a plan is in place, we join the FDIC in urging the Congress to reimpose a ceiling of 30 basis points.

Conclusion

The time has come to address the urgent problems facing the banking industry. We strongly urge Congress to adopt the "Financial Institutions Safety and Consumer Choice Act of 1991."

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

FOR IMMEDIATE RELEASE
March 22, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY FREEZES ASSETS OF IRAQIS TIED TO ARMS TRADE

The U.S. Treasury Department's Office of Foreign Assets Control (OFAC) today froze the assets of Anees Mansoor Wadi, his wife Shamsaban al-Hayderi, and Bay Industries, Inc., a Santa Monica, California company. They have been identified as participants in Saddam Hussein's arms network.

OFAC Director R. Richard Newcomb said, "The three have been linked to international arms procurement on behalf of Iraq. Wadi was expelled from the United Kingdom in September 1990. He has been an officer in several corporations directly connected to Saddam's arms trading and procurement organization. OFAC's action today is a significant step toward identifying and dismantling this network."

OFAC notified 11 banks in nine locations in New York, California and Georgia that Wadi's and al-Hayderi's real property and financial assets and all property of Bay Industries are now subject to the same freeze put in place against the Government of Iraq by President Bush immediately following the invasion of Kuwait on August 2, 1990. Any transactions involving their blocked assets are prohibited unless specifically licensed by OFAC.

OFAC was assisted in blocking physical assets and real property in the metropolitan Los Angeles area by the U.S. Customs Service, the Immigration and Naturalization Service, and the FBI.

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,076 million of 13-week bills to be issued on March 28, 1991 and mature on June 27, 1991 were accepted today (CUSIP: 912794WQ3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.84%	6.03%	98.524
High	5.86%	6.05%	98.519
Average	5.86%	6.05%	98.519

Tenders at the high discount rate were allotted 30%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	33,160	33,160
New York	28,671,045	6,663,955
Philadelphia	26,590	26,590
Cleveland	55,240	54,750
Richmond	50,775	50,775
Atlanta	36,660	36,660
Chicago	2,597,545	249,545
St. Louis	13,330	13,330
Minneapolis	6,615	6,615
Kansas City	42,295	42,295
Dallas	26,745	26,745
San Francisco	516,230	96,230
Treasury	774,985	774,985
TOTALS	$32,851,215	$8,075,635
Type		
Competitive	$28,999,705	$4,224,125
Noncompetitive	1,606,500	1,606,500
Subtotal, Public	$30,606,205	$5,830,625
Federal Reserve	1,805,110	1,805,110
Foreign Official Institutions	439,900	439,900
TOTALS	$32,851,215	$8,075,635

NB-1193

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,002 million of 26-week bills to be issued on March 28, 1991 and mature on September 26, 1991 were accepted today (CUSIP: 912794WU4).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.83%	6.11%	97.053
High	5.84%	6.12%	97.048
Average	5.84%	6.12%	97.048

Tenders at the high discount rate were allotted 93%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	28,935	28,935
New York	20,522,410	6,890,100
Philadelphia	16,390	16,390
Cleveland	35,390	35,390
Richmond	39,925	39,825
Atlanta	29,360	29,360
Chicago	1,552,930	111,750
St. Louis	18,180	18,180
Minneapolis	5,690	5,690
Kansas City	40,040	40,040
Dallas	20,000	19,975
San Francisco	490,890	112,390
Treasury	653,945	653,945
TOTALS	$23,454,085	$8,001,970
Type		
Competitive	$19,772,360	$4,320,245
Noncompetitive	1,244,125	1,244,125
Subtotal, Public	$21,016,485	$5,564,370
Federal Reserve	1,600,000	1,600,000
Foreign Official Institutions	837,600	837,600
TOTALS	$23,454,085	$8,001,970

NB-1194

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

FOR RELEASE AT 4:00 P.M.
March 25, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $13,500 MILLION
OF 15-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $13,500 million of 15-day Treasury bills to be issued April 3, 1991, representing an additional amount of bills dated October 18, 1990, maturing April 18, 1991 (CUSIP No. 912794 WE 0).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Standard time, Thursday, March 28, 1991. 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 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 amount 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.

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 Wednesday, April 3, 1991.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

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

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

FOR IMMEDIATE RELEASE
March 25, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY UNFREEZES KUWAITI ASSETS

The Treasury Department's Office of Foreign Assets Control (OFAC) today returned effective control of most frozen Kuwaiti assets to the Government of Kuwait. The action was taken at the request of the Kuwaiti Government and in accordance with a March 2 United Nations Security Council resolution calling for cooperation in Kuwait's reconstruction.

The only Kuwaiti assets remaining frozen after today's action are those owned by seven Kuwaiti banks. These banks received licenses on February 25 which permit them to use their frozen assets in settlement of most pre-embargo obligations. These banks are: the Al Ahli Bank of Kuwait, the Bank of Kuwait & the Middle East, Burgan Bank, the Commercial Bank of Kuwait, the Gulf Bank, the Industrial Bank of Kuwait, and Kuwait Real Estate Bank.

As a protective measure, Kuwait's assets were frozen by Presidential Executive Order following the Iraqi invasion on August 2, 1990, at the request of the Government of Kuwait. Restrictions on trade and travel-related transactions were lifted on March 8.

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 26, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for $11,529 million of 2-year notes, Series Y-1993, to be issued on April 1, 1991 and mature on March 31, 1993 were accepted today (CUSIP: 912827A28).

The interest rate on the notes will be 7 1/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.13%	99.991
High	7.15%	99.954
Average	7.15%	99.954

$100,000 was accepted at lower yields.
Tenders at the high yield were allotted 72%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	57,085	57,085
New York	26,622,880	10,065,920
Philadelphia	34,350	34,350
Cleveland	50,730	50,730
Richmond	116,250	103,090
Atlanta	50,280	46,600
Chicago	1,648,945	552,945
St. Louis	76,440	72,440
Minneapolis	23,085	23,085
Kansas City	100,750	100,750
Dallas	23,580	23,580
San Francisco	416,855	64,055
Treasury	334,290	334,290
TOTALS	$29,555,520	$11,528,920

The $11,529 million of accepted tenders includes $1,244 million of noncompetitive tenders and $10,285 million of competitive tenders from the public.

In addition, $1,236 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,576 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1197

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

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 15,200 million, to be issued April 4, 1991. This offering will result in a paydown for the Treasury of about $ 4,250 million, as the maturing bills are outstanding in the amount of $ 19,443 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, April 1, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

92-day bills (to maturity date) for approximately $ 7,600 million, representing an additional amount of bills dated July 5, 1990, and to mature July 5, 1991 (CUSIP No. 912794 WR 1), currently outstanding in the amount of $ 20,647 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,600 million, to be dated April 4, 1991 and to mature October 3, 1991 (CUSIP No. 912794 XH 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 April 4, 1991. 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 $ 753 million as agents for foreign and international monetary authorities, and $ 4,537 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 competitive 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.

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.

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.

8/89

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

AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 8:20 A.M. EST
March 27, 1991

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
REMARKS TO THE ASSOCIATION INSIDERS BREAKFAST
WASHINGTON, D.C.
MARCH 27, 1991

Thank you, Don. I appreciate having the opportunity to speak to the Association Insiders Breakfast this morning.

This is a time when all Americans can share in the renewed sense of pride we feel as we welcome our men and women home from the Persian Gulf. It is not only a very proud moment for the United States, but also a time of restored confidence in our ability to meet the challenges that we will face as America prepares for the next century. Now that the Gulf War is behind us, we can refocus that confidence on other priorities, starting with the economy.

As the President said when he recently addressed the Joint Session of Congress, "Our first priority is to get this economy rolling again." Most economists anticipate an end to the current recession by mid-year, and a resumption of moderate growth as the year progresses. The return to positive growth will be based on strong exports, lower and more stable oil prices, increased credit availability, lower interest rates, and renewed consumer confidence.

In fact, we have seen the first tangible signs of a turnaround. Recent reports indicate an impressive rebound in consumer confidence, as measured by both the Conference Board and the University of Michigan. Perhaps the most significant signs can be found in the February housing starts, which shot up 16.5 percent, and sales of existing homes, which increased 7.9 percent.

We may still see more economic figures that send mixed signals before we see clearer signs of a turnaround. And that is why, in the long run, I believe the most important development on which to base economic optimism is the President's long-range plan for the economy -- the budget agreement with Congress. That agreement has reformed Federal government spending and created the framework for future economic growth.

Some have criticized the budget agreement, but think about it. The 1990 budget agreement mandates a $492 billion reduction in federal borrowing over the next five years and dictates that federal spending shall be governed by the principle of pay-as-you-go.

To the average American who must live within a budget -- be it household or business -- the pay-as-you-go provision must sound like just good common sense. In the world of the federal budget process, however, it is revolutionary. This new provision says that if Congress wants to spend more, it must either reduce spending elsewhere, or be ready to go to the American people and explain why Congress wants to increase taxes. The importance of this spending enforcement procedure, as well as other reforms in the budget process, can be seen in the reaction of the financial markets.

Since these reforms, the Federal Funds rate has fallen from 8% in October 1990 to 6% today. This was not an accident. This was President Bush's plan. Remember, prior to the budget agreement, the Chairman of the Federal Reserve, Alan Greenspan, said a "credible, enforceable reduction in the budget deficit" would result in lower interest rates. The President forged just such an enforceable reduction package, and interest rates have dramatically declined.

Over the next five years, the Federal government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the 1990 budget agreement. The interest rate decline that followed makes it clear that the budget agreement has received a positive reaction from the markets.

Those who don't think this will help stimulate economic growth are dead wrong. Americans who have received downward adjustments in their variable rate mortgages and home equity credit lines certainly understand what it means. Those who can buy a car or a house with substantially lower monthly payments know what it means. Lower interest rates and lower monthly payments have always made a difference before, and they will now.

And for American businesses, lower interest rates mean lower capital costs and a greater incentive to invest. And that means more jobs and more economic activity.

Although these developments are encouraging, this does not mean we can just rest on our oars. We are taking additional steps which will strengthen the economy both in the short-run and the long-term.

President Bush submitted to Congress a 1992 budget that maintains spending at less than the inflation rate, meaning that the real level of spending will decline. With this 1992 budget, the President has reaffirmed his commitment to restrain government spending and stick to the pay-as-you-go provisions of the 1990 budget act. Now Congress must also adhere to these provisions.

In addition to controlling the deficit, we will continue to press for initiatives that will induce long-term economic growth and enhance this country's competitiveness. We are again asking Congress to support the following initiatives as part of the budget: a permanent research and experimentation credit, family savings accounts, enterprise zones, the allowance of withdrawals from individual retirement accounts for first-time home buyers, and a reduction in the capital gains tax rate.

In addition to our growth proposals in the budget, we have also taken action to alleviate a nearer-term problem which has restricted the business community's ability to maintain growth and aid in the economic turnaround -- the credit crunch. The availability of credit is key at this juncture if businesses are to maintain jobs, weather the current downturn, and fuel the recovery. However, we still see many sectors and regions facing a tightening of credit.

Together with the Federal Reserve, the FDIC, the Comptroller of the Currency and the Office of Thrift Supervision, we initiated a review of the regulations covering bank lending. Our goal has been to ensure that key regulations are truly based on common sense. As the President said in the State of the Union address, "Sound banks should be making sound loans, now." We should not foster an atmosphere of risk-adversity, apprehension and hesitation among lending institutions. Our review has resulted in a number of regulatory policy clarifications that were announced on March 1.

These steps alone will not end the credit crunch. However, common sense bank regulations, combined with strict adherence to the pay-as-you-go provision of the 1990 budget agreement, and the Fed's action to lower interest rates and reduce bank reserves, should contribute to a renewal of U.S. consumer and industrial activity.

Although the plan to ease the credit crunch addresses a short-term problem in the economy, we must also come to terms with longer range problems. One of the Administration's top domestic priorities is to modernize our antiquated 40- and 50-year old banking laws. We need financial services reform -- a view I know the Chamber shares. This is important not just for the financial services sector, but for the economy as a whole. Your businesses must be able to count on our financial firms, particularly banks, in good times and bad.

As we have seen in the current economic downturn, weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of trouble, jobs are imperiled. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in our own country.

Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in economic downturns. The nation needs a banking system that is strong enough to compete toe-to-toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

The Administration's legislation -- the Financial Institutions Safety and Consumer Choice Act -- was submitted to the Congress last week. Weighing in at some 300 pages, it can modestly be referred to as a comprehensive bill.

Some have questioned whether this is the time for such fundamental reform. Are we taking on too much? Shouldn't we listen to the winds of politics and make sure we don't offend established interests? The answer is no. This time the need for comprehensive reform is impossible to ignore.

To paraphrase President Lincoln, it is a quality of change "not to go by old lines and old laws; but to break up both and make new ones." Narrow, timid approaches are not enough to address the fundamental problem we face -- our banking system is simply out of step with today's realities.

There is much to worry about in the banking world. The state of banking in the U.S. leaves taxpayers overexposed, consumers and businesses underserved, and the industry increasingly uncompetitive. As a result, banks are unable to effectively perform their important role in stimulating and sustaining economic growth.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we led the standings with the top three and had seven banks in the top 25. This is not a size issue, but a competitiveness issue. Foreign banks are increasing lending in the United States as American banks lose market share here at home. Even U.S. investors are not rushing to invest in U.S. banks. Our country's largest bank recently turned to foreign sources for a capital infusion.

The simple fact is, our banks -- large and small -- are being asked to compete in a highly competitive world financial services market with one hand tied behind their backs. For example, we have out-of-date laws on the books that prohibit banks from getting into new financial markets, and even keep them from branching across state lines. Banks in California, Michigan and Utah can open branches in Birmingham, England, but not in Birmingham, Alabama.

What does this all add up to? Bank failures totalled 198 in the 38 years from 1942 to 1980, but reached 206 in 1989 alone. Interest rates and transactions costs are higher than they need to be, due to inefficiency and higher costs. And the bank insurance fund is under stress.

Our banks hold $2.8 trillion in deposits. That means that there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized Bank Insurance Fund. But we also need interstate branching and broader financial activities so that our banks can finance economic growth.

I believe there will be a banking bill this year. The question is, will it address the structural reforms necessary to support economic growth for the 1990s and beyond? Or, will it instead be a quick fix, which allows us all to go home claiming victory, having offended no one, but having done little to solve the real, underlying problems.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to put this country's financial services industry back where it belongs: number one in the world.

If we leave the job half done -- if we only tinker with the problem -- then we'll probably be back again, sooner rather than later, recapitalizing the Bank Insurance Fund again, perhaps the next time with taxpayer money. That's a prospect no one could relish.

The timing is right. By facing up to the reality of the marketplace today, we can help to ensure financial security for the future. We can create a modern financial system that is internationally competitive, that will protect depositors, save taxpayers money, serve consumers and businesses, and strengthen the economy.

Modernizing our financial services industry, encouraging sound lending practices, holding down the Federal Governments' spending, and pushing for lower U.S. interest rates will contribute to the strength of our economy. With President Bush's leadership, we can achieve these policy objectives and provide for a secure economic future for all Americans. With your help, we'll get it done.

Thank you.

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AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 27, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for $8,590 million of 5-year notes, Series M-1996, to be issued on April 1, 1991 and mature on March 31, 1996 were accepted today (CUSIP: 912827A36).

The interest rate on the notes will be 7 3/4%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.80%	99.796
High	7.81%	99.756
Average	7.81%	99.756

$30,000 was accepted at lower yields.
Tenders at the high yield were allotted 55%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	23,989	23,969
New York	28,361,673	8,180,573
Philadelphia	10,433	10,433
Cleveland	29,382	29,382
Richmond	48,262	32,862
Atlanta	25,712	14,812
Chicago	1,213,446	158,796
St. Louis	22,674	18,674
Minneapolis	10,998	10,998
Kansas City	28,157	28,157
Dallas	5,290	5,290
San Francisco	419,047	45,642
Treasury	30,682	30,682
TOTALS	$30,229,745	$8,590,270

The $8,590 million of accepted tenders includes $505 million of noncompetitive tenders and $8,085 million of competitive tenders from the public.

In addition, $162 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $300 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1200

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE March 28, 1991

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of February 1991.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $181.7 billion on February 28, 1991, posting an increase of $0.7 billion from the level on January 31, 1991. This net change was the result of a decrease in holdings of agency-guaranteed loans of $23.7 million, while holdings of agency debt increased by $301.2 million and holdings of agency assets increased by $374.8 million. FFB made 17 disbursements during February.

FFB holdings on February 28, 1991, were the highest in the bank's history.

Attached to this release are tables presenting FFB February loan activity and FFB holdings as of February 28, 1991.

NB-1201

FEDERAL FINANCING BANK

FEBRUARY 1991 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 #543	2/4	$ 5,850,000.00	5/6/91	6.302%	
+Note #544	2/4	3,000,000.00	3/6/91	6.298%	
+Note #545	2/14	6,230,000.00	5/15/91	6.156%	
+Note #546	2/25	10,000,000.00	5/24/91	6.247%	
RESOLUTION TRUST CORPORATION					
Note No. 91-02					
Advance #5	2/19	300,000,000.00	4/1/91	6.203%	
TENNESSEE VALLEY AUTHORITY					
Short-term Bond #79	2/7	175,000,000.00	2/21/91	6.271%	
Short-term Bond #80	2/16	273,000,000.00	3/1/91	6.144%	
Short-term Bond #81	2/18	16,000,000.00	3/1/91	6.144%	
Short-term Bond #82	2/21	72,000,000.00	2/28/91	6.254%	
Short-term Bond #83	2/28	155,000,000.00	3/11/91	6.344%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Morocco 13	2/15	15,564.00	5/31/95	7.395%	
Philippines 9	2/27	762,690.84	5/15/91	6.344%	
RURAL ELECTRIFICATION ADMINISTRATION					
*United Power Assoc. #159A	2/21	500,000.00	12/31/19	7.996%	7.918% qtr.
*United Power Assoc. #212A	2/21	1,959,000.00	12/31/19	7.996%	7.918% qtr.
*United Power Assoc. #222A	2/21	300,000.00	1/3/23	8.016%	7.937% qtr.
*Basin Electric #232	2/28	1,550,000.00	1/3/22	8.212%	8.129% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-91-04	2/28	1,203,854.45	3/29/91	6.344%	

*maturity extension
+rollover

FEDERAL FINANCING BANK
(in millions)

Program	February 28, 1991	January 31, 1991	Net Change 2/1/91-2/28/91	FY '91 Net Change 10/1/90-2/28/91
Agency Debt:				
Export-Import Bank	$ 11,370.2	$ 11,370.2	$ 0.0	$ 30.4
NCUA-Central Liquidity Fund	63.2	80.0	-16.8	6.6
Resolution Trust Corporation	55,890.7	55,590.7	300.0	14,409.0
Tennessee Valley Authority	14,119.0	14,101.0	18.0	-263.0
U.S. Postal Service	6,697.8	6,697.8	-0-	-0-
sub-total*	88,140.9	87,839.6	301.2	14,183.0
Agency Assets:				
Farmers Home Administration	52,544.0	52,169.0	375.0	495.0
DHHS-Health Maintenance Org.	69.6	69.6	-0-	-0-
DHHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,407.2	4,407.2	-0-	-0-
Small Business Administration	7.5	7.7	-0.2	-0.9
sub-total*	57,111.0	56,736.2	374.8	494.1
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,769.0	4,770.3	-1.3	-4,986.6
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.0
DHUD-Community Dev. Block Grant	224.7	232.3	-7.5	-19.2
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.4
General Services Administration +	478.6	478.6	-0-	111.2
DOI-Guam Power Authority	29.7	29.7	-0-	-0-
DOI-Virgin Islands	24.7	24.7	-0-	-0.5
NASA-Space Communications Co. +	32.7	32.7	-0-	-1,063.2
DON-Ship Lease Financing	1,624.4	1,624.4	-0-	-47.9
Rural Electrification Administration	18,906.4	18,906.4	-0-	-135.9
SBA-Small Business Investment Cos.	313.0	324.4	-11.4	-69.6
SBA-State/Local Development Cos.	723.0	727.3	-4.3	-18.6
TVA-Seven States Energy Corp.	2,383.5	2,382.3	1.2	27.4
DOT-Section 511	22.5	22.9	-0.4	-0.8
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	36,462.6	36,486.3	-23.7	-6,281.1
grand total*	$ 181,714.5	$ 181,062.1	$ 652.3	$ 8,396.0

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE AT 12:00 NOON
March 28, 1991

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 $ 10,750 million of 364-day Treasury bills to be dated April 11, 1991 and to mature April 9, 1992 (CUSIP No. 912794 YH 1). This issue will provide about $ 950 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $ 9,807 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Thursday, April 4, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. 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 April 11, 1991. In addition to the maturing 52-week bills, there are $ 19,651 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 $ 938 million as agents for foreign and international monetary authorities, and $ 7,078 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 $ 160 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 competitive 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.

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.

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.

8/89

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 28, 1991

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or
L. Richard Keyser
(202) 708-1591

TREASURY AUTHORIZES HUD CALL OF FHA INSURANCE FUND DEBENTURES

The Departments of Treasury and Housing and Urban Development announced today the call of all Federal Housing Administration (FHA) debentures, outstanding as of March 31, 1991, with interest rates of 8 1/4 percent or higher. Debentures that have been registered on the books of the Federal Reserve Bank of Philadelphia as of March 31, 1991, are considered, "outstanding." The date of the call for the redemption of the more than $120 million in debentures is July 1, 1991, with the semi-annual interest due July 1, paid along with the debenture principal.

Debenture owners of record as of March 31, 1991, will be notified by mail of the call and given instructions for submission. Those owners who cannot locate the debentures should contact the Federal Reserve Bank of Philadelphia (215) 574-6684 for assistance.

No transfers or denominational exchanges in debentures covered by this call will be made on or after April 1, 1991, nor will any special redemption purchases be processed. This does not affect the right of the holder to sell or assign the debentures.

The Federal Reserve Bank of Philadelphia has been designated to process the redemptions and to pay final interest on the called debentures. To ensure timely payment of principal and interest on the debentures, they should be received by June 1, 1991, at:

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

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AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
March 28, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 15-DAY BILLS

Tenders for $13,505 million of 15-day bills to be issued on April 3, 1991 and mature on April 18, 1991 were accepted today (CUSIP: 912794WE0).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.99%	6.12%	99.750
High	6.07%	6.19%	99.747
Average	6.05%	6.16%	99.748

Tenders at the high discount rate were allotted 42%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	0	0
New York	37,847,000	13,035,000
Philadelphia	0	0
Cleveland	0	0
Richmond	0	0
Atlanta	0	0
Chicago	1,950,000	225,000
St. Louis	0	0
Minneapolis	0	0
Kansas City	3,000	0
Dallas	0	0
San Francisco	745,000	245,000
Treasury	0	0
TOTALS	$40,545,000	$13,505,000
Type		
Competitive	$40,545,000	$13,505,000
Noncompetitive	0	0
Subtotal, Public	$40,545,000	$13,505,000
Federal Reserve	0	0
Foreign Official Institutions	0	0
TOTALS	$40,545,000	$13,505,000

NB-1203