Sheila - FYI

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

October 27, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
U.S. Department of the Treasury
15th and Pennsylvania Avenue
Washington, D.C. 20220

Dear Mr. Secretary:

I am in receipt of your letter of yesterday and I am very puzzled as to what has transpired between your October 16 letter informing the Congress of the November 3 default date and your most recent letter indicating that the default date has changed November 9. I am particularly concerned that you now feel compelled to resort to "extraordinary administrative actions" which you did not envision in your earlier letter. I would respectfully request a full explanation of what happened to Treasury's borrowing needs or what transpired to change the default date in the ten days between the two letters. Because I view this as a most serious matter, I am requesting that you respond by Monday, October 30. I anticipate this subject will also be fully discussed at the Oversight Subcommittee hearing scheduled on Tuesday, October 31, relating to the role of federal borrowing and loan guarantees in resolving insolvent thrift institutions.

In addition to your explanation, I would request that you respond to the following specific questions:

1. Will notifying the markets of the unused statutory borrowing of $17 billion and settling on October 31 instead of November 2 cost the U.S. Treasury any additional money, either in terms of carrying extra cash balances or raising the interest cost of that debt issuance?

2. To what extent does the off-budget REFCORP borrowing of $4.5 billion enable you to say confidently in your letter of yesterday that there would be "sufficient cash to cover obligations presented for payment through November 8?"

3. To what extent are you pursuing other "extraordinary procedures" in order to extend the default date from November 3 to November 9? For example, will the normalized transfers to the Social Security trust funds take place as required by law?

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4. To what extent would other actions such as additional REFCORP borrowing enable you to change the default date from November 9 to some later date?

As your earlier letter made clear, the consequences of not enacting an increase in the public debt limit are "unthinkable and irresponsible." To tell the Congress ten days later that suddenly we have an extra week undermines the credibility of the Administration and lessens the seriousness of the financial consequences described in your earlier letter.

Mr. Secretary, I want to emphasize that it is imperative that we receive your response by close of business on Monday and will expect that Assistant Secretary David Mullins, Jr. will be prepared to fully discuss this subject at the hearing. In addition, I urge you once again to devote all of the Administration's considerable energy and resources to having the Senate pass H.J. Res. 280, the long-term debt ceiling extension, without amendment, as expeditiously as possible.

With warm regards, I am

Sincerely yours,

Dan Rostenkowski

Dan Rostenkowski
Chairman

Treasury Actions Related to the Debt Limit in 1989

1. On June 23, Secretary Brady wrote letter to Senate leadership (Sens. Dole, Bentsen, Mitchell, and Packwood) requesting debt limit action by August 1.

2. On July 14, Under Secretary Glauber sent letters to House Speaker Foley, Senate President Quayle, and the Executive Director of the Federal Retirement Thrift Investment Board writing that, in the absence of action by early August, Treasury will be unable to invest or roll over maturing investments of trust funds and other Government accounts.

3. On July 19, Under Secretary Glauber testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, stating that the then current ceiling would be sufficient only into early August. Without an increase by August 1, full investment of the NTT may not be possible.

4. On July 19, Treasury announced the suspension of sales of SLGS effective July 20 because of Treasury's need to plan and avoid exceeding the debt limit in August.

5. On July 19, as part of Treasury's announcement for 2-year notes, to be auctioned July 26, Treasury announced that no foreign add-ons in excess of rollovers would be allowed because of debt limit stringency.

6. On July 21, as part of the 52-week bill announcement, Treasury stated that foreign add-ons in excess of rollovers would not be allowed for the July 27 auction.

7. On July 25, Treasury announced a $400 million reduction in the July 31 regular weekly bill auctions as part of Treasury's need to plan debt levels in August and allow for an orderly regular mid-quarter refunding on Aug 15. Treasury also announced at the same time that there would be no foreign add-ons in excess of rollovers allowed because of the debt limit stringency.

8. On July 31, Secretary Brady wrote to House and Senate leadership, noting that if there were no action by August 1, Treasury would almost certainly be unable to fully invest Social Security trust funds on August 1 and 2, and Treasury would default on other obligations on August 15.

9. On August 1, $1.7 billion of the August NTT was left uninvested for two days.

10. On August 7, the debt limit was temporarily raised to $2,870 billion through October 31, when it will revert to $2,800 billion.

11. On August 8, following enactment of legislation to raise the debt limit, the Treasury authorized the resumption of the sale of SLGS.

FY 1988

Treasury Actions Related to the Debt Limit in 1987

1. On August 21, 1986, a permanent debt limit of $2,111 billion passed. On October 21, 1986, the debt limit was temporarily raised by $189 billion, to $2,300 billion, expiring on May 15, 1987. It was to revert back to $2,111 billion upon expiration.

2. On April 30, 1987, Under Secretary Gould testified before the House Ways and Means Committee that, because the limit would revert back to $2,111 billion, the Treasury would be $160 billion above the permanent limit on May 16.

3. On May 1, Secretary Baker wrote letters to Sens. Dole, Byrd, Packwood, and Bensten and Reps. Wright, Michel, Duncan, and Rostenkowski requesting debt action by May 15.

4. On May 8, Under Secretary Gould testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. (Same Testimony as on April 30).

5. On May 15, a 2-month extension of the temporary limit was passed, expiring at midnight on July 17, which also raised it to $2,320 billion from $2,300 billion.

7. On July 8, Secretary Baker wrote letters to House and Senate leadership outlining what would happen if a new limit were not passed before July 17.

8. On July 14, Treasury announced that it would postpone its weekly bill auctions, scheduled for July 20, unless it has assurance of Congressional action on legislation to raise the debt limit before that date.

9. On July 15, Treasury announced it will postpone its 2-year auction, scheduled for July 22, unless it had assurance of action on the debt limit by that date.

1 10. OK On July 17, Treasury suspended sales of savings bonds and State and local government securities, effective July 18.

2 11. OK Treasury postponed its July 20 regular weekly bill auction.

12. On July 21, Treasury announced it would postpone its regular weekly bill auction on July 27, unless it had assurance of action on the debt limit by that date.

3 13. OK On July 22, Treasury postponed the 2-year note auction.

~~14.~~ On July 24, Treasury announced it would postpone its 52-week auction on July 30, unless it had assurance of action on debt limit by that date.

4 of 8) 15. On July 27, Treasury postponed its regular weekly bill auctions.

16. On July 29, Treasury announced the rescheduling of its regular auctions, contingent on the pending debt limit legislation:

	from	to
weekly bills	July 20	July 31
weekly bills	July 27	July 30
52-week bills	July 30	Aug. 4

5 OK a) 17. Also on July 29, Treasury postponed the announcement of the quarterly financing, scheduled for mid August, in the absence of assurance that the statutory ceiling would permit settlement on Aug 17. It was announced on August 10.

18. On July 30, a 1-week extension of the limit, through August 6, was enacted.

19. On August 3, Secretary Baker sent a letter to the Speaker of House, President of the Senate and other Congressional leadership listing the usual interruptions, including inability to make $14.5 billion of Social Security payments on Sept 3.

6 10) OK 20. On August 7, Treasury announced the suspension of the sale of savings bonds and SLGS, effectively immediately.

21. Temporary debt limit was enacted on August 7, to carry through September 23, raising the limit to $2,352 billion.

22. On August 10, Treasury announced the resumption of the sale of savings bonds and SLGS.

23. On September 11, Asst. Secretary Sethness, in a letter to Speaker James Wright and Senate President Bush, stated that in absence of debt limit action before Sept 23, Treasury will be unable to invest or rollover maturing investments of trust funds, including Civil Service and the Thrift Savings Fund.

7 11) OK 24. On September 21, Treasury announced the postponement of its regular weekly bill auctions scheduled for that day, and also the postponement of 2-year notes scheduled for September 22, and 4-year notes scheduled for September 23.

25. On September 29, a $2,800 billion debt limit bill was signed, which was sufficient until August 1989.

In 1987, the timing of temporary debt limit increases and their expirations obviated any actions

FY 1986

(7)

DEBT LIMIT -- FALL 1985
DISRUPTIONS OF REGULAR TREASURY FINANCING

1) 1. September 11, 1985 -- Announced that no foreign add-ons would be allowed on the 2-year note auctioned September 18.

2) 2. September 17, 1985 -- Weekly bills were reduced to ensure that the debt ceiling would not be exceeded.

3) 3. September 17, 1985 -- Postponed regular auctions of 4, 7, and 20-year securities.

4) 4. October 8, 1985 -- Out of cash -- Substituted $5 billion of FFB issues for Treasury securities in the Civil Service Retirement fund; sold $5 billion of 78-day cash management bills in the market to raise cash.

5. October 9, 1985 -- Settled 78-day CMB.

6. October 28, 1985 -- Announced sale of 3-year 11-month, 6-year 11-month and 19-3/4-year securities. Announced that would disinvest trust funds to permit issance of these securities to raise cash for benefit payments.

7. October 30, 1985 -- DAS John Niehenke testified on the impact of the debt limit crisis on the trust funds.

8. November 1, 1985 -- Secretary Baker announced accelerated redemption of trust fund securities to meet November social security payments.

9. November 5 -- Sold 142-day CMB using debt limit room acquired by disinvesting trust funds. Regular weekly bills were rolled over, raising no cash.

10. November 14, 1985 -- Temporary $80 billion increase in the debt limit was enacted. Treasury announced $61 billion of market financing, including:

$22.0 billion of CMB
22.5 billion November quarterly refunding
9.0 billion 52-week bills
7.5 of 5-year notes

5) 11. December 5, 1985 -- Sales of savings bonds and SLGS were suspended.

6) 12. December 6, 1985 -- Weekly bill auction was postponed.

13. December 7, 1985 -- Debt limit was reached.

14. December 11, 1985 -- Announced 2- and 4-year notes, with a caveat that the auction would be postponed in the absence of congressional action.

15. December 11, 1985 -- Rescheduled regular weekly bills to auction and settle on December 12; a $10 million minimum was set for bids and bidding was restricted to the New York District.

16. December 12, 1985 -- A $2,087.7 billion permanent debt limit was enacted, along with the Balanced Budget and Emergency Deficit Control Act. The act also restored 1985 losses of all of the trust funds' losses and 1984 losses only for the social security trust funds.

Market Finance
July 17, 1985

DEBT LIMIT AND SOCIAL SECURITY TRUST FUNDS IN 1985

1. On September 3 (first working day), Treasury credited the trust funds with NTT of $15.1 billion, but because the debt outstanding was close to the limit, only $1.0 billion was invested. Treasury met payments from the general fund.

2. On September 3, 9, 19, and 30, Treasury redeemed investments, shortest maturity and lowest coupons first. If Treasury had sufficient borrowing authority to fully invest the September NTT at the beginning of the month, $6.9 billion of long-term bonds would not have had to be redeemed.

3. On September 10, DAS Niehenke testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee that without an increase in the debt limit by September 30, investment in trust funds would have to be delayed.

4. On September 25, Secretary Baker wrote Sen. Dole and Sen. Byrd that unless the debt limit was raised by October 7 recipients of government checks, including social security, would be unable to cash them.

5. On October 1, Secretary Baker stated in a letter to Sen. Dole and Sen. Byrd that Treasury was unable to comply with statutory requirements to fully invest trust funds.

6. On October 1, $12.8 billion was credited to the trust funds, but unlike September, none of it was invested. It remained so until after the debt limit was raised. Treasury disinvested $4.8 billion of trust fund bonds in October.

7. On October 22, Secretary Baker, in a letter to Rep. William Gray, stated that the failure to raise the debt limit had resulted in the disinvestment of trust funds. Also, if the limit were not raised, Treasury was prepared to take the extraordinary step of disinvesting funds in advance of benefit payments in order to meet obligations.

8. On October 28, at the quarterly financing press conference, the Treasury announced that it would disinvest trust funds in order to issue new securities to raise funds to pay benefits in November.

9. On October 30, DAS Niehenke testified before the Subcommittee on Social Security of the House Ways and Means Committee on the impact of the debt limit crisis on the trust funds, and on Treasury's plans to accelerate disinvestment of the trust funds at the beginning of November.

10. On October 30, Assistant Secretary Thompson sent a memorandum to Rep. James Jones regarding the Secretary's authority to disinvest the Trust funds, and to subsequently make them whole for direct interest losses.

11. On November 1, Secretary Baker announced accelerated redemption of trust fund securities to meet November payments.

12. On November 1, $13.1 billion was credited to the trust funds, but as in October, it remained uninvested, bringing the total uninvested portion of the NTT to $28.2 billion. To cover social security payments in November, Treasury redeemed $13.7 billion of long-term bonds. None of the bonds would have had to be redeemed if Treasury had been able to follow its normal NTT procedures.

13. On November 1, Treasury proceeded to accelerate disinvestment of trust funds. Under normal circumstances, obligations with face amounts totaling almost $15 billion would have been redeemed by the trust funds on November 1, 7, an 8, but both the timing and amounts were accelerated in November.

Normal Schedule		Accelerated Schedule	
Nov. 1	$6.9 billion (46%)	Nov. 1	$9.6 billion (64%)
7	$4.8 billion (32%)	4	$4.1 billion (28%)
8	$3.2 billion (22%)	8	$1.1 billion (8%)

14. On November 7, DAS Niehenke testified before the Subcommittee on Social Security and Income Maintenance Programs of the Senate Finance Committee on the actions Treasury had taken regarding the disinvestment of the trust funds and the potential associated costs.

15. The Balanced Budget and Emergency Deficit Control Act of 1985 (December 5, 1985) provided that the trust funds be made whole for interest foregone as a result of disinvestment. By December 31, 1985, Treasury had reimbursed the social security trust funds $9 million for losses incurred during the disruption in normal practices in 1985, and $373 million for losses incurred in 1984.

DEBT LIMIT AND SOCIAL SECURITY TRUST FUNDS IN 1984

1. On May 1, Treasury credited the trust funds with NTT of $15.8 billion, but only $4.2 billion was invested, with the remainder credited to a non-interest bearing account.

2. On May 7, Secretary Regan stated in a letter to Sen. Dole and Rep Rostenkowski that the May NTT had not been fully invested, and if action on the debt limit were delayed beyond May 24, future disruptions in trust fund investments would be necessary.

3. On May 16, Assistant Secretary Healey testified before the House Ways and Means Committee that timely action was necessary to avoi a repetition of past actions, including failure to fully invest NTT funds.

4. On May 21, Secretary Regan, in a letter to Sen. Dole and Rep. Rostenkowski, reiterated the need to act on the debt limit by May 24, or Treasury would likely not be able to meet all its obligations when they fell due, including social security checks.

5. On May 25, limit was temporarily raised from $1,490 billion to $1,520 billion.

6. However, because the debt was close to the statutory limit on Jun 1, and again on July 1, the NTT for each month was not fully invested on those dates.

7. During June, there were sufficient short-term securities outstanding to cover benefit payments, but in July, $1.7 billion of long term bonds were disinvested to reimburse Treasury for timely payments.

8. On July 6, the limit was raised temporarily to $1,573 billion.

9. On July 31, Secretary Regan, in a letter to Sen. Dole and Rep. Rostenkowski requesting an increase in the debt limit, stated tha Treasury would have to delay fully investing the September NTT unless the debt limit were raised.

10. On August 31, $4.1 billion of long-term bonds were redeemed because September 3 fell on a holiday. The funds were used to finance payments by electronic funds on August 31, as there were insufficient short-term investments available. Between August 31 and October 12, $9.9 billion of long-term bonds were redeemed.

11. On September 4 (first working day), Treasury credited the trust funds with NTT of $12.4 billion, but the funds were invested in three blocks, on the 4th, 7th, and 10th.

12. On October 1, Treasury credited the trust funds with NTT of $11.6 billion, but it remained completely uninvested until October 13 when the debt limit was raised.

Treasury Actions Which Resulted from Congressional Failure to Raise the Debt Limit in FY 86 & 87

Near the end of that year, on August 1, 1985, the Congress adopted a congressional budget resolution for fiscal year 1986 containing a provision that declared the appropriate level of debt to be $1,847.8 billion or, as of October 1, $2,078.7 billion. This provision was deemed to have passed the House, but no further action was immediately taken.

At the beginning of September 1985, Treasury could not fully invest the receipts of the social security trust funds that are normally transferred at the beginning of the month, because that would have raised the amount of debt over the limit. By the end of the month the debt was still at the limit, social security was still only partially invested, Treasury had postponed or limited the normal auctions for some of its securities, and Treasury had not been able to keep the Exchange Stabilization Fund fully invested. On the last day of September, $17.4 billion was supposed to have been invested for the civil service retirement and disability trust fund; during the first days of October investment was supposed to have been made for the social security trust funds, the military retirement trust fund, and the supplementary medical insurance trust fund. The total of these amounts was $42.5 billion, but because of the debt limit most of the investment had to be delayed, as it had been the year before.

By this time the debt limit bill had become the vehicle for the Gramm-Rudman-Hollings proposal to eliminate the deficit in a series of steps over several years. This proposal, which set deficit targets and created a mechanism to enforce them, was offered as an amendment to the debt limit bill. This amendment became the principal issue before the Congress until December 12, 1985, when the debt limit bill was enacted incorporating a revised version of the amendment designated the Balanced Budget and Emergency Deficit Control Act of 1985.

As a result of this delay, the amount of debt remained at the limit, and several extraordinary steps were taken to prevent a default on the Government's various obligations. The first such step was taken on October 9, the day after Treasury's cash balance became virtually exhausted, when use was made of the Federal Financing Bank (FFB). As explained above, FFB debt is not subject to the general statutory debt limit, so Treasury reduced the amount of debt subject to limit by issuing $5 billion of FFB securities to the civil service retirement and disability trust fund in place of regular Treasury securities. This enabled Treasury to raise $5 billion of cash by selling securities to the public that were subject to the debt limit. A total of $14.2 billion of FFB securities was eventually issued to the civil service retirement and disability trust fund, nearly reaching the FFB's own $15 billion special limit. The FFB securities had the same interest rates and date of maturity (June 30, 1986) as the regular Treasury securities that they replaced.

By the beginning of November, further steps were needed in order for Treasury to finance the outlays for social security and other purposes that are always very large at the start of the month. Treasury temporarily reduced the debt held in Government accounts by disinvesting the social security trust funds, the civil service retirement and disability trust fund, and the railroad retirement account (i.e., by accelerating the redemption of certain securities they held by up to seven days earlier than normal). This decreased the debt subject to limit, which enabled Treasury to obtain cash by selling debt securities to the public that were subject to the limit.

The next critical problem was large payments due on November 15. Treasury was scheduled to pay $16 billion of cash interest on its debt but did not have enough cash to do this (on November 14 it had a cash balance of only $7.3 billion). Inability to meet its obligations would have caused an unprecedented default on the interest and principal of U.S. Government securities. To avoid this, on November 14 the Congress temporarily raised the debt limit to $1,903.8 billion for the period ending December 6. Treasury immediately sold sufficient securities to meet its obligations and fully invested all the trust funds.

By December 5 the debt was at the level of the temporary limit, so when the limit returned to $1,823.8 billion on December 7 the amount of debt exceeded the limit. For the next several days Treasury was forced to postpone its normal auction of bills, to suspend sales of savings bonds and State and local government special issues, and to cease investing trust funds. On December 12, 1985, however, the debt bill was enacted, raising the limit to $2,078.7 billion and including as a separate title the Balanced Budget and Emergency Deficit Control Act of 1985. Treasury immediately sold securities to the public and fully invested the trust funds.

The trust funds had lost interest during this period for several reasons stemming from Treasury's inability to keep them fully invested. As part of the Balanced Budget and Emergency Deficit Control Act, the Congress provided that the trust funds be made or reduced the auctions of some securities and had issued FFB debt up to the $15 billion statutory maximum. On the last day of September, $17.9 billion was available to be invested for the civil service retirement and disability trust fund; during the first three days of October additional funds were available to be invested for the social security trust funds, the military retirement trust fund, and the supplementary medical insurance trust fund. The total of all these amounts was $48.8 billion, but because of the debt limit only about a third could be immediately invested. The rest was either used for benefit payments within the following few days or temporarily left uninvested.

Later in October, just before adjournment, Congress passed the Omnibus Reconciliation Act of 1986, and the President signed it on October 21. This Act raised the debt limit to $2,300 billion through May 15, 1987. Treasury immediately invested the remaining trust fund balances it had not been able to invest, which were relatively small by that date. The Act also provided that the trust funds be made whole for the losses they had incurred because of Treasury's inability to keep them fully invested. As a result, Treasury paid the trust funds $41 million.

Because the new limit expires on May 15, 1987, and then reverts to $2,111 billion, further debt limit legislation will be needed at that time in order to permit the Federal Government to meet its obligations.

Treasury Actions which Resulted from Congressional Failure to Raise the Debt Limit - Fiscal Year 1988

Recent changes in the debt limit.—The statutory debt limit was raised to $2.111 billion on August 21, 1986, and on October 21 it was temporarily raised to $2.300 billion through May 15, 1987. The course of the debt limit legislation during calendar year 1987 was closely tied to efforts by the Congress and the Administration to control the budget deficit.

Specifically, it was an outgrowth of the Gramm-Rudman-Hollings Act of 1985 (the Balanced Budget and Emergency Deficit Control Act of 1985). The Gramm-Rudman-Hollings proposal was designed to eliminate the deficit in a series of steps over several years by setting annual deficit targets and establishing a mechanism to enforce them. During the fall of 1985 this proposal was offered as an amendment to the debt limit bill before the Congress at that time. After lengthy consideration the debt limit bill was enacted incorporating a revised version of this amendment, but subsequently the Supreme Court declared a key part of the enforcement mechanism to be unconstitutional. Proposals were made to develop a substitute, and debt limit legislation again provided a vehicle.

The first critical date in 1987 was May 15, the expiration date for the temporary increase of the debt limit from $2,111 billion to $2,300 billion. Until that time the Treasury was able to conduct its normal debt financing operations, and on that date a new law was enacted temporarily increasing the limit to $2,320 billion through July 17.

On June 24, 1987, Congress enacted a budget resolution for fiscal year 1988. The resolution stated that the appropriate level of debt subject to limit was $2,565.1 billion. A joint resolution specifying this amount as the debt limit was deemed to have passed the House and was sent to the Senate for its consideration. This joint resolution became the vehicle for subsequent proposals to revise the budget process.

In the absence of further legislation, the debt limit dropped to $2,111 billion on July 18. Treasury had to suspend the auction of bills and notes; to stop the sales of bills, notes, savings bonds, special issues of the State and local government series, and all other securities; and to cease the investment of trust funds and all other U.S. Government accounts. Treasury bills that matured had to be redeemed out of cash balances. In order to provide more time to consider budget control measures, Congress passed a bill on July 29 restoring the debt limit to $2,320 billion through August 6. The President signed the bill on July 30, and the Treasury immediately rescheduled a large amount of auctions in order to raise needed cash. 8 - 6

Congressional deliberations on budget control were not completed in time to prevent this temporary debt limit increase from expiring. On August 7, 1987, the debt limit again reverted to $2,111 billion. On the same day Congress voted to raise the debt limit to $2,352 billion through September 23, and the President signed the legislation on August 10. Treasury thus had to suspend the sales of all securities very briefly. Treasury had previously not scheduled certain major auctions because of the uncertainty about the debt limit but scheduled them as soon as the temporary legislation was enacted.

On September 24 the temporary debt limit expired, and the limit fell for a third time to $2,111 billion. As before, Treasury had to postpone the auctions and sales of all securities. However, on that same day, Congress passed the joint resolution on the debt limit amended to incude several changes to the budget process. The principal provision—the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987—revised the annual deficit targets and established a new enforcement mechanism in place of the one declared unconstitutional. The new debt limit itself was changed from the amount specified in the congressional budget resolution. Instead of the $2,565.1 billion declared appropriate for fiscal year 1988, the joint resolution was amended to raise the limit to $2,800 billion in order to carry the Government into 1989. This limit has no expiration date. The President signed the legislation on September 29, 1987.

Because the increase in the debt limit was so large, 1988 was the first year since 1968 that Congress did not have to enact new debt limit legislation. The new limit of $2,800 billion is, however, less than the $2,845.4 billion of debt subject to statutory limit that is estimated to be outstanding at the end of fiscal year 1989. It is therefore estimated that a further increase in the limit will be necessary during fiscal year 1989 in order for the Federal Government to meet its obligations.

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Bentsen Remarks Debt Limit

Mr. BENTSEN. Mr. President, I ask unanimous consent to speak out of order.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. BENTSEN. Mr. President, last evening I received a call from Secretary Brady and then it was followed up by a letter. It informs me of an action by the administration which really is quite surprising. It is astonishing and deeply troubling to me. If there is one trademark which underpins the stability of the financial markets of this country, and to a great extent of the world, it is confidence in the U.S. Treasury and the securities that it sells.

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one of the main reasons for that kind of confidence is that the Treasury Department has ~~in~~ among its professional personnel competent debt management people, a debt management team. And that team ~~promotes~~ handles the sale of T-bills, notes, bonds, in a manner that is designed to promote the best interests of the United States and to maintain stable markets on our securities.

no ¶ They do not gamble ~~or~~ and they do not play politics with the credit of the United States.

And so I was astonished and troubled to learn that the White House has ordered these professionals who manage our public debt to do what they have always resisted doing. ~~they have been ordered~~

~~by~~

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MILT:ja 10:50 Kohl/Bentsen

They have been ordered to depart from the normal, ordinary debt issuance procedures. They have been ordered to speed up the borrowing, even though that will likely raise interest costs. They have been ordered to stockpile cash. They have been ordered to take an action based on a gamble that Congress and the President might do this year what they have never done before, force the country to go into default. We have never done that.

I do not see how such an action can fail to undermine confidence in the integrity of our national credit operations, To lessen the Treasury Department's own credibility , and to

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undermine the certainty that default will never be tolerated.

I am puzzled ABOUT why this administration made this kind of a decision. The letter from Secretary Brady cites uncertainty about whether the Congress is going to raise the debt limit and the need to assure that Social Security payments will be made. But that is not a new and different situation from previous times when we have reached a debt limit. We have been there before. And every time we have acted responsibly. ~~on that~~.

This SITUATION did not cause previous administrations to panic. I might understand that action -- though I would still not agree with it -- if the Congress was tied up in knots over a heavily-amended debt limit bill; but that is not the case. I might understand it if the leadership of the Congress were

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threatening to use the debt limit to provoke some kind of a confrontation with the President. That is not the situation here.

What we have on the Senate calendar is a debt limit bill that has already passed the House of Representatives. What we have is a clean bill; A clean, long-term debt limit bill. That is just the kind of a bill that previous administrations, previous Secretaries of the Treasury, have asked for, and that is the kind of bill I want to see as chairman of the Finance Committee.

Far from threatening confrontation, the chairman of the Finance Committee, the majority leader of the Senate, are ready, willing, and, I believe, able to ask their colleagues to send that bill on to the President in just that form. ~~and~~ And I would ask the

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~~joining in of~~ leadership on the other side to join in this effort.

There was no danger that Congress would fail to pass a debt limit bill in the time to assure THAT ~~debt security~~, Social Security checks could be issued. I do not know anyone in this Senate, Democrat or Republican, who would be politically dumb enough to hold Social Security payments as hostage for achieving some other aim.

I feel certain I can speak for the Democratic Members of the Senate on that, and also I ~~sure~~ do not believe there are any Republican Senators who would want to threaten Social Security checks. If the White House is aware of some who would, then they ought to let that be known. But it sure would surprise me.

Then why did the Treasury take this kind of an

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extraordinary action? I have heard only one explanation that hangs together, although I am reluctant to believe it. I have difficulty with the idea that the administration would compromise the professionalism of the Nation's debt management operation, damage to the Treasury Department's credibility with the Congress, and possibly create instability in the markets all for the attainment of a short-term political victory.

Nevertheless, there seems to be only one reason why Treasury would disrupt the normal debt issuance process to gain a single week, and a dubious one at that, of additional debt limit time. That reason is to let the administration make yet another attempt to attach a capital gains proposal to a bill where it really does not belong.

Let me show you the record on this one. On October 16, 10 days ago, the Secretary of the Treasury sent me a letter which really represents the best professional judgment of that Department, and that letter says that November 1 is the very last day before default. In fact, it says there is "no opportunity for administrative actions to prolong the availability of cash." That is what was said just 10 days ago to me; no availability, no option to get additional cash. Ten days later the administration sends us a letter which says Treasury can pull a rabbit out of that hat and get us to November 8. ~~just 10 days later~~.

What happened in those 10 days? Why this sudden change? What happened was THAT the administration found ~~found~~ that Republican

90/18

Senators were not ready to play that capital gains game if it meant endangering the issuance of the November Social Security checks. So the administration orders the Treasury Department to tear up that original letter, forget it, and find some way to push the default date past November 3. If that is not what happened, I would sure like to hear another credible explanation.

But, in any case, I have to give the administration the bad news. ~~That~~ ~~if~~ that is what you are up to, it is just not going to ~~be~~ wash. The fact is the action the Treasury Department has just taken does not protect Social Security recipients. It does much the opposite. It is true that Social Security checks are issued on the 3rd, but the crucial question is not whether or not they are issued but whether or not they

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are any good when the recipients bring them to the bank on the 6th , 7th, and the 8th, and throughout the month. The question is will the Treasury have enough ~~money to honor, enough~~ cash to honor those checks? ¶ With or without this new trick, the Treasury's ability to raise cash gets cut off at midnight Tuesday. True, they will be stocked up a bit, but predicting cash balances when your credit has been cut off is a very tricky business.

So how sure can you be that checks issued on the 3rd will turn out to be good? Well, if current projections hold and if there is no unpredictable cash demands, then there should be enough cash to make it to the 8th of November. You say, well, is that some Democrats' alarm bell that he is ringing? No.

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That is not my analysis. That is the analysis of the Secretary of the Treasury because in his latest letter he says just this:

"Current" -- current -- "cash flow ~~analysis~~ estimates which assumes" -- assumes -- "no unprecedented cash demands indicates, that this action should" -- "should" is the word -- "provide sufficient cash to cover obligations presented for payment through November 8."

I am not willing and I do not believe any other Senators, Democratic or Republican, will be ~~asking~~ willing to ask the older citizens of this country to gamble their November Social Security checks on that kind of halfhearted assurance that the money "should" be there.

I hope my interpretation is dead wrong and that this action was just a momentary lapse rather than a convoluted plot to trade the sanctity of our national credit and the security of our older citizens for a capital gains law. But in any case, we have to pass this debt limit.

I hope that Secretary Brady and the President will prove my theory wrong by publicly and privately requesting all Senators to agree to let the debt limit go forward without any amendments, without any amendments from Republicans or Democratics.

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NEL:skj 11 am Kohl, APPT/Bentsen

Let us take
~~Take~~ care of the primary obligation of this country and pass that debt limit, without amendment. Let us ask ~~Ask~~ unanimous consent that we do it that way. Let us see who wants to stand up and object to that.

Thank you, Mr. President.

Mr. BYRD. Mr. President, will the distinguished Senator yield?

Mr. BENTSEN. I yield.

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Mr. BYRD. I compliment him on his statement, and he is exactly right in encouraging the administration and the Congress to pass a clean debt limit.

There is another aspect of this. We are told by the chairman of the Ways and Means Committee in the House that if we pass a clean debt limit, we will also get a clean reconciliation bill from the conference.

Our leader showed real leadership a few days ago when he recommended that we strip out what I am told was more than 600 extraneous items from the reconciliation bill, and the distinguished Republican leader joined that.

I complimented them both on that occasion for their act of statesmanship. That took statesmanship. That was real

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leadership, and the Senate followed that leadership, and we stripped down that bill.

Our work is only half done, and we have this opportunity, with the House being willing to strip out those items and come back with that clean reconciliation bill, as well, if we will pass the clean debt ceiling bill.

We ought to take up that offer and demonstrate to this country that we are serious and mean business about the financial matters that confront this country, and serious about cleaning up our own house when it comes to discipline in the appropriations and budget process.

I join the distinguished Senator in his support for a clean debt limit bill and a clean reconciliation bill. We ought

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to stop playing these games. We have all played games at one time or another, but it is time to stop it. Now is a good place to stop it.

I thank the Senator. I think he has made a fine statement and has rendered a real service, and I hope we will take heed.

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Mr. BENTSEN. I thank the distinguished President pro tempore of the U.S. Senate for his generous comments. Between the Ways and Means Committee and Finance Committee, the jurisdictions are such that a great part of reconciliation falls to these two committees, ~~within our jurisdiction~~, ~~and we~~ We have many things in there that we worked a long time on, like child health care, rural health care, many things that we thought were important and should be carried on.

But in trying to move this thing forward and really cut that deficit, and do it expeditiously, we chose to put those off to another day. The distinguished ranking member of the Budget Committee held up that reconciliation bill, and he said, "If we keep on like this, we are going to be measuring reconciliation

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by the pound."

My reply was, "If we do not cut this deficit, and do it effectively, we are going to be measuring reconciliation by the yen." That is what can happen in this country, unless we aggressively cut this deficit, get the interest rates down, and increase investment capital and get personal savings up. That is the responsible action to take.

I yield the floor.

(Mr. FOWLER assumed the chair.)

Mr. BUMPERS. Has the Senator from Texas yielded the floor?

Mr. BENTSEN. Yes.

Mr. BUMPERS addressed the Chair.

254S — COPY —

Mitchell Remarks, Debt, Capital Gains, IRA's

Mr. MITCHELL addressed the Chair.

The PRESIDING OFFICER. The majority leader is recognized.

Mr. MITCHELL. Mr. President, I thank the distinguished Republican leader for his comments and wish now to address some of the issues he raised, and other issues which were not included in his remarks, but are relevant to the subject matter now under discussion.

First, I was surprised yesterday to learn that the Secretary of the Treasury is taking an action that is without precedent -- and he acknowledged that his action is without precedent -- ~~i~~n engaging in accelerated borrowing to extend the debt limit from the currently anticipated expiration date of next Tuesday, October 31, until on or about November 8. This will cost American taxpayers about $20 million, according to the Secretary of the Treasury. And it is an obvious and transparently political decision to avoid or to provide an advantage to those proponents of capital gains in the debate now under way. That is regrettable. The politicization of the management of the U.S. debt is a serious matter, and it calls into very serious question the management by the Secretary and the excessive deference to political considerations in that important task.

It had been, and remains, my hope that we can pass a clean debt limit extension by next Tuesday, midnight, to save the American taxpayers $20 million. We need not go through this

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exercise, and I think it is regrettable. It is a very expensive political tactic, particularly when the cost is being borne by American taxpayers. That may not be possible.

I hope in further discussions with the distinguished Republican leader that we can reach some agreement on how best to proceed on the various issues confronting us -- the debt limit, the reconciliation bill, disposition of the capital gains issue, progress on the Poland-Hungary aid -- that will permit us to do that, and to save the American taxpayers $20 million that, in my judgment, will be unnecessarily expended for what are plainly and purely political purposes.

Mr. President, during this debate we have heard many statistics bandied about. We have heard about capital gains

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taxes in other countries, and we have heard about the cost of capital for American business. On any major public policy issue, many so-called facts can be and are stated. Proponents of capital gains tax cut often make the argument that U.S. tax policy severely disadvantages business investment compared to policies in other nations. Typically, comparison is made of the alleged lower cost of capital in other nations and their lower capital gains tax rates.

We have been told time and time again that a cut in capital gains tax offers a magic way to reduce our cost of capital and make America competitive. First, Mr. President, every American, surely every Senator, ought to recall that it was Ronald Reagan and George Bush who proposed to eliminate the

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capital gains tax differential. Let me repeat that, because that appears to have been lost in the discussion here. It was the administration of President Ronald Reagan and Vice President George Bush which proposed to eliminate the capital gains differential.

It was 49 out of 53 Republican Senators who, just over 3 years ago, voted on this very Senate floor to eliminate the capital gains differential. It was the then Republican chairman of the Senate Finance Committee who stood on this very Senate floor 3 years ago to denounce capital gains tax differential as a gimmick to help the rich, as something that should be removed from our Tax Code.

So the history of this is that a Republican, 259S - 266S

administration in which George Bush was Vice President, a Republican controlled Senate, urged this Congress to abolish the capital gains tax rate, the differential, the very thing that the very same people are now saying is a magic way to restore competitiveness to the American economy.

What has occurred in the past 3 years to make what was so obvious then so obscure now to our colleagues?

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President Bush has played more emphasis on this issue than any other in his administration, and if he feels so strongly about this issue, where was he 3 years ago when the administration in which he was Vice President was proposing to abolish the very thing which he now says is needed to rescue the American economy?

Have Mr. Bush's views on this issue made a complete total and dramatic reverse all in that period of time?

Does the President not have some obligation to explain to Americans how it is that the issue now that to him is the most important thing in his administration, the most important item on the agenda, is something which he participated in abolishing just 3 years ago?

It does not make any sense to me. I do not think it makes any sense to the American people, and I hope President Bush will explain it to us, how is it, Mr. President, that just 3 years ago you participated in abolishing capital gains tax differential and 49 out of 53 Republican Senators voted to abolish the capital gains differential and now we are told it is the most important thing in this administration?

Mr. President, there have been many studies on the cost of capital, most suggesting our trading partners have an advantage. But while economists may differ on the cost of capital in America compared to the rest of the world, they do

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agree that our current tax system narrows the advantage other nations may have.

Businesses in the United States have a lower tax burden than do corporations in Japan and West Germany. They are subject to lower tax rates and have more beneficial cost recovery allowances. This difference alone gives us a cost of capital advantage. But the advantages bestowed by our tax system are more than offset by other factors, the most important of which is our fiscal policy which through the budget deficit encourages a low level of savings and higher real interest rates than those of our major trading partners.

Mr. President, the single-most important thing that we can do to reduce the cost of capital in this country and make

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the United States more competitive is to reduce the Federal budget deficit, and that is why it is so difficult to understand that on legislation that is intended to reduce the Federal budget deficit President Bush would insist that we include his capital gains tax proposal which will increase the deficit by $67 billion over the next decade, according to the Joint Tax Committee, a panel of experts nonpartisan, relied upon by Members of Congress from both parties and in both Houses.

Again I ask, Does it make any sense to propose as part of a deficit reduction bill a provision which will increase the deficit by $67 billion? I believe not.

If the President and his advisers put half as much time, a fraction as much time, into an effort to reduce the budget

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deficit as they are now putting into this effort to reduce capital gains taxes, then they would be doing something to make American business more competitive internationally.

Another misleading comparison that is often made is the look only at selected tax policies in other nations. For example, we are told that Japanese and German companies have a competitive advantage because those nations have a lower capital gains tax rates than the United States. The problem with this argument is that both Japan and Germany have a range of tax laws and other policies, some of which are more favorable, others of which are less favorable. It is highly misleading to make selective comparisons.

Most of our major trading partners have a higher level of

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overall taxation than the United States and almost all have higher marginal tax rates. While many of these nations do have lower capital gains tax rates on some categories of capital assets, the overall burden of taxation on all capital assets is not necessarily lower. The maximum tax rate in the United States is 28 percent. By contrast, the maximum rate in Japan is 5 percent; in Germany, 53 percent; in France, 57 percent; in Taiwan, 50 percent; in Korea, 64 percent; in the United Kingdom, 40 percent.

Total tax revenue as a percentage of gross domestic product is about 29 percent in the United States, a little higher in Japan, in Canada it is 15 percent higher, in Germany about 30 percent higher, in the United Kingdom 35 percent

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higher, in France 53 percent higher.

It is particularly interesting to look at the trend in tax burdens of the last several years. From 1976 to 1986, Japanese tax burdens increased 32 percent, French up 14 percent, British up 12 percent, in the United States up 2 percent.

U.S. tax policy is often criticized for encouraging consumption over investment, yet taxes on consumption account for a far higher percentage of total tax revenues in this country than in Japan, about 30 percent higher, and at the same time business taxes are far higher in Japan, about 20 percent of total revenue as compared to about 7 percent in the United States.

Since Japan is inevitably thrown up as a comparison of

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the Nation's tax policies we should emulate, a closer look at their tax system is in order.

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Since Japan is inevitably thrown up as a comparison of the nation whose tax policies we should emulate, a closer look at their tax system is in order. We have heard it mentioned repeatedly on this floor that Japan does not tax capital gains. That is simply untrue.

The Congressional Research Service recently examined the capital gains tax policies of Japan. It found that with respect to capital assets held less than five years, the capital gains tax burden is higher in Japan than in the U.S. The maximum tax rate in Japan is 50 percent on these capital assets compared to 28 percent in the United States. For assets held longer than five years, the actual tax burden in Japan is probably higher, at least for higher income families. In the

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case of real estate held less than 10 years, the tax burden in Japan is unquestionably far higher. The capital gains tax rates on this property ranges from 40 percent to 55 percent. Only in the case of real estate held longer than 10 years and most stock transactions is the capital gains tax rate lower than in the United States. And then with respect to stock, the maximum tax rate is 20 percent.

While some of our trading partners have lower marginal capital gains tax rates on some assets, it is less clear that the actual effective tax rate on capital in the U.S. differs very much. For example, a study by Don Fullerton, a former Treasury Department Assistant Secretary in the Reagan Administration, found that the effective tax rate on capital gains in the U.S. is less than six percent. This arises because of the ability to defer gains, to recieve step-up basis at death, and because of the substantial corporate equity holdings by tax exempt institutions. While Japan does not tax capital gains at death, it does require that the basis be carried over so that the tax is only deferred; not forgiven as in the United States.

These are the facts but unfortunately facts tend to get lost in a debate such as this. Every American is vitally concerned about our ability to compete in international trade. (END) ~~We in Congress are suckers for any claim, no matter how ridiculous, that if we only spend a few billion dollars reducing someone's taxes, America will become competitive.~~

BEGIN ORAL TEXT GIVEN @ 3:45 pm

~~Distribution of Capital Gains Tax Cut~~

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~~Mr. MITCHELL:~~ Mr. President, I would like to conclude now with some brief remarks on two points that have been raised earlier today.

The White House, the distinguished Republican leader, and numerous Republican Senators have said that since there is a clear majority of both Houses in favor of the capital gains tax cut, why do we not just have a vote on the merits? That is the precise wording -- "vote on the merits" of the bill that has been presented."

The White House spokesman has made several statements suggesting that I am using the Senate rules in a manner as to prevent that result from occurring.

Mr. President, on September 13 of this year, 66 Senators

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voted to place certain restrictions on the FSX fighter plane transaction between the United States and Japan. Thirty-four Senators voted in the contrary. The view of the 34 Senators prevailed. Even though 66 Senators voted to place such restrictions on it, under the rules by which the Senate operates, the position taken by only 34 Senators prevailed.

It was the President's position that prevailed, even though 66 Senators voted to the contrary. There was no Senator, no White House spokesman on that day asking that there be a vote "on the merits, " or who spoke of "the majority in both Houses."

The President's position prevailed, even though it clearly was a minority position. Our view did not prevail, even

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though it was clearly the overwhelming majority position.

On August 3 of this year, 54 Senators voted to place the savings and loan bailout bill on budget. Forty-six Senators voted in the contrary. The view of the 46 Senators prevailed, even though they were in a minority, even though a clear majority of the Senate held a contrary position. The minority view which prevailed was the view of President Bush.

So the President's position prevailed, even though only a minority of the Senate supported it; our view did not prevail, even though a clear and substantial majority of the Senate did favor it.

Those were two of the most recent of 34 occasions, 34 times, since January of 1987, in which the minority view in the

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Senate has prevailed, and the majority view has not prevailed. In every one of those instances, it was the Republican position that was in the minority. In every one of those instances, the Democratic position was held by a majority of the Senate, and in every one of those instances, the majority position did not prevail. The minority position did prevail.

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Not once, not once on any of those 34 occasions did any Republican Senator or any spokesman for the White House or the President stand up and ask "Let's have a vote on the merits" or "Let's let the majority of both Houses prevail."

They did not ask that because, of course, if there had been votes on the merits, if the view of the majority had prevailed on those 34 occasions, the President's position would have been defeated or the administration's position -- of course some of this occurred prior to the current incumbent President -- would have been defeated but was not defeated because of the rules by which we operate.

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Mr. President, just this week, just this week a clear and substantial majority of both the Senate and the House voted to permit medicaid funding of abortions for unfortunate women who have been the victim of rape or incest and who become pregnant and do not have enough money to pay for an abortion. The question was, if an American woman is the victim of a rape or incest and she becomes pregnant, and she does not have enough money to pay for an abortion, should the Medicaid Program, the Federal, State health insurance program for the poor, should medicaid pay for an abortion in those circumstances?

A substantial majority of the House of Representatives said "yes." A substantial majority of the Senate said "yes." President Bush said "no," and President Bush's position prevailed

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because in that circumstance it was not enough to have a majority.

Therefore, Mr. President, it is simply incredible on the very same week that the President's position has prevailed, even though it is a minority position, that the White House and Republican Senators ask that there be a vote "on the merits" on the one issue that they have selected. Their position is that the Senate rules ought to apply to the Democrats but the same Senate rules ought not to apply to the Republicans.

So I asked the President if he wants a majority vote, is he prepared to accept a majority vote on the issue of medicaid funding of abortions? If he wants a majority vote, is he prepared to accept a majority vote on the question of the

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on-budget funding of the savings and loan crisis? If he wants a majority vote, is he prepared to accept a majority vote on the issue of the FSX fighter transaction with Japan?

He cannot have it both ways. He cannot say that when the rules operate in his favor, as they have done 35 times now, with the abortion issue, since January of 1987, he wants to take advantage of those rules, but when the very same rules apply to his disadvantage he wants to be exempted from those rules.

The American people do not understand, nor should they, the rules of the Senate, but the American people understand fairness and playing by the rules of the game. Fairness means that the same rules apply to every Senator and every issue. Fairness means that you do not select which rules you will follow, that you do not select which issues the rules will apply to. Fairness means that the rules are applied evenly, equally to all Senators, equally on all issues.

That is what we are doing. Playing by the rules of the game means that you do not take advantage of rules when they help you and then try to get out from under those rules when they operate to your disadvantage.

It means that if you accept the benefit of the rules on 35 occasions, you accept the disadvantages of those rules on the one occasion when when they provide you with a disadvantage.

That is what is at issue here, Mr. President, fairness, playing by the rules, having the same rules apply to every Senator and every issue.

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So long as I am majority leader of the United States Senate the rules are going to be applied equally, evenly, fairly to all. No Senator need even ask to be exempt from the rules, and that goes to Democratic Senators as well as Republican Senators. No Democratic Senator need even bother to come to me and ask me to change the rules, to bend the rules, to exempt him or her from the rules, to exempt one issue from the rules. If the rules are fair we follow them. If they are unfair, then those who think them unfair should change them. There are processes by which we can change the rules. If people think that this rule ought to be changed, that in every instance it ought to be a simple majority that makes these determinations, then that is what we should discuss and debate and consider and

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vote on.

Mr. President, finally I want to say that it is my hope that we will in the near future be able to proceed to prompt action on the Poland-Hungary aid bill. That is a matter which I know the Presiding Officer has a deep and abiding concern about and interest in. It is important to the people of this country. It is important to the people of Poland. And I hope that the language it has encountered will soon be removed, obstacles will be removed, the delay will be ended, and we will be able to get on with that legislation.

In the meantime Mr. President, it is my hope that we could proceed next week to the long-term debt limit. I would like to discuss that briefly with the distinguished Republican

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Senator privately. So, Mr. President, I conclude my remarks, and I suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The assistant legislative clerk proceeded to call the roll.

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OCTOBER 27, 1989

TO: SENATOR DOLE

FROM: CAROLYN SEELY

SUBJECT: REBUTTAL TO MITCHELL/BENTSEN FLOOR DEBATE

Capital Gains

1. President Reagan (Vice President Bush) proposed eliminating the capital gains differential in 1986.

- President Reagan proposed reducing the capital gains exclusion from 60% to 50% in connection with lowering overall tax rates. Indexing was allowed as an alternative (like Packwood/Roth).

- Treasury (in 1984) proposed replacing the capital gain exclusion with indexing alone.

- Elimination of any favorable differential was first proposed in the Bradley-Gephardt bill and was accepted in 1986 as part of the tax reform compromise.

2. Marginal tax rates and total tax burdens are higher in Japan, Germany, etc.

- As the result of tax reform, the U.S. has the lowest marginal income tax rates and the highest capital gains tax rates of its trading partners. (Many of our trading partners, including Japan, are in the process of lowering their marginal rates in response to U.S. tax reform.)

- Incentives for equity investment, however, depend on the cumulative tax burden imposed on investment capital.

- In the U.S., equity capital is taxed twice. Corporate earnings are taxed at the corporate level. Distributed earnings are taxed again as dividends; retained earnings are taxed again as capital gain.

- Every one of our trading partners reduces the burden of this double tax on equity by dividends paid deductions (comparable to the treatment of interest in the U.S.) or capital gains tax reductions or both.

- The imposition of a full second tax on equity capital in the U.S. is at least partly responsible for the dramatic and dangerous replacement of equity financing with (single-taxed) debt.

3. Capital gains rate reductions are inconsistent with reducing the budget deficit.

- There is serious disagreement among Treasury and Congressional economists over the long-term revenue consequences of a capital gains rate reduction; Treasury estimates that it will <u>raise</u> revenue over ten years.

- Unlocking capital generates revenue for the Treasury, not mere prepayment. At current rates, many gains will <u>never</u> be realized, and that capital will remain invested in a less productive (and lucrative) fashion.

4. Republicans are politicizing the debt limit (and jeopardizing social security) in an effort to pass capital gains.

- The permanent debt limit increase has been on the Senate calendar since July 25. It is the Democrats who have refused to bring this legislation to the Senate floor until the very last day. In other words, the majority is playing politics with the debt limit in an effort to <u>block</u> capital gains.

5. Republicans have blocked majority rule by sustaining President Bush's veto of minimum wage, FSX, etc; the Democrats are doing the same with capital gains.

- The Constitution, not the Senate rules, gives the <u>President</u> the power to block legislation with the concurrence of more than one-third of either House.

- Moreover, in every veto override case, unlike capital gains, the majority had its vote on the merits. This vote is being denied the majority in support of capital gains.

- The Constitution also provides that laws are to be enacted by a majority of both Houses of Congress and the President. The Democratic leadership (as other minorities have done before) is using <u>Senate</u> rules to frustrate the Constitutional scheme. This is a far cry from the exercise of a Presidential power.

DEBT LIMIT STATISTICS

- Since FY 1986 alone, in at least one dozen instances, Treasury borrowing was disrupted specifically due to uncertainty about Congressional action on the debt limit.

- In 1985, $9 million in interest was lost due to non-investment which later had to be paid back.

- In 1984, $373 million in interest was lost due to disinvestment of the Social Security Trust Fund -- which also later had to be repaid. This was also as a result of delays in dealing with the debt limit in a timely fashion.

To: SENATOR DOLE
WALT RIKER/PAUL JACOBSEN

From: AL LEHN

Subject: ORTEGA RELEASE AND MEET THE PRESS

Following sheet is a suggested release on Ortega's announcement, with this proviso: it might make sense to hold some of this back for tomorrow's Meet the Press appearance. If you want to do that, I would suggest stripping out the part on continuing aid to the contras and/or the possibility of a cancellation of the elections.

Talking points for Meet the Press:

o THIS IS VINTAGE DANIEL ORTEGA.

-- TRASH A CEASEFIRE AND CRACK DOWN ON FREEDOM.

-- AND DO IT ALL AT A HEMISPHERIC SUMMIT CELEBRATING DEMOCRACY.

o I WONDER HOW ORTEGA'S APOLOGISTS IN THE CONGRESS ARE GOING TO EXPLAIN THIS ONE AWAY?

o UNDER SOME VERY BAD PROCEDURES CONGRESS PUT IN EARLIER THIS YEAR, WE HAVE TO DECIDE IN NOVEMBER WHETHER TO CONTINUE PROVIDING HUMANITARIAN AID TO THE CONTRAS. AT THE LEAST, I HOPE THIS NEW OUTRAGE FROM ORTEGA WILL PUT TO REST ANY THOUGHT OF CUTTING OFF THE CONTRAS UNTIL AFTER THE ELECTIONS.

o IF THERE IS AN ELECTION. WHAT BOTHERS ME MOST ABOUT ORTEGA'S ACT IS THAT IT COULD BE THE FIRST STEP TOWARD CANCELLING OR POSTPONING THE ELECTIONS SCHEDULED FOR NEXT FEBRUARY.

o I WONDER IF MAYBE COMMANDANTE ORTEGA IS STARTING TO LOSE A LITTLE SLEEP OVER THE FACT THAT ALMOST TWO MILLION NICARAGUANS FOUND A WAY TO REGISTER, DESPITE THE SANDINISTAS' ATTEMPTS TO CONTROL THE REGISTRATION PROCESS.

SENATE REPUBLICAN LEADER BOB DOLE CALLED YESTERDAY'S ACTION BY THE SANDINISTA GOVERNMENT TO UNILATERALLY ~~#####~~ END THE NICARAGUAN CEASEFIRE "VINTAGE ORTEGA."

"Only Ortega," Dole said, "would trash the ceasefire and launch a new assault on freedom at a hemispheric summit celebrating democracy. I wonder how Ortega's apologists in Congress are going to try to explain this one away?"

Noting that under procedures put in place by Congress earlier this year, humanitarian aid to the freedom fighters in Nicaragua will be reviewed in November, Dole said: "At the least, I hope this new outrage by Ortega will put to rest any notions any of our Democratic friends had of trying to cut off the contras before the elections scheduled for next February. I don't think that even they will want to reward Ortega that way."

"What worries me even more than the breakdown in the ceasefire," Dole concluded, "is that this might just be the first step in a new Sandinista crackdown on freedom -- one that could involve cancelling or postponing the elections. I can imagine that seeing nearly two million Nicaraguan register to vote, despite Sandinista harassment, must be giving Commandante Ortega a few sleepless nights."

Treasury Actions Related to the Debt Limit in 1989

1. On June 23, Secretary Brady wrote letter to Senate leadership (Sens. Dole, Bentsen, Mitchell, and Packwood) requesting debt limit action by August 1.

2. On July 14, Under Secretary Glauber sent letters to House Speaker Foley, Senate President Quayle, and the Executive Director of the Federal Retirement Thrift Investment Board writing that, in the absence of action by early August, Treasury will be unable to invest or roll over maturing investments of trust funds and other Government accounts.

3. On July 19, Under Secretary Glauber testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, stating that the then current ceiling would be sufficient only into early August. Without an increase by August 1, full investment of the NTT may not be possible.

4. On July 19, Treasury announced the suspension of sales of SLGS effective July 20 because of Treasury's need to plan and avoid exceeding the debt limit in August.

5. On July 19, as part of Treasury's announcement for 2-year notes, to be auctioned July 26, Treasury announced that no foreign add-ons in excess of rollovers would be allowed because of debt limit stringency.

6. On July 21, as part of the 52-week bill announcement, Treasury stated that foreign add-ons in excess of rollovers would not be allowed for the July 27 auction.

7. On July 25, Treasury announced a $400 million reduction in the July 31 regular weekly bill auctions as part of Treasury's need to plan debt levels in August and allow for an orderly regular mid-quarter refunding on Aug 15. Treasury also announced at the same time that there would be no foreign add-ons in excess of rollovers allowed because of the debt limit stringency.

8. On July 31, Secretary Brady wrote to House and Senate leadership, noting that if there were no action by August 1, Treasury would almost certainly be unable to fully invest Social Security trust funds on August 1 and 2, and Treasury would default on other obligations on August 15.

9. On August 1, $1.7 billion of the August NTT was left uninvested for two days.

10. On August 7, the debt limit was temporarily raised to $2,870 billion through October 31, when it will revert to $2,800 billion.

11. On August 8, following enactment of legislation to raise the debt limit, the Treasury authorized the resumption of the sale of SLGS.

Treasury Actions which Resulted from Congressional Failure to Raise the Debt Limit - Fiscal Year 1988

Recent changes in the debt limit.—The statutory debt limit was raised to $2,111 billion on August 21, 1986, and on October 21 it was temporarily raised to $2,300 billion through May 15, 1987. The course of the debt limit legislation during calendar year 1987 was closely tied to efforts by the Congress and the Administration to control the budget deficit.

Specifically, it was an outgrowth of the Gramm-Rudman-Hollings Act of 1985 (the Balanced Budget and Emergency Deficit Control Act of 1985). The Gramm-Rudman-Hollings proposal was designed to eliminate the deficit in a series of steps over several years by setting annual deficit targets and establishing a mechanism to enforce them. During the fall of 1985 this proposal was offered as an amendment to the debt limit bill before the Congress at that time. After lengthy consideration the debt limit bill was enacted incorporating a revised version of this amendment, but subsequently the Supreme Court declared a key part of the enforcement mechanism to be unconstitutional. Proposals were made to develop a substitute, and debt limit legislation again provided a vehicle.

The first critical date in 1987 was May 15, the expiration date for the temporary increase of the debt limit from $2,111 billion to $2,300 billion. Until that time the Treasury was able to conduct its normal debt financing operations, and on that date a new law was enacted temporarily increasing the limit to $2,320 billion through July 17.

On June 24, 1987, Congress enacted a budget resolution for fiscal year 1988. The resolution stated that the appropriate level of debt subject to limit was $2,568.1 billion. A joint resolution specifying this amount as the debt limit was deemed to have passed the House and was sent to the Senate for its consideration. This joint resolution became the vehicle for subsequent proposals to revise the budget process.

In the absence of further legislation, the debt limit dropped to $2,111 billion on July 18. Treasury had to suspend the auction of bills and notes; to stop the sales of bills, notes, savings bonds, special issues of the State and local government series, and all other securities; and to cease the investment of trust funds and all other U.S. Government accounts. Treasury bills that matured had to be redeemed out of cash balances. In order to provide more time to consider budget control measures, Congress passed a bill on July 29 restoring the debt limit to $2,320 billion through August 6. The President signed the bill on July 30, and the Treasury immediately rescheduled a large amount of auctions in order to raise needed cash. (2) – (6)

Congressional deliberations on budget control were not completed in time to prevent this temporary debt limit increase from expiring. On August 7, 1987, the debt limit again reverted to $2,111 billion. On the same day Congress voted to raise the debt limit to $2,352 billion through September 23, and the President signed the legislation on August 10. Treasury thus had to suspend the sales of all securities very briefly. Treasury had previously not scheduled certain major auctions because of the uncertainty about the debt limit but scheduled them as soon as the temporary legislation was enacted.

On September 24 the temporary debt limit expired, and the limit fell for a third time to $2,111 billion. As before, Treasury had to postpone the auctions and sales of all securities. However, on that same day, Congress passed the joint resolution on the debt limit amended to incude several changes to the budget process. The principal provision—the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987—revised the annual deficit targets and established a new enforcement mechanism in place of the one declared unconstitutional. The new debt limit itself was changed from the amount specified in the congressional budget resolution. Instead of the $2,566.1 billion declared appropriate for fiscal year 1988, the joint resolution was amended to raise the limit to $2,800 billion in order to carry the Government into 1989. This limit has no expiration date. The President signed the legislation on September 29, 1987.

Because the increase in the debt limit was so large, 1988 was the first year since 1968 that Congress did not have to enact new debt limit legislation. The new limit of $2,800 billion is, however, less than the $2,845.4 billion of debt subject to statutory limit that is estimated to be outstanding at the end of fiscal year 1989. It is therefore estimated that a further increase in the limit will be necessary during fiscal year 1989 in order for the Federal Government to meet its obligations.

FY 1988

Treasury Actions Related to the Debt Limit in 1987

1. On August 21, 1986, a permanent debt limit of $2,111 billion passed. On October 21, 1986, the debt limit was temporarily raised by $189 billion, to $2,300 billion, expiring on May 15, 1987. It was to revert back to $2,111 billion upon expiration.

2. On April 30, 1987, Under Secretary Gould testified before the House Ways and Means Committee that, because the limit would revert back to $2,111 billion, the Treasury would be $160 billion above the permanent limit on May 16.

3. On May 1, Secretary Baker wrote letters to Sens. Dole, Byrd, Packwood, and Benstan and Reps. Wright, Michel, Duncan, and Rostenkowski requesting debt action by May 15.

4. On May 8, Under Secretary Gould testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. (Same Testimony as on April 30).

5. On May 15, a 2-month extension of the temporary limit was passed, expiring at midnight on July 17, which also raised it to $2,320 billion from $2,300 billion.

7. On July 8, Secretary Baker wrote letters to House and Senate leadership outlining what would happen if a new limit were not passed before July 17.

8. On July 14, Treasury announced that it would postpone its weekly bill auctions, scheduled for July 20, unless it has assurance of Congressional action on legislation to raise the debt limit before that date.

9. On July 15, Treasury announced it will postpone its 2-year auction, scheduled for July 22, unless it had assurance of action on the debt limit by that date.

1 10. DK On July 17, Treasury suspended sales of savings bonds and State and local government securities, effective July 18.

2 11. OK Treasury postponed its July 20 regular weekly bill auction.

12. On July 21, Treasury announced it would postpone its regular weekly bill auction on July 27, unless it had assurance of action on the debt limit by that date.

3 13. OK On July 22, Treasury postponed the 2-year note auction.

~~14.~~ On July 24, Treasury announced it would postpone its 52-week auction on July 30, unless it had assurance of action on debt limit by that date.

4 8) 15. On July 27, Treasury postponed its regular weekly bill auctions.

16. On July 29, Treasury announced the rescheduling of its regular auctions, contingent on the pending debt limit legislation:

	from	to
weekly bills	July 20	July 31
weekly bills	July 27	July 30
52-week bills	July 30	Aug. 4

5 ok 9) 17. Also on July 29, Treasury postponed the announcement of the quarterly financing, scheduled for mid August, in the absence of assurance that the statutory ceiling would permit settlement on Aug 17. It was announced on August 10.

18. On July 30, a 1-week extension of the limit, through August 6, was enacted.

19. On August 3, Secretary Baker sent a letter to the Speaker of House, President of the Senate and other Congressional leadership listing the usual interruptions, including inability to make $14.5 billion of Social Security payments on Sept 3.

6 ok 10) 20. On August 7, Treasury announced the suspension of the sale of savings bonds and SLGS, effectively immediately.

21. Temporary debt limit was enacted on August 7, to carry through September 23, raising the limit to $2,352 billion.

22. On August 10, Treasury announced the resumption of the sale of savings bonds and SLGS.

23. On September 11, Asst. Secretary Sethness, in a letter to Speaker James Wright and Senate President Bush, stated that in absence of debt limit action before Sept 23, Treasury will be unable to invest or rollover maturing investments of trust funds, including Civil Service and the Thrift Savings Fund.

7 11) ok 24. On September 21, Treasury announced the postponement of its regular weekly bill auctions scheduled for that day, and also the postponement of 2-year notes scheduled for September 22, and 4-year notes scheduled for September 23.

25. On September 29, a $2,800 billion debt limit bill was signed, which was sufficient until August 1989.

In 1987, the timing of temporary debt limit increases and their expirations created any actions

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FY 1986

7

DEBT LIMIT -- FALL 1985
DISRUPTIONS OF REGULAR TREASURY FINANCING

1) 1. September 11, 1985 -- Announced that no foreign add-ons would be allowed on the 2-year note auctioned September 18.

2) 2. September 17, 1985 -- Weekly bills were reduced to ensure that the debt ceiling would not be exceeded.

3) 3. September 17, 1985 -- Postponed regular auctions of 4, 7, and 20-year securities.

4) 4. October 8, 1985 -- Out of cash -- Substituted $5 billion of FFB issues for Treasury securities in the Civil Service Retirement fund; sold $5 billion of 78-day cash management bills in the market to raise cash.

5. October 9, 1985 -- Settled 78-day CMB.

6. October 28, 1985 -- Announced sale of 3-year 11-month, 6-year 11-month and 19-3/4-year securities. Announced that would disinvest trust funds to permit issance of these securities to raise cash for benefit payments.

7. October 30, 1985 -- DAS John Niehenke testified on the impact of the debt limit crisis on the trust funds.

8. November 1, 1985 -- Secretary Baker announced accelerated redemption of trust fund securities to meet November social security payments.

9. November 5 -- Sold 142-day CMB using debt limit room acquired by disinvesting trust funds. Regular weekly bills were rolled over, raising no cash.

10. November 14, 1985 -- Temporary $80 billion increase in the debt limit was enacted. Treasury announced $61 billion of market financing, including:

$22.0 billion of CMB
22.5 billion November quarterly refunding
9.0 billion 52-week bills
7.5 of 5-year notes

5) 11. December 5, 1985 -- Sales of savings bonds and SLGS were suspended.

6) 12. December 6, 1985 -- Weekly bill auction was postponed.

13. December 7, 1985 -- Debt limit was reached.

14. December 11, 1985 -- Announced 2- and 4-year notes, with a caveat that the auction would be postponed in the absence of congressional action.

7) 15. December 11, 1985 -- Rescheduled regular weekly bills to auction and settle on December 12; a $10 million minimum was set for bids and bidding was restricted to the New York District.

16. December 12, 1985 -- A $2,087.7 billion permanent debt limit was enacted, along with the Balanced Budget and Emergency Deficit Control Act. The act also restored 1985 losses of all of the trust funds' losses and 1984 losses only for the social security trust funds.,

Market Finance
July 17, 1985

DEBT LIMIT AND SOCIAL SECURITY TRUST FUNDS IN 1985

1. On September 3 (first working day), Treasury credited the trust funds with NTT of $15.1 billion, but because the debt outstanding was close to the limit, only $1.0 billion was invested. Treasury met payments from the general fund.

2. On September 3, 9, 19, and 30, Treasury redeemed investments, shortest maturity and lowest coupons first. If Treasury had sufficient borrowing authority to fully invest the September NTT at the beginning of the month, $6.9 billion of long-term bonds would not have had to be redeemed.

3. On September 10, DAS Niehenke testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee that without an increase in the debt limit by September 30, investment in trust funds would have to be delayed.

4. On September 25, Secretary Baker wrote Sen. Dole and Sen. Byrd that unless the debt limit was raised by October 7 recipients of government checks, including social security, would be unable to cash them.

5. On October 1, Secretary Baker stated in a letter to Sen. Dole and Sen. Byrd that Treasury was unable to comply with statutory requirements to fully invest trust funds.

6. On October 1, $12.8 billion was credited to the trust funds, but unlike September, none of it was invested. It remained so until after the debt limit was raised. Treasury disinvested $4.8 billion of trust fund bonds in October.

7. On October 22, Secretary Baker, in a letter to Rep. William Gray, stated that the failure to raise the debt limit had resulted in the disinvestment of trust funds. Also, if the limit were not raised, Treasury was prepared to take the extraordinary step of disinvesting funds in advance of benefit payments in order to meet obligations.

8. On October 28, at the quarterly financing press conference, the Treasury announced that it would disinvest trust funds in order to issue new securities to raise funds to pay benefits in November.

9. On October 30, DAS Niehenke testified before the Subcommittee on Social Security of the House Ways and Means Committee on the impact of the debt limit crisis on the trust funds, and on Treasury's plans to accelerate disinvestment of the trust funds at the beginning of November.

10. On October 30, Assistant Secretary Thompson sent a memorandum to Rep. James Jones regarding the Secretary's authority to disinvest the Trust funds, and to subsequently make them whole for direct interest losses.

11. On November 1, Secretary Baker announced accelerated redemption of trust fund securities to meet November payments.

12. On November 1, $13.1 billion was credited to the trust funds, but as in October, it remained uninvested, bringing the total uninvested portion of the NTT to $28.2 billion. To cover social security payments in November, Treasury redeemed $13.7 billion of long-term bonds. None of the bonds would have had to be redeemed if Treasury had been able to follow its normal NTT procedures.

13. On November 1, Treasury proceeded to accelerate disinvestment of trust funds. Under normal circumstances, obligations with face amounts totaling almost $15 billion would have been redeemed by the trust funds on November 1, 7, an 8, but both the timing and amounts were accelerated in November.

Normal Schedule		Accelerated Schedule	
Nov. 1	$6.9 billion (46%)	Nov. 1	$9.6 billion (64%)
7	$4.8 billion (32%)	4	$4.1 billion (28%)
8	$3.2 billion (22%)	8	$1.1 billion (8%)

14. On November 7, DAS Niehenke testified before the Subcommittee on Social Security and Income Maintenance Programs of the Senate Finance Committee on the actions Treasury had taken regarding the disinvestment of the trust funds and the potential associated costs.

15. The Balanced Budget and Emergency Deficit Control Act of 1985 (December 5, 1985) provided that the trust funds be made whole for interest foregone as a result of disinvestment. By December 31, 1985, Treasury had reimbursed the social security trust funds $9 million for losses incurred during the disruption in normal practices in 1985, and $373 million for losses incurred in 1984.

DEBT LIMIT AND SOCIAL SECURITY TRUST FUNDS IN 1984

1. On May 1, Treasury credited the trust funds with NTT of $15.8 billion, but only $4.2 billion was invested, with the remainder credited to a non-interest bearing account.

2. On May 7, Secretary Regan stated in a letter to Sen. Dole and Rep. Rostenkowski that the May NTT had not been fully invested, and if action on the debt limit were delayed beyond May 24, future disruptions in trust fund investments would be necessary.

3. On May 16, Assistant Secretary Healey testified before the House Ways and Means Committee that timely action was necessary to avoid a repetition of past actions, including failure to fully invest NTT funds.

4. On May 21, Secretary Regan, in a letter to Sen. Dole and Rep. Rostenkowski, reiterated the need to act on the debt limit by May 24, or Treasury would likely not be able to meet all its obligations when they fell due, including social security checks.

5. On May 25, limit was temporarily raised from $1,490 billion to $1,520 billion.

6. However, because the debt was close to the statutory limit on June 1, and again on July 1, the NTT for each month was not fully invested on those dates.

7. During June, there were sufficient short-term securities outstanding to cover benefit payments, but in July, $1.7 billion of long term bonds were disinvested to reimburse Treasury for timely payments.

8. On July 6, the limit was raised temporarily to $1,573 billion.

9. On July 31, Secretary Regan, in a letter to Sen. Dole and Rep. Rostenkowski requesting an increase in the debt limit, stated that Treasury would have to delay fully investing the September NTT unless the debt limit were raised.

10. On August 31, $4.1 billion of long-term bonds were redeemed because September 3 fell on a holiday. The funds were used to finance payments by electronic funds on August 31, as there were insufficient short-term investments available. Between August 31 and October 12, $9.9 billion of long-term bonds were redeemed.

11. On September 4 (first working day), Treasury credited the trust funds with NTT of $12.4 billion, but the funds were invested in three blocks, on the 4th, 7th, and 10th.

12. On October 1, Treasury credited the trust funds with NTT of $11.6 billion, but it remained completely uninvested until October 13 when the debt limit was raised.

Treasury Actions Which Resulted from Congressional Failure to Raise the Debt Limit in FY 86 & 87

Near the end of that year, on August 1, 1985, the Congress adopted a congressional budget resolution for fiscal year 1986 containing a provision that declared the appropriate level of debt to be $1,847.8 billion or, as of October 1, $2,078.7 billion. This provision was deemed to have passed the House, but no further action was immediately taken.

At the beginning of September 1985, Treasury could not fully invest the receipts of the social security trust funds that are normally transferred at the beginning of the month, because that would have raised the amount of debt over the limit. By the end of the month the debt was still at the limit, social security was still only partially invested, Treasury had postponed or limited the normal auctions for some of its securities, and Treasury had not been able to keep the Exchange Stabilization Fund fully invested. On the last day of September, $17.4 billion was supposed to have been invested for the civil service retirement and disability trust fund; during the first days of October investment was supposed to have been made for the social security trust funds, the military retirement trust fund, and the supplementary medical insurance trust fund. The total of these amounts was $42.5 billion, but because of the debt limit most of the investment had to be delayed, as it had been the year before.

By this time the debt limit bill had become the vehicle for the Gramm-Rudman-Hollings proposal to eliminate the deficit in a series of steps over several years. This proposal, which set deficit targets and created a mechanism to enforce them, was offered as an amendment to the debt limit bill. This amendment became the principal issue before the Congress until December 12, 1985, when the debt limit bill was enacted incorporating a revised version of the amendment designated the Balanced Budget and Emergency Deficit Control Act of 1985.

As a result of this delay, the amount of debt remained at the limit, and several extraordinary steps were taken to prevent a default on the Government's various obligations. The first such step was taken on October 3, the day after Treasury's cash balance became virtually exhausted, when use was made of the Federal Financing Bank (FFB). As explained above, FFB debt is not subject to the general statutory debt limit, so Treasury reduced the amount of debt subject to limit by issuing $5 billion of FFB securities to the civil service retirement and disability trust fund in place of regular Treasury securities. This enabled Treasury to raise $5 billion of cash by selling securities to the public that were subject to the debt limit. A total of $14.2 billion of FFB securities was eventually issued to the civil service retirement and disability trust fund, nearly reaching the FFB's own $15 billion special limit. The FFB securities had the same interest rates and date of maturity (June 30, 1986) as the regular Treasury securities that they replaced.

By the beginning of November, further steps were needed in order for Treasury to finance the outlays for social security and other purposes that are always very large at the start of the month. Treasury temporarily reduced the debt held in Government accounts by disinvesting the social security trust funds, the civil service retirement and disability trust fund, and the railroad retirement account (i.e., by accelerating the redemption of certain securities they held by up to seven days earlier than normal). This decreased the debt subject to limit, which enabled Treasury to obtain cash by selling debt securities to the public that were subject to the limit.

The next critical problem was large payments due on November 15. Treasury was scheduled to pay $16 billion of cash interest on its debt but did not have enough cash to do this (on November 14 it had a cash balance of only $7.8 billion). Inability to meet its obligations would have caused an unprecedented default on the interest and principal of U.S. Government securities. To avoid this, on November 14 the Congress temporarily raised the debt limit to $1,903.8 billion for the period ending December 6. Treasury immediately sold sufficient securities to meet its obligations and fully invested all the trust funds.

By December 5 the debt was at the level of the temporary limit, so when the limit returned to $1,823.8 billion on December 7 the amount of debt exceeded the limit. For the next several days Treasury was forced to postpone its normal auction of bills, to suspend sales of savings bonds and State and local government special issues, and to cease investing trust funds. On December 12, 1985, however, the debt bill was enacted, raising the limit to $2,078.7 billion and including as a separate title the Balanced Budget and Emergency Deficit Control Act of 1985. Treasury immediately sold securities to the public and fully invested the trust funds.

The trust funds had lost interest during this period for several reasons stemming from Treasury's inability to keep them fully invested. As part of the Balanced Budget and Emergency Deficit Control Act, the Congress provided that the trust funds be made or redeemed the auctions of some securities and had issued FFB debt up to the $15 billion statutory maximum. On the last day of September, $17.9 billion was available to be invested for the civil service retirement and disability trust fund; during the first three days of October additional funds were available to be invested for the social security trust funds, the military retirement trust fund, and the supplementary medical insurance trust fund. The total of all these amounts was $48.8 billion, but because of the debt limit only about a third could be immediately invested. The rest was either used for benefit payments within the following few days or temporarily left uninvested.

Later in October, just before adjournment, Congress passed the Omnibus Reconciliation Act of 1986, and the President signed it on October 21. This Act raised the debt limit to $2,300 billion through May 15, 1987. Treasury immediately invested the remaining trust fund balances it had not been able to invest, which were relatively small by that date. The Act also provided that the trust funds be made whole for the losses they had incurred because of Treasury's inability to keep them fully invested. As a result, Treasury paid the trust funds $41 million.

Because the new limit expires on May 15, 1987, and then reverts to $2,111 billion, further debt limit legislation will be needed at that time in order to permit the Federal Government to meet its obligations.

FRIDAY, OCTOBER 27, 1989

TO: SENATOR

FM: WALT

RE: MEET THE PRESS

HEADING INTO SUNDAY'S SHOW, SENATOR MITCHELL WILL HAVE THE SPIN GOING ALL HIS WAY:

o REPUBLICANS ARE BLOCKING AID TO POLAND/BLOCKING A HELPING HAND TO FREEDOM FOR DEMOCRACY-STARVED EASTERN EUROPEANS.

o REPUBLICANS HAVE PARALYZED CONGRESS WITH THEIR OBSESSION WITH CAPITAL GAINS, A TAX CUT FOR THE RICH AND POWERFUL.

o REPUBLICANS HAVE TALKED ABOUT EDUCATION, THE ENVIORNMENT AND A WAR ON DRUGS, BUT THEY DON'T WANT TO SPEND THE MONEY TO GET THE JOB DONE...UNLESS IT'S FOR THE B-2 BOMBER.

o REPUBLICANS ARE DRAGGING THEIR HEELS ON ARMS CONTROL, GIVING THE COLD SHOULDER TO THE SOVIETS' STARTLING NEW PROPOSALS.

o ALL IN ALL, PRESIDENT BUSH HAS FAILED TO GIVE AMERICA THE LEADERSHIP IT NEEDS -- IT IS TIMID, COW-TOWING TO THE RICH AND UNWILLING TO SPEND THE MONEY AMERICA NEEDS.

AND...BECAUSE THE SHOW IS ENTITLED "STALEMATE, OR SHOWDOWN?" THE DEBATE COULD DRAG YOU INTO A BOX -- YOU ARE LEFT TRYING TO EXPLAIN ARCANE SENATE PROCEDURE; 60 PROCEDURAL VOTES VS. 50 MAJORITY VOTES; DEFEND YOUR PARTY POSITION BY CALENDAR DATES, TYRANNY OF THE MAJORITY, ETC.

AND ALL OF THAT MISERY IN THE NAME OF CAPITAL GAINS. IT IS A TOUGH SELL, BUT MIGHT BE PUT IN A BETTER CONTEXT IF YOU GAVE IRA'S -- TAX RELIEF AND RETIREMENT AND EDUCATION BENEFITS FOR THE MIDDLE CLASS -- AN EQUAL PRIORITY.

IN MY VIEW, STICKING WITH THE BIG PICTURE, REPUBLICANS VS. DEMOCRATS ON POLICY, IS THE WAY TO GO:

o THE <u>REAL PARALYSIS</u> BEGAN WHEN THE DEMOCRATS SAW PRESIDENT BUSH'S POPULARITY HIT 70%! THEIR LEADERSHIP MADE A CONSCIOUS -- AND LET'S BE HONEST -- <u>A BLATANT POLITICAL DECISION</u> (MITCHELL'S SPIN) TO "TAKE ON GEORGE BUSH"; RON BROWN SAID AS MUCH. AND ALL THE CANNED RHETORIC WE'VE BEEN HEARING LATELY CONFIRMS IT.

THE DEMOCRATS AGENDA BOILS DOWN TO THIS: <u>TAX MORE AND SPEND MORE</u>. IF THE PRESIDENT IS AGAINST RAISING TAXES, INSIST THAT HE <u>TAX MORE</u>; AND IF HE PROPOSES TO SPEND ANY MONEY, GO AHEAD AND TELL HIM TO <u>SPEND MORE</u> BECAUSE IT ALWAYS SOUNDS BETTER.

IT IS CHEAP POLITICAL "ONE-UPMANSHIP".

THEN, THERE IS THEIR "TIMID" OFFENSIVE. THE PRESIDENT IS "TIMID", ALL THE DEMOCRATS SAY. AGAIN, AN OBVIOUS AND BLATANT POLITICAL DECISION.

(WE RAN "TIMID" AND "BUSH" THROUGH THE NEXUS COMPUTER AND CAME UP WITH 178 STORIES, ALL OF THEM ATTRIBUTED TO DEMOCRATS AND RECYCLED BY THE MEDIA).

THERE IS ONE THING DEMOCRATS ARE NEVER "TIMID" ABOUT -- RAISING TAXES. THERE IS NO OBSESSION WITH CAPITAL GAINS, BUT THERE IS AN UTTER OBSESSION BY DEMOCRATS TO RAISE TAXES. THEY HAVE PUBLICLY ATTACKED THE PRESIDENT FOR HOLDING THE LINE ON TAXES.

THIS PARTISAN OFFENSIVE EVEN INCLUDED CRITICIZING THE PRESIDENT'S WAR ON DRUGS BECAUSE HE DIDN'T WANT TO RAISE TAXES! THE DEMOCRATIC PARTY MAKES ITS ANNUAL PLEDGE TO CHANGE ITS WAYS, TO SOBER UP, BUT IT JUST CAN'T HELP ITSELF.

o WHEN MITCHELL GETS ON HIS HORSE ON POLAND, YOU CAN SAY: LET'S GO BACK TO THE BEGINNING. THERE WOULDN'T BE A POLAND AND HUNGARY AND SOVIET ARMS CONTROL CONCESSIONS WITHOUT RONALD REAGAN AND GEORGE BUSH: THEIR POLICIES OF STRENGTH -- STRONG DEFENSE, TOUGH NEGOTIATIONS -- PAID OFF AND IT'S TIME THE DEMOCRATS ADMIT IT. THEY FOUGHT US EVERY STEP OF THE WAY -- REAGAN WAS WRONG, THEY SAID, WE SHOULD CAVE ON ARMS CONTROL; REAGAN WAS WRONG, WE SHOULD CAVE IN FOR GORBACHEV; SENATE DEMOCRATS LED THE FIGHT -- AND NOW, HISTORY HAS PROVEN THEM WRONG: IN POLAND AND HUNGARY; IN THE SOVIET UNION; IN AFGHANISTAN; ON THE ARMS CONTROL TABLE.

WHO WENT TO POLAND? WHO MADE THAT ISSUE A PRIORITY? BUSH. SO ALL THE PARTISAN CRITICISM RINGS HALLOW.

Arms Control

MEMORANDUM
OCTOBER 27, 1989

TO: SENATOR DOLE

FROM: MIRA BARATTA

SUBJECT: TALKING POINTS ON ARMS CONTROL

As you know, the Democrats have been hitting pretty hard on the theme of hesitancy. In the area of arms control, Senator Mitchell and others have claimed that there is no evidence of a sustained effort on the part of the Bush Administration.

This is hardly the case. The United States has tabled new proposals in each of the negotiating fora. Moreover, progress was made in several areas at the Wyoming Ministerial.

Therefore, I suggest the following general theme:

*TRYING TO CONTROL THE ARMS RACE IS ONE THING, BUT RACING INTO TREATIES IS ANOTHER.

*THE UNITED STATES MUST SEEK GOOD AND VERIFIABLE TREATIES--WHICH TAKE TIME-- AND NOT TREATIES FOR TREATIES' SAKE.

*THE BEST PROOF OF U.S. ARMS CONTROL ACTIVITY CAN BE FOUND AT THE NEGOTIATIONS AND NOT IN THE NUMBER OF ADMINISTRATION SPEECHES ON THE SUBJECT.

*THE UNITED STATES HAS TABLED NEW PROPOSALS IN EACH NEGOTIATION .

<u>KRASNOYARSK RADAR</u>:

*THE SOVIETS ADMITTED -- WHAT WE ALL KNEW -- THAT KRASNOYARSK RADAR IS A 'CLEAR' VIOLATION OF THE 1972 ABM TREATY.

*THIS SOVIET ADMISSION IS A POSITIVE STEP AND I LOOK FORWARD TO THE DISMANTLEMENT OF THE RADAR.

*THIS CHANGE IN THE SOVIET POSITION IS THE RESULT OF A SUCCESSFUL U.S. COMPLIANCE POLICY: A POLICY OF TOUGHNESS, PATIENCE AND PERSISTENCE.

*THE CONGRESS SUPPORTED THIS TOUGH COMPLIANCE POLICY.

*THE SOVIETS TOOK US SERIOUSLY AND KNEW WE WOULD NOT BACK DOWN.

CHEMICAL WEAPONS ARMS CONTROL:

*CHEMICAL WEAPONS POSE PROBABLY THE TOUGHEST ARMS CONTROL PROBLEM WE HAVE.

*THEY ARE TOUGH FOR TWO REASONS: CHEMICAL WEAPONS ARE EASY TO PRODUCE AND EASY TO HIDE; THAT MEANS THE VERIFICATION TASK IS EXTREMELY DIFFICULT.

*LAST MONTH AT THE UNITED NATIONS, THE PRESIDENT ANNOUNCED SEVERAL NEW INITIATIVES IN THE AREA OF CHEMICAL WEAPONS ARMS CONTROL:

--THE UNITED STATES HAS OFFERED TO REDUCE ITS CHEMICAL WEAPONS STOCKPILE BY 98% OVER EIGHT YEARS. MOREOVER, THE U.S. WILL ELIMINATE THE REMAINING 2 PERCENT AT THE 10TH YEAR GIVEN WORLDWIDE PARTICIPATION.

--THE UNITED STATES ALSO CHALLENGED THE SOVIETS TO ASYMMETRICAL REDUCTIONS TO EQUAL LEVELS AT 20% OF THE CURRENT U.S. STOCKPILE.

If asked about continuing our chemical weapons modernization program (ie., continuing to produce binary chemical weapons) after a treaty is signed (the Democrats have attacked this policy as "inconsistent" since the treaty text in Geneva does not reflect this U.S. position):

*I THINK THAT IT IS A REASONABLE AND RESPONSIBLE POLICY TO KEEP OUR DETERRENT MODERN AND CREDIBLE --AS INSURANCE-- UNTIL WE ARE SURE THAT THERE IS WORLDWIDE PARTICIPATION IN A CHEMICAL WEAPONS BAN.

*THE PRESIDENT WILL HAVE TO DETERMINE WHETHER ANY CHANGES IN THE TREATY TEXT ARE NECESSARY.

GORBACHEV'S PROPOSAL FOR A NUCLEAR-FREE ZONE IN THE BALTIC:

*I DON'T HAVE ALL OF THE DETAILS, HOWEVER, THE IDEA OF A EUROPEAN NUCLEAR-FREE ZONE MAY SOUND GOOD, BUT WOULD NOT MAKE A REAL CONTRIBUTION TO EUROPEAN STABILITY AND SECURITY.

*A EUROPEAN NUCLEAR-FREE ZONE WOULD REDUCE NATO'S DETERRENT CAPABILITY WITHOUT SUBSTANTIALLY ALTERING THE SOVIET WARFIGHTING CAPABILITY.

*IF WE WANT GREATER STABILITY IN EUROPE, WE NEED TO FOCUS ON THE CONVENTIONAL ARMS CONTROL TALKS IN VIENNA WHICH SEEK TO REDRESS THE CONVENTIONAL IMBALANCE THROUGH VERIFIABLE REDUCTIONS IN EQUIPMENT AND TROOPS.

STRATEGIC ARMS REDUCTION TALKS (START):

*AS I HAVE SAID BEFORE, WE NEED TO MOVE SLOWLY AND CAREFULLY IN START.

*MANY BIG ISSUES STILL NEED TO BE WORKED OUT, ESPECIALLY ON VERIFICATION.

*THERE HAS BEEN PROGRESS, DUE TO A LARGE EXTENT TO NEW U.S. INTIATIVES, INCLUDING:

--A VERIFICATION AND STABILITY PACKAGE--WHICH THE SOVIETS AGREED TO IN PRINCIPLE IN WYOMING.

--THE PRESIDENT HAS STATED THAT THE BAN ON MOBILE ICBMs WILL BE LIFTED CONTINGENT ON CONGRESSIONAL FUNDING FOR THE MX AND MIDGETMAN MISSILES, AND THE SOVIETS HAVE ACCEPTED SEVERAL U.S. MOBILE ICBM VERIFICATION PROPOSALS.

*WE NEED TO LET THE NEGOTIATIONS RUN THEIR COURSE; WE WANT GOOD, VERIFIABLE TREATIES.

If asked about Soviet "delinkage" of their position on SDI from START:

*IT SOUNDS LIKE A POSITIVE DEVELOPMENT--SECRETARY BAKER THINKS IT PROBABLY IS.

*BUT, WE NEED TO MAKE SURE THAT THERE IS NOT LINKAGE IN ANY OTHER FORM.

*SDI IS NOT A BARGAINING CHIP.

NOTE: The Defense and Space Talks are moving slowly (Dave Smith is trying to find out what "delinkage" means in terms of the Soviet position on SDI), but the U.S. did invite the Soviets to visit some of our SDI facilities as part of our effort to foster predictability. The Soviets have not yet accepted.

CONVENTIONAL ARMS CONTROL (the Conventional Forces in Europe (CFE) Talks and the Confidence and Security-Building Measures (CSBM) Talks in Vienna):

*THE REAL THREAT TO EUROPE ARISES FROM THE OVERWHELMING CONVENTIONAL SUPERIORITY OF THE SOVIETS AND THE WARSAW PACT.

*THEREFORE, THE EUROPEAN ARMS CONTROL PRIORITY SHOULD BE THE CONVENTIONAL ARMS TALKS SINCE THEY SEEK TO REDRESS THIS IMBALANCE.

*THE PRESIDENT AND NATO HAVE MADE SOME BIG MOVES IN VIENNA TO MOVE THE NEGOTIATIONS ALONG, INCLUDING PROPOSALS ON U.S. AND SOVIET TROOP REDUCTIONS AND VERIFICATION MEASURES.

*THE UNITED STATES HOPES TO CONCLUDE A TREATY WITHIN A YEAR.

If asked about short-range nuclear forces (SNF) arms control:

*NATO KEEPS NUCLEAR FORCES TO DETER THIS OVERWHELMING WARSAW PACT SUPERIORITY.

*SNF NEGOTIATIONS, IF DEEMED TO BE IN THE WEST'S INTEREST, SHOULD ONLY BE CONSIDERED ONCE THE CONVENTIONAL IMBALANCE IS CORRECTED.

Capital Gains

SUMMARY OF PACKWOOD-ROTH CAPITAL GAINS/IRA PROPOSAL

The proposal is intended to promote long-term investment and savings by permanently cutting capital gains rates for individuals and corporations and by creating a new retirement savings account, the "IRA Plus" account.

CAPITAL GAINS:

The proposal calls for a permanent reduction in capital gains tax rates. To encourage long-term investment, the rate cut increases the longer an asset is owned. The proposal applies to all capital assets (except collectibles) which are sold after October 1, 1989.

Individuals can exclude from tax up to 35 percent of their gain:

Assets owned for more than:	Gain excluded from tax:	Top tax rate:
1 year	5%	26.6%
2 years	10%	25.2%
3 years	15%	23.8%
4 years	20%	22.4%
5 years	25%	21.0%
6 years	30%	19.6%
7 years	35%	18.2%

Example: If an individual sells a business owned for four years for a $10,000 gain, the owner would be able to exclude $2,000 (20%) of the gain from taxation.

Instead of the exclusion shown above, individuals have the option to reduce their gains by an inflation factor. This is known as "indexing" for inflation. The proposal adjusts the original cost of assets owned for more than two years for inflation occurring after 1990.

Corporations will pay a lower capital gains rate based on a sliding scale:

Assets owned for more than:	Top tax rate:
3 years	33%
6 years	32%
9 years	31%
12 years	30%
15 years	29%

U.S. Senate Republican Policy Committee

William L. Armstrong, *Chairman* **September 27, 1989**

REFORM THE CAPITAL GAINS TAX

CAPITAL GAINS

What is the history?

What are the revenue effects?

What are the issues concerning tax policy, competitiveness, and fairness?

What are the proposals?

A capital gain is the appreciation in the value of an asset between the date of its purchase and its sale. For example, when a share of stock is purchased at $10 in year 1 and sold for $20 in year 3, there is a capital gain of $10. In essence, capital gains are the income received by investors. It is the prospect of such gains which induces people to invest.

Until the 1986 Tax Reform Act, capital gains were either taxed separately from ordinary income under an alternative tax, or received a partial exclusion from the tax under the regular rate schedule. Below is a brief historical summary of the tax treatment of capital gains:

- Special treatment of capital gains was first introduced into the tax law in 1922. If the holding period exceeded two years, the taxpayer could elect a special tax rate of 12.5 percent. Between 1922 and 1933 the top marginal ordinary income tax rate ranged from 24 percent to 73 percent. [Treasury Dept., *Report to the Congress on Capital Gains Tax Reductions of 1978*, OTA, 1985]
- Between 1934 and 1937 the tax law allowed portions of capital gains to be excluded from income depending on how long the asset was held (e.g. only 30 percent of the gain was includable in income for an asset held over 10 years). [Treasury, ibid.]
- Between 1938 and 1941 the taxpayer could elect an alternative tax with a maximum tax rate of 20 percent for holding periods of 1 1/2 to 2 years, and a 15 percent rate for gains with longer holding periods. [Treasury, ibid.]

- Between 1942 and 1953 only 1/2 of the amount of long term capital gains (assets held longer than 6 months) were includable in income. At the discretion of the taxpayer, capital gains were subject to an alternative tax of 25 percent from 1942 to 1951, and 26 percent between 1952 and 1953. The top tax rate on ordinary income ranged from 86 percent to 94 percent during this period. [Treasury, ibid.]
- The treatment of capital gains between 1954 and 1969 was essentially unchanged. Beginning in 1972, only the first $50,000 of net capital gains were eligible for the alternative tax of 25 percent; the remainder was taxed at 1/2 ordinary rates. [Treasury, ibid.]
- The Tax Reform Act of 1976 increased the holding period required for long-term capital gains to 9 months in 1977, and 1 year in 1978. [Treasury, ibid.]
- The Revenue Act of 1978 included fundamental changes in the capital gains tax. The major change was that for the first time since 1942 the inclusion ratio (the amount of the gain subject to taxation) fell from 50 percent to 40 percent. Under the Act, the maximum possible rate of tax on a taxpayer's net long term capital gains fell from as much as 52.5 percent to 28 percent (the product of a 40 percent inclusion rate and a 70 percent maximum ordinary income tax rate). [Treasury, ibid.]
- The 1981 Economic Recovery Tax Act reduced the maximum marginal tax rate on ordinary income to 50 percent. As a consequence, the maximum tax rate on long term capital gains declined to 20 percent (because of the 40 percent inclusion and the 50 percent maximum rate). [Treasury, ibid.]
- The Tax Reform Act of 1986 dramatically altered the tax treatment of capital gains. For the first time since 1922 capital gains were treated the same as ordinary income. [Lawrence Lindsey, *Capital Gains Taxes under the Tax Reform Act of 1986*, National Bureau of Economic Research, April, 1987]

Revenue Effects of Capital Gains Rate Reduction

THE FACTS ON REVENUE: While the focus of the capital gains debate should not rest with its impact on revenues, there is reason to believe that the effect would be positive. Revenues were quite responsive to the 1978 capital gains tax reduction. Taxes from capital gains increased from $9.1 billion in 1978 to $11.7 billion in 1979, $12.5 billion in 1980, and $12.7 billion in 1981. Similarly, following the 1981 tax reductions (which reduced the top rate on capital gains to 20 percent) revenues rose to $12.9 billion in 1982, $18.5 billion in 1983, $21.5 billion in 1984, and $24.5 billion in 1985. In anticipation of the elimination of the capital gains differential in the tax reform bill, revenues ballooned to $49.7 billion in 1986. [*Treasury Dept. Study Updated by Office of Tax Analysis*, May 24, 1988; See also, *New Estimates of Capital Gains Realizations Behavior: Evidence from Pooled Cross Sectional Data and Panel Data*, OTA papers 66 and 67, May, 1989]

RELEASING THE LOCK-IN EFFECT: The relationship between lower tax rates and additional revenue should not be that surprising. Capital gains are only taxed when an asset is sold. High capital gains rates "lock-in" potential capital gains when the taxpayer defers selling an asset because the tax consequences offset the gain. Taxpayers have discretion in determining whether they will realize capital income. Consequently, the sensitivity to tax rate changes for capital gains is quite strong. This is why very rapid growth in the sale of capital assets occurred following the 1978 capital gains reductions. Net long term gains in 1979 were 45 percent greater than in 1978. [Lawrence Lindsey, *Capital Gains: Rates, Realizations and Revenues*, Working Paper No. 1893, National Bureau of Economic Research, April, 1986]

THE REAL ISSUE: As noted above, the capital gains debate should not rest with its revenue implications. The budget debate is important to the extent that it opens a window of opportunity, but the focus of our concern should be on how the capital gains issue relates to the real world economy.

When Are Gains Really Gains?

ILLUSORY GAINS: The truth of the matter is that our discussion of capital "gains" is often misplaced. What are often referred to as "gains" are purely inflationary increases in asset prices. When adjusted for inflation, these "gains" do not turn out to be gains at all.

A QUESTION OF FAIRNESS: It would seem to violate principles of tax equity to impose an additional burden on taxpayers when there has not been any enhancement of their economic well being as a consequence of an increase in income. It was for this reason that Congress took action to index the taxation of ordinary income in 1981 (effective January 1, 1985). The taxation of nominal [includes effect of inflation] capital gains is really a fairness issue.

AN EXAMPLE: Consider a taxpayer who purchased one unit of the Dow Jones Industrial Average in 1967 for $879. If the investor was smart enough to sell at the top of the market in 1987, he or she would have received $2722 in gross proceeds. This would be considered a capital gain of $1843 and be subject to a tax of $516. However, to keep up with the increase in prices between 1967 and 1987, the taxpayer's investment would have to have grown to $2966. As a consequence, instead of being better off, the taxpayer actually suffered a loss of $244. Of course, the Internal Revenue Service will still claim its share of the "gain."

The fairness concern transcends the debate over capital gains rates. Even if the top rate were to be lowered to a maximum of 15 percent, to the extent that increases in equity prices are inflation induced, lower tax rates merely mitigate the unfairness of taxing nominal gains.

INFLATION INDEXING: One possible way of addressing this inequity would be to index capital assets to an inflation index such as the Consumer Price Index or the GNP deflator. Such an approach would bring additional fairness to the tax system by assuring that gains are really gains before they are subject to taxation.

The Problem of Double Taxation

EARNINGS ARE TAXED TWICE: In addition to the inflation issue, the tax treatment of capital gains also violates equity principles in that it amounts to double taxation. The value of corporate equities in essence reflects a capitalization of the earnings of the corporation. A rise in the earnings of the firm should translate into an increase in share prices. This being the case, to tax the increased value of the shares in a corporation, as well as the income of the corporation when it is earned, amounts to double taxation. To add insult to injury, any dividend income is then taxed to the shareholder.

DISCOURAGING INVESTMENT: This form of double taxation has the effect of penalizing shareholders since the income which affects share prices is after tax income of the corporation. It is the return on investment that influences decisions by individuals and institutions to invest in business. High capital gains taxes discourage such investment and ultimately the purchase of new plant and equipment by those businesses.

Debt and the Capital Gains Issue

THE CAPITAL GAINS-DEBT CONNECTION: While the financial media is replete with handwringing concerning the size of corporate debt in America, few commentators have made the connection of this perceived problem with the capital gains issue. (For an exception to this rule, see Alan Reynolds, *Time to Cut the Capital Gains Tax*, Polyconomics Inc., March 15, 1989.) In fact, the discriminatory tax treatment of corporate earnings has the effect of discouraging corporate saving and encouraging the accumulation of debt as a means of finance.

If new plant and equipment are financed by borrowing, the interest expense is deductible. By contrast, the return to equity—capital gains or dividends—are fully taxable. This bias in the tax system clearly favors debt rather than equity finance.

JUNK BONDS: The unfavorable treatment of corporate equity in relationship to debt also distorts the decisions of investors. If you can be guaranteed interest payments of 15 percent on a Junk-bond, why buy stock with much lower dividends, unless after tax capital gains offer a comparable return on investment.

LBO'S: Those who have expressed grave concern about leveraged buy-outs (LBO's) should at least acknowledge that the tax system itself offers incentives for these activities because of the bias favoring debt over equity finance. A deal can be financed with junk bonds yielding 15 percent of deductible interest payments. Consider investor decisions concerning the relative attractiveness of holding stocks with 3 percent dividends (or in the case of some venture capital deals only a promise of a pay-off sometime in the distant future) versus the appeal of the high yielding junk bond. Lower capital gains taxes would reduce the incentives for LBO's. The fact that investors could keep a larger share of the return on their investments would reduce the seductive appeals of the takeover artist, and make the latter's task more expensive, if not unprofitable.

Uncle Sam as a Limited Partner

TAX TREATMENT OF LOSSES: The taxation of capital income also embodies the logic of a "heads I win, tails you lose" scenario. As described before, nominal capital income is fully taxable in a given tax year. However, losses are not fully deductible. The latter are limited to the amount of any other capital gains and up to $3,000 of ordinary income in any taxable year. In other words, Uncle Sam is fully willing to share in all taxpayer gains, but losses are an entirely different matter.

TAXING WINNERS AND ABANDONING LOSERS: Although the Tax Reform Act of 1986 was supposed to limit tax motivated investment decisions, government itself is our silent partner in all investment decisions as long as the tax consequences favor it with additional revenues. If what's good for the goose is also good for the gander, one would think that if gains were fully taxable in a tax year, losses should be treated likewise. However, the likelihood that this would leave some high income taxpayers with little or no taxable income creates a major political obstacle to leveling the playing field between gains and losses. Yet, by taxing winners and abandoning losers, the tax treatment of capital gains creates an additional impediment to risk taking.

The Competitiveness Issue

A SAVINGS AND INVESTMENT GAP? The new "buzz word" on everyones lips these days seems to be "competitiveness." The globalization of the marketplace has added an international dimension to this equation. We are constantly confronted with the argument that Americans are not saving and investing enough, and that the cost of capital in the U.S. puts us at a competitive disadvantage vis-a-vis our trading partners.

THE COST OF CAPITAL: "Companies in the U.S. face capital costs that are four times those of Japanese companies. A U.S. company acting rationally can forsake $1.00 of current earnings for $1.20 in future earnings only if the payoff comes in three years. A Japanese company acting rationally can wait for 12 years for the same investment to pay off. Clearly, the uniquely steep U.S. tax on nominal capital gains increases the cost of capital, often making investments in some other country more attractive." [*Testimony of Mitchell E. Kertzman,* President, Computer Solutions Inc., on behalf of the American Electronics Assoc., before the House Ways and Means Committee, on April 13, 1969]

AN INTERNATIONAL COMPARISON: In this regard, it is instructive to compare the treatment of capital gains with other participants in the global economy. Although there are divergent approaches to taxation, the following conclusions can be made:

- Some nations, such as Germany, Hong Kong, South Korea, Belgium, the Netherlands, and Italy exempt long term capital gains from taxation. [Arthur Andersen and Co. for the Securities Industries Assoc.; updated by ACCF Center for Policy Research, March, 1989]

- Until recently, Japan did not tax capital gains on securities at all. Japan now taxes gains on securities at the lower of 20 percent of the net gain or 1 percent of the total transaction value. [Congressional Research Service, *Taxation of Individual Capital Gains in Canada, Germany, Japan, the United Kingdom, and the United States*, March 24, 1989]
- The United Kingdom has a basic per annum exemption in 1989 of 5,000 Pounds ($8,600) and taxes gains at ordinary income rates (25 or 40 percent). The U.K. also indexes the basis (cost) of the assets for inflation. [Congressional Research Service, ibid.]
- Canada provides for a lifetime exemption of C $100,000 ($83,890 U.S. Dollars) and C $500,000 ($419,450 U.S. Dollars) for farm property. The taxable portion of the gain is 66 percent in 1988 and 75 percent in 1990, with gains taxed at ordinary income rates (individual rates of 17, 26, and 29 percent). Capital gains are subject to a death tax. [Congressional Research Service, ibid.]
- In the U.S. capital gains are taxed at ordinary income rates of 15, 28, and 33 percent.

Venture Capital and Entrepreneurship

THE SMALL START-UP COMPANIES: If the competitiveness issue is to rise beyond a rhetorical exercise, attention should be given to the capital gains tax as an important element influencing the cost of capital. This is particularly the case with respect to small start-up businesses which are such a dynamic source of employment growth in our economy. These companies are often high risk ventures which have little or no chance of any immediate return on investment. There are likely to be no dividends paid, and the major attraction to investors is the potential of long term capital gains. The tax on capital gains can have a profound influence on the risk-reward ratio.

THE REJOINDER OF OPPONENTS: An argument often voiced by opponents of capital gains reform is that the bulk of venture capital funding comes from tax exempt pension funds and is therefore not directly impacted by capital gains tax rates. While it is not possible to define with any degree of precision where venture capital comes from, this is clearly an overstatement. It is also "out of touch" with the way most small businesses get started in the United States.

A STUDY OF NEW TECH FIRMS: New start-up companies depend on equity financing from family, friends and others. Professors William E. Wetzel and John Freer of the University of New Hampshire surveyed 284 new companies and found that private individuals were the major source of funding for those firms raising under $500,000 or less at a time. They also determined that private individuals tend to invest earlier in the life of new technology based firms than other sources of outside equity capital. Private individuals provided the seed capital that launched the majority of firms in their study. [Wetzel and Freer, *Equity Financing for New Technology Firms, 1988*, Center for Venture Research, University of New Hampshire, Fall 1988]

Capital Invested in New Technology-Based Firms

Size of Financing	Private Individuals	Venture Capital Funds	All Other Sources	Totals
Less than $250,000	102 (84%)	8 (6%)	12 (10%)	122 (100%)
$250,000-$499,000	43 (58%)	14 (19%)	17 (23%)	74 (100%)
$500,000-$999,000	15 (26%)	31 (55%)	11 (19%)	57 (100%)
Greater than $1 million	17 (9%)	120 (63%)	55 (28%)	192 (100%)
Total	177	173	95	445

Source: University of New Hampshire, Center for Venture Research

ENTREPRENEURS—THE NEW TRUSTBUSTERS: Finally, those concerned with the market concentration and antitrust concerns should be natural allies with the cause of capital gains reform. The ability of new companies to get a start, and to challenge established firms is certainly related to their ability to raise the necessary capital to enter the market. It is not the large corporations of America that have a stake in capital gains reform. They don't have difficulty finding sources to finance their continued growth (although as previously discussed, capital gains taxation does distort the preference of debt over equity and increases the cost of capital). Rather it is the small start-up companies, that are the potential competitors of tomorrow, that have the most to gain by a reduction in the burden of capital gains taxation.

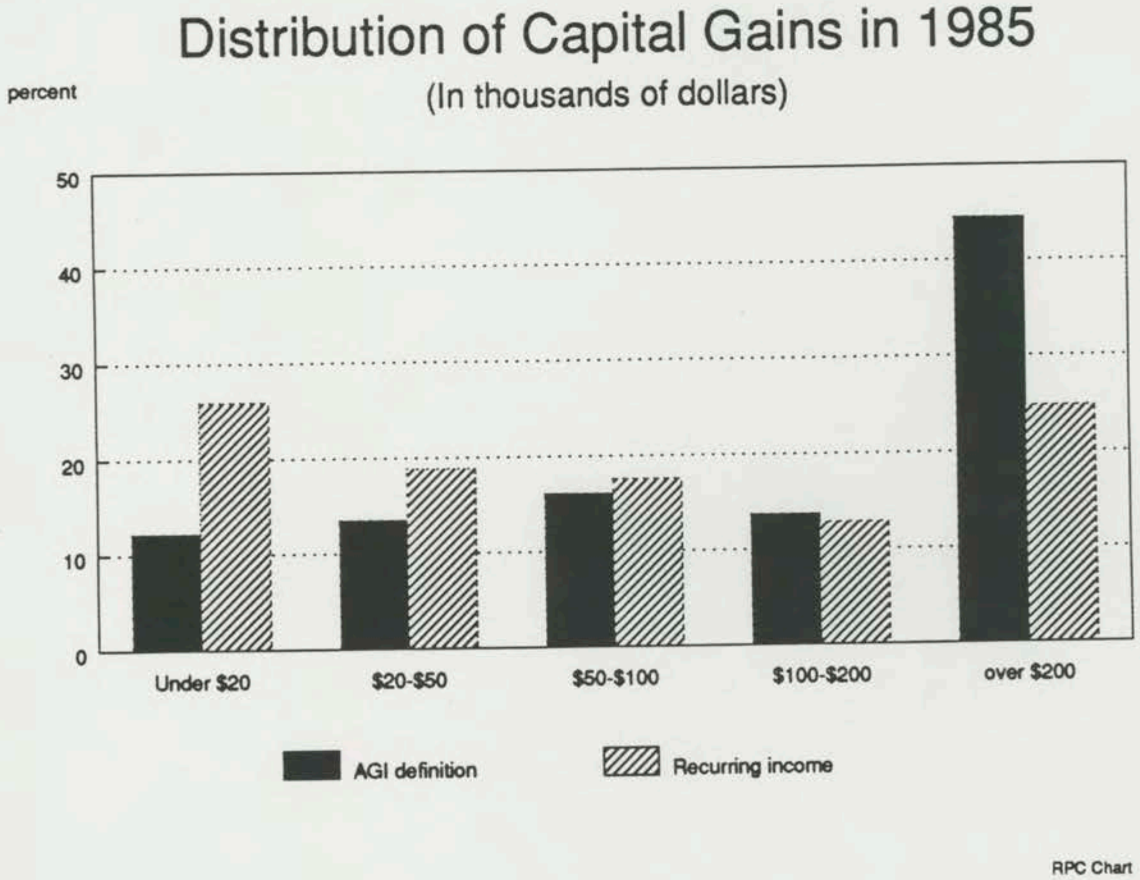
The Fairness Issue

A TAX CUT FOR THE RICH? The major opposition to reductions in capital gains rates is couched in terms of a "tax cut for the rich." Aside from the fact that this is the first time since 1922 that capital gains have been taxed at the same rate as ordinary income, this argument rests on faulty assumptions.

CONFUSING RATES WITH REVENUES: First of all, a distinction must be made between the legally imposed rate of taxation and the actual burden of taxation. As the evidence previously presented demonstrates, lower maximum capital gains rates are associated with higher levels of revenues (as is also the case with ordinary income where revenues received from the top 1 percent of taxpayers increased from 18.1 percent to 26.1 percent between 1981 and 1985). Lower rates should not be confused with lower revenues.

BEATING UP ON THE RICH CAN BE FUN: The point is not that wealthy taxpayers would not benefit from a reduction in capital gains rates. In fact, many would. However, the idea that tax policy ought to be motivated by a desire to beat up on the rich seems somewhat misguided if the alternative would be beneficial to the economy as a whole. As Dr. Wetzel puts it, "To paraphrase Pogo: We have met the beneficiaries of capital gains tax reductions and they are all of us."

WHO ARE THE RICH? Nevertheless, opponents of capital gains reform greatly exaggerate the distributional impact of lower tax rates by counting one time gains (sometimes once in a lifetime) as though this is a normal part of the subjects income. The truth of the matter is that many of those classified as "rich" have a high income in that particular tax year only because of their capital gains. For example, a small businessman with an income of $50,000 per year might retire and sell his business for $250,000. Surely, counting the proceeds from the sale of the business as income overstates the economic well-being of this businessman. We are told by opponents of reform that nearly half of all capital gains are reported by taxpayers earning over $200,000. However, when capital gains are excluded from the definition of income, this figure declines to less than one-fourth of all gains. In fact, if recurring income is used to define income, nearly half of all capital gains accrue to people with incomes under $50,000. [Alan Reynolds, *The Time To Cut the Capital Gains Tax*, Polyconomics, Inc., March 15, 1989]



YOUR NEIGHBORS MAY HAVE CAPITAL GAINS: In fact, the treatment of capital gains is important to low and middle income taxpayers. Aside from the fact that there are over 40 million shareholders in the U.S., the widespread popularity of mutual funds has broadened the impact of capital gains taxation. According to IRS data, 68 percent of returns showing capital gain income were filed by taxpayers with less than $50,000 in income. [IRS, *Sources of Income*, Winter 1987-88]

NEST EGG FOR GRANDPARENTS: It should also be noted that one group most likely to benefit from capital gains reform would be the elderly, who realize capital gains at a rate 2 1/2 times as large as those under 65. They should not be considered rich by the conventional definition of the term just because they are selling off assets for their retirement.

Capital Gains Tax Proposals

THE BUSH ADMINISTRATION PROPOSAL: The Bush Proposal contains a 45 percent exclusion of qualified capital gains and a 15 percent maximum tax rate applicable to capital gains on all qualified assets (financial assets and land). To be eligible for the lower rate, assets sold between 1989 and 1992 will have to be held for 12 months; 24 months for assets sold in 1993 and 1994; and 36 months for assets sold in 1995 or later. A 100 percent exclusion will apply to the gains of taxpayers with adjusted gross incomes below $20,000. [Treasury Dept., *General Explanations of the President's Budget Proposals Affecting Receipts*, February 9, 1989; See also, *Building a Better America*, p. 31, February 9, 1989]

THE JENKINS PLAN: On September 14, the House Ways and Means Committee voted by a margin of 19 to 17 to approve a reconciliation package that includes capital gains reform. The proposal (offered by Congressman Ed Jenkins of Ga.) calls for a 30 percent exclusion from income of capital gains on assets sold between September 14, 1989 and December 31, 1991. The effect of this is to produce a maximum capital gains rate of 19.6%. In addition, for assets acquired after December 31, 1991, taxpayers would be allowed to index the basis of the asset for inflation occurring after 1991.

Other legislative proposals before the Senate include the following:

S. 664 Senator Armstrong: Taxes net capital gains of individuals and corporations at ordinary income tax rates, but would adjust the basis of the asset for inflation if held for more than one year.

S. 1311 Senator Armstrong: Combines the indexing of capital gains with a temporary reduction in the capital gains rate from the date of enactment to December 31, 1990. Taxpayers would have the option of choosing between an exclusion of 46.4 percent of their long-term capital gains or a tax rate of 15 percent imposed on their taxable gains. It would allow taxpayers, who are the first to hold the shares of a small corporation, a deduction from gross income of 25 percent of their capital gain from the sale of such stock if they hold the shares for at least 4 years.

S. 411 Senator Boschwitz: Establishes a two-tier tax rate system for qualified assets of individuals. If a capital asset is held for a period of 1 to 3 years there is an exclusion of 40 percent of the gain when sold. Sixty percent of the gain is excluded for assets held longer than 3 years. Corporate capital gains would be subject to a flat 28 percent.

S. 645 Senator Boschwitz: Taxes net capital gains of individuals at ordinary income tax rates but would adjust the basis of the asset for inflation if held for more than 3 years.

S. 348 Senator Bumpers: Establishes effective tax rates ranging from 11.3 percent for taxpayers in the 15 percent bracket, to a maximum 21 percent rate for individuals.

S. 551 Senator Cranston: Establishes a sliding scale tax rate system for qualified assets of individuals ranging (based on the holding period) from 6 percent for taxpayers in the 15 percent bracket to 25.2 percent for taxpayers in the 28 percent bracket (those in the 33 percent bracket would have a 29.7 percent rate). Corporations would face capital gains rates of 14, 24, or 31 percent, depending on the holding period.

S. 182 Senator Heinz: Taxes capital gains of individuals and corporations at ordinary income tax rates but would adjust the basis of the asset for inflation if held for more than 1 year.

S. 171 Senator Kasten: Establishes effective capital gains tax rates ranging from 7.5 percent to 14 percent (16.5 percent for those in the 33 percent bracket) for individuals. Corporations would be subject to a 17 percent capital gains rate. Assets held for more than 1 year would be indexed for inflation in excess of 4 percent.

S. 1286 Senator Kasten: Cut the capital gains rate to 15 percent for all assets. Individuals and businesses would both be taxed at this rate. Inflation indexing would begin in calendar year 1995. A provision in the bill would eliminate the capital gains rate differential if capital gains revenues are lower in 1995 than they were in 1989.

The Bottom Line

When all is said and done, the question of how we will tax capital gains should be considered more than a budgetary issue. While the experience since the 1978 reduction in tax rates is consistent with revenue growth, our focus should be on enhancing savings and investment.

If the U.S. is to be a cauldron of entrepreneurial activity and dynamic economic growth, the obstacles to risk taking must be minimized. If we are to meet the challenges of an increasingly global economy, we must seek to reduce the cost of capital vis-a-vis our trading partners. The uncertainty of the future coupled with unfavorable tax policy can shorten the time horizons of investors and detract from the longer term investment perspective that will be essential if we realize our competitive potential on into the next century.

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Table 1

ILLUSTRATIVE MAXIMUM CAPITAL GAINS TAX RATES AROUND THE WORLD

United States	33% (Federal; no indexing, no exemptions)
Belgium	0%
Italy	0%
Netherlands	0%
Hong Kong	0%
Singapore	0%
South Korea	0%
Taiwan	0% (Effectively 0%; can be up to 50% but exemptions lower it)
Germany	0% (on assets held 6 mos.)
France	16%
Japan	20% (or 1% of sales price; can be 26% with local tax)
Sweden	29% (on assets held 2 years; includes local tax)
United Kingdom	30% (but indexed for inflation; plus L 5,000 annual exemption)
Canada	34% (incl. Provincial taxes; but $CAN 100,000 lifetime exemption)
Australia	49% (but indexed for inflation)

October 19, 1989

Table 6

Maximum Individual And Corporation Income Tax Rates In 1988

For Selected Industrialized Countries

(Rates Include All Levels Of Government)

Country	Maximum 1988 Individual Income Tax Rate	Maximum 1988 Corporation Income Tax Rate
	(.............percent	.............)
France 1/	57	42
United Kingdom	40	35
Germany 1/	56	56
Canada 1/2/	45	48
United States 1/3/	33	39
Japan 1/	76	52

August 31, 1988

1/ Source: Pechman, Joseph A., editor. World Tax Reform, A Progress Report. 1988.

2/ Proposed rates. Include estimates of average Provincial taxes. Excludes temporary 3% of Federal tax surcharge.

3/ Include estimated State and local income tax rates equivalent to 5 percentage points (net) for both individuals and corporations.

TALKING POINTS
TOP ORDINARY TAX RATES IN U.S. AND OTHER COUNTRIES

- The attached table shows that the United States has the lowest top statutory tax rate (28%) among its six major trading partners.
- The U.S. has the second to lowest corporate statutory tax rate behind the United Kingdom. Top statutory tax rates, however, do not indicate the effective tax rates on corporate income, especially when comparing integrated and non-integrated tax systems.
- The U.S. has the highest effective tax rates on capital gains income of its major trading partners.

TALKING POINTS
PRESIDENT REAGAN'S TAX REFORM PROPOSAL FOR CAPITAL GAINS

- The 1985 Tax Reform Proposals of President Reagan include a 50 percent exclusion for capital gains in combination with a top 35 percent individual marginal tax rate. The top effective rate on capital gains would thus have been 17.5 percent.

- The proposal also allowed elective inflation indexing for capital gains in lieu of the 50 percent exclusion after 1991.

TALKING POINTS
TAX-EXEMPT VENTURE CAPITAL INVESTORS

- The 1985 Treasury study of capital gains showed that over the 1978-1983 period 53% of committed capital to independent private venture capital funds came from tax-exempt investors (pension funds, foundations, and foreign), 21% from individuals and families, and 26% from corporations (including insurance companies).
- The above statistics come from formal venture capital firms. Recent studies suggest that most of the financing of small start-up enterprises comes from the owner's private savings, relatives and friends who would benefit from lower capital gains rates.
- These statistics are averages. The incentive is provided at the margin. How many of these formal venture capital firms would not have gotten off the ground without the 21% of total financing from individuals and families.

TALKING POINTS
COMPARISON WITH OTHER TAX SYSTEMS

Senator Mitchell raised the argument that although other countries have lower capital gains rates than the U.S. they also have higher corporate tax rates than the U.S. which offsets the capital gains relief.

- o Lower capital gains tax rates are important to stimulate investment and savings in the U.S. We believe the U.S. cost of capital is too high. We want to lower it, not raise it.
- o Other countries often have high corporate tax rates, but they tax corporate income at lower rates than the U.S. because they partially integrate the corporate and individual tax rates. Dividend relief at either the corporate or individual level offsets the double taxation of corporate income in other countries.
- o Lower capital gains rates would apply to both corporate and non-corporate investment. This argument can't be made against capital gains for non-corporate investment.

Eastern Airlines

	Mitchell Bill	Republican Bill
The Eastern Strike	Commission would "investigate and make findings of fact regarding the prompt & equitable settlement" of the Eastern Strike & issues arising from dispute.	Commission does not investigate the Eastern Strike.
Investigation of airline industry & report to Congress & Secretary of Trans. regarding:	2 AREAS 1) Powers of the Trans. Secretary to intervene on behalf of public interest to maintain competitiveness in light of mergers, acquisitions and bankruptcies.	5 AREAS 1) Essentially the same, but adds the topic of LBOS
	2) Protection of employee collective bargaining rights in airline bankruptcy proceedings.	2) Same.
		3) The impact of increased concentration and foreign ownership of domestic airlines.
		4) Effectiveness of National Mediation Board in resolving disputes under the Railway Labor Act in a fair, equitable, and timely manner.

		5) Current practices in the airline industry regarding the hiring of airline employees, including pilots, who have lost their jobs in a labor dispute.
Members of Commission	<u>4 MEMBERS</u>: Appointed by Pres. Pro Tem & minority leader of Senate, and Speaker & Minority leader of House.	<u>5 MEMBERS</u>: Appointed by the President, Majority and Minority leaders of Senate, and Speaker, & Minority leader of House.
Time Limit for Commission to Report to Congress	<u>45 DAYS</u>	<u>30 DAYS</u>

IRAs

INDIVIDUAL RETIREMENT ACCOUNTS (IRAs):

The proposal creates a new and innovative "IRA Plus" account intended to boost personal savings in the country.

Workers would be permitted to contribute up to $2,000 annually to an IRA Plus account (increases to $3,000 over the next five years). Non-working spouses can also contribute up to $2,000 annually. Contributions are not deductible.

Unlike current law IRAs, the interest earned on an IRA Plus account is tax-free when withdrawn upon retirement (after age 59-1/2).

Up to 25% of IRA Plus funds may be withdrawn tax-free to purchase a first home, to pay college education expenses of family members (including grandchildren), and to pay catastrophic medical expenses.

Current law IRAs remain intact. Individuals are given the option to choose a current law IRA or an IRA Plus account, or a combination of both.

Current law IRAs may be converted into an IRA Plus account before January 1, 1992. IRA contributions previously deducted will be included in income over a four year period. Interest earned before the conversion will not be taxed unless withdrawn prematurely.

REVENUE EFFECT:

According to preliminary estimates by the Joint Committee on Taxation (dated October 18, 1989), the proposal will increase revenues by $1.3 billion over five years:

($ in Billions)

	FY 1990	FY 1991	FY 1992	FY 1993	FY 1994	FYs 1990-94
Capital Gains:						
Individuals	+.4	+.3	-2.1	-2.5	-3.0	-6.9
Corporations	-.4	-.6	- .7	- .8	- .8	-3.3
IRA Plus Accounts:	Less than -.05	+1.5	+3.4	+3.3	+3.3	+11.5
Totals:	*	+1.2	+ .6	+ .1	- .6	+ 1.3

* For FY 1990, the overall total is a gain of less than $5 million. The column does not add due to rounding.

Poland

Meet the Press

Poland: Why are you holding up emergency aid to Poland over the capital gains issue?

o IT'S A TOTALLY PHONY ISSUE -- AND SENATOR MITCHELL KNOWS IT.

o U.S. AID IS GOING TO POLAND NOW ($9 MILLION IN FOOD AID).

o IF WE PASSED THE POLAND BILL TOMORROW, NO ADDITIONAL AID WOULD FLOW.

-- THIS IS AN AUTHORIZATION BILL -- IT JUST SETS UP PROGRAMS; IT DOESN'T ALLOW US TO SPEND ANY MONEY ON THOSE PROGRAMS.

-- NO ADDITIONAL AID WILL FLOW UNTIL WE PASS AN APPROPRIATIONS BILL -- THE SPENDING BILL. AS SENATOR MITCHELL KNOWS VERY WELL, WE WILL NOT BE PASSING A FOREIGN AID APPROPRIATIONS BILL FOR SOME TIME.

o WHEN WE PASS AN APPROPRIATIONS BILL, ALMOST EVERY DIME OF SHORT-TERM AID TO POLAND THAT ANYONE HAS SUGGESTED -- THE PRESIDENT, SENATOR MITCHELL, SENATOR SIMON, ME -- WILL BE INCLUDED, AND CAN START TO FLOW IMMEDIATELY.

-- THE FACT IS, WE HAVE ALL PROPOSED ALMOST EXACTLY THE SAME SHORT-TERM AID:

-- $200 FOR ECONOMIC STABILIZATION (AS SENATOR MITCHELL KNOWS, THE DEAL FOR THIS IS ALREADY JUST ABOUT STRUCK IN THE APPROPRIATIONS BILL).

-- OVER $100 MILLION IN FOOD AID (DOLE - $112 MILLION, SIMON - $125 MILLION).

-- ABOUT $4 MILLION IN MEDICAL AID.

-- THE REST OF THE AID IN EVERY BILL IS FOR PROGRAMS THAT ARE MUCH SLOWER IN THEIR SO-CALLED "SPEND-OUT" RATES. NO MATTER WHEN WE PASS ANY BILL, WE WON'T START SPENDING FOR THESE PROGRAMS FOR WEEKS OR MONTHS.

-- THE POLISH-AMERICAN ENTERPRISE FUND.

-- THE SIMON BILL'S TRADE CREDIT PROGRAM.

-- MY BILL'S BOND ISSUE.

Where are the FY90 appropriations?

o Economic stabilization fund ($200 million):

-- $140 million from Defense Appropriations.

-- $ 30 million from Energy Appropriations (nuclear waste disposal).

-- $ 30 million from Foreign Ops Appropriations.

o PERSONALLY, I WISH THERE WAS MORE FROM FOREIGN AID, AND LESS FROM THE OTHER ACCOUNTS. I'D RATHER TAKE THE MONEY FROM THE ACCOUNTS GOING OVERSEAS -- THAN FROM OUR DEFENSE OR PROGRAMS FOR THE AMERICAN PEOPLE.

o MAYBE IT'S TIME TO START LOOKING AT SOME OF THESE BIG FOREIGN AID PROGRAMS -- WHICH HAVE BECOME ALMOST LIKE ENTITLEMENT PROGRAMS.

o Food aid ($112.5 or $125 million, depending on whose bill is passed):

-- All from existing food aid appropriations.

o Pivate Enterprise Fund ($45 million):

-- All from existing Foreign Operations appropriations.

o Simon's $200 million in trade credits.

-- From EXIM appropriations.

o Dole proposal for bond issue:

-- Included in Private Enterprise Fund (i.e., Foreign Operations) appropriations; no additional money.

Public Debt

Order No.	Number and Author of Bill	Title	Reported by
162	S. 1367 Mr. Nunn	A bill to authorize appropriations for fiscal years 1990 and 1991 for procurement of missiles for the Armed Forces.	July 20, 1989.—Mr. Nunn, Committee on Armed Services, without amendment. (No written report.) (An original bill.)
163	S. 1368 Mr. Nunn	A bill to authorize appropriations for fiscal year 1990 for the Army and Marine Corps for research, development, test, and evaluation to develop improved weapons and equipment for small infantry units.	July 20, 1989.—Mr. Nunn, Committee on Armed Services, without amendment. (No written report.) (An original bill.)
164	S. 1369 Mr. Nunn	A bill to authorize appropriations for the Department of Energy for fiscal year 1990 for environmental restoration and the management of defense waste and transportation, to establish and carry out a defense waste cleanup technology program, to provide for the establishment of a blue ribbon task group on environmental restoration and defense waste management, to modify the Department of Energy nuclear defense mission, and for other purposes.	July 20, 1989.—Mr. Nunn, Committee on Armed Services, without amendment. (No written report.) (An original bill.)
172	H.J. Res. 280 HEINZ	Joint resolution increasing the statutory limit on the public debt.	July 25, 1989.—Mr. Bentsen, Committee on Finance, with an amendment in the nature of a substitute. (No written report.)
177	S. 975 Mr. Metzenbaum and others HELMS	A bill to amend the Job Training Partnership Act to encourage a broader range of training and job placement for woman, and for other purposes.	July 27, 1989.—Mr. Kennedy, Committee on Labor and Human Resources, with an amendment in the nature of a substitute. (Rept. 90.)
182	S. 110 Mr. Kennedy and others HELMS	A bill to revise and extend the programs of assistance under title X of the Public Health Service Act.	July 31, 1989.—Mr. Kennedy, Committee on Labor and Human Resources, with an amendment in the nature of a substitute. (Rept. 95.) (Additional views filed.)

THE SECRETARY OF THE TREASURY
WASHINGTON

October 26, 1989

The Honorable Robert Dole
Republican Leader
United States Senate
Washington, D.C. 20510

Dear Mr. Leader:

I am writing to reemphasize the immediate need for action by the Congress on debt limit legislation.

As I indicated in my letter of October 16, without any action prior to the expiration of the debt ceiling on October 31, our current projections indicate that the Treasury could run out of cash on November 2, and is certain to default on its obligations on November 3. In light of the uncertainty surrounding Congressional action on debt limit legislation and the necessity of issuing Social Security checks on November 3, I have explored extraordinary administrative actions that could be taken to enable the Federal Government to temporarily meet its financial obligations beyond the November 3 default date.

Our most recent estimate indicates that there will be approximately $17 billion of unused statutory borrowing authority when the temporary debt limit expires at midnight on October 31. In order to extend the period during which we would have sufficient cash to pay Social Security benefits and other Government obligations, the Treasury would need to borrow up to the debt limit before the debt ceiling reverts to its permanent level of $2,800 billion on November 1.

For the reasons stated above, Treasury intends to proceed with plans for such borrowing. Our current cash flow estimate, which assumes no unprecedented cash demands, indicates that this action should provide sufficient cash to cover obligations presented for payment through November 8. However, even with this borrowing up to the debt limit, it is important that Congress act on debt limit legislation no later than November 7, in order to ensure adequate time to arrange market borrowings to avoid default.

I must emphasize that we are aware of no other realistic measures, other than debt limit legislation, that could further extend the anticipated date of default.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

THE SECRETARY OF THE TREASURY
WASHINGTON

October 16, 1989

The Honorable Robert Dole
Republican Leader
United States Senate
Washington, D.C. 20510

Dear Mr. Leader:

I am writing to request action by the Congress on legislation to increase the public debt limit before October 31, 1989.

The temporary debt limit of $2,870 billion will revert to the $2,800 billion permanent ceiling at midnight, October 31. The Congress selected this date and adopted a temporary increase to ensure that new legislation would be necessary to avoid a default on the Government's obligations. When the temporary limit expires, the statutory ceiling drops back; there is no cash maintenance flexibility; and the effects of not acting are swift and damaging.

Our current estimates show that the debt is certain to exceed the permanent ceiling by a substantial amount on November 1. Without an increase in the debt limit by that date, all issuance of Treasury securities would cease. Trust and revolving fund investments and roll-overs of maturing issues would halt, resulting in lost interest to those funds.

We would have to notify the 44,000 issuing agents to stop selling savings bonds, and sales of nonmarketable state and local government series Treasury securities would cease. The October 24 announcement of regular weekly bills for settlement on November 2 would have to be conditioned on enactment of a debt limit extension. The thousands of individuals who invest in Treasury bills directly through the Treasury would have to be notified by October 31 that we might not be able to issue those bills.

Although we would be unable to raise any additional cash, payment of obligations -- including maturing debt -- would continue as long as cash remained available. Unlike bumping up against a permanent debt ceiling, allowing the debt limit to revert to $2,800 billion would provide no opportunity for administrative actions to prolong the availability of cash. As a result, on November 2 when nearly $14 billion of regular weekly bills mature, the United States would run out of cash, default on its debt and subsequently not be able to make $20 billion of social security benefit payments on November 3.

Running out of cash means that the United States would default on its obligations, both domestic and foreign, with all the negative financial and legal consequences that implies. The United States has never defaulted on its debt obligations. To do so would be unthinkable and irresponsible. Such action would seriously erode this country's premier credit position.

For these reasons, we request that the Congress act prior to October 31 to increase the permanent debt ceiling to $3,240 billion, including a $5 billion margin for contingencies. We estimate that this amount will be sufficient to get through July 31, 1991, when the Congress will have had a chance to act on the FY 1992 budget resolution. This amount will also remove the burden of dealing with the time-consuming debt limit issue in the midst of election year schedules.

If the Congress chooses to enact a permanent debt ceiling that is sufficient for FY 1990, however, a $3,065 billion ceiling would be sufficient for that period, including a $5 billion contingency margin. This amount updates and is lower than the debt ceiling that was deemed to have passed the House in the Budget Resolution in May. The difference in large part reflects the change to accrual accounting for Treasury securities that are issued at a discount, which was authorized by an amendment to the public debt statute enacted in August 1989.

The Office of Management and Budget advises that, from the standpoint of the President's program, there is no objection to the presentation of these views.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

RECONCILIATION

October 26, 1989

TO: Senator Dole

FROM: Kathy

SUBJECT: Gimmicks in Reconciliation

Walt said that Senator Domenici has a new list of gimmicks in reconciliation. I have spoken with the Budget Committee and all they have done recently is a list of gimmicks in appropriations bills.

Here are a few talking points that you might be able to use:

0 Approximately $6 billion of the savings in reconcilation come from gimmicks. That means only about $7.4 billion of real deficit reduction is included in reconciliation out of a total claimed deficit reduction of $13.4 billion.

0 Some examples include moving the Postal Service off-budget, delaying Medicare payments one day, and counting a tax on ozone-depleting chemicals twice (Finance and Environment).

0 Not only are sequester savings real, but they are long-lasting. Because so many savings in reconciliation are gimmicks or one time savings, reconciliation saves only $43.1 billion over five years. Keeping sequester in place would save a whooping $128.6 billion over five years.

POLITICS

THE DEMOCRATIC LEADERSHIP'S HALLOWEEN STRATEGY?

Statement: Senator Pete V. Domenici
October 24, 1989

- MR. PRESIDENT, I THINK THE TIME HAS COME TO ASK SERIOUSLY WHY THE DEMOCRATIC LEADERSHIP OF THE CONGRESS HAS CHOSEN TO FLAUNT THE MAJORITY WILL OF THE CONGRESS.

- WE'VE HEARD A GREAT DEAL RECENTLY FROM SOME DEMOCRATS IN THE CONGRESS THAT PRESIDENT BUSH LACKS LEADERSHIP, LACKS DIRECTION, LACKS FOCUS ON POLICY.

- LET ME SAY, MR. PRESIDENT, THAT SUCH PARTISAN CRITICISM SHOULD NOT GO UNANSWERED.

- THE DEMOCRATIC LEADERSHIP HERE IN THE CONGRESS DESERVES BLAME ALSO FOR NOT GETTING THE LEGISLATIVE WORK DONE ON TIME AND PUTTING TOGETHER A <u>HALLOWEEN EVE STRATEGY</u> DESIGNED TO PREVENT THE MAJORITY WILL OF THE CONGRESS FROM WORKING AND SCARING NEEDLESSLY THE SOCIAL SECURITY RECIPIENTS OF THIS COUNTRY.

- LET ME EXPLAIN.

- FIRST THE PRESIDENT WAS ACCUSED OF HOLDING UP THE BUDGET FOR THIS YEAR.

- IN ALL SERIOUSNESS WOULD SOMEBODY PLEASE EXPLAIN TO ME HOW THE PRESIDENT IS TO BE BLAMED FOR THE CONGRESS MISSING ITS DEADLINES ON THE BUDGET THIS YEAR.

- REMEMBER THAT IT WAS THE BUSH ADMINISTRATION THAT SUBMITTED A REVISED REAGAN BUDGET IN RECORD TIME.

- LESS THAN THREE WEEKS INTO HIS PRESIDENCY, PRESIDENT BUSH ADDRESSED A JOINT SESSION OF THE CONGRESS AND OUTLINED HIS AGENDA FOR <u>BUILDING A BETTER AMERICA.</u>

- UNDER HIS LEADERSHIP A BIPARTISAN, BICAMERAL SUMMIT ON THE BUDGET WAS LAUNCHED IN EARLY MARCH, AND AN AGREEMENT REACHED IN APRIL FOR THE 1990 BUDGET YEAR.

- THAT AGREEMENT RESULTED IN THE CONGRESS PASSING IN RECORD TIME A BUDGET RESOLUTION IMPLEMENTING THE AGREEMENT ON MAY 15.

- FROM THAT POINT ON, HOWEVER, IT WAS THE CONGRESS, <u>NOT</u>

<u>THE PRESIDENT</u>, THAT CHANGED THE REPORTING DATES ON THE RECONCILIATION BILL FIRST FROM JULY 15 TO AUGUST 4 AND THEN <u>AFTER THE FISCAL YEAR HAD BEGUN TO OCTOBER 12.</u>

- BIPARTISAN LEADERSHIP WAS FINALLY SHOWN AND THE SENATE PASSED A DEFICIT REDUCTION RECONCILIATION BILL ON OCTOBER 13 LIVING UP TO THE REQUIREMENTS NECESSARY TO AVOID THE MINDLESS ACROSS THE BOARD CUTS THAT TOOK PLACE ON OCTOBER 16 UNDER THE GRAMM RUDMAN HOLLINGS LAW.

- BUT THAT LEADERSHIP WAS SHORT LIVED, FOR WHEN THE POWER LAID IN THE HANDS OF THE HOUSE AND SENATE DEMOCRATIC LEADERSHIP TO AVOID THOSE CUTS AND PASS A CLEAN RECONCILIATION BILL QUICKLY, THEY FAILED.

- A FULL MONTH OF THE NEW FISCAL YEAR IS ABOUT TO PASS, AND NOTHING HAS BEEN DONE TO UNDO THESE MINDLESS CUTS.

- THE PRESIDENT DIDN'T WANT THE SEQUESTER, THE AMERICAN PEOPLE DIDN'T ELECT US TO HAVE MECHANICAL, FORMULA DEFICIT REDUCTIONS DO OUR WORK -- WHERE IS THE DEMOCRATIC LEADERSHIP ON THIS?

- A CLEAN RECONCILIATION BILL IS IN THE HANDS OF THE DEMOCRATIC LEADERSHIP, THEY CONTROL THE AGENDA HERE.

- A CLEAN DEBT LIMIT BILL IS IN THE HANDS OF THE DEMOCRATIC LEADERSHIP, THEY CONTROL THE AGENDA HERE.

- THE PRESIDENT AND THE REPUBLICANS WANT TO SEE SOCIAL SECURITY BENEFITS GO OUT A WEEK FROM THIS COMING FRIDAY -- WHERE IS THE DEMOCRATIC LEADERSHIP ON THIS?

- THE PRESIDENT AND THE REPUBLICANS DON'T WANT TO SEE THE FEDERAL GOVERNMENT DEFAULT ON ITS DEBT OBLIGATIONS ON HALLOWEEN EVE -- WHERE IS THE DEMOCRATIC LEADERSHIP ON THIS?

- THE PRESIDENT AND A MAJORITY OF THE CONGRESS WANT A CHANGE IN THE CAPITAL GAINS TAX LAW. WE KNOW WHERE THE DEMOCRATIC LEADERSHIP IS ON THIS, BUT WOULD THEY SO FLAUNT THE SYSTEM THAT THEY WON'T EVEN GIVE THE MAJORITY OF THE CONGRESS AN OPPORTUNITY TO VOTE ON THIS ISSUE?

- THE MAJORITY OF THE CONGRESS HAS SPOKEN OVERWHELMINGLY ON SECTION 89 -- DOES THE DEMOCRATIC LEADERSHIP WANT IT OR NOT?

- THE MAJORITY IN BOTH HOUSES WANT TO LISTEN TO SMALL BUSINESS WHO HAVE BEEN CRYING OUT FOR RELIEF FROM THIS UNWORKABLE AND UNINTELLIGIBLE TAX PROVISION DEALING WITH FRINGE BENEFIT PLANS.

- THE MAJORITY OF THE CONGRESS HAS SPOKEN OVERWHELMINGLY ON REFORM OF THE CATASTROPHIC HEALTH CARE LAW -- DOES THE DEMOCRATIC LEADERSHIP WANT IT OR NOT?

- DELAYS IN GETTING OUR WORK DONE HERE IS NOT THE PRESIDENT'S FAULT. IT IS THE FAULT OF THE DEMOCRATIC LEADERSHIP OF THE CONGRESS.

- THEY WANTED TO AVOID VOTES ON THESE POPULAR ISSUES SO THEY DELAYED.

- ONLY A FEW DAYS REMAIN, TIME IS RUNNING OUT, BUT A CLEAN RECONCILIATION BILL IS IN THEIR HANDS.

- A CLEAN DEBT LIMIT BILL IS IN THEIR HANDS.

- SOCIAL SECURITY CHECKS FOR OUR NATION'S 23 MILLION ELDERLY ARE IN THEIR HANDS.

- THE MAJORITY WILL OF THE CONGRESS ON CAPITAL GAINS, CATASTROPHIC, SECTION 89, IS BEING THWARTED BY THOSE ELECTED BY THE DEMOCRATIC PARTY TO MAKE THE LEGISLATIVE BRANCH WORK AS REQUIRED.

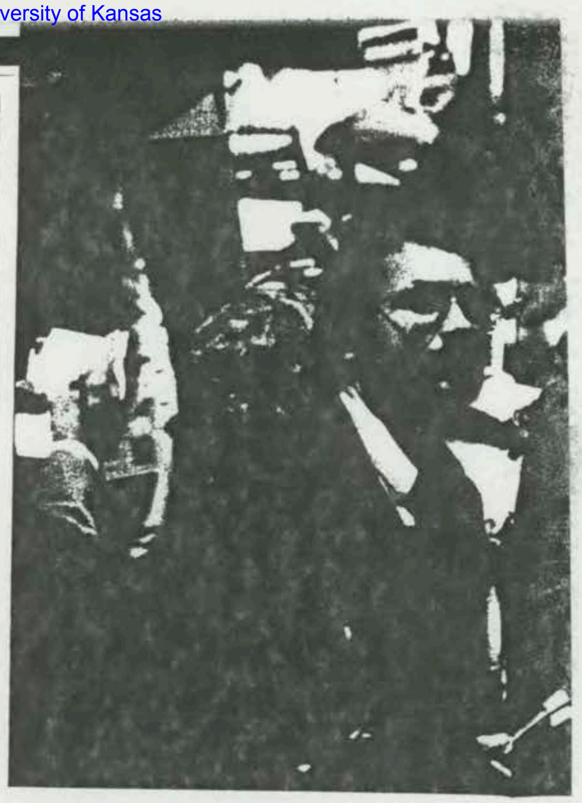
- THIS IS NOT THE PRESIDENT'S FAULT.

- AND COME HALLOWEEN, I DON'T BELIEVE THE AMERICAN PEOPLE ARE GOING TO BE TRICKED INTO BELIEVING IT IS ANYBODY'S FAULT BUT CONGRESS AND THE LEADERS IT ELECTED TO MAKE IT RUN.

- IT NEED NOT END THIS WAY, WE CAN GOVERN. JUST LET THE MAJORITY BE THE MAJORITY. LET'S VOTE AND LET MAJORITY RULE.

They are listening to PVD !

The Message of the Market



On the floor of the NYSE last week

Stock plunges reflect the economic lesson of the '80s: competition ~~has rough~~ side effects, but it works

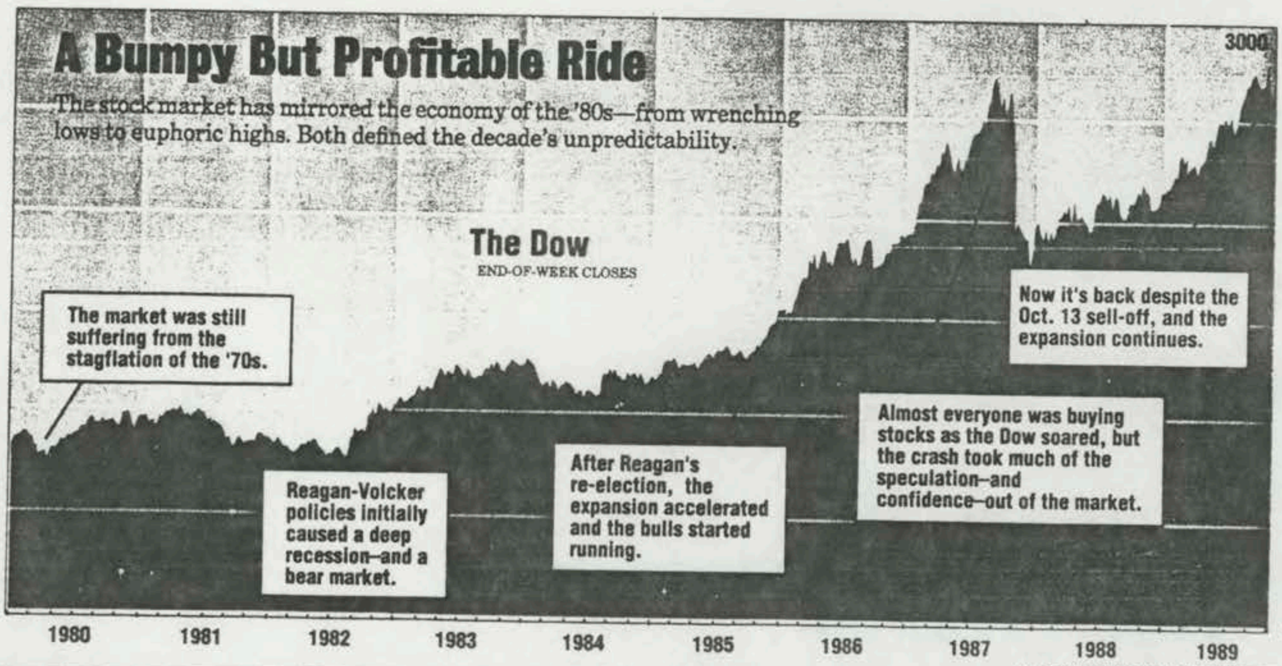
BY ROBERT J. SAMUELSON

If the stock market mirrors the economy, then the market's latest roller-coaster ride—first its 190-point drop on Oct. 13, then its spasmodic struggle to regain lost ground—is a fitting climax for the 1980s. Glance at the chart below. Since 1980, the Dow Jones industrial average has roughly tripled. This is the best performance since the 1950s. But the sudden plunges, in 1987 and two weeks ago, simply highlight the market's turbulence and volatility. The 1980s' economy has been no less baffling.

At times it seemed a throwback to a more tumultuous and greedier era of capitalism. There was the postwar period's worst recession and ferocious foreign competition. There were titanic takeover battles, widespread plant shutdowns and corporate "restructurings." And yet, the 1980s also tell another story. It's been a time of impressive improvements in productivity (the basic indicator of our economy's efficiency and living standards), in exports and in research and development. The economic expansion, now in its 83rd month, is the second longest since World War II. Unemployment has been below 6 percent for two years.

The decade's great paradox is this: the prime catalysts for its advances were precisely the forces that seemed most disruptive. Competition from imports forced manufacturers to overhaul factories. Takeovers (and the threat of being taken over) prodded companies to slim bureaucracies and split up unwieldy conglomerates. Worried about jobs and corporate survival, workers and companies restrained wage and price increases, which helped prolong the expansion by subduing inflation.

Grasp the paradox, and you can understand why the 1980s seemed so confusing and, at times, disturbing. Competition works. That's the basic message. We favor competition in principle, but not its upsetting side effects. After World War II, Americans thought they had created a more orderly and stable economy. It was dominated by huge, well-managed companies that provided job security and generous fringe benefits.



CHRISTOPH BLUMRICH—NEWSWEEK

JACQUES CHENET—NEWSWEEK

1989 The Friday the 13th plunge turned out to be a one-hour aberration, and the market recovered quickly.

Efficient and farsighted, Corporate America would ensure rising living standards and our global economic supremacy. We saw "management" as a sweeping set of business skills that would make capitalism less chaotic and cruel. Well-managed companies would mute competition's bad effects by anticipating change and avoiding adversity.

The 1980s shattered this appealing vision. A skittish stock market simply reflected the decade's deeper turbulence. Some of the companies that succumbed to takeovers were Corporate America's aristocrats: RCA, Kraft, Gulf, Pillsbury and Beatrice. General Motors shut down 26 major plants. Since 1984, American Telephone & Telegraph has cut its worldwide work force by 73,000. The informal compact between companies and workers (secure careers in exchange for corporate loyalty) was shaken. Japanese companies grabbed 25 percent of the U.S. car market and half of the world market for electronic semiconductors. Because these developments so confounded our expectations, we minimize the decade's genuine gains. Consider:

- Since 1980, growth of productivity—output per hour worked—has doubled. It has increased at an average annual rate of 1.6 percent, compared with 0.8 percent between 1973 and 1979. The difference means that the economy now produces roughly $300 billion more each year than it would have with lower productivity. Manufacturing-productivity growth (up at an average annual rate of 3.9 percent since 1980) is faster than at any time since the 1950s.
- After stagnating between 1969 and 1975, corporate research and development has risen sharply. Since 1979, it has increased roughly 50 percent (after inflation).
- The United States has regained its position as the world's largest exporter. Since the low point in 1987, U.S. exports—aided by the dollar's drop—are up about 50 percent, led by sales of paper, chemicals and machinery. For the first half of 1989, the U.S. share of world exports is estimated at 13.4 percent, compared with West Germany's 12.5 percent and Japan's 9.9 percent.

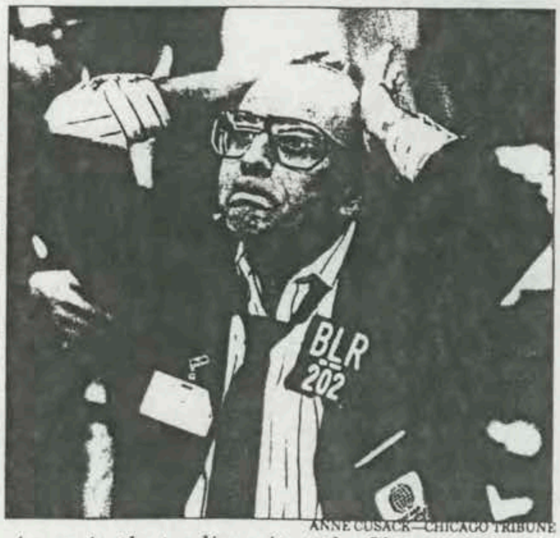
The lessons of the 1980s affect our economic prospects for the 1990s. There's no end of proposals about what we should do to improve our "competitiveness." We're urged to raise savings and investment, subsidize critical technologies and bar hostile takeovers. Some of these proposals might help a bit. A few would hurt. But they're all misleading, because they imply that there's a magic formula for restoring our previous global superiority and raising living standards further. There isn't. The practical reality is that our "competitiveness" emerges from a messy and diffuse process. The economy grows—and the stock market advances—because companies do a lot of little things right.

Consider how Ford raised quality by cutting the number of parts suppliers. The fewer the suppliers, the more easily they could be held to high standards. In turn, better parts helped win the cooperation of production workers who fit or machine the parts. "If you have 10 suppliers [of a component]," as one Ford executive put it, "you're going to get so much variability in quality that the guy at the machine isn't going to be able to make it work. He says: 'If management doesn't care, why should I?'" The same story of major gains from small improvements is told at countless other U.S. companies in the 1980s. Xerox, to give another example, cut its unit-manufacturing costs by 50 percent.

The success of Japanese companies teaches a similar lesson. Their secret has not been "long-term thinking" so much as persistence and constant attention to details. When Japanese firms first moved into low-end products (black-and-white television sets, small cars, basic machine tools), U.S. companies rationalized retreat. These products and businesses represented small, mature markets with low profit margins, it was said. Let the Japanese slaughter one another. Instead, they honed themselves through intense competition and went on to bigger markets.

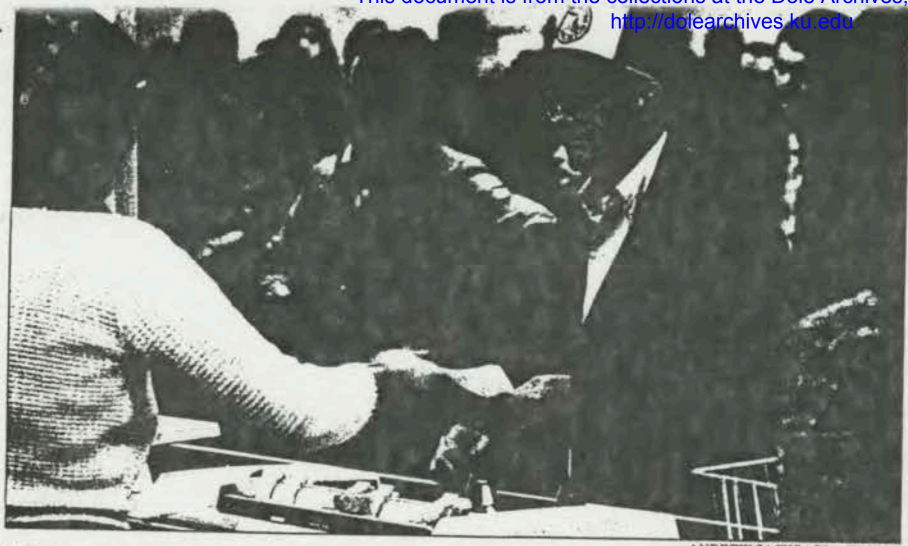
A market economy is simply an ongoing process of trial and error. Superior companies, products and technologies emerge through struggle. The conceit of postwar U.S. management thinking has been that shrewd executives can outwit the market. "[Managers] dread

1987 The economy weathered the scare of the Black Monday crash, and the record expansion continued.



ANNE CUSACK—CHICAGO TRIBUNE

Agony in the trading pit at the Chicago Merc



ANDREW SACKS—BLACK STAR

Victims of the downturn filing for unemployment compensation in Michigan

1982 The recession was the worst in recent memory, but it whipped inflation, the curse of the 1970s.

chaos and rely to an excessive degree on structure, process, and control as means to assure order in the organization," writes Abraham Zaleznik of the Harvard Business School in "The Managerial Mystique." The appeal of market research, strategic planning and many other modern management practices was their promise to predict the future. Risk would be minimized without sacrificing corporate growth and profitability. Unfortunately, the promise is often false.

The VCR is a case in point. To adapt U.S. video technology—used by TV stations—for homes required major changes. As early as the 1960s, Japanese companies offered VCRs. Big and expensive, they didn't sell well. But the Japanese reduced their size and cost, while learning what customers wanted. The U.S. companies that explored VCR-like products waited until they could feel sure of a big success. As a result, they had inferior, costly technology. "You can't research a market for a product that doesn't exist," Masaru Ibuka, Sony's co-founder, once said. Richard Rosenbloom of the Harvard Business School puts it this way: "The Japanese learn by doing—not by studying." The VCR story isn't unique. After a survey of U.S. and Japanese firms, economist Edwin Mansfield of the University of Pennsylvania concluded that the Japanese commercialize innovations faster in part because they spend less time on marketing reports and tests.

Myths enable us to believe what we want to believe, even if it isn't true. The myths about the prowess of American management were not held just by business leaders. They have reflected widely shared popular attitudes that emerged from World War II. America was the Arsenal of Democ-[illegible]. Production was prodigious. The result was a consensus about the unique advantages of big, well-managed companies. Of course, many probusiness conservatives championed that view. But so did many antibusiness liberals, such as economist John Kenneth Galbraith. Only big companies, Galbraith argued, could raise the huge sums for new investment or technology. Through market power and advertising, these firms could control product demand and pricing. They would be highly stable and productive enterprises.

The argument was over how to divide a growing economic pie. Galbraith and other liberals saw the productivity of corporations as an opportunity to enlarge government. Rising national wealth meant more could be spent on public goods—a cleaner environment or more education. Government regulation could be tougher; taxes could be higher. By contrast, companies touted the fruits of productivity, an outpouring of consumer goods and new technologies to show they were already meeting public needs. "We Bring Good Things to Life," as General Electric's slogan puts it.

The trouble is that Corporate America never operated the way its enthusiasts imagined. For starters, big companies don't monopolize innovation, as Galbraith and others contended. True, companies with more than 1,000 employees do more than 85 percent of all corporate R&D. But genuine innovation transcends R&D. It's new ways of doing things, and established companies are often tied to old ways, as consultant Richard Foster noted in his book "Innovation." Many major postwar innovations came from upstarts. Federal Express—not United Parcel—pioneered overnight package delivery. Apple Computer—not IBM—popularized personal computers. Giant companies also suffer another weakness: they often invest poorly.

Why? In big business, there's a crude cycle of growth and decay. Success often gives companies an entrenched market position with stable sales and above-average profits. Companies then waste the extra profits and cash flow. Rather than pay higher dividends—which would limit corporate expansion—executives invest the funds themselves. All their choices involve risks of inefficiency. Consider:

First, a company may overinvest in its existing business. Overinvestment is wasteful: too many widget plants.

Second, a company can hoard its money—in effect, put it in the bank—as protection against setbacks or recession. But with a safety cushion, it's more likely to tolerate higher costs on everything from unneeded workers to padded expense accounts.

Finally, a company can diversify by starting a new business or buying an existing one. But diversification may create excessive bureaucracy, and the company may lack the skills to run its new businesses.

In the 1980s, these problems exacted their revenge on Corporate America. In some industries (steel and autos, for example) years of dominance lulled top firms into complacency. They became vulnerable to new global competition, and the dollar's surge on foreign exchange markets—up about 60 percent between 1980 and 1985—intensified the onslaught. Companies that had diversified too much or were investing poorly became targets of "raiders" or leveraged-buyout (LBO) firms. This new breed of entrepreneurs saw they could profit by buying such companies. Between 1980 and 1988, there were 478 LBOs, culminating with the $24.6 billion buyout of RJR Nabisco.

This process seems confusing and contradictory because it *is* confusing and contradictory. For example, critics of takeovers argue that they're unproductive speculations that distract executives from pursuing "long-term goals." Proponents say that takeovers replace poor managers and splinter inefficient conglomerates. What to believe? A little bit of everything.

On balance, the impact of LBOs and "hostile takeovers" has been good. (In an LBO, investors buy all of a company's stock, usually relying heavily on bank loans or junk bonds.) Debt isn't always bad. It can force companies to operate more efficiently and deter poor investment, as economist Michael Jensen of Harvard argues. A study of LBOs by economists Frank Lichtenberg of Columbia University and Donald Siegel of the National Bureau of Economic Research concluded they result in major productivity gains. Benefits don't stop there. Even the distant threat of an unwanted takeover prompts companies to streamline.

Having diversified in the 1970s, General Mills sold its fashion, retail and toy operations in the 1980s. Its profits soared.

When executives complain they're not free to pursue "long-term goals," their protests are mostly self-serving. Back in the 1960s and 1970s, they had ample freedom. Perversely, America grew weaker, as companies engaged in reckless empire building. Between 1963 and 1980, there were nearly 56,000 mergers and acquisitions worth more than $300 billion, reports W.T. Grimm & Co., a consulting firm. Almost all were friendly mergers between companies. (Indeed, most takeovers are still friendly.) The cumbersome companies that resulted were less, not more, prepared for the future. "Long-term goals" aren't virtuous if the goals themselves are ill conceived.

But Wall Street's critics are also correct: deal mania went to excess. Speculation in takeover stocks was rampant; Ivan Boesky turned it into a crime. More important, some takeovers were no more than giant speculations. The idea has been to buy a company mostly on credit, sell it a few years later at a 20 or 30 percent markup and pocket most of the gain. It's an old formula used repeatedly in real-estate booms. The trouble comes when the boom collapses and the creditors get skunked. Some takeover companies overborrowed; the problems that the Canadian Campeau Corp. has had

The Road to Recovery: A Market Diary

It was almost as if the entire financial community got together last week and decided: not this time. From small investors to big pension-fund managers, from Wall Street executives to Washington officials, the consensus was that the stock-market plunge of Oct. 13 was just a one-hour aberration, not an omen of disaster. For the week the Dow recovered about 120 points, closing at 2689.14. A day-by-day account of the market's recovery:

JACQUES CHENET—NEWSWEEK

PAUL F. GERO—SYGMA

Calming signals and high-level consultations: *Phelan, Greenspan*

Saturday: The first public move to calm fears was made through a leak by a "senior Federal Reserve official" to The New York Times and The Washington Post. In Sunday editions the papers reported that the Fed stood ready to meet any demand for liquidity (cash) that the banking system might need. Market watchers and investors welcomed the news, but the leak irked Fed chairman Alan Greenspan, who wanted to play down any crisis atmosphere. Many mutual-fund firms and stockbrokerages stayed open. Skittish investors asked lots of questions but held firm.

Sunday: New York Stock Exchange chairman John Phelan was in Bangkok when the Dow fell. He flew back, arriving in New York at 9 a.m., and immediately began to reassure NYSE-listed companies that the exchange could handle large trading volume. He talked to brokers and exchange officials in Tokyo and London. He and his team also called large institutional traders, including arbitrageurs and program traders, to talk down any sense of panic.

In Washington, the nation's top economic and market officials secretly convened at 4 p.m. in a third-floor Treasury conference room. Present were Treasury Secretary Nicholas Brady, Greenspan, Securities and Exchange Commission chairman Richard Breeden, Wendy L. Gramm, chairman of the Commodity Futures Trading Commission, Michael Boskin, chairman of the Council of Economic Advisers—about 20 people in all. The conclusion: the plunge was a spasm of volatility, no more. A minute-by-minute chart showed that the panic selling focused mainly on takeover-related stocks, triggered by the collapsed bid for UAL Corp.; a drop in blue chips followed. Other signs were positive: stocks were expensive but not out of line. The economy was stable and inflation waning. No brokerage houses or investment banks had capital shortages.

The officials decided the best course was to play it cool. The consensus, says one participant, was, "'Don't just do something, stand there!'" Most foreign markets opened down, but later recovered.

Monday: Nail-biting time. Brokers were permitted to enter orders an hour early, at 7:30 a.m., to avert a crush. President Bush made an encouraging remark about the economy. At the NYSE, prices began falling at the opening bell, and in 45 minutes the Dow was down more than 60 points. Sell orders left over from Friday fed the drop. Then, at 10:16 a.m., a huge roar lifted from the floor as the market turned. Computerized trading kicked in to accelerate the upward move—60 points in six minutes. Investment banks, money managers and even arbs who had lost a bundle on takeover stocks jumped in, hunting for bargains. Says Roland Machold, who invests $24 billion in New Jersey state pension money: "I came into the trading desk Monday morning and I said, 'Let's take our orders last week and double them'."

At 1:43 p.m. Donald Trump announced he had pulled his $7.5 billion bid for American Airlines. Unlike on Friday, the news of a busted takeover play didn't incite a panic. At the close the Dow was up 88.12 points.

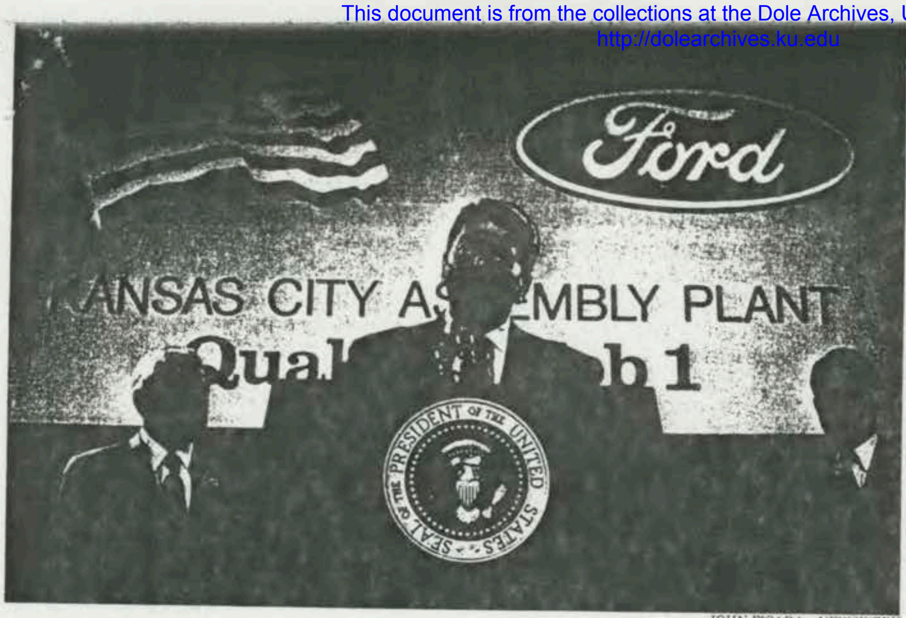
Tuesday: The market remained highly volatile. News of a wider trade deficit and fresh concern over the UAL deal caused a sharp drop. The Dow recovered but finished down by 18.65 points. Special open lines between Washington and the New York exchanges were shut down.

Wednesday: The earthquake sent insurance stocks higher in anticipation of increased premiums. But a mostly ho-hum market ensued as the Dow closed up 4.92 points.

Thursday: Investors marked the second anniversary of Black Monday by bidding up the Dow by nearly 40 points. The catalyst: consumer prices rose a surprisingly moderate .2 percent in September, making the annual rate 4.4 percent. Low inflation meant the Fed might cut interest rates, usually good news for stocks.

Friday: The expected volatility of "double witching" day—the expiration of certain options and futures—didn't materialize, and the Dow finished up 5.94 points. At the end of the day, news surfaced that a new bid was being readied to buy UAL—the deal that started the Friday-the-13th panic in the first place.

CAROLYN FRIDAY *and* RICH THOMAS



JOHN FICARA—NEWSWEEK

The former president at a Ford Motor Co. plant in Kansas City

1984 As Reagan was re-elected, a psychology of prosperity propelled the economy and the stock market.

with its purchase of Bloomingdale's and other U.S. department stores confirm that. Even in productive takeovers, profits often involve speculative luck. Kohlberg Kravis Roberts, the biggest LBO firm, doesn't care whether it makes money by squeezing waste from a company or selling parts of the company at inflated prices.

Part of the stock market's erratic behavior stems from its role as the vortex between the speculative and productive economies. But it's too glib to dismiss the 1980s merely as an era of resurgent greed. Greed had never disappeared. It simply became more conspicuous. The decade's real lesson is that our free-enterprise system is more chaotic and less controllable than most people had suspected or wanted. The need now is to keep our perspective: neither to exaggerate the disorder nor to delude ourselves about the possibilities for quick and easy change.

In this sense, most "competitiveness" proposals overpromise. Of course, government influences the economic outlook. Policies that produce inflation, for example, can do great damage. Policies that improve schools or workers' skills would be helpful. But in general, government can't easily alter business performance. Consider three popular ideas:

1. Raise savings and investment: It's true that the U.S. investment rate (about 17 percent of GNP) is lower than, say, Japan's (about 27 percent of GNP). It's also true that, over a decade or two, higher investment would probably raise living standards. The trouble is that countless efforts to influence savings and investment through the tax code have met with meager success. (The current debate over cutting the capital-gains tax ignores this history.) And even if it can be achieved, higher investment isn't automatically helpful. The investment must be productive. The overbuilding of offices and hotels in the 1980s didn't help U.S. competitiveness. What matters is not only how much we invest, but how well. Business determines that.

2. Subsidize critical technologies: Government could underwrite some technologies (and for national-security reasons, it perhaps should). Dozens have been cited as critical: robotics, supercomputers, biotechnology, advanced materials, high-definition TV, superconductors. But by itself, no single technology is decisive for productivity and living standards. What matters is the broad ability of workers and companies to adapt many technologies to a dizzying array of uses—everything from office work to medicine to air-traffic control.

3. Prohibit "hostile" takeovers or LBOs: Although all takeovers aren't productive, government doesn't know enough to permit good ones and bar bad ones. Successful hostile takeovers are rare—there were fewer than 30 in 1988—and the mere threat of one checks poor diversification or investment. Unfortunately, 39 states have passed laws to inhibit hostile takeovers of companies chartered in their states. (Not surprisingly, many recent takeovers are friendly megamergers between big companies. The claims that these mergers create "global synergies" recall similar contentions made for the 1960s' conglomerates.)

Good ideas, technologies and business practices come from all over the world. We shouldn't shut them out by imposing broad limits on imports or foreign investment in the name of economic security. Just as U.S. technology and management once helped Europe and Asia, the process is now working in reverse. If Japanese automakers force U.S. rivals to run more efficient factories, Americans benefit. With fewer workers making cars, there are more of us to make something else—whether it be computers or Big Macs. This is what determines how easily we can meet demands for better living standards, government services and environmental protection.

Nor should the jolts of competition be overdramatized. Although job security diminished in the 1980s, it hardly disappeared. Corporate loyalty hasn't vanished, because most workers weren't affected by layoffs. Job tenure—the time workers have spent with their current employer—has remained stable during the decade. Among workers 45 years or older, career jobs are still standard. More than half have been with their current employer more than 10 years. The broad problem of most companies is how to motivate workers and engage their pride toward a common goal. This is an art, not a science. Contrary to popular wisdom, the Japanese haven't perfected it with a formula that raises worker satisfaction by providing greater job security.

True, big companies in Japan do provide more job security. But they also require more working hours and a greater willingness to submit to corporate orders. Job satisfaction is higher among Americans. One study asked workers in both countries if they would take their jobs again: 69 percent of the Americans said yes, compared with 23 percent of the Japanese. Most Americans would not sacrifice the freedom to change jobs or have a full family life for Japan's extra job security. Nor should we: these are advantages of our way of life.

Our companies will have to contrive American accommodations to the oft-conflicting pressures of society and competition. As the 1990s dawn, these conflicts will grow. Global competition won't relent. The 1992 harmonization of the European Community and the expansion of Asian economies will compel U.S. companies to become more international in outlook. They will also face more demands at home to clean up the environment and deal with the problems of two-wage-earner families.

Capitalism is "creative destruction," in the famous phrase of economist Joseph Schumpeter (1883-1950), because new technologies and business approaches destroy the old. The stock market's swings remind us of this insight. It's an unwelcome reminder, because we imagined good management would impose order on the tumult. The vision was tantalizing, but it turned out to be mostly a mirage. ■

Drugs/guns

M E M O R A N D U M

October 27, 1989

TO: SENATOR DOLE
FROM: JIM WHITTINGHILL
SUBJECT: MEET THE PRESS

On the drug bill(s) front, the Conferees on the Department of Transportation Appropriations decided to drop from the bill the "authorizing" language included in the drug title by the Senate. This language was passed a second time by the Senate in S. 1735.

When we passed S. 1735, you, along with Senators Mitchell, Hatch and Biden wrote to Senators Byrd and Hatfield to indicate that without the authorizing language being passed by the House "concurrently," it would be difficult to pass the Conference Report.

Both DOT Appropriations and S. 1735 passed one month ago, September 27. To date, no action has been taken in the House on S. 1735.

S. 1735 contains two types of language, 1) four items from the President's Drug Strategy, and 2) language determined by the Senate to be essential if the increased funding was agreed to. For example the Drug Strategy and the Appropriations bill contain a $125 million transfer from DOD to the Andean Initiative to eradicate coca plants in the valleys around the Andean Mountains in South America. Without a waiver of two provisions of existing law (police training and assistance to governments which have defaulted on loans), the money cannot be used. An example of the second type of language is boarder babies. Currently, the money can be used to treat drug-addicted abandoned infants only if they have AIDS. The Senate language would allow treatment for drug-addicted abandoned infants even if they did <u>not</u> have AIDS.

The Senate may further insist on its earlier "authorizing" language.

On guns, remember that Senator Mitchell appears to oppose gun control. If the question is raised, you can say that we continue to await suggestions from those seeking to ban guns to present language which meets your criteria: that it be directed only to so-called "Miami Vice" guns (semi-automatic, with high capacity magazines, easy to conceal, and shooting pistol ammunition), which does not grant discretion to BATF and which does not simply list a number of guns which could be easily changed by manufacturers to make them legal. The language could not ban anything that everyone agrees are normal high capacity semi-automatic handguns, like the GLOCK, and which many use as protection.

JOINT COMMUNIQUE
OF THE DELEGATION OF THE SUPREME SOVIET OF THE U.S.S.R AND THE U.S. SENATE
OCTOBER 27, 1989

At the invitation of Senate Majority Leader George J. Mitchell and Senate Republican Leader Robert Dole, a delegation of the Supreme Soviet of the U.S.S.R. led by Yevgenyi Primakov, Chairman of the Soviet of the Union, visited Washington D.C. from October 25 to October 27. The delegation will be in the United States until November 5. This is the first official visit since the elections to the new Soviet legislature.

The delegation had extensive discussions with a broad range of Congressional and Executive branch officials in Washington. The group met with leaders of the House and Senate, members of the Senate Foreign Relations Committee and the Senate Arms Control Observer Group.

In their meeting at the White House, Chairman Primakov delivered to President Bush a personal message from Soviet President Mikhail Gorbachev. The delegation also met with Secretary of State James Baker and other State Department officials.

Members of the group will also travel to Maine, Kansas, California, Pennsylvania and New York, where they will meet with a wide range of Americans including state and local government officials, business leaders and farmers.

During the delegation's two days in Washington, extensive discussions were held on a broad spectrum of issues relating to U.S.-Soviet relations. Members of Congress explored in detail with their Soviet colleagues the developments in the Soviet Union, particularly the progress of perestroika and political reform. Special attention was paid to the work of the U.S.S.R. Supreme Soviet, its legislative agenda and the Soviet Deputies' perspectives on key domestic and international problems.

In discussions with Senators and Members of the House, the delegation of the Supreme Soviet explored a wide range of arms control issues, including the current status and prospects for nuclear and conventional arms negotiations. Also discussed were the ongoing talks in Geneva concerning nuclear testing and chemical weapons. It was agreed that arms control remains an important and promising aspect of relations between the Soviet Union and the United States. The Soviet delegation was especially interested to learn more about the role of the U.S. Senate in the treaty ratification process.

Members of the United States Congress raised a broad range of human rights issues, including freedom of emigration and religion. Members also expressed deep interest in the developments in the U.S.S.R. concerning the nationalities questions and measures being taken to address these issues. U.S. legislators were especially interested in the Soviet Parliamentarian's views concerning the Supreme Soviet's consideration of a new law on exit and entry to the U.S.S.R as well as other draft laws pertaining to human rights and legal reform.

The Soviet Delegation expressed support for expanded U.S.-Soviet economic cooperation and trade. They urged the United States to remove obstacles that constrain the development of a normalized trading relationship. Legislators from each country voiced support for efforts to undertake measures which would remove obstacles in the two countries' economic systems and administrative and regulatory procedures which currently inhibit greater economic cooperation.

The parliamentarians of each country noted increasing awareness of transnational problems such as environmental degradation, international terrorism, drug trafficking, natural disaster forecasting and world-wide epidemics. It was agreed that the Supreme Soviet and the U.S. Congress can make significant contributions to the international efforts to address these global problems and pledged to work toward that end. Note was taken of the expressions of support for the victims of earthquakes and natural disasters in the two countries.

American legislators and the Soviet Deputies expressed support for greater contact and sustained dialogue on a basis of more regular exchanges to discuss general questions of Soviet-American relations and specific issues of mutual interest. It was agreed that such close working ties would contribute to the progress being made in building a closer and more cooperative relationship between the United States and the U.S.S.R.