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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Karin Lissakers (IMF) to Assistant Secretary Geithner & Deputy Assistant Secretary Atkinson re: Redesign of International Architecture (1 page)	10/16/98	P1/b(1) Unclass.
002. report	re: Architecture - Phase III (written by Karin Lissakers, IMF) (4 pages)	10/16/98	P1/b(1) Unclass.
003. memo	Karin Lissakers (IMF) to Larry Summers, Jeff Shafer, & David Lipton re: Thinking About a Quota Increase & Beyond (4 pages)	11/25/96	P1/b(1) Unclass.

COLLECTION:

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FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [19]

jp21

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
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1997-SE-005950

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 3, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R.
Lawrence H. Summers

SUBJECT: Decision Memo for the Tax Package

There are several issues that need your attention as we attempt to influence the tax bill that is being developed in Congress. This memo summarizes the issues that arise in each portion of the tax package, presents recommendations that have been developed in a series of meetings held by your economic advisors, and, where decisions are needed, highlights the choices that need to be made. The tabs following this memo provide a more detailed discussion of the issues in question.

OUR RECOMMENDATIONS

Education

Phase in Hope Scholarship and Tuition Deduction to attain full levels you proposed after 1999; drop B- requirement and eliminate offset of Pell Grants against allowable credits

Child Credit

Apply to child under 13 through 2002, child under 18 thereafter; refundable to families with at least $2,000 of earned income, but no or insufficient tax liability to use full credit; optional Kidsave to establish nondeductible backloaded IRA type savings vehicle with amount of credit, but with earnings distributable tax free for child's education, and possibly child related events, or for parent's retirement

Capital Gains

40% exclusion for long-term capital gains (with AMT rate on capital gains reduced to 24%); oppose indexing of basis; expand targeted small business capital gains relief on qualified stock held 5 years by increasing eligible gain from $10 million to $20 million, liberalizing eligible assets to qualify as active business

Alternative Minimum Tax (AMT)

Make modest changes to eliminate standard deductions and personal credits (such as Hope and child credit) as preferences in AMT taxable base

Home Office Deduction

Allow home office expenses if substantial management and administration takes place at home, although primary business activities is outside, if no other office is available

Estate Tax Relief

Give special exemption for $900,000 of value in qualified farm and small business in addition to $600,000 value of unified credit; increase estates eligible for liquidity relief in payment as proposed in your FY 98 budget

Urban Initiatives and Other Budget Items

Our suggested package contains a complete set of FY98 Budget initiatives, including the expansion of EZs and ECs, Brownfields, CDFI and the welfare-to-work tax credit and tax incentives for FSC software, D.C., and Puerto Rico, and the equitable tolling provision. It extends expiring provisions that we do not make permanent, including the R&E tax credit, deduction for contributions of appreciated stock to private foundations, the work opportunity tax credit and the orphan drug tax credit.

This recommended package is summarized in the table following this memo.

Education

We recommend option 5 below that phases in the full Hope credit and tuition deduction after 1999.

_____ Accept _____ Other alternative

Other alternatives:

_____ Phase in full credit and deduction after 2000 (rather than 1999), but allow a larger credit during the phase in period (option 4 below)

_____ Trim Hope credit (package 1 below)

_____ Trim deduction (package 3 below)

_____ Other variations (Elimination of the Pell offset could be phased in, though this would not save a lot since completely eliminating the Pell offset costs roughly $3 billion through 2002. The income phaseout ranges could also be altered (the credit and deduction phase out for joint filers with incomes between $80,000 and $100,000 and single filers with income between $50,000 and $70,000).

The following table presents Treasury estimates of several possible combinations of the HOPE scholarship and tuition deduction as well as several other education proposals. The packages illustrate the tradeoffs necessary to fit the HOPE scholarship and tuition deduction into the $35 billion agreement. These tradeoffs are necessary in order to offset the increased costs of the package that would result from dropping the B- requirement (as requested by the education lobby) and the Pell grant offset (as requested by Congressional Democrats). Dropping these two items is estimated to cost approximately $5.3 billion through 2002.

Each of the options set forth below would eliminate the Pell grant offset and the B-restriction. Each option would fully phase in the complete education package by 2003, so the tuition deduction would be $10,000 and the HOPE Scholarship would be $1,500. The effective date of the first four options has been moved back to January 1, 1998, which saves roughly $2.5 billion. The complete education package is fully phased in by 2001 in Option 4 and by 2000 under Option 5. Please note that the Joint Tax Committee may score these proposals as being more expensive than shown in the table.

Education Packages: Preliminary Treasury Estimates, (Dollar amounts in billions)

	1998-2002	1998-2007
HOPE Scholarship, $1,200; Tuition Deduction, $10,000[1]	35.2	89.2
HOPE Scholarship, $1,000; Tuition Deduction, $10,000[2]	34.1	88.3
HOPE Scholarship, $1,500; Tuition Deduction @15% credit[3]	34.9	88.9
Phased in HOPE Scholarship; Phased in Tuition Deduction[4]	35.0	89.0
Faster Phased in HOPE Scholarship and Tuition Deduction[5]	35.1	89.2

[1]The tuition deduction starts at $5,000 through 1999, and increases to $10,000 thereafter.

[2]The tuition deduction starts at $10,000 in 1998.

[3]This variation converts the tuition deduction into a 15 percent credit on expenses up to $10,000 ($5,000 in 1998).

[4]The tuition deduction starts at $5,000 through 2000, and increases to $10,000 thereafter. The HOPE credit starts at $1,200 through 2000, and increases to $1,500 thereafter.

[5]The tuition deduction starts at $5,000 through 1999, and increases to $10,000 thereafter. The HOPE credit starts at $1,000 through 1999, and increases to $1,500 thereafter. The proposal has a 7/1/97 rather than 1/1/98 effective date.

Additional Features of the Education Packages

- With money outside the $35 billion, we propose to make permanent the exclusion of employer-provided educational assistance from taxable income (Section 127). This is a cause that has been championed by Senator Moynihan and others in the House and the Senate. Doing so will cost roughly $3.7 billion through 2002.

_____ Support _____ Do not support

- A student loan interest deduction would provide relief to many middle-income students and is politically popular. Adopting the student loan interest deduction in the Republican Leadership education bill (S. 1) would cost $1.8 billion under Treasury scoring.

  - The proposal to deduct student loan interest would provide a $2,500 above-the-line deduction, phased out at $45,000 to $65,000 for single filers and $65,000 to $85,000 (either for the student or taxpayer claiming the student as a dependent) for joint filers.

_____ Support _____ Do not support

- We are developing proposals to aid K-12 school construction (and other activities) in poor neighborhoods, as urged by Congressman Rangel and others. States would be permitted to allocate a fixed annual amount of tax credits (based on population), much as they do currently with low-income housing tax credits. The States could allocate the credits for projects in public schools located in empowerment zones, enterprise communities or that have a high percentage of low-income students. The schools could use the credits to help pay for construction and renovation projects by giving them as partial payment to developers who perform the construction work or by selling them. Each school would be allocated credits equal to a specified portion of construction costs with the balance to be covered by the State or the school districts.

_____ Support _____ Do not support

Middle Class Tax Relief and Saving Provisions

- We recommend that the IRA and child credit proposals in your FY98 Budget be combined into a"Kidsave" credit, which couples the child tax credit with a tax-preferred saving vehicle that can be used for the child's education and for the taxpayer's retirement. The credit would be refundable for families with earned income of at least $2,000. The credit would be as you proposed for children under 13 through 2002, thereafter including children under 18. See Exhibit A for background.

_____ Agree _____ Alter and adopt the variation as indicated below

_____ Drop refundability

_____ Keep refundability, but drop earnings threshold

_____ Do not broaden to cover children under 18 after 2003

_____ Do not combine with Kidsave saving proposal

_____ Make Kidsave mandatory to obtain credit

_____ Broaden withdrawal options from Kidsave to cover

    _____ First time home purchase by child

    _____ A young child's development grant after age of majority

Points to note:

- Refundability would help draw a striking contrast between the distributional effect of likely Congressional taxes packages and ours. It also ensues that all working families faced with the costs of raising children benefit from the child credit.

- If the credit is made refundable, we recommend the earnings threshold, rather than universality, for two reasons. First, it reinforces the message that "work pays," providing additional incentive for low-wage families to enter the labor market. Second, it helps distinguish the refundable child credit from earlier proposals such as the McGovern demogrant and Nixon's Family Assistance Plan.

- If we have a voluntary Kidsave account, your advisors all agree that withdrawals should be permitted for educational expenses of the child and for the taxpayer's retirement. These uses could be broadened to include purchase of a first home (as in your FY98 IRA proposals), and for "development accounts" for children over 18 (to address concerns that our tax proposals do little to help families with children who do not go to college).

General Capital Gains Relief

If we are to have broad-based capital gains tax relief as appears certain, **our recommended option is a 40 percent exclusion for capital gains (with the AMT rate on capital gains reduced to 24 percent)**. The special AMT rate ensures that the highest tax rate on capital gains is 24 percent under both the ordinary income tax and the AMT. The 40 percent exclusion leaves room for negotiating a slightly higher exclusion, but holding firm against capital gains indexing.

_____ Accept _____ Other option (listed below)

Other options:

_____ 50% exclusion with 20% AMT rate

_____ Indexing

_____ Exclusion plus indexing

_____ Separate rate schedule (10.5% - 20%)

_____ Separate rate schedule (7.5% - 20%)

The following table provides the cost estimates for several broad-based capital gains options that we have considered:

Preliminary Treasury Estimates, (Dollar amounts in billions)[1]		
	1998-2002	1998-2007
40% capital gains exclusion (w/ 24% AMT rate)	-$4.5	-$9.9
50% capital gains exclusion (w/ 20% AMT rate)	-$13.4	-$25.3
50% capital gains exclusion, plus indexing starting 1/1/97	-$32.3	-$96.9
Separate rate schedule: 10.5% for 15% bracket taxpayers, 20% for other taxpayers; 20% AMT rate	+$13.4	+$15.3
Separate rate schedule: 7.5% for 15% bracket taxpayers, 20% for other taxpayers; 20% AMT rate	+$8.2	+$3.7

Points to note:

- **Replacing the current maximum rate on capital gains with a percentage exclusion** provides the same proportional reduction in the rate on capital gains for taxpayers in all tax rate brackets. Current law provides a maximum capital gains rate of 28 percent benefitting only higher income taxpayers. A 50 percent exclusion as in several current Republican bills would lower the top rate on capital gains from 28 percent to 19.8 percent. For AMT purposes, capital gains would be subject to a special 20 percent rate, rather than the regular AMT rates of 26 or 28 percent to ensure that the top capital gains rate is 20 percent for both regular tax and AMT purposes.

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[1] All of the estimates shown include the cost of the proposed exclusion for sales of principal residences, which costs $1.4 billion through 2002 and $2.3 billion through 2007. However, they do not include the proposed expansion of the Bumpers targeted capital gains provision.

- **Separate rate schedule applicable to capital gains.** An alternative means of providing rate relief would be to tax capital gains under a separate rate schedule. For example, a special rate schedule could be established with a rate of 7.5 percent for taxpayers in the 15 percent bracket and a rate of 20 percent for taxpayers in higher tax brackets. A special AMT rate of 20 percent would apply.

  - Thus, in contrast to a percentage exclusion, taxpayers in tax brackets ranging from 28 percent to 39.6 percent would be subject to the same special capital gains rate. This causes a separate rate schedule of this type to be much less expensive than a percentage exclusion because the greatest benefits are given to high bracket taxpayers who are more likely to have induced realizations from the proposal. Conversely, less revenue is spent on lower bracket taxpayers who are less likely to change their realization pattern as a result of the proposal. Obviously, this type of separate rate schedule is more regressive than an across-the-board exclusion.

Indexing Capital Gains

We oppose indexing capital gains as part of the tax bill. Doing so, particularly in combination with a capital gains exclusion, would bestow inappropriately large benefits on high-income taxpayers, add to the incentive to form tax shelters and significantly increase the complexity of the tax system. For similar reasons, the New York State Bar Association has "strongly opposed" indexing for many years both in testimony and several reports submitted to Congress. For example, they stated in a 1995 report sent to Mr. Archer that:

> The indexation proposals currently before Congress are fundamentally flawed. The proposals would: permit unwarranted tax avoidance and revenue loss; potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and vastly increase the burden and complexity of the tax system for all taxpayers, as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point. Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

A more detailed explanation of the problems inherent in capital gains indexing is attached as Exhibit B.

Expand Small Business Capital Gains Proposal (Section 1202)

In 1993, targeted capital gains relief was added under section 1202 the Bumpers bill, for sales of small business stock. Section 1202 presently provides a 50 percent exclusion for capital gains from the sale of qualified small business stock held for more than 5 years. Gain eligible for this exclusion may not exceed the greater of $10 million or 10 times the taxpayer's basis in the stock. We recommend dropping the ten times basis alternative and increasing the eligible gain to $20 million and making technical changes to liberalize the qualification of businesses under section 1202. A more complete description of the proposed changes to section 1202 is attached as Exhibit C.

- <u>**Increase limit on eligible gain**</u>. We would recommend that the $10 million limitation on eligible gain be increased to $20 million and that the alternative limitation of 10 times basis be repealed as a simplification measure.

_____ Agree w/ recommendation _____ Make other change

Other change:

_____ Increase the size of businesses permitted to use the special proposal from $50 million to $100 million of assets. Note, however, that increasing the limit may draw available capital away from smaller firms that were the intended beneficiaries of the provision.

_____ Increase percentage exclusion of gain from 50% to 75%

Points to note:

We recommend that the current law 50 percent exclusion and maximum tax rate of 14 percent be retained. Even if a broad-based capital gains exclusion were adopted, section 1202 would still be more favorable because the maximum rate for other capital gains likely would be about 20 percent. However, if you desire to grant even more generous treatment to small business stock, the exclusion under section 1202 could be increased to 75 percent, i.e., the maximum rate under section 1202 would be reduced to 9.9 percent. (In either case, taxpayers subject to the AMT would be subject to a 14 percent rate.)

Reform of the AMT

We recommend a modest reform of the AMT by eliminating from its base the standard deduction and allowing personal credits (Hope, child credit) against AMT liability as well as the regular tax. We recognize the overwhelming policy merit of a broader package in our memo in Exhibit D.

_____ Accept modest reform

_____ Urge broader reform

_____ Do not mention AMT reform

Points to note:

In the absence of policy changes, the number of taxpayers that pay taxes because of the AMT (as opposed to the regular income tax) will increase by roughly 25 percent per year: from 0.9 million in 1997 to 2.4 million in 2002 to 8.4 million in 2007. The taxpayers who are thrown onto the AMT will increasingly be taxpayers who are not traditionally viewed as aggressive or abusive of the tax system. The items that will force taxpayers onto the AMT are state and local tax deductions, personal exemptions, and the standard deduction; these are not the tax preferences that the AMT was designed to limit. Forcing many millions of taxpayers to fill out a very complicated tax for a parallel tax system will infuriate most taxpayers and may put in peril the survival of the whole progressive tax system.

As described in Exhibit D, Treasury has developed an AMT reform package. Adopting it, however, will raise two major political problems. First, because so many taxpayers will be affected by the AMT in the future, the long-run costs of solving the problem are high and the solution still disproportionately benefits higher-income taxpayers because more of them are subject to AMT than middle-income taxpayers. Second, because the costs of the AMT increase sharply over the 10-year budget window, tackling the problem makes it more difficult to challenge Congressional Leadership proposals with the criticism that costs explode in the out years.

- Our recommended reform simplifies the AMT, but does not solve the long run problem. Going further is arguably the best choice on purely policy grounds, but raises difficult political problems. It would also force you and your advisors to make the correct, but difficult argument that AMT costs explode in the out years because we are saving millions of taxpayers from a future unexpected tax hike, while other proposals cause costs to explode in the out years because they cut taxes for wealthy taxpayers.

Home Office Deduction

Under the Supreme Court's holding in Commissioner v. Soliman, a taxpayer may not take a home office deduction if the home office is used to perform the administrative and management activities of the taxpayer's business, but the taxpayer performs his primary business services at another business location. In response to Soliman, several proposals have recently been made to allow taxpayers to take a home office deduction in these situations. The Treasury is generally supportive of allowing a deduction in these situations, but believe that certain technical modifications are necessary to the proposals that have been offered. First, changes should be made to ensure that *de minimis* management activities would not qualify the taxpayer for the home office deduction. Second, the proposal should be drafted in a manner that does not cause commuting expenses to become deductible. A more detailed explanation of the home office deduction is attached at Exhibit E.

_____ Accept proposal   _____ Other

Costs of the Package in the Second Ten Years

Exhibit F shows the 10-year cost of two different suggested tax packages. The Center for Budget and Policy Priorities (CBPP) received a great deal of attention last week for their analysis of the costs of the budget agreement in the second ten years. They concluded that the net tax cut from 2008-2017 would be $650 billion under the terms of the budget agreement.

The 2008-2017 cost of the first package (detailed at the end of the exhibit) is roughly **$650 billion**. The cost of the second package (with the minor AMT reform) would be roughly **$440 billion** in the second ten years.

Distributional Effects of the Tax Package

In Exhibit G you will find six tables showing distributional effects of different Administration and Congressional tax packages.

- The first two tables show very preliminary estimates of the distributional effects of a proposed tax package. As explained in the exhibit, the packages you are now considering are likely to have a somewhat more progressive distribution than shown in the Tables. Nevertheless, the qualitative patterns shown across various packages are likely to be similar.

    - Treasury will promptly prepare distributional analyses for the package you are shaping to get a better sense of how our suggested package compares to alternatives.

- The next two tables show the distributional effects of the FY98 budget proposals. They target 80 percent of the tax relief to families in the middle three quintiles of the income distribution.

- The last two tables show very preliminary and rough calculations of the distributional effects of S.2. It is provided here to give you an idea of what the distributional effects of a Congressional Leadership package might look like.

- The current package targets more relief than either the Budget or S.2 to the bottom two income quintiles, presumably because of the refundable Kidsave credit. It provides less of its total tax relief to families in the third and fourth quintiles of the income distribution than the President's budget, but more than S.2. It provides a greater share of tax relief to the top quintile than the Budget proposals, but less than S.2.

Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, May 30, 1997

	1998-02	1998-07
Education package		
HOPE scholarship, $1000; Tuition Deduction, $10,000 \1	-35,128	-89,174
Rangel K-12 school finance tax provision, Plug Number	-1,500	-6,000
Make Section 127 Permanent \2	-3,674	-8,443
Student Loan Interest deductibility	-1,837	-4,419
Middle-Class Tax Relief and Saving Provisions		
Refundable Kidsave Credit \3	-77,830	-193,457
Individual AMT reform, start in 2003 \4	0	-5,536
Capital Gains and Estate Tax Relief		
40% CapGn Exclusion and 24% AMT	-3,123	-7,603
Super-Bumpers Plug Number \5	-1,000	-3,000
President's Home Sales Provisions \5	-972	-1,700
Daschle Estate Tax Proposals (JCT)	-3,200	-10,200
Home Office Provision, Plug Number	-600	-1,300
Urban Initiatives		
Distressed Areas Initiatives \6	-2,339	-3,815
Welfare-to-Work	-551	-577
Other Tax Incentives \7	-1,282	-6,243
One-year Extensions of Expiring Provisions	-2,242	-2,250
Gross Tax Cut	-135,278	-343,717
Revenue Offsets	50,001	110,488
Total Net Cut	-85,277	-233,229

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1
and $10,000 thereafter.
\2 Includes 10% employer credit for small business training.
\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for educ
The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each chil
The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed
\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003
\5 Stacked after the 50% exclusion
\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI
\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK ACL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Refundable Child Tax Credit

This memo discusses the advantages and disadvantages of making the Kidsave proposal refundable.[1] In the past, Treasury has taken a strong position against the creation of new refundable tax credits to subsidize health insurance or child care expenditures of low-income families. We would not, however, object to making the proposed $500 child credit refundable.

A refundable credit will ensure that low-income families, with young children, would receive some of the benefits of the tax package. With capital gains and estate tax relief, the Congressional tax package will distribute much of its benefits to higher income families. The Administration's tax package, with a refundable tax credit for families with children, could offer a stark contrast to these Congressional plans.

On policy grounds, it makes more sense to modify the Administration's current child credit proposal by making it refundable rather than extending the credit to less needy families with children who are 13 or older. Further, a refundable credit is a simple and efficient mechanism for distributing funds to needy families, who might otherwise not have any contact with another government agency. Many observers believe that the high participation rates in the EITC are largely due to the simple, non-stigmatizing application process. By limiting the refundable credit to families with a certain level of earnings, the proposal would also complement our welfare-to-work initiatives.

Our reasons for objecting to refundable credits for health insurance or child care credits do not necessarily apply to the $500 child credit. We have opposed refundable credits as a

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[1]A refundable tax credit allows a taxpayer to receive the full benefits of a subsidy through the tax system, even if the subsidy exceeds his or her tax liability. The earned income tax credit is an example of a refundable tax credit. Low-income working taxpayers are able to receive the full EITC to which they are entitled, even if they have little or no individual income tax liability. Taxpayers can claim the refundable credit on their tax return filed at the end of the year and receive the value of the credit as either a reduction in their outstanding tax liability or as a refund.

way of subsiding certain expenditures for three key reasons. First, the IRS cannot verify health insurance or child care expenditures prior to payment of the tax credit, and it is difficult to recapture erroneous refunds paid to low-income taxpayers once the payment has been made. Second, the refundable credit generally would not be available to claimants in "real time" when they need the assistance in order to make the purchase. Third, individuals who are currently outside the income tax system would have to file a tax return in order to benefit from the tax credit. Given these concerns, our position has been that it would be more efficient to provide certain types of subsidies through non-tax administrative mechanisms.

A refundable $500 child credit does not raise similar concerns. Through verification of social security numbers, the IRS can now prevent refunds from being paid to taxpayers who claim nonexistent children. (The IRS still cannot verify the relationship of the child to the taxpayer, but should be developing better screens as a result of the EITC compliance efforts.) Second, the goal of the $500 child credit is to increase disposable income of families with children -- not to encourage a specific type of purchase or behavior. Third, we recommend that the refundable child credit be made available only if the taxpayer has earnings above a certain threshold, say $2,000, and thus are likely to be filing a return under current law. Establishing an earnings threshold also reinforces the message that "work pays."

It is likely, however, that a proposal to make the $500 child credit refundable will be attacked, and these attacks may increase the vulnerability of the EITC. Some opponents of the EITC believe that its noncompliance problems are caused by refundability. Our analysis of the EITC compliance data suggests otherwise: the overclaim rate among those with a positive pre-EITC tax liability in 1994 was nearly three times larger than the rate among those who did not have a tax liability. Further, nearly 95 percent of EITC claimants have a reason to file a return other than to claim the credit. Noncompliant EITC claimants do not enter the tax system merely to claim the credit, and it is unlikely that a refundable $500 child credit (with an earnings threshold) will change this.

Proposing refundability of the Kidsave credit may also deflect attention from EITC problems. Doing so would send a strong message that not only does the Administration support the EITC, it is willing to go further to increase the progressivity of other elements of the tax system.

A refundable $500 child credit may also be compared, unfavorably, to various negative income tax (NIT) proposals of the early seventies (including proposals by both Senator McGovern and President Nixon). Our proposal would differ from an NIT in two key respects: first, the credit would be limited to families with children; and second, recipients would be limited to workers with earnings above a certain threshold. In contrast, NITs extend assistance to all low-income individuals.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK DL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Capital Gains Indexing

The Office of Tax Policy is opposed to indexing capital gains as part of the tax bill. Doing so, particularly in combination with a capital gains exclusion, would bestow inappropriately large benefits on high-income taxpayers, adds to the incentive to form tax shelters and significantly increase the complexity of the tax system. For similar reasons, the New York State Bar Association has "strongly opposed" indexing both in testimony and several reports submitted to Congress. For example, they stated in a 1995 report sent to Mr. Archer that:

> The indexation proposals currently before Congress are fundamentally flawed. The proposals would: permit unwarranted tax avoidance and revenue loss; potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and vastly increase the burden and complexity of the tax system for all taxpayers, as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point. Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

Principal problems with indexing

Double benefit. One of the principal arguments for a capital gains exclusion is that part of the gain represents the effects of inflation and does not constitute real income. Thus, including both indexing and a capital gains exclusion (or separate rate schedule) in a package would overcompensate for the effects of inflation.

Out year costs. Treasury estimates that the indexing provisions in S.2 (indexing on top of a 50 percent exclusion) would add **$40 billion** to the $53 billion ten-year cost of a 50 percent capital gains exclusion. Thus indexing on top of an exclusion, is very costly (3 percent compounded over 10 years is 34 percent, over 20 years it is 81 percent). Revenue losses from indexing are exacerbated beyond the simple effect of compounding because with indexing, a portfolio will have a larger share of assets with no inflation-adjusted gain. Thus, taxpayers will have more opportunity to choose to sell only assets with no realized gains, and hence no tax due.

Complexity. Any indexing proposal, whether in conjunction with an exclusion or by itself, will introduce significant new complexity into the law. Under current law a taxpayer can generally compute the gain from the sale of an asset simply by comparing the amount received from the sale to the cost of the asset. The date an asset was purchased is relevant only in determining whether any gain is long term or short term--if the asset has been held for more than one year the gain is long term and the acquisition date of the asset (and any related improvements) is entirely irrelevant. Under an indexation system, a taxpayer would need to know the date on which an asset was acquired and the date on which any significant improvements were made to the asset. This adds significant complexity to many common situations, as noted by the New York State Bar Association in its testimony before the Finance Committee in 1995: "Activities that are relatively simple today will involve massive calculations under indexing -- buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant." The problems are considerably greater in the case of pass-through investment vehicles (including partnerships, S corporations, real estate investment trusts, and mutual funds). Finally, only certain types of assets typically qualify for indexing, thereby placing additional pressure on distinguishing similar types of assets. For example, debt instruments typically are not indexed, making the distinction between debt or equity more important.

The indexation proposals in recent Republican bills address these concerns with a series of uneasy compromises at best. These compromises are likely to lead to uneconomic transaction motivated solely by the desire to benefit from indexation in inappropriate ways. Capital gains are indexed in the U.K. tax system, but the system allows roughly $20,000 of realized capital gains (per married couple) to be exempt from taxation, so the complexity of indexation is avoided by exempting capital gains from taxation for most taxpayers.

Arbitrage. Any form of preferential treatment for capital gains creates the potential for arbitrage and distorts investment incentives in favor of assets qualifying for the preference. Whether the indexation of basis results in greater incentives for arbitrage than a capital gains exclusion depends upon the size of inflationary long-term gains relative to nominal long-term gains. For example, if inflationary gains are more than half of nominal gains, indexing generally creates greater arbitrage potential than a 50 percent exclusion. The Joint Tax Committee staff recently published a table showing that, for assets held for several years and sold in 1994, the inflationary component was generally above 40 percent of nominal gains.

The easiest forms of arbitrage involve borrowing to invest in the tax-favored assets. In the absence of special provisions, the interest expense associated with the borrowing is fully-deductible at ordinary rates while the income on the tax-favored asset is taxed at lower rates. As a result, taxpayers can make money on an after-tax basis from investments that lose money on a pre-tax basis.

> Example: Under current law the highest rate of tax on ordinary income is 39.6 percent. The highest rate of tax on capital gains is 28 percent. A taxpayer borrowing $10,000 at 10 percent to invest in a capital asset that earns a return of 9 percent would lose $100 on

a pre-tax basis. On an after tax basis, in the absence of anti-arbitrage rules, the same taxpayer would be $44 ahead (the $1,000 interest deduction would reduce tax liabilities by $396 while the 900 capital gain would produce tax liabilities of $252; the net $144 tax savings would more than offset the $100 pre-tax loss). Note: Lenders are often tax-exempt, so that interest income is not taxed.

The Internal Revenue Code already contains a number of complex provisions intended to prevent (or at least deter) such arbitrage transactions. None of the provisions work perfectly. As discrepancies between the treatment of ordinary income and capital gains are increased, the incentive to engage in arbitrage increases correspondingly, with the result that more pressures are placed on the existing rules and new rules need to be considered.

Price index. Typically, CPI is used in the Tax Code to adjust for inflation. Given the recent controversy surrounding CPI's accuracy as a measure of inflation, we would need carefully to consider whether its use would be proper for capital gains indexing.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Information

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK HL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: A Small Business Capital Gains Proposal (Section 1202)

The following memo describes our suggested modifications to Section 1202. The proposal is designed to appeal to constituencies interested in expanding the scope of Section 1202, but focus incentives on smaller companies that were the target of the Administration's original 1202 proposals. Each of the provisions described below could be may more generous.

- o The current law 50 percent exclusion and maximum tax rate of 14 percent would be retained. The tax treatment of small business capital gains would still be more favorable than it is for other capital gains, which would have a maximum rate of approximately 20 percent under a 50 percent capital gains exclusion.

- o The limit on eligible gains would be increased from $10 million to $20 million and indexed for inflation. Inflation indexing would begin in 1999. The alternative limitation of 10 times basis would be repealed as a simplification measure.

- o Excluded capital gains would still be treated as a preference item under the AMT, but a special AMT rate would apply to ensure that capital gains qualifying for 1202 under either the ordinary income tax or the AMT would be taxed at a maximum rate of 14 percent.

- o Certain anti-abuse rules that could unnecessarily disqualify certain businesses would be liberalized.

  - The working capital rules could be modified to provide that (I) working capital will be treated as an active trade or business asset if it is reasonably expected to be used within 5 years (up from current 2 years); (ii) funds spent on R&D will be treated as creating an active trade or business asset dollar-for-dollar; and (iii) the time period for taking full advantage of these working capital rules would be extended from 2 years to 5 years. These changes would benefit bio-tech companies and other R&D firms that have long development periods before products can be brought to market.

  - The Treasury regulatory initiative to permit stock redemptions in certain situations would be finalized in 1997 and extended to include divorce as well as death, termination of employment, mental incompetence and de minimis cases. It would be made clear that the phrase making firms ineligible because their principal asset is the skill or reputation of one or more employees was not intended to disqualify software or R&D or similar firms. Administration and compliance with the provision would be improved by requiring firms to file an annual eligibility form along with their corporate tax returns.

o The $50 million limit on asset size would be retained (but would be indexed for inflation).

- Most startup firms require only a few million dollars of capital and increasing the asset limit to $100 million would draw capital away from these smaller firms that are the intended primary beneficiaries of the provision. The 5-year holding period requirement would be retained as an incentive for patient capital. If a general capital gains exclusion is passed, those who have held shares for less than 5 years would be eligible for the general preference for long-term gains.

-- Proposals for rollover of gains from an eligible small business into investments in other small businesses should be opposed. Such proposals would create complex eligibility questions and create the potential for taxpayers to never pay any capital gains tax if gains are rolled over for life.

o These provisions are most likely to be of interest to Senators Daschle, Roth, Hatch, Lieberman and Mack, and Representatives Matsui, English, McCrery, Dunn, and Watkins who have introduced bills with targeted capital gains provisions for small business. A number of additional Senators and Representatives are co-sponsors of these bills.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **DON LUBICK** DCL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Reforming the Alternative Minimum Tax

In the absence of policy changes, the number of taxpayers that pay taxes because of the AMT (as opposed to the regular income tax) will increase by roughly 25 percent per year: from 0.9 million in 1997 to 2.4 million in 2002 to 8.4 million in 2007. The taxpayers who are thrown onto the AMT will increasingly be taxpayers who are not traditionally viewed as aggressive or abusive of the tax system. The items that will force taxpayers onto the AMT are state and local tax deductions, personal exemptions, and the standard deduction; these are not the tax preferences that the AMT was designed to limit. Forcing many millions of taxpayers to fill out a very complicated tax for a parallel tax system will infuriate most taxpayers and may put in peril the survival of the whole progressive tax system.

The main components of our proposed reforms are (1) index AMT exemption at 2002 levels, (2) allow personal exemptions and the standard deduction to be deducted under the AMT, and (3) allow personal credits (e.g., child-care credit, and the proposed HOPE and child credit) to offset AMT liability. The cost of the proposal would be limited by delaying the effective date until 2003.

There are two major political problems associated with AMT reform. First, because so many taxpayers will be affected by the AMT in the future, the long-run costs of solving the problem are high and the solution disproportionately benefits higher-income taxpayers. The distributional consequences are driven by the fact that the AMT has a $45,000 exemption, which eliminates most low-income taxpayers. Even so, rough preliminary calculations suggest that half the benefit of the proposed AMT reforms in 2007 would accrue to taxpayers with adjusted gross income under $110,000 (in 1997 dollars). Second, because the costs of the AMT increase sharply over the 10-year budget window, tackling the problem makes it more difficult to challenge Congressional Leadership proposals with the criticism that costs explode in the out years.

Strategy

Given the impending AMT problem, there are three policy options.

- **Drop the AMT reform proposal altogether**. OTP opposes this option, because tackling the problem will get increasingly expensive over time, and as more taxpayers get affected by the AMT, support for the income tax is likely to erode. Moreover, by not tackling the problem now, there will be irresistible pressure for future tax cuts (to fix the AMT problem), with resulting pressure to reduce spending and/or increase the deficit. Over time, the AMT is likely to generate resentment that will be easily exploited by those wishing to "rip the tax system out by its roots."

- **Embrace the proposed reform**. To do so will require a willingness to make the (conceptually correct) argument that AMT reform is unlike most of the other tax cut proposals in the balanced-budget package. In contrast to capital gains tax cuts or the exploding costs of backloaded IRAs, the rapidly increasing cost of the AMT arises largely from a rapidly increasing number of taxpayers being subjected to the AMT. In contrast, rapidly increasing costs of capital gains tax cuts come from large benefits being granted to relatively small number of taxpayers. Put differently, most of the cost of AMT reform comes from relieving taxpayers from paying a tax in the future that they do not currently pay and may not even know exists. A second argument is that the AMT, if left unreformed, will reduce the value of the child credit and HOPE credit, so to make these initiatives work correctly, the AMT must be changed.

- **Adopt a middle (though closer to doing nothing) approach**. If the AMT reform package drops indexing and keeps the personal exemption as an AMT preference item (so it eliminates the standard deduction as a preference, eliminates deadwood provisions, allows personal credits to offset AMT liability, and eliminates ties between the parent's AMT return and the kiddie-tax child's AMT return), the package is inexpensive ($5.3 billion in the second five years) and does not explode. This solution <u>does not</u> solve the future AMT problem, but does buy some simplification.

We would welcome your guidance about which AMT approach we should take in our package.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK DCL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Home Office Deduction

Summary

Taxpayers currently are precluded from taking a home office deduction if they use a home office to perform the administrative and management activities of their business, but perform their business services at another business location. Several proposals have recently been made to allow a home office deduction in these situations. We are supportive of the general approach taken in these proposals, but believe that certain technical modifications are necessary (1) to ensure that de minimis management activities would not qualify the taxpayer for the home office deduction, and (2) to prevent the proposals from affecting the deductibility of commuting expenses.

Current law

Under current law, a home office deduction is generally allowed with respect to the use of a taxpayer's residence only in limited circumstances, including where a portion of the home is exclusively used on a regular basis as the taxpayer's "principal place of business." In Commissioner v. Soliman, the Supreme Court disallowed a home office deduction to an anesthesiologist who practiced at several hospitals, but performed his administrative activities in a home office because he was not provided office space by the hospitals. The Court held that the home office was not his principal place of business, because his primary services were performed at the hospitals.

Congressional proposals

In response to the Soliman case, several congressional proposals would allow a home office deduction to taxpayers who manage their business affairs from their home. For example, Senator Bond's Home-Based Business Fairness Act of 1997" would treat a home office as a "principal place of business" if (I) the office is exclusively used by the taxpayer to conduct essential administrative or management activities on a regular and systematic basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, under the bill, a home office deduction would be allowed under circumstances where the taxpayer's home is not in fact the taxpayer's principal place of business.

Under the bill, employees would only be entitled to a home office deduction if the use of the home office is for the convenience of his employer. Moreover, any deduction by the employee would be subject to the 2% floor on miscellaneous itemized deductions and would not be deductible for AMT purposes.

While we generally agree with the approach of the bill, certain considerations must be addressed. In particular, the current rules were enacted by Congress in 1976 to reduce the substantial amount of litigation over the circumstances under which a taxpayer who worked in his or her home could deduct as a business expense a portion of the costs associated with maintaining the home. It is important that we make every effort to avoid turning back the clock and creating a level of ambiguity that would result in more disputes between taxpayers and the IRS. To address this concern, we believe that the services being performed in the home office must be both substantial and essential . This would avoid allowing a home office deduction where only a de minimis amount of administrative or management activities are conducted. Also, we agree with the bill's treatment of employees. Further expansion of the home office deduction for part-time employees and telecommuters would be very expensive and difficult to administer.

We are also concerned that the bill would affect more than home office deductions. By changing what qualifies as a principal place of business , it would also permit deductions for currently nondeductible commuting expenses. We believe the effects of the proposal should be limited to home office expenses.

Revised proposal

We would add a section 280A(c)(1)(D) to allow a home office deduction in cases where (I) the office is exclusively used by the taxpayer to conduct substantial and essential administrative or management activities on a regular and systematic basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, we would not amend the definition of principal place of business, thereby avoiding any effect on commuting expenses.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **DON LUBICK** DL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Costs of Suggested Potential Packages Over the Second 10 Years

The attached tables show the 10-year cost of two different suggested tax packages. The packages include:

- o A refundable Kidsave credit for children under 13 through 2002, and for children under 18 beginning in 2003. The credit is phased in at $200 in 1997, $300 in 1998 and $500 thereafter. Taxpayers eligible for the child credit can also contribute the credit amount to a backloaded IRA to finance the children's college education or the taxpayer's retirement.

- o The education package differs somewhat from "Option 4" that was shown to the President. The current package includes a $1,000 HOPE scholarship and $5,000 tuition deduction through 1999 and the full $1,500 HOPE scholarship and $10,000 tuition deduction thereafter.

  - The advantage of this package relative to previous packages is that the effective date is six months earlier (7/1/97) than the alternatives (1/1/98) and the President's complete proposals are in place by 2000 rather than 2001. It is easy to go back to an alternative proposal if that is preferable.

- o The capital gains proposal includes a general 40 percent exclusion with special 24 percent AMT rate, the latter to ensure that the highest tax rate on capital gains under both the ordinary income tax and AMT is 24 percent. In addition, the President's capital gains proposal for home sales is included, as well as a liberalization of Section 1202, the capital gains preference for venture capital.

- o The two tables differ in their individual AMT reforms. The first shows the full-blown AMT reform. The second reflects a much less far-reaching change to the AMT.

  - The money saved by not fixing the future AMT problem could be left unspent to demonstrate fiscal responsibility. As is clear below, the extrapolated second ten-year costs of the smaller package is much lower than the competing package.

- Alternatively, the child credit could be expanded beyond its $500 level (it already covers children under 18) or the money could be used in some other way.

o The other proposals either come from the FY98 Budget or are carried over from previous packages (like the Daschle estate tax proposal).

Costs in the Second 10 Years

The Center for Budget and Policy Priorities (CBPP) received a great deal of attention last week for their analysis of the costs of the budget agreement in the second ten years. The agreement calls for net tax cuts of $28.8 billion in 2004, $31.4 in 2005, $38.2 in 2006 and $41.8 in 2007. The CBPP extrapolated the $13 billion increase from 2004 to 2007, using the 2007 net tax cut as a base (that is, they assume that the net cut will increase by $4.33 billion per year over the next 10 years), to conclude that the net tax cut from 2008-2017 would be $650 billion.

The CBPP methodology applied to package 1 (with the full AMT reform) would imply that our 2008-2017 net tax cut would be roughly $690 billion. This figure is likely to be overstated, however. Our refundable Kidsave credit does not increase in a uniform manner. Because of the "round-down" rules of indexing, the credit tends to remain at a fixed nominal amount for two or more years and then jump. An increase in the credit coincidentally occurs in the last three years of the Budget agreement, making it appear that the cost of the credit will increase sharply in the out years. This is not the case. When a rough adjustment is made for a reasonable path for the child credit, the 2008-2017 cost of the first package is roughly **$650 billion**.

The CBPP methodology for package 2 (with the minor AMT reform) implies that the 2008-2017 net tax cut is roughly $480 billion. With the adjustment for the non-exploding cost of the refundable Kidsave credit, the 2008-2017 cost of the net tax cut would be roughly **$440 billion**.

Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, May 30, 1997

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
Education package													
HOPE scholarship, $1000; Tuition Deduction, $10,000 \1	-78	-3,714	-5,556	-6,677	-9,219	-9,962	-10,113	-10,473	-10,732	-11,281	-11,447	-35,128	-89,174
Rangel K-12 school finance tax provision (not scored)													
Make Section 127 Permanent \2	-82	-645	-670	-730	-796	-833	-874	-914	-951	-988	-1,042	-3,674	-8,443
Middle-Class Tax Relief and Saving Provisions													
Refundable Kidsave Credit \3	-732	-11,855	-14,049	-17,382	-17,302	-17,242	-19,891	-22,450	-22,287	-24,479	-26,520	-77,830	-193,457
Individual AMT reform, start in 2003 \4	0	0	0	0	0	0	-2,261	-4,705	-6,454	-8,832	-11,950	0	-34,202
Capital Gains and Estate Tax Relief													
40% CapGn Exclusion and 24% AMT	-400	-835	841	-1,023	-1,043	-1,063	-1,015	-945	-940	-855	-725	-3,123	-7,603
Super-Bumpers Plug Number \5	0	-50	-150	-300	-400	-500	-600	-700	-800	-900	-1,000	-1,400	-5,400
President's Home Sales Provisions \5	-10	-90	-241	-228	-214	-199	-183	-165	-147	-127	-106	-972	-1,700
Daschle Estate Tax Proposals (JCT)	0	-440	-540	-640	-740	-840	-1,000	-1,200	-1,400	-1,600	-1,800	-3,200	-10,200
Urban Initiatives													
Distressed Areas Initiatives \6	-40	-426	-505	-509	-478	-421	-368	-326	-292	-260	-230	-2,339	-3,815
Welfare-to-Work	0	-68	-137	-163	-122	-61	-20	-5	-1	0	0	-551	-577
Other Tax Incentives \7	-10	-141	-214	-257	-301	-369	-345	-387	-429	-1,395	-2,405	-1,282	-6,243
One-year Extensions of Expiring Provisions	-438	-968	-747	-330	-145	-52	-8	0	0	0	0	-2,242	-2,250
Gross Tax Cut	-1,790	-19,232	-21,968	-28,239	-30,760	-31,542	-36,678	-42,270	-44,433	-50,717	-57,225	-131,741	-363,064
Revenue Offsets	623	8,488	9,073	9,951	10,411	12,078	11,202	11,679	12,080	12,538	12,988	50,001	110,488
Total Net Cut **(not including Rangel school construction program, expected to cost $3 billion through 2002)**	-1,167	-10,744	-12,895	-18,288	-20,349	-19,464	-25,476	-30,591	-32,353	-38,179	-44,237	-81,740	-252,576

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

\2 Includes 10% employer credit for small business training.

\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.

\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003

\5 Stacked after the 50% exclusion

\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, May 30, 1997

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
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Rangel K-12 school finance tax provision (not scored)													
Make Section 127 Permanent \2	-82	-645	-670	-730	-796	-833	-874	-914	-951	-988	-1,042	-3,674	-8,443
Middle-Class Tax Relief and Saving Provisions													
Refundable Kidsave Credit \3	-732	-11,855	-14,049	-17,382	-17,302	-17,242	-19,891	-22,450	-22,287	-24,479	-26,520	-77,830	-193,457
Individual AMT reform, start in 2003 \4	0	0	0	0	0	0	-382	-760	-1,013	-1,412	-1,969	0	-5,536
Capital Gains and Estate Tax Relief													
40% CapGn Exclusion and 24% AMT	-400	-835	841	-1,023	-1,043	-1,063	-1,015	-945	-940	-855	-725	-3,123	-7,603
Super-Bumpers Plug Number \5	0	-50	-150	-300	-400	-500	-600	-700	-800	-900	-1,000	-1,400	-5,400
President's Home Sales Provisions \5	-10	-90	-241	-228	-214	-199	-183	-165	-147	-127	-106	-972	-1,700
Daschle Estate Tax Proposals (JCT)	0	-440	-540	-640	-740	-840	-1,000	-1,200	-1,400	-1,600	-1,800	-3,200	-10,200
Urban Initiatives													
Distressed Areas Initiatives \6	-40	-426	-505	-509	-478	-421	-368	-326	-292	-260	-230	-2,339	-3,815
Welfare-to-Work	0	-68	-137	-163	-122	-61	-20	-5	-1	0	0	-551	-577
Other Tax Incentives \7	-10	-141	-214	-257	-301	-369	-345	-387	-429	-1,395	-2,405	-1,282	-6,243
One-year Extensions of Expiring Provisions	-438	-968	-747	-330	-145	-52	-8	0	0	0	0	-2,242	-2,250
Gross Tax Cut	-1,790	-19,232	-21,968	-28,239	-30,760	-31,542	-34,799	-38,325	-38,992	-43,297	-47,244	-131,741	-334,398
Revenue Offsets	623	8,488	9,073	9,951	10,411	12,078	11,202	11,679	12,080	12,538	12,988	50,001	110,488
Total Net Cut **(not including Rangel school construction program, expected to cost $3 billion through 2002 and $8 billion through 2007)**	-1,167	-10,744	-12,895	-18,288	-20,349	-19,464	-23,597	-26,646	-26,912	-30,759	-34,256	-81,740	-223,910

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

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The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in :

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\5 Stacked after the 50% exclusion

\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

-Prepared by Karl Scholz and Don Lubick
-OK to autopen per Mike Froman
-LS signed
-NCC cc to REK, LS, MB, SS, JBN, A. Cohen
6/3/97
Please log and file
-ncc

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Very close hold

May 30, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **DON LUBICK** ALL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Distributional Effects of a Potential Tax Package

Attached you will find six tables showing distributional effects of different Administration and Congressional tax packages.

- o The first two tables show very preliminary estimates of the distributional effects of a proposed tax package. The package is from Thursday, and includes the complete, costly AMT package and a Kidsave credit for children under 13 for the entire budget period (our packages now expands the Kidsave credit to children under 18 beginning in 2003).

    - The revised package will have a somewhat more progressive distribution since the expansion of the Kidsave credit to families with older children will add roughly $8 billion in 2007 (we distribute the fully phased-in policies) to the bottom and middle quintiles of the income distribution, and, if we adopt the scaled back version of the AMT reform, we will take away nearly $10 billion of tax cuts that are distributed toward the top of the income distribution.

- o The next two tables show the distributional effects of the President's budget proposals. The President's budget proposals targeted 80 percent of the tax relief to families in the middle three quintiles of the income distribution.

- o The last two tables show <u>very preliminary and rough</u> calculations of the distributional effects of S.2. We would be grateful if these tables were not distributed, since the analysis does not meet the typical Treasury quality standard. It is provided here to give you an idea of what the distributional effects of a Congressional Leadership package might look like.

    - We will, of course, quickly do a complete analysis of Chairman Archer's tax bill when it is released to have a comparison of the Republican tax bill and ours.

- o The upshot is that the current package targets more relief than either the Budget or S.2 to the bottom two income quintiles, presumably because of the refundable Kidsave credit. It provides less of its total tax relief to families in the third and fourth quintiles of the income distribution than the President's budget, but more than S.2. It provides a greater share of tax relief to the top quintile than the Budget proposals, but less than S.2.

Very Preliminary

Baseline Tax Package as of May 30, 1997 (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change ($)	Total Tax Change: Amount (3) ($M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of: Current Federal Taxes (4) (%)	Tax Change as a Percent of: Family Economic Income (%)
Lowest (5)	21.6	-82	-1768	4.6	-14.07	-0.86
Second	22.2	-244	-5435	14.3	-8.82	-1.00
Third	22.3	-296	-6592	17.3	-4.18	-0.69
Fourth	22.3	-397	-8841	23.2	-2.86	-0.55
Highest	22.3	-684	-15228	40.0	-1.67	-0.37
Total (5)	111.3	-342	-38040	100.0	-2.62	-0.51
Top 10%	11.1	-999	-11125	29.2	-1.68	-0.38
Top 5%	5.6	-1559	-8689	22.8	-1.78	-0.41
Top 1%	1.1	-3719	-4173	11.0	-1.61	-0.40

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $16,950; Third $32,563; Fourth $54,758; Highest $93,222; Top 10% $127,373; Top 5% $170,103; Top 1% $408,551.

Very Preliminary

Baseline Tax Package as of May 30, 1997 (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change ($)	Total Tax Change: Amount (3) ($M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of: Current Federal Taxes (4) (%)	Tax Change as a Percent of: Family Economic Income (%)
0 - 15	18.5	-65	-1208	3.2	-12.95	-0.77
15 - 30	21.8	-233	-5084	13.4	-10.13	-1.05
30 - 40	12.1	-270	-3250	8.5	-5.23	-0.78
40 - 50	9.7	-299	-2902	7.6	-3.97	-0.67
50 - 60	7.9	-357	-2814	7.4	-3.58	-0.65
60 - 75	9.4	-403	-3799	10.0	-3.17	-0.60
75 - 100	11.7	-395	-4618	12.1	-2.30	-0.46
100 - 200	15.6	-422	-6575	17.3	-1.52	-0.32
200 & over	3.9	-1945	-7613	20.0	-1.80	-0.42
Total (5)	111.3	-342	-38040	100.0	-2.62	-0.51

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget.

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(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

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(5) Families with negative incomes are included in the total line but not shown separately.

Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change: Amount (3) (\$M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of: Current Federal Taxes (4) (%)	Tax Change as a Percent of: Family Economic Income (%)
Lowest (5)	21.6	12	251	-1.3	2.00	0.12
Second	22.2	-90	-1999	10.2	-3.25	-0.37
Third	22.3	-240	-5331	27.3	-3.38	-0.56
Fourth	22.3	-377	-8384	43.0	-2.72	-0.52
Highest	22.3	-182	-4064	20.8	-0.45	-0.10
Total (5)	111.3	-175	-19518	100.0	-1.34	-0.26
Top 10%	11.1	34	376	-1.9	0.06	0.01
Top 5%	5.6	235	1,313	-6.7	0.27	0.06
Top 1%	1.1	935	1,049	-5.4	0.40	0.10

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of Second \$16,950, Third \$32,563, Fourth \$54,758, Highest \$93,222; Top 10% \$127,373, Top 5% \$170,103, Top 1% \$408,551

Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change ($)	Total Tax Change: Amount (3) ($M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of: Current Federal Taxes (4) (%)	Tax Change as a Percent of: Family Economic Income (%)
0 - 15	18.5	15	274	-1.4	2.84	0.17
15 - 30	21.8	-70	-1526	7.8	-3.04	-0.31
30 - 40	12.1	-162	-1952	10.0	-3.14	-0.47
40 - 50	9.7	-268	-2602	13.3	-3.56	-0.60
50 - 60	7.9	-337	-2651	13.6	-3.37	-0.61
60 - 75	9.4	-366	-3441	17.6	-3.93	-0.75
75 - 100	11.7	-403	-4720	24.2	-2.12	-0.42
100 - 200	15.6	-272	-4246	21.8	0.31	0.06
200 & over	3.9	342	1337	-6.9	0.00	0.00
Total (5)	111.3	-175	-19518	100.0	-1.34	-0.26

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are included in the total line but not shown separately.

Very Preliminary

Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change ($)	Total Tax Change: Amount (3) ($M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of Current Federal Taxes (%)	Tax Change as a Percent of Income (%)
Lowest (4)	21.4	-19	-409	0.7	-2.89	-0.22
Second	21.9	-109	-2388	4.2	-3.90	-0.49
Third	21.9	-300	-6557	11.6	-4.48	-0.78
Fourth	21.9	-528	-11555	20.5	-4.25	-0.85
Highest	21.9	-1600	-35007	62.1	-4.49	-1.01
Total (4)	109.4	-516	-56415	100.0	-4.42	-0.89
Top 10%	10.9	-2330	-25501	45.2	-4.51	-1.03
Top 5%	5.5	-3527	-19294	34.2	-4.65	-1.08
Top 1%	1.1	-9595	-10496	18.6	-4.73	-1.16

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. The Act also includes estate and gift tax provisions which are not included in the table

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and long-run behavior. The effect of the IRA proposal is measured as the present value of tax savings on one year's contributions. The incidence assumptions for tax changes is the same as for current law taxes.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Very Preliminary

Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change ($)	Total Tax Change: Amount (3) ($M)	Total Tax Change: Percent Distribution (%)	Tax Change as a Percent of Current Federal Taxes (%)	Tax Change as a Percent of Income (%)
0 - 10	12.5	-13	-166	0.3	-2.92	-0.23
10 - 20	16.2	-46	-743	1.3	-3.46	-0.31
20 - 30	15.1	-131	-1976	3.5	-3.94	-0.53
30 - 50	22.7	-306	-6957	12.3	-4.45	-0.78
50 - 75	18.3	-514	-9439	16.7	-4.21	-0.84
75 - 100	10.8	-817	-8820	15.6	-4.50	-0.95
100 - 200	10.6	-1224	-12932	22.9	-4.27	-0.94
200 & over	2.8	-5354	-14883	26.4	-4.70	-1.11
Total (4)	109.4	-516	-56415	100.0	-4.42	-0.89

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. The Act also includes estate and gift tax provisions which are not included in the table

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(4) Families with negative incomes are included in the total line but not shown separately.

WAGES

1996-SE-011539

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 6, 1996

MEMORANDUM FOR THE PRESIDENT

Through: Robert E. Rubin

From: Joshua Gotbaum
Assistant Secretary for Economic Policy

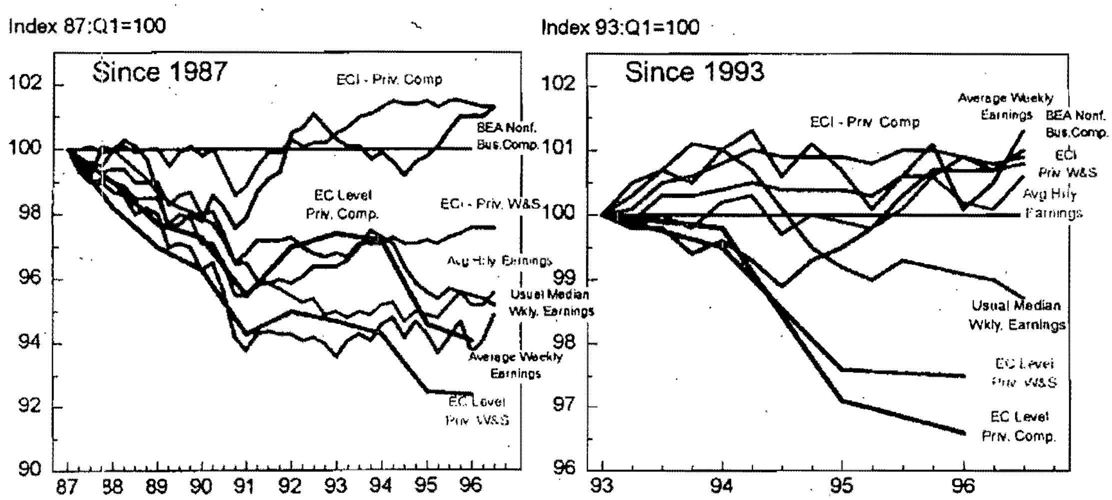
Re: **Are real wages really falling?**

You sent over a recent *Business Week* article that claimed real wages are still falling, based upon a report of the Economic Policy Institute. It notes that, while the official Employment Cost Index (ECI) for hourly compensation had been about flat in real terms since 1987 – and risen in your Administration – another measure, based on the same underlying data, shows a continued drop. Since the difference between the two is that the ECI controls for changes in the mix of industry and occupation, the article argues that the mix of jobs is getting worse and that the average person is earning less.

Take it with a grain of salt. There are, as you know, a variety of measures of real compensation and real wages. As the charts below show, many of them have shown an improvement since 1993, though some have not. Overall, we believe that the fall has stopped and may have begun to turn up.

However, there are measures, including the one that the *Business Week* article highlights (shown in red), that continue to show a decline. The Economic Policy Institute has, in its work over the years, focused on those measures. This narrow focus paints an overly pessimistic picture.

It is also worth noting that, to the extent the CPI overstates increases in the cost of living, all of the measures below understate the growth in real wages.



Note: All series deflated by CPI-U except for average hourly and weekly earnings, which are deflated by the CPI-W. Usual weekly earnings series shown as a four-quarter moving average, since it is not seasonally adjusted.

Prepared by Robert Gillingham, John Roberts, and Karen Hendershot

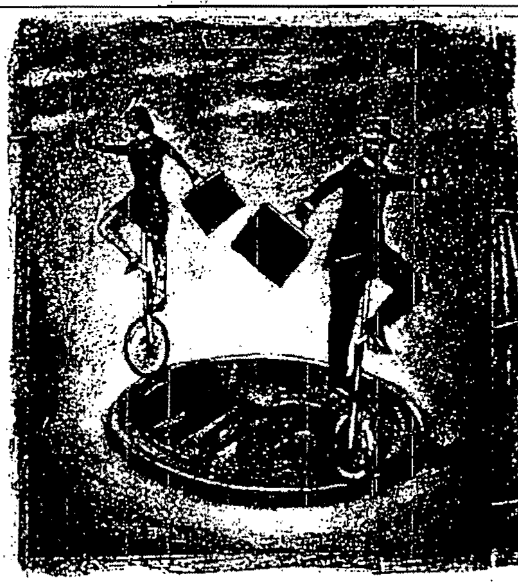
BIZWEEK4.WPD

cc Leon Panetta
Erskine Bowles
Laura Tyson
Bruce Reed

COMMENTARY

By Aaron Bernstein

BIGGER PAYCHECKS, YES. BETTER PAY, NO



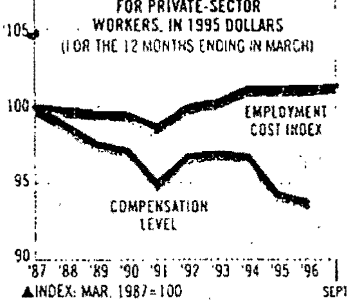
Annual incomes finally rose last year after six flat years. Wage hikes periodically spook the bond market. And President Clinton announces every chance he gets that the economy has turned the corner. It's all true, and many Americans are doing better since job growth finally picked up in the past year or so. But don't celebrate yet: There's strong evidence that the two-decade trend of wage stagnation continues unabated.

It's easy to get a misleading picture, since the government conducts a half-dozen wage surveys that all tell different stories. The monthly series that bond hawks watch, which shows pay outpacing inflation, is so erratic that most labor economists dismiss it. The better assessment comes from a once-a-year snapshot taken each March as part of the Bureau of Labor Statistics' survey of labor costs. The 1996 figure, released in mid-October, shows that compensation growth still trails consumer prices. These numbers "are the best measure of the income of average American workers over the long term," says BLS Commissioner Katharine G. Abraham. And while the figures don't include the past seven months, there's little reason to suspect a sharp turn off the long-term course.

DETROIT SWAP. So how can incomes be rising if wages aren't? Simple. Strong job growth lets people work more hours, so households have more to spend. But that doesn't mean employees are earning more per hour. In other words, paychecks are up because Americans are working harder and longer, not because the long-term trends holding down wages—the shift to services, globalization, weak unions, and so on—have been checked. "All the long-term wage problems haven't gone away," says Marvin H. Kosters, an economist at the American Enterprise Institute, a conservative think tank in Washington.

To see why he's right, look at the BLS Employment Cost series. The data come in two versions. The more closely watched one, a quarterly index, tries to measure the same type of labor year to year. It assumes that the proportion of every type of worker in the economy—factory, service, professional, blue-collar—doesn't change. The second version, the so-called compensation-level survey done each March, includes occupational, industry, and other shifts. It shows that compensation has trailed inflation by six percentage points since the bureau began keeping track in 1987, while pay and benefits as gauged by the quarterly index have outpaced consumer prices (chart).

WAGES: STILL GOING NOWHERE



DATA: BUREAU OF LABOR STATISTICS, ECONOMIC POLICY INSTITUTE

While the index offers the best picture of what employers pay for labor, the so-called level is better for gauging what employees earn, says Kosters and other labor economists. The two aren't the same. Take Detroit auto makers. They recently granted above-inflation raises to union workers, whose pay and benefits run $43 an hour. But in recent years, the Big Three have outsourced jobs to suppliers that often pay only $20 an hour. If suppliers also raise pay above inflation, the index would register real compensation gains. But in reality, thousands of high-wage jobs were swapped for lower-paid ones, reducing average wages. This only shows up in the level survey. Indeed, auto workers battled Detroit over outsourcing in their just-concluded contracts precisely because the practice lowers wages in the industry.

TEMP TIDE. Similarly, because the level method accounts for the shifting mix of job types, it's the only one that factors in such trends as the spread of lower-wage jobs. And these trends have been big in recent years. For instance, employment in the temporary help industry has soared by 70% since 1990, to 2.2 million. This pulls down average wages, because temp jobs pay $8.79 an hour, vs. $11.44 for full-time ones, according to the BLS.

The same holds true when service jobs, which average $15 an hour, proliferate, replacing factory ones that pay $20, according to the Economic Policy Institute, a liberal think tank in Washington. Since 1989, 1 million factory jobs have vanished while service jobs have soared by 10 million, EPI figures show. "The shift to low-wage industries continues to pull down wages," says EPI Chief Economist Larry Mishel.

Americans are doing better in a healthier job market, true enough. But don't mistake the good news for the whole story. Plenty of evidence still weighs wages down.

Bernstein watches workplace trends from Washington.

AFRICA

1998-SE-003514

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
March 17, 1998

SECRETARY OF THE TREASURY

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R. E. R.

SUBJECT: Your Africa Trip

Your Administration has developed a significant economic agenda in Africa in response to the changes on the continent in the 1990s. This shift in US policy toward Africa, articulated in The Partnership for Economic Growth and Opportunity that you announced last June, is perhaps the most significant since these countries attained independence. Its measures are summarized in Tab A. The major points of the strategy include:

-- Support for economic reform, including downsizing governments, selling state enterprises, encouraging private investment, and getting governments to address corruption issues;

-- Positioning trade and investment at the center of our economic relations, and focussing bilateral aid on building economic institutions and human capital;

-- Promoting global integration of closed African economies and encouraging regional integration to expand the size of African markets;

-- Increasing financial support from the International Financial Institutions (IFIs), plus substantial bilateral debt relief, but only for those countries that demonstrate a sustained record of reform; and

-- Initiating a dialogue with Africa's economic leadership at the cabinet level to build consensus on reform and focus attention on the reformers.

Because the financing of our assistance and debt relief comes mainly from multilateral sources, you will need to be careful not to commit more than the fragile coalition we've built among the G-7 can deliver, nor signal a lessening of our requirement for conditionality which seems now to be yielding good results.

The message of your trip nonetheless can be a positive one: you can dramatize to Americans the enormous changes taking place in Africa (dubbed the "African Renaissance" by President Museveni), and demonstrate to Africans your Administration's active support for these changes.

THE "AFRICAN RENAISSANCE"

The economic facts are striking. The World Bank estimates that average growth in sub-Saharan Africa rose from 1.4% in 1991-94 to nearly 5% in 1996, compared to average population growth of almost 3%. Per capita incomes rose in 31 countries in 1996. Inflation fell in most. Growth in stronger reformers such as Senegal, Ghana, Cote d'Ivoire, and Mozambique has reached 5% or better, while a few like Ethiopia and Uganda reached 10% in 1996. While there still are poor performers, they seem more the exception than the rule. Major investors have taken note, with George Soros calling Africa "the coming continent." Tab B provides brief economic sketches of the countries you will visit, all of which are good performers.

SUSTAINING AFRICAN GROWTH

The good results are due mainly to efforts by Africans themselves to cut budget deficits, free exchange rates, increase prices paid to farmers, and force public enterprises to forego subsidies. But basic structural change has been harder. Many countries still are hobbled by bloated public sectors, dependence on a few commodity exports, debt burdens from the past, and corruption. Savings and investment rates are low, the private sector is weak, and infrastructure is decrepit. The reformers have opened their economies substantially in recent years, but the region as a whole still is more closed to trade and investment than any other on the globe.

Resistance by vested interests and the pain of austerity make it hard to sustain reforms. Yet reforms must be sustained, for Africa has a long way to go: at 5% growth it would take nearly forty years -- two generations -- for per capita income in a typical African country to double from, say, $400 to $800. By contrast, US average incomes can grow by that dollar amount in one year. Despite its recent good record, Uganda is just getting back to per capita income levels prevailing when Idi Amin took over. Clearly, something more than current reforms is needed.

THE NEW US ROLE IN AFRICA

The Partnership for Economic Growth and Opportunity is our answer, and it has generated great interest in most African countries. It aims to bring the benefits of freer trade and expanded cross-border investment to countries that hitherto have been treated mainly as aid recipients. The most important stimulus to African growth must come from changes in African policies, not ours; we nonetheless can help take some of the sting out of these adjustments and provide some of the political cover that African leaders need to push forward. Your Partnership packages a number of bilateral and multilateral benefits for those countries that want to reform themselves.

Trade is Essential -- The African Growth and Opportunity Act, which passed the House last week, provides an extension of the U.S. Generalized System of Preferences for poor African countries. It also expands GSP product coverage for the strong reformers to some commercially sensitive sectors, like textiles, apparel, and leather goods, that never were included. It also removes existing textile quotas on Kenya and Mauritius, subject to certain safeguards. African countries provide only a tiny portion of our GSP imports, and only .06% of our textile and apparel imports -- but these sectors typically are where developing countries build their first industries. This is why Administration support for enactment of the Africa trade bill is so vital.

Financial Assistance -- Even the best African performers are poor, and most will need foreign assistance for some time. U.S. financial support for sub-Saharan countries is delivered mostly through the IFIs. Our share of the IFIs of slightly under 18% allows us to leverage every dollar we contribute to at least six dollars of loans. The IMF, addressing macroeconomic stability, and the World Bank and African Development Bank, focussing on sectoral and development issues, provide the largest share of financing, policy guidance, and technical assistance for developing countries. Most African countries receive this financial support on highly concessional terms.

But a growing body of research demonstrates that foreign aid without reform doesn't work. Selectivity is essential, to steer the preponderance of aid toward reformers who will make the best use of it. Our approach to mobilizing financial resources now fully reflects this principle. If you hear criticism during your trip that US aid levels are too low, you should remind your listeners of our substantial contributions via the IFIs and that, through the IFIs, we are making available more concessional assistance to reforming countries than ever before.

Debt Relief -- Another key element of our financial support for Africa's reforms is deep debt relief, designed to achieve a sustainable level of debt. Africa's poor countries already receive debt reduction of up to 67% from Paris Club creditor governments under Naples Terms, and for most of them nothing more is needed.

The United States has been a principal advocate of the Heavily Indebted Poor Countries (HIPC) initiative, to provide up to 80% debt reduction by the Paris Club for the 15-20 countries (mostly African) that need such relief. Since being approved at the 1996 Lyon Summit, HIPC for the first time made possible relief of debts owed to the IFIs. In recognition of its strong reform record, Uganda was the first to become eligible and in April, is expected to receive forgiveness of $700 million in payments coming due. Burkina Faso, Cote d'Ivoire, and Mozambique also have been declared eligible; we expect Guinea Bissau, Mali, and others to become so in 1998.

Despite the great benefits accruing to beneficiaries, you will hear criticisms of HIPC: that it is available only to strong reformers, that the relief should be greater, that it should be delivered faster. You can respond that: (a) debt relief alone without needed reforms does not provide a lasting solution; (b) the objective is sufficient debt relief to attain a sustainable level of debt, since creditors want debtor countries to "exit" from this process too; and © we expect eight countries to be declared eligible for HIPC relief by this April, and are pressing for interim relief from the IFIs until the final relief is delivered.

The United States has been preeminent in forging international consensus for more generous debt relief in Africa. Under your Partnership for Economic Growth and Opportunity, we hope also to fully forgive all concessional debts owed to the U.S. by eligible African countries. By the year 2000, we expect to have provided nearly $3 billion in debt relief for African countries under these various initiatives. (Summaries of IFI and debt programs also are at Tab A.)

Broadening the Consensus -- The G-7 Summit process has been useful to create a consensus among other donor countries around our approach to Africa. G-7 members agree, for example, on the need for African governments to address corruption issues and have supported withdrawal of IFI programs when those efforts were inadequate -- most recently in the case of Kenya's IMF program. We also are proposing to support African efforts to develop a code of "good economic governance" to which countries could subscribe, and a new regional grouping to combat money laundering in Africa along lines already followed in other parts of the world. By the same token, we have committed ourselves to signing the OECD's anti-bribery convention by year-end.

The G-7 agree on the need to spur foreign investment in Africa. The risks investors face include political, economic, and regulatory, and commercial risks. We are attacking some of these risks bilaterally, through USAID's technical assistance, OPIC's investment funds, TDA, Eximbank, and USDA's commodity programs. But the G-7 Finance Ministers also are encouraging the World Bank and African Development Bank to increase investment insurance and innovate with new financial products, including those appropriate to Africa's nascent regional institutions and for projects with regional benefits. We are focussing IFI efforts as well on building human capital, through more support to the education and health sectors, the use of African consultants, and training of economic managers at Anglophone and Francophone universities on the continent.

AFRICA INTRIGUED BY THE PARTNERSHIP

I've discussed the changed orientation of our economic policies toward Africa on several occasions. I can assure you that prominent emphasis on your Partnership for African Growth and Opportunity will be well-received at every stop on your trip.

The Partnership for Economic Growth and Opportunity

In a White House ceremony last June, you announced a "Trade and Development Partnership for the Countries of Africa" that parallels the Crane-McDermott legislation just approved by the House. At the heart of this initiative is a recognition that successful emerging markets in other parts of the world are much more open than African countries to trade. Such openness helps attract investment, and with it, capital, technology, and management expertise. It also fosters competition that brings other changes conducive to stronger growth.

In return for positive steps by African governments to liberalize their trade regimes and create more attractive investment climates, our initiative includes the following major elements:

- Improved access to the U.S. market for African exports, primarily via GSP;
- Enhanced financial support for reforms by the IFIs, since they can provide six dollars or more of concessional lending for every dollar we put in;
- Stressing support for trade and investment liberalization in our bilateral programs, including technical assistance;
- Policy dialogue to help build a consensus for reform and highlight success stories; and
- Persuading other developed countries to follow similar policies.

On the last point, we are working with our G-7 counterparts to build on the work of the Denver Summit by developing financial and economic policy proposals for consideration in Birmingham. By encouraging other countries to follow our lead, we hope to increase the potential benefits, and hence the motivation, for African reformers.

Debt Relief

Debt reduction has been an important component of U.S. policy toward Sub-Saharan Africa since the late 1980s. It is critical for many of these countries because it improves the investment environment, frees resources for other uses, and permits them to escape the cycle of repeated Paris Club reschedulings.

In 1989-91, the United States forgave $1.1 billion in concessional debt owed by nineteen African countries. In 1994, we joined the Paris Club in providing debt reduction to eligible countries under "Naples terms", providing debt reduction of up to 67%. We have committed to forgive roughly $250 million in nonconcessional debt for 10 African countries under Naples terms. Because this action is taken in concert with other Paris Club creditors, it leverages much greater total forgiveness.

The 1996 Lyon Summit acknowledged the need for additional debt relief mechanisms for the most heavily indebted poor countries (HIPC). In September 1996, agreement was reached on a comprehensive, coordinated approach by all creditors (multilateral, official bilateral and others) to assist the heavily indebted poorest countries that are pursuing rigorous economic reforms to achieve sustainable debt levels. Uganda, Burkina Faso, Mozambique, Côte d'Ivoire, Bolivia and Guyana were declared eligible in 1997, and we expect Mali, Guinea-Bissau, and other African countries to be declared eligible this year. In recognition of its strong economic reform record, Uganda was the first country to become eligible and is expected to receive final HIPC relief in April on $700 million in payments due to foreign creditors.

In 1999, the United States also plans to begin a program of bilateral debt reduction under the new Africa Initiative. We will target countries undertaking the boldest economic reforms to receive full forgiveness of the remaining concessional debt which they owe to the United States after Paris Club debt reduction. For FY1999, we are requesting appropriations to cover up to $1.6 billion in debt reduction for African countries under the Africa Initiative and in the Paris Club.

International Financial Institutions (IFIs)

International Monetary Fund/ESAF

The IMF's Extended Structural Adjustment Facility (ESAF) was created in 1988 to provide concessional financing to very poor countries facing balance of payments crises. It combines policy advice and technical support with concessional funding (10 years' repayment, including 5 years grace, and 0.5% interest) to support sound macroeconomic policies.

An ESAF program covers three years, with semiannual reviews by the Fund staff and Board; it often is the key that unlocks support from the World Bank, other multilateral institutions, and bilateral donors, as well as debt relief in the Paris Club. Total outstanding ESAF financing as of Nov. 30, 1997 was $6.95 billion, of which $4.3 billion or 62% went to sub-Saharan countries. New ESAF commitments worldwide were $1.6 billion in the previous 19 months, of which $908 million or 57% went to sub-Saharan countries. Current IMF programs for countries whose officials the President will meet include:

Botswana: No IMF program needed.
Ghana: $222 million ESAF; 2nd annual program, for $111 million, approved 3/23/98.
Uganda: $135.6 million ESAF approved 11/97; HIPC debt relief due April 1998.
Ethiopia: $119 million ESAF approved 7/97; off track; negotiations under way.
Eritrea: No IMF program as yet.
Kenya: $202 million ESAF approved 4/96; off track.
Tanzania: $218 million ESAF approved 11/96.
Senegal: $177 million ESAF completed 1/98; new program expected in June.
South Africa: No IMF program.
Zimbabwe: No IMF program.

World Bank/IDA

The World Bank disbursed $2.7 billion of loans to sub-Saharan African countries in 1997, 90% of it on highly concessional IDA terms. The Bank also is increasing its support to countries undertaking ambitious reforms. The United States maintains a 17% share in the World Bank and a 21% share in IDA.

The International Development Association (IDA) lends to poor countries on 40 year repayment terms, with 10 years' grace, at interest of 0.5%. Half of IDA's projects, representing 38% of the value of its portfolio, are in Africa. Total outstanding IDA credits to sub-Saharan countries exceed $18 billion. Areas of greatest activity are health and education ($2.9b), transportation ($2.7b), agriculture ($2.5b), electric power ($1.38b), and water/sanitation ($1.37b).

IDA's largest African borrowers in 1997 were Ghana, at $1.7 billion or 3.9% of total lending; Tanzania, at $1.3 billion or 3%; Mozambique, $1.2 billion; Ethiopia, $1.13 billion; Uganda, $1.1 billion; and Kenya, just under $1.1 billion. Senegal, South Africa, and Eritrea have much smaller amounts outstanding.

The Bank has created new financing instruments that can be used in Africa, including IDA guarantees of commercial loans; Adaptable Program Loans to fund long-term development strategy; and Learning and Innovation Loans to fund pilot projects or help build a country's capacity for managing larger projects. It is strengthening its microcredit activities. IDA and IFC together have created the Africa Project Development Facility to help African countries define and manage large development projects, and the Foreign Investment Advisory Service to provide training and technical assistance to member countries on attracting foreign investment.

International Finance Corporation (IFC)

The IFC is the arm of the World Bank responsible for direct lending to private enterprises. In 1997 it doubled its investments in Africa, from $190 million to a total of $384 million, covering 72 projects in 35 countries. One of every four new IFC investments is in Africa, the highest concentration of any region.

- Its largest undertaking anywhere will be a $120 million investment in a greenfield $1.3 billion aluminum smelter in Mozambique that also will be the largest private investment ever made in that country. The smelter is expected to boost GDP by more than 7%, triple export earnings, and spark sustainable development via technology transfer and sound environmental planning.

- Other IFC activities include technical assistance and feasibility studies, e.g. in developing capital markets and privatization; infrastructure investment; and training and technical assistance for African businessmen in management techniques, marketing, and project evaluation.

MIGA

The Multilateral Investment Guarantee Authority provides financial guarantees and political risk insurance to worthy private investment projects in developing countries. Increased interest in Africa has led MIGA, since 1991, to issue about $290 million in coverage of foreign investments totaling approximately $2.5 billion in 13 African countries.

- Its activities are as diverse as agribusiness in Cameroon, gold mining in Ghana and Mali, flour milling in Guinea, banking in South Africa, and telecommunications, cobalt processing, fisheries, and rice production in Uganda. There are more than 230 applications pending for prospective investments in 39 African countries.

- MIGA also provides technical assistance to member countries on attracting foreign investment; organizes conferences and workshops on African mining and tourism, such as a successful one in Denver in 1997; trains African investment agency personnel; and disseminates information on business opportunities in Africa, including via the Internet.

African Development Bank and Fund

In large part due to U.S. urging, the African Bank is emerging from the most stringent reform effort undertaken by any of the Multilateral Development Banks. It has recast its lending policies, adopted term limits for its President and Board of Directors, conducted a top-down audit, reduced and reorganized its staffing, and elected a reform-minded President who is continuing to examine the Bank's mission and policies. Its areas of greatest lending activity are agriculture, transportation, public utilities, and social sector projects.

- Negotiations were completed in 1997 on a $1.6 billion replenishment of the African Development Fund (the concessional lending facility). The US pledge was $200 million. We have paid in $45 million, and have requested the other $155 million for FY 1999. Negotiations on a capital increase for the Bank are under way.

- In countries to be visited, outstanding loan balances are: Ghana, $115 million/Bank and $145 million/Fund; Uganda, $22 million/Bank and $167 million/Fund; South Africa has not borrowed from either; Botswana, $91 million/Bank and $60 million/Fund; Senegal, $129 million/Bank and $131 million/Fund.

- The AfDB is positioning itself to play a critical role in Africa's development. With US encouragement, lending to the private sector will increase to 25% of total lending. We also are supporting a move to focus the Bank's lending on areas where it has comparative strength.

Country Economic Sketches
(In order of visits)

Ghana

Ghana was an early star among African reformers. After hitting bottom, economically, in 1983, the then-new Rawlings government implemented an adjustment program that won support from the IMF, World Bank, and other donors. Annual growth rates averaged about 5% over the next ten years, and the country was thought to have "graduated" from the need for IMF financing by the early '90s. Excessive spending on the 1992 elections, however, set off an inflationary spiral that reached 71% in 1995 and forced Ghana to turn again to the IMF for an ESAF program.

In the last three years Ghana has energetically courted foreign investment and been rewarded by a surge of investor interest, especially among Americans. Trade barriers have been simplified and reduced, investment rules have been made more attractive, and the privatization of Ashanti Goldfields two years ago put Ghana on the map for global investors. Problems include lingering difficulties with fiscal discipline, a need to continue and accelerate privatization in such sectors as power and transportation, weak infrastructure, and a poor record in education.

Uganda

Idi Amin virtually destroyed Uganda, but the country began to rebound in 1987 under Yoweri Museveni and has become perhaps Africa's best success story. Museveni's government provided political stability and strong reform backed by the IMF and World Bank; adding strong coffee prices and major bilateral aid to the mix helped produce growth averaging over 5 percent a year (10 percent in 1996). Even so, per capita income, at $225 for its 19 million people, only now is approaching the levels that prevailed before Amin came on the scene.

The government has completely liberalized its trade and investment rules and is courting foreign investors. Its development strategy emphasizes poverty reduction via labor-intensive growth. Public spending focusses on social programs such as agricultural research and extension services, rural water and road projects, health, and universal primary education. In April, Uganda will become the first country to receive comprehensive HIPC debt relief via forgiveness of $700 million in payments due in coming years. President Museveni plans to spend the money that would have gone to debt service on education, health, and infrastructure improvements.

South Africa

South Africa's average per capita income of $3160 in 1995 is one of the highest on the continent but masks wide racial disparities. In 1996, average white household income was nearly six times that of blacks; in addition, the latter face enormous unmet needs for housing, education and jobs. While data in this area are unreliable, black unemployment rates are thought to range as high as 45%. The Mandela government's goal is to reduce the disparities by fostering economic growth, improving delivery of social services, and increasing black job opportunities -- with a specific goal of creating 400,000 new jobs per year by the year 2000.

Economic growth rates rose to about 3.5% in 1996, but the declining value of the currency and the resulting uptick in inflation and interest rates, plus a decline in capital inflows, caused growth to slip to a current rate of about 1.8%. A slowdown in Asian export markets, and the declining world price of gold, have aggravated a problem of declining employment in the all-important mining sector. The good news is that inflation, at 7.4% in 1996, still is low and exports were up strongly in 1996 due to the cheap rand. South Africa's challenge now is to capitalize on its enviable achievement in racial reconciliation by accelerating growth.

Botswana

Botswana's stable political system, sound economic policies, and substantial mineral resources have transformed the country from one of the poorest in the 1960s to a middle-income country in the 1990s. GDP per capita reached about $2,900 in the year ending June 1997. Fifteen straight years of budget surpluses and relatively subdued inflation (8.6% in 1997) have helped. Unemployment of about 21% and a narrow economic base are drawbacks, however. Mining activity accounts for about 33% of GDP, 77% of exports, and more than 56% of government receipts. The government is a large presence, since its revenues are almost 45% of GDP. As a member of the Southern African Customs Union (SACU), Botswana is closely tied to South Africa and cannot unilaterally reduce its tariffs. Close to three-fourths of Botswana's imports and about 60% of non-diamond exports are traded within the SACU region, principally South Africa.

Reducing its own role, fostering economic diversity, and supporting private sector development are the primary goals of the government's Eighth National Development Plan covering the period 1997-2003. Vice President and Finance Minister Mogae takes over the Presidency April 1, in advance of national elections in 1999. He has been largely responsible for economic policy over the last 7 years.

Senegal

Long one of Africa's most open and civil societies, Senegal had a poor economic record due to a stifling, state-dominated economic system that offered the ruling party patronage opportunities. Since the 1994 currency devaluation, however, there appears to have been a change in outlook, with the government pursuing a more private sector-led, market-oriented economic strategy. After a decade of growth averaging 1.9% a year, growth was 5.2% in 1996 and inflation was 3.2%. The telephone company has been privatized, and the electric company, some major hotels, and other parastatals are on the block.

Problems include a small domestic market, high production costs, an illiteracy rate of over 50%, and an unemployment rate as high as 45%; both of the latter figures probably are higher in the case of women. Senegal is a member of the West African Economic and Monetary Union, one of the most promising regional integration initiatives in Africa since it is based on a common currency, single central bank, similar judicial and commercial legal systems, and a customs union planned to take effect in the year 2000.

- Drafted by OASIA
  (Ed Barber/Tim Geithner)
- NCC/WATCH faxed draft to RER per MF 3/16
- NCC to RER
- RER signed
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- NCC cc to MF
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- 3/17/98
- NCC cc to NC
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  B. Boorstin
- 3/18/98
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ARCHITECTURE

1998-SE-011989

DEPARTMENT OF THE TREASURY
Washington

October 20, 1998

TO: Secretary Rubin
Deputy Secretary Summers

FROM: Timothy Geithner TFG

SUBJECT: IMF/Architecture Memo

Attached is a good memo from Karin Lissakers on the Redesign of the International Architecture.

Withdrawal/Redaction Marker
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Karin Lissakers (IMF) to Assistant Secretary Geithner & Deputy Assistant Secretary Atkinson re: Redesign of International Architecture (1 page)	10/16/98	P1/b(1) Unclass.

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RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. report	re: Architecture - Phase III (written by Karin Lissakers, IMF) (4 pages)	10/16/98	P1/b(1) Unclass.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
003. memo	Karin Lissakers (IMF) to Larry Summers, Jeff Shafer, & David Lipton re: Thinking About a Quota Increase & Beyond (4 pages)	11/25/96	P1/b(1) Unclass.

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International Monetary Cooperation since Bretton Woods by Harold James, ©1996 by International Monetary Fund, pages 37 - 39.

A new consensus on the causes of the Great Depression had shifted the emphasis away from the favorite villains of the 1930s literature—the uneven distribution of gold and the sterilizing policies of the Bank of France and the Federal Reserve System, or the allegedly excessive monetary inflation of the 1920s, or structural weaknesses in major industrial centers. Rather, the new view looked at the transmission process of depression and came to the conclusion that the large short-term capital flows of the 1920s and 1930s had led to disaster. These movements had made it impossible for states to pursue stable monetary policies: they threatened exchange rate stability and had made fiscal stabilization highly hazardous.

This approach to the interwar economy oriented toward the diagnosis of capital movements as the fundamental ill had been developed by League of Nations economists in the 1930s. The most influential academic statement was Ragnar Nurkse's *International Currency Experience* (1944). "In the absence of international reserves large enough to meet such speculative and often self-perpetuating capital movements many countries had resort to exchange control and to other less insidious means of correcting the balance of payments." From this historical experience, Nurkse drew the conclusion that greater international cooperation was needed: "But if, owing to anticipated exchange adjustments, political unrest or similar causes, closer control of hot money movements is inevitable, then some of its difficulties and dangers might be overcome by international understanding." As a consequence, when he wrote about plans for an international bank or monetary fund, Nurkse added: "If, in addition to trade and other normal transactions, such a fund had to cover all kinds of capital flight, it might have to be endowed with enormous resources. In fact, no fund of any practicable size might be sufficient to offset mass movements of nervous flight capital."[15]

The restoration of a multilateral financial system thus depended in the view of almost every analyst on control of capital movements for an unlimited time. This approach appealed to Keynes, who had repeatedly asserted his skepticism about the benefits of both capital exports and capital imports. Keynes fully shared the belief that capital flight had been the major international interwar problem: "There is no country which can, in future, safely allow the flight of funds for political reasons or to evade domestic taxation or in anticipation of the owner turning refugee. Equally, there is no country that can safely receive fugitive funds, which constitute an unwanted import of capital, yet cannot safely be used for fixed investment."[16] It is true that Keynes added that the new controls, which might become a "permanent feature of the post-war system," should not bring an end to the "era of international investment": but it would need states and international agreements to define (in accordance with national priorities) what was desirable investment and what was unwanted capital movement. The British economist Sir Hubert Henderson noted: "It has been generally agreed in the United Kingdom that we must retain the right to regulate capital movements, effectively and indefinitely."[17] Many Americans also shared this view.

In the United States, the feeling that the capital exports of the 1920s had been misused was a commonplace for the New Deal. Harry Dexter White, Assistant to the U.S. Treasury Secretary, and the other major architect of what would be the Bretton Woods agreements, fully concurred with Keynes that: "The theoretical bases for the belief still so widely held, that interference with trade and with capital and gold movements etc., are harmful, are hangovers from a Nineteenth Century economic creed, which held that international economic adjustments, if left alone, would work themselves out toward an 'equilibrium' with a minimum of harm to world trade and prosperity. . . . The task before us is not to prohibit instruments of control but to develop those measures of control, those policies of administering such control, as will be the most effective in obtaining the objectives of world-wide sustained prosperity."[18] White's immediate superior, Treasury Secretary Henry Morgenthau, made the target of these controls much more explicit. The new institutions of the international order would be "instrumentalities of sovereign governments and not of private financial interests." The task that the statesmen should set themselves was to "drive . . . the usurious money lenders from the temple of international finance."[19]

The final British proposal was published in April 1943 under the title "Proposals for an International Clearing Union" and preserved all of the most distinctive features of Keynes's approach: the international currency bancor, the quota based on trade in the prewar period, the control of capital movements, and the possibility of the Governing Board of the Union requiring an alteration in exchange rates.

1998-SE-011880

98-011880

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

October 27, 1998

SECRETARY OF THE TREASURY

Dr. Hans Tietmeyer
President
Deutsche Bundesbank
Wilhelm-Epstein-Strasse 14
60431 Frankfurt am Main

Dear Hans:

At our most recent meeting of G-7 Finance Ministers and Central Bank Governors, we agreed that it would be extremely useful for you to consult with relevant international bodies in order to develop some recommendations on how to enhance cooperation and coordination between the various international financial regulatory and supervisory bodies and the international financial institutions interested in international financial stability.

We are particularly interested in hearing your views on potential institutional arrangements and processes that could help promote more effective international financial cooperation. It is our view that new, cooperative mechanisms that build on existing fora could make a useful contribution to these efforts.

One approach that has been proposed would bring together representatives from finance ministries and central banks and financial supervisors from key industrial and emerging market economies, along with the international financial institutions and international regulatory authorities. Such a financial sector policy forum would provide an opportunity for officials having a range of experience and expertise to discuss international financial sector issues across functional lines. It would also facilitate creation of a system for exchanging information on financial sector regulatory and supervisory methods and findings and help begin a process of coordination, such as a clearinghouse, to match demands from individual countries for technical assistance in financial regulation matters with the supply of experts. This approach was among those proposed by the working group on strengthening financial systems, and we believe it merits further consideration, at least as a point of departure, as you proceed with your consultations.

As you undertake this process, we hope that you take into account the interests of all institutions active in regulatory and supervisory areas. Achieving this will depend on careful consultation with relevant international institutions as well as a broad range of national authorities, including key emerging market economies.

We believe that the discussions of the working groups on the financial architecture, and the reports they released on October 5, demonstrate that emerging market economies can make an important contribution to the international effort to improve regulatory and supervisory standards. To play such a role, they must be full participants in the process.

We do not think it is desirable at this time to identify roles and name potential participants in the eventual process or forum for ongoing cooperation and consultation. Thus, we would suggest that consultation be undertaken through a series of meetings with a broad range of interested parties rather than by trying to assemble any one particular group, which could prejudge the ultimate shape of any new forum. In this connection, you may want to consider how the already scheduled final meeting of the working group on strengthening financial systems (in Buenos Aires on November 12-13) could help advance your overall effort. For example, you might formulate a series of questions that Mario Draghi and Pablo Guidotti could put to their group.

We greatly appreciate your willingness to take on this important issue, as your long experience in these areas can help us arrive at an effective approach to enhancing cooperation and coordination. We very much look forward to hearing your ideas on how to proceed.

Sincerely,

Robert E. Rubin
Robert E. Rubin
Secretary of the Treasury

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System

1998-SE-011880

DEPARTMENT OF THE TREASURY
WASHINGTON

October 16, 1998

ACTION

ASSISTANT SECRETARY

MEMORANDUM TO SECRETARY RUBIN

FROM: Timothy Geithner TFG
Assistant Secretary for International Affairs

SUBJECT: Letter to Bundesbank President Tietmeyer on Financial Architecture

Action Forcing Event

Dr. Tietmeyer was directed by the G-7 to consider new arrangements on how to enhance cooperation and coordination between the various international financial regulatory and supervisory bodies interested in financial stability. We recommend that you and Chairman Greenspan send him a letter laying out our vision for this exercise, emphasizing our interest in the institutional arrangements and the importance of being inclusive in his consultations.

Recommendation

That you sign the attached joint letter with Chairman Greenspan to Dr. Tietmeyer.

Agree _____ Disagree _____ Let's Discuss _____

Background

The G-7 communique commissions Dr. Tietmeyer as "a member of our group who is also the Chairman of the G-10 Central Bank Governors, to consult with other appropriate bodies and to consider with them the arrangements for cooperation and coordination between the various international financial regulatory and supervisory bodies and the international financial institutions interested in such matters, and to put to us expeditiously recommendations for any new structures and arrangements that may be required."

There have been many diverse proposals for creation of a new entity to promote international cooperation on financial supervision issues. UK Chancellor Gordon Brown has called for creation of a Standing Committee for Global Financial Regulation. His Committee would be aimed at filling gaps that currently exist in the international regulatory infrastructure in relation to promoting financial sector stability, and coordinating crisis response. Brown conceives of the committee as a coordinating mechanism – not a political decision-making body, super-regulator or lender of last resort.

Our preference is to press for a Financial Sector Policy Forum, which figured among the recommendations of WG2 of the G-22. In contrast to the UK proposal, the Forum contemplates a broader group including finance ministries, central banks and regulators from the G-7 countries, key emerging markets, relevant international organizations and the IFIs, and would meet less often than the UK-envisioned group. It is also less ambitious in its objectives – an important point for the Fed.

Your letter recommends that Dr. Tietmeyer convene a series of meetings to consult with a interested institutions and a broad range of national authorities to discuss potential options. It also suggests that he make some use of the already scheduled meeting of working group 2 in Buenos Aires in November.

1999-SE-002082

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

12/9/98

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Caroline Atkinson
Senior Deputy Assistant Secretary
International Banking and Monetary Policy

SUBJECT: Architecture Memo to the President

Attached are: Deputy Secretary Summers' cover note; a revised version of the main memo on improving the international financial architecture that includes your recent changes; a brief cover memo from you to Secretary Albright and Chair Yellen and a separate cover memo to Chairman Greenspan; and a copy of the summary of the G7 Deputies retreat that Deputy Secretary Summers has recommended attaching to the memo to the President.

On the main memo, you may wish to review again the following sections, which I changed in light of your comments: I F&G; IV A (third tick); IV C; VI B; VIII B.

Deputy Secretary Summers also suggested sending the President a few recent articles on this topic by academics and others, such as Eichengreen, Sachs and Fischer. If you agree, we could add these to the package.

Tab A: Deputy Secretary Summers' draft cover note
C: Improving the International Financial Architecture memo
B: Cover memos to Albright, Yellen and Greenspan
C: Summary of G7 Deputies meeting (to accompany the architecture memo to the President).

CC: Geithner, Truman, Gensler, Boorstin, Robertson, Knight

December 9, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin

SUBJECT: A New International Financial Architecture

At Treasury we have been giving a great deal of thought to the question of the new financial architecture and the even larger question of how finance fits into the challenge of managing global integration. We have consulted closely with the Federal Reserve, market practitioners, leading academics, and our colleagues from other countries – most recently at a G-7 Deputies retreat. This note and the attached paper summarize our thinking to date.

We recognize that events in Asia, Russia and Brazil, coming on top of the Mexican problem of a few years ago, point to the need for substantial steps to enhance stability. It is also true that the sense of urgency created by these problems may make it possible to accomplish changes that have been desirable for a long time. As important as strengthening the system is, it is clear to us that very little will happen without American leadership.

The Challenge

As you stressed at the Council on Foreign Relations and in your speech in Tokyo, the central challenge of international economic policy is insuring that global integration does not mean local disintegration. That is, we need to manage the greater global integration made possible by technology, economic development, and the spread of the market system so as to enjoy its benefits while minimizing the disruptions of people's lives that can come in its wake.

As recent events in Asia, Russia and Brazil point out very clearly, this challenge is especially pressing in the financial sphere. It is the global financial system that makes trade and exchange possible, and the flow of capital can have enormous benefits in creating opportunities for growth. At the same time, we have seen recently that the breakdown in the functioning of that system can have great economic, social and political costs.

That is why increasing the robustness and stability of the international financial system has to be a critical priority. Finding the right approaches here – as in other areas of managing international integration – means finding the right balance between three sometimes conflicting objectives: integration, regulation, and national sovereignty.

Giving great weight to any two of these objectives is easy. Pat Buchanan's policies sacrifice integration in order to be able to maintain our sovereignty and regulate our markets. Milton

Giving great weight to any two of these objectives is easy. Pat Buchanan's policies sacrifice integration in order to be able to maintain our sovereignty and regulate our markets. Milton Friedman and other conservative economists welcome integration and respect national sovereignty because they approve of the pressure on regulation and taxation caused by competition between jurisdictions. Many idealists, though few practical policymakers, favor much greater global governance and erosion of national sovereignty so as to allow regulation and integration to coexist.

The challenge is properly to balance all three objectives so as to realize the benefits of capital flows, without either giving up nations' ability to set their own course, or setting off a race to the bottom in regulation and taxation as jurisdictions compete to attract capital. Through the first 150 years of our history, similar challenges faced American policymakers as economic integration between the states increased.

Inevitably, the need for balance means a need to find solutions that are eclectic and evolving. Integration cannot and should not be stopped. But it will have to be managed. A smaller world will have to be a world of more common standards, and more international concern and leverage over what would once have been considered domestic policies. But there are limits on the global interference that nations will tolerate. This may in turn limit the pace at which integration can safely increase.

While it is important to avoid blaming the victims of international financial turmoil excessively, it is equally important to recognize that the recent turmoil has had relatively little to do with hedge funds or other large financial institutions shorting currencies or countries. It has had much more to do with countries' own citizens fleeing with their capital, and governments choosing to borrow heavily short term in order to support their currencies or pursue other objectives. It is important, but not easy, to encourage prudent financing practices. Most countries will not welcome our efforts to restrict efforts to lend to them or their companies *ex ante*, even if *ex post* they wish that there had been more regulation.

<u>What Can be Done?</u>

We believe that it is necessary to work to and through the Cologne Summit on the new financial architecture at three levels.

(i) *Improving the stability of capital flows.* This will require:

- Stronger incentives for emerging market economies to adopt policies which will improve their ability to capture the benefits of global capital markets, while withstanding its risks;

- Incentives in industrial countries to encourage more disciplined investment and credit decisions, and to reduce leverage and limit systemic risk;

- A more effective regime for crisis management which aims to minimize the severity of crises while maintaining incentives for prudent private credit and investment decisions.

(ii) *Refinement of the existing institutional structure*. If one were to redesign the two global financial institutions today, it is doubtful that one would replicate their current governance structures, division of labor, or modes of raising capital. At a minimum the current division of labor in the financial system area needs to be altered, and there may well be a case for focusing one institution (the Bank) much more on developmental issues, while the other (the Fund) focuses more narrowly on monetary and financial questions. Careful consideration needs also to be given to balancing the need for conditionality in financial assistance, if it is to be effective, with the need to respect national sovereignty and to avoid political backlash. However, it is also doubtful today that one would be able to obtain political support for the creation of two institutions as ambitious in their conception as the Bank and the Fund. This is something we need to bear in mind as we proceed with institutional reform.

(iii) *Consideration of reforms to the existing governance structure*. At present the G-7 functions as a kind of steering committee for the international financial system. But the advent of EMU and the increasing importance of emerging markets raise questions about its composition and its monopoly over influencing the system.

- The current global bodies concerned with these questions – the Interim and Development Committees – are not really suitable supplements to the G-7 because they have odd representation and are under the control of the managements of the institutions and/ or whoever happens to be the chair.

- The G-22 was a response to many of these problems but confronts real issues of legitimacy, since it excludes some 150 nations that are members of the IMF and World Bank. Designing new governance structures requires balancing two imperatives: the need for more inclusion, and the need for lending countries to retain ultimate control over the lending of their money, control that they cannot cede to borrowers.

<u>Getting From Here to There</u>

A rough timetable of key steps – past, present and future – to bring about architectural changes along these three dimensions is attached. Obviously, developments will depend on how the current crisis evolves. As the focus broadens from the technical financial side to the more political questions of institutional mandate and governance arrangements, it will be particularly important to have interaction at the Head of State level.

Getting From Here to There

Recent "Architecture" Events

Winter 1998. U.S. calls for G-22 meeting of industrialized and developing country finance ministers.

Spring 1998. April meeting followed by agreement to create working groups on transparency, strengthening national financial systems, and managing international financial crises with increased private creditor involvement.

Summer 1998. Birmingham Summit Communique calls for proposals in five key areas. G-7 Finance Ministers agree to report on progress to Heads by end of year.

Fall 1998. President participates in the second meeting of Finance Ministers and Central Bank Governors from the key industrial and emerging market economies. Recommendations from the "G-22" working groups, along with the U.S. proposal for a contingent facility, form the basis for G-7 Heads Statement.

APEC calls for a task force to examine proposals to strengthen prudential regulation of financial institutions, including examination of questions related to highly-leveraged and off-shore institutions.

G-7 Deputies, at a recent retreat, discuss various ways to carry forward ongoing work on architecture, as well as substantive elements on the architecture agenda.

Forthcoming Events

Winter 1998-99. Heads receive report of Finance Ministers detailing procedures for taking G-22 and other work forward.

First G-7 Finance Ministers meeting with EMU takes place. May reach agreement on forum for strengthening cooperation on financial stability among international regulators, IMF, World Bank and national authorities in key industrial and emerging market economies.

Sherpa process likely to agree on "architecture" as a major theme of Cologne Summit.

In response to the APEC communique and the need to maintain the process of broader consultation started in the G-22, the G-7 Finance Ministers are likely to invite other countries to send representatives to a series of ad-hoc meetings on architectural issues.

Spring 1999. Spring IMF/ World Bank Meetings. Possible emerging markets/ industrial countries ministerial. APEC Finance ministerial.

Summer 1999. G7 Head of State Summit. Opportunity for pointing the way towards reform of the international governance arrangements, procedures for increasing regulatory collaboration, and, possibly, changes in the mandates of the IFI's.

Fall 1999. Annual IMF/ World Bank Meetings in Washington. Implementation of agreements on reform.

Getting From Here to There

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Improving the International Financial Architecture

Overview

More than $1 trillion dollars in private capital has flowed from developed to developing countries since the start of the 1990s, bringing new expertise and new investment to the developing countries, as well as contributing to rising living standards. These flows have also helped to increase returns and diversify risks in the developed countries. Yet for all the opportunities that large-scale capital flows bring with them, recent events have reminded us that they also bring new risks. Financial crises such as those we have seen in Mexico in 1994-95 and, more recently, in Asia and Russia, have inflicted immense economic and social damage on the affected countries, imposed heavy direct and indirect costs on the international community as a whole, and threaten to undermine political support for closer global integration.

In the wake of these crises, we all have a responsibility to build a better world financial system, one more adept at avoiding crises and more effective in dealing with them when they strike. Key elements in such a system include:

- stronger incentives for emerging market economies to adopt policies which will improve their ability to capture the benefits of global capital markets, while withstanding its risks;
- incentives in industrial countries to encourage more disciplined investment and credit decisions, and to reduce leverage and limit systemic risk;
- a more effective regime for crisis management which aims to minimize the severity of crises while maintaining incentives for prudent private credit and investment decisions.

The following sets out how we see the main issues, and what steps should be considered going forward. In some cases, work is sufficiently advanced to press for specific actions. In other areas this note points more tentatively to ideas that should be considered, both in our internal discussions and internationally.

I. Improved policies in developing countries

Better policies in emerging markets are needed to promote their domestic stability and to limit their vulnerability to crisis caused by shifts in global capital. We should press--bilaterally and through the international agencies--for the following:

A. *Sound macroeconomic policies.* Countries need consistent monetary and exchange rate policies as well as fiscal policies that avoid excessive accumulation of government debt.

B. *Prudent public debt management.* Borrowing short-term, and in foreign currencies, can be very appealing: it appears cheaper and maybe easier in the short-run. But too much of this kind of borrowing makes governments and countries vulnerable to sudden shifts in investor confidence. In the long-run it can be very costly. Sound debt management is important to provide some "insurance" against the risk of temporary market disruptions.

C. *Stronger financial systems.* The following steps could all improve financial systems: adherence to the Basle Core Principles for Effective Banking Supervision (perhaps with higher capital standards to reflect the greater risks in less mature financial systems); adherence to other international standards now being developed, including for deposit insurance systems and financial sector safety nets; greater foreign participation in emerging markets, to spread better regulatory and risk management practices; the development of a better credit culture in the banking system; and prohibitions on directed lending and on "non-arms length relationships" between lenders and borrowers.

D. *Stronger legal infrastructures.* The Asian crisis demonstrated that for private markets to work effectively, better financial regulation is not enough. There must, for example, also be clear and enforceable bankruptcy laws, so that a crisis in a single bank or company can be dealt with before it spreads; sound corporate governance, so that investors' and shareholders' rights are clear; and strong judicial systems, so that laws in these areas can be enforced and disputes settled fairly and expeditiously.

E. *Development of capital markets in emerging economies.* Greater reliance on equity and other financing that does not result in the build up of excessive debt burdens should limit vulnerability to crises. This could include efforts to develop local/regional capital markets.

F. *Other measures to strengthen governance and fight corruption.* Corruption can undercut economic performance as well as be corrosive politically. Inefficient economic structures also can contribute to corruption.

G. *Well-designed social safety nets.* Strong social policies along side other measures are needed to protect the most vulnerable in society.

In section IV below, some direct steps that countries could consider to limit the buildup of excessive short-term debt are also discussed.

II. Measures to induce emerging market economies to undertake sound policies

Global, private capital markets should play a key role in encouraging emerging markets to strengthen their policy regimes, with investors less willing to lend where policies are poor, and insisting on higher returns to compensate for the greater risk when they do lend. But recent events have demonstrated that market discipline is often sporadic, with periods of easily available capital and little apparent attention to risks, followed by swift and sudden reversals. Official action is needed to strengthen incentives for creditors and investors to analyze and weigh risks with more discipline, and for emerging market countries to follow good policies.

A. *Developing a comprehensive set of codes and standards of good international practice, against which countries' policies can be judged.*

– We would support a major international effort to develop and agree international codes and standards across the range of areas now understood to be critical for financial stability. Standards in some areas, such as disclosure of countries' foreign exchange reserves and how these measure up against short-term liabilities, are already close to being agreed and can soon be implemented. In other areas--ranging from bankruptcy regimes, to corporate governance, to ways to deal effectively with weak banks before the entire banking system is crippled--much work is still needed before there is sufficient international consensus on standards that can effectively raise the bar.

As standards in these areas are developed and agreed, countries need to be encouraged to adopt and implement them. International agreement on an array of codes of good practice, perhaps with benchmarks for performance, provides a device for doing this. Making explicit which countries conform to which codes, and which fall short, could provide a vehicle for using the market to differentiate among those with stronger and weaker regimes.

There are a variety of ways to promote the better practices in emerging economies:

B. *Giving a higher profile to countries' adherence to international standards*, with greater disclosure and transparency about how countries measure up against such standards. The G7 has proposed, for example, that the IMF publicly and regularly report on countries' compliance with the international data disclosure standards developed since the Mexican crisis. The G22 called for a transparency report to be prepared, and published, by the IMF on each country. We should press forward with these proposals.

C. *Stronger international surveillance*. Also key is a strengthening of international capacity to monitor financial systems. This could include a strengthened capacity in the IMF and World Bank to review country performance, including compliance with new international standards as they are developed. As a complement, some form of new independent international accreditation process, perhaps involving the private sector, could also be explored.

D. *Financial market access*. We could also explore whether we should seek international agreement to link access to our markets, and those of other major financial centers, to emerging markets' adherence to appropriate international standards. While this could be a powerful tool, it may be difficult to achieve. Possible measures to consider could include:

– Linking the ability of foreign sovereign borrowers to issue bonds in US and other capital markets to their meeting international standards, e.g. for disclosure.

– Linking the ability of financial institutions to do business in major financial centers to their meeting internationally-agreed minimum standards for disclosure and to adequate home-country bank regulation and supervision.

E. *Linking IMF and World Bank finance to adoption of better practices.* We could press for adherence to international codes to be part of IMF and World Bank conditionality when they lend money, with an explicit timetable for steps to conform to standards, and perhaps prior actions before a program begins.

F. *Technical assistance.* The G7 has asked the IMF and the World Bank to develop a strategy to provide technical assistance to help emerging markets improve their capacity to meet stronger international standards. Their work should be coordinated with that of bank supervisors and regulators of financial institutions.

G. *Exploring additional ways to create incentives for strong policies before, rather than only after, a crisis.* Conceptually, it could be attractive to link treatment of countries in crisis to how they had behaved beforehand, thereby encouraging countries to pursue better policies and avert crisis.

-- Creating an on/off switch for favorable access to official financing to countries that have met certain key "qualification" criteria would not be workable. It would be difficult to avoid politicizing the process of qualification; bureaucrats in international institutions are not likely to be better than markets at judging in advance when a country is likely to run into crisis; and the international community will probably choose to help systemically important countries in a crisis even if they failed to "qualify." Moreover, creditors may be less prudent in their lending to countries that have "qualified," in expectations of a bailout.

-- But it may be worth considering further work to develop a matrix that shows how countries perform across a range of economic and financial areas. We could explore whether this could be a guide to the terms of official finance provided in a crisis: better performers may, for example, be likely to need less conditionality. We could also explore the possibility of incentives (perhaps including differentiated capital charges, discussed below) for private creditors and investors to pay attention to countries' performance. This would add to the pressure for stronger policies. An obvious question mark over such ideas is why the official sector should be any better than private rating agencies at predicting a country's vulnerability or resilience to crisis.

III. Measures to induce creditors and investors in industrial counties to analyze and weigh risk appropriately

Measures to induce creditors and investors in industrial countries to act with greater discipline – i.e. to analyze and weigh risk appropriately in their lending and investment decisions – are also needed to dampen investors' tendency to underestimate certain risks during periods of market euphoria, and thus limit the build up of excessive debt during the upswing. Such measures are key if the market is to play its proper disciplining function. Industrial countries as well as emerging market economies should live up to the internationally-agreed standards and codes and be subject to an improved process for international financial sector surveillance.

There are two distinct issues in this area, both linked to measures to strengthen industrial country prudential regulation. The first concerns finance for emerging market economies. The second concerns the broader question of systemic risk in the system as a whole and in major financial centers, highlighted by the near-collapse of LTCM. An international task force to examine measures to promote safe and sustainable capital flows, including questions related to "hedge funds" and off-shore centers, should be set up to take forward work in these broad areas, as called for in the APEC and G7 communiques.

A. *Strengthened risk management systems.* There is a clear need for increased focus on the quality of risk management systems in financial institutions. These systems should also be systematically stress-tested to show the potential impact of unusual changes in financial markets. Regulators need to consider how best to foster the use of high quality risk management models.

B. *Greater differentiation in bank capital standards.* A review of the existing Basle Capital standards is already underway. This will consider greater differentiation in the capital charges on different assets and retuning the existing standards, e.g. to address current biases in favor of short-term interbank lending and riskier corporate borrowers. Higher regulatory charges on riskier assets should prompt lenders to demand higher returns and help focus management attention on risky lending.

- Consideration could be given, for example, to differentiating capital charges on the basis of a set of criteria related to risk, such as poorly-regulated or unsophisticated financial systems, or on loans to highly leveraged financial entities.

- The first would require the official community to make more judgements about the riskiness of different countries, which would be both politically and technically difficult. However, a more refined, if admittedly imperfect structure, would be better than the present crude distinction embedded in the Basle standards, which favor loans to OECD countries over loans to non-OECD countries. It could draw on a matrix (see II.F) that measures countries' performance against international codes and standards.

We could also explore whether to seek regulatory and disclosure changes aimed more broadly at reducing leverage and systemic risk in financial markets. The direct regulatory focus here, as in many other countries, is on the health of individual financial institutions. But at times, what may be prudent for a single lending institution can turn out to be problematic for the system as a whole, if a very large borrower is able to obtain credit to build up exposures that could endanger broader financial stability. One aspect of this is to seek and publicize information about borrowers' total exposure–for countries we are pressing for much better data in this area through the Bank for International Settlements (BIS).

Other possible changes would put greater regulatory focus on the systemic risk that can be created by a wide range of institutions, including institutions that are not currently regulated. For example, the regulatory net could be extended to cover all institutions above a certain size. But far-reaching changes would be politically difficult in the United States – indeed, more difficult in the U.S. than elsewhere given the diversity of our existing regulatory structure, and breadth and sophistication of our financial markets.

Measures that have been suggested include:

C. *Higher overall capital adequacy standards*. If financial institutions are made to hold more capital overall in relation to the total risks in their balance sheet, the total amount of risky lending activity that can be supported by the existing capital base would go down. (Higher capital standards in emerging markets may also be appropriate, even if we do not pursue this in major industrial countries.)

D. *Broader margin requirements*. Consideration could also be given to whether some existing gaps in the margin system should be closed, and more broadly, whether current margin requirements, e.g. on OTC and listed derivatives, are sufficient. Since in some cases margins can be borrowed, margin requirements may not by themselves decrease leverage.

E. *Disclosure standards*. Greater disclosure by industrial country banks and investors of their exposure to higher categories of risks could increase market discipline and discourage the buildup of imprudent exposures. Disclosure is not without its difficulties; open disclosure of actual positions could well undermine financial markets.

- One potential approach is to demand additional disclosure from the banks and other financial institutions that lend to the highly-leveraged institutions ("hedge funds").
- The G7 has agreed to consider the questions raised by disclosure and transparency standards for highly leveraged institutions themselves. It may be more promising to explore whether to extend to other markets (and encourage in other countries) reporting to regulators of large positions in a particular market.

F. *Measures to limit the scope for off-shore regulatory and tax havens.* Strengthened regulation in major financial centers would be undercut if financial and capital market activity merely moved offshore. This is a very difficult area: effective action would need widespread international agreement. Some possible, but controversial, measures that have been suggested include:

- Preventing major financial institutions from establishing branches or subsidiaries in off-shore centers, so that the financial institutions in such centers have to borrow on the basis of the strength of their own balance sheets.

- Conditioning the access of unregulated foreign financial institutions and hedge funds to the major financial centers on their compliance with key regulatory and disclosure standards.

IV. Limitations on the flow of capital

The recent experience of a number of countries has underscored the risk of capital account liberalization that is not paced to the maturity and development of the domestic financial system and broader economy – and, in particular, the danger created when governments in emerging markets actively encourage risky short-term borrowing. We should consider the scope for developing principles to guide countries that are liberalizing and opening up their capital markets on how reduce the vulnerability of their financial systems to sudden shifts in capital flows. These could include, for example, a focus on encouraging longer-term, equity financing with an open policy to foreign direct investment.

A. *Restraints on capital inflows.* A range of possible measures could be considered that may help to discourage imprudent foreign currency borrowing, while relying on market mechanisms to the extent possible. However, it is worth remembering that most countries that have recently experienced trouble have sought to encourage capital to flow in, rather than tried to deter it.

- Prudential bank standards, such as limits on a bank's open foreign currency positions, if enforced effectively, should reduce the riskier kinds of foreign borrowing by banks.

- Some countries have experimented with regulatory requirements that force their banking systems to maintain a "liquidity buffers" to protect against the risk of a sudden shift in funds out of the banking system. Argentina, for example, has required banks to maintain large, liquid reserves against their short-term liabilities, including their short-term foreign liabilities.

- More controversially, some have suggested wider use of market-based, Chilean-style restraints on all capital inflows to deter short-term foreign borrowing by both banks and domestic corporations. The effectiveness of such controls has been questioned by some, in particular for countries with weaker economic policies than Chile.

B. *Limits on capital outflows.* Controls on capital outflows differ fundamentally from well-designed restraints on capital inflows, aimed to curb the borrowing that makes countries vulnerable to market shifts. Temporary controls on capital outflows introduced after crisis has hit, in a general attempt to insulate an economy from the rest of the world, are likely to repel new capital inflows, create inefficiencies, and prove difficult to sustain for long. They may also make more tempting policy errors that will worsen long-term prospects. Only in extreme circumstances, as part of the mechanism of a debt workout when the international community agrees that a country simply cannot afford to pay, is their consideration likely to be justified.

C. *Reducing the amount of trading activity.* In addition to considering whether measures to help restrain capital inflows make sense, we need to consider whether reducing the amount of trading activity – e.g. as a side effect of higher capital charges or stronger margin requirements, or even, as some have suggested, in response to a tax on trading activity (Tobin tax) – would make the international financial system more stable, or only less liquid.

- Some argue that reducing the overall volume of trading activity would make it easier for countries to adopt policies to respond effectively to crisis, maintain macroeconomic stability and avoid sharp surges in inflows/ sudden outflows. Emerging market economies are particularly vulnerable to swings in capital markets.

- Others argue that limiting trading activity would make it more difficult for markets to allocate risk efficiently. It could reduce the benefits associated with the free domestic and international capital markets, without offsetting increases in stability. Liquid markets may be necessary for successful hedging – i.e., protecting yourself against certain risks. Moreover, a small tax on trading activity, even if feasible, would also be unlikely to deter the major swings in capital flows that occur in financial crisis.

V. Exchange rate regimes

Devising appropriate exchange rate regimes, both for individual countries and for the system as a whole, is one of the central issues for the international system.

A. *Currency arrangements between the major industrial countries.* The major currencies in the system have floated against each other since the collapse of the Bretton Woods fixed exchange rates in the early 1970s. This has allowed the U.S. and other major industrial nations with floating rates to aim domestic monetary policy principally at domestic objectives, which is appropriate for large economies for whom trade is a relatively moderate share of the economy. But it has also produced large swings in the exchange rates of major currencies, which at times do not seem to have reflected changes in the underlying economic fundamentals.

- These large swings in the exchange rates among the currencies of major industrial countries have led to proposals to create target zones for the three major currencies, to limit the size of fluctuations.

- However, we believe that the current system provides the best policy option for the United States and that a shift away from floating would likely involve an unacceptable loss of macroeconomic policy flexibility.

B. *Appropriate exchange rate regimes for smaller countries.* Given that large fluctuations between the currencies of major countries economies are likely to continue, that many emerging markets have extensive trading ties to a number of large industrial economies, and that the credibility of the policy environment in many emerging markets will take time to establish, the choice of an appropriate exchange rate for an emerging market economy is particularly difficult. Rigid exchange rates have been a common feature in recent crises, yet most emerging markets have been reluctant to accept the vagaries of a pure float.

- Exchange rate regimes are institutional choices that signal policies, priorities, and commitments. There is not a single exchange rate regime that is best for all countries: rather the choice must be based on a country's circumstances.

- No matter what exchange rate an emerging market economy chooses, it is critical that it be backed by a consistent policy regime. Macroeconomic stability is based on good policies, irrespective of the exchange rate regimes. Adjustable exchange rate regimes can be used to help absorb external shocks, but they cannot substitute for sensible policy making.

- Moving from one exchange rate regime to another, particularly in a crisis, can be particularly destabilizing. A key question is how to reduce the risks associated with such movements. Countries which have adopted fixed exchange rates to eliminate inflation have often held on to fixed exchange rates for too long.

- During periods of crisis and financial chaos, experience shows that it may be better to select a regime that is at one or the other end of the exchange rate spectrum, either extremely flexible (a pure float) or extremely rigid, such as a currency board. Such clarity facilitates policy-making during difficult times.

C. Some have suggested that more far reaching changes in the international monetary system could be considered for the longer-term, such as the development of regional currency blocks and/or "dollarization."

- The experience of Europe has shown that both extensive economic integration to support a common monetary and exchange rate policy and a strong political commitment are needed for a successful currency union.

- Adopting the dollar or another international currency as the legal local currency provides more exchange rate stability than a currency board, but requires an explicit and transparent loss of monetary sovereignty.

VI. Crisis Response

There is a spectrum of crises, from those that stem primarily from poor policies to those that stem primarily from contagion. In practice, most fall somewhere in the middle. A regime for crisis response should provide for some combination of financial assistance and policy changes. The provision of large-scale official international finance raises difficult questions: what criteria should be used for access to large scale assistance, and on what terms; how should it be linked to private sector involvement; and where will the required resources come from.

A. *Provision of official finance.* Just as there is a role for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability.

-- The proposed new IMF precautionary facility will allow large-scale international assistance in the form of a line of credit with appropriate conditionality rather than a traditional, highly-tranched package, so as to facilitate the rapid restoration of confidence for those cases where problems stem more from contagion than from poor policies.

-- It may often make sense in today's world of large and sudden liquidity needs for more official money to be available up-front in return for more up-front policy changes, than in traditional IMF programs.

The current crisis has demonstrated that the official community needs, at times, to be able to provide huge financing packages to quell potential contagion and instability. The increase in the IMF quota due to go into effect shortly will provide the IMF with an important pool of new, uncommitted funds. The World Bank currently has the capacity to provide additional resources, but its lending capacity is not unlimited. Still, the resources available to the International Financial Institutions in the foreseeable future are dwarfed by the scale of current cross-border capital flows. They are also smaller in relation to GDP and world trade than envisaged at the time of Bretton Woods.

-- Some have argued for bolder and politically difficult measures to be put on the agenda, aimed at increasing sharply the available official resources.

  – One such suggestion has been to increase IMF quotas dramatically, perhaps also indexing them to growth of the world economy to assure their continued relevance, and increasing the amount that countries have to pay in and can use in crisis. Countries have automatic and unconditional right to use their "reserve tranche" or paid in capital, but today this is not a significant benefit in times of financial difficulty.

  – Another possible, but also politically difficult, idea that some have argued for would be to allow the IMF to issue additional SDRs (perhaps at a higher interest rate to discourage unnecessary use) to increase the amount of liquidity in the system.

B. *Private sector involvement.* Private sector participation in the resolution of international financial crises is critical to the long-run health of the international financial system, both because of limits on the availability of official funds and of concerns about moral hazard. The type of private sector involvement required by the official sector as a condition for its assistance should vary, depending on the nature of the countries' difficulties.

-- The theoretical ideal towards which the international financial system should move over time is that private sector creditors and investors should bear as fully as possible the consequences of the risks that they voluntarily assume.

– We could consider if there are ways to develop the system so that it is clear that investors who have made risky international investments, and earn large risk premiums in the best case, are not repaid in full if the country experiences a crisis that requires official intervention.

– We need to examine how to avoid creating categories of debt that are treated as senior (paid even when other debts are not being paid) because of difficulties associated with its restructuring. Russia, for example, has defaulted on wide range of domestic and foreign debts, but Russian authorities currently want to continue to maintain payments on Russian Eurobonds, by, in part, using funds obtained from the debt relief granted by other creditors.

– In practice, finding appropriate ways to involve the full range of private creditors in the cooperative resolution of a crisis can be difficult. Concrete options for involving the private sector will continue to need to be explored. Already different models are being developed for different circumstances (Korea, Brazil, Ukraine).

– It can be difficult to convince the private sector to participate voluntarily – particularly if the relevant private creditors are numerous and diverse.

– More coercive means, including support for official lending into accumulated "arrears" on private debt payments, could be employed to generate stronger incentives for broad-based private sector participation. But coercive measures risk prompting additional contagion, so must be used cautiously.

– The expanded use of "collective action clauses" in sovereign bonds issued in foreign offerings also could facilitate the orderly, cooperative restructuring of these bonds.

The members of the G-7 have committed to examine whether to introduce such clauses into their own sovereign bonds issued in foreign offerings.

– It may also be useful to explore ways to encourage emerging markets to purchase more "insurance" against adverse developments, through contingent facilities and debt contracts that contain contractual arrangements that provide greater payments flexibility.

VII. Social Safety Nets

Possibilities for helping to minimize the social impact of financial crises include

A. Granting the World Bank a larger role in the design of international economic policy programs, which would bring both the financial resources and social sector expertise of the World Bank to the table quickly in a crisis.

B. Development of a code of best practices in social policy, as called for in the G7 statement, which could be drawn upon in the design of IMF and MDB programs.

VIII. Institutional Reforms to Carry Forward the Agenda

It may be possible to obtain consensus for a set of institutional changes that would help both implement our architecture agenda and improve international monetary and financial coordination.

A. *A new financial stability policy forum to improve financial sector policy coordination.* We are proposing the creation of a Financial Stability Policy Forum that would meet semi-annually to discuss regulatory policy issues in an inclusive forum that would bring together financial regulators, the relevant international organizations and national authorities from both industrial countries and key emerging markets. It would create an informal, cooperative mechanism at the global level to discuss financial regulatory policy issues that affect the international system, replacing the series of ad hoc groups that have been set up over the last few years. We will be discussing this proposal with Hans Tietmeyer, who was asked by the G7 to look into this issue, and other G7 members.

B. *Ways to strengthen the interchange between industrialized and emerging market economies.* The G22 process worked well, as a way of promoting discussion between the G7 and other industrialized and emerging market economies. But some have raised questions about its legitimacy. We need to consider how best to retain the ad hoc and informal nature of the G7 process while including systemically significant emerging markets on a regular basis. Some favor strengthening the Interim Committe of the IMF, where all 182 countries are represented. However, the IMF mandate does not extend to all of the issues--the World Bank also would need to be represented for example – and the present Interim Committee constituencies are not well balanced (Asians are under-represented, Europeans are over-represented). We will need to work on these issues, as well as how to bring together the IMF and World Bank with the Basel-based groups.

C. *Redrawing the lines between the IMF and the World Bank.*

- One possible reorganization would transform the IMF into an "International Finance Organization," responsible for macroeconomic and financial policy surveillance and the provision of financing to systemically significant economies, and the World Bank into a "World Development Organization," centered around development advice and subsidized lending to the poorest countries. However, this would raise the question o f how to draw a dividing line between different categories of countries, and how to avoid duplication of expertise.

- Another proposed reorganization that may be worth exploring would refocus IMF surveillance and program conditionality on exchange rate regimes, balance of payments, macroeconomic policy and the soundness of the financial sector. The IMF would get out of the business of structural reform and subsidized lending, while the World Bank would transfer all responsibility for financial sector surveillance and restructuring to the Fund.

D. *More dramatic institutional reforms.* Possibilities include merging the IMF and World Bank, or merging the IMF's Interim Committee and the World Bank's Development Committee. Merging the two institutions would create lots of chaos. Merging the Interim and Development Committees is one of the reforms being considered as part of our effort to find constructive fora for interchange between industrialized and emerging market economies.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM FOR MADELEINE ALBRIGHT
Secretary of State

JANET YELLEN
Chair, Council of Economic Advisors

FROM: Robert E. Rubin

SUBJECT: Architecture Memo to the President

As you know, we at Treasury have been giving a great deal of thought to the question of the new financial architecture and of how finance fits into the challenge of managing global integration. I attach a memo to the President that summarizes Treasury's thinking on this subject to date.

I very much look forward to discussing these issues with you. These are complex topics, and moving forward will take lots of time and work from us all.

Attachment: Improving the International Financial Architecture

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WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM FOR CHAIRMAN GREENSPAN

FROM: Robert E. Rubin

SUBJECT: Architecture Memo to the President

The attached memo to the President that lays out Treasury's thinking to date on the international financial architecture. It sets out many of the ideas that you and I have discussed recently. I look forward to continuing our discussion of these issues.

Your staff has seen earlier versions of this memo.

Attachment: Improving the International Financial Architecture

United States Treasury Note Regarding
Meeting of G7 Deputies and Deputy Deputies
Lansdowne Conference Center, Virginia, November 21-22

The discussions covered a wide range of issues raised for the international community by the events of the past eighteen months. While not producing a clear consensus on future reforms, there were substantial areas of common ground on the causes of the crisis and on core issues that the review of the international financial architecture would need to address. This note summarizes the main points raised on an unattributed basis.

I. Lessons for Emerging Market Policies

1. Exchange Rate Regimes

There was broad agreement that problems with fixed but adjustable exchange rate regimes had been a central element in nearly all 1990s financial crises and should be a greater focus of international surveillance going forward. However, given the fallibility of judgments about "equilibrium" exchange rates and governments' deep reluctance to follow international advice in this area, there was a question about how this lesson could be translated in practice.

Main points:

- using the exchange rate as a device for disinflation tended to court overvaluation problems because of continued inflation differentials. Even adjustable pegs tended to harden into symbols of the authorities' overall credibility, making early adjustment extremely difficult politically. ("It is better to devalue sooner than later, but it is actually easier for politicians to devalue later, when there is no alternative.") Long experience with a fixed system also heightened the difficulties of establishing a credible alternative after devaluation; as, for example, in Indonesia.

- nearly all post-1992 crises had come from the combination of exchange rate misalignments, on the one hand, and on the other, a major weakness in the system -- such as a weak banking system -- that made investors doubt the government's credibility in defending the peg. This gave rise to the suggestion that countries relate the degree of fixedness of the exchange rate to the depth and maturity of the domestic financial system.

- one conclusion drawn was that countries should give up trying to import price stability through the exchange rate and instead seek to target the real exchange rate within a system of "controlled flexibility". The authorities would signal to the market that the exchange rate would depreciate in line with the inflation differential, and major misalignments resulting from nominal inertia would be avoided.

- on the other hand, it was pointed out that past attempts to target the real exchange rate had not been very successful (many of the recent crisis countries had in fact been on crawling peg regimes). In part this was because the "equilibrium exchange rate" was very difficult to calculate at any point in time and subject to significant real shocks. In addition, such a system did not provide a clear response to *upward* pressure on the exchange rate in periods of rising capital inflows.

- an alternative lesson from recent events was that -- in a world of relatively free capital flows -- countries would increasingly be driven away from the middle ground of fixed but adjustable exchange rates towards the extremes of "permanent fixing" (as with a currency board) or a pure float. All noted that currency board regimes had so far emerged unscathed in the crisis. However, it was considered striking how few emerging economies today opted for the vagaries of a pure float.

2. *Strengthening Financial Systems*

All agreed that the domestic financial system had been an important factor in the crises in emerging economies, and that greater efforts needed to be made to encourage countries to match the openness of their capital market to the robustness of their domestic financial system.

Main points:

- the crises had underscored the importance of countries pursuing a gradual, or paced approach to opening the capital account. In particular, it was argued that countries should begin with those liberalization measures that strengthen the domestic system, such as opening the system to foreign participation. Far from pursuing such a paced approach, it was noted that many of the crisis countries had actively sought out short-term, risky foreign borrowing while neglecting the development of the domestic financial infrastructure.

- countercyclical "taxes" on inflows or prudential standards, to help check excessive short term inflows in the boom years, were also supported by several participants.

- there was agreement that the international community's efforts to encourage improved regulatory and supervisory systems in the emerging economies had not been very successful. This pointed to a need for more "muscular" forms of encouragement, perhaps making use of international "rating" of national supervisory and regulatory systems. However, several voiced scepticism about the capacity to put such a scheme in place very quickly.

- conditioning access to major financial centers on the quality of home regimes was suggested as a more readily available incentive mechanism. However, it was thought that the authorities already did this informally in several countries, and there was a question whether it was important enough to emerging market economies to make a difference.

II. Promoting Safe and Sustainable Capital Flows and Constraints on Suppliers of Capital

1. Private Sector Contribution to the Crises

There was some agreement that the suppliers of capital in developed markets shared some of the blame for the crisis, both in their excessive risk-taking in boom times, and excessive panic afterwards. While curbing the excesses of international credit cycles was clearly desirable, there was some uncertainty as to how this might be achieved.

Main points:

- there had clearly been an element of "innocent" contagion in recent events, notably in the market pressure on Latin America following the Russian collapse, although opinions differed on the relative distribution of responsibility. The point was made that the markets still "attacked countries in the right order", (ie. with reference to relative policy imbalances).

- while exchange rate misalignments had played an important role in several crises, it was said that countries could now be forced to devalue, even where the rate was not clearly out of line with competitiveness. The international community should insist on countries addressing genuine currency misalignments. But it should also help countries without fundamental imbalances from being forced to devalue by the markets.

- the point was made that the emerging market crises should be considered part of a longer run problem of a "global outburst of liquidity" into emerging market asset markets that had now gone dramatically into reverse. During this period, investors were thought by some to have exercised less prudence in their international lending than their domestic.

- to reduce the scope for such behavior, there was considerable support for changing the Basel risk-weighting system, both to reverse existing biases and to begin to develop greater differentiation in the treatment of emerging market and developed market investments. Possibly, these could be made countercyclical, rising in times of times of heavy lending on the grounds that this was when lending tended to be less prudent.

- there was also a desire to impose greater transparency and disclosure requirements on offshore operations and other nonregulated entities, including hedge funds.

- in addition, the question was raised whether formal rules -- imposed *ex ante* -- requiring creditors to bear some of the burden of adjustments in the event of crisis might also discourage excessive risk-taking by the suppliers of capital. However, this raised a range of concerns, discussed below (Section III, Part 3).

III. The International Response to Crises

1. Content of Adjustment Programs and the Scope of Conditionality

Debate focused on the perceived flaws in the IMF and World Bank's support for troubled economies and on the inherent conflicts in designing adjustment programs -- in particular, balancing the desire to address the structural causes of crises against the need to respect national sovereignty.

Main points:

- some believed that the IMF had focused too much on tightening monetary policy in the Asian programs, particularly Indonesia, and not enough on providing liquidity to restore confidence in domestic financial systems. However, against this had to be considered the hyperinflationary risks of failing to rebuild confidence in domestic assets and the possible need for drastic steps to achieve this in an environment of panic.

- there was some agreement that IFI programs needed to be broader if they were to address the kinds of structural and governance problems that were thought to have contributed to the recent crises. In Russia, in particular, it was noted that the relative allocation of international funds to "macro-stabilization" and "micro-structural" programs had been excessively skewed toward macro measures, in part because of the World Bank's apparent difficulty in finding worthwhile projects to pursue.

- on the other hand, several felt that IMF programs -- particularly in Asia -- had intruded excessively on the choices of sovereign governments in imposing detailed structural and other reforms that were not directly relevant to the problem at hand. Many Asians, in particular, had felt that the IMF's conditionality had been ideological in imposing a "Washington Consensus" that was not universally accepted.

- in this context it was suggested that one might distinguish the scope of programs from the content. Where basic fiscal/ monetary imbalances were concerned, there were perhaps "not many ways to skin a cat". But in other areas -- for example the Indonesian clove monopoly -- there was a question whether it was appropriate for the international community to impose particular choices, however worthwhile these might be thought to be. It was accepted that this needed to be squared with the aforementioned desire to broaden the scope of programs to address governance and related issues.

- the point was made that the unpopularity of IFI programs was perhaps inherent in conditionality, and inevitable where governments had long followed the opposite policies. By imposing such changes, the IMF could serve a valuable function for the G7 and provide cover for difficult but necessary reforms in the recipient countries. However, it was important that the World Bank and IMF maintain a united front and there was a widely-felt concern that the World Bank had not taken sufficient public ownership of joint IMF-Bank programs in Asia when these had come under criticism.

2. Precautionary Mechanisms

There was some agreement on the desirability of "precautionary" and other mechanisms, both to help restore confidence at times of generalized market panic and to provide an incentive for basically sound countries to adjust policy sooner.

Main points:

- recent events had highlighted the value of maintaining relatively high levels of foreign reserves (notably, in the case of Brazil). Several Asian economies were said to have concluded that they should build up very substantial reserve levels to protect themselves.

- given that it is costly for countries to hoard reserves -- and destabilizing for the world system for everyone to be trying to do it at the same time -- there was a question whether there ought to be a general increase in SDRs to provide additional, unconditional funds to fend off contagion.

- however, many felt that the international community was unlikely to support what would be perceived as a major expansion of IMF resources. No amount of reserves would prevent a crisis where monetary and exchange rate policies were unsustainable. And to the extent that countries made use of the new -- unconditional -- liquidity it might simply end up subsidizing bad policy.

- consideration was being given to the possibility of countries "pre-qualifying" for some form of contingent reserve facility from the IMF. However, this raised some of the same concerns about conditionality, not least given the international community's previous difficulties in identifying "model" countries. (It was noted that when a similar facility had been discussed in early 1994, Mexico was considered a prime candidate.)

3. The Scope for a Lender of Last Resort and Private Sector Involvement

There was a widely-held belief among participants that both the practical constraints on international official finance and a concern for moral hazard pointed strongly toward finding more effective ways to involve the private sector in resolving crises. But there was considerable disagreement about how, and whether, this should be determined ahead of time -- and the scope for a more effective international lender of last resort.

Main points:

- it was suggested that financial crises might be viewed as a continuum, with "pure" liquidity problems at one end, and "pure" insolvency problems at the other. Most crises tended to be somewhere in between, and it was impossible to draw clear lines around the different types But the international community needed to retain the capacity to respond to crises that are primarily seen as liquidity crises, even if using this capacity to respond to all crises would be highly undesirable.

- on the other hand, all agreed that moral hazard and basic ethical considerations called for a system that would punish reckless lending. Accordingly, several argued for *ex ante* rules to allow the imposition of temporary standstills and controls on outflows when crisis struck -- to enable orderly work-outs and prevent "irresponsible" creditors being rewarded at the expense of either other investors or the international community.

- however, it was noted that any such measures would bring a range of practical difficulties and also important risks. In particular, there was a risk that imposing any such rule would make crises more likely, by giving investors an incentive to remove their money earlier. In that sense, the problem of finding ways to penalize investors was less a technical problem than a problem of judging how other investors would react.

- against this, it was argued that most developed markets had systems in place for dealing effectively with each kind of problem at the domestic level and it was not obvious why the same two systems could not be constructed internationally. Also, it was said that to the extent that flows to the developing were already depressed, this might actually make it the perfect time to introduce new rules. Even if there were a long-term reduction in flows to the emerging economies, this would not necessarily be such a bad thing given their apparent incapacity to absorb these flows productively.

- moreover, as a practical -- and political -- matter, there was a widespread belief that the international community was unlikely to make available the kind of resources that would be required to have a truly global lender of last resort, especially where this was perceived to serve the interests of irreponsible investors.

- in light of these considerations, it was felt that the treatment of very high-yielding sovereign debt were worthy of particular attention going forward. Such debt played a key role in triggering crises in Russia and Brazil -- neither of which had especially high levels of public debt by international standards -- and could not be said to have been "innocently" taken on by investors.

- all were agreed that it was extremely undesirable for such investors to be fully paid off in countries that are presently, or soon likely to be, the recipients of substntial official finance. However, the extreme hesitance to force private sector rollovers of sovereign short-term debt in the case of Ukraine, a country in which there had been a widely accepted moral hazard element to past lending, was suggestive of the problems involved in applying this principle into practice.

NCC to RER (ACTION)

OASIA (Sonal Shah) to LS (ACTION)

NCC cc to MF

SS

NC/DI/PA/AK

12/9/98

Please hold until

RER reviews then

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