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PRESIDENT'S FISCAL YEAR 2003 BUDGET

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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PRESIDENT'S FISCAL YEAR 2003 BUDGET

TUESDAY, FEBRUARY 5, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:36 p.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Breaux, Graham, Jeffords, Bingaman, Lincoln, Grassley, Hatch, Murkowski, Snowe, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

I am delighted to welcome our Treasury Secretary, Paul O'Neill, for his third appearance today as Secretary of the Treasury.

Mr. Secretary, your testimony comes, obviously, at a very critical time with all that is happening in the United States and in the world. We face, obviously, great challenges.

As the President said in his State of the Union address, we must win a war, protect our homeland, and revive our economy.

The question is, how can we meet these challenges? Where, for example, do we find the resources? In large part, the solutions to this is about our National character. We must find the resources in our hearts, our homes, in our communities.

It is attitude, working together, lending a hand to each other. But it is also, in part, a question of economic resources, of dollars and cents, which brings us here today.

In the same way that a husband and wife need to sit down occasionally and discuss the family budget, we need to discuss our National budget. The President's budget establishes a solid framework. In a time of war, national security comes first. We all agree with that, even if it means we must, reluctantly, postpone the day when we finally pay off the national debt.

We also must take steps to revive the economy. We agree that we must meet other important national objectives.

For example, 43 million Americans lack health insurance. Many seniors pay the highest prescription drug prices in the world. Clearly, two of several other matters that should be addressed. We agree on the broad outlines, but we must work together to resolve the details.

Let me describe several areas. First, the long-term budget outlook. The contrast is stark. A year ago, the projected 10-year surplus was $5.6 trillion. Today, under the administration's estimates, it is $1 trillion; $5.6 trillion to $1 trillion.

We need to get beyond the debate about the cause of the dramatic change. Instead, we need to decide what to do about it. How do we get back on the path to a balanced budget?

Why is this important? In just 6 years from now, the first wave of the massive baby boom generation will be eligible for Social Security. Just 6 years from now. After that, wave after wave of retirees will follow. By the year 2030, less than three decades from now, the number of seniors in the United States will be almost double the number that existed last year: 36 million seniors today, 69 million seniors in the year 2030.

That is not the end of it. Once the baby boomers retire, there will be relatively fewer workers to support them. In the year 2000, there were 3.4 workers for every beneficiary. In the year 2030, there will be 2.1 workers per beneficiary.

What does this mean? Higher costs for Social Security. That is, either higher taxes, payroll taxes, or lower benefits. The same for Medicare. Not just a little bit, but hundreds of billions of dollars in difference.

If we are going to cope with these costs without cutting benefits to seniors, we are going to have to figure out some way to prepare.

How? One of the best ways is invest the Social Security and Medicare surplus in order to pay down the debt. That will reduce our interest costs in future years. In turn, it will make it easier to pay for our increased Social Security and Medicare costs.

But this budget, unfortunately, falls short. Ten years from now in fiscal 2012, the budget is still using $73 billion of Social Security surpluses and $75 billion of Medicare surpluses.

Over the next 10 years, the budget proposes to use $1.4 trillion of Social Security surpluses and $600 billion of Medicare surpluses for other purposes rather than retiring the debt held by the public. Given this, I think we need to find some more balance as we work on determining our priorities.

The second area in which, to my mind, we need further work, is health care. The President has called for broader prescription drug coverage. During our negotiations, as you will recall last year, we found it was hard to come up with a program without charging seniors high premiums, high deductibles, or both.

Unfortunately, the budget the administration presents, I think, moves in the wrong direction because it proposes only $190 billion for a new prescription drug program. As you will recall, last year we were discussing $300 billion, and even that required high deductibles.

The third area where we need further work, is highway funding. The President's budget proposes to spend $9 billion less for the highway program in fiscal 2003 than in fiscal 2002. This will be devastating to every State in the country, including my State of Montana, and it comes at precisely the wrong time. The cuts will reduce the number of highway construction jobs just when we need to be increasing them.

Obviously, the Treasury Department does not have primary responsibility for the highway program. However, some of the problems that we are having directly result from errors in estimating highway user tax revenues. That is the responsibility of Treasury.

In any event, I want to send a strong signal. There is a $20 billion surplus today in the Highway Trust Fund. We should be using it to build highways.

One other issue that is not primarily part of the budget debate but is on everyone's mind, Enron. This committee is responsible for our country's pension funds and our tax laws. Enron has implications for both, a mix of stock and 401(k) plans, the black-out period, hundreds of entities that are offshore and off the books.

This committee will take a hard look at these issues. We are not looking for headlines, we are looking for solutions. We will undertake a steady, solid, vigorous investigation.

I know, Mr. Secretary, that you have been paying close attention to these matters and we will be interested in learning your views, both today and in the future.

Finally, on a personal note, let me congratulate you on your first year in office. When you came before us a year ago as the President's nominee you said that you would speak your mind. You said you would look for facts rather than speculation. You said you would try to solve problems rather than score political points.

You have been true to your word. In fact, I cannot think of anyone in the administration who has tried harder to find solutions that work for the American people.

I was especially struck by your efforts during our discussions on the economic stimulus bill last year. You were always there, always listening, and more than that, always working to try to find a constructive, solid solution.

For those who may not know, I would like to say, Mr. Secretary, that I do not know anybody in the last year, in the fiscal stimulus discussion, who worked harder than you to try to find a solution, irrespective of political points and irrespective of political demagoguery. You were there.

I must say that sometimes you and I were the last two standing last year, but I think in a deeper sense you were the last one standing still, at the last moment, trying to get an agreement. So, I thank you very much for that.

Secretary O'NEILL. Thank you very much, Mr. Chairman.

The CHAIRMAN. Ordinarily, Senator Grassley would next speak. But we have an early bird rule and, according to my chart here, Senator Graham is next. After Senator Graham it is Senator Thomas, Senator Murkowski, Senator Bingaman, and I see Senator Hatch here. We will make sure you are added to the list.

Senator Murkowski?

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Well, somebody has got to be the exception, and I will take the opportunity. I am always an exception.

The CHAIRMAN. Because you are exceptional.

Senator MURKOWSKI. Well, I should quit while I am ahead, but I am not going to. [Laughter.]

Mr. Secretary, I want to chat with you a little bit about energy and natural gas. As you know, our Nation is pulling down its natural gas reserves as a higher rate than we are producing and finding new gas.

There are about 37 trillion cubic feet of gas that has been discovered on the north slope of Alaska in conjunction with the development of the Prudhoe Bay oil field. This is proven reserves. It is the largest reserve known to exist in North America.

The problem, of course, is getting the gas to market. As a former Alaskan, having gone to school in Anchorage, you are aware of what natural gas has meant to our State.

It is estimated that building that 2,700-mile pipeline, or thereabouts, would cost somewhere between $15 and $20 billion. It would be the largest construction project in the history of North America, and employ a thousands of Americans in the project.

Some of the producers, however, tell us the only way that the project's economics make sense is for there to be a tax credit floor on gas. An example of how it would work, if the price of gas at the Henry Hub in the lower 48 was less than $3.75, the producer would get a tax credit that would make up the difference.

For example, if the price was $2.75, the producer would get a $1.00 tax credit. If the price was $3.00, the tax credit would be 75 cents and the credit would be capped at $1.25.

Now, it is vital that the gas get to market. But can you give me an offhand view of Treasury's view of such a tax credit for this project? I would remind you that tax subsidies for energy include the Section 45 credit for electricity for biomass, the Section 29 tax credit for energy from coal bed methane, and some administration proposals on expanding of the Section 45 tax credit to buy hybrid vehicles, tax credits for energy from landfill gas, tax credit for combined heat and power properties.

So, it is not unique. But, nevertheless, this project is of significant magnitude. The question is, can it be built without some kind of an incentive or tax credit? Could you give me Treasury's view?

The CHAIRMAN. I might say, Senator, it is a penetrating question. But we are in the statement session here right now. I want to give the Senators a chance to make any statements before we get into a dialogue.

Senator MURKOWSKI. Well, I will ask that the Secretary respond when he has an opportunity.

My second statement, if you will, concerns a graph behind me, a chart. I would like to call the attention of my colleagues to it because, as we discuss the Enron tragedy and the retirement savings that the employees of Enron have suffered, and the real reason for this loss is that more than 60 percent of the assets in Enron's 401(k)s were in Enron's stock.

But as the chart behind me shows, 60 percent ownership in company stock is not uncommon. As you can see, nearly all of the P&G's 401(k) assets are P&G stock; Sherwin-Williams is more than 91 percent; Abbott Labs and Pfizer are 90 and 85 percent, respectively. Some have suggested that we place a limit on the percentage of company stock that can be held in employee retirement plans.

I have not decided if government should set such a limit, but I think it is appropriate to point out that, clearly, there is not necessarily a relationship between Enron and other corporations as they find their employees hold a much heavier percentage of company stock. I would appreciate it if you could address that in your response relative to the problem with the failure of these programs to diversify.

In my own experience in the banking business, the comptroller of currency disallowed at one time the acquisition of the company's stock in the retirement programs of, say, the outside directors. It would seem to me that a simple limitation would go a long way in ensuring a situation like this did not happen again.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

We are honored to have the presence of Senator Grassley, Ranking Member of the committee.

Senator?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you.

Thank you for coming, Secretary O'Neill, to be with us. We appreciate very much your doing this. We have got to talk ourselves through the President's budget. It is a budget different than we have had for a long time, particularly in relationship to the fact that the economy is not so well, and we have got a war on terrorism to fight, and have different budget balances than what we have had in the first place.

I would like to bring up, though, before I make those comments, about the very fine bipartisan tradition of this committee. The bipartisan tradition means that bipartisan action usually gets things done on the floor of the Senate in a successful way. Far too often, leadership, I think, seeks to stifle the bipartisan spirit of this committee.

Sometimes it is Democratic leadership, other times it is Republican leadership. That stifling usually ends up guaranteeing that nothing gets done. That means that the very important issues this committee ends up dealing with are edited in partisan objectives. Many times, business then is not done because of those partisan objectives.

What I hear from folks back home in Iowa, and I am sure every member of this committee hears in their respective States, is the frustration with partisanship. The proper use of this committee—and if I have my way, and I am sure if the Chairman has his way—will continue to be an antidote to the partisan virus that has infected so many in the Capitol.

We have got a good track record here in the committee. The Chairman has helped contribute to that, particularly just before we went home after the holidays, of getting trade promotion authority out of this committee on an 18 to 3 vote. I want to pledge this year, this being our first hearing, to work with you to do other things like that again. I think most members of this committee will want to as well.

Our topic today is the administration's budget proposals. This is the year that we look back 1 year and we see a very dramatic difference. Last year, as we have begun the budget process, we were told to expect $5.6 trillion over the next 10 years.

Today we will learn, if stimulus is included, that we will face deficits in the years 2003 and 2004. But, on the other hand, if we look 10 years ahead, we should accumulate surpluses of $2.2 trillion.

At the outset, I would like us to focus on the facts that we ought to use real numbers when we look at proposals. We ought to stay away from numbers that are inflated or generated by ideological think tanks with a particular partisan axe to grind.

So when we take a look at our current budget situation we find that, in the short term, most of the shortfall was generated by recession and war-time spending.

Over the long haul, less than half of the 10-year reduction in surplus is attributed to the broad-based bipartisan tax relief that got out of this committee last year and the President signed on June 7. So, if we stick to the facts, I think we can avoid demagoguing the budget situation.

Now, some will argue that the only path to fiscal discipline is to maintain historically high levels of Federal taxation. Fiscal discipline is defined solely by repealing, restructuring, or otherwise cutting back on the bipartisan tax relief legislation.

Likewise, there is little or no alarm at dramatic increases in spending that we have seen over the past few years. In other words, for the cap of big spenders, there is only one side to the Federal ledger, and that is the revenue side. In their view, the only answer is higher taxes and higher spending.

This viewpoint assumes no savings in spending are possible, and that the Federal Government is as efficient as it can be. That does not make sense to me.

We have an interesting bit of history to consider. In 1990, a bipartisan deal was struck in which Republicans yielded to higher taxes, principally raising the 28 percent rate to 31 percent.

Democrats yielded on spending restraints through appropriation caps. But guess what? The history is that the spending caps are gone; the tax hikes are still in the law. Instead of raising taxes in a recession, the first step to restoring fiscal discipline ought to be an extension of the spending caps.

Today we are here to hear you, Secretary O'Neill. You are a very plain-spoken man. I think you bring to us a CEO's focus on results and attention to detail. You do not use the bureaucratese of Washington, DC, and sometimes that gets you in trouble, but I think those sort of candid comments ought to be maintained.

You are going to present a budget that has much bipartisan tax relief, much of it sponsored by members of this committee. As a matter of fact, you have to dig pretty deep to find anything in the President's tax relief package that is not bipartisan. So, I look forward to your testimony.

Thank you, Mr. Chairman and members of the committee, for indulging me for that opening statement.

The CHAIRMAN. Thank you very much, Senator.

Next, Senator Bingaman. I might say, after Senator Bingaman, on the list is Senator Hatch, Senator Breaux, Senator Lincoln.

Senator BINGAMAN. I will be glad to wait until the testimony and then ask questions.

The CHAIRMAN. All right.

Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A. U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. Welcome, Mr. Secretary.

Because I cannot stay, I would like to just say a few words. Personally, I want to congratulate you and thank you for the stellar way you representated our country this last week at the World Economic Forum, which is a very difficult forum because it seems through the years that there is a lot of, I think, very poor criticism of our country by others who are not as fortunate as we are.

There is a failure to recognize how much we really do in this world to help people, not only with foreign aid and assistance, but with hundreds of billions of dollars in keeping weapons of mass destruction under control, and of course helping the world to be free, with up to 25 percent of all the U.N.'s costs and the costs of other U.N.-affiliated organizations, our research and development that has developed some of these drugs and so forth that literally have made a difference for people in lesser developed countries, and just on and on.

I appreciated the way you hung in there and kept saying that we have to do it right, we have to do it responsibly, we have to do it economically.

Let me just say that I cannot stay. But it is important to me, not only as a Senator from a State where, just before Christmas, 1,400 steelworkers were laid off by Geneva Steel, nor also as one who grew up in a steel industry, thriving town, it is because I believe the success of the domestic steel industry is integral to the success of our country's economic and military security.

So I am concerned about it. My unabashed support for free and fair trade notwithstanding, given the prominent role that steel plays in our economy, I feel it behooves our country to support the domestic industry as much as we can. So, I am hoping to actively enlist your efforts in that regard. I know it is a difficult thing, and I hope that you will be sympathetic to that.

We know and respect your record in the private sector on aluminum, where you worked to not only turn around one company, but really helped to stabilize an industry worldwide. I commend you and the President for your stellar actions so far. I think the administration is doing the right thing on the 201 steel case, and I hope a strong remedy is fashioned.

I also hope that the U.S. Government will work with our trading partners and competitors throughout the world to address, in a meaningful way, the fundamental issues of global over-capacity.

I wonder if you can, during the discussions today, give us any thoughts you have on the strategic importance of steel to our Nation, how to resolve the steel over-capacity issue, and, given your track record on just these types of knotty problems, your sense of where steel stands among your personal priorities as Secretary.

Again, I think you have done a terrific job as Secretary of the Treasury under very difficult circumstances, and sometimes very unfair criticism. I stand ready to support you and help you in any way I possibly can. Thanks for listening.

Thanks, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senators, you may wish to speak before the Secretary speaks.

Senator Breaux?

Senator BREAUX. I pass.

The CHAIRMAN. Senator Lincoln?

Senator LINCOLN. Mr. Chairman, I do not want to make an opening statement. But I do have a previous commitment. If I am not able to return, I would like to submit my questions to be answered so they could be in the record.

The CHAIRMAN. Absolutely.

Senator LINCOLN. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Jeffords?

Senator JEFFORDS. Pass.

The CHAIRMAN. Mr. Secretary, welcome. We are anxious to hear your statements.

STATEMENT OF HON. PAUL O'NEILL, SECRETARY OF THE U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary O'NEILL. Thank you very much, Mr. Chairman.

I have a short statement. If you do not mind, I think I will read it because there are some important ideas in it that I think will create a basis for our further discussion.

But before I do that, let me say thank you very much on the public record. You were awfully kind to be on the public record. Often people say things to you that are very nice, but no one knows about them.

It was really great of you to say what you did about the work we did together, and with other members of the committee to try to push a stimulus bill over the top last year. It was an example of one of many things that we did together.

I must say, I enjoy working with the members of this committee very much. You are sitting at the center of so many important issues and it really is a pleasure to have an opportunity to work with you. Even when we do not disagree, I found this is the place where it is still true that disagreement does not mean disagreeable. So, I thank you for that.

The CHAIRMAN. You are welcome. Our challenges are going to be even greater this year.

Secretary O'NEILL. Thank you.

Thank you for inviting me to testify today. We have had a year to work together. You all know that I am optimist about the U.S. economy. I believe we have untapped potential that can be unleashed to spread prosperity throughout the Nation.

In fact, I think it has always been true, and I hope it always will be true, that the U.S. has not found the end of productivity opportunities and opportunities to raise the standard of living for everyone in our society.

Even after a difficult year, my optimism about the fundamentals of the U.S. economy has not changed. I believe we were on the verge of recovery before the September 11 terrorist attacks, and that our resilience and determination have brought us back to the early stages of recovery tonight.

We see more and more signs indicating that the seeds for recovery are there and only need nourishing to speed the process of putting Americans back to work.

I believe we will return to prosperous economic growth rates of 3 to 3.5 percent as soon as the fourth quarter of this year, especially if we are able to pass still-needed economic security legislation to hasten and strengthen our economy.

Strengthening our economy is the key goal of the President's budget. A return to our normal growth rate means job potential for the 1.4 million Americans who lost jobs during this slow-down.

Just as strengthening the economy means greater prosperity for our Nation's people, it also means greater strength for our government. It means greater revenues going into the Treasury without raising taxes, giving us resources to address the Nation's needs, and the retirement of even more Federal debt, leading to long-term economic security for our children.

Even with all that must be done to enhance our security, we expect that a return to economic growth will bring us back to government surpluses in 2005.

The economy's slow-down began in mid-2000, when GDP and job growth slowed sharply. Business capital spending began to plummet in late 2000, and accelerated its decline in 2001, dragging down the economy.

In August, we were beginning to see evidence of an economic rebound. I firmly believe that, had it not been for the terrorist attacks of September 11, that we would have seen an end to the economic slow-down and would perhaps have avoided a recession.

The September 11 attacks created shock waves that rippled throughout all sectors of the economy. Financial markets, you will remember, were shut down for almost a week. Air transportation came to a standstill. As a result, GDP fell 1.3 percent at an annual rate in the third quarter.

By late November, the National Bureau of Economic Research declared the United States was in a recession. They designated the end of the previous expansion to be March, 2001. But they observed that the slow-down might not have met their qualitative standards for a recession without the sharp declines in activity that followed the terrorist attacks.

In sum, the scorecard for the economy in 2001 reflected a combination of adverse events. The private sector lost more than 1.5 million jobs. The unemployment rate rose 1.8 percentage points. Industrial production was off nearly 6 percent. Industry, at the end of the year, was using less than 75 percent of its capacity.

As bad as these numbers are, they could have been worse. The well-timed bipartisan tax relief package enacted in June of last year put $36 billion directly in the consumers' hands in the late summer and early fall, providing much-needed support as the economy sagged. It was the right thing to do and you all did it just at the right time.

It is not surprising that both the Congressional Budget Office and the Office of Management and Budget project deficits for this year and next as a result of the economic slow-down and the response to the September 11 attacks.

The President has presented a budget to speed our recovery. First, the budget includes tax relief to stimulate job creation. The President's proposals—accelerated depreciation, speeding up the reduction in the 27 percent income tax rate, reduction of corporate AMT, as captured in the bipartisan proposal that was passed in the House in December, and checks to those who did not benefit from last summer's tax rebates—enjoyed bipartisan support in both Houses of Congress.

I am eager to work with all of you to complete work on a package to create jobs and assist dislocated workers with extended unemployment insurance benefits and temporary help for health care.

Second, the President's budget proposes strict fiscal discipline, increasing spending for national security and homeland defense, and holding the line on other spending. His management agenda calls for performance measures to be used to determine where budget increases are allocated so that our resources go into the projects and programs that make the biggest difference in people's lives.

As the experience of the 1990's shows, this discipline is crucial to ensuring we do not return to systemic deficits of the past, but fiscal discipline alone will not guarantee budget surpluses. We must return to 3.5 percent annual growth to ensure surpluses for years to come.

We believe the focus must be on restoring growth. Surpluses will then follow naturally. Raising taxes would stifle the process of getting Americans back to work. We believe raising taxes is a bad idea, as our recovery is struggling to take hold.

According to 1999 data, the most recent available, 33 million small business owners and entrepreneurs paid taxes under the individual income tax rate system. They have made business plans that assume that the tax relief enacted last summer will take place as scheduled.

Eighty percent of the benefit of cutting the top two rates goes to small business owners and entrepreneurs, and they are the engines of job creation in our economy.

We believe tax relief should be accelerated, as the President has proposed, to boost job creation. Such relief will have minimal or no effect on long-term interest rates.

According to a recent analysis by the Council of Economic Advisors, a $1 trillion change in public debt over 10 years would tend to raise the long-term interest rate by 14 basis points. Since the tax cut last year, the 10-year nominal rate has averaged 4.93 percent, which is substantially below the 6.16 percent average from 1993 through the year 2000.

Again, we believe restoring growth is the key to America's future. Restoring growth will ensure we have the resources in Washington to fight the war on terrorism, to provide for homeland defense, and provide the services the American people want, need, and demand.

The President's budget will help to ensure that both peace and prosperity are restored to the American people as soon as possible.

That completes my prepared statement, Mr. Chairman.

[The prepared statement of Secretary O'Neill appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary.

I would just like to have a little discussion with you on a problem which is coming over the horizon. We all clearly want to restore growth. That is clear. Some of this is within our control, some not. A lot of it has to do with ordinary business cycles.

A lot of it has to do with consumer confidence in the future to buy products or not, refrigerators, cars, et cetera. Investor confidence, whether to invest in the future or not. Lots of intangibles here. God forbid, other terrorist attacks could have an adverse effect. There are a lot of unknowns that have an effect on growth.

Stimulus certainly is one way to help restore growth and there are various estimates as to what percent growth fiscal policy will result in, particularly after we have had a large number of rate cuts by the Federal Reserve. The question is when that begins to cut in.

But having said all that, with the inability to predict the future, which in a certain sense is good, there is one huge problem over the horizon that we do know about. I think prudence dictates we do the best we can to deal with it. That, of course, is the baby boomers are going to be retiring.

You know the statistics. Pretty soon, 20 or 30 years from now, twice the number of seniors will be on Social Security compared with today. The number of retirees will be much more compared with the number of employees, so there are not only more retirees, but fewer dollars per employee, and employers paying into the trust fund.

We now have a budget proposed before us which will use up, I guess, about $1.4 trillion of the Social Security surplus over the next 10 years. That is the projection, knowing that budgets are basically guesses at the future.

We also know it is true that the Social Security system has a claim under the law on dollars that come in, regardless of how those dollars are used. That is, whether they go in the trust fund or whether they are used for guns and butter, or whatnot.

Nevertheless, at the end of 10 years, there still is a very significant effect of using "Social Security surpluses" for other government purposes. That is, if we were to use those dollars not for other purposes but to retire the debt, clearly in 10 years there would be a lot less interest to be paid on the debt. It would be easier to finance other needs, whatever they may be.

Do not hold me to this figure, but I saw an analysis that, under the President's program last year, suggested that for Social Security private accounts the transition cost of that would be $1 trillion over 10 years.

Remembering, too, as Treasury Secretary, you have a fiduciary duty to seniors. The Social Security Administration has 75-year budgets. It is important to do our best to look at the out years to see what we think is going to be happening over the next significant period of time.

So how do we plan for this large problem that is going to be upon us within 6 years when the first wave starts to retire, particularly with the proposed budget that has been presented to us, which I said uses about $1.4 trillion of the Social Security surpluses and uses that surplus in every year over 10 years, so that we can solve this?

Secretary O'NEILL. If I may, let me sharpen the concepts a little bit. I hope this will be all right with you.

We here in Washington all know—and I think no one will dispute this—that the Federal Government is going to honor the obligations it has made to American citizens to pay the Social Security benefits that we have said people are entitled to when they retire.

I would say, without fail, without regard to anything else, people can count on the fact that their Social Security benefits are going to be there.

Second, again, we all know this here in Washington but I am not sure people out in the country do, every dollar that is collected under the Social Security payroll tax for Social Security and Medicare benefits is credited to the Social Security trust fund. So, people should not have any doubt about that. I would argue that to say that we are using Social Security funds for some other purpose is not technically correct.

I guess I would say it is simply not correct. We are not using Social Security funds for other purposes because we do not have, in effect, a sinking fund for Social Security.

We have never had a sinking fund for Social Security. What we really have, is the good faith and credit of the U.S. Government that, when people come due for benefits, they will be paid.

Now, there is, however, in your question to me, I think, an issue that we should take as an important issue of public policy. It is the question of, what do we do as we approach a point where we have a great many people retired and a relatively small number of people paying Social Security taxes, and we get to the point where the amount of money paid in each year is not sufficient to pay the benefits that are due in that particular year? That is a serious problem.

I would warrant to you, one of the things that would probably be helpful to sharpen this issue for public conversation and working on the issue would be to create a Federal balance sheet that has on it the unfunded liability of Social Security and all other trust funds, and as the Chairman and other members know, that number would give us a balance sheet with an $11 trillion hole in it.

Now, as a public policy analyst, I tell you, I do not shrink from that. It would be on the balance sheet now if it did not look like a thorny problem, I suppose, to people who are in the Congress. But I think we would advance the cause of working on the problem if we would put on the balance sheet the unfunded liability.

Then we would, I think, work perhaps more quickly to figure out a way to deal with this unfunded liability than we are likely to if we just roll into it in the year 2015, when the unfunded liability is going to be larger.

Now, to close the loop on this, if we were in a surplus in the proposed budget year, and that means that we had money coming in on a unified basis that was surplus for paying current benefits and current expenses for the government, what we would do with that money is reduce the amount of debt outstanding held by the public.

That, in and of itself, would improve our balance sheet. That means, going forward into the year 2015 for Social Security benefits without any other changes made, we would have greater debt capacity, if you will, to service the obligations that we have made to ourselves as a people. That, in and of itself, would be a public good for us to have zero or no debt held by the public.

It is feasible, I think, to believe even now that we will be there by the time we get to 2015. Last year, you will remember at this time we were foreseeing that possibility. The real concern was, after we have bought all the debt held by the public, what do we do with the money then?

It could very well be that will be a serious question in another four or 5 years from now. But wherever we are on that question, it will not solve, inherently, the problem that we are facing with Social Security.

It is the reason the President formed the bipartisan, and I think highly competent, group to look at Social Security and they issued a report. It was headed, in fact, by the former Chairman of this committee, Senator Moynihan. They filed a report which I think advances the thought process about what we might do about Social Security going forward.

Of the ideas included there in the study by the President and his advisors, I think we all are attracted to the notion of wealth accumulation for Americans. We do not know the details of how to do it at the moment, to move into a system of wealth accumulation so that all Americans are accumulating wealth during their working period.

But it does seem to me that this is the real issue, the issue of making Social Security better even than it is now, and securing its financial future in the time we have available in front of us. Again, as I say, the most important point is, there is no danger to any American that they are not going to get the benefits that they have been promised.

The CHAIRMAN. I appreciate that. I know other Senators have questions to ask. I just might say that, under the proposed budget, the President's recommendations on Social Security are totally impossible. They are just totally inconsistent.

That just highlights, again, the problems that we are facing, I think, under this budget, namely, not adequately caring and providing for the baby boomers. I am quite concerned about this budget. The public debt is going to increase significantly under this budget.

We are using Social Security trust funds to mask the true public debt increase. We do know that that is going to be a huge problem down the road. That is, the number of seniors will be much greater, plus, as you pointed out, fewer workers paying into it.

So, I will not take any more time, but I frankly think that the administration is ducking that issue in this budget.

Senator Grassley?

Senator GRASSLEY. Yes. Mr. Secretary, I want to visit with you a little bit about the tax bill that the President signed June 7, with the usual history of taxation that we use so often, and the justification for the tax bill.

For instance, taxes before the bill, and still to some extent because it is not fully implemented, would be 20.6 percent of GDP. That is a record post-World War II level. Individual income taxes were even more dramatic levels. CBO reported that individual income taxes were, I think, a record high of 10.2 percent of GDP.

This returned roughly half of the projected on-budget surplus that we projected a year ago to the American people. But even after that, according to the Joint Committee on Taxation, the Tax Code is more progressive. According to CBO, when fully in effect, Federal taxes will still be roughly 19.4 percent of GDP. That is about 1 to 2 percentage points above the historically average level of Federal taxation.

Now there is a lot of criticism from those who oppose a bipartisan plan. One of the main criticisms is that we cut income taxes too much. That is, the allegation is that the bipartisan tax relief plan gutted the revenue base. I am going to make two assumptions. I am not requiring you to answer the question unless the assumption is wrong.

I assume that you disagree with those critics. I assume that you would say no to the fact that we have to maintain this high level of taxation, pre-tax bill, to have fiscal discipline.

So the question is this. Is it safe to say, as these critics do, that there is no down side to future economic growth if record levels of Federal taxation are continued in place?

Secretary O'NEILL. The direct answer to your question is, absolutely.

I have a colored chart which maybe I can submit for the record that demonstrates, Senator Grassley, what you were just saying. Even with the Tax Relief Act of 2001—this is going back to 1945—the average since 1945 tax take at the Federal level of GDP is 18 percent, we are at 19 percent even after the implementation of the Tax Act that you all passed last year.

The CHAIRMAN. It will be included.

[The chart appears in the appendix.]

Senator GRASSLEY. I do not think you intended to give me the answer that you did when you said, absolutely, yes. So let me restate the question.

Is it safe to say, as these critics do, that there is no down side to future economic growth if record levels of Federal taxation are continued in place?

Secretary O'NEILL. I am sorry. I thought your question was the other way.

Senator GRASSLEY. All right.

Secretary O'NEILL. There is no evidence that I know of in economic history or experience that suggests higher taxes are pro-economic growth. In fact, the contrary seems to be clear.

One of the things that is very important in our own economic experience, is the degree to which jobs come from entrepreneurs and sole proprietorships, and, in fact, small business.

One of the things that was important in what you all did last year in passing the Tax Relief Act, was to reduce the rates that those small businesses paid. I think, if you had not done the Tax Relief Act that you did last year, then it is very likely that the depth of our economic slow-down would have been much greater and we would have come out of a recession, or out of a slow period, much slower than we are.

I think it is because of the tax changes you all made that we have experienced what, by all accounts, is the shallowest slow economic period we have seen since 1945.

So, it is a great credit to this committee that you anticipated and took action that served us very well as we had the terrorist acts of September 11, and the consequence of a slow-down from a lack of business investment during half of the year 2000, and most of the year 2001.

Senator GRASSLEY. Mr. Secretary, I am sure you have been alarmed about Enron's use of tax haven subsidiaries, maybe 900. I do not have all the facts, and I want to get all the facts before I draw final conclusions. I have asked Enron to fully cooperate with this committee on the review of their tax returns since they started, since 1985.

It is very disturbing to learn that the company may have used so many tax haven subsidiaries to avoid taxes, and more importantly, to mask financial debt.

In my view, this activity underscores the need for full disclosure of tax shelter and tax haven activities so that the IRS can better do their work on abuses. I think this is a perfect example where sunshine can shine on something. That is a very good disinfectant.

So, I have two questions. Why does Treasury's blue book proposals not contain any measures to combat tax shelters? How does Treasury then propose to do anything about the increasing tax shelter problem? I hope you agree that there is a problem there.

Then my second question. What is the Department of Treasury doing to address the growing use of off-shore tax havens? What are we going to do about using tax havens to hide income, the use of these tax shelters to hide income?

Secretary O'NEILL. All right. There are a number of questions, and I guess some pieces, and I want to be very precise in how I answer your question.

We believe, and I believe, that every American and every corporate entity and business organization should pay the taxes that they are obligated to pay under the Federal law, as it exists, period.

Those who fail to pay should pay the appropriate penalties, including, where those penalties mean going to jail, people ought to go to jail if they violate our tax laws.

Now, I say that at the beginning because there is a use of language about tax shelters and the like that suggest illegal behavior. I think it is very important that we differentiate between what the tax law permits, or encourages, or provides and that which it prohibits.

In those cases where prohibited behavior is engaged in, again, we ought to put the people in jail or fine the devil out of them. But I would observe that, in this complex, 10,000-page Tax Code we have, there are lots of things that apparently the Congress decided intentionally should be permissible on the part of individuals and businesses.

I think when individuals and businesses use the legal provisions of the Tax Code, that we should not hold them up to scorn and ridicule. If we do not like what they are doing and it is legal, then we should stop letting it be legal. I think this is an important distinction.

Now, with regard to so-called tax havens, when I came to the Treasury Department I found that there was a book and a major activity on so-called money laundering, activity of the Federal Government to go after money laundering. One of the sub-subjects of the subject of money laundering was so-called tax havens.

As I began asking questions about what was being done, people were quick to tell me how much money we were spending chasing after money laundering. I will not tell you the whole story, but the number ended up being, for fiscal year 2000, $675 million, as I remember. I said, that is great. Tell me what we have accomplished with that.

I found the answers were very slow coming. So, I said, it seemed to me good public policy, if we are spending $675 million, we ought to get something for it. It seems to me a perfectly logical premise.

So I began pursuing the issue of, how do we get something for our money? I discovered, and I think it is true, since 1990 we have not entered into any new treaties with so-called tax havens to reduce the possibility that people were abusing our tax laws in an illegal way, and they were taking advantage of the laws and practices in places like the Cayman Islands, the Bahamas, and many other places in the Caribbean and other places around the world.

So I made a promise to Senator Levin and the Senate Intelligence Committee that I would do something about this fact and that, within a year's time, we at the Treasury would enter into new treaties for exchanging information that would cover at least 50 percent of the accounts in those so-called offshore tax havens. In fact, we are getting close to that.

In the last few months, we have agreed treaties with the Cayman Islands, with the Bahamas, with Antigua, Barbados, and we are working on the British Virgin Islands and Panama.

When we get those, we will be well over 50 percent of the accounts covered in the so-called tax haven countries, and we will be in full pursuit of anyone and everyone who is in any way abusing their tax responsibilities.

So, we are working these issues very hard. We are determined that people will pay their fair share. We are going to do it quickly. We are not going to say this is a 10-year project. This is something to pursue on a week-to-week basis.

Senator GRASSLEY. I am not going to ask any more questions because my time is up. I think I had three more questions that I am going to have to submit for answer in writing, Mr. Chairman.

One comment on the tax shelter thing. That is only so that you can think of at least where I am coming from, and you are entitled to know that.

That is, I do not disagree with anything you have said. But one thing I was hoping you would address, and I think you probably, by not addressing it, feel that the policy that we have for these under existing law is probably all right. Within your definition, if people do things within the law, obviously they do not need to pay any taxes if the law does not require it.

I guess I happen to believe that maybe those policies are not right. I do not know exactly how far we should go in changing those policies, but I think that it should be done by law and not just by regulation.

Secretary O'NEILL. I agree with you.

[The questions appear in the appendix.]

The CHAIRMAN. Thank you, Senator. I might say, our committee will be holding hearings on all of these subjects. There are many, many issues to get into here, particularly on the question of havens, not only what is the law today, but what should proper policy be? How do we get information to know how much income taxes the United States is not receiving because of the havens?

What about competition with other countries? There are a whole host of questions that we have to get into here, and we certainly will.

I urge you, Mr. Secretary, and I know you will, just to cooperate fully with this committee in getting that information so that we do determine what the right policy should be.

It is not only Enron. Enron is just the collapse that is crying out now for us to examine a lot of the questions that are being asked on account of Enron. Thank you.

The next Senator on the list is Senator Graham.

OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA

Senator GRAHAM. Thank you, Mr. Chairman.

I want to thank Secretary O'Neill for the outstanding leadership that he has given to the Treasury Department and to our Nation in these very difficult times.

Mr. Secretary, I was reading page 37 of the budget, which talks about the need for a realistic budget window. It contains a sentence that concludes, "The events of the past years can lead one to conclude that the recent experiment with 10-year budget projections has been a failure." It then goes on to say that, after 2004, that the budget will not provide 10-year projections.

What will be your recommendation to the Office of Management and Budget next year as it develops budgets that are other than 10 years? Do you agree with the 5-year period that is apparently being suggested?

A year ago during the campaign, both parties adopted what was called the lock box as a concept to protect Social Security. Your earlier comments seemed to infer that you thought we already had a lock box in the form of an accounting requirement, that there be debits and credits to the appropriate trust funds.

Do you propose any kinds of triggering mechanisms so that, if decisions made in year one of the budget window prove to be too optimistic or too pessimistic by the time we get to year 4 or 5, that there be some means by which they are adjusted? You have suggested that unfunded liabilities be placed on the balance sheet.

Which of those are you going to recommend to OMB as it goes to a different budget window?

Secretary O'NEILL. Well, thank you very much for the question. Let me say a word about forecasting in a general sense, and then come more specifically to your question.

I think it makes sense to go through the mental discipline of trying to understand the long-term consequences of our near-term actions. I think when the Congress put in place this notion of looking at 10-year consequences, it was a wise thing to do.

But it has taken on a life of its own, in the sense that people are now doing third decimal point 10-year forecasts as thought that had some meaning. I would submit to you, on the face of it, 10 years always made sense as a mental discipline. It never made any sense as forecasting and as a useful predictor of the future. I would submit to you, it is easy to see that.

No one in this room—I would say no one in this room—anticipated the jumbo jets hitting the Twin Towers. No one. It had a profound effect on our country, not just on our fiscal affairs, but on our mental understanding of the exposure that we have. It was not very long ago. It was not very long ago, a year ago, we sat here and talked about 10-year predictions.

Again, I think it is a useful mental discipline, but we should not confuse useful mental discipline with predictive accuracy. I think it also goes without saying that predicting next month is a lot more likely to be right than predicting next year, or 2 years from now, or 5 years from now.

As a matter of fact, I think back now on the spending side, having been here when Medicare and Medicaid were enacted. I think we are now at something like 100 times, or 1,000 times, what those of us who were here then thought Medicare and Medicaid would ever be.

I think it demonstrates the frailty of our ability to really know the future in the way that is suggested by people now doing, again, third-order derivative forecasts over what was said last year and what is now apparently the truth.

So I think we should continue to use the mental discipline of looking at longer periods of time. We should not expect to be right much further out than 1 year or 2 years. As we go into even 5-year periods, we should not be dismayed if we are wrong in a serious way over short periods of time.

With regard to trigger mechanisms, after all this time having been in Washington and in the private sector, I am still an optimist about our democracy. The notion of a trigger mechanism, to me, suggests that we have to go on automatic pilot because we do not have the courage to do what the facts suggest to us.

So I am not much attracted to the idea of a trigger if it implies that somehow we take ourselves off the hook by not having to make a decision. It seems to me, for example, in this year's circumstance, if there are those who believe the President's proposed budget, which has in it a very small deficit—in fact, on a percentage basis, the smallest deficit that we have ever run in a period of war or recession in this country—if there are those who believe it is the wrong answer, they need to come forward with one of two things.

There are really only two choices if you do not like the President's budget. One, is to say that we should reduce some aspect of spending. The big increases are, of course, in the military expenditures and protecting our borders and homeland in a way that we have not felt we needed to before. So if someone wants to reduced those, they ought to say so.

If someone wants to raise taxes in order to avoid this small deficit, they should say that. But the idea that somehow we should go into a trigger mechanism, for example, and say that this year we should do something different because we have a trigger instead of our own will, it does not appeal to me at all.

Senator GRAHAM. Mr. Secretary, the yellow light is on. I would just like to follow the logic of your statement. This is what the President said last year.

Secretary O'NEILL. Right.

Senator GRAHAM. Twelve months ago, this is what the President said. It is actually on page 3 of his budget.

"After funding important priorities and retiring all government debt possible, my budget uses the remaining portion of the surplus to provide a fair and reasonable tax relief to every American who pays income taxes."

Now, that was the priority of last year, after funding important priorities and retiring all government debt possible, then we will use the remaining.

It seems that what has happened, is we have reversed those priorities, in that we now have before us a proposal to make tax reductions, which do not go into effect for almost a decade, permanent and extended beyond their current period, whereas, we are making very limited efforts to reduce the national debt.

Now, it seems to me that we are not following the priorities that the President set a year ago, and the fundamental reason is because last year's priorities were on an assumption of a much larger surplus than we currently are anticipating.

Secretary O'NEILL. Well, a couple of points. The difference this year between where we are this year and where we were in January last year for fiscal 2003, is 15 percent of the difference is because of the tax bill that you all passed last year, $38 billion out of the $311 billion that we started with last year as a presumption of surplus. All the rest is accounted for by the slow-down in the economy.

Senator GRAHAM. You are referring to what time period, is the 15 percent?

Secretary O'NEILL. I am referring to this fiscal period.

Senator GRAHAM. But over the 10-year period.

Secretary O'NEILL. Over the 10-year period, the difference between $5.6 billion and the current 10-year forecast of surplus is a difference between $5.6 trillion and $1.6 trillion.

So even with the $1.275 trillion worth of tax reduction that you all passed last year subtracted from the $5.6 trillion, we still have a $1.6 trillion forecast surplus over this 10-year period, in spite of the fact that our economy has absorbed $1 trillion worth of the forecast surplus.

Technical adjustments, please note, have absorbed $660 billion over this 10-year period. The rest is for defense spending and for spending largely related to the events of September 11.

So it seems fairly clear to me that the President has been true to what he has been saying for much more than a year. Over the last 3 years, he has said over and over again he favored fiscal balance or surpluses under all conditions except under war conditions, recession conditions, or a national emergency. All three of those are present today.

I would say again, even with all three of those being present, this deficit is the smallest deficit in time of war or recession that this country has ever had.

The CHAIRMAN. Mr. Secretary, I am going to have to ask you to conclude. I apologize to other Senators for not holding Senators to their 5 minutes.

Next, I think, is Senator Murkowski.

Senator MURKOWSKI. Thank you.

Mr. Secretary, you have been distracted a little bit, but you will perhaps recall my question was whether Treasury would view a tax credit for a gas line, in lieu of the other incentives that energy enjoyed for various types of production that were in the national interest.

Secretary O'NEILL. To remind and make sure I get the facts right so that we can do this in a more careful and deliberate way, the notion was to provide and effect an assurance to the investors in the pipeline delivery system that the price of gas would not go below a floor of $3.75.

Senator MURKOWSKI. That is correct.

Secretary O'NEILL. We owe you a carefully considered look at that. Frankly, in my experience, good business investments do not need support of this kind because there is plenty of financing available. If people believe that the rates are going to be at that level or higher, the money will flow.

In my experience, capital is very smart. Where the rate of return is a competitive rate of return, the money will flow.

But, again, in the spirit of wanting to look at every idea and not make rapid judgments without consideration, let me say, too, we will look at this and we will give you a paper.

Senator MURKOWSKI. I will send you a letter outlining the details. I certainly agree with your premise, that if the investment return is there, the capital will flow. On the other hand, this is a significant project and the risk associated with it is measurable only in projections on what the price of gas will be.

Secretary O'NEILL. Right. Right.

Senator MURKOWSKI. We are looking at somewhere in the area of $20 billion. The fact that other energy-related development scenarios deserve some consideration, why, there is a precedent set.

In conjunction with this, let me advise you that next week this committee may be marking up an energy tax bill. My understanding is the area is somewhere between $10 and $15 billion.

My question is, in your opinion, should this bill have revenue offsets?

Secretary O'NEILL. Well, I think the proposals that the administration has put in front of the Congress are ones that were carefully considered and integrated all the parts of what we think an appropriate energy policy should be.

So we are very hopeful that the Congress, and the Senate particularly, will consider in its totality the parts, aspects, and treatments that were recommended last year to the Congress for enactment.

The President keeps saying over and over again that this is one of his highest priorities, that we get this energy legislation through the Congress to strengthen our assurance that we can be less energy-dependent on the rest of the world than we are now.

Senator MURKOWSKI. But relative to offsets, do you have a position on it?

Secretary O'NEILL. Well, if the Congress, in its wisdom, decides that it wants to either provide more incentives through tax reductions or more spending through over-spending, then I think we would want to work very closely with you to find ways to deal with that effect.

We think the budget presented should be enacted as presented, unless people are going to offer counter balances. We think this is the right balance that we have achieved, and what the President has proposed.

Senator MURKOWSKI. Let me ask you, briefly, to comment on those that suggest that the tax cut has had a detrimental effect on the economy, contributing to the recession, when it is generally recognized that the recession started in March, and tax reduction became effective in June of last year. To me it is very logical, but some people cannot seem to quite accept that.

Secretary O'NEILL. As I said earlier, I think it is to the great credit of this committee, to the Senate, and the Congress in its totality, that you passed the Tax Reform Act that you did last year. It, in effect, got in front of events, if you will.

The money started to flow out to people on the 23rd day of July. I think we would have seen a much more serious slow-down in our economy if that money had not flowed beginning in July, through the rest of the year, and for this year and years going forward. I think it is a fiscal policy done about as well as you could imagine it being done.

Senator MURKOWSKI. Under the time sequence, and so forth.

Secretary O'NEILL. Absolutely.

Senator MURKOWSKI. Would you care to comment, just briefly, on the chart behind me relative to the limitation on percentage of company stock that can be held in employee retirement plans?

The obvious chart simply shows where Enron fits in, and has no other applicability but to suggest that other companies do not have the same exposure. If mismanagement is a factor, should we limit? If so, how?

The CHAIRMAN. Senator, I am going to have to ask——

Secretary O'NEILL. May I just quickly respond?

The CHAIRMAN. Very, very briefly. There are other Senators patiently waiting.

Secretary O'NEILL. Yes. This is an important question. In my judgment, it is more complicated than to suggest that the answer to all investment questions is diversification.

The CHAIRMAN. Less than a minute.

Secretary O'NEILL. All right. I believe that adult human beings should be able to make their own decisions about how they invest their money. That includes if they wish to do it.

In the case of a sole proprietorship, for example, the hardware store owner does not have diversification. He and his wife have all of their eggs in one basket, if you will. I think that is appropriate.

It is not inappropriate, necessarily, for an individual to have a single investment or a few investments.

That is all right with me, as long as it is an individually made decision that is not restricted by some other institution, by a company, say, or by someone else making a decision.

I must say, I think it is an heroic jump to say that the Federal Government should legislate the amount of money that an individual can invest in any one investment. It just seems to me so out of keeping with both the spirit and the practice of our society.

The CHAIRMAN. All right. Thank you.

Senator MURKOWSKI. Thank you, Mr. Secretary. I appreciate it.

The CHAIRMAN. Next, is Senator Bingaman.

Senator BINGAMAN. Thank you very much, Mr. Secretary, for being here.

In your statement to us, you quote CBO's projections in support of your belief that last year's tax cut is only responsible for less than 12 percent of the surplus decline in the current year, 2002, or less than 28 percent in 2003.

They also project it is responsible for 42 percent over the 10 years. Do you agree with that?

Secretary O'NEILL. Yes, sir.

Senator BINGAMAN. All right.

The projections you have given us for revenue assume that, after 2 years, the Alternative Minimum Tax will be allowed to apply to everybody, just as it does in current law. So the estimate, again, is that there are 39 million people who will be paying the Alternative Minimum Tax by the end of the 10-year period.

Do you agree with that?

Secretary O'NEILL. Yes.

Senator BINGAMAN. Let me ask about the revenue projections. As I read your budget, $1.2 billion of your revenue projections come from bonus bid receipts for leasing Anwar. Am I reading the budget correctly on that?

Secretary O'NEILL. I think that is right. Let me stipulate it. It is a detail I do not remember, but it is something on that order of magnitude and I assume you are right.

Senator BINGAMAN. All right.

This is not in your budget, but we already enacted, effective January 1 of this year, a cut in Medicare reimbursement to physicians of 5.4 percent. You assume that that stays in place and you do not support any change in the law with regard to that 5.4 percent cut. Is that right?

Secretary O'NEILL. Right.

Senator BINGAMAN. And the same thing with home health care services that are scheduled to be cut 15 percent this year, and I gather another 10 percent in rural areas. You do not propose any change in those cuts and do not support any change in those cuts?

Secretary O'NEILL. There are big increases in health care spending just out of a natural flow of events. It is true that there are recommendations, including some that have been agreed by the Congress, to try to reign in the galloping pace of increased Medicare and Medicaid spending.

Senator BINGAMAN. Let me sort of set to a more philosophical question. Your statements about how we cannot predict more than a couple of years ahead, realistically, and depend upon it certainly resonates with me. I think a lot of the problems we have gotten ourselves into here in Congress has been a result of us assuming that we can predict 5 and 10 year ahead.

It seems inconsistent to argue, on the one hand, that we really cannot predict more than a couple of years ahead, and then propose to the Congress that we change the law, effective December 31, 2010, with regard to our tax structure.

Do you see anything inconsistent in that? It seems to me that, when I go around my State and talk to people, the question is, why are you guys legislating changes in the law in 2010? Why do you not get busy and do something this year that will affect us this year and get us out of the recession?

Secretary O'NEILL. Well, it seems to me not inconsistent at all to want the rules of the game to be clear and to reduce ambiguity and uncertainty going forward. My sense of what happened here last year, is the members agreed that we should eliminate estate taxes.

They did it, but because of the conventions for how score is kept here—which I would say is an invention of the human mind, not something God gave us—there was this tricky business of saying, well, this is not really permanent, and 9 months after it goes into effect, we are going to take it back.

It, frankly, does not seem to me to be intelligent public policy to be taking actions in the Congress because of these artificial devices that we have created for one reason or another.

So for me, I would have said what was done last year in the tax bill was unfortunate to the degree that it played a game for the convenience of getting around the scorekeeping process.

Senator BINGAMAN. One of the reasons I understand why the provision was put in last year's tax bill to sunset the tax cuts, is that the projection for the second 10 years is that the surplus would be reduced $4 to $5 trillion. Would you agree with those projections? Those are the CBO's numbers, as I understand it.

Secretary O'NEILL. I have got a chart which I will submit for all of you to have a copy of. This shows, on the basis of current estimates, what is going to happen to revenue growth at the Federal level between 2001 and 2011.

What it shows, is we are going to take in 55 percent more money at the Federal level, with the tax cuts that have already been enacted, as we go forward between 2001 and 2011.

Again, it does seem to me that we would be well served not to play the game. For example, to go to your point of sunsetting all the laws, can you imagine—let me not do this as a question.

Let me make a flat statement. I cannot imagine that the Congress of the United States, in the year 2011, is going to say to low-income mothers, we are going to raise your taxes from 10 to 15 percent because they decided back in 2001 to sunset the tax law, and we are going to raise your taxes 50 percent. It is not conceivable that that is going to happen, I do not care what we say about sunset.

Senator BINGAMAN. Let me stop with that. Thank you very much.

Senator BREAUX. Thank you. Chairman Baucus has had to step out. I do not know if he will be back, but we have two more questioners, Mr. Secretary.

Thank you for being with us. Also, thank you for the good work that Mr. Weinburger and the rest of your staff do. We work with them on a regular basis and I think they do a very fine job.

Speaking of staff, Senator Lincoln's staff gave me this little point that I want to ask you about. You were here about 12 months ago, in February, before this committee.

You said in your statement at that time, "The Social Security dollars that are going to flow into the government over the next 10 years are safeguarded, lock boxed, fenced off, protected from all evil-doers. I do not know if there are more strong ways to say it. Social Security dollars are set aside without any threat of encroachment." That was 12 months ago.

I looked at an editorial in USA Today, basically saying that Bush is hiding the depth of the deficit. It says, "To make the deficits look smaller, Bush has included the $178 billion surplus that Social Security will run next year and the nearly $1 trillion that it will amass during the following 9 years."

I guess the question is, what happened to the lock box?

Secretary O'NEILL. I think what I said last year is still true. All the dollars that come in from Social Security taxes and Medicare taxes are credited to the Social Security trust fund. I testified for three and a half hours this morning in the Ways and Means Committee. We went over this again, and again, and again.

It does seem really clear to me that there is no member of the administration, and I cannot find any member of Congress, who believes that we are ever going to do anything except pay the benefit obligations that have been made to the American people with regard to Social Security and Medicare.

Senator BREAUX. I do not know that I necessarily disagree with that. But, I mean, it was very clear when both sides were arguing about this mythical lock box, that the idea was we were not going to use it to reduce the size of the deficit. We are clearly doing that in this budget, right?

Secretary O'NEILL. No, I do not think we are. I think what we are doing on a cash basis, is we are finding, in the totality of the Federal Government, we do not have enough cash flowing in to cover all of our obligations, so we are going to borrow $111 billion.

That is not to say that we are using Social Security money for some other purpose. We are taking the Social Security money, we are crediting it to the Social Security trust fund.

In effect, we are buying government bonds with it. When you wash it all through, you can make an argument, if you wish, that somehow we are misusing or appropriating for other purposes Social Security funds. It is just not true.

Senator BREAUX. I agree with that. But that shows you how, from my personal standpoint, the whole concept of this lock box, was a lot to do about nothing. Republicans were saying we are all for a lock box, Democrats were saying we are for a lock box.

We have never missed a Social Security payment. We never will. I mean, it is there. It will be there. The people will get their payments.

Another thing I noticed in the proposal that you have on the book here, is that we are proposing to spend $353 billion to permanently extend the tax provisions that we made last year in the tax bill. I understand the arguments. But nothing is permanent, as long as Congress is in session.

Secretary O'NEILL. Let me stipulate, that is right, Senator.

Senator BREAUX. We can pass a bill tomorrow that says the tax cut of last year is permanent, and next month come back and change it. I mean, we have done that time and time again. It is only permanent until we change it, which means we can say it is permanent today at a cost of $353 billion, and then come back next year and completely change it. We have done that so many times. We do it on a regular basis.

In 1993 when we raised the rates, the top rate was 39. Today, what, it is 37. We have changed it. That was supposed to be permanent. All these things that are permanent are only permanent until the next time Congress meets and decides to change it. But that is another PR type of thing that I think is not with a lot of meaning.

The tax haven question that I think Senator Grassley asked is sort of interesting to me. What we are finding out with the Enron case—and I hope there are not others—is there were thousands of off-the-books, partnerships that were out there.

It seems to me that what we are finding out, is some people in the hierarchy of Enron were acting like Jesse James in a suit, in the sense that they were really crafting these things to deceive, delude, and actually steal from the shareholders and stockholders.

I am concerned that maybe what they were doing was legal, that perhaps Congress has passed laws, as you referred to. But with all the lawyers that Enron had, I cannot imagine that they were not saying to them that this section of the Tax Code allows you to do this, therefore, go form these thousands of off-the-books corporations, without somebody in all these law firms saying, no, this part of the Tax Code says you cannot do that. I am really concerned that the Tax Code actually allowed them to do, legally, what they did.

Someone said, well, that is not the intent. But you cannot send somebody to jail on the intent, or what Congress intended, if the facts say something different.

I was wondering whether you have asked anybody in Treasury yet to take a look at these structures that are coming to light now to see if, in fact, the Tax Code actually allows them to do what, apparently, they did and report back to you if that is, in fact, true or not.

Have you done that, or is anybody looking at that?

Secretary O'NEILL. Well, we will certainly do that when it is possible. As you know, under the law it is not legal for me to know about anyone or any organization's tax filings. I think that is fully appropriate. So, what I know about this case is what I have read in the newspaper and seen on television.

Frankly, with my experience, I do not believe an awful lot of what I see and read until I am able to ascertain the facts for myself. So, I do not know and I do not think any of us really know yet whether some of the activities that they undertook could have qualified as legal activities or whether it is illegal or not.

But for sure, you can bet that as this thing develops we will look at every single transaction that we can understand, and alert the Congress and make recommendations where we think loopholes or super highways have been created for people to drive down that allows organizations to avoid taxes that the Congress intended for them to pay, and to advise you about how to change the language if what some of us would consider evasion really turns out to be avoidance because the statutes are not properly drawn.

Senator BREAUX. That is going to be really helpful. To the extent that you can have someone start looking at that, I think it is very important. I cannot imagine a company of that size, with that many lawyers and accountants, being that bad, that they somehow said that this is illegal, but go ahead and try it.

It is a question of, what did they base it on? It had to be based on something. I just cannot imagine they said, oh, go do this, knowing it was illegal. Somebody must have been saying, well, we found this section of the Tax Code that allows us to do this. Let us go do it. We need to know whether the Code allows them to do that.

Senator Jeffords?

Senator JEFFORDS. Thank you. Thank you, Mr. Secretary. It is nice to be with you. I want to get into the area of important public policy, in particular, health and education.

I am pleased that the President has proposed refundable health care tax credits as a key part of his initiatives to expand health coverage. Last year, I introduced S. 590, the Reach Act, to provide advanceable, refundable tax credits to assist low-income individuals and families in purchasing health insurance.

I have also recently drafted legislation to promote the creation of health purchasing cooperatives in order to provide a mechanism for recipients of refundable tax credits to obtain affordable health insurance.

Please comment on the need for these pooling mechanisms to make it effective.

Secretary O'NEILL. Well, first, let me say that as we have looked at this area, we think there is a lot to commend the idea of refundable credits as a way of assuring equity across our population as we try to do something in these important areas.

There are some complicated questions as we do this related to actually being able to find insurance and insurance mechanisms that will work with so-called refundable tax credits. There is a range of choices here.

Over the years, the insurance industry has developed, not just for health care but for other kinds of insurance policies, a range of ways of thinking about assigning premium values ranging from individual rating—and in a health context, meaning that your insurance premium would be related to your health status, and maybe even to the health status of your parents as a predictor of what your health care costs might be going forward, and to your age.

An alternative concept, in a way, at the other end of the spectrum on the broadest basis, is something referred to as community rating.

On the broadest basis, one might say the United States is a community. If you ignore age, region, and heritage, and all the rest, you can probably get the lowest possible premium rate on an individual human basis if you spread the cost and risk across the total population, on average.

But it will mean, in a community rating sense, that some individuals are, in effect, subsidizing others, those with low-cost experience and a low-exposure experience, while in effect pay a higher premium than they would pay if they were rated on an individual basis.

So, there is a tension in thinking about how we use things like refundable tax credits in trying to decide, what's the appropriate basis for pooling and whether it should be cross-indexed by age and other factors. So, these are very complex subjects.

One of the things we are finding as we work with these ideas, is that there are some mechanisms out there already. For example, Federal employee health plans that we looked at as a possible way of grafting on community rating when we were looking at refundable tax credits for those who were dislocated by the terrorist events on September 11.

So these are really complicated subjects, but I think quite promising in terms of ways that we can think about creating equity and access for people that otherwise might not be available.

Senator JEFFORDS. I would like to offer our help in any way if we can help you do that, because I believe very strongly that this is an important step forward that we are trying to make. We would like to help you. We will work with you on it.

Next, I would like to turn to the question of education and the proposals by the President therein. Your budget has a refundable tax credit given to parents of $5,000 for half of the expenses incurred to send a child to private school if a public school is failing.

But my first question, is the worst problem we seem to have in our educational system is 3-, 4-, and 5-year-olds. In every industrialized nation, after the studies in the 1980's and 1990's, switched and made them part of the public school system.

It seems to me, if we are going to be spending these tight resources, we ought to start at the most critical area. I will certainly be looking to modify and to make those in that category have that benefit available to them. I do not expect an answer from you on that right now, but I think that is where we need the money the most.

But, also, I have some questions, though. The Treasury explanation says that a student who has attended a qualifying school 1 year generally would continue to qualify for the tax credit, even if the local school made adequate yearly progress in the subsequent year.

So if an entering 9th grader qualifies for credit because the high school to which he or she is assigned failed to make adequate yearly progress in the previous year that the student was in the 8th grade, it sounds to me like the student would qualify for a credit not only for the 9th, but also the 10th, 11th, and 12th grades, even though the public school system has made adequate yearly progress in each of these 4 years. Am I correct?

Secretary O'NEILL. Again, it is a difficult choice issue between providing continuity for the individual and the family.

Senator JEFFORDS. What is the reason for the tax subsidy when the public schools are succeeding? How do you justify that?

Secretary O'NEILL. Again, I think you justify it on the basis that, if once you have provided a basis for a student to attend someplace else, that it does not seem fair to them to say, because of circumstances you have got to now do something else which we are going to dictate to you. You have got to go back where you were.

Senator JEFFORDS. I see my time has expired.

Secretary O'NEILL. I would be happy to answer more questions, for the record, for you on this.

Senator JEFFORDS. Certainly. I will be at you with them. Thank you.

Secretary O'NEILL. Thank you.

Senator BREAUX. Senator Snowe has arrived. Any questions, Senator?

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I am sorry I am late, but there are numerous hearings going on today at the same time.

Let me just ask you a question concerning a stimulus package. Obviously we are going to have several votes tomorrow on the cloture, both on Senator Daschle's package as well as on the Centrist package.

Given the various reports about the status of the economy and what we might expect for the type of recovery, how important do you think it is to have some kind of stimulus package that can be helpful to changing the short-term behavior of our economy? At what point may it not be useful to move in that direction?

Obviously, time is of the essence. It is long overdue. Time has passed since we should have obviously considered this bill, as you well know, in the many conversations the three of us have had on this issue in devising the Centrist package.

Senator JEFFORDS. Could we have a vote now while there are only three of us here?

Senator SNOWE. That is exactly right. [Laughter.] That is exactly right. It would be unanimous here. Unfortunately, that is not what we face on the floor. But in looking at the projections by CBO, for example, on economic growth and the impact it is having on the surplus and leading us into deficit circumstances, it is basically in 2001 and 2001. In all of the other years, it is at least equal to what we had anticipated originally, or even higher than the projections CBO had issued a year ago January.

So I think it is abundantly clear that a short-term stimulus package could well affect the economy, and that obviously could have positive implications for the picture for surpluses in the future. The sooner we could do something, the better off we will be with respect to turning around the deficits that we are now experiencing in the budget.

Secretary O'NEILL. I just could not agree with you more. I think what you, Senator Breaux, and others tried to do last fall was exactly right. I continue to believe, if we can quickly put in place the stimulus bill that you are talking about, that you talked about last fall, that it can add as much as a half a percent real growth to the U.S. economy this year.

To translate it into human conditions and questions, it is some hundreds of thousands worth of jobs that either will not be lost or will be added to what we otherwise would have.

When I think about the people who are out there who have used their 26 weeks worth of entitlement, I just cannot imagine that we have not made good on extending unemployment insurance for another 13 weeks, and following through on the other provisions you all put in your bill.

It seems so clear on the face of it, it is the right thing to do. I am very hopeful you are going to be able to do it this week. I think, as you say, if we dally and this is still a question in June, and maybe it does not make any sense in June, but it sure makes sense now.

Senator SNOWE. Exactly. Even Chairman Greenspan, when he testified before the Budget Committee last week, he indicated that the economy will recover in any event. But he also indicated that, "with the potential, at least, that the economy may be more tepid than we would like later in this year, some form of stimulus program probably would be useful."

I guess that is the point. We do not know what type of recovery. But from all indications, it is not going to be a robust recovery. It could be a jobless recovery similar to what we experienced in the aftermath of the 1990 recession.

So that does concern me because obviously those who are unemployed may stay unemployed much longer. In fact, I know some people are drawing positive indications from the decline in the unemployment numbers, and that is positive, but on the other hand it may well be that people are not reporting, as some have indicated, as well.

So we are not going to know the extent of it for a while. I just would regret the fact if we cannot pass some kind of stimulus package that can make a difference. We are not talking about any stimulus package, but I think one that obviously could have an impact in recouping surpluses in the future. That means getting at the short-term condition of our economy.

Secretary O'NEILL. We were very committed to what you all put together as your Centrist Coalition bill. Before you were able to be here, Senator Baucus and I were saying that, left to our own devices, we could have done this last fall. We need to do it now.

Senator SNOWE. It is almost hard to believe it has been 5 months since September 11, and we are still discussing this plan.

On another matter, there has always been a lot of discussion on the Hill about making pension reforms, and the President has indicated that as well and has made some very important proposals to reform the pension laws.

Given your experience as a CEO, can you comment on some of these issues that you think would be helpful and things that we ought to explore, given what has occurred at Enron, and where we could make a difference?

Secretary O'NEILL. The President asked me to head a group to look at this issue. Actually, at two issues. One, the pension and 401(k) questions raised by Enron, and the other, to look at what kind of additional disclosures might be helpful to avoid the meltdown that we saw in Enron as a surprise to people.

Last week, the President issued the first of recommendations that we suggested to him with regard to pension and 401(k) plans.

On the first issue that we spoke to him about and that he has now recommended, we believe it makes sense to give people in 401(k) plans, even where they are supported and matching contributions are made by employers, that employees should have more rapid and certain access to the funds, even if they are corporate contributions, even if they are made in the form of corporate stock, and that the individuals should, after a stated period of time, have the flexibility to diversify into any investment that they want.

Second, as a matter of principle, it seems to us—and the President made a very strong point of this—that the interests of the executive officers and the board of directors and the lowest-level employee in the company should be perfectly parallel.

By that, what we mean is that, for example, when there is a so-called black-out period where the plan administrator is being changed and employees do not have access to, and cannot make decisions about, the investments in their individual plans, to basically say to executive officers and others who have stock holdings either in the 401(k) plan or independently and separately, that we add a burden or a duty to them, that when their employees are in a black-out period, that they cannot and will not do any transactions to buy, sell, or change their position in the company's stock.

So, as the President said, in the right kind of a ship the sailors come before the captain. The captain leaves last. We think the idea of having perfect parallelism and responsibility between the lowest level and the highest level employee in any and every corporation, makes great, good sense.

We also think that it is time to put some requirements on 401(k) plans, that they issue at least quarterly reports on all the holdings and what has happened to them since the last reporting period, and that employers be given incentives to provide education, financial education and investment education, if you will, to all the participants in their pension and 401(k) plans so that they are better informed than many of them seem to be at the moment.

Senator SNOWE. Well, I appreciate that. Obviously we are going to be working with you on some of these issues, because I think, clearly, what happened at Enron, I think, underscores the compelling need for some radical changes with respect to our pension laws. I thought I saw the other day that you recommended some kind of penalties for CEOs.

Secretary O'NEILL. I am one, having been one for many years, who believes that the CEO chairman is, in effect, the steward for all the people who work in their organization.

With that responsibility goes a commitment that the people come first, and that the practices are open, and above-board, and without reproach. Having that conviction, I think our system should be severe in dealing with those who abuse the privilege and responsibility of leadership.

Senator SNOWE. I appreciate that. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator BREAUX. Thank you very much. I am the chairman of the Senate Finance Committee now, for 15 minutes. [Laughter.]

I just wanted to go ahead and maybe ask just one additional question. In the energy tax area, this committee is going to markup an energy tax bill probably next week. I note in the recommendations from Treasury that we have recommendations on tax incentives for solar energy, for hybrid and fuel cell vehicles, for landfill gas, for credits for ethanol.

But we do not have anything for what I would consider to be some of the more traditional incentives for traditional production, like Section 29, the expensing suggestions for geological and geophysical costs, tax credits for marginal wells, all of those things.

I guess the question is twofold. There are also no offsets being recommended. That either means we are going to not do them, or you just want us to have the fund of finding them.

The question, I guess, in looking at Section 29, the geophysical and geological expensing, and the marginal well tax credit, these ideas have been around for a long time. If they find their way into the bill, what is going to be the position of the administration, since they are not being recommended?

Secretary O'NEILL. Well, what you have in front of you in the form of the President's energy proposal is a considered opinion about the composition and size of incentives and spending that we believe are necessary to support growing energy independence for the United States.

Our budget is what it is without offsets, if you will. I suppose, if there are alternative provisions that the Congress would like to consider, we ought to discuss those with you. We ought to get Spence Abraham up here to work through them with you.

Senator BREAUX. We are going to have to do that. There is nothing in here. I mean, if you are talking about balance, there is nothing that I see for oil and gas. I mean, there is a lot of solar, and I am for that. Ethanol is there, and I am for that. Landfill gas. That is a biggie. I am for that. Hybrid fuel cell vehicles. I am for that. But coming from my part of the country, I do not see anything at all for oil and gas.

Secretary O'NEILL. We should sit down and talk through the ideas you have.

Senator BREAUX. All right. I appreciate that.

I look forward to working with you always, and with your staff.

With that, the committee will be adjourned.

Secretary O'NEILL. Thank you very much.

[Whereupon, at 4:30 p.m., the meeting was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Paul O'Neill

Good morning Chairman Baucus, Senator Grassley and members of the committee. Thank you for inviting me to testify today. ow that we've had a year to work together, you should know that I am an optimist about the US economy. I believe we always have untapped potential that can be unleashed to spread prosperity throughout the nation. Never has that been more true than right now. Even after a difficult year, my optimism about the fundamentals of the US economy has not changed. I believe we were on the verge of recovery before the September 11 terrorist attacks, and that our resilience and determination have brought us back to the early stages of recovery today. We see more and more signs every day indicating that the seeds for a recovery are there, and only need nourishing to speed the process of putting Americans back to work. I believe we will return to prosperous economic growth rates of 3 to 3.5 percent, as soon as the fourth quarter of this year, especially if we are able to pass still-needed economic security legislation to hasten and strengthen our recovery.

Strengthening our economy must be our primary goal. It is the focus of the President's budget. That must be our goal, because a return to our normal growth rates means jobs for the 1.4 million Americans who have lost jobs during this recession. Just as a strengthening economy means greater prosperity for our nation's people, it also means greater strength for our government. It means greater revenues going into the Treasury, without raising taxes, giving us resources to address the nation's needs, and the retirement of even more federal debt—leading to long-term economic security for our children. Even with all that must be done to enhance our security, we expect that a return to economic growth will bring us back to government surplus in 2005.

The economy's slowdown began in mid-2000, when GDP and job-growth slowed sharply. Business capital spending began to plummet in late 2000, and accelerated its decline in 2001, dragging down the economy. In August we were beginning to see the evidence of an economic rebound. I firmly believe that had it not been for the terrorist attacks of September 11th, that we would have seen an end to the economic downturn and would perhaps have avoided a recession. The September 11 attacks created shockwaves that rippled throughout all sectors of the economy. Financial markets were shut down for almost a week. Air transportation came to a standstill. As a result, GDP fell 1.3 percent at an annual rate in the third quarter.

By late November, the National Bureau of Economic Research declared that the US was in a recession. They designated the end of the previous expansion to be March 2001, but they observed that the slowdown might not have met their qualitative standards for recession without the sharp declines in activity that followed the terrorist attacks.

In sum, the scorecard for the economy in 2001 reflected a combination of adverse events:

- The private sector lost more than 1.5 million jobs.
- The unemployment rate rose 1.8 percent points.
- Industrial production was off nearly 6 percent during the year.
- Industry was using less than 75 percent of its capacity.

As bad as these numbers are, they could have been worse. Our well-timed bipartisan tax relief package put $36 billion directly into consumers' hands in the late summer and early fall, providing much needed support as the economy sagged. It was the right thing to do, at just the right time.

It's not surprising then that both the Congressional Budget Office and the Office of Management and Budget project deficits for this year and next as a result of the economic slowdown and the response to the September 11 attacks. Last April's budget forecast a fiscal 2002 surplus of $283 billion. The Mid-Session review figures, released in August, took account of the impact of the President's tax relief package and projected a $195 billion surplus in fiscal 2002. The new budget forecasts a fiscal 2002 deficit of $9 billion, assuming no policy action to stimulate the economy. The reduced surplus estimates are the result of the economic downturn and the response to the September 11 attacks. CBO's projections confirm that tax relief played a minor role in the surplus decline in the next few years—accounting for less than 12 percent of the decline in 2002 and less than 28 percent in 2003.

	FY02 surplus (in billions)
April 2002 budget baseline:	$283
Changes from:	
weaker economy/technical changes	-197
enacted spending	-54
tax relief	-40
February 2003 budget baseline:	-9

The CBO budget projects a 10-year surplus of $1.6 trillion. Last August, after factoring in the tax relief package, the CBO projected a $3.4 trillion surplus for the next 10 years. The recession and the war on terrorism depleted the 10-year projections by $1.8 trillion. The lesson from these numbers is simple—10-year projections are a useful discipline but they do not predict the future. None of last year's 10-year estimates foresaw the events of September 11 or a negative $660 billion worth of "technical changes" that are now included in the new 10-year estimates by agreement among the technical experts. We do know about the here and now, and we should deal with the here and now, reigniting growth to restore long-term surpluses.

The Administration's growth projections are similar to the consensus of private forecasts. Over 90 percent of the Blue Chip Economic Indicators panel members say the recession will end before April of this year. We share that assessment. Personally, I am optimistic that the economy will do even better than our budget assumptions suggest. For the near term, we expect the economy to grow 2.7 percent during the four quarters of 2002. That projection includes the foreseeable effects on the economy of the President's economic security package.

The lesson is clear. A strong economy is crucial to restoring budget surpluses. Some would suggest that we need surpluses to improve our economy. They have the logic backwards. Growth creates surpluses, not the other way around.

The federal budget was in deficit every year from 1970 through 1998. From 1970 through the early 1990s, government spending growth exceeded government revenue growth by ¾ of a percentage point a year, on average. Fiscal discipline was imposed by the historic *Omnibus Budget Reconciliation Act*, signed in 1990 by President Bush. With fiscal restraint made an integral part of the budget process, once the economy took off in the 1990s, revenue growth was double the pace of spending growth. It was the rapid economic growth of the 1990s that generated the burgeoning budget surpluses, which appeared even as federal outlays grew about 3.5 percent a year from 1993 through 2000.

Today the economy is recovering. The tax cut of last May helped to keep the economic downturn shallow and it will continue to help. Energy prices have retreated. The Federal Reserve has reduced short-term interest rates 11 times since the beginning of 2001. Measures of consumer confidence are bouncing back. The index of leading indicators increased sharply in December for the third straight gain. Motor vehicle sales have remained strong. And initial filings for unemployment benefits are in decline. But we all know that unemployment itself is a lagging indicator. Although the current trend is positive, too many people will remain out of work. And given the choice, they'd rather have a regular paycheck than an unemployment check.

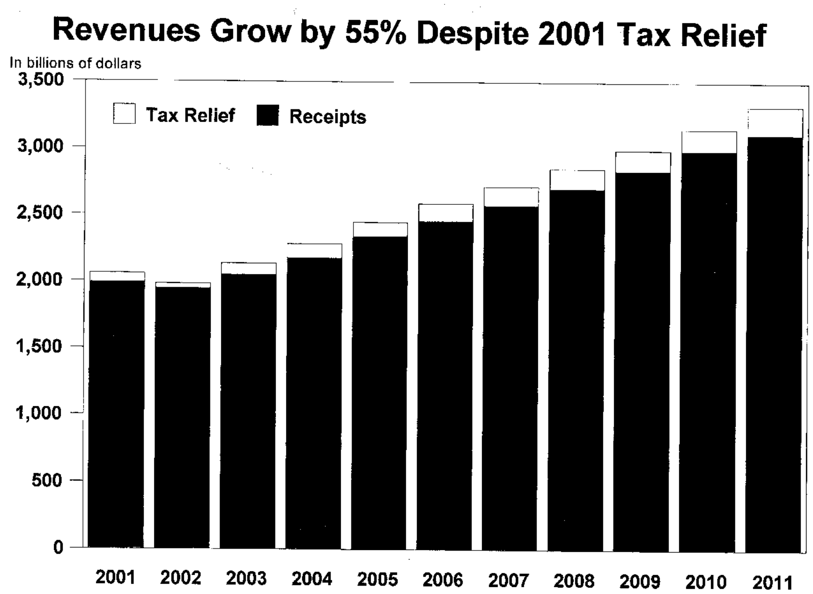
The President has presented a budget to speed our recovery. First, the budget includes tax relief to stimulate job creation as a crucial tool to speed our recovery and put Americans back to work. The President's proposals—accelerated depreciation, speeding up the reduction in the 27 percent income tax rate, adjustments to the corporate AMT so it doesn't cancel out tax relief, and checks to those who didn't benefit from last summer's tax rebates—enjoy bipartisan support in both houses of Congress. I'm eager to work with all of you to complete work on a package to create jobs and assist dislocated workers with extended unemployment benefits and temporary assistance with health care.

Second, the President's budget proposes strict fiscal discipline—increasing spending for national security and homeland defense, and holding the line on other spending. His management agenda calls for performance measures to be used to determine where budget increases are allocated—so that our resources go into the projects and programs that make the biggest difference in people's lives. As the experience of the 1990s shows, this discipline in crucial to ensuring we do not return to systemic deficits of the past. But fiscal discipline alone will not guarantee budget surpluses. We must return to 3 to 3.5 percent annual growth to ensure surpluses for years to come.

The focus must be on restoring growth. Surpluses will then follow naturally. Raising taxes would stifle the process of getting Americans back to work. This is a bad idea, as our recovery is struggling to take hold. According to 1999 data, the most recent available, 17 million small business owners and entrepreneurs pay taxes under the individual income tax rates. They have made business plans that assume that the tax relief enacted last summer will take place as scheduled. Eighty percent of the benefit of cutting the top two rates goes to small business owners and entrepreneurs. These are the engines of job creation in our economy.

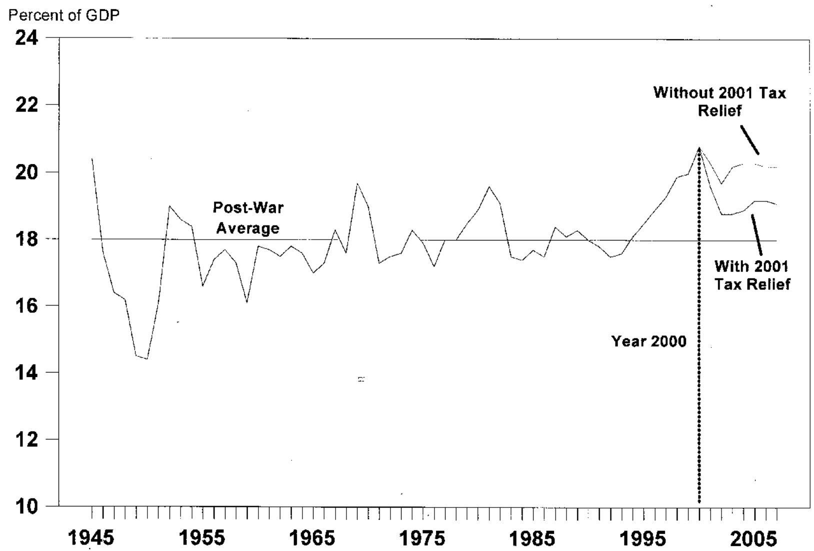
Tax relief should be accelerated, as the President has proposed to boost; job creation. Such relief will have minimal, or no, effect on long-term interest rates. According to a recent analysis by the CEA, an expected $1 trillion change in the public debt over 10 years would tend to raise the long-term interest rate by 14 basis points. Since the tax cut last year, the 10-year nominal rate has averaged 4.93 percent, which is substantially below the 6.16 percent averaged from 1993 through 2000.

Restoring growth is the key to America's future. Restoring growth is the key to ensuring we have the resources in Washington to fight the war on terrorism, provide for homeland defense and provide the services the American people demand. The President's budget will help to ensure that both peace and prosperity are restored to the American people as soon as possible.

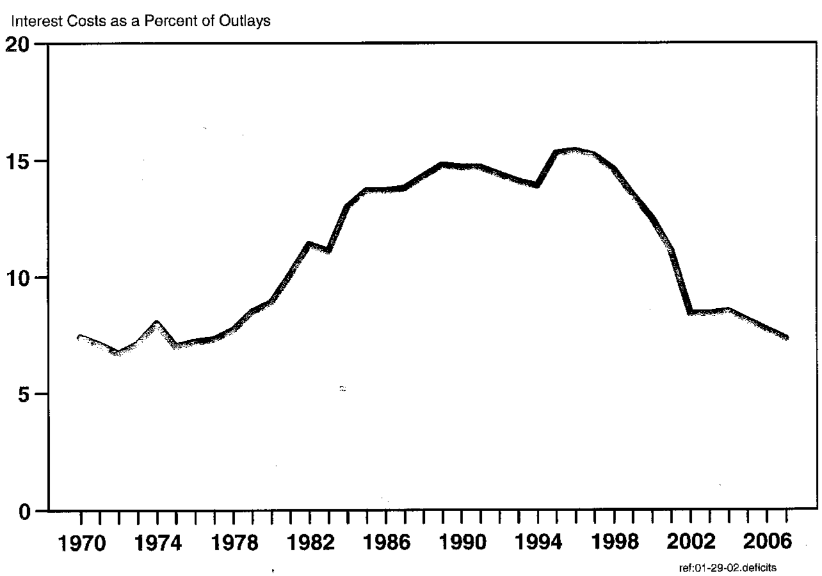


Note: Tax relief includes proposed extension of provisions beyond 2010.

Tax Take Remains Historically High



Government Debt Burden Continues to Fall



RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Any stimulus package that would be enacted needs to be cost-effective. Creating economic stimulus costs the Federal government money. And we have already seen today that we have many priorities competing for Federal dollars. So if we are going to pass a stimulus package, it needs to have a large bang for the buck.

Now the Administration continues to support the House-passed bill. Recently, however, the non-partisan Congressional Budget Office issued a report that evaluated many of the tax cut stimulus options. They concluded that three major proposals in the House-passed package have only small bang for the buck. These are repeal of the corporate alternative minimum tax, bonus depreciation for three years, and accelerating the marginal rate reduction in last year's tax bill. Indeed, almost 60% of the potential stimulus in the House-passed bill would take place after any recession is over.

Question: The President's Budget makes the case that we must weed out ineffective government programs and target our money on those programs that are cost-effective. Shouldn't the stimulus proposals that you support be held to the same standard?

Answer: The Administration is pleased that Congress has enacted the Job Creation and Worker Assistance Act of 2002, P.L. 107–147. The Act includes the partial expensing provision supported by the Administration, an additional 30 percent first-year depreciation deduction. It additionally provides extended unemployment assistance to displaced workers, relief for New York City, and extends expiring tax provisions. We believe the stimulus provisions of this bill are cost-effective. As noted by the Congressional Budget Office, expensing can be an effective stimulus. The additional 30 percent first-year depreciation provision has virtually no long-term costs, as the depreciation deductions taken in the first year offset future depreciation deductions dollar-for-dollar. We are pleased that the Act provides for this provision to be in effect through September 2004. Had the provision been effective only through September 2002, there may have been risks from the expiration of this provision while the economy was still in a potentially vulnerable phase of the recovery.

When the Enron corporation went bankrupt, it highlighted a number of problems with our current pension system, as thousands of workers not only lost their jobs, but suddenly realized their nest eggs were wiped out as well. Unfortunately for the workers, they had put all of these eggs in one basket—the Enron basket—as they were heavily invested in Enron stock. When the stock crashed, a lifetime's worth of pension savings turned to dust.

Unfortunately, it's clear that Enron's workers are not as unique as we might think—thousands of other workers are also heavily invested in one stock and one stock only—that of their employer. For example, the workers at Procter & Gamble have almost 95% of their 401(k) assets invested in their company's stock; workers at Coca-Cola, McDonald's, General Electric, Home Depot, Abbott Labs—all have between 70%–90% invested in their employers stock. These are just a few examples, and though they might be very strong companies with bright futures, their employees are betting the farm that nothing bad will happen to them.

Recently, President proposed a series of changes to pension law designed to prevent future Enrons. These proposals ranged from limits on how long a company can force workers to hold company matching stock, to changes in executive compensation rights and the rule in place during lockdown periods. Secretary O'Neill, you were part of the Presidential Task force that helped develop these proposals.

Question 1: If they had been put in place 5 years ago, how would they have helped Enron's workers avoid the financial nightmare they're in today?

Answer: The president's proposals would have helped Enron employees in many different ways. First, the enactment of the Retirement Security Advice bill would have made it more likely that the Enron employees would have had available individualized investment advice which would have warned them of the risks involved in not being diversified. Second, Enron workers would have been receiving quarterly statement of their 401(k) account balances that would have repeatedly warned them of the importance of diversification. Third, the period of time when they were not allowed to sell employer stock (i.e., the "blackout period") would likely have been shorter, given the Administration's proposals that would drive employers to strive for the shortest blackout possible.

Question 2: We all know that putting all your eggs in one basket significantly increases your risk of loss, and yet the vast majority of employer stock in these upper-concentrated plans is put there voluntarily by workers. Is it possible to adequately protect workers without some kind of limit on their ability to load-up on company stock in their retirement plans?

Answer: The Administration believes that giving participants the information they need to understand investment principles is the most important thing that we can do. Giving employees the tools to make the right decisions in their own cases is better than providing a government mandated one-size-fits-all solution that some have advocated.

Question 3: The pension community has lamented the decline of the defined benefit plan in this country. This decline has occurred partly in response to today's mobile workforce, but also in part because of the complicated rules and funding requirements that accompany these plans. Because they're guaranteed, we need a certain amount of structure to make sure the benefits they guarantee are fulfilled. Are we also running the risk of discouraging companies from offering defined contribution plans, or of providing company matches, if we place too many limits on 401(k) plans?

Answer: The Administration crafted its recommendation recognizing the fact that too much regulation would risk discouraging employers from offering defined contribution plans or company matches. We believe that we have achieved the proper balance of giving freedom to employees to invest their own funds and not putting too many burdens on companies who sponsor these plans.

Question 4: ESOPs can be a great way for employees to share in their employer's future, while also providing benefits to the company. However, when they become the only retirement plan available at a company, they are by definition super-concentrated in employer stock. It is also very easy today to convert from a 401(k) plan into an ESOP, or to integrate an ESOP into another defined contribution plan. How do you suggest we protect both workers and companies with ESOPs?

Answer: The Administration's proposal has addressed the difficult issue of protecting employees and companies with ESOPs. The Administration's proposal exempts from the diversification rules free-standing ESOPs—which are those where there are no employee contributions, employer matching contributions or employer contributions made to meet the 401(k) plan nondiscrimination tests. The result is that employer contributions made to an ESOP to provide stock ownership to employees and not linked to employee's own retirement savings contributions would not be subject to these new diversification rules. We believe this strikes the proper balance between protecting workers' savings while still maintaining the incentive for employers to foster worker ownership through ESOPs.

Addressing abuses involving corporate tax shelters received significant attention during the Clinton Administration. The Administration's FY 2000 and 2001 budgets included both general proposals aimed at discouraging corporate tax shelters and specific proposals targeting particular transactions. At a speech before the Federal Bar Association two years ago, Secretary Summers characterized the threat of corporate tax shelters as "the most serious compliance issue threatening the American tax system today."

For the past two years, the Committee on Finance has been developing legislation designed to deter the purveyance of these shelters, protect the integrity of the tax system, and ultimately reduce the tax burdens of honest tax payers. The Committee's shelter proposal would impose stiff penalties on taxpayers who engage in tax shelter transactions, emphasizing disclosure, and adding penalties for tax promoters and professionals.

Following the collapse of Enron Corp. a number of articles have been written on the company's extensive use of partnerships and other special purpose entities to "manage tax liabilities" or avoid paying taxes. Many of these entities were located in tax haven countries. While the facts surrounding Enron's tax reporting history are not known—the Committee has asked for the company's full cooperation and release of its tax returns—it is clear that the proliferation of abusive tax shelters continue to be a serious problem. The Bush Administration's FY 2003 budget request does not contain any statutory proposals designed to curtail abusive tax shelters.

Question 1: There is nothing in the Administration's FY 2003 budget request to address the tax shelter problem. What is the Administration's response to reports about Enron's extensive use of partnerships in tax haven countries and reports that Enron used various questionable techniques to cut their Federal tax bill?

When workers lost their retirement savings in Enron's 401(k) program, the Administration quickly put forth recommendations to protect retirement saving. Does the Administration plan to make recommendations to address the growing problem of abusive tax shelters?

Will the Treasury Department commit to working with Finance Committee to develop meaningful legislation to curtail the proliferation of abusive tax shelters and penalize those who purchase such products and those who sell them?

Answer: The Administration is concerned with any taxpayer that engages in abusive tax avoidance transactions, including those involving offshore accounts and entities, to avoid or evade tax. The Treasury Department's Enforcement Proposals, issued on March 20, 2002, are a comprehensive package of administrative, regulatory, and legislative actions and proposals to address abusive tax avoidance transactions. These proposals will require the timely disclosure of questionable transactions to the IRS so that they may be scrutinized, and will impose new penalties on taxpayers who fail to disclose questionable transactions and increased penalties on promoters who fail to register questionable transactions. In cases where regulatory or administrative guidance is needed to address a disclosed transaction, the Treasury Department and the IRS are committed to issuing that guidance promptly. Where necessary to address a disclosed transaction, the Administration will seek legislative changes.

Question 2: When workers lost their retirement savings in Enron's 401(k) program, the Administration quickly put forth recommendations to protect retirement savings. Does the Administration plan to make recommendations to address the growing problem of abusive tax shelters?

Answer: As discussed above, the Treasury Department has issued a number of legislative proposals for addressing abusive tax avoidance transactions. We look forward to working with Congress to enact these legislative proposals.

Question 3: Will the Treasury Department commit to working with the Finance Committee to develop meaningful legislation to curtail the proliferation of abusive tax shelters and penalize those who purchase such products and those who sell them?

Answer: Yes. The Treasury Department is committed to working with the Committee to develop and enact meaningful legislation what will allow the Treasury Department and the IRS to respond vigorously to abusive tax avoidance transactions, including the persons who promote these transactions.

The Treasury Department's Explanation of the Administration's FY 2003 Revenue Proposals (the "Blue Book") states in the introduction that the

> "Administration is undertaking a project to achieve significant simplification of the tax code. The Treasury Office of Tax Policy is preparing staff white papers that will develop and analyze a number of options for simplification of tax provisions affecting families and individuals, businesses and investment, retirement and savings, tax-exempt organizations, and excise taxes. These white papers will provide the basis for discussions with the Congress, tax practitioners, and taxpayer which will, in turn, lead to development of tax simplification legislation."

Tax simplification isn't easy. It has costs. It competes with other priorities. Bill Gale from Brookings once argued that "people really don't want to simplify the tax system. Given the choice between simplicity and a tax break, most go for the money." At the Finance Committee's hearing on Tax Law Complexity last April, you mentioned the old saying "everyone complains about the weather but nobody ever seems to do anything about it."

You suggested the creation of a "Bipartisan Blue Ribbon Commission" to help generate momentum for reasoned, common sense simplification proposals.

The AMT is the number one problem facing American taxpayers. According to the National Taxpayer Advocate, the AMT is so complicated that many taxpayers are not aware that they may be subject to it. She recommends its repeal. Unless something is done, 35.5 million taxpayers will be subject to the AMT by 2010. The administration's FY 2003 budget request does not address the AMT problem.

Question 1: Do we need "white papers" to tell us we need to fix the AMT problem? Why didn't the Administration propose legislation to address this most urgent matter? What is the Administration's time table for issuing its white papers and making recommendations for simplifying the tax code?

Answer: No, that's easy. But a white paper can be helpful in examining how to fix the AMT. A number of reports and studies have recommended repeal of the AMT. Few, if any, however, have spelled out how this might be accomplished. Repeal of the AMT would be very expensive. Our estimate is that if the AMT were repealed in 2005, the revenue loss through the remainder of the budget period (FY 2005–FY 2012) would be $679 billion. Hence, a recommendation simply to repeal the AMT doesn't really get you very far.

The Treasury is studying a number of options for dealing with the AMT, ranging from outright repeal to repeal with revenue offsets to more modest changes that would be less costly but also less effective in dealing with the problem. We are analyzing the consequences of the various options in terms of the number of taxpayers affected, the degree of simplification achieved, the revenue cost, and other tax policy considerations. When this assessment is completed, we will share the results with the Congress. We look forward to discussing these issues with you and working with you to develop a viable solution to this problem.

Question 2: Why didn't the Administration propose legislation to address this most urgent matter?

Answer: The Administration believes that the best way to develop viable approaches to dealing with this difficult issue is to work closely with the Congress to develop the proposals. We believe the discussion of options for dealing with the AMT will serve as a solid basis for moving forward in this process.

Question 3: What is the Administration's timetable for issuing its white papers and making recommendations for simplifying the tax code?

Answer: The first white paper, which focussed on providing a uniform definition for a qualifying child under several tax code provisions benefiting families with children, was released on April 15. Additional white papers, which will focus on a wide range of other tax areas, will be issued over the coming months. We hope to engage in a serious dialog with the Congress aimed at developing tax simplification legislation shortly after the release of the white papers.

As you know, Mr. Secretary, you and I spent a good deal of time discussing health tax issues during the economic stimulus debate. And I believe we made a great amount of progress during the debate in understanding each other's concerns.

The economic stimulus debate was limited to a discussion about displaced workers. But we all know that making health insurance available and affordable for the uninsured more generally is critical.

Looking at your FY 2003 health tax credit proposal, it seems to me that many of the concerns we had earlier addressed would be magnified and worsened because of the proposal is not limited to displaced workers.

Question: I would like you to comment on three areas of concern that I have with your proposal.

1. First I am concerned about the impact of your proposal on employer-sponsored health insurance. Because the credit would make non-group coverage relatively less expensive than under current law, some individuals—most likely young and healthy ones—would leave their employer-sponsored coverage. Less healthy, older workers would make up a greater share of the employer-sponsored market. Therefore, the cost of health insurance in that market would increase. Obviously, this was not a problem during the stimulus debate because the bill was limited to displaced workers. Can you please tell me how the Administration would address that problem?

2. Second, I am interested in how the refundable and advanceable credit would be administered. Can you comment on the administration of the credit? In particular, I am concerned about issues such as certification procedure and reconciliation?

3. Finally, during the economic stimulus debate, I raised concerns about subsidizing an immature health insurance market—namely the private individual market. I said that it would be unwise to spend taxpayer dollars on health insurance that would not ensure quality, affordable coverage. You understood those concerns, yet I am disappointed that the Administration did not address them in any meaningful way in its budget.

Answers:

1. Impact on Employer-Provided Health Insurance

One concern in designing a policy to expand health insurance coverage to the uninsured is that a new policy may inadvertently decrease health insurance options to those presently insured. Some have suggested that if incentives for purchasing health insurance outside of the employer market become sufficiently attractive, employers might stop providing health insurance coverage to their workers, potentially resulting in a net decrease in health insurance coverage among the population. Based on these concerns, the Administration's proposal has been designed to avoid "crowd-out" of subsidized employer coverage. Several elements of the health insurance tax credit design contribute to this desirable result. Most importantly, low-income individuals and families, who are least likely to have employer-based health insurance, will receive the largest incentives under this proposal. The tax credit subsidy rate decreases with income, making the new tax credit less attractive compared with the current law tax exclusion for employer-provided insurance at higher income levels. Finally, the tax credit is further limited by a cap on theamount of premium eligible for a subsidy, providing an additional incentive for employers and employees to continue to include employer-sponsored health insurance benefits as part of the compensation package.

2. Administration of the Refundable Advance Credit

The health insurance tax credit would be both refundable and advanceable.

- Refundability means that the value of the credit does not depend on taxes owed; even people who owe no taxes can still receive its full value.

- Advanceability means that those eligible for the credit have the option of using it when they are actually purchasing insurance, to reduce their monthly premium payments, rather than having to wait until they file their tax return at the end of the year. The advance credit is based on the previous year's income, so that people will not have to worry about paying the credit back if financial circumstances change. This means there is no "reconciliation problem" in providing an advanceable credit.

An individual would qualify for the advance credit based on their income from the prior year's tax return. The IRS would send notices to eligible filers informing them of how they could take advantage of the advance payment and the maximum amount of the credit for which they qualify. When an individual signs up to purchase a policy through an insurer, he or she would then pay the difference between the premium for a health insurance policy and the tax credit amount. The insurer would be reimbursed by the Treasury for the advance credits used to purchase qualifying health insurance. Eligible individuals not using the advance credit mechanism could claim the credit on their tax return.

3. Private individual health insurance market

Recent research suggests that the credit would provide good, affordable health insurance options for the vast majority of individuals who are eligible for the credit. This is the subject of a detailed state-by-state analysis by the Council of Economic Advisers, which finds that for lower income Americans, the proposed health insurance credit generally covers more than half of the premium the purchaser would face, and would almost always covers more than a third. This study is available on the CEA website. A recent study by the health insurance distributor eHealthInsurance found that three-quarters of premiums for individual health insurance plans that it sold were less than $2,000 and three-quarters of family premiums were less than $5,000.

The credit would make health insurance affordable not just for the healthy or the young. Some misperceptions caused by a recent Kaiser Family Foundation report on the topic need to be corrected. That report claimed that those with chronic health conditions were unable to obtain reasonably priced comprehensive health insurance in the non-group health insurance market, based on a survey of the plans that would be available to some hypothetical insurance purchasers. But a close examination of the survey results reported in the study reveals that virtually all applicants were able to obtain at least one good policy in every area of the country that was surveyed. The one applicant who generally could not get an insurance offer (a person who was HIV positive) could still obtain subsidized insurance through high-risk pools available in most states. Earlier this year, the House of Representatives passed legislation that would provide additional Federal subsidies for high-risk pools, to help ensure that affordable coverage would be available in all states for persons with pre-existing conditions. Adequately funded high-risk pools are a proven approach to help make sure that all persons in a state can get good coverage. Contrary to what one might expect, health insurance premiums for individuals with pre-existing conditions are often much higher in states that rely on community rating and guaranteed issue than in states with high-risk pools.

Another effective approach to further ensure that affordable coverage options are available to all eligible lower-income persons involves state-sponsored purchasing groups. The Administration's proposal permits certain individuals to purchase private insurance through such state-sponsored health insurance purchasing groups.

Mr. Secretary, as you know, the President's Commission on strengthening Social Security recently proposed three options or models for diverting Social Security payroll taxes into private accounts. The President indicated in his State of the Union address that he still strongly supports the creation of such private accounts.

Recently, the independent Chief Actuary of the Social Security Administration issued an analysis of the Commission's three proposals. The analysis shows that option 1 would add about $600 Billion to the Federal deficit over the next ten years, model 2 would add more than $731 Billion, and model 3 would add $642 Billion. And model 3 calls for more than $159 of general revenue infusions on top of the $642 Billion cost.

Now what is somewhat alarming is that the President's budget—which is already the subject of intense competition among priorities—does not make room for even one dime for Social Security reform. If the President is serious about private accounts, then the budget should have allocated some resources for it, at least as a placeholder if nothing else.

Question: So if the President is serious about private accounts, what programs or tax cuts would you sacrifice once you determine which option or options you favor for implementing private accounts?

Answer: The Administration's budget reflects its belief that a strong economy is a key ingredient to securing future retirement security, rather than a competing goal. The welfare of future retirees and the economy are inextricably linked. Future retirees will enjoy substantial benefits from a stronger economy today. A stronger economy produces more tax revenue to help meet obligations to future retirees. A stronger economy also generates higher paying jobs, thereby allowing for a larger amount of resources to be saved for retirement. It also helps generate larger returns on the investments that millions of workers have made through 401(k) plans and other retirement plans. (The Administration's recent recommendations for reforming 401(k) plans will also help secure future retirement security.)

However, unless action is taken in a timely manner, retirement benefits that must be paid to future retirees have the potential to significantly impact the government's fiscal position. The Administration believes that the best action is to begin pre-funding some of these future obligations today rather than waiting until the time of reckoning is upon us, which will require much larger steps. Personal retirement savings accounts are the best way to begin setting money aside today.

The highway program under the President's FY 2003 budget is $ 9 billion lower than in FY 2002. This will be devastating in every state, including Montana. I've already made clear to Transportation Secretary Mineta that corrective action is necessary.

Question 1: What are your thoughts on fixing this problem in FY 2003? My understanding is that the problems we're having directly relate to errors in estimating highway user tax revenues. What model are you using? How can we improve this process so we don't see such fluctuations?

Answer: The Transportation Equity Act for the 21st Century (TEA–21) specifies that highway program levels will be adjusted from that specified in the legislation. This calculation is called Revenue Aligned Budget Authority (RABA) and it is calculated by the Office of Management and Budget when the Administration presents the budget. This calculation depends on Treasury reports of actual and forecast highway trust fund tax receipts. The RABA calculation for FY 2003 results in a reduction of $4.639 billion from the levels specified in TEA–21. Eighty percent of this adjustment relates to a decline in actual 2001 receipts and the remainder results from a revised forecast of receipts expected in FY 2003. The administration carried out the specified calculation as called for in TEA–21. Any further changes have to be considered as a part of the total budget that weighs many priorities against limited resources.

My understanding is that the problems we're having directly relate to errors in estimating highway user tax revenues.

Question 2: What model are you using?

Answer: Each of the six dedicated Highway Account excise tax sources are separately forecast: (i) Gasoline, (ii) Gasohol fuels, (iii) Diesel and other fuels, (iv) Retail tax on trucks, (v) Highway-type heavy tires, and (vi) Heavy vehicle use tax. The models use historical data to estimate a relationship between historical tax receipts and overall economic trends. The model is then used to forecast future receipts given the administration's economic forecast.

Question 3: How can we improve this process so we don't see much fluctuations? The RABA mechanism compares current forecasted levels with those made by the Congressional Budget Office at the time TEA–21 was drafted, in 1998. The fluctuations, both up and down, are due to the inherent uncertainty in forecasting several years ahead. In particular, downturns in the economy are very difficult to forecast and it was the downturn in 2001 that caused the large RABA adjustment this year.

Answer: The formulation of the RABA mechanism exacerbates fluctuations in receipts and forecasts. As a part of the Highway reauthorization process Treasury looks forwardto providing assistance in evaluating alternative adjustment mechanisms that might produce more stable program levels.

Responses to Questions From Senator Grassley

Question 1: Critics of last year's bipartisan tax cut claim it will raise interest rates and have a negative impact on the economy.

However, all of the evidence that I've seen shows that interest rates on tax exempt bonds are lower than the interest rates on taxable bonds.

Since those who hold tax-exempt bonds are willing to accept a lower interest rate, wouldn't you have to conclude that lower tax rates will result in lower interest rates on taxable bonds?

Answer: I agree with the premise of your question that investors need to be compensated for the taxes that they pay on those investments. You give the example of the lower interest rates on tax-exempt bonds. But the same principle applies to government bonds, and there is evidence that it works for government bonds as well. As a result, as long as Congress can keep spending and deficits under control, the lower tax rates passed last year will eventually help lower interest rates on government bonds.

Question 2: Mr. Secretary, I note that there is a balanced package of energy production and conservation initiatives. I compliment you and the Administration on achieving such a well-balanced package. Is the Administration open to considering additional energy measures in a comprehensive energy package?

Answer: The Administration is pleased that a majority of the provisions of the President's National Energy Policy are included in either the House or Senate versions of H.R. 4. We look forward to working with the Congress on comprehensive legislation that meets the President's objectives as set forth in the National Energy Policy.

Question 3: Because EGTRRA held taxpayers harmless with respect to the AMT through 2004 (despite the fact that the Senate proposal offered to hold taxpayers harmless through 2007), the cost of repeal of the AMT begins to increase dramatically beginning 2005. As you know, budget surpluses also reappear in post-2004 years. To the extent such surpluses do arise as expected in those out-years, do you believe that repeal of the AMT would be an appropriate and effective use of those resources?

Answer: The large annual increases in the number of taxpayers affected by the AMT are a very significant problem that the Administration and the Congress must address together. We hope and expect that prior to 2005 tax simplification and tax reform initiatives will have addressed the AMT issue more comprehensively than would simple extensions of the current temporary provisions. The Administration would be pleased to work the Congress in developing solutions for the AMT, hopefully as part of more comprehensive changes addressing the many problems of the current income system.

Communications

Statement of the National Society of Accountants

Mr. Chairman, the National Society of Accountants (NSA) is pleased to submit testimony for the hearing record on President Bush's fiscal year 2003 budget proposals. The NSA and its affiliated state organizations represent 30,000 accountants, tax practitioners, business advisors and financial planners providing services to over 19 million individuals and small business. Most of our members are sole practitioners or partners in small to medium sized firms. NSA represents the accountants for Main Street, not the accountants for Wall Street.

IMPROVE TAX ADMINISTRATION

The Administration proposes a six-part modification to the IRS Restructuring Act of 1998 (RRA98). We concur with the provision to allow taxpayers to enter into less than full pay installment agreements with the IRS. This is a common sense provision whose implementation is long overdue. The proposal to modify IRS employee infractions subject to mandatory termination is a positive change to the RRA98.

Another proposal would curb frivolous submissions and filings by raising penalties for filing frivolous tax returns from $500 to $5,000 and impose a $5,000 penalty for repeatedly filing or failure to withdraw after notice certain other submissions. While generally supportive, we caution that if improperly crafted these new measures could dampen legitimate resubmissions and filings, such as a resubmission of an Offer-In-Compromise (OIC) based on new or updated taxpayer information. In a similar vein, the proposal to terminate an installment agreement for failure to make timely tax deposits and file tax returns should contain allowances for circumstances beyond the control of the taxpayer.

We support the change that would eliminate the requirement that the IRS Chief Counsel provide an opinion for any accepted OIC equal to or exceeding $50,000. In our view, the Chief Counsel has not added any value to the program to begin with and in fact has been a detriment to the process by withholding approval of offers on policy grounds rather than on legal sufficiency.

On the issue of the OIC program in general, NSA maintains that the program remains fundamentally flawed and ultimately no amount of "process" improvement will help. Until the program is moved from compliance oriented personnel and reassigned to settlement oriented personnel who are allowed to design and administer a settlement oriented program, the goal of achieving what is potentially collectible at the earliestpossible time and at the least cost to the government while providing taxpayers a fresh start toward future voluntary compliance will remain unfulfilled.

IRS NATIONAL RESEARCH PROGRAM

Recently, the IRS unveiled a new compliance study, known as the National Research Program, to revamp its audit selection process. As we understand the program, the tax returns of up to 50,000 individuals and small business' would be subject to review at various levels of intensity. The program would select 2000 taxpayers for detailed line-by-line examination for "calibration" purposes.

First and foremost, we do not question the right of the IRS to perform audits to ensure compliance with tax laws. Nor do we object to the need for the Service to gather statistics for use in improving the process. We do object to the perceived need to subject even 2000 taxpayers to the burden and hardship of intrusive line-by-line audits whose sole reason for selection is to satisfy a debatable statistical need for "calibration." We believe that the IRS has other tools and techniques at its disposal to gather the information needed to improve the audit process, such as data from closed cases. The IRS can and should find another way.

An audit of a tax return is by definition an adversarial process. A notice of audit from the IRS even to a compliant taxpayer is a cause for concern and anguish and many will seek, at substantial cost, professional representation to protect their interests. Adding to the mix is the fact that much of the tax code is subject to interpretation and judgment calls based on facts and circumstances. Reasonable people can and do differ on how the tax law applies to a given situation.

To defuse the adversarial aspects and to enhance taxpayer cooperation and faster resolution of issues, the IRS should grant the taxpayer limited immunity for problems discovered during the audit (barring any criminal behavior on the part of the taxpayer). If the goal of the NRP is to gather better data and truly improve the audit process then IRS should provide these taxpayers something in return for compelled cooperation as compensation for the intrusion and expense caused by these audits.

Mr. Chairman, the scars from the overly intrusive Taxpayer Compliance Measurement Program (TCMP) of the past are still fresh. We are deeply concerned, even after assurances from senior IRS management to the contrary, that this program will morph itself into an updated version of the TCMP. At the very minimum, we recommend that the Finance Committee rigorously exercise its oversight authority to prevent this program from reincarnating into another TCMP nightmare.

FREE ON-LINE TAX FILING

The President's budget contains a proposal to allow taxpayers to file their taxes "free" through an IRS web site as part of the E-Government initiative. The NSA is committed to electronic filing of tax returns and in the wake of the September 11 terrorist attack issued a "Call to Arms" for its members to file returns electronically and use EFTPS for tax deposits as a means of reducing mail to the IRS service campuses. Unfortunately we must oppose the President's e-file initiative.

First, the government should not compete with the private sector. Even if the IRS starts off with a "bare bones" service, pressure will be brought to bear each year to add new features and enhancements and permit the filing of more complex returns. It also raises conflict of interest issues by having the IRS serve as tax preparer, tax collector and tax prosecutor.

Second, the initial development and on-going maintenance of an on-line filing service is expensive. This "free" service will cost taxpayers plenty. The resources of the IRS are better spent improving its woefully inadequate taxpayer service and assistance systems. It has no business in the tax return preparation industry. Even a system designed and built in "partnership" with the IRS raises cost, perception and privacy concerns.

Third, we see no market failure that requires government intervention. The private sector already provides excellent tax preparation and filing service at reasonable cost. The private sector, volunteer groups and the IRS provide a variety of free services to low-income taxpayers. The cost issue is merely a smoke screen.

Why should we spend additional money to fund a new program when it is painfully obvious that the IRS has significant difficulties even with its current programs as evidenced by a less than 75% correct response rate to taxpayer questions. In most schools, 75% is a grade of "D" and does not inspire confidence that free e-filing as envisioned in the President's budget will be successful or fair.

EXTENSION OF TIME FOR E-FILED RETURNS

The Administration proposes to extend the April filing date from April 15 to April 30 for individuals filing returns electronically to help encourage the growth of electronic filing. We sincerely doubt that this change will have any effect on getting more electronic returns filed. The early filers do so to get their refunds sooner. The procrastinators file later because they have balance due returns. Why reward them with an extra 15 days to file and pay?

To truly promote electronic filing, IRS should devote more funds to advertising of benefits to taxpayers and tax practitioners. Removing barriers that limit or discourage the practitioner community from participating as electronic return originators would also be a major step forward.

TAX CREDITS AND THE AMT TRAP

The President's budget contains a number of initiatives using tax credits, including refundable credits, to provide incentives and promote certain behavior and activities. We choose not to argue the merits of the proposals, but rather, focus on the mechanics.

Based on our reading of the description of these proposals we cannot determine how they interrelate with the alternative minimum tax. Our concern is simple: if there is no ability for a taxpayer to offset alternative minimum tax (AMT) by the "regular" tax credit the credit becomes meaningless for many taxpayers. The expansion of the AMT into the lives of middle-class Americans makes it imperative for Congress to consider the AMT implications on any new deduction and tax credit offered under the "regular" tax system and grant similar treatment under the AMT.

TAX SIMPLIFICATION

We applaud the Administration for beginning a "thorough review of means of simplifying the tax code" and developing both short term and longer-term tax simplification proposals. NSA is ready to work with the Administration, Congress and other groups to produce meaningful reform.

The Administration stated its "Highest priority will be given to simplification proposals that will yield the largest benefits, i.e. that will affect the most people and have the largest effects in reducing compliance burdens and administrative costs." We are encouraged that the Administration leads off the list with the individual AMT.

Much has been written on the adverse effect of the individual AMT and need not be restated here. We believe the individual AMT is a predator on the middle-class and the time has come for Congress to slay this monster. For every year that Congress delays action on AMT the price tag for repeal increases. In the not-to distant future the AMT will be the defacto tax system for many taxpayers undoing the many of the benefits targeted under the regular tax for the middle class. This was never the intent of Congress.

Much of the groundwork for simplification has occurred. The recently released National Taxpayer Advocate Office 2001 report to Congress contains many important recommendations supported by NSA. Likewise, the Joint Committee on Taxation's 2001 simplification study (JCS 3–01) is a useful starting point. The Nation's taxpayers deserve a better tax system. The time has come for the political system to deliver.

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