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PRESIDENT'S FISCAL YEAR 2009 BUDGET (REVENUE PROPOSALS)

HEARING

BEFORE THE

COMMITTEE ON FINANCE
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PRESIDENT'S FISCAL YEAR 2009 BUDGET (REVENUE PROPOSALS)

TUESDAY, FEBRUARY 5, 2008

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

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Lincoln, Wyden, Stabenow, Salazar, Grassley, Hatch, Snowe, Kyl, Smith, Crapo, Roberts, and Sununu.

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

The CHAIRMAN. The hearing will come to order.

The French poet and filmmaker Jean Cocteau said, "True realism consists in revealing the surprising things which habit keeps covered and prevents us from seeing."

A good budget must be realistic. It must be realistic in the sense of presenting a true reflection of reality. At the same time, a good budget must also be realistic in Cocteau's sense of revealing things that habit keeps covered.

Today we will test President Bush's final budget against the measure of realism. We will discuss the President's economic agenda with his chief economic advisor, the Secretary of Treasury, Hank Paulson.

As we meet, America's economy is slowing. Secretary Paulson has been the administration's lead negotiator on economic stimulus. Thus, I begin our discussion by commending the Secretary for his work to forge the stimulus bill that passed the House, and I encourage Secretary Paulson to be open to improvements that the Senate will make to the package.

I am thinking of improvements like extending the tax rebate to 20 million seniors whom the House bill left out, and I am thinking of the quarter-million disabled veterans that the House bill left out. I am confident that the Senate will pass these changes. I am also hopeful that the administration will find it realistic to endorse them as well.

Turning to the President's budget proposal, it claims to project a surplus in the year 2012, even while making permanent the 2001 and 2003 tax cuts that expire in 2011. A surplus would be a fine outcome if the projections were realistic, but they are not. The President's budget achieves surplus in 2012 only by omitting several massive costs. It provides $70 billion for the wars in Iraq and Afghanistan in fiscal year 2009 and nothing in any year thereafter. Clearly, it will have to be more than $70 billion, even in 2009.

It omits all costs beyond 2008 for fixing the Alternative Minimum Tax. In my home State of Montana, about 6,000 families paid the AMT last year. Without a fix after 2008, this number would greatly multiply. The admission of any AMT fixes in those 5 years unrealistically lowers the cost of extending the 2001 and 2003 tax cuts.

The budget's growth rates for non-defense discretionary spending are unrealistically low in each of the out-years. If these costs were not omitted, the President's budget would not be in surplus in 2012. This administration's last budget ends with the same lack of candor that characterized those that preceded it.

The budget also proposes deep and misguided cuts for Medicare and Medicaid. The health portion of this budget is not realistic policy, but an ideological statement. For Medicare, this budget proposes more than $182 billion in cuts over 5 years, but the budget proposes no cuts to private plans in Medicare despite extensive evidence that these plans are over-paid.

The budget also cuts Medicaid. It would reduce spending by $17 billion over 5 years. All of these cuts would have devastating effects on medical care for seniors, people with disabilities, children, and the poor, whom Medicare and Medicaid service. Congress will not carry out those proposals.

On taxes, the President once again requests that Congress simply make permanent its 2001 and 2003 tax cuts. Once again, this proposal fails the test of realism. I helped to enact the 2001 tax cuts, but we need to examine the effectiveness of each of these tax changes. It is only realistic to acknowledge that this discussion must be part of a larger debate on tax reform.

The budget also reflects the President's lukewarm commitment to administering the tax laws effectively. Every year, $345 billion of taxes legally owed go unpaid. Allowing this tax gap to continue is fundamentally unfair to honest, hardworking Americans who pay what they owe on time. They should not have to carry the tax burden of those who do not.

Last year at my insistence, the Treasury developed a plan to reduce the tax gap. I question the administration's commitment to see that plan through. The budget simply does not have sufficient resources to carry it out.

And a realistic budget would reveal the surprising degree to which our economy has grown more integrated and global. A realistic budget would shed the habits that prevent us from showing our commitment to American workers, farmers, and fishermen through Trade Adjustment Assistance. The budget rightly increases funding for the TAA for workers and TAA for firms programs, but astonishingly discontinues funding for the equally critical TAA for farmers program.

We have the opportunity to get Trade Adjustment Assistance right this year. Reformed and expanded TAA is my top trade priority. Other items on the agenda. Free trade agreements with Columbia, Korea, and Panama will take a back seat until new, robust TAA is in place.

Finally, budget deficits projected for 30, 40, or 50 years from now are unsustainably large. The President's budget falls into the old habit of just blaming the three big entitlement programs, Social Security, Medicare, and Medicaid. But a realistic budget would reveal the surprising truth, that the long-term problem is not an entitlements problem, it is a health care problem.

Health care costs are growing faster than the economy in the private health care sector as much as in the government programs. We must find a way to control the growth of health care costs in the entire economy. The solutions for the private sector will help Medicare and Medicaid, and vice versa. The President's budget is wrong and argues that we should just cut benefits in Medicare, Medicaid, and Social Security. We cannot solve the problem of growing health care costs on the backs of seniors, people with disabilities, and the poor.

So let us work together to formulate an economic policy that presents a true reflection of reality. Let us work together to formulate an economic policy that addresses challenges that habit keeps covered. Let us work together to formulate an economic policy that truly meets the test of realism.

I will turn to my colleague, Senator Grassley.

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

Senator GRASSLEY. Today we focus on the revenue side of the budget. It is almost entirely in this committee's jurisdiction. Today we will focus on what the President is proposing for taxes, but my guess is, for the rest of this year everybody concerned about tax policy is going to be focused on what the presidential candidates are saying about taxes. It is very clear that there is quite a distinction between the approaches of the two political parties as the presidential campaign comes up.

Every candidate for President of the United States on the Democratic side wants to let the tax laws of 2001 and 2003 expire, by which we would have the biggest tax increases in the history of the country without a vote of Congress, whereas Republican candidates have pledged to have the tax policy of 2001 continue beyond the year 2010, and that is part of the President's budget. But I think the focus is not going to be on the President's budget, the focus is going to be on what the next President will do, whoever he or she is.

The President's budget acknowledges that the bipartisan tax relief has not gutted the tax base. In fact, we have been, and are projected to continue for the mid-term, on a revenue glide path that is above the historic average of revenue as a percentage of Gross Domestic Product.

Now, some on the other side may argue that higher-than-historic average taxation is not enough to fund the government; they have the idea of yet bigger government. But that is a different debate. That is a debate about higher taxation as a deficit reduction matter. It is a fair debate to have, but we ought to be intellectually honest about it.

This is a debate that should be fully engaged when the parties nominate their presidential candidates; as I indicate, that will be the debate for the rest of the year. The debate ought to be about where the level of taxation ought to be. It implicates this budget over the short-term, the mid-term, and the long-term.

For instance, my guess is that my friend, Senator Wyden, might bring up tax reform and the plan that he has worked so hard on. A key question on tax reform is whether we assume all tax relief that expires at the end of 2010 is in place or not. If we assume current law, then the level of higher taxes American families will face on average is over $2,000. If we assume current law, tax relief provisions are not going to be permanent beyond 2010. If we extend bipartisan tax relief, American families will get to keep what they have now. Again, middle-income families that we're talking about would have $2,000 more in their pockets.

We will see some on the other side focus on the next 2 fiscal years, where the stimulus proposal takes effect. If you look back at the debates that we had in 2002 and 2003, there was a lot of focus on fiscal year 2004. That was a year when a lot of stimulus kicked in. Revenues dipped then, but they came roaring back in fiscal years 2005, 2006, and 2007.

Another point needs to be taken into account for the next 2 fiscal years. It is this: the stimulus package is bipartisan, and Democrats control both bodies of Congress. So my friends on the other side, you own the deficit effects of the economic stimulus package just as much as the President does.

For those of us who are participating in that process, including this Senator, we bear responsibility as well. You cannot take credit for responding to the economic downturn and be critical of the deficit impact of the package that we are legislating.

So, as we look at the trend line in the budget, let us bracket the impact of the stimulus package. What is clear today with the stimulus package accepted is that the bipartisan tax relief, with the Alternative Minimum Tax accounted for, has a track record of maintaining the Federal revenue base. That is good news that Democrats and Republicans should agree on.

Democrats from the bluest of the so-called blue States ought to be most appreciative because it is families in those high-income, high-cost, and high-tax areas that have benefited greatly from the bipartisan tax relief. I am referring to the marginal rate relief, marriage tax relief, increased child tax credit, education tax relief, death tax relief, and, yes, the Alternative Minimum Tax.

While we are talking about the AMT, I want to praise the administration for being transparent about the so-called patch. It is covered in the budget. It is not offset, and affects the bottom line of the budget. The last Congressional budget was described as covering the AMT, but relied on unspecified and unscored offsets. I pointed this defect out as we went through the budget process last year. My prediction was proven true at the end of last year. I will make the same prediction this year. My guess is, I will meet the same denials, and we will have the same results.

So, Mr. Secretary, with respect to the AMT, your budget is more transparent than I expect our budget is going to be. With that said, Mr. Secretary, I do not think that your budget or the Congressional budget should count AMT revenue for years beyond this fiscal year.

Transparent budgets would eliminate this revenue that we will not, and should not, collect.

In Chairman Rangel's words, "the mother of all tax reforms" was transparent about AMT. Chairman Rangel put on the table, repeal. He substituted a new tax on upper middle-income and higher-income taxpayers. Chairman Rangel's proposal also used revenue from the expiration of the bipartisan tax relief plans that I referred to earlier. We can applaud Chairman Rangel for his leadership. He has taken heat for the proposal. I agree with him on repeal of AMT. It is a tax that was never intended to pull in 25 million middle-income families.

I disagree with Chairman Rangel that we need to keep revenues at historic highs as a percentage of GDP as a condition for repealing a tax that we never intended to collect in the first place from middle-income taxpayers. Chairman Rangel is being transparent about the AMT and his viewpoint that a high revenue base needs to be maintained.

Mr. Secretary, though your budget counts AMT revenues beyond fiscal year 2009, like Chairman Rangel, the administration's budget accounts for the bipartisan tax relief of 2001 and 2003. As he has done every year, the President proposes to make the tax relief that virtually every American taxpayer enjoys permanent. It is there in the black and white of the budget. It affects the bottom line of the budget. It is very transparent.

Unlike Chairman Rangel and the administration's budget, the fiscal year 2008 Congressional budget is not transparent. It stated by default what Chairman Rangel and the administration were transparent about. What I am referring to is the fact that the Congressional budget basically assumed the post-2010 tax relief expired. That budget did contain an allusion to $180 billion of tax relief. It was a small fraction of what is involved. That tax relief was subject to a trigger mechanism that would have made Rube Goldberg proud.

Mr. Chairman, we have a fiscal crisis. The baby boom generation will be retiring, and that is going to cost big numbers in the next decade. That is an entitlement problem. It is not derived from the current or future state of the Federal revenue base. The revenue base is fine unless the predilection of a particular member is to solve the entitlement problem with record levels of Federal taxation. As I said before, that is a separate debate. We can have it. We ought to have it, and we ought to be transparent about it.

The President's budget keeps the burden of taxation in check. The President's budget also lays bare the defects in the tax treatment of health insurance. Finally, Mr. Secretary, I appreciate the comprehensive set of tax gap initiatives that are in the budget.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I will turn now to Treasury Secretary Paulson. Mr. Secretary, as you well know, we would encourage you to limit your remarks to 5 minutes. Frankly, if you have a couple minutes more, that would be all right. Your entire statement will be in the record. We look forward to your presentation of the President's budget.

Why don't you proceed?

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary PAULSON. First of all, Chairman Baucus, Senator Grassley, members of the committee, I am very pleased to be here today to discuss the President's budget for fiscal year 2009.

As Treasury Secretary, my highest priority is a strong U.S. economy that will benefit our workers, our families, and our businesses. Through a measured approach that balances our Nation's needs with our Nation's resources, the President's budget supports that priority.

This is especially important now as, after years of unsustainable home price appreciation, the U.S. economy undergoes a significant and necessary housing correction. This correction, combined with high energy prices and capital markets turmoil, caused economic growth to slow rather markedly at the end of 2007.

The U.S. economy is diverse and resilient, and our long-term fundamentals are healthy. I believe that our economy will continue to grow, although at a slower pace than we have seen in recent years. Yet, the risks are clearly to the down side. President Bush knows that economic security is of the utmost importance to the American people.

In recent weeks the potential benefits of quick action to support our economy became clear and the potential costs of doing nothing too great, so we are gratified that Congress is advancing the growth package to support our economy as we weather the housing correction. We believe that a growth package must be enacted quickly. It should be robust, temporary, and broad-based, and it must get money into our economy quickly.

The Senate has begun to consider its version of this bill, and I am hopeful that you will complete your consideration soon. If we keep moving along the fast track and Congress sends the President a bill that meets our shared principles, rebate payments can start in May and be completed in the summer. Together, the payments to individuals and investment incentives for businesses will help create more than half a million jobs by the end of this year.

In addition to an economic growth plan to help us weather this housing correction, the administration will continue to focus on aggressive action to provide alternative options to foreclosures. This includes encouraging Hope Now Alliance's outreach to struggling homeowners. Congress can do its part by finalizing the FHA Modernization and Government-Sponsored Enterprises Regulatory Reform bills, and by passing legislation that will allow States to issue tax-exempt bonds for innovative refinancing programs.

We continue to monitor capital markets closely and to advocate strong market discipline and robust risk management. Working through the current stress is our first concern. Through the President's Working Group on Financial Markets, we are also reviewing underlying policy issues, as it is just as important to get the long-term policy response right.

While we are in a difficult transition period as markets reassess and re-price risk, I have great confidence in our markets. They have recovered from similar stressful periods in the past, and they will do so again.

The administration will also continue to press for long-term economic policies that are in our country's best interests: a pro-growth tax system, entitlement reform, and a balanced budget. To that end, the President's budget makes the 2001 and 2003 tax relief permanent, and keeps the Federal budget on track for a surplus in 2012.

In the future as in the past, our long-term economic growth will also be enhanced by supporting international trade, by opening world markets to U.S. goods and services, and by keeping our markets open. Congress can help create jobs and economic opportunity by passing the pending free trade agreements with Columbia, Panama, and South Korea.

I appreciate the cooperation and the cooperative and bipartisan spirit that has brought the Congress and the administration together to support our economy and look forward to that spirit continuing as we work through this period.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Paulson appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary. I very much appreciate your openness to Senate improvements on the House-passed stimulus package. I very much appreciate that because, clearly, the Senate is going to act as it should act.

We also should act very quickly. The basic date we have all given each other is by February 15; we certainly can pass and have on the President's desk a stimulus package which reflects the Senate improvements to the House bill by then. I very much thank you for your expression of openness and working with the Senate in the sense of improvements to the House-passed bill.

I have a question, though, about the budget. Just a basic kind of yes or no sort of answer. That is, would the projected surplus in the President's budget not evaporate if an AMT patch was included for not only 2009, but for the subsequent years? My calculations are, according to CBO, that the cost of the AMT fix is about $75 billion in 2009, $76 billion in 2010, $71 billion in 2011. Then it is down to $42 billion in 2012.

But then the budget's assumption of extension of the 2001 and 2003 tax cuts increases that, so the total for 2012 is about $103 billion, which does not include Iraq or supplemental costs, which are not included. So is it mathematically true that, if an AMT patch were included and it would have an interactive effect on the extension of the 2001 and 2003 tax cuts, that the budget would not be in surplus in that year?

Secretary PAULSON. Mr. Chairman, let me, first of all, react to your comment on the stimulus. The sooner we get this enacted and signed, we can begin work immediately on working toward getting the checks out to the American people. So the day this is signed is the day we can make real progress with the IRS to begin reprogramming, and so on.

So, first of all, I just appreciate very much you and the leadership of the Senate working collaboratively to get this done quickly. Second, as you know, I am not here to negotiate a stimulus package at a public hearing. I have strong preference for the approach the House takes. I recognize that you are working with similar principles, and I think we will work through this and come out to a satisfactory, quick end. I just appreciate the spirit with which you are driving this.

Now, to get to your question about AMT, I want to even come back and say something about transparency. I believe that this is a transparent budget on every issue. I think we are very transparent on AMT, because we have the AMT patch in this budget.

The CHAIRMAN. For 2009 only.

Secretary PAULSON. For 2009.

The CHAIRMAN. Only.

Secretary PAULSON. That is right. Then beyond 2009, it is also very transparent, that we have the revenues in the budget. We say very explicitly, this is a tax that we think, if it goes into effect, is going to be an unexpected tax on the American people. I agree with Senator Grassley. Then what we said——

The CHAIRMAN. I might ask that, if you have the patch in one year, why do you not have the patch for subsequent years?

Secretary PAULSON. The reason we do not is, I think we have been very clear in saying we think that we need to look at this issue in the context of the broader entitlement issue. We need to look at it in the context of Medicare and Social Security, the issues that you have raised. We need to look at it in the context of what percentage——

The CHAIRMAN. Does that mean more cuts in Medicare and Medicaid?

Secretary PAULSON. I think——

The CHAIRMAN. If you have an AMT patch, basically what you are implying is even deeper cuts to the budget that provides for Medicare and Medicaid.

Secretary PAULSON. What we tried to do, and what I was sure trying to do, was to say, let us come together, let us come to the table and let us talk about the elephant in the living room, which is the point you made at the end of your remarks, which is a big structural deficit. When we looked at the deficit, the $160 billion today, 1.2 percent of GDP that we had at the end of 2007, is not the issue. The big issue, and the longer-term issue, is the entitlements. What we have said is, during transparent——

The CHAIRMAN. Mr. Secretary, is it not health care? It is not entitlements, it is health care. It is not entitlements, it is health care. Let me repeat. You know the facts. If you were to look at a chart and the long-term trends of the Social Security and Medicare trust funds and the big drivers as to what actually increases the debt, what are they? The big driver is not Social Security. Let me finish, Mr. Secretary.

It is not Social Security, it is interest on the debt and it is Medicare. Those are the big drivers. Now, look at Medicare more closely. CBO has a very strong analysis on this. CBO says, the reason the Medicare trust fund is increasing is not so much because of more baby boomers. That is true that is a factor, but it is not really the factor.

The real factor is health care costs for the entire economy are going up, both the public sector and the private sector. It is health care costs that are going up. So it is wrong to just slash Medicare.

That is just going after the symptom of the problem, not the causes of the problem.

The right thing to do is go after the causes. The right thing would be for the administration, for this Congress, and for the private sector to figure out how we are going to get health care costs for the entire economy down, and then we will be able to have a good handle on the only real problem in entitlements, and that is Medicare. It is a health care problem, a health care cost problem. It is not a baby boom problem, it is a health care cost problem. That is the way to get at the solution here.

Secretary PAULSON. Mr. Chairman, I will agree with part of what you said. As I look at the entitlements, it is Medicare and Social Security. Medicare is the biggest——

The CHAIRMAN. By far.

Secretary PAULSON. And it is the most complicated.

The CHAIRMAN. Correct.

Secretary PAULSON. Social Security is analytically easier, and that is why we started there. But the problem is 2-fold. It is demographic, and with Medicare, as you pointed out—and with health care, which is the number-one problem we have, and we have two problems—we have demographics and we have the problem that the costs are growing much faster than the entitlement.

The CHAIRMAN. I urge you to read the CBO study. You will find it is much less demographic and it is much more health care costs.

Secretary PAULSON. I have to say, in terms of being in agreement, we do agree that the health care costs are growing much faster than the economy.

The CHAIRMAN. All right. Thank you. I am way over my time.

Secretary PAULSON. And that is a big issue.

The CHAIRMAN. All right. Thank you.

Senator Bingaman?

Senator BINGAMAN. Thank you very much for being here, Mr. Secretary. Let me ask, first, the budget deficit projection is $407 billion, as I understand it. That is based on an assumption that the economy is going to grow, in 2008, at a rate of 2.7 percent. At least, that is the way I am understanding what you have presented here. As I understand it, the economy grew at 0.6 percent in the fourth quarter of last year, 2007, and CBO now estimates that in 2008 it will be 1.7 percent, not 2.7.

So I would ask if you think, obviously the slower the growth in the Gross National Product and GDP, the less revenue the government can expect, and the larger the deficit. Have you done a calculation as to what the size of the deficit would be under this budget if growth is at the level CBO projects?

Secretary PAULSON. Yes, Senator Bingaman. Let me say that the 2.7 percent estimate that was in the budget was the one that was put out in November and the economy has slowed since that time. That is a couple months old.

If you look at the estimate on economic growth over the 5-year budget window, they are very close, whether any of the estimates are on top of each other. If you were to take the 1.7-percent CBO estimate for this year, the difference is $15 or $20 billion. Again, I was getting back to the point I made to the chairman. When we are talking about the long-term issues, there are structural issues. But in any event, your question is $15 to $20 billion.

Senator BINGAMAN. Now, let me also understand, on funding for the war in Iraq, are the budget numbers that you have presented to us and that $407 billion deficit, does that assume a certain level of funding for the war in Iraq or does it not in this coming year?

Secretary PAULSON. You will be able to obviously talk with others in more detail about this, but what we have in terms of 2009, you have $70 billion, which is a placeholder. That will need to be updated when General Petraeus comes back and reports, and so on. In terms of what we are going to spend this year, Congress, I believe, is yet to appropriate $108 billion which is going to be needed right now.

Senator BINGAMAN. So we need the $108 billion, plus we need the $70 billion, plus we need whatever General Petraeus says in his report in March. The amount that General Petraeus asked for is not included in the budget.

Secretary PAULSON. Because it is unknowable now. To me, as I said to the chairman, I think it is pretty transparent. That is a placeholder and that will change based upon what the requirement is.

Senator BINGAMAN. One of the issues that we have spent a lot of time on here in this committee is trying to maintain the various renewable and alternative energy tax provisions that we have put into law in the 2005 energy bill, such as the section 45 production tax credit for wind, energy, and the investment tax credit for solar as well.

There is nothing in your budget to indicate a desire to extend those beyond their expiration date the end of 2008. Do I take it that the administration opposes extending those provisions?

Secretary PAULSON. Senator, let me begin by saying that I am personally a great admirer of what you are doing in the energy area. I very much appreciate your leadership. When you look at the extenders, there is a large number of extenders; some are in the budget, others are not. You should not take as a given the fact that if something is not in the budget, that we will be opposing it.

But looking at it more generally, energy is a very high priority for the President. Alternative energy is. We are pleased with the bill that the President signed last year. More needs to be done. There are other ways of getting energy through the tax code. I know that is the focus of this committee.

The Treasury Department is not an expert in energy, that is the DOE. So, there are sometimes issues in terms of whether Treasury should be administering our energy policy. But again, these are things we can talk about. We certainly share your objectives as it relates to energy security for this country.

Senator BINGAMAN. My time is up, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you very much, Senator.

Senator Crapo?

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Secretary, I appreciate the careful attention that you are giving to our capital markets and the attention that the administration has paid in trying to address some of the underlying infrastructure issues that we deal with in this Nation as we put this budget forward.

I want to go back to the AMT as well. I also noted that the administration did not essentially deal with the repeal of the AMT in the out-years after the first year of this budget, but I understand that the administration is still very supportive, is it not, of a fix for the AMT, including a repeal of the AMT, or at least a permanent fix along the lines that Congress has been working on on a yearly basis in the past. Is that correct?

Secretary PAULSON. Yes. We clearly would like to patch it this year. I very much endorse what Senator Grassley said. We could remove a lot of uncertainty and just get to the chase, because I do not think anyone is going to believe, at the end of the day, we should be raising taxes to pay for the AMT relief this year.

In the out-years, what we are saying is, Congress needs to come together, work with the administration—they have to do it at some time—to address this issue and address it against the backdrop as to how big a share of our GDP is going to be taken up by taxes. How big a share of the GDP by taxes, and also addressing some of the other issues in that context, which are going to be the entitlement reform. So that has been our position, and it has been pretty transparent.

Senator CRAPO. In the context of what portion of the GDP should be taken up by taxes, it seems to me that we need to make the tax policy permanent that we have dealt with already through 2001 and 2003 tax cuts. We need to deal with the AMT in terms of, in my opinion, permanently repealing it and then dealing with the issue.

But that is also going to require us to have an overall look at our tax code and really go through the tax code with a fine-toothed comb and engage in some very significant tax reform policy, is it not?

Secretary PAULSON. I think it will.

Senator CRAPO. Let me, in just the few minutes we have left, shift to the entitlement issue. I know that you and the chairman just had a discussion about whether it is health care or entitlements. As I see it, Medicare is health care. One way or the other, we are going to have to deal with the issue. I noted in the budget that the President has suggested that we cut back in the neighborhood of something like $174 billion, which over time will help us to address something like $34 trillion of our unfunded liability. Could you explain that part of the budget a little better?

Secretary PAULSON. Yes. Thank you very much, Senator. Yes. I would agree with the chairman and with you, that a big part of the entitlements issue is health care, and that is reflected in Medicare. I would also agree that the problem is compounded by the fact that, added to the demographic issue, health care costs are going up so quickly.

So what this administration has done is put out a plan where the $178 billion is a net cut over 5 years, but what it really is doing is changing the trajectory of growth. Those payments are going to be going up. What it is going to do is, it would change the trajectory of growth from 7.2 percent to 5 percent. What that does is, if you look out 75 years, it will take a third of that deficit, which is your $34-trillion number.

So again, we cannot make a dent in this unless we start dealing with the root problem. This is a way to get the discussion going. The focus is means-testing and ways of making it more efficient.

Senator CRAPO. I was just going to ask that. The specifics of how you suggest that we achieve these savings is primarily in means-testing and efficiencies?

Secretary PAULSON. Efficiencies. Yes.

Senator CRAPO. All right. Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Salazar?

Senator SALAZAR. Thank you. Thank you very much, Chairman Baucus and Ranking Member Grassley.

Secretary Paulson, thank you for your service.

The stimulus package obviously is a major concern of this committee, and obviously of the Senate as we move forward in considering that stimulus package, hopefully this week. I would like you to respond simply yes or no to the following questions, since you were one of the key negotiators, I understand, of the House and the President's package.

First, with respect to undocumented workers, would it be an improvement upon the House package if the final stimulus package prohibited undocumented workers from receiving tax rebates?

Secretary PAULSON. The intent was always to obey the law. We agree, we should work to get a clarification.

Senator SALAZAR. So the answer to that is yes, that would be an improvement?

Secretary PAULSON. The answer is what I gave you.

Senator SALAZAR. All right. So it is yes.

The second question. Would it be an improvement to the stimulus package in terms of putting money into consumers' pockets for investing into the economy if we were to cover the 20 million seniors who are now left out of the House package?

Secretary PAULSON. I am not going to give you a yes or a no to that. I will give you an answer, if you would like it. Would you like it?

Senator SALAZAR. I would like it short.

Secretary PAULSON. I will be short and to the point. Our starting point was to deal with those who pay taxes, like you all did in 2001. In the House, this was expanded to deal with working families with a big refundable portion to it. Clearly we recognize the difficulties that low-income seniors and veterans are facing, and I am sure we will be able to work something out and get something quickly done that is broad-based.

Senator SALAZAR. I appreciate that, Secretary Paulson. It seems to me that with respect to both the 20 million seniors and the 250,000 disabled veterans that, if we are talking about getting money into the pockets of American consumers who will help us stimulate the economy, that that would be a good place to go. I am hopeful, as you included in your statement there, that we in the Senate can work with all of you to try to get that aspect across the finish line here.

Secretary PAULSON. Yes. Senator, I am not trying to be rude with "yes" or "no." It is just, I do not think this is the right forum to negotiate this.

Senator SALAZAR. All right. I understand that.

Let me ask you this as well. There is some debate on the stimulus package and the high unemployment rates and whether we extend unemployment benefits. There are at least some pockets of the country—Michigan, notably, and my colleague from Michigan is here, as well as places like Nevada and others—where you are having unemployment rates reach as high as 8 percent. Would it be appropriate for us in this stimulus package to take a look at extending unemployment benefits at least to those parts of the country that are receiving that kind of unemployment sticker shock?

Secretary PAULSON. Senator, you have focused on an issue that has received a lot of discussion, and I think implicit in your question is my apprehension that, with unemployment of 4.9 percent, to extend benefits would be unprecedented and it would send a message to the world which I think is the wrong message here. I have looked over the years, and the one time where I have seen unemployment insurance extended—I guess I would put it this way. It has never been extended when unemployment was below 5.7 percent.

Senator SALAZAR. I understand the facts there. I also understand the reality of the regional differences that we are seeing around the country.

Let me shift off the current stimulus package to anther question, because I know I have a limitation on time here. It would seem to me as just one Senator—I am not speaking for Senator Baucus or the leadership or anybody else—that the stimulus package has to be but phase one of how we try to get our economy out of the ditch and back on solid track, and that we ought to move quickly from passing the stimulus package over to dealing with at least three central economic issues, in my view. One of them is the housing crisis. I think you outlined a number of different provisions that we could respond to affirmatively to deal with the housing crisis.

Second, to move forward with the passage of a farm bill that will help us with our food security, which we have spent a lot of time on here in the last few years.

Third, moving forward with a more robust energy package, which is the tax portion of the energy bill, which was not included in the bill that the President signed in December.

Do you think that a second phase like that, quickly on the heels of passing the stimulus package, might make sense, whether it is those aspects of it or other parts of a package that you might put together?

Secretary PAULSON. Yes. Senator, first of all, your objectives in all three of those areas, I agree with. Now, in terms of the details, there will be plenty of room for discussion. But first of all, with regard to housing, we have a number of initiatives. There are additional actions we need from Congress, and I could go through those if you wanted me to take the time, number one.

Number two, there have been some big——

Senator SALAZAR. Would it make sense—just on that one, because I am already out of time—to do that quickly as soon as we get the stimulus package, to move over and to deal with those issues?

Secretary PAULSON. Yes. There are parts that could be done as quickly, or even quicker, than the stimulus package if they are on a separate track. I mean, they are all important. But FHA modernization. We have a House bill, we have a Senate bill. They could get together and have something on the President's desk next week.

Senator SALAZAR. Thank you, Secretary Paulson.

The CHAIRMAN. Thank you, Senator.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. Secretary, since this hearing is about the revenue side of the budget, I will start off by looking into the trend line of revenues.

CBO reports said, over the past 40 years, taxes as a percent of GDP averaged 18.3 percent. In the year 2000, Federal taxes took 20.9 percent of GDP. That is a record post-World War II level. Individual income taxes were at even more dramatic levels. CBO reported individual income taxes were 10.3 percent of GDP.

CBO has also indicated that revenues hit a trough at about 16.3 percent in 2004, but in 2005 revenues increased to 17.5 percent, in 2006 to 18.5 percent, and in 2007 jumped to 18.8 percent. That is higher than the historical average, all with the AMT patch and the 2001 and 2003 tax cuts in place. We have a chart here, so you know what the trend line is. I am sure you are aware of that. Maybe most of the public is as well.

CBO's most recent projections show that total taxes will continue to be above the historical average through 2010 when the 2001 and 2003 tax cuts expire. Then revenues are expected to jump up to somewhere around 19, 20 percent, and I have even seen some above 20 percent of GDP, back up to that historical high.

Now we hear a lot of criticism from those who oppose the bipartisan plan of 2001. 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 Federal revenue base.

Three questions. Do you agree with these critics? Two, is the only path to fiscal discipline to maintain record levels of Federal taxation as a percentage of the economy? Three, is it safe to say, as these critics do, that there is no down side to future economic growth if we return to record levels of Federal taxation?

Secretary PAULSON. First of all, Senator, I agree with your points. So to be very clear, I think a major question which we have to deal with as a Nation is, what percentage of our GDP do we want to be taken up with taxes? How big should taxes be as a percentage of our overall economy? So I think that is a helpful analysis and is something that we need to look at quite closely. I also believe the last thing we need right now is a tax increase, so I agree with you.

Senator GRASSLEY. All right. I want to make clear that I think that the 40-year average proves two things. One, it is a level of taxation that has not hurt the economy, because we have had good growth in the economy for 40 years. Number two, it is a level of taxation that it seems like the people of this country have accepted as something that they can live with.

Mr. Secretary, once again we find ourselves facing the individual Alternative Minimum Tax, AMT. Thanks to a provision that was developed here in the Finance Committee in 2001, we have temporarily not made the problem worse. That provision ran out last year. A renewal of that patch is very important, so we have a major problem we will have to deal with right now. Thankfully, the President's budget does contain room for this year's patch.

To the critics, I would say that that is 1 year more that we have currently budgeted. Unfortunately, I do not see any provision for a long-term solution in the President's budget. According to the Joint Committee on Taxation, this tax, which was intended to hit only a thin slice of high-income taxpayers with tax preferences, will ensnare 25 million families this year if we do not act.

According to the CBO, the AMT will bloom Federal revenues to record levels of GDP with or without an extension of the bipartisan tax relief next decade. Now many on the other side insist that we cannot reform AMT unless we offset the "lost revenue." I always put "lost revenue" in quotes because we were not intending to take it in in the first place.

So for 2008, for example, their basic position is that the harm to those 25 million families is secondary to retaining the Federal revenue from this unintended, broadly applicable tax. The President's budget, like the Congressional budgets advocated by those on the other side, also counts the vast amount of revenue from this unintended tax.

Two questions. Mr. Secretary, is it fair to condition AMT reform on substitution of revenue when we never intended the AMT to generate the projected revenue in the baseline? And two, why should AMT reform be secondary to maintaining an unintended stream of revenue?

Secretary PAULSON. Senator, let me start with your point about this year, because I do not want to skip over this year. You said at the beginning, and I said at the beginning of last year, we knew that AMT was going to be patched and we knew taxes were not going to be raised to pay for it. But we went through this kabuki dance and we delayed and delayed, and then it was patched at the end, but the uncertainty hurt the American taxpayer.

So I do hope that this year, given what is going on in the economy, people can just come together and say, let us just deal with AMT this year. If we do it this year, that will eliminate plenty of uncertainty, it will make the job easier on the IRS, and it will just be a good thing.

Now, looking to the future, I agree with you that, were the AMT not to be patched, it would be a very difficult thing to explain to all those who got hit with the increase, this unexpected increase, that that was not a tax increase. So, it is something we need to deal with. Our position has been, we need to deal with it in the context of the broader question, the major question of entitlements, Medicare, Social Security, and the broader question which you so skillfully raised about how big taxes should be as a percentage of our economy.

The CHAIRMAN. Thank you, Senator.

Senator Roberts, you are next.

Senator ROBERTS. Thank you, Mr. Chairman.

Mr. Secretary, thank you for coming. I know you have a very difficult job, and I know you are doing your very best, and I appreciate that.

Having said that, let me just say right off the bat that in regards to the budget, the Medicare cuts, or the provision in regards to Medicare, the proposals are not realistic. I am not going to get into my CMS rant, which is becoming sort of redundant and, I guess, infamous on this committee, but we already have doctors who will not accept Medicare patients because of the reimbursement problem. We have the same thing with home health care providers who are in a bidding competition now that is somewhere between a briar patch and a swamp. We have ambulance drivers who are not being reimbursed at the right rate.

We have druggists who are really the only source of knowledge and preparation to seniors on their Medicare Part D; despite the fact that other people try to provide the best information possible, they get reimbursed probably 70 percent on a generic drug. We already have a situation where we have a bifurcated health care system. We have the clinics that are owned by the doctors who do not accept Medicare patients, but who also practice in the community hospitals that obviously have the Medicare, and it is just not working. So, I would urge you to take another look at those proposed Medicare cuts. It is just not going to happen. I do not mean that as a pejorative, that is just the way it is.

It is important, and I think Senator Grassley pointed out the problem of the taxes that are owed but not paid. Obviously, the President's budget proposes 16 changes to help reduce the amount of taxes that are owed but not paid. One initiative will improve revenue reporting of small businesses and the self-employed, estimated to be the largest component of the tax gap.

Well, I will tell you what. I do not get a lot of letters—I do not get any letters anymore because of the anthrax situation, but e-mails. [Laughter.] Well, I do, but they are 2 weeks old and they are cut up. So, phone calls, e-mails, faxes and town hall meetings saying they want this or that. They say, what on earth are you doing to me, saddling me with regulations and paperwork and enforcement with my margin, and I cannot find somebody to fill out all the paperwork.

I want to know on these 16 changes, are we going to streamline this or are we going to be like Wyatt Earp, who was told by the deputy that there was cheating down there at the Long Branch and it was at the roulette wheel, and Harry was cheating again, so he just went down there with a shotgun and fired through the front door and everybody got hit? We need a rifle, not a shotgun.

What worries me is, we have the law of unintended effects trying to get more people to pay, which I want if they are not paying it. But, I do not want a system that is going to add more regulatory overkill and burdensome regulations, paperwork, et cetera, et cetera, on small business. How are we going to do this with the 16 changes? Are we going to streamline it or are we going to use a shotgun?

Secretary PAULSON. Well, Senator, you have raised the dilemma. That is the question. When you look at the tax gap, by far the biggest portion of it, by far, are individual taxpayers with nonreported income. So, now the question is, how do we make a dent in this without providing a painful burden, without creating one on all the honest taxpayers who are doing their job?

Senator ROBERTS. Exactly.

Secretary PAULSON. There is not an easy way. There is no gain without some pain here. I hate to tell you, there is just not a free lunch. So what we have tried to do is come up with legislative solutions that will be more like a rifle shot, but will make a difference. Basis reporting. We had 16 proposals last year, and I think a couple of them were enacted. But the ones that will make a difference are things like the credit card companies reporting to merchants and sending a record to the IRS, things like basis reporting on stock transactions.

They are serious, but the only way to get at this is to have some more reporting. So we have tried to carefully choose those that will cause as little difficulty as possible while making a difference, so that is what we have tried to do. You see the list that we have in the budget. We have vetted them carefully and we support them. There will be resistance to all of them from some quarters. We have left out things like withholding, on interest, dividends, pensions, all those kinds of things. When they were tried before, there was a revolt. But they would also make a difference in closing the tax gap.

Senator ROBERTS. Well, you know, there are some members who have introduced legislation in regards to the tax code to just get rid of the IRS. That will show you the frustration that we have. I appreciate it is a tough problem, and I thank you for comments.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. First, a couple of comments on other discussions that colleagues have engaged in, and then a question.

First, to support the chairman on health care. You have talked about the big question being the proportion of GDP that we will pay in taxes. I think the bigger question is the proportion of our GDP that we will spend on health care, since right now we are spending twice as much of our GDP on health care as any other country. So, I think that is the big question and the big challenge of our time.

Second, as Senator Salazar was talking to you about unemployment compensation, I think it is important to note that both Goldman Sachs and the Bureau of Labor Statistics have indicated that by next year the national unemployment rate is estimated to be at 6.5 percent. We have heard from a number of economists, as well as the Congressional Budget Office, but we certainly heard from Dr. Feldstein, the former chair of the Council of Economic Advisors under President Reagan, that one of the two ways that is most likely to stimulate the economy is extending unemployment compensation. A dollar of extension equals $1.64 in stimulus.

Finally, I would just say this whole notion that somehow extending unemployment compensation, which is 40 percent of a worker's average wage, is going to stop somebody from trying to get a job is just a myth, which goes to my question in terms of the economy.

Right now, we have 7.7 million Americans, middle-class working men and women, vying for 4 million available jobs, so the real stimulus is to have a good-paying job. When we look at the underpinnings of this economy, we are not just in another downturn. There is talk about, we just need to weather a housing correction. I totally disagree with that view, with all due respect. We are in a global economy with large factors that are affecting the fundamentals in terms of the middle class in this country and businesses in this country.

So I would ask you, when we look at the President's budget, not the deficit, but the debt, in 2001 the Nation's debt was $5.8 trillion. In the budget now that is being proposed, this budget of the President's calls for more than $12 trillion in debt in 2013. Twelve trillion dollars, which does not include the cost of the war, which is inching up to $1 trillion by itself. We have seen a doubling of the debt owned by foreign entities during the Bush presidency, so half of the foreign debt is owned by China and Japan, which goes to my question.

We have a huge trade deficit now with China: out of 11 months of last year, $237 billion. They are breaking the trade laws. They are manipulating their currency, sending us toys with lead in them, and toothpaste with poison in it, and counterfeit auto parts, et cetera, et cetera.

How do you view us tackling, specifically, I would ask, the currency issue in terms of the fact that in this global economy, given this situation and the challenges that Americans are going through, a 40-percent discount on R&D coming into this country versus what we are doing? What is the Treasury going to do about this?

Secretary PAULSON. Senator, two things. First of all, one additional thing on unemployment. Unemployment is 4.9 percent. We think the economy is going to continue to grow. I have looked at the past when we have extended it: in March of 2007, it was 5.7 percent; in November of 1991, it was 7 percent; in September of 1982, it was 10.1 percent; in January of 1975, it was 8.1 percent; in January of 1972, it was 5.8 percent.

If the economy continues to worsen to the point that it stops growing and this problem becomes more severe—and again I am predicting it is going to keep growing—if it does, that is something that should be discussed and taken up.

Senator STABENOW. So you are just agreeing at this point with Goldman Sachs and the Bureau of Labor Statistics?

Secretary PAULSON. I am saying that every projection out there has uncertainty. I have never seen any economist that can project with certainty. I have watched this very closely. When we saw this turning down, we did something that was quite unprecedented. I had to argue with plenty of economists who say, why are you moving with a stimulus bill when the economy is still growing? I think we have been all over this, and we are moving quickly. But again, to make a projection a year from now, if those economists are right, then you should debate this and discuss it then.

Senator STABENOW. Mr. Secretary, quickly, I know I am out of time here, but the issue is whether or not it is growing for Americans, middle-class Americans, and what is happening in terms of our jobs, which is a very different thing than what you are talking about. So how do you deal with China?

Secretary PAULSON. I am going to give you three sentences there, and then China currency. You are absolutely right. There are structural changes going on, here and in the world, that are related to the forces of globalization, technology, and automation. I really do think the highest priority to be thinking about—and it is going to be the challenge that we and other developed countries are going to face over the next 10 years—is how to get the skills to the people who need the skills to compete in this economy and globally. I think there are structural issues, I do agree with you.

Now, on currency.

The CHAIRMAN. Briefly, Mr. Secretary, because we are way over the time here. Very briefly, please.

Secretary PAULSON. All right. I will be very brief on the currency. As you know, we have advocated for a long time that China appreciate the renminbi. The pace of appreciation doubled over the last year to 6.7 percent. In the last 3 months, it has appreciated 4 percent. I would still like it to move quicker, and we are working to persuade them.

The one thing I would say, though, that would be very dangerous, in my judgment, would be a currency bill, particularly with what is going on in the world right now, where one sovereign nation dictated to another and said, we are going to legislate your macroeconomic policies, we are going to legislate your currency. It just would seem disconnected from what is going on in the world, because right now the fact that the Chinese economy is growing and doing well is a good thing for all of us, and it benefits not only them, it benefits the rest of the world. We are benefitting, to a large extent, by growth outside of this country. Our exports are growing, and have been for some time, faster than imports, and that is creating jobs in the U.S.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I thank you for your steadfast leadership, and most especially with the stimulus package. We certainly appreciate it, and I know the people in this country appreciate it as they are greatly concerned about their own economic futures.

Let me just explore the jobless issue again. I know my colleagues Senator Stabenow and Senator Salazar have raised it. I am concerned about the unemployment rate and the underpinnings, because we do not see an economy that is creating jobs.

So one of the reasons we have had this conversation—I know that I thought it was so important that the stimulus package, thanks to the leadership of Chairman Baucus and Senator Grassley, included extending the unemployment benefits—is we have to recognize that the long-term unemployment rate is double what it was in 2002 when we included extending unemployment benefits in that particular stimulus package, and that the rate of unemployment is up more than 18 percent compared to where it was a year earlier.

So I think that we have a lot to be concerned about. One-point-three-million Americans have been unemployed for an extended period of time, and we do not see the job creation in this economy. *Business Week* cited recently that, once workers lose their jobs, they have a harder time finding new ones. I know some people say, well, if we include extended unemployment benefits, it is going to be a disincentive to finding a job.

I say, well, I think you had better visit some parts of Maine. I mean, we just had a big headline last week saying sawmills are closing, and people saying they are going to have to move further south to other States to find a job with a living wage of some type.

I mean, it is dramatic. We have lost a lot of the manufacturing jobs in Maine, and I think it is a microcosm of America. So, when I compare the job creation of this economy compared to where we were between 1991—and that was the beginning of that recession—to 2001, we created 24 million jobs in that period, and between 2001 and 2007 we created 7 million. Even if you extend it out to 10 years, it would not nearly reach the rate of 24 million.

So I am concerned about the job creation future of our economy. I would like to have you address that, and particularly in conjunction with the tax cuts, extending the tax cuts. Frankly, I think we need tax reform. You will be extending the tax cuts of the wealthy. The top 20 percent of the households have seen a major increase in their income, 49 percent of the wealthiest households in America, compared to the lower-income which has seen 17-percent growth.

So we have some disparities and we have to address that, and also the Alternative Minimum Tax, which I will get to in a moment. But could you address the unemployment issue and how you see this economy creating jobs, and why we would not need to extend unemployment benefits?

Secretary PAULSON. Yes, Senator. First of all, I appreciate the comments. I also appreciate that you and Senator Stabenow have issues in Maine and in Michigan that are significant. As I said to Senator Stabenow, I am concerned about extending unemployment benefits right now because of the message that it sends, because unemployment in this country of 4.9 percent is much lower than it has ever been at any time than when we have extended it in the past. So what you are talking about is another, but related, issue. It is a significant issue and it a structural issue.

Because what we are seeing when you look at the economy, and even when I have looked at income distribution, I have noticed that we have a dynamic economy and we have great mobility, so that half the people in the bottom 20 percent are going to move out of it every 10 years, half in the upper 20 percent are going to be new every 10 years.

But the structural issue, which is to some extent by globalization but to a large extent by automation and technology, is how do we get skills to the people who are going to need them to compete? How do we keep creating new jobs? The economy has created over the last year, over the last number of years, a lot of jobs. We have had 52 months straight.

The last numbers that came out—and who knows whether they will be restated or not—indicated that this streak was broken for 1 month. But we created a lot of jobs. I do not think that is the issue you are talking about. I think you are talking about some of the structural issues and how to get skills to people to help them find jobs in today's world.

Senator SNOWE. Well, if the goal of the stimulus package is to put the fiscal tools in place, then that is one way to avert it. You still have the long-term unemployment. The fact is, a lot of people go unreported, as we well know, in unemployment the longer they are unemployed. So I do not know if that is the true reflection, but to have this in place and to address the long-term unemployed, I think it is significant.

Secretary PAULSON. Well, the goal of stimulus, as I saw it, was to do something that was temporary and get money quickly and boost the economy, and then some of the longer-term issues were going to be on a separate track.

I think on unemployment, what I have said is, if this situation worsens to the extent that some of you are projecting, then that is something that should be discussed at a later time.

Senator SNOWE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Snowe.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Welcome. We are happy to have you here. I appreciate the work you are doing. It is a tough job, and I am grateful to you.

Once again, the centerpiece of the President's budget is a provision to extend permanently the tax cuts of 2001 and 2003. Now, the estimated revenue effect of this provision, according to the Treasury, is nearly $2.2 trillion over 10 years, as I understand it. Correct?

Secretary PAULSON. Right.

Senator HATCH. Some say that removing the sunsets for these tax cuts would cost the Treasury this much money. But looking at it another way, is it not accurate to say that not extending them means American taxes would go up by $2.2 trillion?

Secretary PAULSON. Correct.

Senator HATCH. How would such a tax increase rank in terms of size compared to other tax increases in our history? My understanding is it would be the largest. Is that correct?

Secretary PAULSON. I have not done the analysis, but it sounds right to me.

Senator HATCH. What do you project would be the effect on the economy on job creation, investment, and on our ability to compete globally as a result of such a massive tax increase?

Secretary PAULSON. Senator, I do not think it would be a positive one. It is not something that we clearly would recommend. I think it would create a serious problem.

Senator HATCH. It could be a disaster. Is that a fair comment?

Secretary PAULSON. Well, as Treasury Secretary I will use my words advisedly. I am not going to talk about "disaster," but I would certainly say it would be unadvisable.

Senator HATCH. A matter of great concern, then.

Secretary PAULSON. I think one of the most important things we can do for our long-term competitiveness and our fundamental economic strength is to make that tax relief permanent.

Senator HATCH. Many of my colleagues on the other side of the aisle agree that some of the tax cuts should be extended, but most would not extend the top rates, only the lower rates, and the child credit, marriage penalty, and so forth.

Time and again, we hear them say that the higher-income earners do not need or deserve the lower rates. From an economic standpoint, however, is this not really a question of job creation and growth and not about fairness to the so-called rich, especially when we think about the number of businesses that pay their taxes at the individual rates?

Secretary PAULSON. Yes. I think you are very wise to focus on individual businesses and small businesses. That was something that I had not been as aware of until I came down here as Treasury Secretary and started analyzing the situation. Seventy percent of those flow-through small businesses are in those top two brackets. I will tell you, one thing I just learned over the years in working with small businesses, if they save a dollar, it goes right back into the business and creates jobs and growth.

Senator HATCH. That is my understanding.

I note that the President's budget once again calls for a permanent extension of the research credit. As you know, Chairman Baucus and I have introduced a bill to not only extend the research credit permanently, but also to reform it. We believe that the time has come to make structural changes to the credit to make it more effective. Therefore, I was especially pleased to see that the budget indicates that the administration will work closely with Congress to develop reforms to the credit, so I am grateful to you for that.

Secretary PAULSON. Thank you for your good work on that area.

Senator HATCH. Well, thank you.

Will Treasury take a look at the Hatch-Baucus research bill, or Baucus-Hatch research credit bill, and give us your thoughts on the changes that we propose, and also help us think of a way to get us out of the current mind-set that it is all right to keep extending the research credit a year or two at a time and never get around to making it permanent? We would like a strong statement on that.

Secretary PAULSON. Yes. We will work with you on your bill. I could not agree more strongly that permanence gives business a sense of certainty and makes it easy for them to plan. The reverse is also true.

Senator HATCH. Sure.

Now, many are criticizing the President's budget for showing a deficit in fiscal year 2008 in excess of $400 billion. I think it is important to dissect this number before passing judgment. One thing that I think they have missed is the revenues are projected to actually decrease this year by over $47 billion after years of significant increases.

Now, at the same time, spending is projected to keep growing at a rapid clip. If the growth of revenues in 2008 had kept up with the revenue growth of the previous year, the projected deficit, as I understand it, would be under $200 billion. Is that correct?

Secretary PAULSON. It would definitely be meaningfully less. You are right.

Senator HATCH. I think my time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Sununu?

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Secretary, as I travel around New Hampshire and talk to people about taxes, it is almost inevitable that the first thing they mention is that the tax code is very complicated. Businesses, individuals, people who itemize see it getting more complex every day. The people who do not itemize wonder what the people who do itemize do to minimize their tax burden. There is a higher cost of compliance, lower compliance rates because of the complexity, and I assume a lot less accuracy because of complexity.

Congress has a role to play, obviously. I wish we would do more in reforming and simplifying the tax code. But leadership from the administration is of great value, so I would like to know what, if anything, in your budget submission gets at the root of complexity, and reform may not be the right word, but do you have proposals that simplify the tax code and make it a little bit more straightforward and easier for taxpayers to deal with?

Secretary PAULSON. Senator, only around the margins. We are always working. We have done work with regulation to simplify. There is great complexity. Just to step back and say one of the major issues we as a country face is overwhelming complexity in many areas, whether it is disclosure when someone is taking on a mortgage, whether it is complexity in regulation, and clearly huge complexity in the tax code.

This is something that—hopefully you will be in the Senate for many years and you will be able to help lead an effort to get something done there. I do not think it is going to happen while I am in Treasury. So what we do is, we work in smaller areas to simplify the regulations, make it somewhat more understandable, make it easier for taxpayers to get their Earned Income Tax Credit, or what have you.

But in terms of dealing with the complexity, as a matter of fact, much of what I am fighting off are things to make it more complex, just even in the energy area. This is an area where we really need to focus. Energy security is very important for this country, alternative energy. But if Senators or Representatives are on a tax committee, they would look to achieve their goals through the tax system. So there are a lot of forces to make it more complex as opposed to making it simpler.

Senator SUNUNU. Well, I appreciate the answer. I believe your sympathies are in the right place, but I think this is a missed opportunity. There is no question that the administration has more opportunity and more potential in this area because you are able, through working with your counterparts, to speak with a unified voice, whereas obviously it is a little tough to make simple, straightforward tax policy with 535 legislators. Congress has a role to play, but I would hope that you would be in a position, even if it is simply over the coming year, to provide a little bit more leadership.

Let me move on, obviously, because we work under time constraints here, to ask you a little bit about credit and attempts to deal with credit constraints in the marketplace. We are going to pass an economic growth package. I think that is of some value. I think it will have an impact in the latter half of this year, and I think you would agree. But there are fundamental problems in the economy having to do with capital markets, availability of credit, and liquidity that are at least as significant and as important as anything we might do on the tax or demand side.

What in your budget, or what can Congress do to complement what is in the budget, that might have an impact in these areas, availability of credit and the credit constraints we have seen in the economy right now?

Secretary PAULSON. Well, I would say you are right in terms of your point, that capital markets turmoil impacting our financial institutions is, and can increasingly, spill over to our real economy unless we do something about it. The biggest focus I have had has been encouraging financial institutions to recognize loss and raise capital, and to raise capital when they can get it because that is much better than shrinking their balance sheet and then restraining their lending.

Senator SUNUNU. Are there tax or regulatory obstacles to that that we need to address?

Secretary PAULSON. No, there are not tax or regulatory obstacles. As a matter of fact, as we look at it, the other thing I am thinking about a lot is, what is the right regulatory response to do everything we can to ensure we do not go through this problem again?

There, sometimes I want to make sure that, in looking to fix the longer-term problem, we do not do things that are going to compound the problem we are dealing with today, because some of the things that regulators can do in the short term can make it worse. So we are working on this, but the ideas we have are already up there, ideas to deal with the mortgage market, and you already have them before you in Congress.

Senator SUNUNU. Thank you very much, Mr. Secretary.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, both, very much.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. We appreciate you coming to the committee. I would like to cover a couple of things that you have mentioned a little bit. Senator Salazar mentioned the stimulus package that we worked on under the traditional leadership of Chairman Baucus and Senator Grassley in a very bipartisan way to come up with something that we felt did make sure we corrected or picked up the issues that the House and the administration may have left out.

One of those that was of particular importance to me was obviously the seniors, but also the disabled veterans. Senator Snowe and I authored a provision that was included in the Senate version to ensure our Nation's disabled veterans would qualify for that stimulus package.

I know you answered the Senator from Colorado that we need to quickly work something out, but this is not the place to do it. My concern is, we have been hearing from all people, all sides that this is something we need to do quickly. This is the committee to do it. If this is not the place to do it—I guess where my confusion comes from is, if the administration does not believe that disabled veterans and seniors should be a part of the stimulus package, that is one thing, but working something out has to happen. We have done a great job here in a bipartisan way to come up with something to move, and apparently it is not supported by the administration, I guess.

Secretary PAULSON. Well, let me say I commend Chairman Baucus, Senator Grassley, all of you in working so quickly to get something done that meets the principles. I think we will have a very quick—I am optimistic. I think that your leaders have set a goal of getting something on the President's desk as soon as possible, but prior to the President's Day recess. All I said is I do not think that a public hearing is the forum to negotiate this, and I think you would understand that and respect that. I think you were here when I answered the Senator's question. If you want me to give you just——

Senator LINCOLN. Well, I was just curious, because it seems as if the administration's efforts are not to pass the package that we have before us.

Secretary PAULSON. Because what you have heard me say, just to go on record, when I looked at things generally and looked at what you have done, I am very pleased with the spirit and the speed in which you are working. I will say, when I look at the business side, I prefer the House approach because I think there the focus is very much on getting the greatest bang for the buck and getting the most stimulus quickly to the economy.

Senator LINCOLN. Well, do you think it is beneficial to drag our feet while you all kind of try to come up with something different than what we have done?

Secretary PAULSON. No, I do not want to. I want you to pass it, and I want to see it.

Senator LINCOLN. So you would support the package that came out of committee?

Secretary PAULSON. I did not support the package the way it is right now. I support the spirit. So what you have heard me say is, I think the business side will be more effective. You have heard me say——

Senator LINCOLN. That takes a lot of time. I think one of the things we have heard from most of the financial world like yourself is, it needs to be timely.

Secretary PAULSON. I agree.

Senator LINCOLN. And we have done a good job at keeping the lid on it, but putting things in that we felt might be important.

Secretary PAULSON. Senator Lincoln, I am not trying to argue with you here. I appreciate what you are doing. You asked me for an answer. I prefer what the House——

Senator LINCOLN. You think we need to wait then.

Secretary PAULSON. I prefer the House's. No, I want to move quickly. I would like to see it up there and on the floor and voted on, and worked through. But I said to you, I think unemployment insurance, I think some of the specific programs you put in on the tax side——

Senator LINCOLN. You do not like everything that is in our package, that is obvious. That is life. You do not get everything you want.

Secretary PAULSON. Absolutely.

Senator LINCOLN. Right.

Secretary PAULSON. That is what I said.

Senator LINCOLN. All right. I have my next question. I do not want to waste all my time.

Secretary PAULSON. I said I would like you to move. I am not trying to hold it up, I am trying to speed it up. I would like to see it on the floor to be voted on.

Senator LINCOLN. Good. Well, hopefully we will get our package down there because we worked hard in the committee to get there.

Secretary PAULSON. And I do hope, as you work to do what you believe are improvements——

Senator LINCOLN. Well, I think disabled veterans and seniors are very important improvements.

Secretary PAULSON. Also, there are parts of the—but anyway, you have heard what I have to say.

Senator LINCOLN. Right.

Just one other, to shift my visit here for a moment. The administration's position on what you all deem to be, I guess, tax increases, because it seems as if most of what comes out of the administration is that any revenue-raiser is a tax increase. But at least from the President's State of the Union address, that is what I gleaned. He certainly said that he would veto any bill that raises taxes this year.

My hope is, you would expand on that statement just a little bit. I want to be clear. I ask, because the President's budget that you sent us includes 25 proposals that bring tax revenues into the Federal coffers, 25 proposals that I am not going to pre-judge. I am not going to try to rename them as a tax increase or anything else until I certainly look at them and view them for their policy and how it makes sense.

But I would ask the same of the Treasury, and certainly of the administration and the White House. Just because any proposal may bring revenues in to the Federal Government, that does not necessarily make it bad policy or deem it a tax increase right off the bat. We would like to have your opinion on that.

Then before I finish, you mentioned to Senator Snowe how important it was to get skills for workers in terms of boosting the economy and really helping us to be competitive. We would just ask you, the President's proposal eliminates 48 education programs, for a cumulative shortfall of $85.6 billion since the enactment of No Child Left Behind. We are so far behind in funding the basics that Americans need to get those skills. I would just be curious why it is that we want to eliminate these education programs and once again fall short on the funding for education.

The CHAIRMAN. Briefly, Mr. Secretary.

Secretary PAULSON. I will be brief on the last part. The Senator is going to have to talk with Margaret Spellings about our education program and what is in the budget, the details on that. I was speaking specifically about skills to workers. Also, in terms of revenue raisers, I would simply say I am going to let the President's statement stand where it is and agree that I do not think that we need—this year in particular—to be raising taxes. I think you can assume that everything in the budget we support, and I am just happy to talk with you about any specific proposal you have, or as it comes up, that is a revenue-raiser.

Senator LINCOLN. But you do support the revenue-raisers, the 25 proposals that are in the budget?

Secretary PAULSON. Well, I support what is in the budget.

The CHAIRMAN. Thank you, Senator.

Senator LINCOLN. Right. Thank you.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I want to ask about a budget issue which is colored by the stimulus debate. Now, the economy lost 17,000 jobs in January. Your Department of Transportation has indicated that, for a billion dollars spent on infrastructure, you would create 47,500 jobs, many times the jobs that were lost in January.

Now, Senator Thune and I led a bipartisan effort to try to get some money for road resurfacing, something that can be done very quickly, into the stimulus budget. You opposed it. People like Mike Bloomberg say it will create a lot of wealth and be a shot in the arm in a hurry. So be it. We have had that discussion, and we are going to still try to prevail. We will see what happens.

But what I would like to ask you is about the budget. You are also cutting highway and transportation funds in the budget, something like 10 percent. You are the person who is the point man on job creation. I am trying to find areas in the budget, now that you are fighting us on the stimulus, that are going to do as much to have an economic multiplier, both in the short term and in the long term, as infrastructure and transportation funding.

I cannot find anything in your budget proposal that does it, and it is especially troubling to see a big cut when people say it would have made a difference in the stimulus and it would certainly make an effort in the budget. So, square those numbers for me and tell me where you are going to see the economic multiplier, the job-creating potential in other areas that your own administration says you would find in infrastructure.

Secretary PAULSON. Well, Senator, let me begin by saying you are right in saying that with the stimulus plan we wanted to stick to things that were broad-based and would make a difference this year, not putting money into spending programs.

Senator WYDEN. The Congressional Budget Office, Mr. Secretary, respectfully, said that the transportation money could get out quickly, and in fact it will get out weeks and weeks faster than the rebate checks arrive. We have had that debate. Tell me about the budget.

Secretary PAULSON. I disagree in terms of looking at the details.

Senator WYDEN. Fine.

Secretary PAULSON. But anyway, go on. But the longer term, to get to your question, there is no doubt that we have infrastructure needs in this country. There are tough decisions that were made in the budget process to do the things that I think we all know are necessary in terms of having discipline and getting to a balanced budget number. In terms of the details, in terms of what in——

Senator WYDEN. Now, where in the budget, Mr. Secretary, can you find the economic multiplier that your own Department of Transportation says you get with infrastructure spending?

Secretary PAULSON. Where in the budget do you get——

Senator WYDEN. Yes.

Secretary PAULSON. I can find some very, very little things that I can talk about in terms of the kinds of multipliers we are going to get with our enforcement budget and IRS in terms of the kinds of multipliers we get with keeping tax rates low, which I think are fundamentally very important. There are a number of spending programs where there is a multiplier. What you are saying is, you would like more of transportation spending, infrastructure spending.

Senator WYDEN. I would like to wring more value out of the stimulus dollar and the budget dollar. You know I am for keeping tax rates low. Where are we going to get it, other than in areas like I am pointing to?

Secretary PAULSON. Well, that is a debate that Congress will need to have, and you will be able to have with Mary Peters and other members. At the end of the day, you all may decide there is more that is needed there. I would say there has been a very disciplined look taken at this budget.

Senator WYDEN. We will have it, Mr. Secretary, with Mary Peters. But I see you, and it is because of my respect for you, as the point person in the job creation effort. When the headlines said Friday, we lost 17,000 jobs in January, your own Department of Transportation says you can create 47,500 jobs with just a billion dollars of transportation funding, I say to myself, that looks like a no-brainer for the economy. Then we look at your budget numbers, which cut transportation.

So I know that my time is out. I hope you will take another look at it, and particularly look at Mike Bloomberg, a New Yorker who knows something about creating wealth. Look at his comments when he said, both short-term and long-term, this is where you get the real benefit.

Secretary PAULSON. I have huge regard for him. I will look at what he said. I will look at the Department of Transportation study you cite.

Senator WYDEN. Very good. I will look forward to working with you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

A vote has begun in the Senate, so we have to finish pretty quickly here.

Mr. Secretary, you said increased information reporting and keeping taxpayer burden down is important to improve tax compliance. But for the information to be effective, the IRS clearly has to have the appropriate technology to do the job and reduce the burden on taxpayers. Apropos to the question asked by Senator Sununu, filers must have the ability to e-file and electronically pay, and so forth, and be up to date, basically.

Secretary PAULSON. Right.

The CHAIRMAN. Yet, your proposal, your budget asked for a cut of almost 17 percent in the information technology budget. How do you expect your proposals to work if you want to cut your technology budget by 17 percent? We are talking about the IRS budget here. I might just say, too, the BSM—that is the basic technology budget, Business Systems Modernization—basically it is going down. One year it went up a little bit, but that is an anomaly because labor costs were reported someplace else over the years. But how are we going to close the tax gap and bring the IRS up to date with a 17-percent cut?

Secretary PAULSON. Well, Mr. Chairman, first of all, thank you for the question and thank you for all the help you have given in terms of working with the IRS, working with our budget, and working with management.

I would say that, first of all, the technology in the IRS is not where we would like it to be, in the Treasury it is not where we would like it to be, and in the Federal Government it is not where we like it to be. When I came to my job, I found that we needed to make a number of changes at Treasury. We have the right people in the right jobs.

I would say, when we looked at what we needed, it does not all come down to dollars. There is a question as to how fast you can spend the dollars. It is not always just throwing money at a problem that will make it get better. I think we have what we need here. But what I would look forward to doing, is talking with you about that in more detail, and talking with your staff. If, at the end of the day, you believe that that would be helpful, we will gladly accept it, I would say.

Then on the tax gap, on the enforcement side, we did not get the money we needed for the compliance and enforcement side last year, and we would like to get it this year. But again, we have had a working relationship where we can talk about these things and we will get into it in some detail with you, and you will either be convinced that we have what we need or you can give us more money and we will that take.

The CHAIRMAN. Well, it is my very strong opinion that the IRS's computer systems are virtually in the Dark Ages. We have a big tax gap, as you well know. We are having a huge and growing technology gap between the private sector—many in the private sector have very efficient and up-to-date technology and IT processes, whereas the IRS does not. A lot of the systems at the IRS cannot talk to each other. If someone files their employment returns, we do not know whether they filed income tax returns, and vice versa. I mean, it is more than an embarrassment, yet you want it cut.

Secretary PAULSON. Well, I would say to you, we are in agreement in that there is——

The CHAIRMAN. Do you want people to pay taxes or not?

Secretary PAULSON. We are in agreement that there is room for improvement.

The CHAIRMAN. You are darned right, there is room for improvement.

Secretary PAULSON. We will be very supportive with a new Commissioner who is very, very technology savvy. We will be able to work together and——

The CHAIRMAN. Well, I hear you. You are saddling him with a big——

Secretary PAULSON. Hold on. I would say to you, though——

The CHAIRMAN. He seems like a good man, but he needs resources.

Secretary PAULSON. I would say to you, let us work together and let us make sure. But I would say to you, with all due respect, I wish it were just a matter of throwing more money at it.

The CHAIRMAN. You hire really good people who know what the information technology systems should be, then start putting them in place.

Secretary PAULSON. That is right.

The CHAIRMAN. And this budget says no. It says you are going to cut.

Secretary PAULSON. Well, now, I would just simply say, and I think you do know what we have done to begin with at Treasury and what we are doing in terms of putting people in place, we are putting good people in place. And if the biggest disagreement we have is over how much money we are going to throw at technology——

The CHAIRMAN. Senator Salazar, you are next.

Senator SALAZAR. Thank you very much, Chairman Baucus. I know we have a vote under way, so I will be brief here.

The CHAIRMAN. We have 7½ minutes left.

Senator SALAZAR. When I look at the world, at least from my point of view as one Senator, I think the whole issue of national defense and foreign relations is huge, what we do with health care is huge, and what we do with energy is huge as well. Those are my few big issues. I know the President addressed our addiction to foreign oil again this year, as he has in prior years. Yet, there is a contradiction in terms of that priority and what he has done here with the proposed budget.

Just on the renewable energy programs and energy efficiency, there is a 27-percent cut that is proposed by the President in those programs. I think that is the wrong direction to go, and I think we need to beef those up, including with the package that this Finance Committee passed on a bipartisan basis that fell one vote short in the Senate last time around.

I guess I would ask you, just from a policy point of view, as you look at the macro issues of the Treasury and our country, whether or not investments in terms of new technology and renewable energy and efficiency are the places where we ought to put a very high priority for the country, and whether you think this budget that has been presented here by the President does that.

Secretary PAULSON. First of all, I believe that the area that you have cited is one that is of the highest priority. When you look at the long-term risks, they are right up there with the structural deficit, with entitlements. It is the energy issues and energy security.

Senator SALAZAR. Do you think we walk the talk, though?

Secretary PAULSON. What?

Senator SALAZAR. We can agree on that concept, we can agree on that goal. Do you think this budget walks the talk in getting us there?

Secretary PAULSON. Yes. I think, first of all, what was done last year was a meaningful step. I think we need to do more. I do not think when we look at energy we should look at it just through the lens of the tax system and the tax code, because I do think that flies in the face of Senator Sununu's issues about complexity, and I think the IRS has—and Treasury is not really the agency that is the expert on energy. So I think we need to look at it more broadly, but I look forward to talking with you. I am not wanting to argue with your basic point, and I look forward to talking with you on it.

Senator SALAZAR. I appreciate that, Secretary Paulson.

Let me just say, in our conversations tomorrow in the Energy Committee with Secretary Bodman, as we move forward with trying to get the farm bill together, I think this issue is of the highest priority to the country, and I would hope that you could help us with the President and his people to get a robust, clean energy package together, because we are not there yet.

Thank you very much.

Secretary PAULSON. Thank you.

The CHAIRMAN. Thank you, Senator.

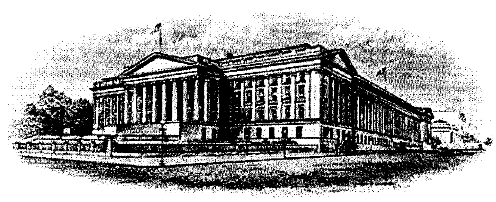
Thank you, Mr. Secretary. We very much appreciate your taking the time to come and testify before us.

The hearing is adjourned.

[Whereupon, at 11:48 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record



U.S. Treasury Department Office of Public Affairs

Opening Statement by Secretary Henry M. Paulson, Jr. on the President's Fiscal Year 2009 Budget before the United States Senate Committee on Finance

Washington, DC—Chairman Baucus, Senator Grassley, Members of the Committee: I am pleased to be here to discuss the President's budget for fiscal year 2009. As Treasury Secretary, my highest priority is a strong U.S. economy that will benefit our workers, our families and our businesses. Through a measured approach that balances our nation's needs with our nation's resources, the President's budget supports that priority.

This is especially important now as, after years of unsustainable home price appreciation, the U.S. economy undergoes a significant and necessary housing correction. This correction, combined with high energy prices and capital market turmoil, caused economic growth to slow rather markedly at the end of 2007.

The U.S. economy is diverse and resilient, and our long-term fundamentals are healthy. I believe our economy will continue to grow, although at a slower pace than we have seen in recent years.

Yet, the risks are clearly to the downside and President Bush knows that economic security is of the utmost importance to the American people. In recent weeks, the potential benefits of quick action to support our economy became clear, and the potential costs of doing nothing too great.

So, we are gratified that Congress is advancing a growth package to support our economy as we weather the housing correction. We believe that a growth package must be enacted quickly; it must be robust, temporary, and broad-based, and it must get money into our economy quickly.

The Senate has begun to consider its version of this bill, and I am hopeful that it will complete consideration soon.

If we keep moving along a fast track, and Congress sends the President a bill that meets our shared principles, rebate payments can start in May and be completed this summer. Together, the payments to individuals and the investment incentives for business will help create more than half a million jobs by the end of this year.

In addition to an economic growth plan to help us weather this housing correction, the Administration will continue to focus on aggressive action to try to provide alternative options to foreclosures. That includes encouraging the HOPE NOW alliance's outreach to struggling homeowners. Congress can do its part by finalizing the FHA modernization and GSE regulatory reform bills and by passing legislation that will allow states to issue tax-exempt bonds for innovative refinancing programs.

We continue to monitor capital markets closely and to advocate strong market discipline and robust risk management. Working through the current stress is our first concern. Through the President's Working Group on Financial Markets, we are also reviewing underlying policy issues because it is just as important to get the long-term policy right.

While we are in a difficult transition period as markets reassess and re-price risk, I have great confidence in our markets. They have recovered from similar stressful periods in the past, and they will again.

The Administration will also continue to press for long-term economic policies that are in our country's best interest – a pro-growth tax system, entitlement reform and a balanced budget. To that end, the President's budget makes the 2001 and 2003 tax relief permanent, and keeps the federal budget on track for a surplus in 2012.

In the future, as in the past, our long-term economic growth will also be enhanced by supporting international trade, by opening world markets to U.S. goods and services and by keeping our markets open. Congress can help create jobs and economic opportunity by passing the pending Free Trade Agreements with Colombia, Panama and South Korea.

I appreciate the cooperative and bipartisan spirit that has brought the Congress and the Administration together to support our economy, and look forward to that spirit continuing as we work through this period. Thank you.

RESPONSES TO QUESTIONS FOLLOWING THE TESTIMONY OF SECRETARY PAULSON BEFORE THE SENATE COMMITTEE ON FINANCE ON THE PRESIDENT'S FISCAL YEAR 2009 BUDGET

Department of the Treasury
April 10, 2008

SENATOR GRASSLEY

Question 1

I expect that we will see a repeat of last year's Congressional budget on the AMT. That is, we'll hear that it is accounted for in the FY 2009 budget. Unlike the Administration's budget, we will not see the revenue loss accounted for in the bottom-line. We'll see the budget assume that the revenue loss is offset by unidentified and unscored revenue raisers that this committee will be charged with developing. Of course, if the President agrees with many on this side that AMT relief doesn't require offsets, then we can't change the tax code to patch the AMT if Democrats insist on offsets. I'm sure everyone here would prefer to avoid last year's late action on the AMT patch. So, I'm going to ask you to tell me if the Administration will oppose an AMT patch that is offset. If your answer is yes, then I think we should cut to the chase and patch the AMT sooner rather than later.

Answer

The Administration's Fiscal Year 2009 Budget provides for alternative minimum tax (AMT) relief for the 2008 tax year through an increase in the AMT exemption amounts and an extension of AMT relief for nonrefundable personal credits. This relief is necessary in order to prevent millions of taxpayers from being subject to an unexpected and unwelcome tax increase.

In December 2007, legislation (H.R. 4351) passed the U.S. House of Representatives to provide AMT relief for the 2007 tax year, but only with a large tax increase. The Administration opposed this legislation and objected to the use of tax increases as the price for protecting tens of millions of taxpayers from the AMT. Should Congress again seek to enact tax increases as the price to pay for AMT relief, the Administration would oppose them.

The Administration encourages Congress to act quickly to provide AMT relief for 2008, to avoid the uncertainty surrounding AMT relief that occurred last year.

Question 2

Mr. Secretary, I would like to explore the effects that the lower capital gains tax rate has had on the level of federal tax revenues. According to the nonpartisan Congressional Budget Office, tax receipts in 2007 were $161 billion higher than in 2006, following annual increases of $253 billion and $274 billion. Some of these increases came from non-withheld taxes, which include taxes on dividends and capital gains.

In January, 2004, CBO forecasted that tax liabilities from capital gains, for calendar years 2003 through 2007, would be $259 billion. Now, with actual figures in, CBO expects those tax liabilities to be $470 Billion-that is $211 Billion more than previously projected over a five year period.

In its latest Economic Outlook, the CBO reports that realizations of capital gains grew by about 8 percent in 2007, 16 percent in 2006, 38 percent in 2005, and 54 percent in 2004. The rising revenue pattern has been good news for the federal budget. Now, I wouldn't say that these tax cuts have quote "paid for themselves", but the correlation between lower tax rates and increasing capital gains realizations can't be denied.

Under current law, the 15% capital gains rate is scheduled to go back up to 20% at the end of 2010, and dividends will be taxed at ordinary income rates as high as 35% (or 38.6% after 2010). The Administration has called for making the lower rates permanent, and has estimated the cost over the next ten years to be $196 billion for dividends and $105 billion for capital gains.

Mr. Secretary, would you comment on the effect the lower dividends and capital gains rate has had on the federal budget deficit over the past 5 years, the effect of making the rate cut permanent, and the consequences of allowing it to expire?

Answer

At the time the lower rates were introduced, Treasury estimated the tax rate reductions for dividends and capital gains would cost approximately $60 billion through Fiscal Year 2008. Currently, we estimate that the FY 2009 through FY2018 cost of extending the dividend and capital gains rates permanently is roughly $300 billion, as you suggest.

Allowing the dividend and capital gains tax rates to expire would increase several tax-induced distortions, including those that encourage firms to use debt rather than equity finance, to adopt unincorporated rather than corporate structures, and to retain earnings within the firm rather distributing them. By increasing the overall tax on capital income, allowing the tax rates to expire also would encourage households to consume relatively more now, and to save and invest relatively less in the future. Each of these distortions drags down the U.S. economy, reducing economic growth and performance.

Making the tax rate relief on dividends and capital gains permanent would reduce these distortions, and thereby promote better economic performance. Permanence also is preferable to temporary extension because it reduces uncertainty, making it easier for businesses and households to plan effectively for the future.

Historically, capital gains realizations and tax receipts have been volatile and have had a strong relationship to asset market prices. Because of this, forecasting tax receipts from capital gains is difficult, and it is not always possible to determine the extent to which realizations have been affected by tax rates. That said, we believe that the tax rate reductions on capital gains and dividends have caused higher levels of gains realizations and dividend payouts.

Question 3

Do you think that temporarily extending the net operating loss carry back period would have a stimulative impact on investment and the economy?

Answer

Taxpayers with 2007 losses already have the ability to obtain quick refund of those losses by applying them against any outstanding tax liability from 2005 and 2006 (years that were profitable for most firms). The effectiveness of the proposal, therefore, would depend on the number of firms having losses that would not otherwise be available for carryback. It is not known how many firms would be affected because tax year 2005 is the most recent year for which corporate tax data are available for analysis.

Extending the carryback period from two years to five years would have uncertain effects on the incentive to invest. The increased cash flow resulting from an extended carryback period could potentially lower a firm's cost of funds and stimulate investment. Extending the carryback period could also allow firms to carry back more NOLs than they would have otherwise. This could increase the firm's incentive to invest by allowing firms to benefit from accelerated depreciation. But the effect of that lower cost of funds may not significantly influence the decision to invest to the extent that the firm faces higher future effective tax rates due to the elimination of loss carryforwards, which may result from an extended carryback period. Firms with persistent loss carryovers face a low marginal tax rate on the returns from new profitable investments. It is not known which effect would dominate.

An extension of the carryback period might be a complement to accelerated depreciation or other investment incentives, because firms in a loss position would receive the benefits of those incentives. A temporary extension of the carryback period could reduce job loss to a limited extent by providing relief for cash constrained firms.

SENATOR KYL

Question 1

Do you believe we can tax our way out of the entitlement problem?

Answer

Social Security and Medicare reform remain important Administration priorities. The President and I have both emphasized that we are willing to sit down to negotiate a Social Security agreement without preconditions. My preference is for a reform plan that fixes the problem permanently, does not repeat the mistakes of the past, and does not threaten economic growth.

Reforms that depend on tax increases may harm economic performance and growth. In addition, if tax revenues were to be considered, a mechanism is needed to ensure that trust fund accumulations represent an accumulation of resources—true pre-funding. Currently, there is nothing to prevent current contributions in excess of current benefits from being unwound by larger deficits in the non-Social Security portion of the federal budget.

Medicare poses a far greater financial challenge than Social Security. In addition to facing the same demographic trends, Medicare must cope with expected large increases in health care costs. The Administrations' FY 2009 Budget proposes important steps to slow the growth of Medicare spending. The Budget proposes reducing the growth of provider payments, increasing means testing and cost sharing, reducing excess payments to providers, and cracking down on fraud and abuse. The Budget proposals are important first steps in addressing Medicare's long-run financial problem, but more fundamental changes are needed. These changes will require a broad rethinking and consensus on what is the optimal 21st century health insurance program for the elderly and disabled, and how that health insurance should be financed.

Question 2

What kind of policies could address the liquidity problem for sustainable economic growth – and would it help to extend existing tax rates before 2010?

Answer

On March 13, 2008, the President's Working Group on Financial Markets (PWG), which I chair, released its comprehensive "Policy Statement on Market Developments." The PWG's statement was intended to help to restore market liquidity, market discipline, and investor confidence through recommendations to enhance disclosure/transparency, due diligence/independent analysis, valuation techniques, risk management practices, regulatory policies, and market infrastructure. The statement includes recommendations for all stakeholders – all market participants and regulators – and for all links in the chain of the securitization process – mortgage brokers, originators, securitizers, financial institutions, credit rating agencies, investors, and state and federal regulators. With regard to extending the 2001/2003 tax relief, the Administration strongly supports making that tax relief permanent as soon as possible, as reflected in the President's FY 2009 Budget. Making the tax relief permanent will reduce uncertainty, helping businesses and households to plan effectively for the future.

Question 3

What is the immediate effect of a UI extension on jobs and, potentially economic growth? And why? What does empirical data show?

Answer

Past experience suggests the immediate effect during the first four weeks of an unemployment extension would be to provide less than a billion dollars in additional benefits for the long-term unemployed. This cost estimate is based on the experience during the initial stages of the Temporary Extended Unemployment Compensation Act of 2002. This assumes extended benefits would become available to workers whose regular unemployment insurance benefits expired in late 2007, and to workers whose regular benefits expire in 2008.

This additional billion dollars in spending would not have an appreciable macroeconomic impact on jobs or output, and job market conditions do not warrant a UI extension at this time. The unemployment rate is currently 5.1 percent. The last time unemployment insurance benefits were extended, in March 2002, the unemployment rate was 5.7 percent, and most past extensions began when the unemployment rate was 7 percent or higher. It is also important to note that we expect to deliver over $112 billion in stimulus payments to over 130 million households beginning in May, with the bulk of those dollars distributed by the first week in July. The boost from the individual and the business tax relief components of the stimulus package will support our economy while the housing and credit market adjustments proceed.

SENATOR BINGAMAN

Question 1

Secretary Paulson, you responded to my question about the effect of slow GDP growth on the deficit by testifying that a one percent decrease in the rate of GDP growth in 2008 – to 1.7 percent from 2.7 percent – would increase the deficit by $10 billion to $15 billion in FY09. You repeated this answer at the Senate Banking Committee hearing the very next day. However, an OMB analysis shows the deficit would grow by over $37 billion under that scenario (Table 12-5 in Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009). This issue is important because the President's budget assumes that GDP would grow by 2.7 percent in 2008 but in January CBO estimated that growth will be only 1.7 percent. What will be the true effect on the deficit if GDP grows at this slower rate? How large will the FY09 deficit be if GDP grows at 0.8 percent as it did during 2001, the last year the country went through a recession?

Answer

My answer and Senator Bingaman's citation are both correct, but each was referring to a different year. The figure in my testimony refers to the effect on the deficit (and receipts) of lower GDP growth in the same year, that is, in FY2008.

Analysis from the Office of Management and Budget (OMB) shows that a reduction of 1 percentage point in economic growth (accompanied by a 0.5 percentage point increase in the unemployment rate) will raise the deficit by $16.4 billion in the same year that GDP is lower. Without an increase in the unemployment rate, the deficit would be $14.1 billion higher. Receipts losses alone are about $13.8 billion with lower growth in the same year. That is the basis for the $10 billion to $15 billion provided in my answer.

With respect to the effect on the FY2009 deficit, your question correctly points out that the OMB analysis also shows that the effect on the next year's deficit is larger. The deficit would be $37 billion higher in FY2009, with most of that accounted for by a $29 billion reduction in receipts.

If GDP growth in 2008 were to be 2 percentage points lower than the Administration forecast, the deficit in FY2009 would be about $74 billion higher, with most of that accounted for by a $58 billion reduction in receipts.

While these OMB calculations are informative, they assume that if GDP grows more slowly than trend in one year, it is not made up in subsequent years. In other words, it assumes that the level of GDP is permanently lower. However, data suggest that slow periods of GDP growth, such as we are likely to experience in 2008, are followed by more rapid periods of growth (above the long-term trend) as the economy recovers.

Over the five-year budget horizon, the Administration and CBO average GDP growth rate forecasts are close, which suggests that CBO and the Administration share roughly similar views on economic trends, even though there might be differences in the timing of growth. For example, while CBO looks for lower growth than the Administration in 2008 (1.5 percent for the four quarters of 2008), it assumes higher growth than the Administration in 2009 (3.3 percent for CBO and 3.0 percent for the Administration).

Question 2

The President's budget replaces the existing exclusion for employer-sponsored insurance with a standard deduction. The budget touts an 8 million reduction in the number of uninsured due to this proposal. In your estimates, what is the expected decline in employer-sponsored insurance likely to be? And of that decline, what percentage of those losing employer-sponsored insurance would become uninsured? By 2018, what percentage of individuals who now have health insurance through their employers will pay more under the deduction proposal?

Answer

The current tax exclusion for employer-provided health insurance encourages employers to provide more coverage than is necessary and has resulted in higher and less efficient health spending. In particular, the value of the current exclusion rises without limit with the amount of insurance purchased for the employee. Furthermore, the current law exclusion is only available to those receiving insurance through their employer, and those purchasing insurance directly typically receive no tax benefit.

If enacted, the President's proposal to replace the unlimited employer exclusion for health insurance with a standard deduction amount would remedy the bias and overspending caused by the unlimited exclusion, and would eliminate the disparate treatment of taxpayers purchasing insurance on their own. As a result, we do expect the policy to reduce the number of individuals receiving health insurance through their employers. With the availability of tax subsidies for insurance outside of employer-provided coverage, some employees will prefer purchasing coverage on their own, and some employers will discontinue offering group coverage. We further expect that workers in firms discontinuing health plans will receive higher salaries to compensate for any loss of benefits. The size of the behavioral response by employers and employees is uncertain, and a fairly wide range of estimates of the reduction in employer coverage is plausible. Thus, our estimate of a net reduction of 8 million in the number of persons without health coverage takes into account that some persons who are no longer covered by their employers may not be able to obtain individual coverage, but this effect on the number covered is more than offset by the increase in individual coverage among persons who previously had no coverage at all.

The President's proposal is revenue-neutral over the budget window, but in each year there are some taxpayers that would pay higher taxes, and some lower. The proposal would lower taxes for those purchasing insurance outside of employment and those purchasing relatively inexpensive policies through their employer. Under the proposal, the new standard deduction may not completely cover those employees who purchase relatively expensive policies through their employer. In 2018, we estimate that, under current law, slightly more than half of taxpayers who receive insurance through their employer would have premiums above the proposed standard deduction amount, although other factors could result in lower total costs.

Finally, the President's proposal has the potential to benefit all taxpayers as a more efficient subsidy for health insurance purchase. By limiting the exclusion, the tax system would no longer favor overspending on health insurance and medical care and may lead to increased cost-consciousness throughout the health care system. A net reduction in uninsured may lead to lower costs for everyone, as there will be fewer uninsured with costly uncompensated urgent medial care. And the availability of the tax subsidy outside of employer-provider coverage will encourage more job mobility, and a better-functioning labor market.

SENATOR STABENOW

Question 1

I was disappointed to hear your response to extending unemployment insurance during the Senate Finance Committee hearing on February 5, 2008. I do believe we are at a critical time. Numerous families are facing layoffs and companies are devastated by plant closings. For me it is not simply that Michigan has a 7.6% unemployment rate, but also more unemployed workers are without a job for a longer period of time. This is not just true in Michigan, but across the country.

As a comparison, in March 2002, when the most recent stimulus package was passed, workers spent an average of 15.4 weeks looking for a job. Today, they spend 17.5 weeks. Another useful measure is the percentage of unemployed workers who have spent more than six months looking for a job. In March 2002, that number was 15.9%. Today it is higher at 18.3%.

This data clearly illustrates that workers are having a more difficult time finding a job. Additionally, economists such as Mark Zandi of Moody's Economy.com and Lawrence Summers who has served as Treasury Secretary and World Bank Chief Economist agree that unemployment insurance is the quickest and most effective way to stimulate the economy. In your testimony you stated that the economy was worse in 2001 than now, yet I only see a one-tenth of a percent difference in the unemployment rate (5.0% unemployment in September, 2001 and 4.9% in January, 2008) which is nearly identical. It is apparent that today's unemployed workers face longer periods of joblessness. How is this situation not worse than or at the very least similar to 2001?

Answer

I appreciate your concerns about the difficulties that confront the long-term unemployed but believe that job market conditions today do not warrant an extension at this time. The unemployment rate is currently 5.1 percent. The last time unemployment insurance benefits were extended, in March 2002, the unemployment rate was 5.7 percent, and most past extensions began when the unemployment rate was 7 percent or higher.

The average duration of unemployment is higher now than in March of 2002, as you point out. However, it declined in the first quarter of this year, while it increased in the first quarter of 2002. The median duration of unemployment also declined in first quarter of this year, while it rose in the first quarter of 2002. Both the average and the median duration of unemployment remain well below the 26 weeks of unemployment insurance benefits available to most workers. The percentage of workers unemployed for 15 weeks or longer is stable at 1.6 percent. The percentage of workers out of work for 15 weeks or longer was higher and rising at the beginning of 2002. Furthermore, the Federal-State Extended Unemployment Compensation Program, which provides up to 13 weeks of additional benefits to a state confronting historically high unemployment rates, is already in place.

It is also important to note that we worked with Congress to enact a broad stimulus package that will provide about $150 billion in tax relief for individuals and businesses in 2008, leading to the creation of over half a million new jobs this year. We expect to deliver over $112 billion in stimulus payments to over 130 million households starting in May, with the bulk of those dollars distributed by the first week in July. The boost from consumer spending and business investment will support our economy while the housing and credit market adjustments proceed.

OPENING STATEMENT
SENATOR KEN SALAZAR
FINANCE COMMITTEE HEARING
The President's Fiscal Year 2009 Budget Proposal
February 5, 2007

Thank you, Chairman Baucus and Ranking Member Grassley for holding today's hearing on the President's budget request for Fiscal Year 2009.

I am pleased to have the opportunity to discuss some of the broad economic and budgetary implications of the President's budget request with my colleagues on the Committee, and with the distinguished Secretary of the Treasury. Thank you for being here, Mr. Secretary.

In general, I have mixed feelings about the budget that the President presented to us yesterday. I am glad to see that the President has included funding increases for the Pueblo Chemical Depot in my home state of Colorado, and for efforts to improve security at our nation's borders.

But, as has been the case each of the four years I have served in the Senate, the downside of the President's budget request far outweighs its upside. In this case, the downside consists of additional deep cuts in important federal programs ranging from law enforcement to health care to renewable energy and persistent dishonesty about the severe fiscal challenges facing the federal budget in the coming years.

I am extremely concerned by this Administration's unwillingness to acknowledge some basic facts in its annual budget. I do not believe the costs included in this budget for our ongoing obligations in Iraq and Afghanistan are realistic. I also do not believe it is realistic to assume that the cost of addressing the Alternative Minimum Tax will simply disappear after 2009.

The President's budget once again projects that the deficit will be completely eliminated in five years. That is an admirable goal, and I will work with the President to find ways to achieve it. But eliminating the deficit is a task that will require the willingness and good faith of members of both parties in Congress as well as the Administration, and part of that is being honest about the fiscal challenges we know we face.

It is also worth noting that the President's request estimates significantly larger deficits in 2008 and 2009 in large part as a result of the economic stimulus legislation currently under consideration in Congress. Again, while I support that effort, I also believe we need to be honest with our constituents about the budgetary implications of the policies we advocate.

I am sorry to say that this budget does not meet that standard. I am hopeful that we can find a way to face up to the challenges we face, and that we can find a way to tackle them together.

Thank you.

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