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REVENUE PROPOSALS AND TAX CUTS IN THE PRESIDENT'S BUDGET

HEARING

BEFORE THE

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UNITED STATES SENATE

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REVENUE PROPOSALS AND TAX CUTS IN THE PRESIDENT'S BUDGET

WEDNESDAY, FEBRUARY 28, 2001

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

The hearing was convened, pursuant to notice, at 2:23 p.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Murkowski, Gramm, Lott, Jeffords, Snowe, Baucus, Breaux, Conrad, Bingaman, Kerry, and Torricelli.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. We are going to do things a little bit differently. Because we did not have a quorum to do our organization business, we are going to start seven minutes early with our hearing with the Secretary. Then when we get 11 people here, we are going to do a little bit of the organization business, plus the two nominees that I had originally planned on doing.

Today we are here to hear testimony on revenue proposals in President George W. Bush's first budget. Our witness, obviously, is Treasury Secretary Paul O'Neill.

For the Secretary and for my colleague, Senator Baucus, and all the rest of the people on the committee, I think it is fair to say that we find ourselves with a wonderful opportunity to deliver meaningful tax relief to American working men and women.

There might be some differences on how that should be done, but it seems to me like there is unanimity that there should be tax relief of some amount and some form that there was not that consensus on just 12 months ago.

The cornerstone of President Bush's campaign was tax relief, and I believe that is why we are here today the way we are. Virtually all members of this body, and even the body across the Capitol, promised to deliver income tax relief to the people that sent them here to the Nation's capital.

So all of us, I believe, Republicans and Democrats together, have hired on to lighten to some degree the record income tax burden of the American people. We have a job to do, and we owe the people a seriousness and a focus at the task at hand. The record levels of individual income tax receipts provide a Federal budget surplus. It might be called a tax surplus. Let me point out that, since 1993, individual income tax receipts have doubled.

The surplus provides us with options: (1) we can return the excess collections to the people in tax relief; (2) we can pay down the Federal debt; (3) we can address other priorities, such as education, through spending increases.

Fortunately, the size of the surplus means that all of these options can be pursued at the same time. This is the course President Bush has chosen with his first budget submission.

President Bush's budget pursues all three of these options. His budget provides tax relief, pays down the Federal debt, and addresses very important priorities, especially education, through spending increases.

Under this budget blueprint, we can deliver tax relief to everyone who pays income taxes. Chairman Greenspan and others have warned that, if we are to sustain this country's growth, particularly the long-term growth, we should reduce marginal tax rates.

We can provide this rate reduction in a manner that Congress' nonpartisan tax scorekeeper, our own Joint Committee on Taxation, says that we make, in the end, the income tax system even more progressive.

The President's budget blueprint ensures that we continue to reduce Federal debt. We will set aside payroll taxes for Social Security. That means at least $2.5 trillion for debt reduction.

Finally, the third option, increase spending for important policy initiatives such as education, defense, and Medicare modernization, is employed in this budget before us.

Now there are other courses we can pursue. If we follow the path of the last Congress, we can spend the surplus, deny or obstruct tax relief, provide modest debt reduction.

It seems to me that the President has chosen a very wise path. The President's budget blueprint shows that we can provide tax relief, pay down the Federal debt, and address important priorities through targeted, responsible spending increases.

So I look forward, Secretary O'Neill, to your discussion of these tax relief proposals and for your response to our questions.

Now, to Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

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

Secretary O'Neill, welcome. Particularly, welcome to the first substantive hearing of your tenure. I will cut to the chase. As I consider the President's budget, I have six questions.

First, is whether the budget keeps us on a path of fiscal discipline. That principally means paying down the debt. I say that, because I think we should, if I might use the word, be conservative. After all, these 10-year projected surpluses may be less than meets the eye, and a projection of what will happen that far off in the future is very uncertain at best.

A good business person, certainly you in your former life at ALCOA, probably would be reluctant to lock in a dividend for 10 years based on a mere estimate of how your company will be doing 10 years down the road.

No sane CEO would do that. I do not know why we, as the trustees of the people's tax dollars, should be doing the same thing. We are locking in a tax cut here over 10 years just based upon an estimate of how the economy is doing.

I am also concerned about this new idea of unredeemable debt. It may well be that there is a large amount of debt that, for one reason or another, cannot be paid off.

Frankly, to me, it sounds a little too convenient. Sort of like, gee, I would really like to pay off the debt, but the accountants will not let me. So, I want to explore this to ensure that the notion of unredeemable debt is not being used to disguise a retreat from fiscal discipline.

I want to make sure that we use straightforward accounting. For example, both the spending and tax sections of the budget achieved considerable savings from what are called offsets that the footnotes tell us have not really been figured out yet.

We have faced that kind of accounting before. Dave Stockman confessed that that footnote, that asterisk, was intended to obfuscate. I hope we do not go down that road again.

My second question, is whether we are truly protecting Social Security and Medicare. After years of cuts in Medicare, and they have been painful, and threats to Social Security, we are finally in a position to set the Medicare and Social Security surpluses aside and then figure out how to shore up both programs.

The new budget makes some surprising changes. As far as I can tell, it does not protect the Medicare Part A surplus the way we have all wanted it to be protected, that is, with the Medicare lock box. In fact, if you look at the budget, the Part A surplus is not protected at all.

Instead, the budget sets up a new accounting system that seems to deny that the Part A surplus even exists. It appears to fund the new Social Security accounts out of the Social Security, which would reduce the overall solvency of the Social Security trust fund. I want to look carefully at the ledger sheets to determine what, in fact, is going on, but that is how it looks.

My third question, is whether the budget allows us to establish an effective prescription drug benefit. The President's short-term proposal does not go nearly far enough.

It does not provide universal coverage, or coverage for all seniors. The $153 billion that is allocated is not enough to fund even a bare bones prescription drug benefit.

There is broad agreement, I think, in Congress that we can do better, quite a bit better, and I think the budget should allow us to do that.

My fourth question, is whether the budget allows us to take significant steps to expand health insurance coverage to more kids and more families.

The President's proposed tax credit is a start, but we may have to accomplish more, should accomplish more, through a combination of improving Medicaid, improving the CHP program, along with tax incentives. Again, I believe the budget should allow us to do this.

My fifth question, is whether the tax cut is fair and whether it is affordable. I support a tax cut, a large tax cut, a tax cut that does go, in fact, to all taxpayers. I believe the President deserves considerable credit for putting a tax cut high on the agenda.

But, clearly, we also have to make sure that the tax cut is consistent with other priorities, and there are a lot of other very demanding priorities. I have mentioned a few. We have to make sure that the cut is really fair to all Americans.

I want to make it clear here, I disagree with those who claim that any tax cut that benefits upper income Americans is necessarily a bad thing. I do not believe in that. That is not my view.

But there is an important issue here. About 80 percent of Americans pay more in payroll taxes than they do in income taxes. About 20 percent pay hefty payroll taxes and no income taxes at all.

This latter group does not benefit in any way from the President's proposal. These are people who are working hard, very hard, to make ends meet. They are paying taxes and they get no help from the President's program.

I believe we should consider whether we can do something about this. Not by cutting payroll taxes, because that would undermine the Social Security and Medicare systems, but there may be other approaches, like a credit or a deduction that we can apply against either income taxes or payrolls that would broaden the President's proposal, giving a tax cut to more families. It is something I think we should consider very, very closely. As you know, a lot of ideas have been broached, and I think we have a responsibility to try and see if we can work that out.

Which brings me to my final point. I hope that all of us can take a deep breath, keep a little bit of an open mind, if only for a nanosecond. Back off, step back, cool it. Let us see what this is really all about. We, as members of the Congress, you in the administration, want to do what the American people want. What do they want? They want us to pass a responsible budget, a responsible tax cut, and responsibly meet other needs that I mentioned, and probably some more.

They do not want us to engage in politics. If there is one thing that is clear, the American people are sick and tired of partisan politics in Washington. They are tired of campaigns. They are tired of campaigns by the President, they are tired of campaigns by Congress. They are just tired. I think there is a tremendous opportunity here for us to put together, as I said, a responsible program, including a significant tax cut.

I look forward to working with you toward that objective. When it comes time for questions, I will have a couple I want to ask you to try to clarify a few things in this budget. Mr. Secretary, I wish you well. I wish us all well, because we have a big burden ahead of us.

The CHAIRMAN. Now, Mr. Secretary, as I indicated, I would like to have you give your statement. We will start to ask questions based upon the rules of order of people coming in.

But just as soon as the eleventh person shows up here, I want to ask you just to sit there quietly while we conduct a little organization business and vote out a couple of the President's nominees.

Would you proceed, please?

STATEMENT OF HON. PAUL H. O'NEILL, SECRETARY OF THE TREASURY

Secretary O'NEILL. Thank you, Mr. Chairman, Senator Baucus, members. It is great to be back here so soon on these important subjects.

If I may, I will simply submit for the record the prepared statement.

The CHAIRMAN. Your entire statement will be printed in the record as you submit it.

Secretary O'NEILL. All right. Great.

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

Secretary O'NEILL. Then maybe I would just summarize the key points that I think should be the centerpoint of our discussion today.

The centerpoint itself is the President's budget. I thought it was worth summarizing the critical points. I must say, I am going to find very difficult to live up to the standards set by the President last night in summarizing his own important principles in the budget, but for you, they are these.

First of all, the President's budget calls for a 4 percent increase in spending in the next fiscal year. As we have looked at the details and the priorities that we think are important for the Nation, we have settled on a 4 percent rate, which is something less than half the rate of increase last year, and 50 percent less than the rate of increase over the last 3 years.

But, nevertheless, it is an increase. Within the increase are some very strong increments of funding proposed for the most important priorities, beginning with education and including such things as a $2.8 billion a year increase for the National Institutes of Health. We are headed toward a doubling, well over $20 billion a year now. So, the priorities are funded in this budget.

The Social Security dollars that are going to flow into the government over the next 10 years are safeguarded, lock boxed, fenced off, protected from all evil-doers. I do not know if there are more strong ways to say it. Social Security dollars are set aside without any threat of encroachment.

The President's budget would pay down $2 trillion worth of debt over this time period. To the degree that we can do more than that to the question indicated by Senator Baucus, we will do it.

There is a technical judgment as to how far one can actually go in getting to zero, but this budget provides for $2 trillion worth of debt defeasance and whatever else we are able to do.

Having taken care of spending priorities—in fact, maybe it is worth retreating just for a minute to say, with the 4 percent increase proposed for this year and with the follow-on increases for the next 10 years, Federal spending in an absolute dollar sense would increase $5.2 trillion over this 10-year period.

Where I come from in the private sector, we do not count on, you get a free ride for what you call inflation adjustment, so I cannot help noting $5.2 trillion on top of the available nominal spending number is a very big number.

After taking care of priority needs, and after lock boxing Social Security, and after paying down $2 trillion worth of debt, the President's proposals provide for a $1 trillion contingency reserve in the event that things go wrong, where we agree to additional increment needs above what we have provided in an assumption of $5.2 trillion worth of additional spending.

We still have money left over, and it is this additional money, $1.6 trillion, that the President proposes we give back to the American people. Recognizing that it was, after all, the hardworking American people who sent these dollars here, and recognizing that we have taken care of priorities, including a contingency reserve of $1 trillion, it does seem to the President and to the rest of us that we should speed this money on its way back to the people who sent it in.

So, these are the important principles that are incorporated in the President's budget. There are many details. Since it is so freshly printed, I doubt you have had an opportunity to investigate every principle. But there is lots of thought behind these proposals. They are not without substance.

Senator Baucus, again, to one of the points that you raised about a lack of specificity, it is true, as in all new administration budgets, that the final details in the catalog version that we are used to seeing will be here in a few weeks. But you should have no doubt that the summary numbers that you will see are backed up by decisions to stay within those numbers.

The reason you do not see great detail is because there has been some flexibility provided within departments and agencies as between programs that are in the same appropriation bills for distribution within the totals that are provided.

So, there are no magic flying asterisks, or funny accounting, in these budget documents. We can live with, and recommend to you all that we live with, this 4 percent increase overall, with special priority funding for over an 11 percent increase for things like education.

Mr. Chairman, if you will, that concludes my opening remarks. I would be very pleased to take your questions.

The CHAIRMAN. We will take 5-minute turns. Turn the lights on so nobody abuses that. This is the order. If anybody has got any dispute with the order, tell us quietly ahead of time. Grassley, Baucus, Gramm, Breaux, Snowe, Bingaman, Kerry, Hatch, and Jeffords. All right.

Secretary O'Neill, at Table S.9, there is an item called "Additional Tax Incentives," which adds up to about $123 billion over 10 years. There is not much detail, although it is my understanding that there are things like the adoption credit, health credit, and I am very pleased to hear that another bill that has passed the Senate a couple of times, the farm and ranch risk management account proposal, are included.

But I understand that Treasury staff is still fleshing out further details on that. So could you tell us now, or what can you tell us now? More importantly, when would we get the details of what might be included in those proposals, adding up to $123 billion?

Secretary O'NEILL. We will be working, as we always do, on tax legislation with the Ways and Means Committee staff and jointly developing legislative language to back them up.

Many of these are proposals made by the President over the last couple of years, and we will flesh out the details and get them into a legislative form with Ways and Means in the next few months. It is my guess that they will then be the subject of an additional tax bill, hopefully some time in this session.

The CHAIRMAN. All right.

Let me suggest to you that, maybe for the way the Senate might do a tax bill as opposed to the way the House will do it, we may have one tax bill after the budget is adopted. So maybe by the middle of April, we should have that information.

Secretary O'Neill, you will recall that the income tax policies of the 1970's and 1980's led to the problem that we had bracket creep, meaning that you were pushed by inflation into higher brackets without a realized increase in income, standard of living, et cetera, kind of a back-door tax increase for every taxpayer. Fortunately, in the 1980's Congress corrected the inflationary bracket creep problem by indexing the basic structure.

We had a statement by Chairman Greenspan identifying a new form of bracket creep. In this case of the new bracket creep it came because of productivity gains producing taxable income that far outstripped inflation that was previously corrected for.

The Federal Government, of course, ends up reaping a revenue windfall from this unanticipated growth in real income. This new form of back-door tax increase could impose a very long-term drag on the economy, especially if these private sector productivity gains end up growing the Federal Government and diverting resources that have better return if invested in the private sector where real wealth is created.

So, first of all, do you agree that fighting this form of bracket creep is a compelling reason for reducing marginal tax rates?

Secretary O'NEILL. I certainly do. Chairman Greenspan observed it is one of the derivative functions of the very good and remarkable change in productivity, that we have experienced in our economy that we have thrown people into higher marginal rates.

I think, over time, it is quite clear the difference between what the President has suggested with his 33 percent top rate, and the current rate on a total basis, that entrepreneur's basis, of something approaching 44 percent is a huge disincentive to what is, and has been, the driving force in productivity growth and entrepreneurism in our economy.

The CHAIRMAN. My next question deals with a response that you gave to Senator Lincoln of this committee when you were here during confirmation.

I hope I am quoting you accurately: "I absolutely agree that the individual AMT must be reformed so that individuals are not trapped in what has been referred to as a ticking tax time bomb. I will certainly work with you to fix this problem that will ensnare millions of middle-income Americans."

Now, that is a very emphatic statement. But just a few days ago, it seems like things have changed a little bit, with your statement before the Ways and Means Committee that 85 percent of the AMT impacts those making $100,000 a year and that the administration is only interested in helping those making below $100,000.

First, let me note that there appears to be nothing in the administration's proposal to even assist those making under $100,000 and correcting the AMT for it.

Second, it is somewhat misleading to state that 85 percent of the taxpayers affected by the AMT make over $100,000. Your own taxpayer advocate says that taxpayers with an adjusted gross income of less than $100,000 will owe 60 percent of the Nation's AMT bill by the year 2010.

In addition, President Bush's plan to bring millions of more Americans into the AMT process, the Joint Tax Committee estimates that the Bush tax plan will nearly double the number of American taxpayers affected by the AMT.

Finally, we should remember that the AMT relief is listed as the number two issue being resolved by the taxpayers' advocate.

My two questions to you are, will the administration provide us with their proposal for addressing AMT, and does the administration believe that AMT relief should be limited to only those making $100,000, despite the fact that this will, to use your words, "eat away" at the benefits all people receive from the President's tax proposal?

Secretary O'NEILL. All right.

First, I think it is important to say that, with the President's proposals, in spite of what the AMT would do if nothing is done to it, every taxpayer would still be better off whether the AMT bites them or not. So, I think it is important to establish a grounding base for what the implications are from a distributional point of view.

The second thing that is important to note, is that the reason for what I would call a notch effect, and I use $100,000 as a conceptual way to talk about the distribution of people that are affected by the AMT, the reason why most of the people below $100,000 are not affected by the AMT is because of the interaction between what the President has proposed on the one hand for marginal tax rates and what he has proposed on the other hand for the child credit. When you put these things together, most of the people with low and moderate incomes are not going to be negatively affected by the AMT.

Having said that, I would reaffirm to you what I said to Senator Lincoln when she asked me the question at the confirmation hearing. I think, in time, we—and I mean by that the administration and the Congress—have got to deal with the AMT.

But I would suggest to you, it is only one of many problems that we need to deal with in the United States' Tax Code. It is fraught with a complexity, and inconsistency, and devilishly difficult to understand interactions between well-intentioned provisions of the Code that I think are dangerous to us.

They are dangerous to the degree that intelligent, well-intentioned people have trouble figuring out what it is they are supposed to do. So, yes, I think we are going to eventually have to deal with the AMT. I think we are dealing with the most important part of the AMT in what we have proposed.

If you all would like to do something more, we are prepared to work with you to see if there is a way that we can incorporate something more within the limit of the $1.6 trillion tax bill that still stays within the principles that the President has recommended having to do with reflowing funds to individuals in our society.

The CHAIRMAN. Thank you, Mr. Secretary.

Now, Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate your comment about the asterisks and the footnotes. I am just wondering if we are going to get legislative language and scoring for each of those. I think there are about 21 of them in the budget.

The sooner, the better, because Ways and Means, as you know, is going to mark up a portion of the President's tax cut, I think, on Thursday. Tomorrow is Thursday. So the answer is yes? You will get that to us?

Secretary O'NEILL. Absolutely. But please let me say again, these asterisks do not have anything to do with uncertainty about what the levels of the programs are. They have to do with the internal distribution of funds within bureaus and departments.

If anyone does not get it, let me make sure that this is really clear. This is not about funny accounting, this is about internal distribution of funds between programs.

Senator BAUCUS. I understand that. But they say "net of offsets," so it is important to know what those offsets are.

Secretary O'NEILL. Fine.

Senator BAUCUS. On both the spending and the tax side.

Secretary O'NEILL. All right.

Senator BAUCUS. I was also very heartened to hear you say that Social Security is, and I have forgotten your exact words, but totally locked up, safe, and so on, and so forth.

Secretary O'NEILL. I was trying to exhaust all of the synonyms that I could think of.

Senator BAUCUS. All right.

Does that mean that you will now make a Shermanesque statement that none of the Social Security surplus will be used in any Presidential proposal for individual accounts?

Secretary O'NEILL. I would say this. The Social Security trust funds will be used only for Social Security, but I would not rule out that those funds, at least in a conceptual way, could be used to ensure the actuarial integrity of the Social Security concept, including even higher levels of benefits in association with individual retirement accounts.

So, indeed, some of these funds could conceivably be included in a reform that strengthens and improves Social Security for its beneficiaries.

Senator BAUCUS. So the answer is, no, you will not make that statement.

Secretary O'NEILL. If you wish me to, I would be happy to, but within the boundaries of the definition I gave you. Yes.

Senator BAUCUS. Yes. Right. Which is to say that it could very well be that part of the Social Security trust fund surplus could well be used, under a Presidential proposal, to fund and set up private Social Security accounts. Is that correct?

Secretary O'NEILL. No, I would not say that.

Senator BAUCUS. I misunderstood. What did you say then?

Secretary O'NEILL. If I may, let me say it to you in my words. The President—and I have seen him do this, I am tempted to say, almost every time that I have been with him in public and private sessions—believes that it is critical for our generation, those of us who are here, to fix Social Security. He, like I, watched the parade of people who said how important it was to fix Social Security. I think I said to you once before, coming here in 1973 with George Schultz, and George Schultz testifying to the Senate Appropriations Committee, that we were headed toward an intergenerational fire fight because we had not fixed Social Security.

Senator BAUCUS. Right.

Secretary O'NEILL. Here we are, 28 years later, and we have not fixed it. President George W. Bush is determined.

Senator BAUCUS. We all want to fix Social Security.

Secretary O'NEILL. We are going to fix Social Security and we are not going to violate the President's commitment that every dollar that comes in for Social Security will be used for Social Security, even though it may be a better, emboldened program even than the one we have.

Senator BAUCUS. I understand. I understand. I am not trying to get into an argument with you, I am just trying to understand where the administration is. So you are basically saying that, yes, some of the dollars could, in any proposal for private accounts, come out of the trust fund, so long as, in your judgment—that is what you said—on the net basis, it improves and enhances Social Security generally.

Secretary O'NEILL. I do not know that.

Senator BAUCUS. All right. Thank you.

I ask, because it just seems to me that when the Social Security surplus is being built it, it is very important to keep the surplus in the trust fund, because we do not have those situations all the time. As you know, down the road it will probably decrease.

My time is a bit short, but see if you could help me a little bit on the math.

Secretary O'NEILL. Good.

Senator BAUCUS. As I understand it, the non-Social Security surplus projected is about $3 trillion.

Secretary O'NEILL. Right.

Senator BAUCUS. As I understand it, the President's tax cut is about $1.6 trillion.

Secretary O'NEILL. Right.

Senator BAUCUS. That brings us down to $1.4 trillion.

Secretary O'NEILL. Right.

Senator BAUCUS. As I understand it, the interest cost will be about $400 billion over 10 years.

Secretary O'NEILL. With the funny accounting we use, yes, that is right.

Senator BAUCUS. All right.

So that is $1 trillion. That is net $1 trillion. We are down to $1 trillion.

Secretary O'NEILL. Right. That is the contingency reserve I spoke about.

Senator BAUCUS. Right. That is the $1 trillion contingency reserve.

Secretary O'NEILL. Right.

Senator BAUCUS. Now, the President's Helping Hand, which is an addition, is about $153 billion over 10 years, which leaves a contingency reserve of about $840 billion over 10 years.

Now, the Part A trust fund, if it were completely set aside, as we all understand it to be, is about $526 billion. So if you take out the Part A trust fund and save it and not use it for Medicare and everything else, subtract that $526 billion from $840 billion, you get a new of about $300 billion. Instead of $1 trillion, we are down to $300 billion.

Now, on top of that—these are just questions that are in the minds of an awful lot of people—the President talks about making the tax proposal retroactive. It depends on how it is done. That could cost anywhere from $20 to $30 billion to, say, $100 billion.

Business tax breaks at some time, people see them coming, could be any amount, who knows what? AMT is $100, $200 billion. Extenders, over 10 years, is going to cost $100 billion. Defense spending over 10 years increases, NMD, TMD, whatnot, is about $250 billion. A real prescription drug benefit is about $200 billion more; with the uninsured, it is about $100 billion.

You always have disaster assistance bills, agriculture assistance, natural disasters, so I am throwing in $100 billion there over 10 years. I think that is reasonable. Those total up to almost $1.5 trillion, and we only have a remaining surplus of $300 billion. How does all this add up?

Secretary O'NEILL. Well, Senator, I would stipulate this, that if we have no discipline—and I do not mean just the Congress, but those of us in the administration and those of you in the Congress—then it is a fairly simple matter to see how we could spend the surplus of $5.6 trillion and ask the American people to send in some more money because we still have an appetite.

I think we could add to a very long list of what you have already said, things that somebody would say, these are really great ideas and things that we ought to do. That is not what the President believes.

The President believes that if we are willing to discipline ourselves to a 4 percent increase in next year's spending and limit our appetite to another $5.2 trillion worth of spending over the next 10 years on top of the base we have already got established, and put aside $1 trillion for contingencies, and set aside $2.6 trillion for debt relief, that we have still got $1.6 trillion for a tax cut for the people.

Senator BAUCUS. I appreciate that.

Secretary O'NEILL. I would not dispute that it is possible to imagine huge amounts of additional spending that one person or more would say is a good idea.

Senator BAUCUS. If I might, Mr. Secretary, just quickly make a point here. Here is my problem. Here is my problem. We all have a deeper problem, and this is it.

There are a lot of people in our country who are going to be wondering, why are they not going to get a significant prescription drug benefit, for example. Instead, those dollars are being used, say, for a tax cut, particularly when most of it goes to the most wealthy.

Now, I am not in this tax class warfare at all. I am just stating the facts. We are talking to people in the country and they are going to have some concerns. So those of us who support a tax cut have to deal with this. I am just raising this all with you so that you can help us work this out.

The CHAIRMAN. You and I are going to see that we get a significant drug benefit for our seniors, too.

Senator Gramm, we have 11 people here. Am I right?

Senator GRAMM. That is right. Well, he has not sat down yet. Do you want me to go ahead and speak?

The CHAIRMAN. No. Just wait a minute.

[Whereupon, at 3:00 p.m., the hearing was recessed, and was back on the record at 3:07 p.m.]

The CHAIRMAN. I now return to the hearing and call on Senator Gramm, the next in order under our rules.

OPENING STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM TEXAS

Senator GRAMM. Mr. Chairman, let me thank you for calling on me. I can see already, in listening to the comments earlier, that a sense of humor is going to be needed in this process, and I want to commit myself to it.

First of all, the idea that the Secretary of the Treasury would be badgered because someone is talking about investing Social Security money on behalf of paying Social Security benefits is one of the great peculiarities in legislative history.

We act as if paying down the public debt somehow helps Social Security. That is a complete fraud. It is pillaging the Social Security funds because we are using them to benefit the Federal Government and the Treasury, and they are doing nothing to benefit Social Security.

Second, it seems to me that maybe there might be a proposal at some point to use the Medicare "trust fund" to pay for Medicare benefits, and I guess someone might complain about that.

I just would like to go on record as saying I always thought that is what there were for. I never knew that they were to pay rich bond holders. I thought they were to pay for Medicare benefits.

Third, I have been in Congress since 1979. I have been involved in writing budgets when we had Republican majorities and Republican Presidents since 1981. Your budget is the best and most responsible budget that has been submitted since I have been a member of Congress, and I want to go on record as saying that.

Let me also say that it never ceases to be a source of amazement to me that, according to the Congressional Budget Office, between August and January we added $561 billion of new spending over the next 10 years, and nowhere did anybody that I can see say, well, what about these projections? Are you not concerned about these projections?

We added $561 billion in new spending in 6 months, and nobody was the least bit concerned. At that rate, in 12 more months we will have spent the whole tax cut. But, yet, when we are talking about giving tax relief, suddenly people are very concerned. I would like to ask, where was that concern 6 months ago? I do not think it existed.

Now, in terms of these lock boxes, do I not remember that, last year, Democrats killed the Social Security lock box? Did I forget that? Now, not only are you talking about Social Security lock boxes, but you are talking about Medicare lock boxes.

You question, what happened? Let me tell you what I think happened. What happened, is these lock boxes were designed to stop spending last year, and now by doing them you try to stop the tax cut so you can spend this year. There is one consistency, and the consistency is spending.

Now, in terms of this huge tax cut, we are talking about, as I figure your numbers, Mr. Secretary, that of every dollar paid in the next 10 years, the President's so-called "huge" tax cut gives them 6.2 cents back.

Now, do I not recall that that is substantially smaller as a percentage of projected revenues than the Kennedy tax cut proposal that he made in 1961, and the Reagan tax cut proposal in 1981?

Secretary O'NEILL. Yes.

Senator GRAMM. Does my memory fail me, or was it John Kennedy who proposed a tax cut with across-the-board cuts so that these rich people and these poor people all got the same percentage reduction? When people raised a question he said, "A rising tide lifts all boats."

Am I wrong or right in that your tax cut actually reduces the rates more for lower income people and makes the system more progressive, yet some people are worried that somehow this is helping rich people by making the tax system more progressive? Do you see an inconsistency in all that?

Secretary O'NEILL. I certainly do.

Senator GRAMM. Well, good. I thought you would. [Laughter.]

Now, let me pose my question in the final moments I have. In looking at the next 10 years and looking at where we are, do you believe that there has ever been a 10-year period in American history where we were debating cutting taxes in a better environment for a tax cut?

The surplus has never been as big. The economy has had no economic growth in the last quarter. As I look back, at least in sort of a cursory view at all of American history, I cannot ever remember.

The tax rate is the highest it has been since 1944, and that is the only year in history it has ever been higher. We were in a life-and-death struggle with fascism then. There is no war going on now. Can you recall any period in history, despite all this talk about uncertainty, where you could have made a stronger case for a tax cut than today?

Secretary O'NEILL. Absolutely not. These circumstances are really unique. Part of the modern period I have been here, I was at the Office of Management and Budget when it was still the Bureau of the Budget, and helped to write the last balanced budget before the ones that occurred the last couple of years, which was fiscal year 1969.

The circumstances that exist today are truly unique. Certainly in modern times, in a situation where our structural tax system is going to throw off so much money, that we must do something with it. Hopefully we are not going to spend more than the President has recommended, and we are going to give back people some of their money.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. The next person is Senator Breaux.

Senator BREAUX. Thank you very much.

The CHAIRMAN. Then Senator Snowe will be next.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Mr. Secretary, we are happy to have you back, and look forward to working with you.

If you looked at all these little name tags up here, the name plates that we have, and you count them all up, you would find that you have 10 on this side and 10 on that side. Russell Long would have loved that situation, but I love it, too.

What concerns me, are the public statements from the administration with regard to, here it is, take it or leave it. It is not quite that harsh, but it seems to indicate, this is it, do not change it. It is $1.6 trillion, it is across-the-board rate cuts, this is what I want, this is what I need, and really, do not change it.

Now, you have been around even longer than I have, and we all know that this is what Congress does. Particularly, this is what Congress is going to have to do to get that bill out of this committee when we still have 10 and 10.

So I would hope, and I do not want you to negotiate now because it is not the time, but there will be a time that will come that, in order to get that proposal out of this committee with something better than a tie vote and the chance of it passing on the full Senate floor, that people who want to get something done are going to have to negotiate.

I would just continue to encourage you, as an old negotiator, to keep that in mind. If we do not, I am awfully afraid that the old phrase, my way or no way, that no way wins. When no way wins, the American public loses. So that is just a continued cautionary note that I would put out there on the table.

The second thing, is the concept that I like and am becoming increasingly interested in is to try and do something with a question of fairness with regard to the payroll tax. American people understand it. They know it hits them harder, in most cases, than the income tax does.

I would like you all to consider the concept of doing something on the payroll tax by giving a credit against income taxes paid to take care of that bottom group, as opposed to the concept of just reducing the rates for the lower income, which for many people who do not pay income tax, you do not get a lot of help.

The child credit doubling is great, but if you do not pay any income tax it is not helping you very much. For those in the lower categories, it does not help very much if we have that situation. So, I want you all to consider that. This is something that may be part of this, break a 10–10 tie, and yet do something for all the brackets.

The other point I want to make, the things on education, and you talk about a tax credit for health insurance, Senator Jeffords and

I have a bill to encourage the use of the Tax Code to help the uninsured people buy health care.

Again, it is not refundable, so if you do not pay income tax you do not get any help in that area. That is something that needs to be addressed to make sure you are helping people that need the help the most. Help for education, help in the areas of investments by families and State investment programs are all good ideas.

The question I have now, is that you said in your testimony that the proposal on the rate cuts maintains the progressivity of our Tax Code. Now, Senator Gramm talked about the Kennedy proposal where the rate cuts were all the same and it was good public policy.

I do not think the rate cuts, as I look at them, are the same. For instance, in the 39.6 top bracket, for people who are single making almost $300,000 or more, the rate is reduced from 39.6 to 33 percent. That is a 16.6 percent reduction in the top rate.

Whereas, in the 28th percent bracket, you go down to 25 percent, which is only a 10.7 percent rate reduction. That is not an even, across-the-board rate reduction. If we average it all out, it is about a 13.6 percent rate reduction if you add them all.

So, the top bracket is getting higher than what the average would be. At least, that is how I figure it. The 15 percent bracket is a zero reduction, because it stays at 15. To me, the 39.6 to 33 is a 16.6 percent reduction. That is a larger percentage reduction than the other brackets are getting.

Could you comment on that, if you can?

Secretary O'NEILL. Senator, let me help you with the numbers, and let us do them together.

For a four-person family with an income under $35,000, their tax reduction will be 100 percent.

Senator BREAUX. What bracket is that?

Secretary O'NEILL. This is the lowest tax bracket.

Senator BREAUX. You are talking about the 10 percent bracket?

Secretary O'NEILL. This is a zero bracket.

Senator BREAUX. All right.

Secretary O'NEILL. We are proposing to do a new strike line, where people begin to pay positive income taxes. So we are saying, for the lowest income tax payers, for the people who are now paying tax at the lowest rates, they are going to go to a zero rate. So their reduction is 100 percent.

Senator BREAUX. I agree with that.

Secretary O'NEILL. For a four-person family with $50,000 or $45,000 worth of income, they are going to have a 50 percent rate drop.

Senator BREAUX. What bracket is that?

Secretary O'NEILL. It is the 25 percent bracket. I do not know. What I have in my mind, is what does this do to real families? For people with $75,000 worth of income in a four-person family, they are going to have a 25 percent cut. I agree with your arithmetic on what the top people are going to get. They will get the smallest rate cut, which is 16.6 percent. Everyone else is going to get a larger reduction.

Senator BREAUX. I will tell you what, you are a smart man, and obviously a lot smarter than I am. But when I say that the 28 percent bracket goes down to 25 percent, that is a 10.7 percent reduction. If you take the 39.6 bracket and reduce it to 33 percent, that is a 16 percent bracket reduction. That is more than 10.7.

Secretary O'NEILL. I am talking about what is going to happen to real families.

Senator BREAUX. Well, real families are somewhere in those categories.

Secretary O'NEILL. We are slipping the whole rate structure up. So you cannot just look at what the rates are, you have got to look at what levels of income they apply to draw a conclusion about what the distribution effect is going to be. You are quite right. Let us go back to where you were with 39.6 and 33 percent. This is the smallest of all the rate reductions.

Senator BREAUX. Even though it is the highest percentage reduction?

Secretary O'NEILL. No, it is not the highest percentage reduction. It is the smallest percentage reduction. It is why, with these changes, the Tax Code is going to be more progressive than it is now.

Senator BREAUX. I tell you, I do not understand a lick of that. I am going to need more work in this area.

Secretary O'NEILL. Senator, under the President's proposal, the highest income taxpayers are going to pay a larger fraction of total Federal income taxes than they do now, and people at the lower and moderate levels are going to pay a smaller fraction of total Federal income taxes than they pay now.

Senator BREAUX. In terms of dollars.

Secretary O'NEILL. In terms of percentages of total Federal tax take.

Senator BREAUX. We need some discussion on this, because I still am not clear. It seems to me that the top brackets have a much larger percentage reduction in the rates than the middle brackets and the lower brackets. You are saying that is not true, and I just need to understand that.

Thank you.

The CHAIRMAN. Thank you.

Senator Snowe, then Senator Kerry will be the next person.

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Secretary O'Neill. I wanted to pursue several issues, but one, of course, is how the administration arrived at the issue of the level of minimum debt level over the next 10 years to be $1.2 billion.

I think it is an important issue, obviously, because there have been some suggestions and criticisms about the fact that more debt could be eliminated over the next 10 years and has been recommended by the administration.

In fact, there was an article yesterday that appeared that quoted a former official of the Treasury Department that oversaw government debt markets during the Clinton Administration who said that it could be paid off much faster than President Bush's budget.

He said, no more than about $500 billion of the debt would be difficult to buy back, which is an interesting statement, since the last economic report that was issued by the previous administration in January showed the same debt level over the next 10 years to be $1.2 billion.

So I do not know if it is revisionist history on the part of this former official at Treasury, or they did not work with OMB when this economic report was designed and released in January.

Secretary O'NEILL. I had a question this morning. We did a press briefing downtown, and I was asked about this question. I made a new discovery of things one cannot talk about if you are the Treasury Secretary. Frankly, I was so careful in saying to that audience that one needs to separate budget document and economic concepts from the practice of managing the Nation's debt and cash stream, and I thought I was really very careful in precise.

Almost before I got back to my office, I had a wire service story saying, "O'Neill is Changing the Nation's Debt Management Policy." So I do all that preamble to say to you, I am not changing the Nation's debt management policy today.

I know that is more than you want to know, but I do want to answer your question. There is, I think, an area of legitimate debate about how far one would want to go in reducing debt.

When Chairman Greenspan raised this subject in his testimony before the Congress, he said to them that he believed—and he and I have talked about it subsequently several times—that there is what we would call a frictional level of debt that one probably does not want to buy back, and exactly how much it is, one does not know.

In part, it is dependent on what we do in our regular debt management policy by way of the maturity that we sell to the market. So, there is a range of uncertainty and ambiguity about this and it is not all unintentional as we try to get the best price for the debt that we sell to the public on behalf of our population.

But, in any event, if we could buy back a $2.6 trillion instead of $2 trillion, that would be perfectly fine. No one is saying that we want to put an arbitrary limitation, for some nefarious reason, on how much we want to buy back. It is only an estimate of how much one can prudently buy back.

Senator SNOWE. I appreciate that. I just thought it was interesting that the previous administration agreed with this administration, as recently as January in their own economic report, that shows right here, debt held by the public, to be $1.2 trillion over the next 10 years. So they obviously concurred with the level that this administration is putting forward.

Secretary O'NEILL. But by yesterday they changed their mind.

Senator SNOWE. Right. Exactly.

In addition, I would like to pursue the issue of the tax cut and a trigger. I know I have discussed this whole issue several weeks ago, and it is one that some of us are working on here in the Senate.

I compliment the administration for including a contingency fund in the budget. I think that certainly is wise. I think the problem is imposing the self-discipline necessary so that there are not the inevitable temptations with using that contingency fund. That is the purpose that a trigger serves.

It ensures that you tie the tax cuts and new spending initiatives to debt reduction goals. States have incentives. Their credit rating is affected by their inability to balance their budgets. They pay a consequence.

There is no consequence here if we fail to achieve the bottom line. So, I would hope that the administration would give that consideration as we proceed in this debate in terms of the tax cut issue.

Secretary O'NEILL. Indeed, as you say, we have discussed the so-called trigger concept. This is a sophisticated group, so I would offer you one thought which I think is an important thing to consider.

There is a function that was a discount of present value, and the idea of it is that if you have a stream of money coming toward you, that it has a present value and you can calculate exactly what that is. In a way, that same process takes place, I think, when ordinary families make decisions about money flows that they see coming at them and that they are anticipating in the form of wages, raises, and bonuses, and the rest of that.

If you can think about what this tax proposal is about in terms of an ordinary family and what they are going to see coming at them, if you enacted the President's proposal as he has proposed it, it would set up a series of consequences out there with real families where they would say, I now understand I am going to pay a lower rate of tax, and we have children, and we are going to get another $500 per child. We have got a marriage penalty, and we are going to get something from that. There is an estate tax consequence down the road, either for our parents or for us.

Those combinations of things, if you enact them into law, will begin to affect the decisions that people make about what level of mortgage they can afford, how much money they need to save for their children's education, and what kind of car they can have.

So if you, or we, together, promise the American people that they are going to get a level of tax reduction, it will have a series of consequences that will get backed up into today and tomorrow.

If you put a trigger in that says you cannot effectively count on this money, it will affect those forward-looking decisions and have the effect of compounding uncertainty about what real human beings can expect from their government.

An effect you might think about, at least the triggers I have heard talked about, suggest that when things get bad we are going to raise people's taxes. That does not seem like a good idea to me.

Senator SNOWE. That would not be, in this instance.

Secretary O'NEILL. If the main effect of the tax reductions are marginal rate cuts and child credits, it is hard to see how you could come to another conclusion if you put in a trigger that basically takes something away from people that they have already counted on.

I must say, there is a kind of trigger I favor. I do not mean this facetiously. It seems to me it would be great if, in the event we close our books each year and have more than a $25 billion surplus, that we ought to just automatically send 65 or 70 percent of it back to the people who sent it in. That would be a great trigger.

Senator SNOWE. Thank you.

The CHAIRMAN. Thank you, Senator Snowe.

Now, Senator Kerry of Massachusetts.

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

OPENING STATEMENT OF HON. JOHN F. KERRY, A U.S. SENATOR FROM MASSACHUSETTS

Senator KERRY. Mr. Secretary, we appreciate your being here. We love your testimony. But, while you are talking, I want you to know, the real deal is being cut right over here to my left. [Laughter.]

I am sorry that the Senator from Texas has left. Probably the most correct thing he said, is that we are all going to need a terrific sense of humor. Having listened to him, I agree. [Laughter.]

I am not so sure that I would be rushing around, bragging on my role in the budget of 1981. We spent 15 years trying to dig out from that. I think you would agree that the excesses of the early 1980's and the budgeting process—and we had a Republican President and we had a Republican-run Senate back then, and I remember coming here and signing on to something called Gramm-Rudman-Hollings 1985. It took us until 1993 until we made a serious effort to reduce the deficit.

With that in mind, I want to come back to what the Ranking Member is asking about, because I am having trouble getting a handle on these numbers and I want to run through them with you again a little bit.

First of all, on the 11 percent increase, it is my understanding you are taking money and counting money that was appropriated last year, about $2.1 billion, in that education increase. That has already been appropriated. Is that correct?

Secretary O'NEILL. I do not think so, but I am not positive, Senator.

Senator KERRY. I would ask you to take a look at that. That is my understanding. I think the real increase is more like 5 percent, 5 point something, right in there. But I wish you would take a look at that.

Second, Senator Domenici, the chairman of the Budget Committee, has agreed, and I think Senator Conrad agrees, that you start out with the CBO, $5.6 trillion over the 10 years.

Now, Alan Greenspan, 7 months ago, raised interest rates because the economy was growing too fast. Seven months later, he said we were at zero growth.

It is very difficult for me to understand the safety in our being advised to take a proposal, which CBO itself has only a 5 percent chance of being accurate, 45 percent chance it is higher, 45 percent chance it is lower. But, given the Greenspan experience, we are being asked to lock in 71 percent of these tax cuts in the back 5 years. Agreed?

Now, that $5.6 trillion, you have agreed, we are going to set aside Social Security, it is not going to be touched, $2.5 trillion.

Secretary O'NEILL. Right.

Senator KERRY. Senator Domenici agreed there is $400 billion that goes into Medicare for Part A insurance. That brings you down to $2.7 trillion, a figure that he agreed was the figure you get down to.

Now, I do not think the administration is proposing to get rid of the R&D tax credit or the low-income housing tax credit. I will tell you, if you do propose it, I know this committee will not get rid of either of them, nor will the Congress.

So you have the so-called tax extenders that are about $100 billion. I cannot understand. Notwithstanding what you said about some people being still better off with the AMT, I will tell you, we are going to hear from constituents who are going to be screaming about the fact that they were promised they are going to do better, and in effect, with the tax cut they get, they get less than they anticipate and ought to get, without being thrown into the Alternative Minimum Tax.

Now, I think we are going to do something about it. I think you are going to propose that. So, you are going to have to factor that in. Whether it is $100 billion, or $200 billion, we could argue about that.

You have agreed here today that there is a funny way of calculating interest, but we are going to have $500 billion of interest we must pay because we are not paying down the amount of debt we are giving in a tax cut. I gather you agree, you are going to have interest foregone.

Secretary O'NEILL. $400 billion. To your point about funny accounting, the notion of funny accounting is, in effect, we are penalizing ourselves with dynamic scoring for the interest costs of a tax reduction and we are not taking any credit for the improvement in the economy that will come from a tax reduction.

I know you knew Martin Feldstein. He was one of the preeminent economists of our time. He testified, I think, before this committee.

Senator KERRY. I am just trying to deal with the numbers that we have. The light is going on. I agree, we could go off there. I would love to follow up with you. I just want to finish on the numbers.

Secretary O'NEILL. All right.

Senator KERRY. So you and I are within $100 to $200 billion of each other, depending on where you come out on the tax issue and how much is in the interest. But that brings you down, with retroactivity, to $1.7 trillion available out of the 10-year surplus.

Now, your tax cut is $1.6 trillion, leaving you $100 billion to $200 billion, some flexibility, $250 billion, for everything else you want to do. Where does your $1 trillion rainy day fund come from?

Secretary O'NEILL. You spent $1 trillion so fast, I did not see it go by.

Senator KERRY. We have talked about the tax. I am talking about the interest.

Secretary O'NEILL. We have got $400 billion in the $1.4 trillion contingency slice of the $5.6 trillion pie.

Senator KERRY. But there is no contingency, because you have set aside Social Security.

Secretary O'NEILL. No, no, no.

Senator KERRY. You have set aside the Medicare Part B. You only have $2.7 trillion, therefore, to "use." You cannot double count; you have got $2.7 trillion. From the $2.7 trillion, you subtract the interest, $400 billion. That brings you down to $2.3 trillion.

You then subtract your tax extender, you subtract your AMT, you subtract your retroactivity, you are below $2 trillion for a $1.6 trillion tax cut. Where does a $1 trillion fund come from?

Secretary O'NEILL. I would be happy to sit down and do these numbers with you so we do not use up everybody else's time.

Senator KERRY. Well, this is what this committee is meeting for. This is our time.

Secretary O'NEILL. Well, then let us go through the numbers. There is $2.6 trillion for Social Security, right?

Senator KERRY. Right.

Secretary O'NEILL. There is $1.6 trillion for the President's tax program.

Senator KERRY. That is $4.2 trillion.

Secretary O'NEILL. All right.

Senator KERRY. Then you have the Medicare trust fund, Part B, $400 billion. You have got the tax interest, $400 to $500 billion. That is another $800 billion away from that. That is up to $500 billion now. You have only $5.6 trillion. You have got your tax extenders, your AMT, and your retroactivity.

Secretary O'NEILL. You just gave me back $400 billion. I appreciate that.

Senator KERRY. No, no, no. I am accounting for the $400 billion that goes to Medicare. So if you say you are at the $4.2 trillion, I have just added $800 billion of expenditure, $400 billion for Medicare and $400 billion for tax. That is $800 billion.

That means you are at $5 trillion on expenditure. That leaves you $600 billion left. You have got tax extenders, the AMT, retroactivity, and all the needs of the country in that $600 billion. How do you do that? Where is your $1 trillion fund? I do not see it.

Secretary O'NEILL. I think the budget documents are in front of you.

Senator KERRY. I do not see it in there either. I see it double counted. I see them taking it out of Social Security and moving it down.

Secretary O'NEILL. I do not think there is any double counting at all.

Senator KERRY. But you cannot give me the numbers. I just ran through them with you. We just added them up. $5.6 trillion minus $2.5 trillion, minus $400 billion, minus $500 billion in interest, minus the Alternative Minimum Tax.

Secretary O'NEILL. I just do not accept the notion that we have got to do all these add-ons that you are suggesting.

Senator KERRY. You do not accept that there are interest payments?

Secretary O'NEILL. No, no, no. I do not accept your running through AMTs and——

Senator KERRY. You do not think we are going to do anything about AMTs?

Secretary O'NEILL. I did not say that you were not going to do anything about AMTs. I guess what I would assert, is that if we are going to do something about AMTs and we are going to do something about endless things that people would claim that we should be doing, as I said to the Ranking Minority Member, there is no end to how big these numbers can be. I think, if you will accept the proposition that we have got $5.6 trillion. I am not arguing about that any more. Right?

Senator KERRY. Fair enough. My time is up. We need to go through this. But let me just say to you, Mr. Secretary, I have tried to be as conservative and as realistic as one can be about what Congress does every single year here and what is really on the table, and what will not be on the table.

This is before we even get into the fights about things that most people here know, factoring in inflation, factoring in population growth, entitlement growth. I just think we are looking at numbers that are just very different in the end, and the realities of what will be acceptable for reduction here.

Secretary O'NEILL. May I just say one thing? Senator, perhaps you were not here when I observed that what is in this budget contemplates the absolute level of spending over the next 10 years is going to rise by $5.2 trillion. This is not a no-increase budget.

Senator KERRY. I accept that. You are trying to hold it at 4 percent, and CBO is slightly above that. I accept that. We will have another round. I apologize.

Thank you, Mr. Chairman. We will pick it up.

The CHAIRMAN. Senator Bingaman?

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

One of the justifications mentioned by the President last night, and mentioned in this budget document that you gave us here, for this tax cut, is that it will stimulate growth this year. It will help ensure that this downturn, or this slowdown, is not longer and deeper than otherwise would be the case.

On page 194 of your document that we got this morning, it lists effective proposals on receipts. I assume that is where this should show up, this stimulus to the economy.

If you look under 2001 there, there is no effect on receipts in 2001, except for the case of the $169 million that you expect to get from the phase-out of the death tax.

How do you expect that this plan will stimulate the economy this year?

Secretary O'NEILL. Last night, I am sure you were there. The President said that he believed we should implement this program retroactively to January 1, and that means that there will be more stimulus effect. But I would rely more on what I was saying to Senator Snowe and on the number that you are going to find in the budget, for this reason.

People will take your action and they will make decisions about what kind of a house they can afford, what kind of a car they can afford. If that means, for example, even for a family that gets $500 a year, and you look at that $500 as debt service money, it means a family could afford $5,000 more worth of house. It is not a trivial number.

Senator BINGAMAN. Let me ask about that, though. If the President's request last night is agreed to by the Congress and all of this is retroactive, then the $1.6 trillion estimate for the size of this tax cut over the next 10 years is too low.

Secretary O'NEILL. No.

Senator BINGAMAN. You think, by advancing these tax cuts a year, you do not lose additional revenue in the 10-year period?

Secretary O'NEILL. Not if you accept the principle that we are going to live within $1.6 trillion. That means we are going to have to look at——

Senator BINGAMAN. So you would terminate it?

Secretary O'NEILL. No. You are going to have to look at the rate of phase-in of the elements of the program in order to stay within the total. This is saying you do not get two pieces of cake. You are going to get one piece of cake, and it is called $1.6 trillion.

Senator BINGAMAN. So that is the part that you would not change. You would not just advance the effective date of all of these rate cuts by 1 year.

Secretary O'NEILL. No, because then it makes, who knows, a $1.7 billion, or $1.8 billion.

Senator BINGAMAN. That was my point.

Secretary O'NEILL. Of course.

Senator BINGAMAN. But you are saying that that would not be done.

Are you going to give us an alternative that explains when you would phase these in now, in light of the President's changed plan?

Secretary O'NEILL. Yes. We are working with Ways and Means people, which is where this is starting. They are looking at ranges of alternatives of how they can stay true to the principles and provide for some retroactivity, but still living within the idea that we are not just going to keep ramping up the amount of money we are going to include in this tax cut proposal.

Senator BINGAMAN. All right.

Another one of the tables, I think this is page 192 of this same document you gave us this morning, indicates where some of these savings are going to occur in mandatory programs.

One of the areas you have identified here, where you expect about $17 billion in savings, is in Medicaid. Could you advise us as to how you expect to achieve those savings in Medicaid?

In my State, Medicaid costs more every year. The State is constantly struggling to come up with its match to the Federal Medicaid amount. I was surprised to see that this was one area where we could save money.

Secretary O'NEILL. It is a proposal coming from the Department of Health and Human Services. I cannot give you details on how the $17 billion comes from their program intervention.

But this is an area I have spent a lot of time working on personally and professionally over the last 5 years, and it is not so much about Medicaid or Medicare, but I think, with the right kind of organization and deployment of health and medical care resources, the productivity improvement potential, from the point of view of patients and from the point of view of payors, is enormous.

Senator BINGAMAN. Let me ask, also, I just have another few minutes here, or a few seconds, probably. You propose in this document that you would cut the funding for the Department of Energy by 3 percent. That is from this current year's level, it is not from an inflation-adjusted level. It is from the current year's level.

The 3 percent cut in that department funding happens at a time when you are also proposing to ramp up spending for the stockpile stewardship part of it, which is a good share of that budget. Which parts of that budget would you be planning to cut significantly in order to achieve that 3 percent overall cut in the entire department budget?

Secretary O'NEILL. My memory is that the composition of the reduction that is proposed here is not renewing some one-time programs that were in the budget in the previous year. In addition to that, I think if you look at the 3-year program flow for Energy, they are still significantly above where they have been over the last 3 years.

So it is a cut in a relative sense. But, in an absolute sense, at a program level, I think the Energy Department, I think it is true, as is the case of every department agency that is included in this budget, if you look at the trend over the last 3 years, this year's budget numbers are higher than the average of the last 3 years, even where cuts have been made in programs to ensure that we could stay at no more than a 4 percent increase year to year. Higher than the average in the last 3 years, but 3 percent lower than the current year.

Senator BINGAMAN. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. The next person, is Senator Torricelli.

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

OPENING STATEMENT OF HON. ROBERT G. TORRICELLI, A U.S. SENATOR FROM NEW JERSEY

Senator TORRICELLI.. Mr. Secretary, it is early in these deliberations, but it is never too soon to begin counting votes. I want to make clear to you, I believe there should be a Federal tax cut. I would like to be part of a Federal tax cut, and I would like to work with you on a Federal tax cut.

Secretary O'NEILL. Thank you.

Senator TORRICELLI. I come at this not only, however, with some partisan responsibilities, but also with some geographic responsibilities. I thought it would be helpful, in asking you questions, to also begin, frankly, to outline what are some of my concerns.

Like all of my colleagues, my paramount concern is that this Federal Government remain with a surplus into the indefinite future.

I have served in this Congress too long and have been part of too many sacrifices in important programs, and even raising people's taxes when they could not afford it, in order to end deficits. Under all circumstances, I do not want them restored.

Second, as the President addressed last night, while our country is in good times, it is not in perfect times. There are real and continuing social needs, education, the environment, and health care that still must be addressed, even in a time when we all believe in limited, and in some cases reduced, government.

Third, and perhaps more uniquely on this panel, I want to address with you what is a continuing concern of the people that I represent. Like your administration, I believe that there are people in our country who not only should be paying less in taxes, there are groups of people who should not be paying taxes at all.

A young couple that is earning $20,000 or $25,000 should not have reduced Federal taxes. We simply do not have a right to be asking them to pay taxes at all. Their money should be going to educate their children, pay for their mortgages or their rent, and try to get themselves through life and prepare for the future.

Second, there are real regional differences in what constitutes the middle class in America and who can afford these higher tax brackets. There has been a tradition in this Congress of eliminating certain benefits or preventing placement in lower tax brackets for people who, in my judgment, are of relatively modest means.

In the tax proposal that Senators Coverdell, Breaux, and former Senator Kerrey and I introduced last year, we were reducing people into the lowest tax brackets who actually made up to $70,000 for a family of four.

A family of four who lives in my region of the country and who has a family income of $70,000 is not the landed gentry. They are struggling every day. That is a schoolteacher and a policeman.

I am very concerned about where and how these brackets are defined. This goes not only to the brackets, but it also goes to some of the credits we provide in the Tax Code and other benefits.

Let me give you an example, from recent years, of some of the things that we have done. President Bush's new 10 percent bracket will help, but families in the 28 percent bracket making $60,000 to $75,000 are not targeted. As I pointed out in our bill last time, we would have moved them to the 15 percent tax bracket.

As we trade off revenues for different things, I want us to keep that in mind, whether we are actually getting to people who are really middle class all over this country.

Another example. The HOPE scholarship and lifetime learning credit were part of the 1997 tax bill. They phase out, for a family, at $80,000. How do you tell a family in America of two wage earners and several children that we are phasing you out of a scholarship fund to educate your children, to go to college, when college tuition can be $30,000, $40,000 a year? These may not be the American poor, but they are also not the American rich. It is totally unavailable at $100,000.

The $500 child credit from 1997 is unavailable for families over $110,000. A $110,000 family income is a good income, but it does not mean that a person should be grouped with the very wealthy in America and have a child credit unavailable. A family with a $110,000 income is still saving money every year to educate their children. They are not taking this out of expendable funds.

Deduction for student loan interest is unavailable for families over $75,000. How do you go to a family that makes $75,000 and say, we are including you with the very wealthy, not those who are struggling to pay for college assistance?

So I make this point to you, because I genuinely do want to work with you on a tax cut. In this, I make myself of no political party. I may be an interest of one. But that one interest is the region of the country I represent, specifically the State of New Jersey. We pay more in Federal taxes per capita than any State in the Nation. No one is ahead of us. The cost of living in my State is second to none. It may be second to nowhere in the world. It is expensive.

These families that earn $50,000, $60,000, $70,000, even $100,000 a year deserve to have a real part of every benefit and every reduction. So, while I look forward to a long, fruitful, ongoing conversation with you, because I would like to be part of this tax reduction, I start our long conversation, in meeting you for the first time, by making clear to you what my priorities are as we go forward.

I recognize that there was no question in there. That is not uncharacteristic of me. [Laughter.] But, nevertheless, we should meet on the proper terms.

Secretary O'NEILL. Yes. Thank you, Senator.

The CHAIRMAN. Thank you, Senator Torricelli.

Now I turn to Senator Conrad from North Dakota.

Senator CONRAD. Thank you, Mr. Chairman.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Secretary, for being here and for the courtesy of your call earlier today as well.

Secretary O'NEILL. Thank you.

Senator CONRAD. We certainly appreciate the tone that you have brought to these discussions. We can have honest policy differences and not have any personal animus. I think we have got very, very serious choices to make for the country and it is important that we very seriously debate them. It will be in that context that I try to discuss issues.

First, let me respond to something the Senator from Texas said about Democrats killing the Medicare and Social Security lock box last year. He has a much different memory than I have.

I actually authored the Medicare/Social Security lock box that passed the Senate last year with bipartisan support. In fact, virtually every Democrat voted for it, nearly 20 Republicans voted for it. So, the charge that he made here earlier that Democrats killed the Medicare/Social Security lock box is simply false.

The Medicare/Social Security lock box proposal that he favored, the previous Secretary of the Treasury advised us, would threaten Social Security—of course we were not going to do that—and would threaten the ability of the country to honor its debt obligations, including Social Security. That is the provision that the Democrats opposed.

But the fact of the matter is, Democrats and Republicans supported a lock box proposal that I authored, and it passed with strong bipartisan support. So I say that just to set the record straight.

Secretary O'NEILL. Senator, with your permission, I will stay out of last year's fights.

Senator CONRAD. You certainly have my permission.

How much of this $1.6 trillion proposed tax cut would take effect this year?

Secretary O'NEILL. It depends what those of you here and the members of the House decide to do. The President said last night that he believes it is smart for us to act on these things with a retroactive implementation date of January 1 of 2001.

Were that to be the case, and if nothing else were done to add acceleration to retroactivity, then the marginal rate cuts would take effect, and the child credit would take effect, and the marriage penalty would begin taking effect, and the estate tax credit always had a delayed beginning of implementation.

They would all become law, but their effective impact on Federal revenues would begin with the marginal rate cuts and the child credit having the most impact in this year.

Senator CONRAD. But my question is, how much money, how much stimulus, would it provide this year?

Secretary O'NEILL. It depends. If you do retroactivity alone, then $20 or $30 billion.

Senator CONRAD. Does $22 billion sound about right?

Secretary O'NEILL. If you do acceleration, you could go as high as $100 billion or more without encroaching on the trust fund money.

Senator CONRAD. As I understand it, if we put in place what the President has currently proposed, that would provide $22 billion this year.

Secretary O'NEILL. In cash effect. But, as I was explaining with Senator Snowe when you were out of the room, an important part of what is going to happen with the President's tax proposals, if they are fully enacted, is families are going to make consequential longer term decisions because of an anticipation of a higher level of disposable income, which is how people decide how large a mortgage they can afford.

I used as an example, even for a family that received $500 over a year, the leverage effect with a 10 percent interest rate has the effect of giving someone $5,000 worth more of buying power if you are prepared to dedicate it to a mortgage.

For the typical family that we have talked about, with $1,600 with the same leverage effect, it is $16,000 worth of buying and investing power that would come to people as a consequence of a decision to implement this stream of money for people.

Senator CONRAD. Let me just say that another way of looking at it is, in terms of our economy, $20 billion of stimulus this year represents one-fifth of 1 percent of our gross domestic product. It is pretty small potatoes, in terms of a stimulus. But I am about to run out of time.

Let me turn to another subject, if I could, and that is this question of paying down debt. The President has asserted that all of the debt we could pay down during this 10-year period is $2 trillion. Otherwise, we run into what is called the unredeemable debt.

Secretary O'NEILL. Right.

Senator CONRAD. We have done an analysis and we have concluded that it is simply not correct that we could only pay down $2 trillion of debt. We could save all of the Social Security and Medicare trust fund surpluses and not run into any unredeemable debt until out in the year 2010, which means we would be paying down much more of the $3.2 trillion national debt.

Some of us believe very strongly our top priority here ought to be to continue to get this long-term or this publicly-held debt paid off before the baby boomers start to retire.

I just would hope that perhaps we would have another chance—I have run out of time here—to talk about the different analysis. We have done a detailed cash flow analysis and concluded we have got no cash build-up problem at all until the year 2010. Do you have a different view on that?

Secretary O'NEILL. I guess you were not here earlier when I was explaining the great sensitivity of this matter, which I discovered in a way I really wish I had not this morning.

We had a press conference downtown, and I allowed as how we would be buying back debt as it matured, not realizing that there are people out there, apparently a whole lot of them, who make an enormous amount of money, even when there is no intention to make new policy, to put words in the Secretary of the Treasury's mouth which suggests that you are making new policy.

So, again, I am really learning to be awfully careful about what I say in this town, especially about subjects like this.

What I am now about to say to you is not in any way intended to convey a new policy about how the U.S. Treasury manages its debt position and cash.

Now, having hopefully made the record really clear, I would stipulate that we would buy back the debt that we can, that it makes sense to buy it back in the context of a professional financial management program for the United States. It is impossible to know exactly what that number is.

Part of the reason there is a difference of opinion about what this number is, there is a different set of assumptions about what length and maturity of instruments are put into the market over the period going forward. This is a really complicated, technical subject, but with your background you can appreciate why this is a pretty nuanced thing.

But there is no intention in what we proposed, and in what the President proposed last night, to play some kind of funny game with the Social Security money. To the degree that we can intelligently buy back debt, we will buy back debt.

It was Chairman Greenspan, incidentally, who first observed what he called an unrecoverable outstanding debt with things like savings bonds, and the rest. So this is an area that I think we should stipulate as one for technical professional management, and it ought to be off limits in terms of arguing about it as though somehow we had a policy different about it.

Senator CONRAD. I thank the Chairman.

I thank the Secretary, and look forward to working with you.

The CHAIRMAN. Mr. Secretary, I have some more questions. But before I get to those, I have a couple of questions to follow up on a dialogue that you had with other members of the committee.

Secretary O'NEILL. Yes, sir.

The CHAIRMAN. I think it gives an opportunity to clarify, or else my views need to be clarified.

One, would be your discussion with Senator Kerry. In that discussion, Senator Kerry added $100 billion for extenders such as the R&D credit.

Is it not true that the President's budget already accounts for extenders such as the R&D credit, so the additional costs associated with extenders, a rise in interest costs of the tax cut, is already figured into the budget? Is that correct?

Secretary O'NEILL. The R&D credit is included in the budget. Yes.

The CHAIRMAN. Then I would like to go to a discussion that you had back now an hour with Senator Baucus. He used the figure of $500 billion as additional interest costs when tallying the cost of the tax cut.

Is it not true that the interest costs are already accounted for in the President's budget?

Secretary O'NEILL. It is in the $1.4 trillion contingency and debt reserve. Yes.

The CHAIRMAN. All right.

Then, second, it appears that additional spending would also carry and interest cost like tax cuts. You have already accounted for spending increase-related interest costs in your budget. Is that not correct?

Secretary O'NEILL. That is correct.

The CHAIRMAN. So, in conclusion, Mr. Secretary, the interest costs related to both spending increases and tax cuts have already been accounted for in the President's budget?

Secretary O'NEILL. That is right.

The CHAIRMAN. All right.

In regards to an issue that has likewise been a little bit discussed today, but I want to get it out again so that we can associate certain think tank conclusions associated with some of the members' statements.

Some opponents of the President's tax cut claim that its benefits flow disproportionately to high-income taxpayers. They cite the study by the Center of Budget Policy and Priorities. That study concluded that 43 percent of the benefits of the tax cut go to the top 1 percent of the taxpayers.

Now, the Joint Committee on Taxation, and that is Congress' official nonpartisan tax policy analyst and scorekeeper, and as a matter of fact, five members of this committee, both Republican and Democrat, serve on that committee. Joint Tax says the President's tax cut plan makes the income tax system more progressive. I think you have said that as well.

I spent some time looking at the basic components of the President's tax cut, and I do not see how you can disagree with the Joint Tax Committee's analysis. The major part of the tax cuts come from marginal tax rates.

The rate cuts are, by definition, skewed to higher income tax payers, and that is in the lower brackets. Other elements of the package, with the arguable exception of the death tax relief, are geared toward middle income taxpayers.

So, Mr. Secretary, looking at the President's plan, and more importantly looking at the Joint Tax conclusions that progressivity of the current system is enhanced, how do you think some folks could argue that the tax plan is unfair? Would you in any way think of this as fuzzy math?

Secretary O'NEILL. Indeed, I would.

The CHAIRMAN. I want to bring up something about retirement security income. This is an issue I raised with you at your nomination hearing. Enhanced retirement security is a goal for President Bush and members on both sides of the aisle. We have a very broadly backed bipartisan bill in this regard, Senator Graham of Florida, and myself.

A few months ago, this committee unanimously approved most of that package. Unfortunately, there was not time to get it considered in the last Congress on the Senate floor. The House passed a similar package in an overwhelming bipartisan vote.

These proposals generally would enhance individual retirement accounts and employer retirement plans. Senator Baucus and I intend to re-introduce this very popular legislation in just a short time.

Considering the importance and bipartisan support for these packages, could you give me the position of the administration on these types of legislation? It would not necessarily have to be the Grassley-Baucus bill, or the Portman-Cardin bill, but if you could do that, I would appreciate it.

Secretary O'NEILL. We share your interest in working in these areas. As you get your ideas formulated, we are prepared to work with you to see if there is a way that we can include such ideas in the ambit of the 10-year program that the President has suggested to you.

The CHAIRMAN. All right.

Then along the same lines, I would ask you another question that we discussed a few weeks ago. I am hoping, as time goes by and a lot of new people are in office, we get a little more firm views from the administration on this.

Improving the Nation's education system is a priority, again, for President Bush, and also a bipartisan support for these things in the Congress. Last year, the Senate approved this committee's bill that included a broad array of educational tax relief measures. Most of these proposals have been approved by the Congress several times.

As the administration's top tax official, could you indicate whether President Bush's education tax agenda would include expanded provisions in this area that are in bills of the nature I just spoke about?

Secretary O'NEILL. I think the President started last night, and any time he speaks anywhere, he rearticulates the highest priority for him is education. He has continued to advance and propose interventions that will make sure that we deliver on his idea that no child will be left behind.

So, yes, I think we are interested in looking at ways that we can improve, and reform, and get more value from every education dollar that is made available to State and local governments, and in turn to communities. So, yes, we are constantly interested in this subject.

The CHAIRMAN. All right. That is the end of my questioning.

I would now turn to Senator Baucus. If nobody comes, then I think we will be able to let you go and do some of your work downtown.

Secretary O'NEILL. Thank you.

Senator BAUCUS. Mr. Secretary, thank you for taking the time. It has sometimes not been easy, and I appreciate your taking all this time.

Just a couple of thoughts. One, I do caution the administration against using the Part A Medicare trust fund to pay for other Medicare benefits. Say, for example, prescription drugs. I just do not think that is going to fly.

The boomers are retiring down the road. If we start to rob Peter to pay Paul, we are going to be hurting ourselves more than helping ourselves in establishing the solvency of the Medicare trust fund, as well as Medicare, generally.

I just urge you and the administration to take another look at that so we do not have to go down that road, because it would be a huge fight and one that I do not think you would want to get into. My guess is, the American people would want to keep Part A intact and not use it to pay for other Medicare programs.

We can use maybe some of the surplus, some of the non-Social Security surplus to pay for some additional Medicare programs, but do not rob Part A to pay for other programs.

The second point, is the idea, twice, came to me as I was listening to you, when you twice talked about sort of the dynamic effect of tax cuts. We agree. For years, we have been wrestling with the static versus dynamic effect of revenue measures. It is an age-old battle we are never going to completely solve. Obviously, the big problem is, how do you measure the dynamic factor? It is just extremely difficult to measure.

Secretary O'NEILL. Right. Right.

Senator BAUCUS. So we just do not go down that road. We just keep a static analysis.

However, there really is a dynamic effect, clearly. We know that. Economists know that. But I wondered if, in addition to sort of the dynamic effect of the tax cut, if there is not another, too, that is very important for us to maintain. That is, consistency, constancy, stability, predictability.

I think the American people, particularly in these somewhat turbulent globalization times, are looking for a little bit of predictability. I think that is one reason why they are so fed up with partisan politics, because it just adds to the unpredictability.

In the 1980's, we did pass a big tax cut. In the 1980's we also enacted a couple of tax increases because the deficits were just getting so large. It had immense consequences politically at both ends of Pennsylvania Avenue.

So I just wonder if perhaps even a more powerful dynamic is that of constancy, for Congress not to be a yo-yo, to have yo-yo tax cuts, up 1 year, down the next, and back and forth. Or the same in spending. That is, out of bounds of reasonableness.

I think the more we can just show to the American people in the business sector, and in America generally, sort of steady as she goes, we are going to manage the taxpayers' dollars prudently, wisely, and fairly.

We would be performing a huge public service and have, I think, a quite powerful, positive dynamic. Investment is more assured. People can plan a little more for the future and plan for their vacations, and know a little bit better, on the margin, what is down the road.

So I just wonder if maybe, as we are looking at all this, we kind of slow down a little bit and just try to find some good, prudent way to just manage all of this. The spending proposals that Senator Kerry raised, and that I raised, are real. Whether it is AMT, whether it is other extenders in addition to the R&D, whether it is prescription drugs, you name it, they are real.

Those are honest proposals. It is not that anybody wants to go on a big spending binge, it is just that these are real and we have to deal with them. They are pushing up a little bit against this proposed tax cut.

A few of us were here in the 1980's. The Chairman was here, I was here, and a few others. And we remember, and we do not want to have to go down that road again of too big a tax cut, because we then, a couple, 3 years later, have to increase taxes because we went way too far.

Back at that time, the estimates were of surpluses when we passed that tax cut in 1981. The estimates were, in each of the succeeding years, we were going to have surpluses. That is what we were told. It did not turn out that way.

Secretary O'NEILL. That is because of the unidentified reductions that were proposed to be made, which were never made.

Senator BAUCUS. The main reason is because we just cut taxes a lot, and we also increased spending a lot, particularly defense spending in those years.

All I am saying is, let us kind of stand back a little bit, and be cool, calm, and collected about it.

The CHAIRMAN. Let me ask Senator Baucus to think of this. Regardless of the tax cut, we still had more income every year throughout all the 1980's, 1 year over the previous year, so we always had an income growth.

So it was not because the income was not coming in, it is because we spent more. We were spending at 22, 23, 24 percent of gross national product, but our taxes were coming in at about 19 percent of gross national product. They have been coming in at 19 percent of gross national product for 40 years.

Secretary O'NEILL. I think it is, we doubled the revenue and tripled spending.

Senator BAUCUS. Well, those are generalizations and they could well be accurate. But I think, listening to the President, he and his administration are building up to a pretty big spending increase in defense, in TMD, NMD, and whatnot. You can hear the drum beats just over the horizon.

In addition to that, we have no idea what might happen down the road that is going to cause a big jolt to this economy, another Asian currency crisis, for example. The long-term capital management crisis, for example. There are all kinds of possibilities.

I just think the basic conservatism of the American people is to, hey, wait. Let us kind of go slow here. Let us get this debt paid down. Let us sort of save. I think we should listen to that.

Secretary O'NEILL. If I may, Senator. I think I like the tone of what you say. I think there is a very real challenge, and it is reflected in the last item you mentioned about future defense needs.

I must say, I think it is really profoundly important that the President of the United States has said to the Secretary of Defense, do not tell me what you want to add on, tell me what the strategic construct of defense and international security policy should be as we go forward. Then, instead of adding it on, let us see how we can reformulate.

I must say to you, I think this is a really important concept. It is not just important for defense, I think it is, frankly, important for a lot of what we do in the public sector.

I think there is so much opportunity for us to do well in a way that everyone would agree is wonderful, but we are not going to live up to our potential unless we insist of ourselves that we not just keep adding on to the past, but that we reformulate and get much higher levels of performance out of the assets that used that belong to the people.

Senator BAUCUS. Absolutely. Absolutely.

Secretary O'NEILL. So I think there is a huge opportunity, not just at the Federal level but in State and local governments in the nonprofit sector, to be as productive and as growth oriented in productivity as what has happened in the very best of the private sector, and then the cornucopia of revenues are going to come flowing in here and it is just going to be unbelievable.

Senator BAUCUS. Let us hope. Thank you.

The CHAIRMAN. Thanks, Senator Baucus.

We thank you for your loyalty to be here, and to discuss with us in the principle of exchange between the two branches of government. Thank you very much. Thank you, Secretary O'Neill.

[Whereupon, at 4:20 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Paul H. O'Neill

Good afternoon Chairman Grassley, Senator Baucus and members of the Committee. It's a pleasure to be here with you today.

President Bush unveiled his budget this morning, and it is full of good news for the American people. First, it funds America's priorities, especially in education. Second, it walls off every dollar of the Social Security surplus and proposes Medicare reform to strengthen retirement security for every generation. And finally it reduces individual income taxes, to eliminate the structural overtaxation that has created a tax surplus today.

There's no question that the numbers in the federal budget are enormous. We are proposing $1.9 trillion in government spending for next year alone. For the next 10 years, total spending will be over $22 trillion. These are changes of an entire order of magnitude since the last time I served in Washington. In fact, this year's projected budget surplus of $281 billion is almost as large as the total on-budget government spending in my last year of service in Washington. That's evidence of how much our economy has grown, and how much Washington has grown.

The federal budget surplus is projected to be $5.6 trillion over the next ten years. And this is a fairly conservative estimate, given that we've underestimated the surplus several years in a row now. Even after setting aside the Social Security surplus, there is plenty of room for a $1.6 trillion tax cut. The numbers are big, but the math is fairly simple: Start with the $5.6 trillion surplus, take away $2.6 trillion in Social Security surplus and $1.6 trillion for tax relief, and we are left with a $1.4 trillion cushion to address our priorities—beginning with Medicare reform, to service the debt, and to be prepared for unexpected needs.

This is a fiscally prudent budget. Under this plan, we will pay off a large portion of the publicly held debt over the next six years. Washington ran deficits instead of surpluses for so long that no one gave much serious thought to the prospect of retiring our debt instruments before they mature. Only now, as we face the reality of rapidly mounting surpluses, are we confronted with serious questions about the potential impact of buying back the publicly held debt from a public that may not be willing to sell it all back early.

The debt held by the public will amount to $3.2 trillion at the end of this year. Retirement funds, state and local governments and foreign investors all have come to rely on the security of U.S. Treasuries. It could be very costly—if not impossible—to retire all of those holdings prematurely. Moreover, there needs to be a replacement opportunity for them. Experts are already thinking about alternatives to Treasury Securities for use by the Federal Reserve and others, but these are novel concepts that will take time to put in place.

In addition to systemic adjustment questions, there are cost questions related to paying off the entire publicly held debt. In testimony before the Senate Budget Committee, Fed Chairman Alan Greenspan explained it this way: "some holders of long-term Treasury securities may be reluctant to give them up, especially those who highly value the risk-free status of those issues. Inducing such holders, including foreign holders, to willingly offer to sell their securities prior to maturing could require paying premiums that far exceed any realistic value of retiring the debt before maturity."

Under the assumptions supporting the President's plan, we pay off all but this "non-retireable" debt by 2008. While we are paying off the retireable debt, the plan also increases spending on education next year by 11 percent, increases defense spending next year by $14 billion, and provides $661 billion in overall discretionary spending next year. Discretionary spending will increase by 4 percent, more than enough to account for inflation and address real needs.

Some want to increase spending even further. We disagree. Instead of simply piling on new spending, we must be better stewards of the taxpayers' dollars. We have overlapping programs throughout the government with little or no information on how well they deliver services to the taxpayers. We need to find out where we are getting results and where we aren't, and adjust federal spending accordingly.

Once we've paid down the debt that can be retired, walled off Social Security funds where they can't be drained for other government spending, and increased spending for America's priorities, we face the question of how to use any additional surplus dollars. If they aren't returned to the taxpayers, they can only be spent in Washington, creating new government programs or buying up private assets. Government is big enough, and it has no business owning private companies.

People make better decisions than government about how to spend their money. That's why we must eliminate structural overtaxation and let people keep more of what they earn.

Today the federal individual income tax burden is higher than at any other time in our nation's history. We have no business taking from taxpayers more than it costs to pay for agreed public purposes.

The President has proposed tax relief that reinforces the values that make America great—opportunity, entrepreneurship, strong families and individual success.

First, the President has proposed reducing income taxes for every American who pays income taxes. The current five rate system will be simplified to four rates, and the tax rate on the first $6,000 of taxable income earned by every American will fall from 15 to 10 percent.

High income tax rates block access to the middle class for working Americans struggling to get ahead. And high income tax rates punish success. We must have a tax code that keeps the American Dream in everyone's reach and helps people move up the economic ladder of success. We must have a tax code that fosters entrepreneurship and does not penalize hard work.

Cutting income tax rates is the most effective fiscal policy action we can take to put our economy back on the path of long-term economic growth. The best minds in this nation contain incredible knowledge and creativity. If we work together to unleash that potential, we can achieve permanent high rates of growth that will make all our other goals more achievable.

The President's tax relief plan also strengthens the ties that hold families together.

- It doubles the child tax credit to $1,000 per child. Parents everywhere have one goal above all others: to give their children the best possible opportunity for success and happiness in life. The increased child tax credit will give parents more resources to save for college tuition, pay for braces or hire a tutor.
- This plan also reduces the unfair marriage penalty. We as a society celebrate when two people decide to spend their lives together. Why would our tax code punish them?
- And this plan eliminates the unfair death tax. Government has no business confiscating the legacy parents work their entire lives to build for their children.

This package is a pay raise for working Americans. Four-person families earning $35,000 a year will no longer bear any federal income tax burden. Four-person families earning $45,000 will see their income taxes cut in half. And four-person families earning $75,000 will see their income tax burden reduced by 22 percent.

The President's tax relief plan maintains the progressivity of our tax code—and, in fact, increases the share of federal income taxes paid by upper-income taxpayers. In 1998, the top 10 percent of income earners paid 65 percent of federal income taxes, while the bottom half of income earners paid 4.2 percent of the total federal income tax burden. After implementing the President's tax relief plan, the top 10 percent of income earners will pay 66 percent of all federal income taxes. The average family will keep $1,600 a year that they would otherwise have sent to Washington. That's enough for two monthly mortgage payments or for a year of junior college tuition.

Taxpayers in the higher tax brackets are likely to invest their tax relief in the economy, creating jobs for all Americans. Small businesses are the engine of growth in our economy, and a majority of small businesses pay taxes under the individual income tax system. A small businessman receiving tax relief will plow that back into the firm, either to increase productivity, which results in higher wages, or to hire more workers. A farmer will be able to use his tax savings to trade in his old tractor and purchase the newest technology to improve his crop yield. America's economy will grow as these investments go forward.

This tax relief package is sound fiscal and economic policy. It fits easily within our budget framework, leaving a $1.4 trillion cushion over the next ten years to service the debt, to address priorities—beginning with Medicare reform, and to handle unexpected needs. I like to refer to it as the Goldilocks tax relief plan—not too big, not too small, just right.

This budget strengthens the three platforms that make success and prosperity possible for all generations of Americans—improved education, fiscal responsibility, and tax fairness. I look forward to working with the members of this committee to implement these common sense budget priorities, so that America continues to lead the world toward greater freedom and opportunity.

Thank you.

COMMUNICATIONS

STATEMENT OF THE COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers is composed of forty-one life insurance companies that issue annuity contracts, representing approximately two-thirds of the annuity business in the United States. The Committee of Annuity Insurers was formed in 1982 to address Federal legislative and regulatory issues affecting the annuity industry and to participate in the development of Federal tax policy regarding annuities. A list of the member companies is attached at the end of this statement. We thank you for the opportunity to submit this statement for the record.

The Administration's proposals relating to the taxation of life insurance companies and their products are largely a rehash of last year's discredited budget proposals, which Congress rejected. All of these proposals remain fundamentally flawed and should be rejected again. The focus of this statement, however, is the Administration's proposal to increase retroactively the so-called "DAC tax" imposed under IRC section 848 and, in particular, the increase proposed with respect to annuity contracts used for retirement savings outside of pension plans ("non-qualified annuities"). Increasing the DAC tax continues to be bad tax policy, and doing so retroactively would make a bad situation far worse.

As was the case last year, the Administration's proposed increase in the DAC would have a substantial, adverse effect on private retirement savings in America. The Administration continues to show that it does not understand the important role that annuities and life insurance play in assuring Americans that they will have adequate resources during retirement and adequate protection for their families.

Annuities are widely owned by Americans. At the end of 1997, there were approximately 38 million individual annuity contracts outstanding, nearly three times the approximately 13 million contracts outstanding just 11 years before. The premiums paid into individual annuities—amounts saved by individual Americans for their retirement—grew from approximately $34 billion in 1987 to $90 billion in 1997, an average annual increase of greater than 10 percent.

Owners of non-qualified annuities are predominantly middle-income Americans saving for retirement. The reasons for this are obvious. Annuities have unique characteristics that make them particularly well-suited to accumulate retirement savings and provide retirement income. Annuities allow individuals to protect themselves against the risk of outliving their savings by guaranteeing income payments that will continue as long as the owner lives. Deferred annuities also guarantee a death benefit if the owner dies before annuity payments begin.

The tax rules established for annuities have been successful in increasing retirement savings. Eighty-six percent of owners of non-qualified annuities surveyed by The Gallup Organization in 1999 reported that they have saved more money than they would have if the tax advantages of an annuity contract had not been available. Nearly all (93%) reported that they try not to withdraw any money from their annuity before they retire because they would have to pay tax on the money withdrawn.

As discussed below, the proposal contained in the Administration's FY 2001 budget to increase the DAC tax is in substance a tax on owners of non-qualified annuity contracts and cash value life insurance. It would make these products more expensive and less attractive to retirement savers. It would also lower the benefits payable to savers and families. As discussed below, the DAC tax is already fundamentally flawed and increasing its rate would simply be an expansion of bad tax policy. The fact that the Administration proposes to increase the DAC tax retroactively suggests that the proposal is simply a device to raise a targeted amount of revenue from the insurance industry.

1. THE ADMINISTRATION'S DAC PROPOSAL IS IN SUBSTANCE A TAX ON THE OWNERS OF ANNUITIES AND LIFE INSURANCE

The Administration's proposal to increase the DAC tax is an attempt to increase indirectly the taxes of annuity and life insurance contract owners. Two years ago, the Administration's proposed direct tax increases on such owners were met with massive, bipartisan opposition. Last year and again this year, the Administration seeks to increase indirectly the taxes on annuity and life insurance contract owners. We urge this Committee to reject once again the Administration's back door tax increase on annuity and life insurance contract owners.

IRC section 848 denies life insurance companies a current deduction for a portion of their ordinary and necessary business expenses equal to a percentage of the net premiums paid each year by the owners of certain types of contracts. These amounts instead must be capitalized and then amortized over 120 months. The amounts that currently must be capitalized are 1.75 percent of non-qualified annuity premiums, 2.05 percent of group life insurance premiums, and 7.70 percent of other life insurance premiums (including noncancellable or guaranteed renewable accident and health insurance). Under the Administration's proposal, these categories of contracts would be modified and the percentages would be dramatically increased. Specifically, the rate for annuity contracts would more than double to 4.8 percent, while the rate for individual cash value life insurance would increase by a third to 10.3 percent.

The DAC tax under section 848 is directly based on the amount of premiums paid by the owners of the contracts. Thus, as individuals increase their annuity savings (by paying more premiums), a company's taxes increase—the higher the savings, the higher the tax. It is clear that since the enactment of DAC in 1990, the DAC tax has been passed through to the individual owners of annuities and life insurance. Some contracts impose an express charge for the cost of the DAC tax, for example, while other contracts necessarily pay lower dividends or less interest to the policyholder. Still other contracts impose higher general expense charges to cover the DAC tax. (See The Wall Street Journal, December 10, 1990, "Life Insurers to Pass Along Tax Increase.")

According to the Treasury Department, the increased capitalization percentages proposed in the Administration's FY 2001 budget will result in increased taxes of $8.29 billion for the period 2001–2005 and $11.82 billion for the period 2001–2010. A large portion of this tax increase will come from middle-income Americans who are purchasing annuities to save for retirement and cash value life insurance to protect their families. According to a Gallup survey conducted in 1999, most owners of non-qualified annuities have moderate annual household incomes. About three-quarters (71%) have total annual household incomes under $75,000. Eight in ten owners of non-qualified annuities state that they plan to use their annuity savings for retirement income (81%) or to avoid being a financial burden on their children (82%).

The Administration's proposal will discourage private retirement savings and the purchase of life insurance. Congress in recent years has become ever more focused on the declining savings rate in America and on ways to encourage savings and retirement savings in particular. As described above, Americans have been saving more and more in annuities, which are the only non-pension retirement investments that can provide the owner with a guarantee of an income that will last as long as the owner lives. Life insurance contracts can uniquely protect families against the risk of loss of income. Increasing the cost of annuities and cash value life insurance and reducing the benefits will inevitably reduce private savings and the purchase of life insurance protection.

2. CONTRARY TO THE ADMINISTRATION'S CLAIMS, AN INCREASE IN THE DAC TAX IS NOT NECESSARY TO REFLECT THE INCOME OF LIFE INSURANCE COMPANIES ACCURATELY

The Administration claims that the proposed increase in the DAC tax is necessary to accurately reflect the economic income of life insurance companies. In particular, the Administration asserts that "life insurance companies generally capitalize only a fraction of their actual policy acquisition costs." The Administration is wrong. As explained below, life insurance companies already more than adequately capitalize the expenses they incur in connection with issuing annuity and life insurance contracts. The Administration's proposal would further distort life insurance company income simply to raise revenue.

The current tax rules applicable to life insurance companies capitalize policy selling expenses not only through the section 848 DAC tax, but also by requiring (in IRC section 807) reserves for life insurance and annuity contracts to be based on a "preliminary term" or equivalent method. It is a matter of historical record that preliminary term reserve methods were developed because of the inter-relationship of policy selling expenses and reserves. Since the early 1900's, when preliminary term reserve methods began to be accepted by state insurance regulators, the relationship between policy reserves and a life insurance company's policy selling expenses has been widely recognized. See, e.g., K. Black, Jr. and H. Skipper, Jr, *Life Insurance* 565–69(12th ed. 1994); *McGill's Life Insurance* 401–408 (edited by E. Graves and L. Hayes, 1994).

Under a preliminary term reserve method, the reserve established in the year the policy is issued is reduced (from a higher, "net level" basis) to provide funds to pay the expenses (such as commissions) the life insurer incurs in issuing the contract. The amount of this reduction is known as the "expense allowance," i.e., the amount of the premium that may be used to pay expenses instead of being allocated to the reserve. Of course, the life insurance company's liability for the benefits promised to the policyholder remains the same even if a lower, preliminary term reserve is established. As a result, the amount added to the reserve in subsequent years is increased to take account of the reduction in the first year.

In measuring a life insurance company's income, reducing the first year reserve deduction by the expense allowance is economically equivalent to computing a higher, net level reserve and capitalizing, rather than currently deducting, that portion of policy selling expenses. Likewise, increasing the reserve in subsequent years is equivalent to amortizing those policy selling expenses over the subsequent years. Thus, under the current income tax rules applicable to life insurance companies, policy selling expenses are capitalized both under the section 848 DAC tax and through the required use of preliminary term reserves. The Administration's FY 2001 budget proposal ignores this combined effect.

This relationship between policy selling expenses and preliminary term reserves has been recognized by Congress. In accordance with the treatment mandated by the state regulators for purposes of the NAIC annual statement, life insurance companies have always deducted their policy selling expenses in the year incurred in computing their Federal income taxes. Until 1984, life insurance companies also computed their tax reserves based on the reserve computed and held on the annual statement. However, under the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"), if a company computed its annual statement reserves on a preliminary term method, the reserves could be recomputed on the higher, net level method for tax purposes. Because companies were allowed to compute reserves on the net level method and to deduct policy selling expenses as incurred, life insurance companies under the 1959 Act typically incurred a substantial tax loss in the year a policy was issued.

When Congress was considering revisions to the tax treatment of life insurance companies in 1983, concern was expressed about the losses incurred in the first policy year as a result of the interplay of the net level reserve method and the current deduction of first year expenses. In particular, there was concern that a mismatching of income and deductions was occurring. As a consequence, as those who participated in the development of the Deficit Reduction Act of 1984 (the "1984 Act") know, Congress at that time considered requiring life insurance companies to capitalize and amortize policy selling expenses.

Congress chose not to change directly the tax treatment of policy selling expenses, however. Rather, recognizing that the effect of the use of preliminary term reserve methods is economically identical to capitalizing (and amortizing over the premium paying period) the expense allowance by which the first year reserve is reduced, Congress decided to alter the treatment of selling expenses indirectly by requiring companies to use preliminary term methods, rather than the net level method, in computing life insurance reserves. See, e.g., Jt. Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, at p. 595 (relating to amendments to section 832(b)(7)) (Under the 1984 Act, life insurance reserves "are calculated . . . in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses.").

In summary, life insurance companies are already overcapitalizing policy selling expenses for income tax purposes because of the combination of the current DAC tax and the mandated use of preliminary term reserves. In these circumstances, increasing the DAC capitalization percentages will not result in a clearer reflection of the income of life insurance companies. To the contrary, increasing the percentages as the Administration proposes would further distort life insurance company income simply to raise revenue.

3. CONTRARY TO THE ADMINISTRATION'S SUGGESTION, AN INCREASE IN THE DAC TAX IS INCONSISTENT WITH GAAP ACCOUNTING

The Administration's explanation of the DAC proposal suggests that increases in the DAC percentages are consistent with generally accepted accounting principles (GAAP). The Administration states that "[l]ife insurance companies generally capitalize only a fraction of their actual policy acquisition costs. . . . In contrast, when preparing their financial statements using generally accepted accounting principles (GAAP), life companies generally capitalize their actual policy acquisition costs, including but not limited to commissions." See Treasury Department, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals 170–71 (February, 2000). This explanation is disingenuous. The Administration fails to disclose that, while GAAP accounting does require actual acquisition costs to be capitalized, GAAP accounting does not mandate the use of preliminary term reserves. In fact, no system of insurance accounting "doubles up" on capitalization by requiring a combination of capitalization of actual policy acquisition costs combined with the use of preliminary term reserves. Thus, far from promoting consistency with GAAP accounting, the Administration's proposal to increase the DAC tax would exacerbate the distortion that already exists under current law.

Apart from the foregoing, the Administration's reference to GAAP accounting is misplaced. In 1990 when the DAC tax was first enacted, Congress expressly considered and rejected GAAP as a basis for accounting for life insurance company policy selling expenses. Instead, Congress chose a proxy approach of amortizing a percentage of premiums over an arbitrary 10 year period, rather than capitalizing actual selling expenses and amortizing them over the actual life of the contracts. In short, when Congress enacted the DAC tax in 1990, it knew that the proxy percentages did not capitalize the same amount of acquisition expenses as does GAAP accounting. However, as discussed above, the combination of the current DAC percentages with the mandated use of preliminary term reserves already results in two different capitalization mechanisms. If GAAP accounting is the appropriate model for taxing life insurance companies, as the Administration suggests, then the DAC tax should be repealed, not increased.

4. THE ADMINISTRATION'S PROPOSAL TO INCREASE THE DAC TAX RETROACTIVELY IS PUNITIVE AND SUGGESTS THAT THE ADMINISTRATION IS SIMPLY SEEKING TO RAISE A TARGETED AMOUNT REVENUE FROM THE INSURANCE INDUSTRY

Last year, the Administration's proposal to increase the DAC tax was strongly criticized and rejected by Congress. Not only is the Administration resurrecting this discredited proposal, but now it seeks to apply the tax increase retroactively to 1990 under the guise of a "change in accounting method." Retroactive tax increases are bad tax policy and violate basic notions of fairness. Moreover, in this case a retroactive increase in the DAC tax would have a severe punitive effect on insurers, which priced their products based on the law in place when those products were sold.

The Administration offers no explanation for why the proposed increase in the DAC tax should be treated as a change in accounting method. When the DAC tax was first enacted in 1990, Congress specifically stated that the DAC tax was not a change in accounting method. The proposal to treat the proposed increase in the DAC capitalization percentages as a change in accounting method, and thus apply the DAC tax increase retroactively, suggests that the Administration's true motive is simply to raise a targeted amount of revenue from the life insurance industry. The retroactive DAC proposal was contrived to achieve this overriding goal. Singling the insurance industry out for a tax increase of this magnitude ($11.82 billion over 10 years) is entirely inappropriate. The insurance industry has and continues to pay more than its fair share of corporate income taxes.

In conclusion, the Committee of Annuity Insurers urges the Committee to reject the Administration's proposal to increase the section 848 DAC tax. The proposal is a disguised tax on the owners of annuities and life insurance contracts. Furthermore, the proposal lacks any sound policy basis and further distorts the income of life insurance companies.

THE COMMITTEE OF ANNUITY INSURERS

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Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton, CT
Conseco, Inc., Carmel, IN
COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
GE Financial Assurance, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, MI
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
ManuLife Financial, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Minnesota Life, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT
Principal Financial Group, Des Moines, IA
Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corp., Minneapolis, MN
Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement Equities Fund (TIAA–CREF), New York, NY
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

NATIONAL COUNCIL ON TEACHER RETIREMENT (NCTR)

NCTR SUPPORTS INCLUSION OF BIPARTISAN RETIREMENT SAVINGS PACKAGE IN TAX REDUCTION PACKAGE

As the American economy slows, the effort to reduce taxes is accelerating Policy makers justify tax cuts for several reasons. First, reducing taxes will provide Americans with more take-home pay thus encouraging them to consume more. This result will spur economic growth. Second, it will allow Americans with large debt burdens to pay down their obligations.

Policy makers should also consider the beneficial effects that savings make to economic strength. Savings not only shores up the long-term financial security of individuals and families but also results in positive effects as a whole for our economy. Thus, it is critical that any tax relief package also encourage Americans to save.

1. The Bipartisan Retirement Savings Incentives package concentrates tax relief toward individuals. The President's tax reduction plan is focused on tax relief for individuals. It would reduce marginal rates, end the marriage tax pen-

alty, and broaden the child tax credit. Likewise, the retirement savings package is directed at individuals and thus complements the President's provisions.

2. Retirement savings help create investment capital. The package would encourage more employers, especially small businesses, to set up tax-qualified retirement plans. These plans help employees save for their retirement. The package also expands the amount that an individual may contribute to an Individual Retirement Account (IRA). Increased retirement savings augments the supply of investment capital thereby triggering beneficial economic effects.

3. Retirement savings incentives are needed to reverse stagnating savings rates. The personal savings rate in the U.S. was -0.1% in 2000, according to the Department of Commerce. This is the first negative annual savings rate since 1933. By encouraging people to save more for their retirement, the package will stimulate savings and reverse the current stagnant rate of savings.

The National Council on Teacher Retirement (NCTR) strongly supports enactment of the Bipartisan Retirement Savings package introduced last year by Committee Chairman Grassley and Senators Graham, Baucus, Hatch, Breaux, Jeffords, and others (S. 741). Similar legislation was cosponsored by 200 House members (H.R. 1102). The legislation was passed several times by each House of Congress, but not enacted before adjournment.

Seventy-five state and local government retirement systems belong to NCTR. Their plan participants are made up of teachers and other public employees. These participants need the portability provisions in the Bipartisan Retirement Savings package. Many participants are deferring critical decisions in their lives until the package is passed as illustrated in the attached real life examples.

Because of the overwhelming congressional support during the 106th Congress, the demonstrated need of individuals for it, and its beneficial economic effect, we urge the Finance Committee to include the Bipartisan Retirement Savings package in its tax reduction proposal.

For more information, contact Cindie Moore, NCTR Washington Counsel, at 703–243–1667.

Attachment.

REAL LIFE EXAMPLES: HOW THE BIPARTISAN RETIREMENT SAVINGS PACKAGE WILL IMPROVE PENSION PORTABILITY FOR TEACHERS AND OTHER PUBLIC EMPLOYEES

BY

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JANUARY 2001

Real Life Examples of the Problem

- In a North Central state, an entire department in a high school is eliminated. All the teachers who work in it are terminated. Some of the teachers are close to retirement and can begin drawing their pensions, but the amount is reduced because they have not achieved the age and number of years required for a full benefit. State law will allow them to purchase years of teaching for school districts in other states. Many of them cannot afford to do so, but they do have sufficient money in their tax sheltered annuities (also known as Section 403(b) arrangements after the section number in the Internal Revenue Code that regulates them) to pay for the purchase. The purpose of a 403(b) is to allow a teacher to contribute voluntarily to a retirement savings vehicle on a pre-tax basis. Under federal law, they may not use the 403(b) money on a pre-tax basis to purchase the credit, however, and thus may not take full advantage of the state law.
- An auditor works for a state in the South. He has worked for several different states over the course of his career. He is close to retirement. The state in which he currently works allows the purchase of years of service in other states. If he takes advantage of this opportunity, his benefit will increase by 5% a month. The purchase will cost $16,000. The auditor has no savings equal to that amount, but has enough money in his deferred compensation plan (also known

as a Section 457 plan after its section number in the Internal Revenue Code).[1] The purpose of a 457 is to allow a state or local government employee to contribute voluntarily to a retirement savings vehicle on a pre-tax basis. Federal law prohibits the auditor, however, from transferring that amount on a pre-tax basis to purchase the years of service.

- A school teacher in a large Midwestern city learns that her mother has been diagnosed with Alzheimer's disease. The teacher must retire early and move to another part of the state to care for her mother. Because of the early retirement, her pension will be far lower than she expected. Her state allows her to purchase an upgraded pension formula that will offset the loss. She does not have ready cash to do so, but like the teachers in the North Central state, has money in her 403(b). Like the other teachers, she cannot use the money on a pre-tax basis to make the purchases.

Why the Problem Exists

States have favorable laws that encourage pension portability. As will be explained, current federal law frustrates these helpful state laws.

What are the favorable state laws that are inhibited by federal law? Virtually every state authorizes teachers and other public employees to purchase service credit (i.e., work performed) for years for which they are not eligible for a pension. For example, a teacher works only two years in a state that requires five years of work before she will be eligible, sometime in the future, for a pension. This minimum number of years is called the vesting requirement. Then the teacher moves to another state that requires her to work 30 years to receive a full pension. She works 28 years and purchases the two years of teaching in the first state, resulting in the 30 years she needs. If she did not have the right to purchase, she would have had to have worked an additional two years.

States allow the purchase for other types of service such as private sector work and for various types of leave including maternity/paternity leave. As noted in the example of the teacher in a Midwestern city, some states allow an employee to purchase an upgraded pension formula to increase his/her pension. In addition, employees who left a position and withdrew their pension contributions may, upon returning to the position, repay the amount representing the previous service credit.

Purchasing service credit is very expensive in some states. In the case of the North Central state mentioned above, a year of service may cost around $20,000. Most employees do not have that amount of funds readily available. Many do have money in a 403(b) or a 457. They are prohibited, however, under current law from transferring the money in their 403(b)s or 457s on a pre-tax basis to purchase service credit. Instead, they must cash out the money and pay tax and any penalties, which results in a far lower amount being available.

What is particularly frustrating is that if the employees have a 401(k) account, they can use the money on a pre-tax basis to purchase service credit. Colorado, Tennessee, and Kentucky, all of which offer 401(k)s, allow such transfers. Thus, employees there do not need to cash out their 401(k)s to purchase the service. But most states do not provide 401(k)s. The Tax Reform Act of 1986 eliminated the authority of state and local governments to offer them. (Colorado, Tennessee, and Kentucky set up their programs before the Act's enactment.)

The Need is Real

Public pension organizations have heard from many of their member systems and their plan participants about these problems and the desire to change the federal law. For example, a western state recently expanded its purchase of service credit options. The response from plan participants has been overwhelming. In the past year and a half, the state's retirement system has received over 7,000 inquiries about the new options. Even more significantly, around 15% of those inquiring ask whether they can use money in their 403(b)s or 457s to make the purchase on a pre-tax basis.

Employees with 401(k) plans may use the money in it on a pre-tax basis (i.e., do not have to cash out the plan) and purchase the service credit. Employees with 403(b)s and 457s need to have the same right to use the money on a pre-tax basis as employees with 401(k) plans.

Public pension organizations support the provision in the pension reform bill (H.R. 1102 and S. 741 in 106th Congress, no numbers yet for the new Congress) that will allow money in 403(b)s and 457s to be used to purchase service credit. The House

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[1] 403(b)s are available to education employees such as school teachers and college professors. 457s are offered to non-education state and local government employees, such as police officers, fire fighters, and general employees.

version was sponsored by Reps. Rob Portman (R–OH) and Ben Cardin (D–MD) and the Senate's by Finance Committee Chairman Charles Grassley (R–IA), Sens. Bob Graham (D–FL), Max Baucus (D–MT), Orrin Hatch (R–UT), John Breaux (D–LA), and Jim Jeffords (R–VT). The legislation was passed several times by each House of Congress, but not enacted before adjournment.

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

The U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses of every size, sector and region, supports strongly President Bush's historic tax-cut proposal. This proposal represents a long overdue and major shift in the direction of fiscal policy toward a reduction in the size, scope and intrusiveness of the federal government.

By late last year, Federal Reserve interest rate increases, higher energy prices, and a flagging stock market left the economy perched precariously on the brink of recession. Investment had slowed, consumption was faltering, and the manufacturing sector was in outright decline. Both business and consumer confidence had eroded to the point that a continuation of our record expansion was in grave doubt.

In early January, as the negative statistics mounted, the Federal Reserve Board stepped in to shore up the economy with a surprisingly aggressive 50 basis point interest rate cut, followed with another rate cut a few weeks later. While these cuts certainly had a salutary effect on the stock market as well as consumer and business confidence, it remains to be seen whether or not they will be enough to keep us out of a recession. With the fate of the economy still in doubt, we should not try to attack this problem with only one blade of our policy scissors. The time for a tax cut is now.

Moreover, we can easily afford a tax cut. The various official forecasts for our fiscal balance point toward an expected cumulative surplus over the next 10 years of about $5.6 trillion. With $2.6 trillion of this amount "reserved" for fixing Social Security, the remainder is more than enough to pay off a healthy portion of outstanding federal debt and still provide for a substantive tax cut. By any measure, a tax cut is proper and prudent policy, and with the economy on a downward track, sooner is better than later.

To a large degree, the impact of a tax cut will depend upon whether it fosters increased savings and investment or more consumption. Tax relief aimed primarily at increasing the disposable income of the middle and lower income groups generally gives an immediate boost to consumption spending that can jumpstart a flagging economy.

Tax cuts designed to encourage saving and investment on the other hand generally have a somewhat weaker near term impact on the economy, but by boosting capital formation and enhancing productivity growth, they foster greater long-term sustainable growth. Business tax cuts generally meet this latter description. They traditionally may not be as fast acting as personal tax cuts, but they are more likely to stimulate long-term economic growth. And, because they enhance productivity growth, they promote real wage growth generating pressure on prices.

The tax-cut plan outlined by President Bush has elements addressing both personal and business taxes. We are heartened by the inclusion of a number of provisions that will bolster not only our near-term economic growth but also our long-term productivity growth as well. Reducing marginal rates on all taxpayers will stimulate the economy, put disposable income in the hands of consumers and provide needed tax relief to a host of small businesses that file as individuals. It will also increase the incentive for work and encourage the entrepreneurial spirit, which is the heart of the free enterprise system.

Furthermore, the President's proposal addresses other important tax priorities: repealing the "death tax" would remove one of the most ineffective and distorted taxes in the federal tax code. Its elimination will encourage the introduction of new businesses and the growth of new jobs. Permanently extending the research and experimentation tax credit will foster research and development of new technologies more effectively. The inclusion of provisions to expand the lower-income tax credits and to address the tax inequities faced by some married couples are also laudable goals and will help to boost consumption and get the economy growing again.

We strongly support the tax reduction proposal put forth by the President and we recognize his intention to ensure long-term economic and productivity growth. In that regard, we believe additional areas of the tax code need to reflect today's modern, fast-paced, pro-growth economy including, for example, accelerating the cost recovery of business assets, eliminating the corporate and individual alternative minimum tax, expanding individual retirement accounts, enhancing retirement savings, reducing capital gains taxes, and lowering marginal corporate tax rates.

Small businesses are also in need of some encouragement in the tax code to help them maintain their place in the economy. Suggestions include an immediate 100-percent deduction for health insurance, an increase in the section 179 expensing allowance, a reamping of the S-corporation rules, and the unrestricted use of the cash method of accounting.

Ultimately, we need a simpler code that reduces compliance costs. With global competition increasing and trade becoming a more important part of our economy, we should also work to eliminate tax rules that reduce our competitiveness abroad and force our companies to locate—and create jobs—elsewhere.

While some may debate the form any specific tax package should take, there can be no debate that timeliness is paramount. The sharp slowdown in economic growth coupled with growing government surpluses make now the time to act. Long-term goals of increased saving, investment and productivity, together with the short-run need to avoid an economic downturn should provide both Congress and the Administration all the incentives they need to act expeditiously.

In closing, we reiterate our support for enactment of President Bush's tax proposal on a timely basis. We look forward to seeing tax reduction become a reality for the American taxpayer.