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PRESIDENT'S FISCAL YEAR 2000 BUDGET AND TAX PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

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PRESIDENT'S FISCAL YEAR 2000 BUDGET AND TAX PROPOSALS

TUESDAY, FEBRUARY 2, 1999

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

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

Also present: Senators Chafee, Grassley, Nickles, Gramm, Moynihan, Baucus, Graham, Bryan, and Robb.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

It is always a pleasure to welcome you, Mr. Secretary. This is certainly an historic moment, when one considers our Nation's current economic environment. Not only are we looking at the largest budget surplus in history, some $2.6 trillion over the next 10 years, but we are gathered to consider issues that will set the economic blueprint for a new millennium.

I believe these conditions, Pat, speak volumes about what can be accomplished when Congress and the administration work together. Frankly, it is a moment to be enjoyed and one that prompts us to extend heart-felt appreciation to the men and women, the workers, the farmers, the researchers, the financiers, teachers, homemakers, risk-takers, and visionaries, those who cumulatively comprise the real engine of growth.

If current economic conditions are seen as an historical achievement, it is their achievement. If they represent a miracle, it is their miracle. The President's budget outlines surpluses totaling more than $4 trillion over the next 15 years, surpluses that offer us an opportunity like no other to meet the very real demands of shoring up important programs like Social Security and Medicare, while at the same time ensuring future growth and opportunity by keeping the spirit of commerce alive in that segment of our society which created the wealth in the first place.

This committee is dedicated to working with you to meet the objectives of preserving and strengthening Social Security and Medicare. But our vision must not be so confined as to simply ponder how Washington can use its surplus to make government bigger.

Rather, it must be broad enough to ask what Americans can do with their surplus to make the economy stronger.

There are many good proposals that have been presented by members of this committee. One that I believe is especially meritorious is giving part of the surplus back to those it belongs to, the taxpayer, and to do it with at least a 10 percent across-the-board tax cut.

It is fair, it is simply, it is economically advantageous, and it can be achieved at the same time we are ensuring the viability of Social Security and Medicare. It is also bipartisan. History has proven that tax cuts are good for economic growth. In an important way, we can ensure economic growth into the 21st century.

To be candid, Mr. Secretary, I find it incomprehensible that the President's plan would not allow for a wide-gauge tax cut in the next 15 years. The typical American family is having great difficulty in providing educational opportunities for their children, while providing adequate retirement security for themselves and their families.

I do not believe Americans should have to wait at least 15 years for a tax cut. The administration's budget does contain a number of new tax credits or tax benefits aimed at various problem areas. It also contains a number of tax increases, in fact, a net tax increase, which I find troubling at a time of historic government surpluses and at a time when Americans are already being taxed higher than ever before.

Some 40 cents of every dollar earned by the taxpayer goes to State, local, and Federal Governments and Americans are currently paying over 20 percent of our gross domestic product to taxes, the highest percentage since the end of World War II. I do not believe that is right.

So, as we look to a new century, even a new millennium, we must look to an economic blueprint that provides real tax relief, one that encourages savings, rewards investments and risk taking, one that promotes jobs and opportunity.

It is now my pleasure to call upon my good friend and colleague, Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. You will not mind if I say, among those institutions and individuals who brought us to this happy state, the Senate Committee on Finance is not the least, and the Secretary of the Treasury is not the least.

It is an extraordinary moment. In 1992, we had a deficit of $290 billion, the largest in our history, and in a succession that had begun 12, 13 years earlier and led to the present debt.

I thought it was rather striking, I might say. On the front page of The Washington Post there is a little pictogram this morning which divides a dollar bill up into the units of outlays. The outlays for interest payments, 11 cents in every dollar. Defense is only 15 cents. Social Security, which we are always talking about, is just 22 cents.

Yet, we have endless hearings about those other items. We have never had a hearing on the cost of the debt. It is automatic and it just takes place. It is a lesson of, if we go on that way we will have trouble with all of the other categories. The administration's proposal to reduce the debt back to the level of 1917 is an extraordinary one.

Mr. Chairman, I see that the Senator from Virginia has arrived, and he has to leave for the funeral of Miles Goodwin, which is in Suffolk, Virginia. I wonder if he might make a statement?

The CHAIRMAN. Yes. We will be pleased to let the distinguished Senator from Virginia speak at this time.

OPENING STATEMENT OF HON. CHARLES S. ROBB, A U.S. SENATOR FROM VIRGINIA

Senator ROBB. Mr. Chairman, I thank you and I thank the distinguished Ranking Member for the courtesy.

Just for the record, and I understand there are differences between New York and Virginia, there was a character from a book several years ago that was actually named Miles Goodwin. But this particular Governor was Mills Godwin.

For Virginians in the audience who might somehow recognize the difference and think that we were talking about the mythical character rather than the real character, I wanted to correct the record. But I am very grateful to the Senator, and would like to follow up.

First, let me just say to Secretary Rubin that I look forward to working with him on this question. I had a longer statement, and I want to thank you and the members of your Treasury Department staff for the information they have shared with all of us.

One question that still bothers me in the macro sense has to do with those elements of the fix for Social Security that address, perhaps, the near-term needs but do not address the structural concerns that we have with respect to fixing Social Security for the long term. If you could, in your remarks this morning, address that. The same question basically has to do with Medicare.

My concern is that any time we have the appearance of an easy solution for a long-term structural problem, we will take the easy solution and postpone serious consideration of the types of things that may have to be done to solve the problem in the long run.

One other question I might raise in a more abstract way and ask that you address during your comments has to do with what I would call the tough questions that you would like to have Congressional input on to solve, beyond coming up with a specific approach on Social Security and Medicare, but others where the natural inclination is to try to present the best picture possible but where, without the kind of working relationship between the administration and the Congress, we are not going to solve problems. If you could kind of highlight some of those for us as we begin to put on our green eyeshades and look at all of the elements of the budget.

With that, Mr. Chairman, I thank you very much. I will look forward to reviewing the record and working with you on this question. I am especially grateful to my Ranking Member.

The CHAIRMAN. Thank you very much.

Let me, at this time, welcome Ms. Mathews. It is a pleasure to have you here today.

Next on our list, is Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman. I want to thank you for holding this hearing today.

At the outset, let me say, Mr. Secretary, that I am heartened by the administration's proposal to dedicate a large portion of the surplus over the next 15 years to reducing the Federal debt. You can count on me as one who believes firmly we should use nearly all of the surplus that materializes for debt reduction.

We have incurred the greatest portion of this debt over the last 15 years and we ought to pay it back and not leave it for our children to have to pay. An overwhelming number of economists agree that paying down the debt is the best single step we can take today to ensure future economic prosperity and prepare ourselves for budget pressures that will occur when the baby boom generation comes.

If we paid off the debt right now, if we had no debt now, we would have $244 billion that we could spend on programs, tax cuts, or whatever it is. That is all going for interest on the $5 trillion debt.

In fact, in connection with debt reduction, the chairman of the Federal Reserve, Chairman Greenspan, testified last week before the Budget Committee, reiterating his preference for using the surplus for debt reduction. Economic growth would be materially enhanced by doing so. The director of the budget, CBO, June O'Neal, urged Congress to avoid the temptation of spending this surplus on new programs or tax cuts.

In her remarks she noted, "It would be hard to come up with a proposal that could do more for the economy than a decision to do nothing at all with the surplus, in which case it would be used to pay off the debt." So I applaud you, Mr. Secretary, for making that decision. I urge you to consider increasing the percentage that goes for that purpose.

Having said that, however, I am extremely leery of your proposal to use a portion of the debt reduction as a basis for issuing additional Treasury IOUs to the Social Security fund.

Now, this is complicated, but if I understand this situation correctly, what you are proposing, the Social Security Trust Fund would receive IOUs from the Treasury in exchange for Social Security surplus payroll taxes. Now, that is the normal system. That is the way it is done.

Social Security's surpluses are then combined with those generated by the on-budget accounts of the Federal Government, the non-Social Security surplus, to create a unified surplus. The administration then proposes to issue additional IOUs to the Social Security trust fund in the amount of 60 percent of those unified surpluses.

The net result of this creative accounting is that the Social Security Trust Fund will receive about $5.1 trillion in assets, Treasury IOUs, over the next 15 years, even though the Federal Government will only generate surpluses totalling $4.4 trillion. Only in Washington would this type of double accounting be considered.

My greater concern, however, is that this proposal obligates the general fund—now, this is a key point, Mr. Secretary—which comes from the Federal Government, which is individual and corporate income taxes, to help resolve Social Security's funding shortfall. This is an entirely new approach in which we are using the general fund to bolster Social Security. It does so without asking whether there are other changes in the program that ought to be considered.

Had your approach been taken in the 1983 Congress when we made those changes as a result of the Greenspan Commission, we would not have made any of those changes, such as increasing the retirement age gradually to 67, in order to shore up the program solvency. The same goes for Medicare. If we can all look to this ability of drawing down the general fund, all the incentive to make the programmatic changes that are necessary in Medicare and in Social Security will evaporate.

By votes of over 60 percent in the Senate 2 years ago, we passed four major programmatic changes in Medicare in order to make the thing solvent. We went to means testing of the Part B premium, we increased the eligibility age to correspond with Social Security from 65 to 67, we had a $5 co-payment on home health visits. I said there were four changes; there were three changes. Every one of those passed by over 60 percent.

But I will guarantee you this, Mr. Secretary, if we can look now to the general fund to take care of any of these shortfalls, all of the incentive to make those tough decisions to rescue Social Security and Medicare will disappear, regrettably. So, I just want to make that point, if I might.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Chafee.

Next on the list is Senator Baucus.

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

Senator BAUCUS. Thank you, Mr. Chairman. Mr. Chairman, Mr. Secretary, and Ms. Mathews, all of us are sort of happy that we are here today. We have a surplus, a big surplus. And the problem is, what do we do about all this surplus rather than what do we do about a deficit?

I think the praise goes to lots of people. It goes to the President for his budget decisions over the years; frankly, to the Republican Congress, which I think helped; to American businesses, which became very efficient in responding to, say, the Asian challenge of several years ago, downsizing, which caused its own set of problems; new technologies, particularly communications technologies. There are a whole host of reasons why our economy is doing well and why we have a budget surplus.

The real question now is, how do we keep it? There are a couple of ways we can lose it, obviously. One, is to squander it. Another, is through circumstances beyond our control, such as high interest rates or high inflation rates.

Having said that, Mr. Secretary, when it comes time for you to comment, I would just like your thoughts on what sort of fail-safe measures are here, because times will not always be good, and how do we deal with that, how you calculated that thought into preparing this budget.

Second, I would like you to address, and I will, a little bit, my questions, our private savings rate, which is terrible. The Department of Commerce, I think, reported yesterday for the second month in a row, Americans have negative savings rates. It is 0.5 percent for the year, the lowest since 1933. While we have a Federal surplus this year, hoping to work down the debt, our private savings rates are going down.

I appreciate your attempts to try to solve that with the USAs, the savings accounts. I hope, though, that we could also work to buttress up employer-provided pension plans, particularly for small business.

A lot of small businessmen—most small businessmen—cannot provide for pension plans for their employees. I hope that the USA proposal does not work against buttressing up private pension plans through employer-provided savings accounts.

History has taught us, when a company matches an employee's contribution there is more than likely going to be a pension plan on down the road than if it is all entirely voluntary, that is, an employee just saves for himself for a rainy day.

So we have good news. I am just urging us all to be prudent, wise, cautious, not gloat, because it is not always going to be good. So what do we do to help prepare for those rainy days that will inevitably come?

The CHAIRMAN. Thank you, Senator Baucus.

Next, I call on Senator Grassley.

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

Senator GRASSLEY. I would urge the same caution that Senator Baucus just ended with, because good news can turn very quickly into bad news. Our hard-fought budget surpluses can turn into deficits in the blink of an eye if the American economy would falter.

In our agricultural economy, for instance, the Asian crisis of last year caused our agricultural exports to go way down and bring grain prices to a 10- or 15-year low. The Brazilian currency just was lowered, and that brought soybean prices to an 11-year low just within the last two weeks.

So, what happens someplace else in the world that might not be very easily predictable ought to cause us even to have more caution here in the Congress of the United States, and the President as well. Good news can turn to bad if the Congress and the President would once again begin to spend too much based on anticipated budget surpluses. The Congress and the President, it seems to me, still must exercise spending caution.

This, in my view, means a definition, a very tight definition, of the term "emergency spending." Emergency spending should be just that, unanticipated spending needs that must be addressed immediately so that dire consequences can be averted. But it cannot in any way be a license to spend by skirting the current system.

The Congress and the President must also have clear spending priorities. To that end, I applaud the President for putting Social Security first, and I heartily agree that we must address this issue early on at a time of budget surpluses.

Our surplus at this point is solely because Social Security is bringing in more money than it spends. We must have a workable solution to Social Security solvency, and I look forward to having those detailed plans from you on the President's proposal.

My Committee on Aging looked into the impact of the collective investment of the trust fund in the stock market. I think it was almost a year ago that the GAO did a report which concluded for our committee that interest rates are likely to increase with collective investment. On the other hand, paying down the debt will hopefully have the impact of keeping interest rates low.

So you might want to comment this morning if your assumptions take into account the possible tension between equity investment and debt repayment. In 2014, you believe that our debt service payments will be two cents for every dollar. What would they be then in the year 2032 as a result of this tension between equity investment and debt repayment?

Then also, how did you come to the conclusion that a 15-year budget estimate is reliable when, most times, we have problems with even 5- or 10-year forecasts?

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Graham of Florida, please.

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

Senator GRAHAM. Thank you, Mr. Chairman. Thank you for holding this hearing so quickly after the release of the President's budget.

Mr. Secretary, thank you for the leadership that you have given to put us in the happy position we are in today. We are asking a whole set of different questions than we would have been asking had this hearing taken place 5 years ago.

I have got four issues that I would like to put on the table, and they follow up on comments that have already been made.

First, in terms of the strategy of using the unified surplus. I share Senator Grassley's concern about putting excessive reliance in a 15-year forecast. As Senator Moynihan stated, in 1992 we had a $290 billion deficit. If you had looked at a 15-year projection from 1992 forward, we were to continue a significant deficit.

Senator MOYNIHAN. As far as the eye could see.

Senator GRAHAM. So that causes me to be a little bit caution about making commitments that are relatively irreversible based on 15-year projections.

I am particularly concerned, recognizing that, while we talk about a unified surplus, that the reality is that, for the next several years, that surplus is going to be totally or overwhelmingly the surplus generated by the Social Security Trust Fund.

It concerns me in these early years to be spending 38 percent of the Social Security-generated surplus on non-Social Security items. It creates the potential that, if our numbers are soft in the out years, we may not be able to achieve our objective relative to debt retirement and the benefits that that is going to generate for Social Security.

A second, related issue is what we experienced last October. We reduced the estimated Federal surplus by over $21 billion in one fell swoop last year when, as part of the end-of-the-year, get-out-of-town budget bill and appropriations bill we put $21.4 billion into the emergency account and, therefore, did not have to go through the discipline of finding an offsetting revenue source or spending reduction.

Now, while some of that $21 billion was in areas that we would traditionally have called legitimate emergencies, much of it was in items that had never before been characterized as an emergency.

So I would be interested in knowing if there had been any steps taken in this budget such as replacing the funds that were improvidently spent as emergencies last year, or building some stronger fire walls against a repetition of our 1998 action in the future that will give us greater security that the surplus will not be rated in the way it was last year.

Third, I am very supportive of the approach that you have taken to Social Security reform, which I would define as elevating the issue to retirement security reform, focusing not just on that portion of retirement benefits that come through the Social Security system, but also the other non-Social Security retirement funds which, for most Americans, represent half or more of their retirement income.

The proposal for the Universal Savings Account is a positive development, although I share some of the concerns that Senator Baucus has stated, that if we do not structure this right we could have the effect of chasing off the relatively few small businesses that do provide retirement benefits for their employees today, while what we ought to be doing is encouraging more small businesses to provide such benefits.

The final point is, I am concerned about the provision which would provide some $18 billion from tobacco recoupment of the States which have secured a tobacco settlement. I would hope that the administration would not get overly committed to retrieving those funds from the States as a means of financing specific spending.

There were good negotiations under way with the States at the end of 1998, and I hope that they will continue in 1999 and that the Federal Government will not end up in the position of attempting to recover a significant portion of the settlement that the States have worked so hard to secure.

Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you.

Next, we have the Senator from Nevada.

OPENING STATEMENT OF HON. RICHARD H. BRYAN, A U.S. SENATOR FROM NEVADA

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

Mr. Secretary, welcome to the committee. It is always a pleasure to have you and the OMB office representative here.

My comments parallel some of the thoughts that some of my colleagues have previously expressed. If, a decade ago, someone would have projected that we would be talking about these kinds of numbers when I first came to the Senate, I suspect that we would have referred that individual to General McCafferty for special treatment.

This is truly extraordinary. You and the President deserve ~~to be~~ congratulated for your efforts in bringing us to that position, with 94 months of business expansion, a peacetime record. Those are extraordinary numbers, and it is pretty heady stuff.

But I guess I would sound a bit of a cautionary note, because I do not believe that the business cycle has been repealed. We do not know how long this economic expansion will continue.

I think even the experience of the last couple of years when the numbers have come in so much better point out to me how difficult it is to honestly forecast what that revenue stream is going to be.

Each member of this committee knows, that became a moving target and moved favorably in terms of budget surpluses. So, we are always pleased to hear those revised numbers. I suspect that, in a different economic climate, those numbers could move in the other direction and perhaps as rapidly as they moved favorably to us.

So I would hope that, in structuring the budget, we are not structuring this budget so we are locked into some kind of a permanent mechanism where we are not going to be able to make some adjustments if, in the years ahead, the numbers do not come in as positively.

I am always troubled, as most of my colleagues are and my constituents in Nevada. We talk about a budget surplus. I always describe that in Nevada, yes, it is a budget surplus, sort of.

It is good news, there is no question about that. But it does, as has been pointed out and as both of you know, rely upon the Social Security revenues, which I believe currently are about $100 billion more than is paid out in benefits. That is going to change very rapidly and produces that 2032 deadline that we are all very much familiar with.

To some extent, I think it is less than an honest presentation because we do not really get to the surplus without relying upon that Social Security balance, even under the CBO numbers, until fiscal year 2001. I believe that is the first year in which, excluding the Social Security surplus, we actually get a surplus. That, it seems to me, is the number upon which we really ought to fix our focus of attention.

Here in the Congress we have an irresistible temptation. We do spend money, either in the form of tax cuts, which everybody loves, very easy, very attractive politically, or a lot of programs that all of us have some special interest in. So, I would hope that we could exercise some restraint.

Finally, an observation, if I may. I think the priority in terms of preserving Social Security is an appropriate one. I would be interested in the testimony, because I know there is a difference between what OMB is projecting and what CBO is projecting.

I believe that your numbers are considerably more conservative, if I am correctly informed. I would be interested in that testimony. And, always, we look forward to working with you and your able staff.

Thank you so much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bryan.

The Senator from Oklahoma.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you very much. Mr. Secretary, welcome.

Mr. Secretary, I am troubled. In the Budget Committee a lot of times we talk about smoke and mirrors, but the Social Security proposal seems to be really smoke and mirrors. You are doing some double counting, or correct me if I am wrong. I would love to be corrected.

But you are taking and counting the Social Security surplus twice in your effort to save Social Security. I have looked at the next 5 years. The Social Security in the Social Security Trust Fund is $714 billion.

The on-budget surplus that Senator Bryan alluded to is $114 billion. Basically, you are taking that and saying, all right, the Social Security Trust Fund gets the $714 billion, so that is credited to the account, and then we are going to take 62 percent of that and credit it again and act like we are saving Social Security when, in effect, all you are doing is putting in more IOUs.

Now, I will tell you, if you want to be honest and say, we want to take a certain percentage of the surplus and pay down national debt, fine. But to say we want to artificially credit Social Security surpluses twice, or a portion of that money twice, is not going to fly. It is so deceiving. It is very troubling to me. I am bothered by it. It seems to be very, very misleading.

I think you heard Senator Chafee say that he is interested in a very significant portion of the surplus to be used to pay down national debt. If we did nothing, if we did not spend the additional money, if we did not make tax changes, it would be used to spend down national debt, but I think you have done some double counting. Again, I would love to be corrected, but I do not think that is the case.

I think you are taking a large portion of the Social Security Trust Fund, its credit in the trust fund originally, and then you say, well, then we will take 62 percent of it and credit it towards that account again.

I think that is unfortunate. It gives the false premise that it is saving Social Security when it does not, because frankly what it does is add more IOUs, and those IOUs are going to have to be paid off. If you want to say it is used to pay down national debt, fine. That may make it easier to borrow money in the future for Social Security, and maybe that would make a little more sense.

Let me also just add a cautionary note. I, for one, think Social Security taxes are pretty high. I have serious reservations about using non-Social Security or non-payroll taxes to finance Social Security and to finance Medicare. There is some discipline installed when you have the payroll tax.

To get away and say, well, we are going to fund Social Security out of general revenues or fund Medicare out of general revenues as if there is no problem with the underlying premises of the program, I think, is a serious mistake.

Social Security taxes right now, if somebody is making $72,000, are already $9,000 for them and their employer, and a couple of thousand dollars for Medicare. That is $11,000 that is coming out of an individual's paycheck from them and their employer if they have an income of $72,000. That is a lot.

So I have some reservations about trying to say, well, we will just solve those problems by general revenue infusions. But really, you do not solve them by general revenue infusions, you solve them by IOUs. That is not a solution, that is just a postponement, if even a postponement.

It does not change the fact that the program basically is paying out more than it takes in, not 30 some-odd years from now, but basically about 13 years from now. That is a problem, I have talked to you before, we are going to have to address. We are going to have a cash flow problem. It is going to be paying out more. It is going to have to borrow money. Adding more IOUs does not solve that problem.

So I hope we can get this across. I have told you before, Mr. Secretary, I think we have to work together to solve Social Security, to save it. I think just giving additional IOUs and double counting is not a proper solution.

I might also mention that it looks to me like part of the reason why this was done was to enable the administration to have a lot of money to spend in both the form of new spending and targeted tax cuts which, over the next 5 years, exceed $280 billion.

If you went by the rhetoric that was used last year, you could not use any of it, not one dime of it, because it would be coming out of the Social Security Trust Fund. Most all of that money does come out of the Social Security Trust Fund if, again, we are operating under the same rhetoric that the administration used last year. It is little inconsistent.

Then, finally, I would just say, revenues over the next 5 years is $10 trillion, in the next 10 years, $22 trillion, and the administration does not give a tax cut. That is pretty pathetic. Twenty-two trillion dollars in revenues, exceeding the expenditures by over $2.5 trillion, and taxpayers get zero. The government gets it all. The 15-year figure of $4.4 trillion, the government gets it all, taxpayers get zero. That is a rip-off.

If the taxpayers are paying in a lot more than is necessary to fund the government, let us let taxpayers keep it. Let us not give it back to taxpayers, let us let them keep it in the first place and not send it to Washington, DC and have it redirected and micromanaged by government.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Nickles.

Senator Gramm?

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

Senator GRAMM. Thank you, Mr. Chairman.

I am sure it is always instructive for Secretary Rubin to come over and listen to us.

The CHAIRMAN. He thanked me ahead of time.

Senator GRAMM. I want to thank him for coming.

I want to accentuate the positive of the President's proposal. First of all, there are some fundamental things we agree on. I think by agreeing on them, it raises the quality of the debate that we are going to have in Congress and the country.

The most important thing in the State of the Union address, the most important thing in the budget, is the agreement that, for the next 15 years, 62 percent of the surplus, on average, is going to save Social Security.

Now, we are going to have a tremendous debate about how we use that money and what saving Social Security means, and how valuable are paper IOUs in a metal filing cabinet in West Virginia. But the point is, we now can end the sort of gamesmanship of talking about who claims they want to save Social Security.

We can really debate how you would use 60 percent of the surplus to do it. It seems to me that America can only benefit from the competition of ideas, and that this ought to be one of the highest quality debates we have had in Congress in many, many years.

The second important thing that this budget does and the President's proposal does, is that it says that, on average, for the next 15 years, that we agree—and Republicans do agree—that 38 percent of the surplus does not come from Social Security. Therefore, that 38 percent is there for us to have a debate as to what should be done with it for the general good of the public, independent of Social Security. It is clear, by looking at the proposal the President has made, that basically through direct spending programs and targeted tax credit, which is really an expenditure, that the President wants to spend that $38 billion. We are going to hear, I am sure, here today and for a long time about how this money is going to be spent for education, housing, nutrition, all the things we are all for.

I think that this allows us to have a debate where we take all those programs and all their benefits and we list them, we add them up, and we give them the benefit of the doubt, or we do not give them the benefit of the doubt, and then we look at what kind of tax cut we could have, an across-the-board tax cut of 10 or 15 percent, so that every taxpayer in America would get a tax cut, something that has not happened since 1981. Then we can say, is America better off with these 77 new spending programs or are they better off with an across-the-board tax cut of 10 or 15 percent? Now, that is debatable. We are not talking past each other or using the same words to mean different things.

So I want to thank the President. I think, for the first time since Ronald Reagan left the White House, despite the fact that Republicans have desperately tried to draw a bright line of distinction between the two parties, our basic incompetence has produced failure.

The President has succeeded in drawing a bright line of distinction that is as wide as the Mississippi River. That bright line of distinction really boils down to two issues.

One, do we want to try to save Social Security by putting paper IOUs in the filing cabinet in West Virginia, or do we want to have investments that are owned by the workers and managed by professional money managers that are built into Social Security that can grow as America grows to help fund Social Security benefits? I mean, that is something you can get your hands on and debate.

Second, we can debate, do we really want all of these billions of dollars spent in Washington on education, housing, nutrition, whatever, or do we want them spent with families sitting around their kitchen table spending money on education, housing, nutrition where they are making the decision?

So there are a lot of little things I could talk about this budget does, a lot of little gimmicks that every budget, I guess, does. But the point is, this budget sets the parameters for a real debate in America about our future. I want to congratulate the President for doing it. Now it is up to us to put content in that debate. I think America can only win by having these two debates.

I thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you, Senator Gramm.

Mr. Secretary, I am a strong believer that Americans should not have to wait 15 years. Before we start our questions, it would be appropriate to hear the Secretary. [Laughter.] That is the rule of the house.

Secretary RUBIN. I had the impression, Mr. Chairman, from Senator Gramm that I was here to learn and to listen. [Laughter.] So I was prepared to accept that role.

Senator GRAMM. You did not learn anything?

Secretary RUBIN. I listened. [Laughter.]

The CHAIRMAN. Mr. Secretary, we always listen with great eagerness as to what you have to say. As I said, I think we can all take great satisfaction that we are where we are due to the cooperation between the White House, the Treasury, and the Congress, so we are looking forward to your statement.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY OF THE TREASURY, WASHINGTON, DC, ACCOMPANIED BY HON. SYLVIA MATHEWS, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, DC

Secretary RUBIN. I will try to delay your comments as little as possible, Mr. Chairman. Thank you very much.

Let me say, before I make my remarks, that I have been to a lot of hearings in the time I have been here. I think this panel has raised a very goodly number of very important questions about what really is a very serious set of issues. I think Senator Gramm put it rather well.

In many ways, we have framed a tremendous national debate that is of great importance to the country. The President responded to that debate in his State of the Union with the budget and with his other proposals.

Overall, Mr. Chairman, as a result of the fiscal policy of the last 6 years, the economy it helped generate, and the interaction between the two, our Nation, as a number of Senators has observed, has moved from an era of annual budget deficits that were both large and growing into a period of surpluses now and for a long time into the future, as projected.

In the President's judgment, that gives us an historic opportunity to meet challenges that will affect our economic and social well-being for decades to come, including the pressures created by the baby boomer generation's retirement.

The budget and the President's State of the Union address were designed exactly to meet those challenges. I think it is very important to note that the core of this budget is fiscal discipline and, thereby, increased national savings in order to promote economic growth and retirement security in the years ahead.

Very briefly, before reviewing the budget, let me comment on what has happened over the last 6 years. In 1992, as you know, we had a $290 billion deficit. Projections were for that to increase very substantially. Federal debt had quadrupled during the past 12 years. Both the deficit and the debt were projected to increase at a very rapid rate.

We responded, the President responded, with a three-pronged economic strategy: fiscal discipline, equipping people for the future, and open markets. This strategy has functioned in contributing greatly to both moving us from deficits to surplus and to creating what many have considered, and do consider, the best economic conditions in many decades, the longest peacetime economic expansion in our history, a very high rate of job creation, the lowest unemployment rate in decades, and real increases in income across all income strata.

Having had this occur for 6 years, it seems to me that we need to take this very seriously as a set of economic events and try to examine why this happened, and then use that examination as help in determining what we should do facing policy issues going forward.

Let me also stress, the tax burdens on working families are at record lows for recent decades. For a family of four with a median income, the Federal income tax and payroll tax burden is at its lowest level in 21 years, in part because of the Child Tax Credit enacted in the 1997 Balanced Budget plan.

For a family of four with half of the median income, the income and payroll tax burden is at its lowest level in 31 years, in part because of the 1993 EITC expansion which helped 15 million families, as well as the Child Tax Credit in 1997.

For a family of four with double the median income, the Federal income tax burden is at its lowest level since 1973. While overall tax revenues have risen as a percentage of gross domestic product, that is primarily because the most affluent individuals have had large increases in incomes, in part from bonuses based on high stock prices and increased realization of capital gains, and in part because of increased corporate earnings.

Against that backdrop, the President's new budget proposes that in order to generate jobs, raise standards of living, and promote retirement security most effectively, we must save—save—the great preponderance of projected budget surpluses, not consume them for spending or tax cuts.

Specifically, the budget proposes that 62 percent of the surpluses be allocated for Social Security and 15 percent for Medicare. These resources will then be used predominantly to pay down publicly held Federal debt and purchase, in part, equities, both of which will, in effect, preserve and invest the surplus rather than eliminate the surplus through tax cuts or spending.

In addition, national savings has increased by allocating 12 percent of the surpluses to creating new Universal Savings Accounts.

Finally, the budget insists that none of the surpluses be used at all until we put Social Security on a sound financial footing.

Let me focus on debt reduction for a moment, if I may. When President Clinton was first elected, publicly-held debt equaled 50 percent of the gross domestic product. Under this plan, 80 percent of the surpluses allocated to Social Security and all of the surpluses allocated to Medicare will reduce debt held by the public. As a result, by 2014 publicly-held debt will decline to roughly 7 percent of GDP.

This reduction in debt will have three effects. First, the government will not have to refinance Federal debt and thereby will consume less of national savings, thus making capital more readily available to the private sector. That, in turn, will reduce interest rates, should increase confidence, and all of that will increase economic growth, job creation, and standards of living.

Second, when the President came into office debt service costs to the Federal Government, a matter I think Senator Moynihan referred to, in 2014 were projected to constitute 27 percent of the Federal budget. Under the President's proposal and because of the progress we have made to date, we estimate the debt service cost will be roughly 2 percent of the Federal budget in 2014.

Third, the decrease in debt means the Federal Government will have a greatly improved capacity to access external capital should the need arise, a response, I think, to the concern that many of you have correctly expressed, that life does not always go one way and we need to be prudent in thinking about the future.

In addition to reducing publicly-held debt, the President's budget strengthens Social Security and Medicare. With regard to Social Security, the President has proposed two measures that, taken together, will extend the life of the trust fund to 2055.

The first measure, is to purchase Treasury special non-marketable securities which are, in effect, a first claim against the general revenues of the Federal Government to meeting the already existing—already existing—Social Security commitments.

The second proposal is that, of the 62 percent of the surpluses transferred to the Social Security Trust Fund, about one-fifth will be invested in private sector equities.

Mr. Chairman, I have had, and have expressed, concerns about investments in equities by the trust fund. I would like to make two observations about this particular proposal.

First, it would result in roughly 15 percent of the trust fund being invested in equities. Given that equities do have risks, which I think is too often overlooked, that seems to me to be a prudent balance between receiving the potentially greater return from equities and keeping the investment small enough so the trust fund is not exposed to undue danger.

Second, we are proposing to have two levels of protection to make sure there is no political influence in the investment process. Money managers would be from the private sector and there would be no investment function performed by government officials. Also, a mechanism would be devised, in concert with Congress, to provide apolitical oversight and apolitical selection of these managers.

In addition, the President is proposing that a bipartisan process be created to develop and recommend the tough choices necessary to extend the life of the trust fund beyond 2055 to 2075.

However, within the framework of these tough choices, the President is committed to reducing the high rate of poverty for elderly widows and to eliminating the earnings test for working seniors.

With regard to Medicare, we extend the life of the trust fund to 2020, again, by purchasing Treasury specials. In addition, and as already mentioned, that flow of the surplus into the Medicare Trust Fund will, in addition and very importantly, reduce publicly-held debt of the Federal Government.

In addition, the President proposes that a bipartisan process be used to enact reforms and that that happen after the Medicare Commission submits its report—which I gather is scheduled to be submitted in March—and that those reforms should include the coverage of the cost of prescription drugs.

Let me focus, now, on the Universal Savings Accounts. These accounts would receive 12 percent of the surplus, be separate from Social Security, and would provide incentives for workers to save for retirement.

The government would provide a refundable tax credit of an equal amount for each account, and also a match for each additional dollar voluntarily saved with larger matches going to lower income workers. The exact details of the program are being worked on now by the administration, and then would have to be worked out by the administration and Congress. Eighty-nine percent of the surplus would thus be directed toward increasing national savings in one fashion or another.

Finally, the remaining 11 percent of the surplus would not be saved, but would be allocated for defense to protect our National security and for critical domestic discretionary investment priorities. This 11 percent supplements other discretionary expenditures that are within the limits imposed by discretionary spending caps.

Let me now, very briefly, highlight some of the key investments and priorities in the discretionary mandatory side of the budget. Leaving aside measures in the budget that are paid for out of the surplus after Social Security has been addressed, all new tax cuts and mandatory spending are fully paid for and the budget complies with the discretionary caps.

The President, in the State of the Union, focused on our key investments for the future, with respect to both spending and tax credits, as falling into the categories of education, working families, communities, and fostering a strong economy and a strong America in the world.

Let me focus on a few specific initiatives. First, for education. The budget proposes to helps States and school districts build and renovate schools with $3.75 billion of tax credits over 5 years. We also propose to extend Section 127, employer-provided educational assistance.

Second, for working families, the budget proposes a long-term care initiative that includes a $1,000 tax credit to help compensate families for the cost of caring for an elderly or ailing relative. That is actually just an ailing relative, whether elderly or not.

The budget also includes a new $700 credit to assist workers with disabilities. The budget helps with child care costs through a child care tax credit, and through a tax credit for a stay-at-home parent.

Third, for communities, the budget provides for a new markets investment initiative that we estimate could spur $15 billion in new capital investments in under-served inner cities and rural areas. It also includes an increase in the Low-Income Housing Tax Credit. Finally, we have various law enforcement initiatives, building on the work that has already been done over the last six years.

Further, to help foster a strong economy, the budget proposes to facilitate Y2K amelioration activities through the Council on Year 2000 Conversion and extend the Research and Experimentation Tax Credit.

Finally, the budget asks for resources to help strengthen America's leadership in the world. I believe that the Congress contributed greatly to global financial stability last year by providing the full amount of requested resources for the International Monetary Fund.

I think Congress could similarly contribute to international well-being and our security by approving the request in this budget to meet all of our financial obligations to the United Nations.

Before I close, Mr. Chairman, let me mention one other very important element of this year's budget, and one that might be of very special interest to this committee.

Our budget contains several proposals aimed at curbing corporate tax shelters. Corporate tax shelters are proliferating and they erode the corporate tax base, while at the same time breeding disrespect for the tax system, both by those who participate in the corporate tax shelter market, and by others who perceive corporate tax shelter users paying less than their fair share of tax.

Our budget proposals address these issues by increasing disincentives for entering into abusive transactions and by attacking specific corporate tax shelter transactions.

The Treasury Department will continue to study additional remedies in this area and would very much like to work with this committee, with members of Congress, to address this issue.

To conclude, Mr. Chairman, restoring fiscal discipline to our country has contributed enormously to the strong economic conditions of the past 6 years. Because of what has been accomplished, we now have, as a number of Senators have said, a unique opportunity to further economic and social well-being for the years and decades ahead.

The President has proposed that the surpluses be used predominantly to increase national savings and improve the fiscal condition of the Federal Government, while at the same time strengthening Social Security and Medicare.

The effect of all this should be to increase jobs, raise standards of living, and improve the economic security of future retirees and workers. We look forward to working with this committee, and all members of Congress, as we face these critical challenges.

Thank you very much. Ms. Mathews and I would now be delighted to respond to any questions you might have.

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

The CHAIRMAN. Well, thank you very much, Mr. Secretary. As I have indicated, it bothers me that the American people will have no substantial tax cut for the next 15 years, at least the next 15 years.

As I understand the President's proposal, there is no significant tax relief in his outline until at least the year 2015. In fact, if we follow his tax proposals, there is, as I understand it, a slight net increase in taxes.

Now, taxes are higher today than they have been any time since the end of World War II. They are in excess of 20 percent of GDP. I think that the typical American taxpayer pays about 40 percent of his earnings to the Federal, State, and local government.

Now, it seems to me it is just wrong, when we are in a period of an increasing budget surplus, that the working people of America do not participate.

Now, as you point out, a number of those on the lower end of the scale are doing better, but the middle class, where in many cases both husband and wife are working in order to keep abreast of costs—one of the real problems with the typical family, Mr. Secretary, is to pay for education. That is a matter of real concern, higher education as well as first through twelfth grade.

Another deep worry, is about retirement security. The only way the middle class can take care of these is if they can retain more of their hard-earned money.

So my question to you is, does it make sense to provide for no tax cuts for the working people of America over the next 15 years?

Secretary RUBIN. Let me respond in two ways, if I may, Mr. Chairman. In the President's budget, if Social Security is addressed, we then, as you know, allocate the surplus. One piece of that, which was 12 percent, would go to the Universal Savings Accounts, which are a tax cut.

It is very much in keeping with the kind of measures that I know you have been very supportive of over the years. That is to say, it is a tax cut that is directed basically toward increasing savings. The way we would structure it, although the specifics are not out yet, that would go to lower and middle income families predominantly, and that is a very substantial tax cut.

More generally, I think that you are faced with the fundamental question of how you want to use the surplus. At least, in our judgment, once you have taken care of Social Security, and if, in fact, that winds up using 62 percent, you have then got 38 percent of the surplus left. In our judgment, middle income families will be far more favorably affected by using that to pay down debt and thereby promote econoimc well-being of the country, to create first claims against general revenues for the Medicare Trust Fund and thereby extend the Medicare Trust Fund to put in place our Universal Savings Accounts, and then to have a small increase in discretionary spending and military spending. All of these other items, if we had a 10 percent across-the-board tax cut, everything from Medicare on that I have just mentioned would be consumed by the combination of the tax cut, plus the additional debt service.

I think it comes to roughly, from my recollection, I do not know the exact numbers but I think that a 10 percent tax cut across the board, we have estimated, including debt service, would cost about $1.5 trillion.

And if you put $2.7 trillion into the Social Security Trust Fund, that only leaves another $1.7 trillion, and virtually all of that, including that which we would have put into Medicare and the Universal Savings Accounts, would all be consumed by the 10 percent tax cut. That is one problem, and therefore would be consumed rather than saved.

The second problem, is who it actually goes to. My recollection is, with a 10 percent tax cut, about 35 percent of the benefit goes to the top 1 percent of the taxpayers, and I think, roughly speaking, two-thirds of the benefits, or thereabout, goes to the top 20 percent of the taxpayers. So it is very, very heavily skewed toward the upper income people who are, in all other respects, doing best in our society.

I think Senator Gramm was right. I think this is the debate that we need to have. Our view of this is that, once Social Security is taken care of, the balance of this should be used predominantly to improve national savings, improve our fiscal position, and then be targeted, as we have done, toward lower and middle income taxpayers.

A 10 percent tax cut across the board favors, predominantly, the top 20 percent of taxpayers and I believe would contribute far less to economic growth than would a continuation of the fiscal discipline than we have had in the last 6 years.

The CHAIRMAN. Well, just let me point out that the first across-the-board tax cut dates back to the days of John Kennedy, at which time it was used to get the economy moving. The same thing was done during the Reagan days. So, it seems to me there is good precedent for it, and it is one way to make sure that the economy does continue to grow and create meaningful jobs.

But what concerns me, and I listened carefully to what you were saying, but the fact of the matter is, the middle class—not just the lower middle class, but the upper middle class—is having increasing problems of providing, as I said, for the education of their children, they are having problems providing for their retirement. So what is wrong with letting them keep more of their hard-earned money for that purpose?

Secretary RUBIN. Well, I guess, Mr. Chairman, my response, in a sense, was framed by my prior remarks. What has actually happened by virtue of focusing the Federal Government's resources on reestablishing our fiscal discipline, in my judgment, what would happen as a result of focusing the resources in the surplus going forward predominantly on debt reduction, is to continue doing what we have done over the last 6 years, which is to enable people to improve their standards of living—as you know, incomes have gone up substantially—and within that context, to also improve retirement security.

I think the other issue you raise is, if you are going to have a tax cut, what kind of a tax cut should you have? The 10 percent tax cut across the board, at least, would, as I said, favor predominantly higher income people. But I think there is a very basic look.

The CHAIRMAN. Let me ask you this. Was it unfair when Kennedy did it?

Secretary RUBIN. I think Kennedy was trying to deal with a different problem, as I recollect it, Mr. Chairman. I do not profess to be an economic historian, but I think he had a paucity of demand and he was trying to engage in kind of a Keynesian demand generation. That is my recollection.

What we have today is not a paucity of demand. Actually, we have a rather robust demand in our society. What we have, unfortunately—and one of your colleagues mentioned it; I do not remember which one—a very low savings rate in this country. This is a hard path to tread. I mean, this is a politically difficult path to tread.

But what the President is saying is, let us increase national savings, let us reduce our publicly-held Federal debt, and let us basically put the country in a far better position than it is today—just as it is far better today than it was, say, 6 years ago—fiscally and let us free up the resources so that the private sector can more readily invest and contribute to productivity. That has been the heart, really, of what we have done over the last 6 years, and project going forward.

The CHAIRMAN. Well, I would just repeat once more, the working people of America, the typical American family, husband and wife are both working and between the two of them, they may be doing fairly well. But they are having problems.

They are having serious problems of taking care of child care. They are concerned about, how do they pay for higher education for their children, as I mentioned. Most importantly, we all admit, they are not making the kind of savings that are necessary in order to have retirement security. I just do not understand the opposition to letting the working people keep more of their hard-earned dollars.

Secretary RUBIN. I think the way to deal with those problems is really to follow the lead that, in many ways, you have set. We have the Roth IRAs, which I think were a very constructive contribution to the Nation's tax structure to target the resources that we use so that they go to precisely the problems you mentioned. We have the Roth IRAs. We are suggesting Universal Savings Accounts.

On education, post-secondary school education, under your chairmanship, the President's Hope Scholarships were put into place. On child care, we have, as you know, a robust set of child care proposals in our budget, and we would very much like to work with you on getting those enacted.

The CHAIRMAN. Let me, because I am pleased that you mentioned the Roth IRAs——

Secretary RUBIN. I thought you might be, Mr. Chairman.

The CHAIRMAN [continuing]. And the retirement programs, in general. I will be introducing a bill which will allow Americans to save for retirement by adding some new savings options. For example, increasing the contribution limits for IRAs from $2,000 to $5,000. Actually, if you indexed the $2,000 allowed in the early 1980's, that would roughly amount to $5,000 today.

Also, I am bothered by the caps. In the 1980's, we permitted everybody to save that amount. What is wrong with that? I am happy to hear you say you will work with us. Are you willing to expand these opportunities to save?

Secretary RUBIN. Well, I think the question we need to examine together, and it is a subject you and I have discussed over the last two or 3 years, is making sure—the answer to, are we willing to work together? We would be delighted to work together.

But I think the issue we need to continue to examine, as we have very constructively with you over the last two or 3 years, is how do we use the Federal dollars so that we are not simply sheltering saving that would have occurred anyway?

By and large, since it is the least well off and middle income people who save least and upward income people who will be saving anyway, it has been our view, as you know, that when you create shelters that, in effect, are available to upper income people, you may be just transferring savings from the non-sheltered to the sheltered vehicle. But those are the kinds of issues we would very much like to work with you on.

The CHAIRMAN. I just would stress, though, Mr. Secretary, the administration seems to be so nervous that somebody may shelter something that they are going to save otherwise. But the more important principle is to promote savings broadly. The only way you are going to do that is to make savings more simple.

One of the major complaints we are getting now, is that these programs are so tied up with different rules and regulations that, for the average person, it is almost impossible to understand.

Can we not do something to make it simpler so that every year you do not have to have a tax expert come in and advise you what to do?

Secretary RUBIN. I think we certainly should aim toward that objective, Mr. Chairman. All I was really saying was that we have to see how much additional savings we get for each marginal dollar of tax of Federal revenues that we use for this purpose.

But when all is said and done, when one worries about the national savings rate—and I think you are correct in worrying about it—by multitudes, the most powerful thing we can do is put in place the debt reduction that about, I think, roughly 77 percent of the present proposal would be directed toward it.

The CHAIRMAN. I am all for debt reduction. But that does not put more money in the pockets of the working people to address some of the problems they are facing.

Secretary RUBIN. Well, there I think we might have a slight disagreement. I actually think it does.

The CHAIRMAN. Indirectly.

Secretary RUBIN. Well, through better jobs, higher wages.

The CHAIRMAN. I would argue, of course, that by an across-the-board tax cut, you spark the economy so that you have greater productivity, greater growth, greater creation of jobs. I think it is highly desirable to give the people that opportunity.

Well, my time is up, so I will call on Senator Moynihan.

Senator MOYNIHAN. Let me continue in the themes you have offered. Mr. Secretary and Ms. Mathews, I would like to make two comments, as it were, and ask one question.

On Social Security, last year the President launched a series of forums on Social Security.

Secretary RUBIN. Series of fora?

Senator MOYNIHAN. Forums. We had a big hurrah at the Blair House, and so forth. Many of us took this seriously up here and produced rather complex and comprehensive proposals.

In the end, none of us, to my knowledge, was in any way consulted about the President's proposal. It seemed to have come wholly from the Brookings Institution, which does not have that many votes on this committee. [Laughter.]

Now, for example, in the matter of taxes, in 1969, the taxes were 19.7 percent of GDP, and last year they were at 20.5—a slight increase, but not much—all of it was taken up by a large increase in the payroll taxes we associate with Social Security. They have gone from 4.1 to 6.8 percent.

Just as an example, Senator Kerrey and I have a proposal which would divert to other savings purposes that 2 percentage points in that payroll tax which are, in fact, surplus.

In 1977, and nobody knew it, we went to a partially-funded system in Social Security. I was a conferee, and I did not know it. Five years later, it was finally explained to me. Those are the surpluses we have been living off.

We would propose just to go back to what we need to pay as you go. That would be an $800 billion tax cut over 10 years. And 80 percent of those American working families, TAFs, typical American family, pay more in Social Security and Medicare payroll tax, tax on the first dollar, than in income tax. So, I hope we will have a little more consultation. I am sure we will, with you here.

I would like to make one comment about the education proposals. This may just be idiosyncratic. But when Washington talks about education, and the bureaucracies here, it is not quite clear how clear they are.

Back in 1994, we passed the Goals 2000 Educate America Act. We said that, by the year 2000, the United States would be, in international test scores, first in math and science. The latest returns are, we are 28th in math and 17th in science. It was not that different in 1994.

Anyone who thought we were going to be first was delusional. If they would think that, what else will they think? You might pass that around, next cabinet meeting. [Laughter.]

Secretary RUBIN. If we did not have delusions, Senator, what else would we have? [Laughter.]

Senator MOYNIHAN. Well, there you are. All right.

For Ms. Mathews, if I may. It is a detail in the budget, but it is a principle of concern. When this committee was taking testimony on health care legislation in 1994, we had a rather startling epiphany of sorts, when a gentleman over there, a Jesuit from Fordham, said about health in this country and health care. He said, what you are seeing is the commodification of medicine, the introduction of rational pricing devices with which you are familiar.

Down on that end a gentleman doctor who is head of the UCLA Hospital in Los Angeles said, can I give you an example? In Southern California, we now have a spot market for bone marrow transplants.

What that left us with, and which we included in a bill we passed, was the fact that hospitals, particularly teaching hospitals and medical schools, were becoming a public good, as economists would say, that the market will not provide for. Public goods do not provide for markets. Markets do not provide fire departments, or whatever.

Yet, you have a $4 billion reduction in the provisions of Medicare for hospitals. Does that not go against our understanding that hospitals are one of our particularly vulnerable institutions that, in a world of HMOs and price competition, are going to find they need public support in the way other public goods do?

Ms. MATHEWS. The concept of supporting hospitals and ensuring that we are able to train and teach in our hospitals is one I think that we fully agree with. As a matter of fact, because there is a discrepancy for the teaching hospitals that teach for children and pediatricians, we have actually put special money in this year to help ensure that teaching hospitals that do those functions have money.

So the broader concept, we absolutely agree with. As far as the specific Medicare offset that we have proposed, what we have found is that there are 16 percent profit margins on the Medicare inpatient population. I think that is what our hope is, is to correct for an area where we believe that the Federal Government is unduly paying there.

Senator MOYNIHAN. Fair enough. Could I ask, and my time is up, that you give us some more data here on this 16 percent profit margin and so forth?

Ms. MATHEWS. Yes, sir. We would be happy to. That is only on the Medicare inpatient portion, but we will get you all the statistics.

Senator MOYNIHAN. And we can continue this subject in time.

Thank you, Mr. Chairman. Thank you, Mr. Secretary.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, I would just like you to reflect a little bit on what it takes to encourage higher personal savings in this country. We talk a lot about it, we have for years and years. While we are talking about it and enact various incentives, IRAs, for example, our personal savings rate has continually declined. As we mentioned earlier, over the last 2 months it has been negative. This year, it is 0.5, the lowest level since 1933. Annual personal savings rates is 0.5 percent.

First of all, is it a problem? That is, we have a large national rate. We have surpluses. People feel good. Maybe that is part of the problem. Maybe they think the government is taking care of them. I do not know.

But if you could just tell us a little bit about your feelings about savings rates, how to increase personal savings rates, and tie that in a little bit with the USA idea and the point I mentioned earlier, namely, how it might conflict with or dovetail with pension incentives, particularly for small business, in employer-provided pension provisions.

I am worried that the USA idea, if it is particularly government plan, say, like the thrift savings plan of some kind, that it might compete with it and be counterproductive. So, just your thoughts on all of that, please.

Secretary RUBIN. Let me, if I may, Senator, go down the line of your questions. I think you have raised are what are exceedingly important questions about what our economy is going to be like in the years ahead.

Our personal savings rate is very low, as you know. Some people have speculated it may be because the stock market has been so strong, it has given people a feeling that they are more secure and, therefore, they can afford to spend their incomes.

I guess my view is, that is a big problem. We, as a country, because of the confidence that exists around the globe, have been able to attract a lot of foreign capital and that has enabled us to continue to finance a very high rate of investment, which obviously is good, at relatively low interest rates, which is, I think a tribute to the way that fiscal monetary policy is both viewed abroad, and the confidence people around the world have at the present time in this economy.

But I do think that life can go both ways and I think it would be much safer and much sounder for this country to have a higher personal savings rate.

In terms of how you get it there, I think that the IRS has given us one good example of what you do. It is not just the incentives. In fact, I think in some ways it is more than the incentives, it is the education that takes place. It is the fact that brokerage firms then have tremendous incentive to promote saving, and saving is a cultural phenomenon.

Unfortunately, we do not have enough focus on it and it is not part of our culture today. So, I think anything that can be done to promote the culture of saving, and I do think IRAs and other similar kinds of vehicles serve that purpose.

I think our USA accounts really have a real opportunity to contribute to savings in this country because what it will do, in effect, is save a portion—12 percent, it so happens—of the surplus by moving it into these savings accounts, and also creating a match so that individuals will have an incentive to save even more.

Amongst the challenges we have is the one that you mentioned, Senator. We are acutely conscious of it. We need to structure this in such a way that it is not simply taking out of one pocket and putting into another. That is to say, we have to structure it in such a way so that it has the minimum negative impact on the provision of employer-provided pension plans, and we are very focused on doing that.

Senator BAUCUS. How do you do that? What are some of the things you have to do or think about so there is not a transfer from one pocket to another, but rather a net increase?

Secretary RUBIN. I think probably the most important thing that we can do is, though there are a lot of issues around this—and I do not want to get ahead of where we are either, Senator. I think that is not——

Senator BAUCUS. But some thoughts.

Secretary RUBIN. I think part of this is to make sure that it is targeted to the very large numbers. I may be wrong in my numbers, so do not hold me do it, but I think that there are 120 million

American families that are not the beneficiaries at the present time of employee-provided pension plans. Do not hold me to that number; I may be wrong.

But it is a very large number of families. You can try to target it in such a way that it aims as much as possible towards those families. But, clearly, there is a lot of work we need to do in this area, and our people are very much involved in doing that.

Senator BAUCUS. I would just urge you to work, and I know you will, but I am just reemphasizing the need to focus on that point, so we have net increase and we are not transferring from one pocket to another.

Secretary RUBIN. Yes.

Senator BAUCUS. And I also want to particularly help small business. In my State, particularly, we are a small business State. We do not have any big businesses.

If I might, Mr. Chairman. The more the administration can tailor a program which helps everyone in America, but also with special emphasis on small business, I think that will make a big difference.

Secretary RUBIN. I might add, Senator, there are also some pension reform proposals. We have had some before, we have some now——

Senator BAUCUS. Right. I know that.

Secretary RUBIN. [Continuing]. That we hope at least will increase the provision of pension funds by small business.

Senator BAUCUS. But they are more in the administrative arena.

Secretary RUBIN. Yes.

Senator BAUCUS. Rather than in the money for the plant arena, which we need.

Secretary RUBIN. Those are administrative in process, I agree.

The CHAIRMAN. I would just like to underscore that I think the complexity of the administration of these various savings plans is an extremely negative factor in getting a lot of people to participate. Simplicity is the name of the game.

The problem when we start talking about targeting this, and doing that, that is where we build in all of the complexities which, as I say, result in no saving. So, we may have won the battle, but lost the war. I think simplicity has to be a key factor in change if we are going to promote broader savings.

Senator Chafee?

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

Mr. Secretary, just one quick question. I am strongly in favor of the Work Opportunities Tax Credit which, as you know, is primarily directed to employers who will employ somebody who has been on welfare, and then they get a tax credit for it.

You have only got a 1-year extension of that. In order to have these programs function correctly and in order for the employer to set up the structure and all that, there has got to be more certaintude to it.

So I would hope you would take another look at that, and I would be glad to work with you folks on getting a longer extension than just 1 year. I do not want to say it kills the program, but it certainly diminishes the attractiveness of the program.

Having said that, I would like to change gears now.

Secretary RUBIN. Can I just say one thing, Senator?

Senator CHAFEE. Yes.

Secretary RUBIN. We obviously agree with your objective. As with the R&D tax credit, and all of these things, they benefit from certainty. As you correctly say, the question always is the same one, which is money. But we can all work together and maybe we can do something.

Senator CHAFEE. All right.

Now, am I correct in understanding what I said in my opening statement, that what you are doing here is taking money from the general fund to shore up the Social Security Trust Fund and the Medicare Trust Fund?

Secretary RUBIN. Well, it depends, I suppose, on how you look at it. The surpluses are in the general fund. Then we take the surpluses. Just take Social Security, for example. We take 62 percent of that unified surplus.

When you cut right through it all, we put that into the Social Security Trust Fund, and then about 80 percent of that reduces debt, and about 20 percent of that purchases equities. Then we put in first claims, in effect, which are the specials. That is what we are doing. However you want to label it or characterize it, that is, in effect, what we are doing.

Senator CHAFEE. Well, I think Medicare is easier to understand. Medicare is funded by 1.45 percent of payroll for the employer and for the employee, going right up to the top.

Now, we look to Medicare. Is there enough money to keep the program going?

Secretary RUBIN. It is the same thing.

Senator CHAFEE. As I understand what you are proposing, there are some problems with Medicare, so we will just take some money from the general fund and shore it up. That is where I run into problems in that, as I mentioned, you reduce any incentive to make the structural changes that you need in the program.

Secretary RUBIN. Well, let me, if I may, Senator, sort of characterize that a little bit differently. It is exactly the same thing with Social Security and in Medicare. They are really precisely the same thing, except for the purchase of the equities in the Social Security Trust Fund.

I think we are really doing three things. One, is that when you cut through it all, if you take all of the accounting labels off and you just sort of cut through to what is actually happening, I think we are doing three things. We start with existing Medicare beneficiary commitments which, as you correctly say, we at the present time do not have sufficient revenues to meet.

Then we do three things. We take funds from the general fund, in our case 15 percent, we put that into the Medicare Trust Fund. We immediately use that to reduce publicly-held Federal debt, which improves the capacity of the Federal Government to fund Medicare benefits in the future, or Social Security benefits, for that matter, if need be.

And at the same time, we create in the Medicare Trust Fund a first claim through these specials against the general revenues of the Federal Government to meet the needs of Medicare beneficiaries.

So we have both put the Federal Government on a sounder footing so that it can meet its obligations, and we have created a first claim against revenues for purposes of the Medicare beneficiaries.

Then the third thing that the President has proposed that we do, is engage in Medicare reform, though he has not, as you correctly say, put forth specific proposals because his intention is to wait until the Medicare Commission reports—which originally was supposed to be March 1. I am not sure what their proposed date is now, but I believe it is March—and then work from there to accomplish specific reform of Medicare. It is really precisely the same model for Social Security.

Senator CHAFEE. What I worry about, as I mentioned, is once you start bringing in these outside funds other than from the payroll tax, what you are doing, if I understand this correctly, then you reduce the incentives tremendously for us to make what you referred to in your statement as tough choices. Why bother making a tough choice? Just tap into the marvelous surplus and just take some of that money to make up the problems.

Secretary RUBIN. Let us go back to Social Security for a moment. While it is more complex, it is also larger, but it is the same thing in either case. I guess where we really have come out, Senator, and I think it is the right place to be, myself. We spent enormous amounts of time on this. We have tried to find a balance, because what you say has validity to it.

We tried to find a balance between reducing debt of the Federal Government which, by increasing national savings and improving the fiscal condition of the government, I think should be an enormously high priority at this time. We have combined that with extending the life of these trust funds.

I think there is at least the possibility, which we could discuss, that if we had not combined this with extending the life of the trust fund, that politically we might not have been able to preserve, or it is less likely we would have been able to preserve the resources to reduce the debt in the first place, which we view as an imperative.

Well, imperative may be not quite the right word, but an extraordinarily important thing to accomplish. By doing that, we have done the two things I have already said, reduced debt and extend the trust fund. Then we have left open the question of the tough choices. I think you may be right, we may have made it somewhat more difficult to get the tough choices made.

But the trade-off against that is that we have made it, at least we think, a lot more likely that you will get the debt reduction which has all the benefits that I have already talked about, and we made a judgment.

One could debate this judgment, I suppose, but we made a judgment that Social Security has a kind of priority, if you will, as such, that we wanted to create a first claim against future general revenues. Those are the sets of decisions we have made and, if you will, the judgments we have made.

Senator CHAFEE. Well, my time is up. I want to thank you, Mr. Chairman. I just want to say that, as you know, I am four-square for reducing the debt and have said so at every opportunity. But

I have a feeling here that there is some double accounting taking place, and it is terribly complicated. But my time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. I would just like to make one or two comments. I thank the Senator for his raising this matter.

First of all, I do want to compliment Chairman Breaux, the chairman of the bipartisan commission. He has undertaken a very difficult job and is trying to come up with some real recommendations.

But, Mr. Secretary, looking at the language in your statement, it bothers me. It says, first of all, you talk about putting more money into it. But then you go on and say, "In addition, the President proposes that a bipartisan process be used to enact reforms, but only after the Medicare Commission submits its reports in March."

What bothers me, to be candid, I think it is going to take strong leadership on the part of the White House to bring about true reform. It cannot be just ditched off to some bipartisan commission. It is going to take Republicans, Democrats, and the Congress. But I cannot emphasize too much how important strong leadership on these reforms must come from the White House.

Secretary RUBIN. I would not disagree with the importance of strong Presidential leadership. I think what you have seen over the course of the past, what was it, over a year now, I guess, Mr. Chairman is that the President decided over a year ago that we needed to address Social Security, and he really has spent the last year protecting the surplus from a lot of other claims that people are making on it in order to get us to where we are today. He is very much, as you know, focused on health care.

The CHAIRMAN. But what bothers me is the point that Senator Chafee, I thought, brought out so well, is that the steps that have been taken are making it that much more difficult to make the tough decisions.

Secretary RUBIN. Well, I think, as I said, Mr. Chairman, you have got trade-offs and judgments within those trade-offs, which was my response to Senator Chafee. I think we need to wait until Senator Breaux's commission issues its report. I am absolutely confident, based on what I know is happening, that you will see the White House very actively involved in the question of Medicare reform.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. I want to visit mostly about taxes. But before I do that, and I think you were very clear in your statement but I just want to check it out, that the budget complies to the discretionary caps. That means that the $21 billion that we have spent on emergency appropriations last October are not recurring expenditures in this year's budget, unless offset.

Secretary RUBIN. That is correct, Senator.

Senator GRASSLEY. First of all, just three things that we agree on by way of emphasis, so that you know that there are people on this committee who have an interest in it as well.

After 10 years of trying, I finally got through my bill to do the student loan interest deduction. There was a 60-month cap on that. Now it is my understanding the administration is for removing, or at least increasing, that cap. I am glad to hear that. I will be introducing legislation to accomplish that goal.

In a second area, the administration is proposing extending the Wind Energy Tax Credit. I do not know whether you are propo^ing it for 5 years, but I am going to propose it for 5 years. I think tnat this will go a long ways toward helping us encourage less dependence upon fossil fuels so the already low oil prices will not go up again. I say that for the benefit of my colleague here from Oklahoma.

Senator NICKLES. I heard you.

Secretary RUBIN. I believe we are proposing five years, too, but we can check that, Senator.

Senator GRASSLEY. All right. Thank you.

We also, in a little different variation, Senator Graham of Florida and I want to thank you for the President's interest in long-term care problems and the tax credit that is available there. We have a different approach, but I think there are opportunities to work things out there.

So, unless you have comments on any of those, that would bring me to my first question on another matter. I want to turn to the Universal Savings Accounts. You indicated that the President wants to work with Congress to formulate the actual proposal. I am glad, of course, that the administration is acknowledging that people are capable of investing at least a little bit of their retirement income.

I believe the only benchmark that has been set down by the administration is that the benefits of this program should be targeted to low income individuals.

First, do you have a feeling for the type of administrative structure you would like to see for these accounts? Would workers be limited to a small number of investments options similar to what maybe Senator Roth's proposal is, to use the thrift savings plan, or would you like to see more choice?

Secretary RUBIN. Senator, it may be a mistake in one of our documents, but the targeting would be toward low income people, as you said, but also middle income people.

Senator GRASSLEY. All right.

Secretary RUBIN. But the match would be inversely proportionate, if you will, to the income, so the higher the income, the lower the match. But it would be designed to reach both middle income and lower income people.

In terms of the range of choice, I think the TSP is a possible model, if that is what you were thinking of.

Senator GRASSLEY. And Senator Roth has suggested that.

Secretary RUBIN. That is a possible model.

Senator GRASSLEY. But are you thinking in terms more broadly than that, I guess is really what my question is directed to?

Secretary RUBIN. This is really very technical, what is going on at the Treasury Department right now. We are working on all of this right now. In fact, we probably will be having a meeting on this this afternoon over the White House to carry this one step further. I think it might be more useful if I wait to respond until after we have reached our decisions, but we certainly will be providing a range of choice. How wide, I do not know.

Senator GRASSLEY. I want to give a comment in regard to them. The examples that I have heard from various statements made by the administration describing how this idea can work do not seem to take into account the reality of financial demands of low and middle income families.

I would question, first of all, whether these accounts will deliver increased personal savings. The $100 credit, as an example, would be $9 a month. Then in order to get the additional money, people would have to consume less in order to save more.

This works in some employer pension plans where a match is provided, but not as much as one would hope. Only 50 percent of low income workers participate when the employer offers a match. That is pretty significant, because the employer needs to get their employees to participate to ensure compliance with the non-discrimination rules. They have that advantage that a government program would not have.

Employers engage in education, as well as employees, to get them to participate. The government would have to invest in education as well, I would think. It seems that if we want people to participate in some kind of savings account to get the most bang for the buck, would be to have it as part of Social Security.

In other words, would it not be more effective to cut the payroll tax and put this savings towards an Individual Retirement Account that is part of Social Security, than the approach that you do, to have it separate?

Secretary RUBIN. We have made the judgment, Senator, and I think rightly, that we ought not to cut the Social Security tax, that the benefits that that funds and the tax ought to be kept intact, and that this should be done outside of the Social Security system.

I think outside of the Social Security system, the question of creating an effective mechanism, the series of questions you are raising, are really very much the questions that we are focused on. When we come back with our specifics, my suggestion at least, would be discuss the specifics we come back with in the context of the criteria you have just set forth.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Secretary, on the issue of the Universal Savings Account and how to mitigate the potential that it might have an unintended adverse effect of discouraging, particularly small businesses, to continue their pension accounts.

I would like to suggest that you might consider, instead of establishing a new set of saving instruments, use this as a means to, first, induce, and then supplement existing savings instruments. For instance, we have the 401(k)s and the IRAs.

If we could encourage more small businesses to establish a 401(k) type program by saying, if you do this then we will supplement additional contributions through a Federal matching program, you might have the effect of inducing the 80 percent of small businesses that do not provide any employer-based pension/retirement program to do so, so you would be leveraging the Federal money as opposed to what Senator Baucus is concerned about, taking it out of one pocket and putting it into the other without any net increase.

Secretary RUBIN. Senator, I think that you and Senator Baucus, and I think there was somebody else who made the same comment, have focused in on one of the key issues with respect to these USAs, which is, can we make this incremental, in which case, at least in my view, it has a very real opportunity of increased personal savings, or is it going to in some fair measure simply displace existing instruments, in which case it may well not be a good thing to do. But it is our view that we can structure this in a way that will be predominantly incremental, and that is what we are aimed at doing.

Once we develop the details and the specifics, then I think—again, you framed another way of looking at it, which is, are we better off using the resources for these accounts or, in the manner that you suggested that might be a good alternative, and we can compare the two accounts and use the resources and see what we think will do most for savings, and also what will reach the kind of people who are not reached by the employer benefits systems we have today.

Senator GRAHAM. On the issue of the unified budget, and I have been doing some additions without the benefit of an abacus or most rudimentary means of addition, but looking at your estimates through the fiscal year 2004, it appears as if the cumulative estimated surpluses, starting with the actuals in fiscal year 98 through the estimates of 2004, are approximately $725 billion, of which $695 billion are from Social Security, and $30 billion, which is the $30 billion that comes in the year 2004 and is contributed by non-Social Security sources in the unified budget.

I am concerned that we are proposing to start now spending 38 percent of the unified budget on non-Social Security items, whereas, for the first 5 years of this program, virtually 100 percent of the surplus is not going to be unified, it is going to be Social Security.

Would we not be wiser to front-load the investments in Social Security in these first 5 years, and therefore get more of the benefits that we will derive by paying down the debt even more rapidly than your plan calls for?

Secretary RUBIN. I think there are two separate questions here, at least, Senator. One, is the question of whether we should take Social Security off budget. I mean, that may be somewhat implicit in what you are raising.

It seems to me, at least, that the answer to that would be no, if for no other reason—though I think there are actually other reasons—when you look at the macroeconomic impact of what happens in the Federal Government on the economy, it is really the effect of the deficit or surplus in the unified account that has the macroeconomic impact, not what happens in one piece or another. Similarly, I might add, available capital to the private sector by extension of interest rates are affected by what happens in the unified budget.

By the way, and I probably should have clarified this in my statement and I did not. Our 62 percent is not constant every year, that is what it is over the course of the 15 years. But, on a year-by-year basis, that would differ somewhat.

I believe, and let me ask Ms. Mathews if I am right, that in the early years more of it goes into Social Security, if I remember correctly. Is that correct?

Ms. MATHEWS. In the earlier years, more will come from what we will call the off-budget surplus, but in the later years more will come from the on-budget. It is the evening out of what happens when the demand, when it comes to the point where we are calling in the existing Treasury specials, and those would be greater than the amount.

Senator GRAHAM. In terms of the allocation, you have an allocation of use of the surplus, which is 62 percent for Social Security, approximately 15 percent for Medicare, 12 percent for the Universal Savings Accounts, and the balance for additional spending. That percentage allocation of how to use the surplus, how is it in the early years?

Ms. MATHEWS. In the early years, you will see more going to the other items, but over the 15-year period——

Senator GRAHAM. Do you mean less to Social Security and more to the other items in the early years?

Ms. MATHEWS. What you will see, is that the numbers will not match in the first year, the 62 percent, but over the time, in terms of the needs because it is related to what Social Security will actually need. So in the out years, we will pay.

Senator GRAHAM. I guess my question is, between now and fiscal year 2004, what percentage of the approximately $725 billion surplus——

Secretary RUBIN. Senator, could I make a suggestion? Let us get back to you with year-by-year numbers. I have a recollection, and it may be wrong, that the percentage allocated to Social Security in those first 5 years is actually higher than 62, but that may not be correct. We will get you the numbers.

I think I would like to make one comment, though. Whatever it may be, whether I am right or I am wrong, what we tried to design was an overall 15-year program, with all of the purposes that we have explained. I do not know that it matters all that much how you do it year by year, but we will get your the numbers.

Senator GRAHAM. I see my time is up. My concern, is that I think the big risk with this is in the latter years. The question is, are you going to allocate relatively more of the risk of non-attainment of these levels of surplus to Social Security, or are you going to be risk-adverse to Social Security by front-loading?

Secretary RUBIN. It is a good question. I think you are going to find by the time you get to the outer years, and again, I do not have it in front of me so I am not going to say I am absolutely right, I suspect this sort of averages out to the 62/38 by the time you get into those outer years.

But remember, by the time you get to those outer years you will have enormously increased the capacity of the Federal Government to deal with adverse circumstances because of the debt reduction between both Medicare and Social Security, if it happens that we have difficult times. But we will try to get you the numbers.

Senator GRAHAM. All right.

The CHAIRMAN. Senator Nickles.

Senator NICKLES. Mr. Chairman and Mr. Secretary, the numbers for the first 5 years is 57 percent, just for your information, if you want that.

Let me talk about the year 2001. In 2001, our unified budget surplus is $134 billion, and the on-budget surplus, taking Social Security out, is zero. Maybe I can get the Senator from Florida's attention, because it kind of complements what you were talking about.

So Social Security surplus in the year 2001, according to your budget, is $134 billion. On budget, is zero. Now, Senator Chafee kind of alluded to this, and we are dancing around it. I was critical of you for double counting, and you kind of grimaced like, oh, I would never do that.

According to your budget, correct me if I am wrong, in the year 2001, we have $134 billion surplus and that is all Social Security, none of it is on budget. You also credit the Social Security account with $70 billion, is that not correct?

Secretary RUBIN. In terms of the use of our surplus, we would put $70 billion in Social Security. That is correct.

Senator NICKLES. All right. So in the year 2001, you have a $134 billion surplus. That is automatically credited to the Social Security Trust Fund, is it not?

Secretary RUBIN. You have an off-budget surplus in your first round. You would get specials equivalent to the off-budget surplus.

Senator NICKLES. Just a second. You already get credit for the $134 billion that is going in, Social Security taxes in excess of outlays. That is correct.

Secretary RUBIN. Senator, to the extent that you have a surplus in the Social Security count in the first year, what happens is, that goes into the general fund and there are specials in the Social Security Trust Fund.

Senator NICKLES. Yes. Equal to the $134 billion. Equal to whatever the number is, just like we have always done.

Secretary RUBIN. Right.

Senator NICKLES. And you want $70 billion on top of that.

Secretary RUBIN. And, as I discussed before, we would then take that in the general revenues, and then whatever the unified surplus is, which in this case happens to be the same $134 billion.

Senator NICKLES. Right.

Secretary RUBIN. That is just coincidence.

Senator NICKLES. Right.

Secretary RUBIN. We would take whatever the percentage is for that year, on average over 15 years, would be 62 percent.

Senator NICKLES. I understand.

Secretary RUBIN. And we would do exactly what I said before.

Senator NICKLES. And I have got your budget. But I want to show you how hypocritical this is. Seriously.

Secretary RUBIN. Could I make a suggestion, Senator?

Senator NICKLES. Yes. Or how misleading it is. Maybe that is a better term.

Secretary RUBIN. No. I do not think it is either one, actually. I have spent a career, for better or worse, trying to look through how accountants played with numbers to find out what was actually happening.

And if you look through the 15-year program that we have put forth, I think what you will find, and I guess that is why Chairman Greenspan was so positive about it when he testified, is exactly what I said. Whatever the accounting mechanisms may be, what you will find, is you will find very substantial debt reduction, enormous debt reduction.

Senator NICKLES. Wait a minute. You are going to make a speech. I am not——

Secretary RUBIN. It is no speech. And claims against general revenues to extend the trust fund.

Senator NICKLES. You have to answer my question, though. There is a $134 billion surplus going into Social Security automatically. Out of that $134 billion, you are trying to say that there should be $204 billion credited into the Social Security trust fund that same year.

Now, that does not add up. There is a $134 billion surplus and, by financial finagling, you are coming up and saying, wait a minute, we should credit the trust fund with $204 billion.

Secretary RUBIN. Well, let me just go through it again, if I may, Senator. You have outstanding existing Social Security commitments that have to be paid. I do not think, by the way, doing it on a 1-year basis is as useful as doing it on a 15-year basis, but it does not matter.

Senator NICKLES. But you do it year after year. I am just using this as an example.

Secretary RUBIN. Yes. It does not really matter how you do it. When you get all finished with what we want to do, what you will have accomplished in this case is you will have—you start the same place we started today, with $134 billion in the general fund. That is where we are under current law. Now you have a question of, what are you going to do with that $134 billion? Some people would like to use it for tax cuts.

Senator NICKLES. But right now, 100 percent of it is in Social Security.

Secretary RUBIN. No. Stay with me one second, Senator, because you are raising very complicated questions. I mean, as Senator Chafee said, it is a very complicated set of issues, I think an extremely important set of issues, and I think getting it right can really contribute enormously to the well-being of this country.

You have $134 billion in the general fund and you have equivalent specials in the Social Security Trust Fund. That is where we are today, under current law.

Senator NICKLES. Right. And zero surplus.

Secretary RUBIN. No. Actually, you have a $134 billion surplus.

Senator NICKLES. On budget surplus.

Secretary RUBIN. Unified budget.

Senator NICKLES. Right.

Secretary RUBIN. Unified budget. Yes. As Ms. Mathews says, that is cash in the general fund. Now we have to decide what to do with it.

Let me tell you what we would like to do with it. Some people think it should be used for a tax cut. That would dissipate, or consume, if you will, the $134 billion and there would be no national savings resulting from the surplus.

Our judgment is, national savings are essential to the future of the country, so we have divided it up in the way we have described to you. As you correctly say, under our system, $70 billion of this would go back into the Social Security Trust Fund instead of being used for a tax cut.

Forgetting for a moment purchase of equities because it makes it a bit complicated, of that $70 billion, it immediately, if it were not for the equity pieces, take that out for simplicity, that $70 billion would immediately go to debt reduction, which has all of the benefits I discussed before.

At the same time, we would put in the Social Security Trust Fund, because we believe Social Security benefits should have a priority over other kinds of activities the Federal Government conducts, and you can agree or disagree as you sit fit, but we do, we would put in a $70 billion special which is a first claim, if you will, against general revenues of the Federal Government.

Senator NICKLES. I understand.

Secretary RUBIN. That is what we are doing.

Senator NICKLES. So the net result, and correct me if I am wrong, at the end of that year there would be $204 billion of debt obligation to the Social Security Trust Fund. That is correct.

Ms. MATHEWS. You would have increased the assets.

Secretary RUBIN. No.

Senator NICKLES. No, I do not agree with you. You would increase the Social Security Trust Fund by $204 billion, even though the surplus of the Social Security Trust Fund was only $134 billion.

Secretary RUBIN. Look what we did with the extra $70 billion, forget the equities again. This is important. What we have done——

Senator NICKLES. You also spent $26 billion of it on new spending initiatives, and another $16 billion on the Universal Savings Accounts.

Secretary RUBIN. Well, we spent 15 percent of Medicare, which we, at least, think is very important, and we spent a little bit on——

Senator NICKLES. New spending, $26 billion. $20 billion for Medicare, and $16 for Universal.

Secretary RUBIN. We believe Medicare is a very important national priority. It is true that we do allocate funds to Medicare. We can debate whether we should strengthen the Medicare Trust Fund or not. We believe we should, and you might think we should not. I do not know.

Senator NICKLES. But you have taken the $134 billion surplus and said, all right, that is in the Social Security surplus and that is debt, so we add more debt to the Social Security Trust Fund. Then you spend it again.

Secretary RUBIN. No. I think, Senator, if you do what I used to do for a living and you put aside the accounting labels and see what actually has happened, you have the $134 billion in the general fund. Of the $70 billion we put into Social Security, we are really doing two things.

We are creating a first claim, which helps the Social Security Trust Fund, and then we are further helping the Social Security Trust Fund, and I believe our economy, by saying we are going to improve the fiscal position of the government so that if it does have to actually raise money to someday meet its obligations, it will have $70 billion less of debt. That is what we are doing.

And you are correct, we are doing the same thing in Medicare. We have made a judgment, rightly or wrongly—I think rightly—that Medicare should be enhanced. So we have done exactly the same thing, with exactly the same beneficial effects.

Senator NICKLES. But that $134 billion is debt. That trust fund is increasing by $134 billion by present law, and you are increasing it by $70 billion in addition to it.

Secretary RUBIN. Under current law, what we are doing is we are giving $134 billion of first claims—and that is what it amounts to—within the unified budget against the general revenues of the Federal Government.

Senator NICKLES. That is present law.

Secretary RUBIN. Under current law. Then you go from current law to where you want to go from there. Where we want to go from there is the place I have already described. Somebody else might prefer to go to a tax cut, or whatever. That is not where we would go. We would go to Social Security and Medicare, basically.

Senator NICKLES. But you are not taking away the $134 billion, so you still have the $134 billion of IOUs, plus now you are adding another $70 billion in IOUs.

Secretary RUBIN. We all start at the same place, Senator. We all start with $134 billion in the Social Security Trust Fund. Some people, as I said a moment ago—and you might be amongst them, I do not know—would say, let us take the $70 billion to a tax cut.

We say we do not think we should do that. We say, instead of the tax cut which would dissipate our National savings, let us reduce national debt and also let us create a claim against future revenues for the benefit of Social Security.

Senator NICKLES. But that is the second claim on that $134 billion.

Ms. MATHEWS. But I think what is important is that the $134 billion that we are talking about is cash in the U.S. Treasury. No matter what, it exists in the form of surplus. It exists. It exists because, when we buy Treasury specials, the dollar exchange, we are the government. So, the cash still exists.

The real question that we all face that we are all going to talk about is, that money exists. Once you have made the Social Security commitment, because the bonds are there, we, as a government, still hold that surplus. Then the real question becomes, what happens afterwards?

Senator NICKLES. I understand. I understand. Just to comment, so all my colleagues will know. Of that $134 billion, they, I am going to say, double count $70 billion back. So the net increase in the trust fund obligations is $204 billion in the first year, plus $20 billion is transferred to Medicare, $26 billion to new spending initiatives, and $16 billion to Universal Savings Accounts, and it takes another $2 billion for debt service to get to your $134 billion.

My point being is, instead of increasing government IOUs to Social Security of $134 billion, which is present law, it ends up at $204 billion. That still is double counting.

Secretary RUBIN. I respectfully respond, Senator, we may have this debate for a lot of months to come, but I do think, looking at any country—and it is what I do all the time—or looking at any company, my recommendation would be to look through the accounting labels and figure out what is actually happening within the entity. If you look at what actually is happening, I think you will find my description is in accordance with what is actually happening.

Senator NICKLES. I am all for getting debt down. I just think we should be honest about doing it. I do not think paper IOUs make Social Security any more solvent than not doing it.

Secretary RUBIN. Actually, it does. If you are in favor of getting debt down, and if you are in favor of strengthening Social Security, and you are in favor of strengthening Medicare, then I think you should at least consider joining us where we are, because the first claims actually do strengthen those two programs.

Senator NICKLES. Would debt not come down the same amount without the transfers?

The CHAIRMAN. I think the time has come. We have to move on.

Senator NICKLES. Just one yes or no. Would the debt not come down by the same amount or more without this transfer, the gross debt?

Secretary RUBIN. You could take down the debt without enhancing the two trust funds, if you wanted to. It was our view that, both substantively and politically, it was better to enhance the trust funds.

The CHAIRMAN. I would just point out that, according to Newsweek, the 15-year shortfall, what you are talking about, is $2.3 trillion. So I am persuaded, we will talk about this a lot more.

Senator Gramm?

Senator GRAMM. Mr. Chairman, if our dear friend Secretary Rubin had used accounting like this when he was in private practice, he would be in prison today instead of sitting before us.

Secretary RUBIN. No, no. Your dear friend Secretary Rubin looked through accounting to find out what was really happening.

Senator GRAMM. Mr. Secretary, let me, first, say that this does not upset me. It upsets my dear colleague, Senator Nickles, it makes Senator Domenici apoplectic, but it does not upset me. Let me explain why it does not, then try to rationalize this whole thing.

It does not upset me because this IOU, this $134 billion next year that Social Security is going to collect more than it saves, is going to produce us to print out on a computer in West Virginia a little IOU with perforated paper, and they are going to put it in a steel filing cabinet. It is fire-proof, but apparently you could break in it. But they are not worried, because you would not have anything if you broke in. [Laughter.]

Now, whether you give them once piece of paper or a cigar box full, it does not make any difference, which is why I do not get upset about it. But Senator Nickles does, and Senator Domenici gets apoplectic. I would like to explain why. I do not want you to get off on one of these things, which I often do when I do not have a good answer.

Secretary RUBIN. That which you referred to as "one of these things" was my response.

Senator GRAMM. Let me explain basically what you have done. All right. Next year, Social Security runs a surplus of $134 billion. Other than Social Security, there is no surplus, so it is simple arithmetic.

Now, we say by our old accounting when we were running deficits, that we would have had to borrow $134 billion had Social Security not been there paying us this money, so we are going to send them this IOU that prints out in West Virginia. Senator Byrd, I am sure, put it in an appropriation to put it over there. They put it in a filing cabinet, $134 billion that you at the Treasury owe Social Security.

Now we have got surpluses. Things are different. So what you want to say is, all right, here is the deal. We send them the IOU for $134 billion from the Treasury. Then we got $134 billion, something we never had before, not in my adult life. So you say, well, look, we will spend $64 billion of it, which means we have got $70 billion left.

Then we will take the $70 billion that we have got left after we spent the $64 billion, then we will go out and buy government bonds, something we were never able to do before because all we would do was not sell them before because of the surplus, and then we would take those $70 billion worth of government bonds and we send them over to West Virginia. When you add them up, you have got $204 billion.

Now, here is my point about prison. My point about prison is, if you had said, I will take $134 billion and then I will take $64 billion of it and put it my pocket, and then I will issue you an IOU for $204 billion, number one, nobody would have ever been stupid enough to enter into that agreement with you. But the point is, what really happened—and then I am going to explain why it is all right—is you had $134 billion and it was real money. So you gave them the IOU like you always gave them, but now you only spent $64 billion of it now. You will spend more later. So you have got $70 billion.

You say, all right, we will buy back government bonds and we will put those government bonds into the Social Security Trust Fund. So now you have got $204 billion because the $134 billion did not make any difference to begin with. So you are counting the $70 billion and you get $204 billion.

Well, here is my point: it does not make any difference. It is true that you borrow $70 billion less today than we would have borrowed had you not had $70 billion of the surplus you did not spend.

Secretary RUBIN. Actually, I think it is $90 billion less, because Medicare will also go into debt reduction.

Senator GRAMM. Does it go into the Social Security debt reduction?

Secretary RUBIN. No, no. It goes into the debt reduction via the Medicare Trust Fund.

Senator GRAMM. You are not counting it for both of them, are you? That is all right. I do not mind if you do. [Laughter.] But here is my point, and I will end before the light goes out. Here is the problem with all this: it is double counting and it is crazy. But here is why it does not matter. It does not matter how many IOUs you have got in that filing cabinet in West Virginia, or how much debt you are piling up now. The amount we are borrowing now is the amount we are preempting from the private sector. It is true, if we preempt $70 billion less, things are better.

Secretary RUBIN. You have got it.

Senator GRAMM. You agree with that.

Secretary RUBIN. And $90 billion, they are ever better yet.

Senator GRAMM. Ninety billion would be even better, $100 billion, if you could get it. But 15 years from now, the fact that you have got those IOUs in that filing cabinet helps you not zip because it is the amount of capital you are going to preempt 15 years from now, not the amount you are preempting today. Only if you can find a way to invest that money that creates wealth that belongs to Social Security have you really dealt with the problem 15 years from now.

Secretary RUBIN. Well, I know where you are heading, because I am familiar with your plan.

Senator GRAMM. No, no. I am heading toward the truth.

Secretary RUBIN. Oh. Then you are heading toward me, which is where I welcomed Senator Nickles, but he left.

I think what you are really doing is extraordinarily constructive. I do not mean what you are doing. What you are doing is constructive, too. But what the Nation is actually doing here, Senator, if we wind up doing this, is extraordinarily constructive. When you cut through it all, what you are really doing is—we are not piling up debt right now, by the way, we are reducing debt because we have a surplus. We have been actually reducing debt since about 1998, I guess.

What you are doing, is you will reduce the publicly-held debt by about $90 billion, forgetting the equity purchase for a moment because it just confuses the numbers. Ninety billion dollars between these two accounts. What you will have is $90 billion less of Federal claim on the available savings in our society during this year.

Senator GRAMM. This year.

Secretary RUBIN. Yes.

Senator GRAMM. This year.

Secretary RUBIN. Yes.

Senator GRAMM. What about 15 years from now?

Secretary RUBIN. Well, wait a second. Each year you will have the same thing in some amount. Over the course of the whole time, and I probably will not be able to do this in my head, but it is $2.8 billion from Social Security, and it is how much from Medicare, it would be 15 percent of—it must be about $3.4 billion or something, but do not hold me to the number.

You will have about $3.4 billion, or some such number—but do not hold me to the number—of lessor claims by the Federal Government on the available pool of savings in the Nation, which means that will then be available to the private sector over this whole 15 years to invest and do exactly what you say, which is to increase the economic growth of the country.

Senator GRAMM. Mr. Chairman, let me just make two points and I will quit. The point is, however, that however big that IOU pool is, 15 years from now when you try to use it you are going to preempt capital 15 years from now.

The fact that you are not preempting it today is good for economic growth, but it has nothing to do with Social Security because all of these years while this money is being invested it is being invested by people and companies, and 15 years from now when you need it, you are going to have to take it away from them.

The way you are going to have to take it away from them is by raising their taxes, or by cutting spending, or by preempting it in the capital market. And you all are acting as if the money you are not preempting today somehow can be added up and preempted 15 years from now with no effect. It is just simply not true.

Secretary RUBIN. Actually, though, 15 years from now you would only have to go out into the external capital markets if you did not at that time otherwise have a unified surplus. Because if you have a unified surplus, then you can meet these first claims on the general revenues without ever actually going into the outside capital markets.

And my recollection is that, under this proposal in the President's plan—and again, do not hold me to the numbers, but I think I am right—the surpluses are projected to go at least until 2039 under one set of assumptions, and to 2049, I believe, under another set of assumptions.

Senator GRAMM. No. The surpluses end when you start to pay up——

Secretary RUBIN. No. I think, Senator, that the unified surplus goes to at least 2039.

The CHAIRMAN. Just let me comment. I do not know whether it is more difficult to understand two politicians or two economists, but I think the time has come where we must move on. I want to thank you for being here today, Mr. Secretary.

Senator MOYNIHAN. Mr. Chairman, you will not mind if I suggest that we have blackboards at the next meeting.

The CHAIRMAN. It is a worthwhile suggestion.

Senator CHAFEE. Mr. Chairman, are we through? Is that it? Does the Secretary have to leave? I have a question or two I was going to ask him, but I do not want to jump ahead.

The CHAIRMAN. Yes. Are you able to stay on?

Secretary RUBIN. If you would like. Whatever you would like, Mr. Chairman.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Well, I would just like to ask and see if I can understand this Universal Savings Account. I just do not understand it very well. Could you briefly outline what it is?

Secretary RUBIN. Senator, we will have a lot more specificity. In a sense, I guess I apologize for not having it at this point. But we have been working on it, and it is complex to work it through in a way that meets the very correct comments that other Senators have made about not interfering with employer-provided pension plans, and various other problems.

Basically, what it amounts to is that we will take part of the surplus and we will contribute a flat amount to each individual's account, so that will then become savings of that individual. In addition, we, the Federal Government, will match additional savings by people who have accounts, and that also will come from the surplus.

Then whatever is in each of these Universal Savings Accounts, these individual accounts, if you will, can be invested. While I am not sure what the mechanism will be, it will be some sort of mechanism which will provide some range of choice.

Senator CHAFEE. So, in effect, you supplement from the Federal Government the savings that individuals make.

Secretary RUBIN. Yes, I think that is a fair way to put it. You supplement it. I think that is a fair way to put it. You supplement it, in part, by a so-called block grant. It is not a grant, it is a refundable tax credit.

Senator CHAFEE. And then they commit themselves to keep it in there. I presume you do not send them a check and then they can go buy and automobile right away.

Secretary RUBIN. As presently contemplated, but we are still working on this. The plan would be for retirement only, but that is as presently contemplated. The refundable tax credit is the grant and then the match would also be in the form of a refundable tax credit.

Senator CHAFEE. I just want to say, this reminds me somewhat—I do not know. These gentlemen were here when I first came about 1977 or 1978. The head of the OMB was Bert Lance. He had some kind of a proposal. I cannot remember. He was going to send everybody in the country $500, I think.

Senator Long, whose voice, as he would get excited, would rise, "You are flying over the country in an airplane. You shovel it out with pitchforks." That never flew, finally, here. I am not so sure that this Universal Savings Account is that much different.

Secretary RUBIN. Well, my recollection—and again, I am not sure I am right—whatever that number was that Mr. Lance had, I think that that was designed to stimulate economic activity and could have been used to curry consumption. I think that is right. Ours would be solely for savings, and I believe probably would wind up solely for retirement savings, but that has not yet been determined.

Senator CHAFEE. It is a unique approach. In any event, we are learning a lot today. Mr. Secretary, I want to pay tribute to you also. I think you have done a wonderful job down there in Treasury. Much of our current prosperity and success is due to the way you have had a good hand on the tiller, and I want to congratulate you.

Secretary RUBIN. Thank you, Senator.

Senator MOYNIHAN. Could I add that today's debate will teach you what comes from doing. No good deed goes unpunished. You have got a surplus, now you are going to pay for it. [Laughter.]

Secretary RUBIN. Senator, we are still trying to figure out here whether it is series of forums or series of fora.

Senator GRAMM. Mr. Chairman, I have two quick questions.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. One, is it seems to me that, if I am a small employer and I have got a little 401(k) plan and I match a little bit of what my employees make. They are low income, I am not too high income myself.

It seems to me that, if the government comes up with a program that every one of my employees qualifies for, that I am not going to have to be a genius to figure out it is better for the government to match their retirement than me, and so I am going to end my program.

You might say, we will somehow try to prohibit that. So what I say is, all right, for you guys that are here right now I will keep it, but for new employees I will get rid of it, or if I am really small, I just dissolve the company, rehire everybody again.

So I can in essence say to my employees, I am spending $100 apiece on your retirement. The government will do it; why do I not take $50, you take $50, and then I will get out of this business? So the net result is no savings occur, no new retirement occurs, you simply displace private retirement. If you are not concerned about that, you ought to be.

Secretary RUBIN. No, we are enormously concerned about that, Senator. In the response to somebody, I have forgotten who it was, you have precisely identified the issue that we are trying to figure out how to avoid.

Senator GRAMM. The second point I want to make is, I think I am persuaded by your argument that we ought not to let companies deduct things like punitive damage payments from their taxes. But let me ask you a hypothetical question. I am a bank and I have to, each year, have a CRA evaluation as to whether I am lending in the communities I serve.

Let us say that, in order to assure that no one protests my designation, that I go out and pay in cash $500,000 to a group of people, and in return they do not protest, or in return they come and testify saying I am doing a good job. Should that be tax deductible?

Senator MOYNIHAN. Do not answer that.

Secretary RUBIN. I think, Mr. Chairman of the Banking Committee, not of this committee, I would like to take that under advisement.

Senator GRAMM. Well, please do.

The CHAIRMAN. Mr. Secretary, let me make just one observation. At one point on the USA, you said it is somewhat the equivalent of a tax cut. Now, it does have a definite benefit to the taxpayer, but I do not think it is the same as a tax cut. It does not put more money into the family budget to meet some of their problems. I would just make that distinction.

Let me again say that one of the reasons we are here today having these positive problems, if you want to call them that, is because there has been cooperation between the executive branch and the Congress. I have to tell you that, in order to make continued progress, that becomes critically important.

I cannot emphasize too much that if we are really going to address the problems of Medicare, if we are really going to address the problems of Social Security, there does have to be strong leadership with ideas from the White House. We all have to work together, but I do hope that the President and others like yourself will provide strong leadership in these areas.

Secretary RUBIN. Let me assure you, Mr. Chairman, at least in my judgment, the President has provided extraordinarily strong leadership for Social Security over the last year and a half, and I can tell you he intends to be enormously engaged with both of these subjects going forward.

The CHAIRMAN. But the question is, we are not very close to a consensus on what those reforms are.

Secretary RUBIN. We have work to do.

The CHAIRMAN. Thank you for being here today. We look forward to your——

Senator MOYNIHAN. Do we not welcome Ms. Mathews? Is this not your first appearance?

Ms. MATHEWS. Yes, sir, it is.

The CHAIRMAN. Yes. We are delighted to have you.

Secretary RUBIN. She happens to be from West Virginia as well, Mr. Chairman. [Laughter.]

Ms. MATHEWS. And we will be happy to hold all of that paper at home.

The CHAIRMAN. Thank you very much.

The committee is in recess.

[Whereupon, at 12:25 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Orrin G. Hatch

Thank you, Mr. Chairman. I join in welcoming Secretary Rubin and Deputy Director Matthews. I look forward to your testimony and a discussion of the President's budget proposal for fiscal year 2000—the budget that will be, as the President has said, the bridge to the new century.

Considering that this is a historic budget, I wish I could say that this was a budget that took bold steps to reform and protect the Social Security and Medicare programs—but I can't.

I wish I could say that the first projected surplus in 30 years would provide relief to all American families, whose shouldering of high taxes contributed to this surplus—but I can't.

I was hoping that the budget that would take us into the new century would have seized these opportunities.

In fact, I am concerned that this budget does just the opposite. President Clinton's budget creates or expands a myriad of programs ranging from education to the environment to urban sprawl. This budget would increase spending in fiscal year 2000 by $39 billion or 2.3% over last year's levels. If you look closely at specific program spending, you see that this budget contains only one major spending reduction—$10.4 billion from the Medicare program. I am concerned that this budget fails the test of fiscal responsibility. It clearly suggests that the era of big government is not over.

The budget before us does propose a tax relief package containing $32.6 billion of targeted tax relief. That is good as far as it goes. But, on closer examination, we see that it does not mean much of a tax cut for most taxpayers.

Almost every measure reported shows that federal taxes are at record levels. According to estimates in this budget, total federal receipts for fiscal year 2000 will reach a level of 20.7%. Only once before, in 1944, has it been higher. According to some studies, the average family in America—say, a family in Ogden, Utah—spends almost 40% of their household income on taxes—that is more than food, clothing, and shelter combined. This budget could have done something about that. But it does not.

All of the targeted tax relief in this budget is not bad. For example, I am glad to see the President step forward on issues such as long-term health care, child care, extending the expiring tax credits, and tax simplification. As a member of this committee, I look forward to working with the President on these tax provisions.

But, it is important to note that these targeted tax provisions do not benefit all Americans. I am disappointed to see that the President did not see fit to reduce the high level of taxation on all taxpayers. While certain targeted tax relief has its place, I believe the American people deserve more. They have been footing the bill for big government for 30 years. It is time for some across the board tax relief.

I was also glad to see the President move forward on shoring up the Social Security system—as far as his plan goes. While I strongly disagree with his call to have the government invest a portion of the trust fund in the equities market, I believe that we can find common ground on the use of private retirement accounts as part of the solution.

But, let's look at this budget proposal for Social Security realistically. It does not save Social Security at all. Instead, it merely provides some extra short term cash in order to put off the day of reckoning further into the future. I hope that the President doesn't intend to just stop with what I see in this budget, but will put a comprehensive reform plan on the table that will guarantee the financial solvency of this critical program for the long-term. We want to work with him on a real solution, not just a temporary band-aid plan. When it comes to the financial safety net for our nation's seniors, we cannot afford to be wimpy.

We have gotten the good news from CBO this week that the surpluses are larger than previously reported. This should show us that bolder action is not just warranted, but possible.

I look forward to hearing from the witnesses today. This dialogue should move us in the direction of working together to craft a budget that is fiscally responsible—meaning that it does not renege on our commitment to spending restraint—as well as progressive in terms of saving Social Security and of providing much needed, long overdue, across-the-board tax relief to the American people.

PREPARED STATEMENT OF HON. ROBERT RUBIN

Mr. Chairman, members of this Committee, I appreciate the opportunity to discuss with you the President's FY 2000 Budget, the first budget of the 21st century.

As a result of the fiscal policy of the last six years, the economy it helped produce, and the ongoing interaction between the two, the nation has moved from an era of large annual budget deficits to an era of budget surpluses for many years into the future. And this gives us an historic opportunity to meet challenges that will affect our economic and social well-being for decades to come, including the economic and fiscal pressures created by the retirement of the baby boom generation. And meeting those challenges is exactly what the President's budget does. The core of this budget is fiscal discipline, and thereby increased national savings, in order to promote economic growth and retirement security in the years ahead.

Before I discuss how this budget will meet these challenges, let me review what has taken place in the last six years. In 1992, the deficit reached a record of $290 billion, the Federal debt had quadrupled during the preceding twelve years and both the deficit and debt were projected to rise substantially. The President responded with a three-pronged economic strategy of fiscal discipline, equipping people for the future and open markets at home and abroad. This strategy contributed greatly to moving us from deficits to surpluses, and to what many consider to be the best economic conditions in recent memory—the longest peacetime economic expansion in our history, a very high rate of job creation, the lowest unemployment in decades, and real increases in income across all income strata. It seems to me that focusing on the economic conditions of recent years, and on the strategy that contributed so much to them, provides very useful guidance as we face policy issues going forward.

Let me also stress that tax burdens on working families are at record lows for recent decades. For a family of four with a median income, the federal income and payroll tax burden is at its lowest level in 21 years, in part because of the child tax credit enacted in the 1997 balanced budget plan. For a family of four with half the median income, the income and payroll tax burden is at its lowest level in 31 years, in part because of the 1993 expansion of the Earned Income Tax Credit for fifteen million families as well as the 1997 enactment of the child tax credit. And for a family of four with double the median income, the federal income tax burden is at its lowest level since 1973. While overall tax revenues have risen as a percentage of GDP, that is primarily because affluent individuals have had large increases in incomes, in part from bonuses based on high stock prices and increased realizations of capital gains, and in part because of increased corporate earnings.

Against that backdrop, the President's new budget proposes that in order to generate jobs, raise standards of living and promote retirement security most effectively, we must save the great preponderance of projected budget surpluses, not consume them for tax cuts and spending programs. Specifically, the budget proposes that 62 percent of the surpluses be allocated for Social Security, and 15 percent of the surpluses be allocated for Medicare. These resources will then be used predominantly to pay down publicly held debt of the federal government, and in part to purchase equities, both of which will in effect preserve and invest rather than consume and eliminate the increase in national savings that comes from the surplus. In addition, national savings is increased by allocating 12 percent of the surpluses for creating new Universal Savings Accounts. Finally, the budget insists that none of the surpluses be used at all until we have put Social Security on sound financial footing for the long-term.

Let me focus on debt reduction for a moment. When President Clinton was elected, publicly held debt equaled 50 percent of GDP. Under the President's plan, 80 percent of the surpluses allocated to Social Security and all of the surpluses allocated to Medicare will reduce debt held by the public. As a result, by 2014, publicly held debt will decline to about 7 percent of GDP. This reduction in debt will have three effects. First, the government will not have to refinance federal debt and thereby will consume less of national savings, thus making capital more readily available to the private sector. That, in turn, will reduce interest rates and increase confidence in the economy, increasing economic growth, job creation and standards of living. Second, debt service costs will decline dramatically. When the President came into office debt service costs of the federal government in 2014 were projected to constitute 27 percent of the federal budget. Under the President's proposal, and because of the progress we have made to date, we estimate the debt service costs will be 2 percent of the federal budget in 2014. Third, the decrease in debt means the federal government will have a greatly improved capacity to access external capital should the need arise.

In addition to reducing publicly held debt, the President's budget strengthens Social Security and Medicare. With regard to Social Security, the President has proposed two measures that—taken together—will extend the life of the Trust Fund to 2055. The first measure is the purchase of Treasury "special" non-marketable securities, which are in effect a first claim against the general revenues of the federal government to meet the already existing Social Security commitments. The second proposal is, that of the 62 percent of the surpluses that will be transferred to the Social Security Trust Fund, about one fifth would be invested in private-sector equities.

I have had concerns about investment in equities by the Trust Fund. Let me make two observations about this particular proposal. First, it would result in roughly 15 percent of the Trust Fund being invested in equities. Given that equities do have risks, that seems to me to be a prudent balance between receiving the potentially greater return from equities and keeping the investment small enough so that the Trust Fund is not exposed to danger. Second, we are proposing to have two levels of protection to make sure that there is no political influence in the investment process. Money managers would be from the private sector and there would be no investment function performed by government officials. A mechanism would be devised in concert with Congress to provide apolitical oversight and apolitical selection of these managers.

In addition, the President is also proposing that a bipartisan process be created to recommend the "tough choices" necessary to extend the life of the Trust Fund beyond 2055 to 2075. However, within the framework of these "tough choices," the President is committed to reducing the high rate of poverty for elderly widows—and to eliminating the earnings test for working seniors.

With regard to Medicare, we extend the life of the Trust Fund to 2020 by purchasing Treasury "special" non-marketable securities, as under current law. In addition, the President proposes that a bipartisan process be used to enact reforms, but only after the Medicare Commission submits its report in March, and that coverage of the cost of prescription drugs should be part of any package recommended by this bipartisan process.

Now let me focus on our proposal for the new Universal Savings Accounts. These accounts would receive 12 percent of the surplus, be separate from Social Security, and would provide incentives for workers to save for retirement. The government would provide a refundable tax credit of an equal amount for each account and also a match for each addition dollar voluntarily saved, with larger matches going to low income workers. The exact details of the program would be worked out by the Administration and Congress.

Finally, the remaining eleven percent of the surpluses would not be saved, but would be allocated for defense spending to protect our national security and for critical domestic discretionary investment priorities. This eleven percent supplements other discretionary expenditures in the budget that are within the limits imposed by the discretionary spending caps.

Let me now highlight some of the key investments and priorities in the discretionary and mandatory sides of the President's budget. Leaving aside measures in the budget that are paid for out of the surplus after Social Security has been addressed, all new tax cuts and mandatory spending are fully paid for and the budget complies with the discretionary caps.

In his State of the Union Address, the President made clear that our key investments for the future and our critical priorities were concerned with providing important programs and tax credits for education, working families, communities, and fostering a strong economy and a strong America in the world. Within these broad areas, I would like to focus on just a few specific initiatives.

First, for education, the budget proposes to help states and school districts build and renovate schools through $3.75 billion of tax credits over five years. The budget also proposes to extend and expand the tax deduction for employer-provided educational assistance.

Second, for working families, the budget proposes a long-term care initiative that includes a new $1,000 tax credit to help compensate families for the cost of caring for an ailing relative. The budget also includes a new $1,000 tax credit to assist workers with disabilities. And the budget helps with child care costs in three ways: through greater tax relief for working families and for those parents who stay at home, through subsidies to help families pay for child care, and through dramatic increases in funding for after-school programs.

Third, for communities, the budget provides for a "New Markets Investments Initiative" that could spur $15 billion in new capital investment in businesses in underserved inner cities and rural areas through tax credits and loan guarantees. It also includes an increase in the low-income housing tax credit. Finally, the budget calls for a new 21st century policing initiative that would help communities add between 30,000 and 50,000 more law enforcement officers, give law enforcement officials access to the latest crime-fighting technologies, make the Brady law permanent, and permanently ban violent juveniles from buying guns.

Fourth, to help foster a strong economy, the budget proposes to facilitate "Y2K" amelioration activities through the Council on Year 2000 conversion and extend the Research and Experimentation tax credit.

Finally, the budget asks for resources to strengthen America's leadership in the world. The Congress contributed to global financial stability last year by providing the full amount of resources for the International Monetary Fund. I would like to strongly encourage the Congress to approve the request in this budget to meet all of our financial obligations to the United Nations. We are also asking for resources to promote trade with Africa.

Before I close, let me mention one other important element of this year's budget. Our budget contains several proposals aimed at curbing corporate tax shelters. Tax shelters not only erode the corporate tax base, they also breed disrespect for the tax system both by people who participate in the corporate tax shelter market and by others who perceive corporate tax shelter users as paying less than their fair share of tax. Our budget proposals address these issues by increasing disincentives for entering into abusive transactions and by attacking specific corporate tax shelter transactions of which we are aware. The Treasury Department will continue to study additional remedies for the corporate tax shelter problem and to work with the members of Congress and their staffs to address this issue.

Mr. Chairman, restoring fiscal discipline to our country has contributed enormously to the strong economic conditions of the last six years. Because of what has been accomplished, we now have a unique opportunity to further our economic and social well-being for the years and decades ahead. The President has proposed that the surpluses be used predominantly to increase national savings and improve the fiscal condition of the federal government, while at the same time, strengthening Social Security and Medicare. The effect of all this should be to increase jobs, raise standards of living and improve the economic security of future retirees and workers. I look forward to working with the members of this Committee as we face these critical challenges. Thank you very much.

COMMUNICATIONS

STATEMENT OF THE NATIONAL STRUCTURED SETTLEMENTS TRADE ASSOCIATION

I. Background and Policy of the Structured Settlement Tax Rules

The National Structured Settlements Trade Association (NSSTA) is an organization composed of more than 500 members which negotiate and implement structured settlements of tort and worker's compensation claims involving persons with serious, long-term physical injuries. Structured settlements provide the injured victim with the financial security of an assured payout over time. Founded in 1986, NSSTA's mission is to advance the use of structured settlements as a means of resolving physical injury claims.

A. Background

- **Structured settlements in wide use today to resolve physical injury tort claims**

Structured settlements are used to compensate seriously-injured, often profoundly disabled, tort victims. A lump sum recovery used to be the standard in tort cases. All too often, this lump sum was prematurely dissipated by the victim or his or her relatives. When the money was gone, the victim was left still disabled and still unable to work. In such cases, responsibility to care for this disabled person fell to the State Medicaid system and public assistance system.

Structured settlements provide a better approach. A voluntary agreement is reached between the parties under which the injured victim receives damages in the form of a stream of periodic payments tailored to the future medical expenses and basic living needs of the victim and his or her family from a well-capitalized, financially-secure institution. This process may be overseen by a court, particularly in minor's cases. Often this payment stream is for the rest of the victim's life to make sure that future medical expenses and the family's basic living needs will be met, and that the victim will not outlive his or her compensation.

A recent study underscored the fact that structured settlements typically are used in the case of major physical injuries "when the loss payments are very large." ("Closed Claim Survey for Commercial General Liability: Survey Results, 1995", p. 19, prepared by ISO DATA, Inc., a nonprofit arm of the Insurance Service Office, Inc., which conducted the survey under the auspices of the National Association of Insurance Commissioners (NAIC), the national group of the State insurance regulators).

The study found that the average present value as reflected in the upfront annuity cost (not the total of future payments) of the structured portion of the settlement was $340,000. In terms of overall case size, it is important to keep in mind that the structured amount generally is accompanied by a significant upfront lump sum cash payment to pay off accumulated medical bills and to meet the injured victim's immediate cash needs (e.g., retrofitting the home for wheelchair access) and a second lump sum payment of a third or more of the present value of the total recovery for attorney's fees for the injured victim's lawyer. All of these amounts must be added together to determine the true overall case size. Accordingly, given the average upfront annuity cost of $340,000 for the structured portion of the settlement, in terms of overall case size the total upfront recovery once these upfront lump sums are taken into account is likely to be double or triple the annuity cost for the structured settlement portion.

- **Structured settlements provide crucial <u>financial protection to seriously-injured tort victims</u>**
  - Protection against premature dissipation by injured victims lacking the experience to manage the financial responsibilities and risks of investing a large lump sum to cover a substantial, ongoing stream of medical and basic living expenses for a lengthy period.
  - Payout tailored to the living and medical needs of the victim and his or her family.
  - Avoids shift of responsibility for care to the taxpayer-financed social safety net.
- **Congress has adopted special tax rules to <u>encourage and govern structured settlements</u>**

Congress has adopted a series of special rules in sections 130, 104, 461(h), and 72 of the Internal Revenue Code to govern the use of structured settlements by providing that the full amount of the periodic payments constitutes tax-free damages to the victim and that the liability to make the periodic payments to the victim may be assigned to a structured settlement assignment company that will use a financially-secure annuity to fund the damage payments.

In the Taxpayer Relief Act of 1997, in a provision co-sponsored by a majority of the House Ways and Means Committee, Congress recently extended the structured settlement tax rules to the worker's compensation area to cover physical injuries suffered in the workplace.

B. Structured Settlement Tax Rules Were Adopted by Congress to <u>Protect Victims from Pressure to Squander Their Recoveries</u>

In introducing the 1981 legislation that originally enacted the structured settlement tax rules, Sen. Max Baucus (D-Mont.) pointed to the concern over squandering of a lump sum recovery by injured tort victims or their families:

> "In the past, these awards have typically been paid by defendants to successful plaintiffs in the form of a single payment settlement. This approach has proven unsatisfactory, however, in many cases because it assumes that injured parties will wisely manage large sums of money so as to provide for their lifetime needs. In fact, many of these successful litigants, particularly minors, have dissipated their awards in a few years and are then without means of support."
>
> [*Congressional Record* (daily ed.) 12/10/81, at S15005.]

By contrast, Sen. Baucus noted: "Periodic payments settlements, on the other hand, provide plaintiffs with a steady income over a long period of time and insulate them from pressures to squander their awards." (*Id.*)

In introducing legislation last year to protect structured settlements and injured victims from the practice of factoring, Sen. Baucus reiterated this original legislative intent:

> "Thus, our focus in enacting these tax rules in sections 104(a)(2) and 130 of the Internal Revenue Code was to encourage and govern the use of structured settlements in order to provide long-term financial security to seriously injured victims and their families and to insulate them from pressures to squander their awards."
>
> [*Congressional Record* (daily ed.) 10/5/98, at S11499.]

Therefore, the federal tax rules adopted by Congress to govern structured settlements reflect a policy of insulating injured victims and their families from pressures to squander their awards.

In addition, Congress was concerned that the injured victim not have the ability to exercise such control over the periodic payments that he or she would be deemed to have received a lump sum recovery that was then invested on his or her behalf, destroying the fully tax-free nature of the periodic payments to the injured victim. The House Ways and Means and Senate Finance Committee Reports adopting the structured settlement tax rules both state: "Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments." (H.R. Rep. No. 97-832, 97th Cong., 2d Sess. (1982), 4; Sen. Rep. No. 97-646, 97th Cong., 2d Sess. (1982), 4.)

Reflecting this Congressional policy of protecting injured victims from pressure to squander their recoveries and the need to avoid any risk of constructive receipt of a lump sum by the victim, the structured settlement tax rules prohibit the victim from being able to accelerate, defer, increase, or decrease the periodic payments. (I.R.C. § 130(c)(2)(B)). In addition, the periodic payments must constitute tax-free damages in the hands of the recipient. (I.R.C. § 130(c)(2)(D)).

In compliance with these Congressional requirements and consistent with State insurance and exemption statutes, including "spendthrift" statutes that restrict alienation of rights to payments under annuities and under various types of claims (*e.g.*, worker's compensation and wrongful death claims), structured settlement agreements customarily provide that the periodic payments to be rendered to the injured victim may not be accelerated, deferred, increased or decreased, anticipated, sold, assigned, pledged, or encumbered by the victim.

As the Treasury Department has noted, "Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, [structured settlement] agreements with injured persons uniformly contain anti-assignment clauses." (U.S. Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (Feb. 1999), at p. 192).

Sen. John Chafee (R-R.I.), in introducing along with Sen. Baucus recent legislation to protect structured settlements and injured victims from the practice of factoring observed: "Structured settlement payments are nonassignable. This is consistent with worker's compensation payments and various types of Federal disability payments which also are nonassignable under applicable law. In each case, this is done to preserve the injured person's long-term financial security." (*Congressional Record* (daily ed.), 10/2/98, at S11340).

II. Purchases of Future Structured Settlement Payments by Factoring Companies Directly Undermine the Important Public Policies Served by Structured Settlements

A. Background

Over the past two years, there has been dramatic growth in a transaction, variously known as a "factoring", "factoring company", or "gray market" transaction, that effectively takes the structure out of structured settlements.

In such a factoring transaction, the injured victim who is receiving periodic payments of damages for physical injuries under a structured settlement sells his or her rights to future periodic payments to a factoring company. In exchange, the injured victim receives from the factoring company a sharply discounted lump sum payment.

This is a transaction that the injured victim enters into with a third party, completely outside of the structured settlement and generally without even the knowledge of the other parties to the structured settlement. The factoring company is not in the structured settlement business, and the structured settlement company is not in the factoring business.

In an effort to avoid the anti-assignment provisions in the structured settlement agreements, the factoring companies typically have the injured victim simply present the structured settlement company with a change of address to a post office box, or change of direct deposit to a bank account, under the control of the factoring company to accomplish the redirection of payments to the factoring company. Thus, the structured settlement company obligated to make the periodic payment damages under the structured settlement is not a party to the factoring transaction and often has no notice of it at all.

B. Rapid Growth in Factoring Company Purchases of Structured Settlement Payments

Factoring companies use extensive advertising and telemarketing, as well as direct appeals to plaintiffs' lawyers coupled with a finder's fee, to solicit new business. For example, one major factoring company, J.G. Wentworth, stated in a recent SEC filing that during the first 9 months of 1997 alone, it ran 56,000 television commercials. Wentworth runs a telemarketing call center with 200 telemarketing stations operating 24 hours a day, 6 days a week.

The factoring companies direct considerable advertising at the plaintiffs' bar, promising the injured victim's lawyer a second fee on the same case -- this time by unwinding the structured settlement. For example, an ad by Stone Street Capital., a factoring company, placed in a prominent trial lawyer publication, states:

> "You helped your clients once by winning them a structured settlement. Now you can help them again by showing them how to convert all or a portion of their settlement to a lump-sum payment.
>
> "For each of your clients who exercise this exciting new option, your firm will be compensated for legal fees by facilitating the standardized processing of an annuity purchase agreement. <u>On average, these fees amount to about $2,000 per conversion</u>. [Emphasis in original]."

The factoring company business is a rapidly growing one. J.G. Wentworth recently announced that it has undertaken approximately 7,700 structured settlement purchase transactions with a total value of $370 million. According to SEC filings, during the first 9 months of 1997 alone, J.G. Wentworth undertook 3,759 structured settlement purchase transactions. These purchased structured settlement payments had a total undiscounted maturity value of $163.6 million and were purchased for $74.4 million. Blocks of purchased structured settlement payments are now being "securitized" by the factoring companies and marketed on Wall Street.

C. Public Policy Concerns Created by Factoring Company Transactions

Factoring company purchases of structured settlement payments create serious problems affecting all participants in structured settlements and directly thwart the clear Congressional policy that underlies the structured settlement tax rules.

- **Factoring company purchases of structured settlement payments trigger the very same dissipation risks that structured settlements are designed to avoid**

All of the careful planning and long-term financial security for the injured victim and his or her family can be unraveled by a factoring company offering to buy future structured settlement payments for quick cash at a sharp discount.

Just as lump sum tort recoveries are frequently dissipated, all too often this lump sum from the factoring company can be quickly dissipated, and the injured person finds himself or herself in the very predicament which the structured settlement was intended to avoid.

Having factored away their only assured source of future financial support and then dissipating the cash received, these injured victims may face the prospect of public assistance to cover their future medical expenses and basic living needs.

As Sen. Baucus observed in introducing the legislation to address the problems raised by factoring:

"I speak today as the original Senate sponsor of the structured settlement tax rules that Congress enacted in 1982. I rise because of my very grave concern that the recent emergence of structured settlement factoring transactions -- in which factoring companies buy up the structured settlement payments from injured victims in return for a deeply-discounted lump sum -- completely undermines what Congress intended when we enacted these structured settlement tax rules."

[*Congressional Record*, (daily ed.), 10/5/98, at S11499]

Sen. Baucus then went on to say:

"As a long-time supporter of structured settlements and an architect of the Congressional policy embodied in the structured settlement tax rules, I cannot stand by as this structured settlement factoring problem continues to mushroom across the country, leaving injured victims without financial means for the future and forcing the injured victims onto the social safety net -- preciseely the result we were seeking to avoid when we enacted the structured settlement tax rules."

[*Id.*, at S11500.]

Sen. Chafee, lead Republican co-sponsor of the legislation, echoed Sen. Baucus's concerns: "These factoring company purchases directly contravene the intent and policy of Congress in enacting the special structured settlement tax rules." [*Congressional Record* (daily ed.) 10/2/98, at S11340.]

- **Factoring company purchases often are made at sharp discounts**

In many cases the injured victim's dissipation risks are magnified because the lump sum payment that the injured victim receives in the factoring transaction is so sharply discounted. While factoring transactions apparently reflect a range of discounts, it is not uncommon for an injured victim to receive a lump sum payment of less than 50 percent of the present value of the structured settlement payments being sold.

In one recent case, a 20-year-old structured settlement recipient who was receiving monthly payments from a tort action when she was a child was persuaded to sell a series of her future payments for approximately 36 percent of their discounted present value. A few months later, she was persuaded to sell additional future payments for approximately 15 percent of their discounted present value.

Based on this case and many similar examples, it is clear that in factoring company transactions structured settlement recipients often are persuaded to sell future payments for far less than the payments are worth.

- **Factoring company transactions create serious Federal income tax uncertainties for the original parties to the structured settlement**

The structured settlement tax rules require that the periodic payments constitute tax-free damages on account of personal physical injuries in the hands of the recipient of those payments. (I.R.C. §§ 130(c)(2)(D); 104(a)(2)). Following the factoring away by the injured victim, the periodic payments are received by the factoring company and its investors and do not constitute tax-free damages in their hands. This creates serious Federal income tax uncertainties under the structured settlement tax rules for both the victim and the company funding the structured settlement.

Injured victim

- The injured victim not only loses the benefit of the future tax-free damage payments, but also runs a risk of being taxed on the lump sum received from the factoring company if such payment is treated as received on account of the sale of the victim's future payment rights and not on account of the original injury.

- If the structured settlement payments were freely assignable by the injured victim and a ready market of financial institutions was available to acquire such payments, the victim might be deemed in constructive receipt of the present value of the future payments just as if the payments could be accelerated. In that case, from the outset of the settlement a portion of each periodic payment would be treated as taxable earnings, rather than tax-free damages.

Company funding the structured settlement

Under the structured settlement tax rules, the settling defendant (or its liability insurer) assigns its periodic payment liability to a structured settlement company in exchange for a payment which is excluded from the structured settlement company's income if the structured settlement tax rules under I.R.C. § 130 are satisfied and such payment is reinvested in either an annuity or U.S. Treasury obligations precisely matched in amount and timing to the periodic payment obligation to the injured victim. The structured settlement company's income from the payments under the annuity or Treasuries is matched by an offsetting deduction for the damage payment to the victim.

- The factoring transaction raises the concern that the structured settlement tax rules no longer may be satisfied and the risk that the structured settlement company may be required to recognize and pay tax on amounts previously excluded from its income or to pay tax on the "inside build-up" under the annuity, for which there is no cash distribution to pay the tax. This is a tax risk that the structured settlement company had sought to avoid through use of the anti-assignment provisions in the structured settlement agreement and is not in a position to absorb.

- The structured settlement company may face an obligation to report the payments made to the factoring company as taxable income even though in many cases the identity of the purchaser or even the existence of the factoring transaction itself is unknown.

- **Factoring company transactions create risks of double liability for the structured settlement companies**

While factoring transactions normally involve only the injured victim and the factoring company, the underlying structured settlements typically involve multiple parties such as family members, defendants, liability insurers, and state workers' compensation authorities in workers' compensation cases. Because structured settlement agreements prohibit transfers of payments, if the structured settlement company makes the payments -- even unwittingly -- to the factoring company, the structured settlement company may become subject to later claims that it paid the wrong party and could still be required to make the payments as originally required under the settlement. This has happened in several recent cases.

In many cases this risk of double liability is magnified by state statutes that (i) in more than 20 states give statutory effect to contract provisions prohibiting transfers of annuity benefits and (ii) in nearly all States directly restrict or prohibit transfers of recoveries in various types of cases (*e.g.*, workers' compensation, wrongful death, medical malpractice).

- **The uncertainties created by factoring company transactions may discourage future use of structured settlements**

These tax risks and double liability risks raised by the factoring transaction are risks that the structured settlement company specifically sought to avoid through the anti-assignment provisions in the structured settlement agreement and is not in a financial position to absorb, years after the original structured settlement transaction was entered into.

These uncertainties and unforeseen risks could jeopardize the continued ability of structured settlement companies to fund settlements in the future. The structured settlement company's participation is necessary to enable structured settlements to be undertaken in the first instance by satisfying the objectives of both sides to the claim: the injured victim needs the long-term financial protection that the structured settlement company's funding arrangement provides, and the settling defendant wishes to close its books on the liability rather than bearing an ongoing payment obligation decades into the future.

III. A Stringent Penalty Tax Should Be Imposed on Factoring Company Purchasers, Subject to a Limited Exception for Genuine, Court-Approved Hardship, Protects Structured Settlements, the Injured Recipients, and the Underlying Congressional Policy

A. Gravity of Problem Requires Strong Action by Congress

In acting to address the concerns over factoring companies that purchase structured settlement payments from injured victims the Treasury Department noted that: "Congress enacted favorable tax rules intended to encourage the use of structured settlements -- and conditioned such tax treatment on the injured person's inability to accelerate, defer, increase or decrease the periodic payments -- because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance." (U.S. Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (Feb. 1999), p. 192).

Treasury then observed that by enticing injured victims to sell off their future structured settlement payments in exchange for a heavily discounted lump sum that may then be dissipated: "These 'factoring' transactions directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims." (*Id.*, at p. 192 [emphasis added].)

The Joint Tax Committee's analysis of the issue last year echoes these concerns: "Transfer of the payment stream under a structured settlement arrangement arguably subverts the purpose of the Code to promote structured settlements for injured persons. (Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal* (JCS-4-98), (February 24, 1998), p. 223).

While noting that the States traditionally have been the province of consumer protection, the Joint Committee's analysis reasons that there is a clear role for the Federal tax law to address the policy concerns raised by sales of structured settlement payments: "On the other hand, the tax law already provides an incentive for structured settlement arrangements, and if practices have evolved that are inconsistent with its purpose, addressing them should be viewed as proper." (Joint Committee *Description*, *supra*, at p. 223).

As Sen. Chafee observed last year in introducing legislation to address the structured settlement factoring problem by means of a penalty tax on the factoring company: "It is appropriate to address this problem through the federal tax system because these purchases directly contravene the Congressional policy reflected in the structured settlement tax rules and jeopardize the long-term financial security that Congress intended to provide for the injured victim. The problem is nationwide, and it is growing rapidly." (*Congressional Record* (daily ed.), 10/2/98, at S11340).

There is broad bipartisan support among Members of the Finance Committee, the House Ways and Means Committee, and from Treasury for addressing the structured settlement factoring problem by means of a stringent penalty on the factoring company to discourage the transaction, except in cases of genuine, court-approved hardship of the injured victim.

B. Treasury Proposal

The Treasury Department in the Administration's FY 2000 Budget has proposed a 40-percent excise tax on factoring companies that purchase structured settlement payments from injured victims.

Under the Treasury proposal, "any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 40 percent excise tax on the difference between the amount paid by the purchaser to the injured person and the undiscounted value of the purchased income stream, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original recipient render such a transaction desirable." (*Treasury General Explanation* (Feb. 1999), at p. 192). The proposal would apply to transfers of structured settlement payments made after date of enactment.

The Treasury proposal represents a strong and appropriate response to the structured settlement factoring problem.

C. **Bipartisan Congressional Proposal**

1. **Stringent penalty on factoring company that purchases structured settlement payments from injured victims**

Reps. Clay Shaw (R-Fl.) and Pete Stark (D-Ca.), two senior Members of the House Ways and Means Committee, have introduced H.R. 263 (the "Structured Settlement Protection Act") which adopts a similar approach by imposing a 50 percent excise tax on the difference between the amount paid by the purchaser to the injured victim and the undiscounted value of the purchased payment stream. H.R. 263 is co-sponsored by a broad bipartisan group of more than a dozen Members of the Ways and Means Committee.

Sens. John Chafee (R-R.I.) and Max Baucus (D-Mt.) introduced companion legislation last year with similar broad bipartisan support among Finance Committee Members.

As Sen. Baucus noted, the excise tax approach is a penalty, not a tax increase or a new tax: "I would stress that this is a penalty, not a tax increase -- the factoring company only pays the penalty if it undertakes the transaction that Congress is seeking to discourage because the transaction thwarts a clear Congressional policy." (*Congressional Record* (daily ed.), 10/5/98, at S11500).

2. **Exception for limited cases of genuine, court-approved hardship**

This stringent excise tax would be coupled with a limited exception for genuine, court-approved financial hardship situations. The excise tax would apply to factoring companies in all structured settlement purchase transactions except in the case of a transaction that is pursuant to a court order finding that "the extraordinary, imminent, and unanticipated needs of the structured settlement recipient or his or her dependents render such a transaction appropriate and a further finding that the proposed transfer is not expected to subject the structured settlement recipient or his or her dependents to undue financial hardship in the future."

This exception is intended to apply only to a limited number of cases in which a genuinely "extraordinary, imminent, and unanticipated" hardship actually has arisen (*e.g.*, serious medical emergency for a family member) has been demonstrated to the satisfaction of a court, as well as a showing that transferring away such payments will not leave the injured victim and his or her family exposed to undue financial hardship in the future when the structured settlement payments no longer are available.

3. Need to protect the tax treatment of the original structured settlement

In the limited instances of extraordinary and unanticipated hardship determined by court order to warrant relief, adverse tax consequences should not be visited upon the claimant or the other parties to the original structured settlement. Accordingly, the bipartisan Congressional proposal would clarify in the statute or the legislative history that in those limited instances in which the extraordinary, imminent, and unanticipated hardship standard is found to be met by a court, the original tax treatment of the structured settlement under I.R.C. §§ 104, 130, 72, and 461(h) would be left undisturbed.

That is, the periodic payments already received by the claimant prior to any factoring transaction would remain tax-free damages under Code section 104. The assignee's exclusion of income under Code section 130 arising from satisfaction of all of the section 130 qualified assignment rules at the time the structured settlement was entered into years earlier would not be challenged. Similarly, the settling defendant's deduction under Code section 461(h) of the amount paid to the assignee to assume the liability would not be challenged. Finally, the status under Code section 72 of the annuity being used to fund the periodic payments would remain undisturbed.

Despite the anti-assignment provisions included in the structured settlement agreements and the applicability of a stringent excise tax on the factoring company, there may be a limited number of non-hardship factoring transactions that still go forward. If the structured settlement tax rules under I.R.C. §§ 130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the original tax treatment of the other parties to the settlement -- i.e., the settling defendant and the Code section 130 assignee -- should not be jeopardized by a third party transaction that occurs years later and likely unbeknownst to these other parties to the original settlement.

Accordingly, the bipartisan Congressional proposal also would clarify in the case of a non-hardship factoring transaction, that if the structured settlement tax rules under I.R.C. §§ 130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the section 130 exclusion of the assignee, the section 461(h) deduction of the settling defendant, and the Code section 72 status of the annuity being used to fund the periodic payments would remain undisturbed.

Finally, the bipartisan Congressional proposal would clarify the tax reporting obligations of the annuity issuer and section 130 assignee in the event of a factoring transaction. In the case of a factoring transaction, either on a court-approved hardship basis or a non-hardship basis, of which the annuity issuer has actual notice and knowledge, assuming that a tax reporting obligation otherwise would be applicable, the annuity issuer would be obligated to file an information report with the I.R.S. noting the fact of the transfer, the identity of the original payee, and the identity where known of the new recipient of the factored payments. No reporting obligation would exist where the annuity issuer (or section 130 assignee) had no knowledge of the factoring transaction.

Conclusion

The imposition on factoring companies of a stringent penalty tax on the amount of the discount reflected in the purchase of structured settlement payments, subject to a limited exception for "extraordinary, imminent, and unanticipated" hardship, fully protects structured settlements, the injured victims, and the Congressional policy underlying structured settlements.

The bipartisan Congressional proposal should be enacted as part of any tax legislation considered by Congress this year.

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