

**REVENUE PROPOSALS IN THE PRESIDENT'S
FISCAL YEAR 2006 BUDGET**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED NINTH CONGRESS
FIRST SESSION

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FEBRUARY 8, 2005
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CONTENTS

OPENING STATEMENTS

	Page
Grassley, Hon. Charles E., a U.S. Senator from Iowa, chairman, Committee on Finance	1
Baucus, Hon. Max, a U.S. Senator from Montana	2

ADMINISTRATION WITNESS

Snow, Hon. John, Secretary, U.S. Department of the Treasury, Washington, DC	5
---	---

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:	
Opening statement	2
Grassley, Hon. Charles E.:	
Opening statement	1
Snow, Hon. John:	
Testimony	5
Prepared statement	41
Responses to questions from:	
Senator Baucus	43
Senator Rockefeller	63
Senator Santorum	70
Senator Schumer	72
Senator Smith	72
Senator Wyden	75

COMMUNICATION

Investment Company Institute	77
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REVENUE PROPOSALS IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET

TUESDAY, FEBRUARY 8, 2005

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

The hearing was convened, pursuant to notice, at 2:25 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Lott, Snowe, Kyl, Thomas, Smith, Crapo, Baucus, Rockefeller, Jeffords, Bingaman, Lincoln, Wyden, and Schumer.

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

The CHAIRMAN. Thanks, everybody, for being patient. This is always the day that we have our Republican and Democrat caucuses and luncheon, so we are always a little bit late getting back from those. I thank everybody for being patient, as I said before.

Today we are going to hear testimony on the revenue proposals of President Bush's fifth budget. That budget covers, as you know, the 2006 fiscal year. We have one witness today, and it is Hon. Treasury Secretary John Snow. We welcome you back before the Finance Committee, Secretary Snow.

Mr. Secretary, Senator Baucus, and members of this committee, we find ourselves with a very ambitious agenda that the President has laid out for the country and before Congress last week in his State of the Union address.

President Bush wants to tackle Social Security problems and tax reform, among a lot of other things on that agenda. But he also puts our fiscal house in order by cutting the deficit in half over 5 years.

The American people reelected President Bush and sent him large majorities in the House and Senate. That should tell members on both sides of the aisle that the American people expect us to take the President's agenda and challenges very seriously.

But the American people also returned a significant Democratic minority to this same Congress. Although Republicans may be in the majority in the House and Senate, and we are, we are not in a position to force through the President's budget without bipartisan support. As everyone here knows, that is not the way I do business anyway, particularly in this committee.

The Finance Committee is the focal point for much of the President's agenda, so I and my fellow committee members hold the key

to that agenda, at the very least on the Senate side, and perhaps on Capitol Hill altogether.

This committee has a strong history of bipartisan problem solving. I believe, despite the strident statements of the last week, we will rise to that challenge again. If not, those who play simple political games will be held accountable, whether they are Republicans or Democrats.

There is a price to be paid for not tackling issues in a constructive manner. Both sides have learned lessons over the years. The only thing is, sometimes those lessons are forgotten.

The subject matter of this hearing is the revenue proposals in the President's fiscal year 2006 budget. The President laid out many of the details of his Social Security reform proposal last week without presenting a specific proposal to the Congress. Neither proposal is in this budget, but I expect that Secretary Snow will engage us on these issues.

Now, as I see it, Mr. Secretary, we have the two, big long-term reforms involving Social Security and tax reform. We also should try to rationalize the tax system. Widely applicable provisions from the 2001 and 2000 tax relief packages expire at different times.

America's workers, our investors, our business folks, ought to be able to count on a rational and very predictable Tax Code. That is the way you get investment, that is the way you create jobs.

That is why we need to extend or make permanent the bipartisan tax relief from the last 4 years. In addition to the two big issues and Tax Code rationalization, we have a lot of time-sensitive tax legislative business before us because we have several Tax Code provisions expiring at the end of the year. If you add those provisions up, they cost well in excess of \$50 billion just for a 1-year extension.

Finally, in the context of tax reform, good tax policy, and deficit reduction, I would encourage you, Mr. Secretary, to take a look at the Joint Tax Committee's report on the tax gap.

I look forward to Secretary Snow's presentation, and now I will call on my friend, Senator Baucus, the leader of the Democratic members of this committee.

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

Senator BAUCUS. Thank you, Mr. Chairman. I very much appreciate your holding this hearing.

Our witness today, just to remind ourselves, is the Nation's spokesman on fiscal policy, and also the managing trustee of the Social Security system, Treasury Secretary John Snow.

Nearly 70 years ago on January 15, 1935, another Treasury Secretary, Henry Morgenthau, joined with four other officials to submit a report to Congress about America before Social Security.

Here is what he said. He said that "at least one-third of all our people, upon reaching old age, are dependent upon others for support." Continuing, he said, "There is insecurity at every stage of life."

He went on to say that "children, friends and relatives have borne, and still carry, the major cost of supporting the aged. This

burden has become unbearable,” he said, “for many of our children.”

They responded back then to that challenge with the system that we call Social Security. They also concluded: “The measures we suggest should result, in the long run, in a material reduction in the cost to society of destitution and dependency, and we believe will immediately be helpful in allaying those fears which open the door to unsound proposals.”

In the nearly 70 years since, Social Security has freed generation after generation of seniors from that destitution and dependency. Social Security has freed generation after generation of children from the burden—sometimes the unbearable burden—of supporting the aged.

But now, 70 years later, some, once again, fan the fears which open the door to unsound proposals. The budget that the President submitted yesterday does not include his Social Security privatization proposal, even though it is the most sweeping budgetary proposal of his presidency.

That is unfortunate. We need to examine his privatization proposal in the context of the entire budget. Even by the standards of an administration that has omitted voluntary wars and necessary changes to the Alternative Minimum Tax, this is a huge omission.

The President announced part of his privatization proposal in the State of the Union address. He presented a plan to divert revenues from the Social Security trust fund into private savings accounts.

The White House announced that the President also proposes to lower each retiree’s Social Security benefits by a large proportion of the value of the retiree’s account at the time of retirement, but the White House has acknowledged that these changes do not extend the solvency of Social Security.

That is because the President and the White House have left out the rest of their proposal. They have left out the recommendation for benefit cuts that would extend the solvency of the system. They, therefore, left out the hard part.

The President has fanned the fears of America’s younger workers and has argued that we need to do something immediately to eliminate the long-term insolvency of the Social Security system. But what he has announced so far does not get us one dime closer to solving the problem. What he has proposed thus far would actually make the problem worse.

In his speech accepting the 2000 Presidential nomination, President Bush promised leadership to fix Social Security. Four and a half years later, he has still not provided that leadership. He has not told us what benefit cuts he recommends to do.

So I will ask, Secretary Snow, when will the President propose how to extend the solvency of the Social Security system? I want the President to know one thing: if he will not recommend how to extend Social Security solvency, Congress will not do it for him. He is the President. It is his job to lead. It is his idea, his agenda. We need to see his proposal.

The President laid out part of his privatization plan in the State of the Union message. In that message, he proposed to allow workers to divert up to 4 percentage points of their Social Security payroll taxes into private savings accounts.

Away from the lights and all the press, the White House staff later explained that under the President's privatization plan, at the time of retirement, workers would lose some of their Social Security benefits compared with what the law now promises.

They would lose an amount equal to all of the contributions to the worker's private account. They would also lose that interest that would have been earned had these contributions earned a 3 percent return above inflation.

Retirees would get to keep the private account, but for workers with typical investment portfolios, the Social Security checks would lose an amount equal to 70 percent of the value of their private account. That is the functional equivalent of a 70 percent tax on those accounts.

Now, what is the effect of all of this on Social Security's finances? These changes worsen Social Security's finances. That is right, they worsen them. The privatization part of the President's plan, even with its associated reductions to Social Security benefits, makes Social Security's finances worse.

Why? Because the plan would divert Social Security payroll taxes into the private accounts while the individual was working, but the worker would not pay the money back to the trust fund until the worker retired. There would be a lag paying the trust fund back, and, as a result, Social Security's finances would be worse off.

Well, the President said we have a crisis in 2018 under the current law, because in that year Social Security's out-go will begin to exceed its income. But if we adopt the President's privatization plan, what the President calls a crisis would come 6 years earlier, in 2012. That does not sound like a very good plan to me.

The President tells us, in what is an overstatement, that Social Security will go bankrupt in 2042. But if we adopt the President's privatization plan, the trust fund will exhaust 11 years earlier, in 2031. That, too, does not sound like such a good plan.

Over 75 years, the actuaries say, Social Security is out of actuarial balance by 1.89 percent of the Nation's payroll. But if we adopt the President's privatization plan, the system will be out of balance by an additional 0.6 percentage points, rising to about, if you total them up, about 2.5 percentage points, and that does not sound like a very good plan.

What about Federal debt held by the public? If we adopt the President's privatization plan, it would increase debt held by the public no matter what year you look at. Over the first 10 years that the plan would be in effect, it would add \$1.3 trillion to the debt held by the public. Over the first 20 years, it would increase debt held by the public by \$4.5 trillion. That is 14 percent of the economy.

By the end of 75 years, his plan would increase debt held by the public by an amount equal to 30 percent of the economy, resulting in a dollar amount so large that nobody has yet come up with a calculation.

The President proposes his privatization plan in the context of the budget that in itself would lead to massive amounts of new debt. The President claims that he is cutting the deficit in half in 5 years. It does not look that way.

To get there, the President simply leaves out of his budget a lot of things that cost money. He leaves out the cost of wars in Iraq and Afghanistan, the cost of reforming the Alternative Minimum Tax, the cost of realistic growth assumptions for the non-defense appropriations for the government, and, of course, Social Security.

Basically, Mr. Chairman, we have got a budget deficit that is going to be very huge. It is a proposal which, frankly, is not very candid with the American public. There is a lot of PR, but not a lot of candor. I hope that, after we get a closer look at it, we can find some way to make some sense out of all this and get something passed that makes real sense.

I might also add that the budget proposal proposes about \$1.35 trillion in new tax cuts over 10 years without paying for them, and the budget is also very weak in closing the tax gap. It is about \$311 billion.

I know there is a \$500 million annual increase for 2 years. That is a pittance compared with the size of the problem, and, frankly, under the budget proposal, they are robbing Peter to pay Paul, because they are getting that \$500 billion someplace else in IRS, which is not going to solve the problem either. So, I have concerns, quite clearly.

I thank you, Mr. Chairman, and thank you, Mr. Secretary. I look forward to getting to some of this, and hopefully get some real, honest answers and some real candor to advance the ball. I mean, this hearing should not be a charade. It should not be show-and-tell. This is a hearing to get the honest-to-goodness answers that the American people are looking for.

So I invite candor, Mr. Secretary. I ask you to be honest with us. I will be honest with you. I will tell you up front, we have things we have to do. I ask you to do the same thing, for the sake of good governance.

Thank you, Mr. Chairman.

The CHAIRMAN. Now, Mr. Secretary, it is your turn.

**STATEMENT OF HON. JOHN W. SNOW, SECRETARY,
U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC**

Secretary SNOW. Mr. Chairman, thank you very much. Ranking Member Baucus, thank you. Thank all the members. I appreciate the chance to be here today and engage in this discussion with you on the budget, on Social Security, and on the direction of the economy.

It will surprise none of you, I think, to know that I will take strong exception to many of the things, if not most of the things or all of the things, that Senator Baucus put forth, except his closing observation that we ought to try to find a way to work together. I completely and thoroughly agree with that.

I do disagree with his characterization, however, of the President's budget and the direction it is taking the country. Quite the contrary. The President's budget is transparent, it is open, and it points to the things that are most important to the country. One, sustaining our economic growth. We are on a much better economic growth path today than we were a year or 2 years ago when I appeared before you.

And Mr. Chairman, I want to thank you and the members of the panel for that, because it was your action, the Finance Committee action, that made possible the significant tax reductions that lie at the very heart of the much-improved performance we see in the American economy today.

You know the numbers. The growth rate is now 4.4 percent, the best growth we have seen in a sustained period for 20 years. The unemployment numbers have fallen to 5.2 percent. The jobs are coming back, and coming back strong. There have been 2.7 million jobs since the President's tax cuts took effect, since your actions in turning them into law.

Productivity is high, inflation is low. Home ownership is the highest in the history of the country. National wealth is the highest in the history of the country. All of that is a tribute to the action of the Congress, the Senate and the House, in moving forward with this historic tax reform legislation.

We want to make the tax cuts permanent, because making the tax cuts permanent helps to sustain the strong growth path of the American economy. At the same time, we recognize, as we have always recognized, as I have testified before you, Mr. Chairman, many times, that we need to address the deficit. It is too large. It is unwelcome.

It is understandable in light of the crash of the bubble, the bursting of the bubble and what that took out of the revenue, the receipts of the U.S. Government. It is understandable in light of the recession. It is understandable in light of 9/11 and the spending that was required to protect the homeland. It is understandable in light of soldiers in Iraq and Afghanistan.

It is understandable in light of all that we have gone through, including those wretched corporate scandals which so tested confidence in our equity markets. But now the deficit is beginning to come down.

Why? It is coming down because the receipts of the U.S. Government are rising as the economy gets stronger and as people go back to work and as businesses are more profitable. That is exactly what one would have foretold would be the consequences of the tax reductions.

We are on a path to cut the deficit in half over the next 5 years. This budget lays out that path. In addition, the President is calling, as you know from the State of the Union message, to deal with the longer-term deficits which become the real problem for the country in the period beyond this budget window: Medicare and Medicaid, rising costs there, taking a larger share of the GDP, and Social Security.

The President has teed up the issue of Social Security. He said, now is the time to deal with it. It is an urgent problem. The sooner we get to it, the better. He has tried to define the problem for the American people. He has traveled across the country. He will continue to do that. He has asked people like myself to do that.

Senator Moynihan, your former colleague, chaired a panel and opened the panel by saying to the panel members, "Some of you are Democrats and some of you are Republicans. Some of you are independents, some of you are liberals, some of you are conservatives, some of you are Libertarians. May I ask you to set aside"—and

this, Senator Baucus, I think goes to some of your points to me—“your political points of view for a minute until we get the facts, and after we get the facts let us put back on our political hats. But let us not do that until we have the facts.” The facts on Social Security tell only one story, and it is the story of a system that is not sustainable.

Senator Baucus, you talked about the noble purposes. I agree with you about the noble purposes of Social Security. The problem is, unless we act soon, we cannot secure those promises. We cannot maintain for younger generations the promise of Social Security.

The President’s initiative is to secure and make safe for future generations Social Security to avoid the dramatic reduction in benefits that will be faced in 2042 when the system is technically bankrupt.

Bankruptcy means you do not have revenue streams to meet your obligations. That is precisely what happens to Social Security in 2042. The deterioration is visible in 2018 when, for the first time, the in-flow to Social Security is exceeded by the outflow.

Every year thereafter, Social Security is running a deficit. The deficit will draw down the IOUs, the bonds, that Social Security holds and those bonds will be paid off by 2042. Then the system is technically bankrupt. It cannot meet its obligations.

That is why the President has called on the Congress to act. In addressing you at the State of the Union, he laid out a plan. He defined the problem and laid out a plan, a plan that called for use of personal accounts as a way to help offset the problems that younger generations will face, to give them a better retirement outlook than the one that would be available to them under Social Security, which contains promises that cannot be kept. That is the heart of the problem: its promises cannot be kept.

Senator Baucus, in the spirit of your opening comments, I would say I want to work with you. We want to work with you. We want to make sure that we are communicating, that all the options are on the table.

The President said, all the options are on the table except protecting the benefits of people who are 55 and older. That is not on the table, in his mind. And do not solve the problem by raising payroll taxes. That should not be on the table either, because that is the surest way to make sure that the American economy does not perform well.

Raising payroll taxes is a sure-fire formula for higher unemployment rates, for hurting the job engine of the United States. We do not want to do that, you do not want to do that, so payroll taxes should not be on the table.

The President did suggest there were a number of other options to be pursued, and I would be happy to try to elaborate further on what those options are.

But I want you to know that we meet you in a full spirit of cooperation here, meet you in a spirit of trying to find answers to what I think most people who have looked at the problem, whether it is the actuary of the Social Security system, GAO, the commission appointed by President Bush, or the commission appointed by President Clinton, have concluded is a genuine problem, one where

the sooner we act, the better the prospects for future generations. I thank you very much.

The CHAIRMAN. Thank *you* very much.

We will have 5-minute rounds of questioning.

First of all, a commentary on a small part of what Senator Baucus said. Whether it is President Clinton or President Bush, I think they both are now doing what a leader should do.

There is a misunderstanding about the problems that face Social Security. Whether it is President Clinton, what he started to do, or now President Bush just now starting to do, he has kind of got to be like a professor leading a seminar, discussing the issue of Social Security.

I think if the President can describe the problem and convince the American people that Congress ought to do something, I would be willing to take the responsibility of finding a solution.

I think I can, in a bipartisan way, regardless of the President putting forth a proposal. I do believe the President will put forth a proposal. I kind of wish he would not. I think it would make our job easier here in the Senate. But I think he will.

But I am not sure that we should sit back and wait here in the Congress because we are an equal branch of government. Suppose we had a President that never wanted to deal with Social Security, and you wait until you have a crisis in 2018, 13 years from now? Then we would not be doing our responsibility.

So, the idea of our government and checks and balances is that not all brains lie with whoever is President. We have a responsibility here to lead, and even fill in a vacuum, when the President does not.

So I am going to go to my first question, which is not about Social Security, but about the permanency of the Tax Code.

Since this hearing is about the revenue side of the budget, I would like to start off by looking into the trend lines on revenues. CBO reports that, in the year 2000, the Federal tax burden, as a percentage of GDP, Federal taxes took in 20.9 percent of GDP, a record post-World War II level.

The individual income taxes were at an even more dramatic level. CBO reported that that was 10.3 percent of GDP, just for the personal income tax.

CBO has also indicated that revenues hit a trough, at about 16.3 percent for 2004. CBO indicates that revenue trends are back upwards over the balance of the period for tax relief plans.

CBO says that, as a percentage of GDP, revenues will return to, or near, their historic average levels over the next few years. It is also clear that if the tax relief package is not made permanent, revenues will return to historically high levels. For instance, in 2015, Federal taxes would hit 19.6 percent of GDP.

Now we hear a lot of criticism from those who oppose the bipartisan plan. One of the main criticisms is that we cut income taxes too much. That is, the allegation is that the bipartisan tax relief plan gutted the Federal revenue base.

I would like to know if you agree with the critics. Is the only path to Federal fiscal discipline to maintain record levels of taxation as a percentage of the economy? Is it safe to say, as these

critics do, that there is no down side to future economic growth if the record levels of Federal taxation continue at a high level?

Secretary SNOW. Thank you, Mr. Chairman. That chart reflects, as well, what is in the budget of the United States, very similar trend lines.

Allowing the taxes as a percentage of GDP to get up above that 18 percent line and stay there for a long period of time is dangerous. Eighteen percent is the long-term sort of average. But when we get into the higher levels, I think we threaten the prosperity of the future.

I think you have demonstrated with the tax legislation that low marginal tax rates, lower tax rates on individuals, lower tax rates on capital through the dividends and the capital gains, create an environment in which the economy performs well. We see that now with the numbers I briefly mentioned.

One reason for the fact that the line is going up is the fact that the tax cuts took effect. Lower tax rates are consistent with rising government revenues. Government revenues are now rising as a fraction of GDP, and will continue to rise and will get back, by the end of this budget cycle, to the roughly 18 percent number, which is the historic average.

That is what we fully expect. As we continue to have the economy grow and prosper, more people working, business is more profitable, lo and behold, what happens?

Government receipts go up. We are seeing that right now.

One reason the deficit is narrowing is that government receipts are rising so nicely. I think they are estimated this year to go up about 9 to 10 percent.

The CHAIRMAN. As a follow-up, it appears that some of my colleagues are using the unusual circumstances to imply that 2004 establishes a long-term trend. That is, colleagues are arguing that we should not reduce taxes in the near term or long term because the Federal revenue base has been gutted.

In fact, according to the bipartisan CBO, 2004 was an unusual year and should not be used as a barometer for near-term or long-term trends of the Federal revenues. We have got a chart here, that same chart that shows that downturn in 2004.

According to CBO, you can see that 2004 was a very unusual year. The trend line is that revenues are headed back upwards. According to the CBO—and I am going to ask you to comment on this—the pattern comes from a combination of unusual factors.

One, we, on a bipartisan basis, put a stimulative tax policy together, like bonus depreciation, that really changes the timing of a tax benefit. Those measures, along with a lag in revenues from the recession, stock market bubble, and 9/11 all combined to drive down revenues for that year.

Secretary SNOW. Mr. Chairman, I agree with that assessment of CBO. It parallels our own assessment, the assessment of the Office of Tax Analysis at the Treasury, and the OMB. We were dealing with an unusual set of circumstances that took the annual receipts of the U.S. Government as a percentage of GDP to an unusually low level.

Now that the economy is coming back, more jobs, more profitability, we see that line turning and rising, as your chart demonstrates. That is a healthy and fully expected phenomenon.

The CHAIRMAN. Now, the next four people—I will not list everybody unless you ask me to right now—would be: Senator Baucus, Senator Thomas, Senator Rockefeller, and then Senator Bingaman.

Senator BAUCUS. Mr. Secretary, you said earlier that we should not begin our debate until, in your words, “we get the facts.” When will we get the facts of the President’s proposal?

Secretary SNOW. The President laid out, I thought commendably, the problem and the role of demographics. This is essentially a problem of demographics.

Senator BAUCUS. Are we going to get a proposal?

Secretary SNOW. Senator, you—

Senator BAUCUS. And when are we going to get it?

Secretary SNOW. Yes. Well, you got a proposal on the personal retirement accounts. A good part of the budget focuses on that. We have documents that deal with that that are part of the distribution from the administration. The President talked about the proposal in some detail. We have acknowledged that the personal accounts—

Senator BAUCUS. But are we going to get a proposal?

Secretary SNOW. Sure.

Senator BAUCUS. When are we going to get it? Next week? Next month? Can you give us a rough guess?

Because most everybody who is concerned about this issue wants to know the answer to that question, and you are here to give it to us.

Secretary SNOW. Well, we are also here to talk to you about the nature of the problem.

Senator BAUCUS. Well, I think we all know the nature of the problem. There is not anybody here who does not know the nature of the problem.

Secretary SNOW. Well, if we can stipulate to the nature of the problem, then we can turn to solutions.

Senator BAUCUS. We all know that there is a \$3.7 trillion shortfall in net present value over the next 75 years. We all know that. We all know about the year 2018, we know about the year 2042 or 2052. We all know all that. We discussed this ad nauseam.

You talk about a solution. Well, what is the solution? When are we going to get the President’s proposal?

Secretary SNOW. Senator, you have a well laid out proposal on a very important part of the Social Security issue.

Senator BAUCUS. If I might interrupt.

Secretary SNOW. That is the personal accounts.

Senator BAUCUS. My time is expiring. And you agree, do you not, because the White House has said it, that personal accounts do not in any way solve the solvency problem. In fact, they make it worse.

Secretary SNOW. I disagree with that, certainly.

Senator BAUCUS. It has to make it worse if, as I described, with the lag when benefits are paid out and when dollars are put in. Every estimate and every analyst in town says the nature of the problem caused by private accounts is about \$4.2 or \$4.3 trillion, paid for, in half, with benefit cuts.

That is, with the principal and interest, in effect, not going back to the account holder. That is how they get about \$2 trillion. The other \$2 trillion is borrowed. So does that not make Social Security worse?

Secretary SNOW. Senator, no. I would take exception to those numbers.

Senator BAUCUS. The White House has admitted that it does not solve the problem. It does not even begin to solve the problem, the White House says.

Secretary SNOW. Well, the White House has suggested, the President has suggested—I never know quite who the “White House” is.

Senator BAUCUS. Well, it is the background briefing by the White House staff after the President talked about this.

Secretary SNOW. And what the briefing will say, I am sure, is that any solution to Social Security has the personal account as an integral part of it. That is what the Moynihan Commission found. All three of the options that came out of the Moynihan Commission employed those personal accounts.

Senator BAUCUS. Let me see if you agree with this analysis. Right now I think we have established, everybody who studies this knows that personal accounts do not solve the problem by any stretch of the imagination. Everybody knows that.

Second, the only potential solutions are tax increases or benefit cuts. The President has taken tax increases off the table. That, by definition, means that the only way to solve Social Security is benefit cuts. Is that analysis correct?

Secretary SNOW. Well, as I have said, the personal accounts play an important part here.

Senator BAUCUS. They add to the solvency problems. They do not help it. The White House has said so.

Secretary SNOW. No, they do not add to the solvency problems.

Senator BAUCUS. Do you disagree with the White House?

Secretary SNOW. I disagree with the assertion that they add to the solvency problem.

Senator BAUCUS. You disagree with the White House that says they do not solve the problem.

Secretary SNOW. I disagree with the assertion I thought you made that they add to the solvency problem.

Senator BAUCUS. They do both.

Secretary SNOW. I do not think they add to the insolvency problem.

Senator BAUCUS. The White House has not admitted that yet, but they have admitted that it does not begin to address it.

Secretary SNOW. It is part of the solution. I would accept your characterization that it is not the full solution.

Senator BAUCUS. It is not any question. Chuck Blauhaus, a senior administration official, admitted so.

Secretary SNOW. The personal accounts are an important part of any long-term solution to the problem because they give people the ability to fill in their retirement with a higher rate of investing, earning a higher rate of return than they would otherwise get out of Social Security.

Senator BAUCUS. But is it true that, under the personal account proposal—strike that. Under the privatization proposal.

Secretary SNOW. You said it right, I thought.

Senator BAUCUS. Is it true that, in effect, the account holder, when he or she retires, has to return the principal plus interest on Treasury notes, so all the account holder gets back is net rate of return, if there is any positive, absent the principal and absent the Treasury interest rates in the form of an annuitization which is very much reduced because of the non-receipt by the account holder of the principal, and also because whatever rate of return he or she has is reduced by Treasury interest, 3 percent?

Secretary SNOW. Yes. If the account earns in excess of 3 percent and that far below the blended bond equity rate, the account holder will come out well ahead.

Senator BAUCUS. Is it true, though, that the principal has to be returned? The account holder cannot keep the principal.

Secretary SNOW. There is a reduction in the defined benefit—

Senator BAUCUS. The answer must be yes because you are not saying yes or no.

Secretary SNOW [continuing]. Equal to the amount put in. I just do not want to be misunderstood. There is a reduction in the defined benefit equal to the amount put into the personal accounts, so that they are equal amounts.

Senator BAUCUS. My time has expired, except to say that I have not heard you say when the President is going to submit a proposal to us, nor have I heard you say that he actually is going to submit a proposal to us.

Secretary SNOW. The President talked about three or four options in his address in the State of the Union. He also laid out in some detail the personal accounts and the role they play, as well as helping to define the overall problem and what is required to solve it.

So I think we have moved the ball a long way down the road. I think the President deserves credit for putting this issue on the table.

Senator BAUCUS. I agree. But he has put it on the table. It is time for him to come up with a solution, because he is the one that has raised this, not anybody else. My time has expired.

Secretary SNOW. He is inviting others to help.

Senator BAUCUS. I am sorry. My time has expired.

Senator Thomas?

Senator THOMAS. Thank you. Can I answer your question? I guess I am following just a little bit along. The priority here with the personal account, is that to assist in strengthening the program or is that to give more emphasis to individual responsibilities and opportunities to do something for themselves?

Secretary SNOW. I think its primary role, as you suggest, is to give individuals the chance to do better than they would do under Social Security alone. So, this augments the benefits they would receive and gives them a chance to have a better retirement than the one they would have if they depended entirely on Social Security. But it also is in furtherance of this important idea of ownership, of people taking charge of their own retirement.

Senator THOMAS. Well, I certainly particularly want to commend the administration's recommendation with regard to LSAs, RSAs, and ERSAs. I intend to introduce legislation that will put those

funds together and make more of an incentive for people to invest privately in their own, to assist.

I believe the original understanding is that Social Security is a supplement to retirement, generally, and that is what we are seeking to help accomplish, is it not?

Secretary SNOW. Exactly. Exactly. It was to make sure that people could retire with dignity and maintain at least a minimum standard of living in retirement.

Senator THOMAS. In terms of the budget, in broad terms, there are lots of details. Let me say that I think that the President has spelled out his plan pretty well, but fortunately has left some opportunities for us then to deal with the details. I think that was his plan, was it not?

Secretary SNOW. Exactly. Exactly, Senator. I think, Senator, you captured it entirely. The President said, I have a role to lead here, and he has led. He has taken the issue to the country. He has laid out some specifics on how it can be fixed and he has laid out specifics on the personal accounts, but he said, I do not have all the answers.

I am inviting members of Congress to work with me to find the answers and to fashion the legislation that will accomplish the objectives. He laid out the objectives: a permanent solution, no adverse effects on people 55 or older, and personal accounts so younger people have a chance to do better than they would otherwise do.

Senator THOMAS. With respect to the budget, which of course is very complicated, and so on, how would you imagine we would deal with the details? Will the President be more inclined to veto a change in the program that is not left as he suggested or will he be talking more about the total expenditure, with some room to adjust within the programs?

Secretary SNOW. Well, I think the President has laid out his best effort at how the budget could be constructed, just as he did last year. Congress came in with budget numbers for last year that were very much in line with the President's numbers, although the details were somewhat different.

I think the President is primarily interested in making sure we hit those deficit targets and stay on the path to cut the deficit in half over the course of the next 5 years.

Senator THOMAS. So the individual programs would not necessarily be the turning point in getting some agreement.

Secretary SNOW. As I say, I do not know what the specifics of the individual program are, but I think the President's overall objective here is to see that the deficit comes down in line with his budget proposals.

Senator THOMAS. We will all, of course, be very interested in those issues that pertain to our constituencies. For instance, it says something about more revenue from the abandoned mine reclamation. Do you happen to know what that is?

Secretary SNOW. No, I do not.

Senator THOMAS. That is a little detail. We are working on that in some other ways, so I was kind of interested in it.

That is all I have right now, Mr. Secretary. Thank you.

Secretary SNOW. Thank you, Senator.

Senator BAUCUS. Thank you, Senator.

Next, Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I want to make one comment, first. You said an interesting thing. Let us put the politics aside. I find this increasingly used by either side which wants to make a point.

They say, if you disagree you are being political. Would you not agree that if I genuinely have a policy disagreement as to what is good for the people I represent, the people of the United States, if I express that in very strong terms, it does not necessarily mean I am being political? It could actually be that I believe that it is a very bad policy. Is that not possible?

Secretary SNOW. Oh, absolutely, Senator.

Senator ROCKEFELLER. Well, then do not say, let us put the politics aside and let us get to the facts. We have put that aside. We are concluding what we think and we are trying to tell you.

Secretary SNOW. Senator, I was quoting one of the most eminent colleagues and distinguished people that the Senate has ever produced, Senator Moynihan. Senator Moynihan suggested that often to find resolutions to problems, it starts with getting agreement on the facts.

All I was suggesting was, we ought to focus first on the facts and make sure we have agreement on the facts. I was heartened by Senator Baucus' comment that we all agree on the facts. I do not think that is quite the case, but I was glad to hear that.

Senator ROCKEFELLER. If I could continue.

I do not share the administration's priorities and policies on some of these budget matters and on Social Security, for reasons which have nothing to do with politics and have everything to do with the nature of the people I represent, whom you know very well, and generally the people of the country whom you have come to know much better.

When I was a Governor, I could never go before the legislature—and of course West Virginia is a much more intimate situation—of my State and put forward a program which was really crucial to me without giving a really good explanation of it.

Then the budget digest which would follow, as it does here, on the following Monday would have to, in fact, fill in all the details or else I would be crucified, and should be crucified.

I think that is, partly, what some of us are concerned about here. Why is it that the President has taken, when the budget is in such a difficult situation, when the tax cuts are 1.3 plus \$350 billion, that that enters into it? That enters into it.

Now, you said, I want to come half way, we ought to come half way. I have something I will just throw out at you. If you make the tax cuts permanent, as the President proposes to do, that would be, I think, about \$1.1 trillion over the first decade and about \$11.6 trillion over 75 years.

Now, we have this gigantic problem called Social Security, which the President has framed in those terms. I would not necessarily agree with that, but let us just take his terms for the moment.

If you were to take one-third—one-third—of that \$11.6 trillion between now and then and use it, you could solve the Social Security problem through 2075, no wrinkles left behind.

Now, that would imply that maybe I would have to vote for the permanency factor. That is me coming towards you. I am not saying I am there yet, because you are not saying you are there yet.

But that is the simplest way I can think of, both of dramatizing the nature of the problem and creating a fail-safe, immediate solution to solve a problem which I, from a policy point of view, do not think needs to be solved immediately, particularly under this sort of heated atmosphere.

How do you react to that?

Secretary SNOW. Well, Senator, I would say, first of all, I think it does need to be solved because the sooner—

Senator ROCKEFELLER. No, no. To my proposal.

Secretary SNOW. To your proposal, which is to drop the call for permanence on the tax cuts?

Senator ROCKEFELLER. No, no. Just take one-third of that \$11.6 trillion, which would leave two-thirds made permanent.

Secretary SNOW. So you are proposing to make most of the President's tax cuts permanent in that proposal.

Senator ROCKEFELLER. Evidently. I mean, this is what I am throwing out at you.

Secretary SNOW. Well, I think there will be lots of discussions and lots of ways to approach this. My own counsel would be, the last way—

Senator ROCKEFELLER. You have got a good deal there. You should be accepting that.

Secretary SNOW. The last way to fix it, though, is with tax increases. I think—and I mean this sincerely—we have learned a lot about the advantages of a low tax environment to sustain prosperity in America.

Senator ROCKEFELLER. Well, now this will be our third big tax cut in 4 years. Right?

Secretary SNOW. Fourth, I think.

Senator ROCKEFELLER. All right. So, fourth. People like me have been doing very well. People that I represent have not been doing very well as a result of that, and that is why there is no AMT in the budget, there is no privatization transition cost in the budget, there is no funding for Iraq in the budget. The President pretty much has to put up an odd budget.

But I am just putting that out. I am trying to test your sincerity. I would do something which I would ordinarily be very uncomfortable doing or considering if you would consider my proposal, which is simply to solve it whole-cloth, one swipe.

Senator BAUCUS. Senator Bingaman?

Senator ROCKEFELLER. Oh.

Senator BAUCUS. Time is up.

Senator ROCKEFELLER. You were not going to give him a chance to say yes?

Senator BAUCUS. If he says yes, yes. [Laughter.]

Secretary SNOW. I said I am, Senator, disinclined to agree for the tax increases as a way to solve these problems, because I do not think our basic problem is that we, as a people, are under-taxed.

Senator ROCKEFELLER. It is not a tax increase because it is prospective. We have not done anything yet.

Secretary SNOW. But the effect would be to have future taxes higher than they are today.

Senator ROCKEFELLER. Two-way street. Your words.

The CHAIRMAN. Now, Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman. Secretary Snow, thank you for coming and speaking with us.

When I came to the Senate back in the reasonably early 1980s, the big concern around the Congress was the twin deficits, that is, the budget deficit and the trade deficit.

Secretary SNOW. Right.

Senator BINGAMAN. Of course, most of this discussion today has been on the budget deficits and the Social Security plan, and all that.

I wanted to ask just a few questions. Since your responsibility is broad, I would ask you about the trade deficit, if I could.

Here is a chart back here. I do not know how well you can see it.

Secretary SNOW. I will put my glasses on and look through Senator Jeffords, and I will see it.

Senator BINGAMAN. Maybe they can pull that up a little. The red line on that chart is the trade deficit, the real trade deficit. You can see, back in the 1980s, the first half of the chart, it went way up and everyone said that we had a crisis. It was 3 percent of Gross Domestic Product at that time, the trade deficit was.

Then the value of the dollar started dropping. There were a lot of discussions with our allies in various meetings in New York and all, and the value of the dollar started dropping and the trade deficit started coming back down and everybody heaved a sigh of relief.

In recent years, the trade deficit has been going up again. Now, instead of being 3 percent of Gross Domestic Product, the estimate is that it is about 7 percent, which is the highest anyone can remember. The dollar has started coming down relative to other currencies. That is that black line up there.

Relative to a basket of other currencies, the dollar has been dropping. While it has been dropping, the trade deficit continues to go up. That has been going on now for some period of time, a few years at least.

I wanted to know what your plan is. To my mind, the administration's budget gives me no confidence that you really have a credible plan to deal with the budget deficit. But, also, I am even as concerned that there seems to be no plan to deal with the trade deficit. Anything you could tell me to relieve my concern on that subject, I would be greatly appreciative of.

Secretary SNOW. Senator, the so-called current account deficit, reflected by that red line, is a function of a number of things. It is not a simple phenomenon to talk about. It reflects a whole variety of vortices that come together. But the three that we can talk about and identify clearly, we are working on.

One, is we are not exporting as much as we are importing because our growth rates are much higher than the growth rates of other countries around the world. Our very high growth rates mean we are creating more disposable income here in the United States

than our trading partners are. Some part of that greater disposable income we are creating is going to imports.

Senator BINGAMAN. Why does that not apply to China?

Their growth rate is 2, 3 times ours and they seem to have an enormous trade surplus with us and with the rest of the world.

Secretary SNOW. China is in a little different position because of the pegging of their currency. We are addressing the pegging of the currency hard with them, urging them to move to a flexible exchange rate. I think we are making some real progress there.

The third factor. What are the factors? Well, there are the differential growth rates among our trading partners and ourselves. There is the peg of the yuan. We are addressing that. We are addressing the differential growth rates.

And, finally, there is our savings rates. Here is where, Senator, I appreciate what you said on the RSAs and the LSAs. Getting higher savings rates in the United States will also help deal with this current account deficit.

Senator BINGAMAN. Well, the biggest problem with the savings rate, as I see it, is the Federal budget deficit. I mean, the Federal Government is the one that is refusing to save.

One issue I want to just ask about before the red light goes on there is the Alternative Minimum Tax. Last year when you came before this committee you gave us a budget document and it said in there, "the Treasury Department has been directed to study the AMT with the goal of producing a long-term solution." There was in last year's budget at least a proposal for a 1-year solution.

Secretary SNOW. Right.

Senator BINGAMAN. In this budget, there is not even a proposal for a 1-year solution, let alone a long-term. And this is a big item. I mean, this is a lot of money, which totally discredits your claim that you are going to cut the budget deficit in half.

Secretary SNOW. Senator, we are going to cut the budget deficit in half. The issue of the AMT will be dealt with in the context of cutting it in half. You may have seen, the President appointed a tax panel chaired by former Senator Connie Mack and former Senator John Breaux, and gave them the charge of looking at the Code and looking at all the options to come up with a Code that is simpler, fairer, and more growth-oriented.

One of the things I have talked to former Senators Mack and Breaux about is making sure the AMT is looked at in the context of broad-based tax reform, and they have agreed to do that.

Senator BINGAMAN. Thank you very much.

Senator BAUCUS. Thank you, Senator.

Next on the list is Senator Wyden.

Senator WYDEN. Thank you.

I, Mr. Secretary, wanted to ask about that AMT issue as well, because out there in the real world, this is what people are talking about. This is the killer tax for millions of middle class people. In effect, they have to pay their taxes twice, then pay a larger share of their income to the Federal Government.

The reason I am concerned is, because the administration's budget seems literally trillions of dollars off reality, the President's commission is not going to have the money in order to look at reforms like AMT.

Let me go through this math with you. The Congressional Budget Office is now estimating that the cost of AMT repeal would be \$600 billion over 10 years. I do not see how the administration comes up with the \$600 billion that CBO says it needs to solve the AMT problem, if you just take what the Vice President said on television last weekend.

The Vice President said on television last weekend, it is going to take trillions of dollars—not billions, trillions—to do Social Security privatization.

So how would we solve the AMT problem, if you look at what the Vice President says is going to be necessary for Social Security, and then you lose vast additional sums in terms of making the President's tax cuts permanent?

That math does not just fail to add up. It leaves us literally, if you take the Vice President's math, trillions of dollars off reality.

Secretary SNOW. We have put out the 10-year budget window numbers on financing the personal accounts. That is not trillions, that is \$750 billion.

Senator WYDEN. These were the Vice President's words, Mr. Secretary, not mine. The Vice President.

Secretary SNOW. Yes. Since we do not have, as Senator Baucus pointed out, a plan yet—we will have one—we do not have a multi-year plan. That plan will depend on what the Congress does. The size of the borrowings will depend, therefore, on what comes from the negotiations with the Congress, so I cannot give you an answer as to what those numbers will be.

But I can say that the President, in charging the panel with finding ways to make the Code simpler, fairer, and more growth-oriented, said also it must be done in a revenue neutral way.

Now, there are many ways, as you know, to make changes in the Code and have them come out revenue neutral. There are many levers in the Code to change things, improve things, with the effect that this goes up, but that goes down, and achieve revenue neutrality and get a better Code, get a Code that has lower compliance costs, a Code that promotes higher growth rates, and so on. That is the charge to the panel.

Senator WYDEN. But the notion that this goes up and that goes down, to use your words, does not meet my mother's test of coming up with a sharp pencil and making it add up. We have looked specifically at what it is going to cost to deal with AMT. CBO says \$600 billion. The Vice President says trillions of dollars for Social Security. Tax cuts make it even more difficult.

I think what you are doing, essentially, with your policy with respect to making the tax cuts permanent and the trillions that are going to be needed for Social Security, is you make it impossible for that Commission, headed by two good people, to have any real running room for reform.

You are, in effect, killing it while it is just getting off the ground, and I think that is a shame. Middle class taxpayers are going to look at this budget. Here we go. This is the document, Mr. Secretary. It does not contain a dime for the biggest headache that the middle class faces.

The IRS's own Advocate says that the most serious problem is this Alternative Minimum Tax, and it is not even mentioned in this

document. Then you come and say, well, it is going to get taken care of down the road because some things are going to go up and some things are going to do down.

I will tell you, I just think that is pure fantasy. I would love to meet with you privately and discuss this with you further, but these numbers, not only do they fail to add up, I think that they are literally trillions of dollars off reality.

The bottom line is, once again, when middle class people have a real problem, not something that is going to come up in 2042 or 2052, when they have a real problem, the administration has some sort of thesis as to why they are going to put it off. I think that is a shame.

Secretary SNOW. It is not being put off, Senator.

Senator WYDEN. It is not in the budget. It is not mentioned anywhere, Mr. Secretary.

Secretary SNOW. I am telling you why it was not mentioned. It is a matter which will be thoroughly, carefully, and expertly reviewed by a panel headed by two distinguished former Senators of the United States. I have confidence in those people.

They have a lot of running room, contrary to what you say. They have been asked to approach this with all options on the table, with total running room, and they have been asked to do it in a way that is revenue neutral with respect to the President's baseline.

Senator WYDEN. A new meaning to voodoo, Mr. Chairman. Thank you.

The CHAIRMAN. A couple of Senators have left, so I will skip over those names unless they come back, and go to Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

Mr. Secretary, welcome to the committee. Just a couple of questions, I guess.

I am enormously alarmed about the borrowing of all of this money to cut taxes, what you call "pro-growth," which we are still waiting to see some of that. But I guess my concern is, do you feel like we are creating this artificial bubble in the near term?

I mean, you talked about the trouble of the bubble and the burst, and what it did to our economy. Is what we are doing not like taking out a cash advance on our credit card and just pretending that we got a raise?

Secretary SNOW. No.

Senator LINCOLN. I guess what I am saying is, do you not feel like the bill is going to come due sometime?

Is it not eventually going to hit us?

Secretary SNOW. Senator, the personal retirement accounts, which I think is what you are talking about here, or are you talking about the tax permanence?

Senator LINCOLN. Well, all of it.

Secretary SNOW. All of it.

Senator LINCOLN. I mean, it is all creating debt.

Secretary SNOW. Well, on the personal retirement accounts now, there is, of course, borrowing. But that borrowing all goes into savings.

That is not like borrowing that you use to go build bridges, highways or schools. It is not a spending program, it is a savings pro-

gram. So, the personal retirement accounts need to be thought of as an entirely different sort of animal than the usual government borrowing.

Senator LINCOLN. Well, what happens if those accounts hit a bubble right before these people are supposed to retire, like you mentioned?

Secretary SNOW. Well, these accounts are going to be safe and secure. They are going to have options for the safest investments in the United States, the Treasuries that will be tied to the inflation-protected Treasuries. They will all be funds of these investment vehicles. It will not be individual stocks, it will not be hedge funds, and so on.

Senator LINCOLN. But when you talk about this, who are we borrowing from?

Secretary SNOW. We borrow from whomever will lend the money.

Senator LINCOLN. And right now?

Secretary SNOW. That is people who buy the Treasuries of the United States.

Senator LINCOLN. Foreign governments, mostly.

Secretary SNOW. Some. Some foreign governments. They are a major participant.

Senator LINCOLN. Who sets the interest rate?

Secretary SNOW. The interest is basically set through the interaction of the demand and the supply for government paper.

Senator LINCOLN. The last bond offering we had, there was not a lot of demand, was there?

Secretary SNOW. Well, Senator, no. I think the fact is, we have the lowest interest rates that the country has seen in a long, long time, 40 years. So the financial markets are giving great credence to the fiscal policies of the administration. How do we know that?

Look at the interest rates. Interest rates reflect that fact better than anything else.

Senator LINCOLN. Well, Mr. Secretary, all of this that we are borrowing to cut taxes and to allow for these private accounts where you are going to divert payroll taxes to give to people in these private accounts, all of that borrowing is going to be required to be paid back. We are going to be required to pay all of this debt back. Is that correct?

Secretary SNOW. Sure. Debt has to be repaid.

Senator LINCOLN. And by law, that requirement requires you to increase taxes if we do not have the money to pay that back when it comes due. Is that correct? What happens in 2019?

Secretary SNOW. 2019?

Senator LINCOLN. When the general fund has to pay back the Social Security trust fund.

Secretary SNOW. 2019 is the first year—unless Congress takes action, which I pray you will before then—when the outflow from the Social Security trust will be larger than the inflow, which means you are running a cash flow negative balance.

Senator LINCOLN. So if you were in the administration at that point, would you be required to increase taxes in order to pay that debt?

Secretary SNOW. Well, that is not the only option, of course. There are other general revenue programs.

Senator LINCOLN. But you have limited the others.

Secretary SNOW. You can borrow, you can raise taxes, you can cut other programs. But there is a real amount of money that has to be found to meet that shortfall.

Senator LINCOLN. Well, I know that all of us have wonderful staff, and we enjoy working with them. They all tend to be pretty young, too. I do not know about the rest of the members, but my staff have had some real questions, I guess, about this whole Social Security debate.

Many of them are in their early 30s. A lot of them get these statements from the Social Security Administration and it tells them that if they are going to be retiring at 67, it gives them the number of what their monthly retirement is going to be from Social Security.

At the end of it it says, by 2042, if we look at these numbers, that the payroll taxes collected will be enough to pay only about 73 percent of what that scheduled benefit is on their little Social Security sheet.

So if in 2042 these young 30-year-olds are 68 years old, and if we take more payroll tax dollars out of the system, will their checks not be smaller than even the 73 percent that they are talking about getting, that 73 cents on the dollar?

And if we give them a stock account like you are professing would be a good solution, how can we assure them that there is not going to be another bursting of a bubble, like you mentioned earlier, the year before they buy this annuity, before they are going to need something drastically in their retirement?

I guess my last question would be, do you think that they will end up paying higher or lower income taxes over the next 37 years to pay off the debt that is issued to create their private accounts?

Thank you, Mr. Chairman.

The CHAIRMAN. Answer her first question. She asked that before the red light went off.

Secretary SNOW. All right. The Social Security trust fund goes bankrupt. That is the technical term for what happens to the Social Security trust fund in 2042. It goes bankrupt, in the sense that any company that cannot meet its obligations goes bankrupt and goes through a restructuring and reorganization.

In 2042, those young employees of yours who will be retiring will find that the Social Security trust fund can only pay them 72 cents on the dollar that they had expected.

By acting now, we can put them in a position that they can do better than that 72 cents because they will be able to build up, through these personal accounts, returns that are greater than could be paid to them through the Social Security system.

That is really the heart of this idea, is to allow younger people to invest in personal accounts and then use the magical power of compounding, that Einstein called the most powerful force in the universe, to use that magical power of compounding for 30 or 40 years to their advantage, and retire with a nest egg that is bigger than what they will be able to gain otherwise through the Social Security system.

Senator LINCOLN. Mr. Chairman, I would just like to add that the actuaries that were here last week indicated to us, though, that

it would be 2065 until those accounts really did what you are saying they would do. So in 2042, we still have a problem.

The CHAIRMAN. Senator Jeffords?

Senator JEFFORDS. I guess we should not hold our breath waiting for a proposal from the President.

Secretary SNOW. The President's proposal is well fleshed out on the personal accounts, Senator. The President wants to have a dialogue with you and your colleagues about other aspects of putting Social Security on a sustainable basis.

In the State of the Union, he laid out four or five options and invited others to suggest other options, and to look at that those options and work with the administration and work with him to put together an overall plan.

But I think the President has indicated, he is prepared to lead on this subject. I think people in both parties have praised him for his willingness to put the issue on the table and to proceed with a vigorous effort to inform the country about the problem and to find answers.

Senator JEFFORDS. You have, or the party has, been accusing people—we, Democrats and Independents—of obstructing a plan, but no plan exists. Is that not kind of hard to harp on?

Secretary SNOW. Senator, I do not know who has said that anybody is obstructing the plan. I think the President is inviting more ideas, more discussion, more discourse on how to get a plan. But we are certainly not saying anybody is obstructing the plan.

Senator JEFFORDS. What percentage of the Social Security funding gap of 30 percent or so is to be closed by personal accounts?

Secretary SNOW. Well, what the personal accounts primarily do is help the individual retire with a better retirement than they could get depending on Social Security alone. That is the principal role of the personal accounts. But that makes the personal accounts an integral part of any solution, because the end objective of Social Security is the retirement well-being of individuals.

The personal accounts give young people the chance to do better than they otherwise would do. If you are 55 or older, you will not be affected. So, these are entirely voluntary, but they are really designed to help younger people.

Senator JEFFORDS. Thank you.

Secretary SNOW. Thank you, Senator.

The CHAIRMAN. I am going to go back and pick up Senator Schumer, who has come back now, to take his turn.

Senator Schumer? Then after Senator Schumer, I will go to Senators Crapo, Lott, and Kyl.

Go ahead.

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you, Mr. Secretary.

First, just a point to note. If interest rates were simply a measure of how happy the markets were with White House policy of whatever party—I mean, there are many other factors—then they are getting less happy every quarter because interest rates were at 1.5 percent, they are now, I think, 2.5, and everyone expects them to go up to 4 percent, so things are not getting better.

Now, I do not buy that. We are just using your logic. The administration could be doing everything possible, and if the economy is in a recession, interest rates are going to be low.

The CHAIRMAN. Can I interrupt you without taking time away from you?

Senator SCHUMER. Please.

The CHAIRMAN. On interest rates, we are in a situation right now where, a year ago, they were forecasting that 10-year bonds would be 5.25. They started in 2004 at 4.25, and they ended up at 4.26.

Also, since they have been keeping track of interest rates since 1831, interest rates are at the average that they have been since 1831. So, it seems to me that interest rates are in a pretty ideal situation for the economy and for everything that involves government borrowing.

Senator SCHUMER. Thank you, Mr. Chairman. The only point I was making is, the prognostication this year is that they are going to go up. If you look at the *Wall Street Journal*, they list those 50 prognosticators, and the overwhelming majority said they—

The CHAIRMAN. A year ago they did say that, but a year later they are wrong. They are right back where they started on January 1, 2004.

Senator SCHUMER. That is true. That is true. All right. Meanwhile, I opened up by saying I do not think interest rates are a measure of how good the fiscal policies are, the only measure of how good fiscal policies are.

But, Mr. Secretary, on a happier note, I noticed that the administration did include a \$2 billion tax provision for New York as replacement for some of the unused authority under the original Liberty's Own statute, the so-called \$20 billion.

I know your staff worked closely, because my staff was involved with the State and city, Senator Grassley, and Senator Baucus last year, and the committee was kind enough to put those in. I just want to make sure that you will continue to push this, not so much with the Senate, which has approved this before, but with the House, which did not.

Secretary SNOW. Yes, Senator. It is in the budget because we believe in it. We have talked with your office, we have talked with the mayor's office, and the Governor's office, and we are committed to doing it.

Senator SCHUMER. Great. All right.

Second, I want to turn to the overall budget. My biggest problem with the budget—well, one of my biggest problems with the budget—is the sort of misleading efforts here. They are, I think, a little bit cynical. I know that is a bit of a harsh word. But during the presidential campaign, the President said his top economic priority was to make his tax cuts permanent.

He has won reelection, and now his second top priority is Social Security. I was looking over the budget, and I noticed something pretty interesting and wanted to make sure that we pointed it out.

The President's two top priorities, two top domestic priorities for his second term, are not things that are even in his budget, at least for this fiscal year. What is more, his top two priorities are things that will not even take effect until the second term. That is the only way he can promise to cut the deficit in half.

I think it is misleading—there is no other word for it—to talk all about tax cuts and how Social Security is in crisis, about how every year we delay action it costs taxpayers \$600 billion, and then put the actual proposals in that will not take effect until 6 years from now. These little charts say what I am talking about.

First, the tax cuts are the President's top economic priority, but only \$53 billion of the \$1.1 trillion takes effect during the 5-year budget window.

More than \$1 trillion in additional debt—that is what I called in the last hearing the birth tax faced by each American—is added after the budget ends. That is 95 percent of the cost.

Even more to the point, Social Security. How can you call it a crisis that needs immediate action and say it will not take full effect until 2011—I think it starts in 2009—conveniently after the President is retired and happily enjoying the rest of his life.

Your administration says it is going to be \$787 billion. That is just for the first 10 years. It goes up higher. Yet, the amount included in the 2006 budget is zero, and even the amount, if you did the 5-year budget, is a very small amount.

If any private company did that, I think that some of the bond raters and everybody else would be scratching their heads and saying this is not fair accounting. Can you justify this?

Justify two things: how is Social Security a crisis that needs immediate action when we do not really have it take effect until 2011; and second, how can we take this budget seriously when it seems it just puts off the two major liabilities until after the President's term is over?

Secretary SNOW. Well, Senator, the 10-year cost, the window cost of Social Security is incorporated in the numbers you see there. It is \$785 billion over that 10-year period. It is being phased in, I think wisely phased in. With these personal accounts, we have been advised by Wall Street, among others, to go slow.

Senator SCHUMER. Privately, they would advise you to do even less than that.

Secretary SNOW. I think privately they are applauding us for taking this issue on. But we are starting small so we can educate participants. It takes the better part of 3 years for the Social Security Administration to be able to administer the accounts. We are not trying to hide anything. We are trying to put it all out there.

Senator SCHUMER. But is it not true, the two major liabilities do not take effect until after not only this year's budget, but even the 5-year budget takes effect and things get a lot worse debt-wise at that point?

Secretary SNOW. Well, we cannot go beyond the 10-year window.

Senator SCHUMER. No. I am talking a 5-year window.

Secretary SNOW. Well, you have a 10-year number for the Social Security private accounts. That is the \$765 billion.

Senator SCHUMER. Yes. Excuse me, sir. I know my time is up. I am not talking beyond 10 years. I am saying, for the next 4 years or the next 5 years, all these huge liabilities which you want us to incur this year are not shown in the budget numbers.

Secretary SNOW. But Social Security's are not shown because they do not fall, they do not hit, until 9 and 10, I think, the first 2 years.

Senator SCHUMER. That is the way you have planned it.

Secretary SNOW. Because that is the way the program will be laid out. As I say, the Social Security Administration has advised us that it takes at least the better part of 3 years to administer the accounts, put them up, get them going, started, and the accounts filled out. So, that is only appropriate. And with respect to the tax cuts being made permanent, that is included. That is included in the budget.

Senator SCHUMER. A small amount.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Crapo?

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

Mr. Secretary, I must say that I am fascinated by this discussion, and I wish I had 50 minutes instead of 5 to go through some of the issues that you have been questioned on in the last little while.

But I want to try to quickly hit two areas. The first one, which I would like to hit rather quickly and then spend most of my time on Social Security, is the issue of making the tax cuts permanent.

It seems that so much of the discussion about the so-called cost of making the tax cut permanent is based on the assumption that whenever you cut taxes it is a direct loss to the Treasury, that behavior in our economy is not impacted by tax policy.

Now, I do not quite understand that rationale, but could you please discuss with me whether there is any kind of a dynamic effect on the economy by tax relief, particularly things like the capital gains tax cuts and the dividend tax relief, and marginal rate tax relief?

Does that not have a very positive impact on the economy, and are we not seeing that in today's economy?

Secretary SNOW. Senator, I would agree with you, certainly you are seeing it today, the tax cuts that this committee was so instrumental in making possible, lower marginal tax rates, expensing for small business, the dividend reductions, the capital gains reductions.

All of those things are having a pronounced and powerful effect on the American economy. That is why we have had the highest growth rate over the last 2 years since they took effect.

Senator CRAPO. And has the economy's growth not basically cut \$100 billion off the projected deficit already?

Secretary SNOW. Yes, it has. It is growing, the government receipts, at a very good clip. Central to our being able to cut the deficit in half over the course of the next few years is the fact that the revenues of the U.S. Government are rising so rapidly. Senator, we would not have the 2.7 million additional workers in the American economy who were paying taxes if it had not been for those tax cuts.

Senator CRAPO. Well, I appreciate that. It just seemed to me that, from the discussion we have had in the last 45 minutes or so, that there was sort of an omission of the fact that there is an impact of good tax policy.

As we discuss deficits, we have to recognize that the best way—among the many ways we must deal with this deficit—to deal with this deficit is to maintain a strong economy.

Secretary SNOW. Senator, I agree thoroughly. You were not in earlier when I said our basic problem is not that we are under-taxed.

Senator CRAPO. Right.

Secretary SNOW. It is, we spend too much. We have got to focus on that.

Senator CRAPO. This really is a piece of the ongoing historic battle here in these halls over high taxes and high spending, or low taxes and government fiscal responsibility.

Let me move to Social Security. Again, there is a lot of talk about these debts. We just saw a chart showing \$700 and some billion, which is the administration's number for the initial loan or borrowing that would be needed for the personal accounts.

But it is discussed as though there was, in a vacuum, a giant debt being created. But what is on the counterweight there is not discussed. If I understand the Social Security system correctly and the personal accounts proposal correctly, these so-called debts are really already at least projected obligations of the United States.

It is not as though we are incurring something that we do not owe. What we are doing, is borrowing to help pay for something that is going to be an obligation in the outer years of the Social Security system. Is that not correct?

Secretary SNOW. Precisely, Senator. What we are doing is making explicit a debt that is implicit. We are making an obligation explicit that is implicit.

Senator CRAPO. And it seems to me that those who complain about that are simply forgetting the fact that, in all of the calculations we see with regard to the Social Security system, this debt is, as you say, implicit. It is out there and it is going to come due, and we are dealing with it now.

Secretary SNOW. We are dealing with it in an honest way and we are pre-funding it.

Senator CRAPO. And we are pre-funding it in a way that that should help us dramatically as we get into the out years of Social Security.

Secretary SNOW. Senator, absolutely. What this really comes down to with the PRAs—and I am glad you raised this—is American workers become owners of their own retirement accounts rather than merely creditors of promises that probably cannot be kept.

Senator CRAPO. Well, thank you. I really do believe that as we approach the Social Security debate, it is important for us to get past the rhetorical debate and discuss the actual fiscal impact. That is one question I wanted to pursue with you further.

As we talk about these so-called transition costs, if I can try to sum this up, and I would like you to characterize it for me better if you can, what we are really saying is that we are going to have to pay these obligations to today's workers when they retire.

We want to borrow the money now to help them transition into the new personal account system so that, as they retire, they have greater personal control over their retirement assets, they have a greater asset, and this obligation can be then handled much more easily by the economy, or by the government, and the individual retirees will have more dollars in their pocket for retirement.

Secretary SNOW. Absolutely, Senator. That is what this does. It also does one more thing that is awfully important. It enables the Social Security system to be put on a feasible basis, a long-term, self-sustaining basis, which means the \$10.4 trillion obligation, which is a real obligation identified by the Social Security actuary—

Senator BAUCUS. Over what period of time is that?

Secretary SNOW. That is the permanent hole.

Senator BAUCUS. That is infinity.

Secretary SNOW. That is the permanent hole. But that gets eliminated. So, in effect, the borrowing is for a long time. The hole is for a long time. The borrowing helps eliminate the hole, and you are spending \$2 to get \$10 back. That is a pretty good trade.

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

The CHAIRMAN. Senator Lott?

Senator LOTT. Thank you, Mr. Secretary, for being here.

Secretary SNOW. Thank you, Senator.

Senator LOTT. I apologize to you for a couple of us coming in so late that we did not have a balanced questioning period here. But Senator Kyl and I will do our best to even it up a little bit.

It has been very interesting to listen to this discussion, like we are trying to put off to the next administration the impact of this. How about this response: we are trying to do it now and not dump it on the next administration.

Three weeks ago, I talked to former President Clinton, and he and I had a very interesting discussion about how, in the mid-1990s, he and I talked about, with a very distinguished member of this committee, Senator Moynihan, about how we needed to address the Social Security problem, and the way to do it was to have an honest CPI. He, Moynihan and I were willing to do it.

But when I talked to him 3 weeks ago, he said, we should have done it then. That would have solved 98 percent of the problem. We did not do it because we could not get the Speaker in the House—Newt Gingrich, at the time—and Gephardt to go along with it because they were trying to out-manuever each other on Social Security.

So, I mean, as far back as the mid-1990s, we could have done some things that would have kept us from being in the position that we are in now.

On this whole Social Security issue, look. Who are we fooling? The average American person out there between the coast—not on the coast, necessarily, but in Scarborough country in America—understands the numbers do not add up.

You can deal around with semantics all you want to, but the fact of the matter is, we know the numbers of people paying in are going down and people are living longer. I mean, it just does not add up.

People have got that figured out. And people like my daughter and my son have got it figured out that their Social Security is either not going to be there, or if it is, it is not going to be worth very much, and our grandchildren are going to have to pay for all of us. We can argue about it all we want to.

Also, the younger people, the 35-year-old working women like my daughter, they want personal savings accounts because they know that they are going to need it.

But at any rate, we will work through that. I am one of those who is not saying, do not do this, do not do that. I am trying to say, what can we do? Let us get together on something.

I think the administration is going to have to fill in more blanks, but you are saying, look, let us look at all the different plans. Let us do this thing. This is very important for the next generations.

Now, on the economy. First of all, Mr. Secretary, I was in New York yesterday. I do not just talk to average people out there in my State. I go to New York and see what the people "on the street" have to say.

I said, how is the economy? It is pretty good. Unemployment is down to 5.2, job creation is going up, interest rates are low, housing starts are up. I worry a little bit about the value of the dollar. We are trying to do more about trade. How am I doing? Am I about right about the economy?

Secretary SNOW. I think you have hit it right on the nail.

Senator LOTT. All right.

I guess the one thing they did say is we need to try to deal with the deficits. Now, we have the luxury here of saying, why do you folks not deal with the deficits, and then when you come up with a budget that deals with the deficits, both by some savings or cuts and by some incentives to grow the economy, then we say we do not like the way you did it. We do it in Democrat administrations, we do it in Republican administrations. But you do have some things here that are very important.

In talking to the people at Goldman Sachs, and UPS, and others in New York, in talking to their economists and how they see things, they say, clearly, the reduction in dividends and capital gains had a dramatic impact on the economy. I said, what if we do not extend it? They said, oh, wait. We have already discounted that. You guys are going to do that. So, we have already acted on that.

So here is a two-part question on that. Was that the right thing? I mean, who among us does not want to extend small business expensing? Those things made a difference, Mr. Secretary. If they did, what would happen if we did not extend it?

Secretary SNOW. Senator, I would hate to see what would happen if you do not do it because, as you say, it is already built into the market. The market thinks the Congress has made these permanent, or at least has extended them for a long time into the future and will never raise those tax rates.

Because remember, if you do not act as the administration suggests, the tax increases. It is higher taxes on dividends, it is higher taxes on capital gains, it is higher taxes on small business, and it is higher taxes on the hardworking, average Americans all across this country.

So, it is awfully important that we do not visit on America higher taxes, because higher taxes means a less bountiful future for our economy and for our citizens.

Senator LOTT. But you are a former CEO. Now you are Secretary of the Treasury. Do we need to do it now?

Does it make any difference? I mean, I guess they do not expire until 2008. What difference would it make if we did it this year, or the next fiscal year, or the next fiscal year?

Secretary SNOW. Well, what it does is deal with the uncertainty. The thing that business people hate the most is uncertainty. They cannot deal with uncertainty. They do not know how to plan for uncertainty. So I think the basic answer there is, you take off the table the uncertainty that is the most troublesome thing business people face.

Senator LOTT. There are a lot of things in your proposals that are very good. You can argue about them, but it would be easier to condemn you en bloc. But when you get into specifics, for instance, you have some proposals here—empowerment zones for urban and rural areas—where there is not a whole lot of money, but it can have a tremendous impact on a devastated, distressed area. Is that something we should do or not?

Secretary SNOW. Oh, I think so, Senator. The President, yesterday, met with the Cabinet and talked about his budget, and then had a press conference. In the press conference, somebody said, well, what about this program and that program?

The President said—and I think the answer to your question is—look, we have done the best we can. If the people in the Congress have better ideas on how to meet the objectives of these programs, deliver the goods to the American people more effectively, then more power to them. But these are our best thoughts on how to do it.

Senator LOTT. One admonition, Mr. Secretary. Yes, work with us and look for us to work on the menu, but stay very close because we have been known to mess up a good idea when given an opportunity. Welfare reform, last year, is Exhibit A. Thank you.

The CHAIRMAN. Senator Kyl?

Senator KYL. Thank you, Mr. Chairman.

Thank you, Secretary Snow. My first two questions were really the same questions that Senator Lott has asked you. Let me just ask one of them a slightly different way.

I, too, was in New York yesterday and, while people have discounted to some extent, or actually accounted for the fact they cannot believe that we would not continue to extend these tax cuts—I am specifically talking about capital gains and dividends—nevertheless, there is some apprehension about it. I think that is the reason your budget does accommodate making all of the tax cuts permanent, which would include these two tax cuts.

Realistically, if it takes 60 votes to make them permanent, and we simply want to extend the cuts that expire during the next 2 or 3 years so that they at least go out 5 years from now past 2010, that would include, among other things, dividends and capital gains, and I presume the administration would support the extension of those taxes, obviously, if it would support their permanence.

Secretary SNOW. Sure. Extending them is good. Making them permanent is better.

Senator KYL. Even better. Right.

Secretary SNOW. But it goes to the very question you and Senator Lott are dealing with, and that is removing uncertainty about the Code and the rules of the road with respect to investments, and

clarifying the returns on investment makes business people far more inclined to be willing to make an investment because they can calculate the returns.

Senator KYL. Exactly. Thank you.

One of the tables accompanying the budget shows—on dividends, now—the tax relief raising revenue in 2005 through 2008.

I just wanted to ask, I am assuming that since your calculation is that it is a revenue raiser in the short term, that the only reason it is not a revenue raiser on out is because you are stuck with a static analysis and you cannot use the reaction of the market to the lower rates. Is that correct?

Secretary SNOW. Exactly. It is a behavioral assessment, that people will pay the dividends, and then the next year they will not be there.

Senator KYL. Right. In fact, a couple of weeks ago the *Wall Street Journal* had a chart on its editorial page showing the result of the capital gains. It is a direct relationship: capital gains rate goes down, revenues from capital gains to the Treasury go up.

Now, as I read your statement, too, you indicate that total Treasury receipts are rising, with revenues up 10.5 percent in 1 year.

Secretary SNOW. Senator, just as you would expect, when there are more people working, more people paying taxes, the economy growing, business is more profitable, businesses and individuals pay more taxes, and the government receipts go up.

Senator KYL. Even if some of the rates are lower.

Secretary SNOW. Because the rates are lower.

Senator KYL. Right.

Secretary SNOW. Because the rates are lower.

Senator KYL. One thing, too. One of the Senators made a statement, and perhaps I would modify the grammar of this, but I do hear it repeated every now and then. It was to this effect: we are going to give money to employees to invest in personal accounts. I am struck by the fact that, of course, it is not our money, it is their money.

Secretary SNOW. Exactly.

Senator KYL. It is the employees' money. What we are doing with the Social Security concept is to allow them to keep a part of their money to invest in these personal accounts.

I was also struck by the fact that we are talking about young employees who work here. Well, of course, the employees who work here get to invest in the Thrift Savings Plan, the TSP.

I would venture a guess that the full participation in the Federal Employee Thrift Savings Plan is probably about 90 percent. Anybody that had an option, an opportunity to do that, would do it. That is one reason all the employees here do it.

As you understand the administration's general approach in terms of the expression of the principles with regard to the investment in the personal savings accounts, would it be correct to say that, as a general proposition, the concept is similar to the Federal Employee Thrift Savings Plan in terms of the kind of investments that could be made, how those investments would be managed, and the kind of return that you would expect on them?

Secretary SNOW. Yes. That is the model we are using for the investment vehicles.

Senator KYL. The last question I have concerns the budget with respect to a proposal for refundable tax credits for the purchase of insurance.

We are going to be talking about fundamental tax reform, trying to simplify the Tax Code, which means probably, among other things, getting rid of a lot of tax credits.

We, clearly, are going to be careful, it seems to me, or should be careful, about using the Tax Code to advance certain domestic policy goals by creating refundable tax credits. I am reminded of a former member of this committee, Phil Gramm, who used to talk about how tax cuts are for taxpayers.

But the proposal that would call for additional tax credits would be antithetical, would it not, to try to simplify the Tax Code by trying to minimize, reduce, or eliminate the tax credits?

Secretary SNOW. Yes, Senator. When you think about simplification, you immediately turn to the things that create complexity. The things that create complexity, by and large, are preferences, deductions, and credits.

We have asked them, without making any foreshadowing of what might come from the panel, to take a hard look at simplification and how it could be done. Of course, simplification takes you down the road to look at credits, deductions, and preferences.

Senator KYL. Thank you. I want to thank you, and the administration generally because I know OMB was a big part of this, for putting together a budget that tries to meet the objective of the American people, which is to give only the money to the Federal Government that is necessary to do the things the Federal Government needs to do, and tries to begin to cut back on the amount of spending by the Federal Government to get our fiscal house a little bit better in order than it had been in the past.

I appreciate your testimony today.

Secretary SNOW. Thank you very much, Senator Kyl.

The CHAIRMAN. Secretary Snow, I would like to go back to a point I think Senator Rockefeller made about the extent to which tax increases from general revenue would solve the Social Security problem.

A couple of statistics have been cited. The revenue loss from making permanent the tax relief of 2001 and 2003 is \$11.6 trillion, 1.95 percent of GDP. The second, is that the revenue loss for making permanent this tax relief for the top 1 percent of the taxpayers is \$3.4 trillion, or about 0.5 percent of GDP.

I guess the implication is, by raising taxes on the top 1 percent, it will fix the Social Security shortfall for over the next 75 years. For the record, these figures, I believe, come from a prolific liberal think tank known as the Center for Budget Policy and Priorities.

For the record, you should also know that the Joint Tax Committee of Congress, our nonpartisan Congressional scorekeeper under both Democratic and Republican Congresses, will not estimate revenue outside of a 10-year window. Joint Tax does not distribute tax effects beyond 5 years.

For these reasons and many others that I have not gone into, I do not accept these statistics, but for purposes of this question, let us assume they are correct.

I would like you to focus on a couple of the assumptions that the think tank I have referred to is making. One, all revenue raised by raising taxes will either not be spent or will be set aside for Social Security. By the way, that has only happened twice since the program has been in effect.

The second is the assumption that there is no down side for the economy from Federal taxes going to at least 25 percent of GDP, 20 percent higher than at any other time in history. So what is your response to the likelihood of these critical assumptions?

Secretary SNOW. Senator, three quick responses. One, I do not know those numbers. They are not anything that I have ever seen. I do not think they are credible numbers. They are not OMB numbers, they are not GAO numbers, and they are not CBO numbers.

Second, it is an extraordinarily implausible scenario at best to think that that much money would come in to the U.S. Treasury and not be spent. We saw what happened with the surplus. It quickly got evaporated. I would have no confidence that those monies would be used for those purposes.

Third, the effect on the American economy would be devastating, to take taxes as a percent of GDP to the levels that are talked about in that report. They would just simply shrink the output of the American economy. They would shrink jobs, they would shrink investments, and have a devastating effect on the performance of the economy. That is no path, in my view, we want to go down.

The CHAIRMAN. It kills the job-making machine that our economy is.

Secretary SNOW. Exactly.

The CHAIRMAN. On another point, but following up on this, about repealing the bipartisan tax relief and using the revenue for Social Security. This proposal would de-link the payroll tax and Social Security benefits.

So your view about this being appropriate to de-link the traditional revenue source, the payroll tax and the Social Security benefits, I would remind my colleagues, particularly on the other side of the aisle, that Senator Moynihan kept making the points that de-linking the payroll tax from Social Security would endanger the program with the political support that it now enjoys because of that linkage between payroll tax and the program.

Secretary SNOW. Senator, I agree with Senator Moynihan. I think the administration view is the same. The answer is not to de-link the payroll taxes and the benefits. The answer is to set up the personal accounts and otherwise take steps to make, as the President suggested in the State of the Union address, the system sustainable.

The CHAIRMAN. I would follow up on the last couple of questions. According to the non-partisan Congressional Budget Office, repealing all of the 2001 and 2003 bipartisan tax relief package raises revenue equal to 7/10ths of 1 percent of GDP in the year 2050. We see our friends on the other side of the aisle citing a larger statistic, 1.95 percent of GDP.

As I said before, their statistics do not come from CBO. These charts indicate that repealing the bipartisan tax relief plan does not supply the necessary general fund revenues to fix the Social Security problem.

I would say, do you agree? I guess it is quite obvious.

Secretary SNOW. It shows it there. What that does not show is what is happening to GDP, jobs, and investment at the same time.

The CHAIRMAN. Yes. But it would be more negative than this.

Secretary SNOW. It would be more negative, I would think, than that.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I would like to ask you just a couple of questions about the tax gap. Former Commissioner Charles Rossotti told the IRS Oversight Board in 2002 that the IRS does not even have the resources to pursue identified tax debtors and cheats.

And here are the numbers he provided in his report: 60 percent of identified tax debts are not pursued; 75 percent of taxpayers who do not file a tax return are not pursued; 79 percent of identified taxpayers who use abusive devices to evade taxes are not pursued; 56 percent of identified taxpayers with incomes of \$100,000 or more who under-report tax are not pursued.

Those are 2002 numbers. Three years later, do you know what those numbers are now?

Secretary SNOW. Senator, no, I do not. Maybe the IRS would have them. But we do acknowledge, there is a sizeable tax gap issue. That is one reason we have asked for a large increase in the enforcement budget at the IRS.

Senator BAUCUS. Can you get those numbers to us?

Secretary SNOW. Yes. I will do the best I can, if they have them. We will certainly do the best we can.

Senator BAUCUS. Well, if they had them back then, they ought to have them now. My understanding is, the National Research Program data will be released in 2005, which should have that help out there.

Secretary SNOW. Yes. That is what I was thinking, Senator. I am not sure we have it now. The data we are using on the tax gap analysis is fairly well dated.

Senator BAUCUS. Right. Seventeen years.

Secretary SNOW. Yes. And it is being updated.

Senator BAUCUS. It is old data.

Secretary SNOW. Yes. It is very old data.

Senator BAUCUS. But if you could tell us and keep us informed, I would appreciate that.

Secretary SNOW. I will.

Senator BAUCUS. With all this talk about savings and so forth, and retirement, why is the administration not proposing enhanced additional retirement provisions?

Instead of carving and taking it away from Social Security, why not more personal accounts?

Secretary SNOW. Yes.

Senator BAUCUS. Why are there not proposals on enhancing benefit plans? Take my State of Montana. It is a small business State. Small businesses have a hard time providing pension plans. It is the administrative costs. You know the problem.

Secretary SNOW. Sure.

Senator BAUCUS. But why is there not something serious about that, so it is in addition to Social Security, not taking away from Social Security?

Secretary SNOW. Well, two answers. We are proposing a number of, I think, very attractive savings vehicles: the lifetime savings accounts and the retirement savings accounts.

Senator BAUCUS. I understand that. But why also take it away from Social Security? Why not find a way to truly solve Social Security's solvency, which personal accounts do not do, and then figure out, how do we get some additional personal savings in pension and retirement income?

Secretary SNOW. Senator, the problem I have with the so-called add-ons is the budgetary impact they have.

Senator BAUCUS. It is a \$2 trillion cost for your personal accounts.

Secretary SNOW. But the way we are proposing the personal accounts, there will be no net financing cost long-term because—

Senator BAUCUS. When does "long term" begin?

Secretary SNOW. It begins the day the accounts start.

Senator BAUCUS. No, no. When is that \$2 trillion going to be paid off?

Secretary SNOW. I am not sure where you are getting the \$2 trillion from because we do not have the numbers laid out yet beyond 2015.

Senator BAUCUS. Let us take your figure of \$785 billion, or whatever it was.

Secretary SNOW. \$750 billion.

Senator BAUCUS. That is a short-term number. When is that going to be paid off?

Secretary SNOW. Well, that begins to get paid off a couple of generations out, 40 years.

Senator BAUCUS. Well, we are talking now about people who want to start retiring now and not have these big budget deficits.

What about a much more serious problem, Medicare? It is much more serious than Social Security. Why is the administration not addressing a much more serious problem like Medicare, Medicaid, the rising health care costs?

Secretary SNOW. The administration is, Senator, addressing those issues.

Senator BAUCUS. In a meaningful way like they are trying to address Social Security? That is, in a real way, not just working around the edges?

Secretary SNOW. Well, I think you belittle our efforts if you think that we are only working around the edges. A number of initiatives are under way to deal with the fundamental problem of Medicare, which is rising health care costs, and a delivery system that is inefficient.

In the Medicare Modernization Act recently, there is great potential, I think, to lower long-term health care costs. I actually think the prescription drug part of it will have sizeable benefits for lowering health care costs outside of the prescription drugs. As people take these drugs, they will not have to do other procedures.

Senator BAUCUS. My time is expiring.

Secretary SNOW. HSAs. Let me just mention HSAs, savings accounts.

Senator BAUCUS. HSAs have a real future. I agree with you.

Secretary SNOW. A big future.

Senator BAUCUS. But if the administration would devote the same time and resources to attacking the problem of rising health care costs rather than, or in addition to—would probably have to be rather than, because any White House can only think of one thing at a time, really; it cannot do two things, big-time—it would perform a huge public service.

As you well know, we pay twice as much per capita on health care in America than does the next highest country, Switzerland, and I do not think we are twice as healthy as the Swiss. In addition, in the long term, it is my understanding that the Medicare trust fund insolvency problem is twice that of Social Security over the next 75 years. Why are you not doing something that is real?

Secretary SNOW. Senator, we are. Social Security is real.

Senator BAUCUS. I am talking about health care costs.

Secretary SNOW. HSAs are real.

Senator BAUCUS. I am talking about health care costs.

Secretary SNOW. Information technology improvements in the health care field are real.

Senator BAUCUS. I understand. I know what those all are.

Secretary SNOW. Tort reform for malpractice is real.

Senator BAUCUS. We all talk about that.

Secretary SNOW. That is real.

Senator BAUCUS. But, frankly, that is not real. Let me deal with real. The only thing to do that is real, in my judgment, is—and you started down this track when you spoke earlier—namely, to find ways to measure outcomes and pay for performance, pay for outcomes, in conjunction with a real IT initiative. People tell me that the administration's IT dollars are getting cut back. There is just not a real IT effort here. But this country has got to address health care costs, generally.

Secretary SNOW. Senator, I agree with you.

Senator BAUCUS. That does not address costs. That just lets people pay for them a little easier, but does not address the underlying problem of costs. That is what is driving Medicaid up so much, and that is what is driving Medicare up: the cost point. We have got to find ways to address the increase in health care costs.

Secretary SNOW. Senator, I would suggest—and you may not agree—that by changing consumer behavior, which is what HSAs will do, you will change provider behaviors, and we will find that the system does move toward greater levels of efficiency.

Senator BAUCUS. Thank you, Mr. Secretary.

Secretary SNOW. Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

Senator WYDEN?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Secretary, I am interested in working in a bipartisan way. I voted for the prescription drug bill, for example. I still have the welts on my back to show for it. But I think what is going on here is that we have a difference with respect to what is really hammering people in the real world today.

I mean, I have constituents at home—and there are millions of them all across the country—who are sitting down, filling out their tax forms, going through the water torture of AMT, and you have given us all kinds of reasons as to why we are not going to deal with it. Senator Baucus asked about health care.

Again, I would like to work in a bipartisan way, but any way you slice it, any objective analysis of what is ahead, is that Medicare is supposed to run into solvency problems 23 years before Social Security. But at the State of the Union and everywhere else, we did not have that same focus on health and Medicare that we have had on Social Security.

Now, my question for this round is something where I think we can work together immediately, and I want to get your responses to it. I think what you are talking about with respect to enforcement and the additional funding is constructive. I am glad to see that you are going to put those additional dollars into enforcement.

The problem, of course, is that it has been well documented that in the past, enforcement efforts have primarily targeted the working poor and people of fairly modest means. The people who are really powerful, influential people and big companies, somehow seem to skate by.

So my question to you is, what specifically is your enforcement plan to go after the big tax cheats? Now, this is an area where we can cooperate and, by the way, where the gains are much greater. I mean, that is where the big money is. There is not as much money going after all these people at the bottom. So, we can get a bipartisan effort going here.

If you would, tell me how you want to use that enforcement request to go after the big scofflaws, the big tax cheats who have not been targeted in the past.

Secretary SNOW. Senator, we are going after them full force. I want you to know that. We are going to be armed with some new tools that this committee gave us as a result of your legislation last year to get at abusive tax shelters, the silos, and some other things.

The administration of the IRS is really committed to full and fair enforcement of the law against everybody, large corporations, mid-size, wealthy people, middle income people, everybody.

I will send you their budget proposal for the deployment of the additional, roughly, \$500 million, about a 7.8 percent increase in their budget. But believe me, it is targeted across the board and a sizeable part of that will be on corporate enforcement efforts, more corporate audits, more reviews, more investigations.

I will be glad to amplify and give you a full layout of what those plans are.

Senator WYDEN. I would like to see that because there have been additional tools given, but the countryside is strewn with past efforts where additional tools were given and not much changed. So, can you tell us, at the end of this year, we will see a different pattern with respect to who the agency is going to go after in terms of under-reporting and cheating?

Secretary SNOW. Senator, I agree with you. I think a mistake was made some years back when the enforcement efforts at the

IRS got downgraded, denigrated, under-funded, and it showed up in the effectiveness of the compliance programs.

Senator WYDEN. That only compounded the problem. I mean, the history of enforcement has been primarily to let the powerful and influential skate free, and to have people at the bottom targeted.

One other area that I wanted to ask you about is, what is your sense of the current amount of the employment tax gap that is owed, but not collected, for Social Security, Medicare, and other programs that are funded by employment taxes? This is a different aspect of the under-reporting issue. I am talking about a ballpark. I realize you do not run around with exact figures.

Secretary SNOW. I would want to get back to you so as not to misstate our estimates or give a false impression of accuracy here. But I will get back to you on that.

[The information appears in the appendix.]

Senator WYDEN. Now, the IRS Commissioner told me unofficially when I met with him that he thought the amount was in the ballpark of at least \$60 to \$70 billion. That is a significant sum. Does that sound like a ballpark to you?

Secretary SNOW. It could be, Senator. Again, I am reluctant to confirm a number that I have not given more thought and attention to. I know we have the \$300 billion tax gap number out there. That is a number not based on real good data; it could be larger, it could be smaller.

We are hoping to refine the data and come back and be able to talk to you on the basis of the new study and the new data. It could well be in the ballpark, but I would want to confirm that with you if you do not mind.

Senator WYDEN. All right.

Well, thank you. I am interested in working with you, Mr. Secretary. I just think that if we really listen to the American people, the American people are saying that there are a variety of problems that are much more immediate and hitting us much harder in our living rooms and kitchen tables than some of what you have talked about today. That is the reason that I really zeroed in on the AMT.

I share your view that Connie Mack and Senator Breaux are terrific people to head it. What I am concerned about is, if we lose trillions of dollars to set up Social Security privatization, lose more in terms of permanent tax cuts, we are not going to be able to do some of the historic work that I think would be possible in terms of tax reform.

I hope we will work together in a variety of areas. Trade is an area where I have consistently tried to reach out to work with the administration. But I would just urge, as one member of the U.S. Senate, that we tackle the kinds of issues that are really causing people stomach lining pain right now, and that is issues like the AMT. Any way you slice it, we are putting it off when they are wishing that we would put that up to the head of the priority list.

Secretary SNOW. Senator, thank you. I want to work with you in that same spirit you expressed. I hope to be able to convince you that those numbers that you are citing are not the real numbers, and the borrowing does not have the consequences on the deficit that you say it does.

But on the AMT, let me say, that is a serious issue. We know it is a serious issue. I talked to you about it a year ago when I was here. It is not simple, it is not fair, and it is not pro-growth. It creates enormous complexity. It creates enormous burdens. It is ensnaring millions and millions of additional Americans, and we have got to fix it.

I am confident that the Mack/Breaux Commission will address that and come up with answers, and that we will be able to get something done on that so that people are not ensnared in it, and I hope we can do it before the time when the patch runs out and they will be hit with the 2006 tax bill, which is April of 2007.

Senator WYDEN. My only concern, Mr. Secretary, is you did talk about it a year ago. But we did not hear anything about it in the State of the Union. We heard about something that had to be tackled in 2042.

And you bet there are challenges in Social Security. The demographics are relentless. There are going to be more older people retiring, fewer younger people. It is indisputable that there is work to do.

But you talked about the AMT a year ago. We did not hear about it in the State of the Union. Now I represent a lot of people who are going to get hammered when they fill that out in a few weeks, and that is what I would like to work with you on.

Secretary SNOW. Right. We will work. We trust that there will be action so they have the patch for 2005 and 2006, that there will be time to put in place a fix so that they do not get ensnared.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. To all of my colleagues, about the AMT—and I have one other question, but before I get to that question—and to you, Mr. Secretary, about the AMT, what keeps the AMT happening is this silly thing that somehow we always have to offset everything we do around here.

Now, most of the time I agree with offsets. But dealing with the AMT is an entirely different situation. The people who are supposedly going to be paying the tax who will lose revenue were never supposed to be hit with the AMT in the first place.

It started in 1969 when we wanted to tax about 4,000 or 5,000 people who were very wealthy and avoiding all forms of taxation, and they ought to contribute something to it. It was not indexed. In fact, we did away with AMT in 1998 or 1999, and President Clinton vetoed the bill.

So, way back then there was a decision that we ought to do something about it. How idiotic it is that a law that was supposed to touch just very wealthy people avoiding all taxation to make them pay something, because it was not indexed, is now hitting about 3 or 4 million people.

If we had not kicked the can down the road, it would probably be hitting 5 or 7 million people. In another 10 years, it is going to hit 30 million people. It is going to be ruining the middle class that was never intended to pay it in the first place.

So what is the big debate about doing away with a tax that is going to hit people that were never supposed to pay it in the first place? It just ought to be done away with. It ought to be done away with. I am not accusing you of not doing away with it.

I am accusing people up here that say it is such a problem, but that it has got to be offset. It is taxing people that were never intended to be taxed. So why should you not do away with a policy that is ruining the very people that were never meant to pay the tax in the first place?

Where is most of this tax paid? It is paid in the blue States. The blue States are all the high-income States. It is the residents of the blue States that are paying this tax in the first place. I would think the Democratic Party, if they are representing their people in those States, would take the lead and get rid of it, and get rid of it without worrying about an offset.

Senator WYDEN. Mr. Chairman?

The CHAIRMAN. Because it is ruining their own people.

Senator WYDEN. I want to co-sponsor your bill, Mr. Chairman. Let us get it done.

The CHAIRMAN. Without an offset?

Senator WYDEN. You have got it.

The CHAIRMAN. Well, praise the Lord! [Laughter.] I have not thought about introducing a bill, but with your support I think I will.

One last question, to just explore with you the opportunities of maybe moving the Social Security debate a little bit beyond just Social Security. So, I get back to the 2001 tax bill containing \$50 billion of tax incentives to enhance retirement plans. That relief would be evaporated if we do not make it permanent.

So, it is one of the very good reasons for making this tax bill permanent, because it has got something about incentives to save, and particularly incentives to save for people who are near retirement, additional incentives to save to make up.

Those tax incentives should be made permanent so that taxpayers can have certainty and so that ordinary Americans can plan for their retirement years. These pension provisions, I think, benefitted for the most part the middle income people that we hold up here, and rightly hold up, as the symbol of people that we ought to be concerned about.

So, Mr. Secretary, should we not look at Social Security as part of a broader issue of retirement security? If so, would the administration be supportive of combining permanent retirement security tax incentives as well as Social Security reform, and maybe even in the same discussion?

Secretary SNOW. Senator, the issue of Social Security is inherently the issue of an aging population, which deals with the broader question that you are talking about. The administration is clearly eager to engage you and members of the Senate and the House on how to find answers to all those problems. So my answer is, certainly, yes.

The CHAIRMAN. All right.

I think, as I find both visiting with Democrats, and now even visiting in greater depth with Republicans, there is a feeling that if we are going to be successful on Social Security changes to make it a viable program for children and grandchildren, as well as for the near term, that one possible avenue of getting the bipartisan support we have to have, at least in the Senate, is that expansion.

So, I offer that to you to think about. You have already answered my question, that you would be glad to look at that, but I think it is very important that we give it probably more consideration.

Maybe getting back to, I think it was Franklin Roosevelt who described it, or somebody back early described it, as a three-legged stool. We refer to that often in this committee of Social Security being a basis for retirement, but for that retirement to have personal savings and pensions on top of it.

I think it gets us back to the original debate about Social Security and the foundation for Social Security, and it might open up avenues we do not have now. So, I would just leave that with you and I will stop there.

Secretary SNOW. Senator, I agree. I think the President has made it clear that he wants to find answers to these problems. The essential problem is an aging population. He has laid out some principles and some broad ideas and helped define the problem, I think. I think he deserves credit for that.

But he also realizes that you are the Senate of the United States. You are the legislative body that will ultimately determine the shape and the form of any legislation. So, he is more than anxious to work with you. I think you know that. I think he has said that to you personally.

The CHAIRMAN. Yes. Thank you very much for your time today in helping us understand the budget better. We will look forward to working with you as we get these budgets adopted and these tax provisions adopted, and especially on Social Security. Thank you very much.

Secretary SNOW. Thank you, Mr. Chairman.

[Whereupon, at 4:33 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. JOHN SNOW

Good afternoon and thank you, Chairman Grassley and Ranking Member Baucus, for having me here today to discuss the President's budget. I think you'll find that it exhibits a dedication to fiscal discipline, transparency, and economic growth.

By focusing on priorities and looking for savings in every agency, across the board, the President's administration has come up with a budget that we believe is fair while also holding the government accountable. As the President announced in his State of the Union address last week, this budget adheres to the principle of "Taxpayer dollars must be spent wisely, or not at all."

It holds the growth of discretionary spending to just 2.1 percent, below the expected rate of inflation. Non-discretionary spending in this budget falls by nearly 1 percent, the tightest such restraint proposed since the Reagan administration.

This administration appreciates that cutting taxes and exercising fiscal discipline must go hand in hand. We appreciate that this is the people's money with which we are dealing, and that we work for the taxpayers.

That is why we are committed to making the President's pro-growth tax cuts permanent and building on our strengthened economic fundamentals as we submit to you a budget that will increase the efficacy of our government programs without over-spending the taxpayers' money.

Over the weekend, the finance ministers of the G7 met—the U.S. was represented by Treasury Undersecretary for International Affairs John Taylor—, and they discussed the importance of promoting and achieving economic growth in our countries, as well as keeping our respective financial houses in order. These two issues are inextricably linked.

The way that we, as the executives of the Federal Government, manage the taxpayers' money sends a message to the people of America as well as to our trading partners and investors around the globe. When we control our spending, we are showing our citizens and the world that fiscal discipline is a priority on par with our policies that promote economic growth.

I'll talk more about fiscal discipline in a moment, but I'd like to start with a look at what we have recently achieved through pro-growth economic policies.

Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, have resulted in very good economic growth and, most importantly, continual job creation. The economy has created over 2.7 million jobs since May of 2003. And while job growth can never be fast enough for those looking for work, the steady pace of job creation has been an unmistakable sign of an economy that has recovered from very tough times, and is now expanding.

Whenever I speak with my counterparts in the G7, I am reminded that the American economy is the envy of the world. Our recovery and growth, our successful dedication to entrepreneurship—all these things are admired, and increasingly emulated, by our G7 partners.

Is it any wonder that they want to learn the secret to our economic resiliency? A quick look at the facts reveals much to be envied: GDP growth for 2004 was 4.4 percent. Our economy has posted steady job gains for 20 straight months. The unemployment rate is down to 5.2 percent—lower than the average rate of the 1970s, 1980s and 1990s. Real after-tax income is up by over 11 percent since the end of 2000, and household wealth is at an all-time high. Inflation, interest rates, and mortgage rates remain at low levels. Home ownership rates are at record highs.

Tax cuts can be hard on budgets and deficits in the short term, but, if the tax cuts are geared toward improving incentives, there are long-term benefits as well

as short-term ones, and this fact has been well illustrated by these outstanding economic results.

I point to this record because it is so important that we continue on a pro-growth path. Continued economic growth is needed, and will be needed, to continue to improve our standard of living and until every worker in America who is still looking for a job can find one.

For example, we've got to make the President's growth-enhancing tax cuts permanent—and that is included in this budget. The President's Panel on Tax Reform was also created with economic growth in mind. It is a group of some of the best minds in our country, and they'll be looking critically at the entire existing code and coming up with proposals that would make it fairer, less complex, and more pro-growth.

While the panel is working on that historic task, our efforts to grow the American economy will continue in many other areas—I am particularly interested in legislation that will reduce the burden of frivolous lawsuits on our economy—and this budget is part of the administration's overall pro-growth policy agenda.

As I already mentioned, economic growth is good for our country because of the jobs it creates and the prosperity it spreads. But it is also, importantly, part of a winning strategy on deficit reduction—one of the top priorities of this budget—because economic growth increases Treasury receipts.

Treasury receipts are rising—in the second half of calendar 2004, individual income tax revenue is up 10.5 percent versus the same period in 2003—and will continue to rise, as long as we have economic growth. That must be accompanied, as I emphasized earlier, by strict fiscal discipline. That is why the President's budget proposes real savings. I know it will have its critics as a result, but its frugality is essential.

Let me be very clear on this: we have deficits and they are unwelcome. But we are not under-taxed, and higher taxes will not be the solution to reducing deficits. Fiscal discipline, combined with economic growth, is the correct path.

Using this approach, we are making headway on deficit reduction, and we're on track to halve the deficit by 2009. The deficit is also forecast to fall to 3.0 percent of GDP in 2006 and to 1.5 percent by 2009, well below the 40-year historical average of 2.3 percent of GDP.

The 2004 deficit came in at 3.6 percent of GDP—nearly a full percentage point lower than had been projected. And the 2005 deficit is projected to show another decline.

While we are pleased with this progress, we recognize that more needs to be done.

We need to make the tough choices on spending and stand steadfast in our commitment to continuing economic growth in order to see that deficit whittled down.

We also need to look at our long-term deficit situation. I spoke earlier about transparency, specifically the honesty of this budget, which deals openly with the needs of the times in which we live, from the war on terror to the need for continuing growth.

In the interest of honesty and transparency, I encourage all of us to follow the politically courageous leadership of our President by looking at, and dealing with, the \$10.4 trillion deficit facing our children and grandchildren in the form of an unsustainable Social Security program.

The program is an important institution, a sacred trust, and it worked well for the times in which it was designed. It is, however, doomed by our country's demographics and in need of wise and effective reform.

The arithmetic is simple. As people live longer and have had fewer children, the ratio of workers paying into the system and retirees taking benefits out has dwindled dramatically. We had 16 workers paying into a system for every one beneficiary in 1950, and today we have just three workers for every beneficiary. That ratio will drop to two-to-one by the time today's young workers retire.

We all must agree that this demographic reality exists, that this problem exists. Social Security *is secure* for today's retirees and for those nearing retirement; it will not change for those people who are 55 and over . . . but it is offering empty promises to future generations. When today's young workers begin to retire in 2042, the system will be exhausted and bankrupt.

It is the future of the program that President Bush is concerned about, and it is the future of the program that we must address, this year, here on Capitol Hill. I echo the President's State of the Union address in saying that we must join together to strengthen and save Social Security.

We can, and should, do this without increasing payroll taxes. The level of increases that would be necessary, if we maintain the status quo, would have a terrible impact on our economy. It would negatively impact economic growth; jobs would be lost. We don't have to go that way.

We can, and should, reform the system in a way that encourages younger generations of workers to build a nest egg that they own and control and can pass on to their loved ones.

Saving Social Security is an undertaking of historic proportions. We have hard work ahead of us as we strive for consensus in the name of younger generations.

We also have hard work ahead of us when it comes to strengthening the fundamentals of our economy: deficit reduction, good fiscal policy, energy policy, lawsuit abuse reform, and encouraging savings.

I appreciate that this administration has an ambitious agenda . . . but it is a good one, worth the work it will take to move forward, together, on it.

Let's start by passing this responsible, pro-growth budget.

Thank you for having me here today; I'm pleased to take your questions now.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

HIGHWAY TRUST FUND

Question: The administration's budget proposes legislative changes that will increase the receipts to the highway trust fund by more than \$1 million per year during FY 2005 through FY 2010. There is no description in the budget of a legislative proposal that would increase highway trust fund receipts by these amounts. Please provide a description of the legislative proposal(s) that would result in these additional receipts. Why was the proposal not described in the budget?

Answer: The following information was provided to the Treasury Department by the Office of Management and Budget:

Under current law, refunds are routinely paid from the general fund, and the highway trust fund reimburses the general fund once each quarter. The refunds are predominantly for off-road farm diesel, use by State and local governments, and transit use. Having the general fund bear the cost of the refunds shifts the cost of about \$1 billion in refunds to the general fund. It also allows the trust fund to retain taxes from non-highway fuel, like farm diesel.

RETIREMENT SECURITY

Question: The President has proposed to allow workers to divert 4 percentage points of their Social Security payroll taxes from the Social Security trust fund into private savings accounts. However, when the workers retire, their Social Security benefits will be reduced. The reduction will be by an amount equal to the payroll taxes plus the interest those taxes would have earned if they had been invested in Treasury bonds with a rate of interest 3 percent greater than the rate of inflation.

Doesn't this mean that if the private accounts—through bad luck or bad investing or both—have earned less than 3 percent above inflation, the retirees will lose money relative to current law?

Answer: Any final legislation will be accomplished in a bipartisan fashion, and will specify how defined benefits prior to PRA offsets are determined. Until a comprehensive bipartisan plan to reform Social Security is developed, it is not possible to say how individuals who choose personal retirement accounts will fare relative to current law promises. It should be noted that the current schedule of defined benefits is not sustainable; under current law and the SSA actuary's current projections, benefits will be cut by 26 percent starting in 2041 and by larger amounts thereafter.

Your question can be answered with reference to how the choice to elect a PRA would affect a person's benefits. It is not necessarily the case that all individuals earning a real PRA return less than 3 percent would lose from PRA election. Whether a person does better with a PRA depends both upon the PRA's rate of return, and how long the person lives. For example, for single individuals who die prior to the retirement age, the net gain for the estate if a PRA is elected is the entire PRA balance at the time of death, while under the traditional system their estate would not receive any benefits.

It is important to note that a discount rate of 3 percent is simply the Social Security actuary's long-term projection for the rate of return on Treasury bonds. Thus, a worker need not take on any risk in order to expect the same benefits through the account that they would have received by staying entirely in traditional Social Security. If they remained invested solely in Treasury bonds, their projected benefit would not change, they would not face investment risk, and they would have the additional benefit of a personal retirement account that they own and control and can pass on to loved ones at death.

We agree with the non-partisan analysis of the Social Security actuaries which finds that workers will likely gain based on historical experience with long-term in-

vesting. We also believe that workers will gain because their accounts will be fully funded (unlike a pay-as-you-go system), and they will gain the ability to bequeath assets to loved ones. In any case, personal retirement accounts will be totally voluntary. Individuals will be given the choice of whether to participate or not.

HEALTH SAVINGS ACCOUNT EMPLOYER TAX CREDIT

Question: The President has proposed a new tax credit to reimburse employers for contributions to Health Savings Accounts (HSAs). The President has also retained his proposal to give low-income workers a fixed dollar amount to purchase insurance in the individual market as a way to provide health coverage to the uninsured. The employer tax credit is contingent on the employer making a high-deductible health policy (HDHP) available to employees, but the employer is not required to pay any part of the premium. In fact, the tax credit for individual purchase of insurance would not be available if the employer did pay some part of the premium.

How would a tax credit for an HSA contribution be more effective at expanding small employer health coverage than a small employer tax credit for insurance premiums?

Answer: While employer-sponsored coverage is widespread in the large group market, smaller firms are far less likely to offer coverage to their workers. Half the uninsured are employees of small firms and their families. The existing favorable tax treatment of employer-sponsored health coverage has thus proven less effective in the small group market. The tax credit for an HSA contribution would provide an additional incentive to small employers to sponsor health coverage as well as to contribute to their employees' HSAs. These accounts enable consumers to pay ordinary health care expenses and save for future medical needs, thus giving them both the incentive and the means to base their health care decisions on quality and price. Moreover, the accounts belong to the workers and are fully portable, providing new protections to people who change jobs.

Question: Would the administration support extending the tax credit for individual purchase of HDHPs to small employers who make HDHPs available to employees?

Answer: Extending the tax credit for individual purchase of health insurance to small employers is more expensive and less efficient than what the administration has proposed. The credit would be claimed by employers who already provide coverage to their workers, resulting in substantial revenue loss to the Federal Government on behalf of people who already have coverage. The new tax credit for employer contributions to HSAs is a less-costly way to provide assistance to these firms and would encourage coverage that empowers consumers to take greater control over their health care decisions.

This approach also is more fiscally responsible than a broader tax credit for small firms. Moreover, it is more appropriate to target the refundable tax credit and the above-the-line deduction to non-self-employed people who purchase coverage outside the group market, since they now get no favorable tax treatment of their health insurance expenditures.

For clarification, the proposed tax credit for individual purchase of health insurance is not limited to HDHPs, although it can, at the individual's option, be split between a premium subsidy for HDHP coverage and a contribution to a health savings account. Individuals who elect to receive their credit in this way can receive employer contributions to their health savings accounts.

SAVINGS ACCOUNTS PROPOSAL (LSAs AND RSAs)

Question: The administration's proposal for LSAs and RSAs is presented as an expansion of savings opportunities. In analyzing the proposal, it appears that there are two groups that would have expanded savings opportunities—those whose income is too high to make contributions to RSAs or deductible contributions to traditional IRAs, and that 6 percent of the population that is already maximizing contributions to their 401(k) and IRA accounts. Some of the second group is probably included in that first group. It is true that LSAs would allow individuals who do not currently qualify for HSAs to save for medical expenses, and other unanticipated expenses. But Roth IRAs already allow these individuals to withdraw contributions without penalty, but not earnings, to cover some of these costs.

How much new savings would you anticipate if this proposal to "Expand tax-free savings opportunities" were enacted?

Answer: We strongly believe that the Lifetime Savings Account and Retirement Savings Account (LSA/RSA) proposals will increase personal savings. However, we disagree with the premise of your question, that this effect would come primarily from higher income taxpayers that are currently limited by Roth-IRA or deductible

IRA income limits. The primary effect will come from the simplification of the rules for tax-preferred savings accounts.

There are many savings incentives in the tax code. However, the effect of these incentives is blunted by the maze of complex rules that surround the incentive. Taxpayers must determine their eligibility for each account and then must decide which plan is best given their circumstances. Furthermore, as their circumstances change over time, taxpayers must continually re-evaluate their eligibility for each plan and determine which plan best meets their needs. The goal of the LSA/RSA proposal is to have two simple accounts for taxpayers: one dedicated to retirement savings (and only retirement savings) and one dedicated to savings for any other purpose, including augmenting retirement savings, health care, covering emergencies, and education. The LSA/RSA proposal will mean that taxpayers will no longer need to sort through the maze of savings options and allocate savings accordingly.

Currently, IRAs allow penalty-free withdrawals for a long list of qualified expenses not related to retirement, and this list has grown over time. In addition to retirement, death, or disability, penalty-free withdrawals are allowed for: equal periodic payments; medical expenses allowable as an itemized deduction; health insurance premiums while unemployed; higher education expenses of taxpayer, spouse, child or grandchild; first-time home-buyer expenses of up to \$10,000 total including for child or grandchild. And, as you mention, Roth IRAs allow withdrawal of principal without tax or penalty. The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving. In addition, special purpose saving accounts exist for educational expenses—Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs), and medical expenses—Archer Medical Savings Accounts (MSAs) and Health Savings Accounts.

However, despite the long list of exceptions to IRA withdrawals and the growing number of specialized savings vehicles, restrictions placed on withdrawals and tax penalties imposed on non-qualified distributions discourage many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them. In addition, the restrictions place a burden on taxpayers to document that withdrawals are used for certain purposes that Congress has deemed qualified.

The goal of the savings proposals is to encourage more savings by simplifying the tax law. For example, the proposals would remove income limits on contributions. Income limits increase complexity and likely reduce participation among low- and moderate-income taxpayers. After IRA income limits were imposed in 1986, participation fell among lower-income taxpayers, even among those still eligible for a deduction. This may have occurred because many potential participants may have incorrectly believed themselves ineligible. In addition, financial institutions curtailed their marketing activities in response to the income limits, reducing knowledge about the accounts among those still eligible. Repeal of the income limits would eliminate confusion about eligibility and encourage new marketing efforts by financial institutions.

The primary focus of this proposal is not high-income taxpayers. Under current law, higher-income taxpayers have ample opportunities to save in tax-favored accounts. Nearly all high-income taxpayers work for employers that offer retirement plans. All can establish a Section 529 qualified tuition plan for their children or grandchildren. Many are eligible to contribute to an IRA, Coverdell ESA, Archer MSA, or HSA. These saving incentives are designed around the savings needs of most high-income taxpayers. Two-thirds of households in the top quartile of income cite qualified purposes—retirement, education, or buying a house—as their primary reason for savings, compared to one-third of households in the bottom income quartile. In contrast, 56 percent of low-income households cite non-qualified purposes—access to funds in an emergency or saving for a big-ticket purchase—as their primary reason for savings, compared to 29 percent of high-income households.

Lower-income taxpayers are less likely to save in retirement plans or other tax-preferred accounts. Fewer lower-income taxpayers work for employers that offer a retirement plan. They are less likely to be aware of saving opportunities or to be financially sophisticated. They are unlikely to save in any account that restricts access to their funds, as they place a high value on unrestricted access to invested funds for a variety of unforeseen, but critical needs, such as medical emergencies, unemployment spells, and other contingencies.

The lack of restrictions on the use of LSA withdrawals substantially increases the likelihood that lower-income taxpayers will participate. Low-income taxpayers have traditionally been less likely to participate in IRAs and other tax-preferred savings accounts, because they have fewer resources to devote to savings. With fewer dollars to save, such taxpayers would be more likely to face a penalty if they needed the funds in an emergency and had saved in an IRA. LSAs give them tax-free earnings

from their first dollar of savings, and withdrawals can be made at any time for any purpose with no tax or penalty.

We would expect personal savings to increase, although any exact estimate would be necessarily imprecise. A recent study that is forthcoming in the Proceedings of the Fall 2004 National Tax Association Conference suggested that, after 10 years, LSAs would increase personal savings 1¼ percent, with the increase coming primarily from lower-income taxpayers. This pattern of increased savings by lower-income taxpayers would square with research done by Treasury economists. Savings incentives encourage more savings only if they provide a marginal incentive to save—*i.e.*, if taxpayers do not simply transfer existing savings into the accounts. Our analysis shows that 65 percent of taxpayers would be able to place all their liquid financial assets in an LSA in the first year after they are enacted, and 80 percent would have all of their financial assets in an LSA after 10 years. Thus, the vast majority of taxpayers would have a marginal incentive to save under the LSA proposal.

Question: How much savings would be shifted from current taxable vehicles to these new tax-advantaged vehicles by individuals whose income is too high to contribute to the existing Roth IRAs?

Answer: With the caveat that these estimates are imprecise, after 10 years our estimates suggests that, although only 20 percent of taxpayers would still hold taxable financial assets, over 80 percent of financial assets that would otherwise be taxable would still be held in taxable accounts. We do not have specific estimates for those ineligible for Roth-IRA contributions, but we estimate that taxpayers with AGI over \$200,000 in 2002 dollars would only be able to transfer about 2 percent of their taxable financial assets into LSAs after 10 years.

We believe that the removal of income limits is an integral component of the savings proposals, that the proposals will lead to greatly simplified and understandable savings options for individuals, and that they will allow financial firms to market a single product to all individuals.

Again, we do not believe that the main response to these new accounts will be from higher-income individuals. High-income individuals currently have ample opportunity for tax-advantaged savings. Unlike lower-income taxpayers, almost all high income taxpayers are covered by a pension or retirement plan. Up to \$41,000 a year may be contributed on behalf of an employee into these employer-provided retirement plans. In addition, high-income individuals may set up a Section 529 plan for their children or grandchildren and contribute up to \$55,000 to the account of each beneficiary in a single year without creating a taxable gift, assuming no other gifts to the beneficiary are made during that 5-year period.

TAA HEALTH CARE TAX CREDIT PROGRAM

Question: The TAA health care tax credit program (HCTC), which provides a 65-percent refundable, advanceable tax credit toward the purchase of health insurance for certain displaced workers and PBGC beneficiaries, has not proven to be as successful as many of us imagined. Enrollment is low, premiums charged by insurers are high—in some cases as high as 500 percent above standard rates, according to the GAO—, administrative costs are high, and not all States have adopted legislation to provide coverage for those who are eligible for the credit but not eligible, or choose not to enroll, in COBRA continuation coverage.

How much does the Treasury Department expect to spend in FY 2006 to administer this program? How does that figure compare to benefits paid under the program?

Answer: Currently, the proposed administrative cost for FY 2006 is \$20.2 million for the HCTC. This represents a significant reduction in administrative costs over the first 2 years of operation, reflecting improvements we have made in the program based on our experience.

For budget purposes, the estimated benefit payment under current law is approximately \$140 million for FY 2006. However, it should be noted that this is a rough estimate. Because of the newness of the credit, it is hard to predict how much the take-up rate will increase. We have started to see a rise in enrollment in the advance payment option and expect claims for the end-of-year credit to increase gradually.

Question: What are the administration's plans to fix some of the problems that have been identified with the HCTC program?

Answer: The HCTC is an entirely new program: we are serving populations that have never been given assistance for health insurance before, and we are providing the assistance through a new mechanism, a tax credit. Not surprisingly, we are learning many new things about both the recipients of the credit and how to admin-

ister the tax credit. The administration's goal from the beginning has been to make the credit as effective and efficient as possible in assisting eligible individuals and their families in purchasing health insurance. To that end, we are continually assessing our own performance and making adjustments as appropriate. Moreover, outside groups have been assessing our actions. For example, last fall the GAO released a report with a number of recommended changes, all of which we accepted and are moving to implement, and we have also reviewed the work of outside researchers for ways to improve the program.

The administration includes in the budget a proposal that would make several changes to improve the HCTC. First, the administration proposes to make the requirements relating to qualified State-based coverage under the HCTC more consistent with the rules that have been available since 1997 under the Health Insurance Portability and Accountability Act (HIPAA). We believe that this consistency would encourage health plans to offer coverage to the HCTC-eligible population, making qualified plans more readily available and expanding the coverage option. Second, the administration proposes to permit spouses of HCTC-eligible individuals to claim the credit under certain circumstances, when the HCTC-eligible individual is entitled to Medicare. This change would address the sympathetic situation where a younger spouse loses the benefit of the HCTC because their HCTC-eligible spouse becomes entitled to Medicare. Third, the administration's proposal includes a number of technical clarifications that are important to facilitate the administration of the HCTC.

There are also changes in tax administration that will make delivery of the HCTC benefit more efficient. As the function of the HCTC program is transitioning from developing the infrastructure to carrying out the daily operation, the cost of administering the credit is declining. For example, the HCTC program office restructured the task orders with its main contractor, which resulted in significant cost savings. The IRS has also been working aggressively to reduce other operational costs. As a result of these efforts, the resources requested by the IRS to administer the credit for FY 2006 are reduced substantially to \$20.2 million, a major reduction over the past 2 years.

The administration is fully committed to maximizing use of the tax credit among those who are eligible and in need of coverage, by increasing awareness and minimizing the timeframe for enrolling individuals for advance payment, through education, administrative change, and increased coordination with partner agencies. We will continue to identify ways to enhance efficiency in delivering the benefit. We look forward to working with Congress to improve the credit.

Question: The GAO has identified the affordability of premiums as one of the major reasons enrollment is so low among those eligible to participate. Would the administration support increasing the tax credit above 65 percent? Would the administration support placing more restrictions on the level of premiums that insurers are allowed to charge?

Answer: The high premiums we have seen reflect a number of factors: the relatively older ages of the eligible population, the older ages of other enrollees in the plan, the nature of State insurance rating practice, and the fact that some of the eligible individuals are undoubtedly high risks. For example, PBGC pension recipients have to be 55 years or older to be eligible for the credit, and the average age of those enrolling is over 50 (including TAA and PBGC eligibles). These individuals may pay a relatively high premium for COBRA because their health plans include a considerable portion of retirees who are of similar or even older ages (*e.g.*, steel industry plans). Due to the age and health factors, they may also face a high premium for State-based coverage, for which rates are generally under State regulation.

The administration is concerned about the burden of high premiums on eligible families. However, we do not believe that significant changes to the HCTC, such as raising the credit rate or restricting premium charges, are appropriate at this time. We are working very hard to assist eligible individuals in registering in the advance payment program promptly and providing required documentation in order to shorten the waiting period for the initial advance payment. To increase the effectiveness of our outreach efforts, we continue to explore ways—through surveys, public data, and working with health plans—to better understand the demographics and health risks of the eligible population. Given that the HCTC is still relatively new, health plans may still be learning about the risk profile of eligible enrollees. Plans that have not taken actions may be waiting for the participating plans' experience to decide whether to provide qualified coverage. We will continue to monitor closely the operation of the HCTC and evaluate options to expand eligible enrollment.

TAX REFORM

Question: Does the President's public promise of a revenue neutral tax reform package assume that his 2001 and 2003 tax cuts are permanent?

Answer: Yes. In the Executive Order establishing the Advisory Panel on Federal Tax Reform, the President has directed the panel to report with revenue neutral options for reforming the Internal Revenue Code. The baseline against which the standard of revenue neutrality is measured is one that includes the assumption that the tax cuts enacted in 2001 and 2003 are made permanent.

Question: Chairman Grassley and I sent a letter to Senators Mack and Breaux in which we urged them to use the Joint Committee on Taxation's (JCT) scoring methodology because Congress is bound by such scores when we determine revenue-neutrality. According to press reports, the President's call for a "revenue-neutral" tax reform proposal from his tax reform panel will be determined using the "President's policy baseline." Congressional actions are not measured by a presidential policy baseline. Will the administration commit to use JCT scoring conventions for purposes of determining the cost of its tax reform package?

Answer: The President has directed the Advisory Panel on Federal Tax Reform to submit revenue neutral policy options for reforming the Internal Revenue Code to the Secretary of the Treasury. The President has chosen the policy-baseline of the FY 2006 budget as the reference for determining revenue neutrality because it assumes permanence of the tax cuts enacted by Congress in 2001 and 2003. The President believes that the continuation of the 2001 and 2003 tax cuts is important to sustained economic growth, and that a baseline reflecting permanence provides the best standard against which revenue neutrality should be measured. Revenue neutrality options will also be consistent with the conventions generally used by the Treasury Department for estimating the revenue effects of changes in tax policy.

Question: The President's budget does not include reforms to the Alternative Minimum Tax. The administration indicates it intends to take care of the problem next year, and the President's tax reform advisory panel will address the matter. Nonetheless, the budget did include making permanent the other tax cuts from 2001 and 2003—including estate tax repeal—at a cost of \$256 billion and the dividend rate cut—at a cost of \$102 billion. Yet none of these tax cuts expires before the AMT relief provision expires. What is the administration's justification for placing 8 million middle income taxpayers at risk by not asking for the AMT fix now?

Answer: Last year, the Working Families Tax Relief Act extended the higher AMT exemption amounts through calendar year 2005. That extension has kept the impact of the AMT from increasing dramatically for 2005 and has provided time for the administration and the Congress to address the AMT issue.

Because of the complexity of our tax system and the interrelations between many of its provisions, issues involving the AMT should not be dealt with in isolation. Any solution to the AMT issue is likely to be in the context of overall changes to the entire Federal tax system. Given that the tax reform panel appointed by the President will be examining the tax system and providing options for the future of the tax system, it seems prudent to await the findings of the tax reform panel before recommending solutions to the AMT issue. That way, the President will be able to recommend overall changes that include the AMT.

Question: The annual cost of the President's tax proposals more than doubles from 2011 to 2015. Please explain how can such increases be affordable?

Answer: The President's tax proposals are not only affordable, they are essential. The tax relief measures that have been signed into law during the past 4 years helped pull the economy out of recession and fueled the recovery, business investment and job creation.

Making them permanent will enable families and businesses to invest and plan with confidence and help sustain the expansion.

If we allow the tax cuts to expire, the economy will suffer. Higher tax rates will discourage economic growth and job creation and reduce paychecks.

The economy cannot afford a plan that does not include the President's tax proposals.

TAX GAP

Question: Former Commissioner Charles Rossotti told the IRS Oversight Board in 2002 that the IRS does not have the resources to pursue identified tax debtors and cheats. The numbers provided in his report are staggering:

- 60 percent of identified tax debts are not pursued.
- 75 percent of taxpayers who did not file a tax return are not pursued.
- 79 percent of identified taxpayers who use abusive devices to evade tax (tax shelters and offshore financial accounts) are not pursued.

- 56 percent of identified taxpayers with incomes of \$100,000 or more who under-report tax are not pursued.

It has been 3 years since Commissioner Rossotti's report. What are these numbers now?

Answer: The numbers Former Commissioner Rossotti reported to the IRS Oversight Board resulted from a series of special analyses he requested. Although we remain committed to identifying the causes of noncompliance, and to developing effective strategies to combat noncompliance, the IRS has not conducted a similar set of special analyses recently, so we do not have comparable figures to report at this time. A cornerstone of our commitment in this area is completion of the ongoing individual income tax reporting compliance study under the National Research Program (NRP). The NRP is the first broad-based compliance study since the Taxpayer Compliance Measurement Program (TCMP), which was based on data collected in the 1980s. We expect preliminary analysis of the initial round of NRP data to be forthcoming in late March of this year.

Although the numbers cited by Commissioner Rossotti have not been updated, since his report the administration has, with Congress' support and assistance, acted aggressively to promote better compliance, particularly in the area of abusive tax avoidance transactions that are a major component of the compliance problem. These initiatives include:

- Focusing and increasing the disclosure requirements for abusive transactions.
- Using regulatory authority to shut down specific abusive transactions.
- Taking vigorous enforcement action against promoters of abusive transactions and taxpayers who participate in such transactions.
- Proposing and supporting recently-enacted legislation to shut down abusive transactions.
- Proposing and supporting recently-enacted legislation to allow IRS to supplement its collection workforce with private collection agents for uncontested tax debts.

The President's FY 2006 budget includes a request for greater IRS enforcement resources—a \$500 million or 7.8 percent increase for IRS enforcement activities—that will allow the IRS to accelerate these efforts and address a wide range of non-compliance.

A significant factor contributing to noncompliance is the enormous complexity of our tax laws. The complexity of the tax code makes it hard for taxpayers to understand and comply with and is also more costly for the IRS to administer. Faith in the fairness of our tax system is undermined when taxpayers believe others can exploit the complexities of the law to avoid paying tax. The President's Advisory Panel on Federal Tax Reform will submit options later this year to fundamentally reform the tax law to make it simpler and fairer and to reduce the cost and burden of compliance.

Question: How would you characterize this level of noncompliance?

Answer: The figures cited by Commissioner Rossotti relate more to the extent to which the IRS forgoes enforcement opportunities due to a lack of resources than to compliance levels generally. In this area, the IRS has been guided by the working equation that Service plus Enforcement equals Compliance. We have generally halted the decline in enforcement activity by focusing resources in that direction over the past 2 years. Continuing that trend, however, will require that Congress support the President's FY 2006 budget request for additional resources to support our enforcement activities. The budget request is especially important in the face of growing workloads, population increases, and the difficulties inherent in administering an increasingly complex tax code.

Question: Is the administration's effort to address noncompliance commensurate with the threat this deliberate cheating poses to the integrity of the tax system?

Answer: The tax gap also helps to illustrate why the tax system is in need of reform. The President has made reform of the tax code a key priority and has appointed a panel of experts to take a fresh look at the current system and develop options to make it simpler and fairer.

Question: Taxpayer service, enforcement, and modernization are each critical components to closing the \$311 billion *annual* tax gap—that is, the difference in the taxes owed versus the taxes collected. What specific steps in taxpayer service, modernization, and enforcement is the administration taking to eliminate the tax gap?

Answer: The tax gap consists of three main components: (1) filing noncompliance; (2) payment noncompliance; and (3) reporting noncompliance. Effectively addressing each of these components requires a careful balancing of priorities in the areas of taxpayer service, modernization, and enforcement.

Taxpayer Service. The IRS is working to further its strategic goal to improve taxpayer service and to further Treasury's strategic objective to collect revenue through

a fair and uniform application of the law. Taxpayer service includes assistance activity, outreach, and processing. Resources allocated to assistance activity enable taxpayers to fulfill their tax obligations timely and accurately, while minimizing taxpayer burden. Outreach activity includes proactive programs for individual taxpayers, businesses, non-profit organizations, tax practitioners, and others to ensure they understand their tax obligations and have the information and materials necessary to fulfill their responsibilities. Processing activity includes the processing and disposition of tax returns, refunds, and other information. These taxpayer service programs directly address the portion of the tax gap related to filing noncompliance.

Modernization. In the modernization area, the IRS will continue to strategically manage resources, associated business processes, and technology systems to effectively and efficiently meet service and enforcement strategic goals. Improvements in this area address all three major components of the tax gap. Current systems modernization projects include the Customer Account Data Engine (CADE), Filing and Payment Compliance (F&PC), and Modernized e-File (MeF). The IRS is also moving aggressively to implement systems and programs that simplify and automate the return filing process. Reaching the goal of having 80 percent of all Federal tax and information returns filed electronically will reduce the reporting burden on taxpayers while improving the efficiency and effectiveness of government operations, helping to address the problem of noncompliance.

Enforcement. With the FY 2006 budget request, the IRS will enhance its enforcement efforts, with an emphasis on corporations and high-income individuals. This will permit the IRS to directly address payment noncompliance and reporting noncompliance. For corporations, the IRS will focus enforcement efforts on providing resources to increased coverage of high-risk compliance problems such as abusive tax shelters and corporate tax fraud. The IRS will also focus on increasing audit coverage for high-income individuals.

In the enforcement area, the IRS has instituted a number of process improvements to address payment noncompliance and reporting noncompliance. These include instituting the following process improvements to reduce cycle time, thereby increasing audit coverage:

- Elimination of sections of the Internal Revenue Manual (IRM) that lengthen the examination process without providing any additional value.
- Establishment of Inventory Managers at each campus to ensure the timely movement of inventory.

The IRS has also started other enforcement initiatives, including:

- Refocusing Automated Collection Services (ACS) on the collection mission while maintaining quality, customer satisfaction and employee satisfaction.
- Improving collection coverage for high-dollar/high-income balance due and non-filer accounts through expanded use of locator services and in-depth analysis.
- Continuing to expand the Federal Payment Levy Program (FPLP) to collect unpaid taxes.
- Focusing on a multifunctional non-filer strategy that targets compliance efforts.
- Redesigning the withholding compliance process.
- Pursuing the use of private collection agencies (PCAs) to help collect Federal tax debts, as authorized by Section 881 of the American Jobs Creation Act of 2004. While ensuring that taxpayer rights are preserved, the use of PCAs to support the IRS's overall collection effort enables the IRS to:
 - Efficiently address a significant number of cases that now go untouched due to collection and resource priorities, and
 - Focus its existing collection and enforcement resources on more difficult cases and issues.

Question: On January 11, 2005, the National Taxpayer Advocate released several proposals to improve tax compliance. On January 27, 2005, the Joint Tax Committee released a package of 70 proposals to improve tax compliance that would raise \$400 billion. However, the President's budget only includes \$2.6 billion in proposals to close loopholes and improve tax compliance. Are the loophole closers contained in the budget the only loopholes identified by the administration? What is Treasury's view of the Taxpayer Advocate's recommendations? To what extent is the administration working on additional proposals? Please provide Treasury's comment on each of the Joint Committee on Taxation's proposals to improve compliance.

Answer: We have reviewed both the Joint Committee's proposals and the Taxpayer Advocate's report, and we believe them to be helpful in considering ways to improve taxpayer compliance. The Joint Committee's proposals were issued in late January of this year, near the end of the budget process. Accordingly, although we generally support a number of the Joint Committee's proposals, they are not necessarily reflected in the administration's budget, and our consideration of the proposals is ongoing. Similarly, the Taxpayer Advocate's report was not published until

early January, and we were not able to fully consider its recommendations in drafting the administration's budget proposals. Notwithstanding, there is some consistency between the Joint Committee's proposals, the Taxpayer Advocate's report, and our budget proposals, particularly in the context of improving taxpayer compliance.

Many of the Joint Committee's proposals and the recommendations in the Taxpayer Advocate's report relate to compliance problems that arise from complexity of the tax laws. We have identified complexity as a primary reason for fundamental tax reform, and the President's Advisory Panel on Federal Tax Reform is currently working to develop proposals to make the tax code simpler and fairer. We look forward to addressing this issue in more detail once the panel has completed its work later this year.

Question: What do you say to those who suggest the IRS always goes after the easy cases by sending letters (e.g., correspondence audits) but is incapable of pursuing deliberate cheating?

Answer: In the past few years, the IRS has taken a number of steps to address the compliance problem created by complex tax avoidance transactions. In FY 2004, the IRS brought in a record \$43.1 billion in enforcement revenue—an increase of \$5.5 billion from the year before. A significant part of this increase is attributable to the IRS's increased focus on complex, abusive transactions. The President's FY 2006 budget request includes an increase in resources devoted to enforcement, which would allow the IRS to continue its focus in this area.

While increasing its focus on sophisticated, abusive transactions, the IRS continues to balance its commitment of resources in this area with the use of traditional correspondence audits. Correspondence audits are examinations focusing on a limited number of specific issues on a tax return that cannot be addressed through math error authority. While these examinations minimize the burden on both taxpayers and the IRS, they also provide a significant compliance impact. In FY 2004, the IRS assessed \$3.6 billion in tax as a result of its correspondence examination program—with an average assessment of more than \$4,400.

Because the vast majority of taxpayers make every effort to comply with the tax laws and do not engage in activity that requires detailed field examination review, errors and discrepancies on most returns can be resolved through correspondence audits. Judicious use of correspondence audits allows the IRS to devote its field examination resources to more complex, high-risk cases, such as abusive tax avoidance transactions, corporate tax shelters, and high-income taxpayers whose tax situations involve pass-through income and structured transactions.

IRS FY 2006 BUDGET REQUEST

Question: The IRS Oversight Board recommends \$11.629 billion for IRS. In contrast, the administration requested \$10.679 billion, a difference of \$1 billion. What specifically would IRS be able to do in taxpayer service, enforcement, and modernization if the Oversight Board recommendation were adopted? Why has the administration proposed a budget for the IRS which is less than the IRS Oversight Board's recommendation?

Answer: The administration's FY 2006 budget request for the IRS takes a balanced, measured approach to the challenges facing our tax system, with an emphasis on strengthening enforcement. The proposal recognizes the fiscal demands placed on all Federal agencies. The budget request is designed to ensure that the tax system is fair for all taxpayers, while protecting taxpayer rights. The budget request, if fully funded, is adequate to support IRS tax administration responsibilities. The administration's budget has proposed an increased budget for the IRS in each year of this administration, including a 7.8-percent increase in IRS enforcement for FY 2006.

Question: In the IRS Restructuring and Reform Act of 1998, Congress stated "that taxpayer service is of such importance . . . a key part of the IRS mission must be taxpayer service." Nonetheless, the President's FY 2006 budget request for the IRS calls for a combined 1 percent reduction (\$38.5 million) in taxpayer services, and shows a shift in some resources from service to enforcement. Furthermore, by walling off enforcement dollars, any potential across-the-board cut in discretionary spending will disproportionately affect taxpayer service.

Page 880 of the budget appendix refers to a 2004 program assessment of taxpayer service as partial justification for a reduction in dependence on walk-in service centers. Please provide the program assessment and explain how these results led to the President's cuts in taxpayer service.

Answer: The Office of Management and Budget performed the program assessment with their Program Assessment Rating Tool. The results of the program assessment are included in the President's budget. The 2004 program assessment doc-

uments that taxpayers are decreasing their use of walk-in service centers and direct telephone contacts and increasing their use of alternate, more efficient forms of service. This trend has resulted in reductions in the number of direct contacts and increases in overall efficiencies. Additionally, the IRS is making improvements in electronic customer access, such as the suite of e-services applications introduced to provide electronic alternatives to payers and authorized agents to match payee taxpayer identification numbers (TINs) against IRS records, and to allow tax professionals to obtain powers of attorney, resolve account issues, and request account transcripts. These efforts and changes in taxpayer behavior support the proposed reductions in taxpayer service appropriations reflected in the budget. Consistent with promoting electronic customer service is the parallel effort by the IRS to implement systems and programs that simplify and automate the return filing process. Reaching the goal of having 80 percent of all Federal tax and information returns filed electronically will greatly reduce the number of processing errors on returns, thereby reducing the number of instances where taxpayers must interact with the IRS.

Question: What impact will less funding have on taxpayer service (e.g., affect on telephone access, potential for layoffs, closing of taxpayer assistance centers)? Please explain in detail.

Answer: The IRS continues to refine its taxpayer service capabilities, and recent program assessments have found significant improvements in taxpayer service over the past few years. These program assessments also identified an opportunity to shift towards greater use of telephone and internet options rather than walk-in service. The IRS is answering a higher percentage of calls, and electronic filing is growing steadily. The IRS has used new technology—particularly the internet and electronic filing—to improve taxpayer service and productivity. The IRS will continue to make productivity gains while working to improve overall service to taxpayers. When coupled with productivity gains, less funding does not lead to a decrease in the level or quality of taxpayer service.

The budget does call for the IRS to do a modest amount of belt-tightening in the area of taxpayer service. We expect to make selected service cuts, including closing some taxpayer walk-in offices. These walk-in sites are relatively expensive, and the number of visitors has dropped as use of the IRS website has dramatically increased. We believe that we can utilize efficiencies in processing and workflow in order to ensure that no decrease in taxpayer service will result from the reduced appropriation.

Question: What criteria or strategy will be used to identify specific areas of service to be cut?

Answer: We are still developing the criteria that will be used to target service cuts, and hope to have them established and ready to share with you soon. We will be happy to brief you when we establish the criteria.

Question: Commissioner Rossotti said it would take 10 to 15 years to modernize the IRS. Unfortunately, very little success has been achieved with respect to the most significant modernization effort—Customer Account Data Engine (CADE). The IRS announced reductions in its modernization efforts to accommodate budget decreases in FY 2005, and the President's FY 2006 budget cuts modernization even further.

What modernization and productivity savings will not be achieved because of the proposed FY 2006 cuts?

Answer: We firmly believe that we are making progress on all our systems modernization commitments. The President's budget proposes spending \$199 million in FY 2006 on business systems modernization. This appropriation provides for re-vamping business practices and acquiring new technology. The IRS is using a formal methodology to prioritize, approve, fund, and evaluate its portfolio of business systems modernization efforts. The \$199 million enables us to provide a reasonably balanced program that builds out essential infrastructure, delivers taxpayer value, improves internal operations, and is within our ability to manage and implement.

The Business Systems Modernization (BSM) program has been steadily working on implementing management processes based on best practices in cost and scheduling planning, configuration management, risk management, management progress reporting, acquisition management, and other factors. As these management processes mature, the BSM program will run closer to cost and schedule estimates, and our capacity to initiate additional projects will increase. With regard to the proposed FY 2006 budget, the financial impact is a total of \$4 million (\$203 million vs. \$199 million). This difference of \$4 million in a single year is not likely to have a long-term demonstrable impact on the program with regard to tax administration savings and productivity. The total BSM request of \$199 million provides the appropriate balance within the total IRS budget among modernization, enforcement and customer service activities.

Question: How many of the 11 central systems to business systems modernizations (BSMs) have been delivered on time and within budget? Please provide detail.
Answer:

PROJECT	Cost Met	Schedule Met
Computer Account Data Engine (CADE) (2004)		
<ul style="list-style-type: none"> • Release 1.0 • Release 1.1 • Release 1.2 	No Yes Yes	No Yes Yes
Integrated Financial System (IFS) (2004)	No	No
Modernized eFile (2004)		
<ul style="list-style-type: none"> • Release 1 • Release 2 • Release 3.1 	Yes Yes Yes	Yes Yes Yes
e-Services (2003/2004)		
<ul style="list-style-type: none"> • Release 1.1 • Release 1.2 • Release 2.0 	No Yes Yes	No Yes Yes
HR Connect (2002) (funded by Treasury)	Yes	No
Internet Employer Identification Number – EIN (2003)	Yes	Yes
Internet Refund Fact of Filing (IRFoF)	No	Yes
Advanced Child Tax Credit (2003)	Yes	Yes

The BSM missed most of its timeline and dollar targets in the past. However, substantial progress has been made in the past 2 years in improving performance.

Question: When will the modernization effort be completed?

Answer: The hallmark application of the BSM program is the Customer Account Data Engine (CADE), which is the application the IRS is building to incrementally replace the existing Individual Master File and the Business Master File. CADE is now in service and handling its first filing season. Currently, CADE is only handling a subset of Form 1040EZ filers, with the expectation that it will process approximately 1.9 million returns this calendar year. The IRS has set plans for CADE for the next 2 years, with the expectation that CADE will handle 33 million returns in calendar year 2007.

It is impossible, however, for the IRS to predict when it will fully implement CADE, since this timing is based on a variety of unknown factors, including BSM funding levels, insertion of new technology to improve development productivity, and policy decisions regarding the extent to which CADE will need to handle returns from prior years. As a point of comparison, former Commissioner Charles Rossotti stated that he expected BSM implementation to last 10 years. Progress anticipated in the first 4 years of the project, however, fell short of goals for reasons that the IRS has stated publicly. In addition, the 10-year estimate was based on the expectation of robust funding levels for FY 2005 and FY 2006. Because of steps the IRS has taken to streamline and focus the work it is doing on BSM, the IRS requested and received lower funding levels than Commissioner Rossotti anticipated when he provided his estimate.

Additionally, given the size and complexity of the IRS's information technology (IT) assets, modernization must be an ongoing endeavor. Modernization programs at the IRS have been difficult, mainly due to the fact that the IRS previously did not have a program of continual modernization of its IT assets. This deficiency has led to a situation of increasingly antiquated software applications that are not well documented, are difficult to maintain and upgrade, and are difficult to interface with. Given that the heart of the IRS IT effort is to increase the effectiveness and efficiency of tax administration, modernization will always be an ongoing activity at the IRS.

Question: How much has been spent thus far? How much additional expense is anticipated? How do these figures compare with original estimates?

Answer: On August 25, 2004, the IRS submitted to the Government Accountability Office (GAO) a reconciliation of the BSM cost variance schedule analyzing the BSM baseline estimates. This schedule includes expanded capabilities for existing projects and deliverables, which the IRS did not capture in the original baseline amounts.

Based on the August 25, 2004 BSM cost variance schedule, which has been reviewed and validated by the GAO, the original project baseline amount is \$678.4 million, versus a total BSM project cost of \$1.1 billion, an increase of \$380.5 million. It is important to note that the original baseline schedule did not include funding for project releases reflected in the reconciliation that total \$190.6 million. When this is taken into consideration, the new net increase over the baseline amount is \$189.9 million, 28 percent of the original baseline amount.

The IRS has shown marked improvement in reducing from 33 percent in 2002 to 4 percent in 2004 the variances between BSM cost estimates and actual delivery costs.

Question: The budget places conditions on any increase in enforcement funding by requiring that the \$446 million increase in Tax Administration and Operations be contingent on funding a baseline amount of \$6.446 billion that is restricted for enforcement. The budget also states that "the IRS yields more than 4 dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget."

What yield does the administration estimate from the increase in enforcement funding?

Answer: The IRS has developed a general methodology for computing direct return on investment (ROI) for enforcement initiatives. Over the years, the methodology has been refined and updated to reflect changes in economic factors, productivity, training, and the marginal yield of working additional cases, but it remains an imprecise tool. Applying this methodology and using a conservative estimate, if the IRS received the enforcement increase set forth in the budget request, it is expected to generate over \$1 billion of revenue annually once new hires become fully operational.

Question: What is the IRS's strategy for using this substantial increase?

Answer: The additional funding would be focused on the enforcement priorities of reducing the promotion and use of abusive tax schemes, including offshore transactions, abusive employment and corporate tax avoidance transactions, and non-filing by high-income individuals. Ninety-one percent of the increase would be used to detect and deter non-compliance, with an emphasis on non-compliance by corporations, high-income individuals, and other high-profile contributors to the tax gap. Four percent of the additional funding would be used to address criminal activity, and the remaining 5 percent would be used to detect and deter non-compliance by tax-exempt and government entities.

Question: Have quantitative goals for increased enforcement efforts been set?

Answer: The IRS has set performance goals, which may be found in the FY 2006 Treasury Congressional Justification.

Question: What is the IRS's strategy for enforcement if the request is not fully funded?

Answer: The enforcement initiatives in the FY 2006 budget request would be substantially reduced or eliminated if the actual appropriation is less than requested. Without the requested funding, the IRS will continue to perform its examination, collection, investigation, regulatory compliance, and research functions. However, the IRS will not realize the performance gains expressed in the FY 2006 budget request, and the projected additional annual revenue from these performance gains will not be realized.

Question: In recent years, the IRS's unbudgeted costs have included portions of salary and rent increases above those assumed in formulating the IRS's budget request.

What are the IRS's plans to cover any unbudgeted costs for FY 2006?

Answer: We will make every effort to protect the enforcement initiatives in the FY 2006 budget request. However, if Congress provides an unfunded pay raise or

other unbudgeted costs arise, this will likely have a detrimental impact on the FY 2006 initiatives. To continue to realize the returns on the proposed FY 2006 initiatives, such a shortfall would have to be covered by other base resources.

Question: To what extent, if at all, would those costs be covered from the budget increase designated for enforcement?

Answer: To the extent possible, the IRS will protect its enforcement programs while absorbing the effects of any unfunded mandates. However, continued unfunded mandates, as in past years, will necessarily have a negative impact. For example, if Congress provides a higher pay raise than proposed by the President, IRS would have to cover the shortfall within its base.

Question: In 1998, Congress directed the IRS to “continue to offer and improve its Telefile program.” Instead, the IRS has confirmed it is canceling its TeleFile program. The administration is thus canceling a program relied on by 4 million taxpayers with a 90-percent satisfaction rate. TeleFile is one of the few modernization success stories. The marginal cost of the TeleFile program is actually lower than paper filing if the TeleFile were simply expanded. Yet the IRS confirms that it has not marketed the program and that it has done little to expand the program. Instead, the administration plans to eliminate the program, which shifts millions of taxpayers back to paper filing and away from a digital form of filing. While cancellation may seem to save \$18 million in the short-run, switching taxpayers back to paper filing will actually increase the IRS’s costs in the long-run.

Why is the administration canceling TeleFile?

Answer: As a result of the increasing cost of maintaining the TeleFile infrastructure, declining taxpayer use, and the availability of other e-file alternatives, the IRS will discontinue the TeleFile program on the following timeline:

- Form 1040EZ and Form 4868 filers after August 16, 2005.
- Form 941 filers after February 11, 2006.

The IRS began TeleFile on a limited basis in 1992, as an initiative to move taxpayers to a paperless filing system. The IRS expanded the program in 1997 to include all 1040EZ filers, and expanded the program in 1998 to include Form 941 (Employer’s Quarterly Federal Tax Return) filers. In 2001, TeleFile was expanded again to include Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return) filers. Despite the successful delivery of TeleFile, participation in the program has been in decline. Participation by 1040EZ filers (72 percent of total TeleFile usage) has declined over 32 percent, from 5.6 million taxpayers in 1999 to 3.8 million taxpayers in 2004. This trend is predicted to continue through 2009. Over the same period, TeleFile declined as a percent of overall e-filing from 19 percent to 6 percent, while overall e-filing increased 110 percent, and on-line filing increased 493 percent.

TeleFile is the most expensive acceptance channel for 1040EZ returns, per transaction. As TeleFile usage continues to decline, the cost per transaction will continue to rise. Currently, while TeleFile costs the IRS \$2.63 per return, paper costs \$1.51 per return, and e-file costs \$0.67 per return. TeleFile usage would need to triple for costs even to be competitive with paper. To reach this volume, the TeleFile adoption rate would need to reach 80 percent among TeleFile-eligible taxpayers, although it is currently between 25–30 percent, and declining steadily. The decreasing use of TeleFile comes despite the IRS’s direct mailing of over 15 million TeleFile packages at a cost of \$3.3 million. The IRS spent an additional \$6 million for a Form 941 TeleFile mailout.

TeleFile is a short-term e-file solution for most individual taxpayers. Telefilers lose their eligibility as they have a child and claim a dependent, as do students with student loans and taxpayers over age 65. Additionally, a 2003 survey shows that eligible non-users have a strong resistance to TeleFile. Most non-users cite complexity and time-consumption as the main barriers.

In making the decision to sunset TeleFile, the IRS considered the declining use of TeleFile, the discontinuation of several State TeleFile programs, including California’s decision to cease TeleFile in 2005, and the growth of other electronic filing alternatives, such as Free File. In fact, Free File volumes grew from 2.8 million returns in 2003 to 3.5 million returns in 2004, a 26 percent increase. More than 60 percent of all individual filers qualify for Free File services and all TeleFile-eligible filers with access to the internet can use Free File. Additionally, the IRS considered the June, 2004 Electronic Tax Administration Advisory Commission (ETAAC) report recommendation to discontinue TeleFile. By sunseting TeleFile, the IRS will eliminate the growing operational costs (\$11.6 million in FY 2005 compared to \$8.6 million in FY 2004), and allow approximately \$18 million in operational, printing and postage costs to be used for other critical needs during 2006.

Taxpayers who use TeleFile may initially revert to paper filing (37 percent according to a customer satisfaction survey), but research shows they rebound to electronic

filing at a higher rate than the general population. Sixty-two percent of TeleFile users said they would try another e-file option if TeleFile was no longer available.

Question: Furthermore, the President's budget states that it "promotes increased electronic filing" (page 880 of Appendix). Please explain how cancellation of TeleFile supports this budget objective, when only 37 percent of TeleFile users indicated they would revert to paper filing in response to a survey conducted by IRS.

Answer: Discontinuation of TeleFile promotes electronic filing by enabling the IRS to devote scarce resources to providing less costly electronic filing alternatives. These alternatives are enjoying substantial growth in customer usage, in contrast to the antiquated telephone-based TeleFile system that is used by only 25 percent of eligible individual taxpayers and costs the IRS 4 times more per return than other e-file options and twice as much as paper filing.

Question: Deficits are at historical levels and the tax gap exceeds \$300 billion annually. Additionally, taxpayer service and modernization are just as critical to ensuring voluntary compliance as enforcement actions.

In that light, why is the agency that is responsible for collecting the funds that keep the government operating—the IRS—treated by the administration like all other agencies with respect to its appropriation?

Answer: The budget is a responsible proposal to seek efficiencies to maintain customer service while expanding enforcement programs and continuing investments in technology. Enforcement increases by 8 percent, while IRS's overall budget increases by 4 percent. These increases are well above the levels for most discretionary programs. Additionally, the IRS's enforcement budget is not treated like most other spending, because the administration has proposed adjustments to the discretionary caps for program integrity initiatives, including the proposed IRS enforcement increase.

Question: Does it make sense to exempt all of the IRS's operations from limits on discretionary spending to ensure its ability to fairly and effectively administer our tax laws?

Answer: We believe that IRS operations should continue to be subject to the same level of scrutiny and review as other Federal agencies.

We have proposed a restructuring of the IRS's budget beginning in FY 2006 that would ensure proper fiscal accountability. This restructuring will facilitate full alignment and integration of the IRS's goals and measures with its resources. The new budget will have a more direct relationship to major IRS program areas and its 5-year strategic plan. The new budget will combine the IRS's three major appropriations—Processing, Assistance, and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (IS), into one appropriation called Tax Administration and Operations (TAO).

Question: How do you respond to the suggestion that administration of the tax system and collecting taxes should cost whatever is required?

Answer: The budget is a responsible proposal to seek efficiencies to maintain customer service while expanding enforcement programs and continuing investments in technology. Enforcement increases by 8 percent, while IRS's overall budget increases by 4 percent. These increases are well above the levels for most discretionary programs. Additionally, the IRS's enforcement budget is not treated like most other spending, because the administration has proposed adjustments to the discretionary caps for program integrity initiatives, including the proposed IRS enforcement increase.

Question: IRS tells us that 740,000 people have set up offshore financial accounts concealing taxable income, costing the government \$20 to \$40 billion a year. Yet only 1,300 taxpayers came forward during the IRS's offshore voluntary compliance initiative (OVCI) program.

What is the IRS doing about the other 738,700 taxpayers?

Answer: The Offshore Voluntary Compliance Initiative (OVCI) program was implemented on January 14, 2003, and taxpayers had until April 15, 2003, to apply for the program. We received 1,321 applications, representing 3,436 returns. At this time, we cannot accurately estimate how many taxpayers participated in these schemes, although the Small Business/Self-Employed Division is currently working on a research project to estimate the number of potential promoters and participants involved in offshore and other abusive tax avoidance transactions. Meanwhile, we continue to aggressively pursue noncompliant taxpayers in the offshore arena by using information received from promoters and other sources. We collected over \$270 million in payments through the OVCI Project, and we expect additional collections as we focus on taxpayers who participated in these abusive transactions but failed to participate in the OVCI program.

Question: Please explain Treasury's efforts to shut down this abuse. Is the effort commensurate with the problem?

Answer: Please see the prior response for an explanation of the efforts the IRS is making to shut down these abusive transactions. Based on information currently available as to the nature and extent of the problem, we believe that an adequate portion of the IRS's limited enforcement resources is being targeted to these transactions.

Question: The National Research Program (NRP) is looking into the level of non-compliance. NRP results are due in early 2005.

Have you received preliminary information on the NRP?

Answer: At the end of September, 2004, the IRS generally completed examinations related to the individual income tax reporting compliance study conducted by the National Research Program (NRP) for Tax Year (TY) 2001. Data cleaning and refinement are ongoing. IRS analysts are now examining the data and developing a rough updated estimate of the TY 2001 individual income tax under-reporting gap, which the IRS expects to release by the end of March, 2005.

Question: Does the administration's IRS budget reflect preliminary data from the NRP indicating the tax gap is greater than expected?

Answer: As explained above, the IRS is developing an updated estimate of the under-reporting gap for the individual income tax, and expects to have that available by the end of March, 2005.

Question: What can you tell us about the level of compliance with our tax laws? Has it gotten better or worse in the past few years?

Answer: Anecdotally, the IRS has evidence of new pockets of non-compliance that have arisen in recent years. Moreover, the increasing complexity of the tax laws, combined with increasingly sophisticated efforts by lawyers and accountants to develop methods to evade taxes, could lead one to believe that non-compliance has increased across the board. There are, however, countervailing trends (such as improved record-keeping and income reporting) that may have led to increased compliance. As noted above, the IRS expects to have the first preliminary answers from the NRP with respect to individual income tax under-reporting by the end of March, 2005.

PROTECTIVE DETAIL

Question: The IRS collects \$2 trillion dollars each year to ensure the operations of our Federal Government. The IRS is asked to administer complex tax laws in a complex society. Congress also expects the IRS to simultaneously provide quality taxpayer service and vigorous tax law enforcement. Furthermore, the IRS modernization effort is critical to the success of our voluntary compliance tax system. The IRS has had difficulty achieving its mission and congressional expectations under the President's budget requests. Nonetheless, the Department of Treasury has furthered drained the IRS of resources by using IRS Criminal Investigation Division agents to transport the Deputy Secretary from home to work and to various places during the workday. The Finance Committee was informed that this "protective service" was necessary because of an elevated threat level for the financial services sector and that the IRS would be reimbursed for such services.

Deputy Assistant Secretary for Security, Ron Bell, stated that he determined a "protective service" was needed for Deputy Secretary Bodman. Mr. Bell said he did not follow secret service criteria for making such a determination and that the service was only for working hours. Please explain how an assessment that "protective services" were required for the Deputy Secretary because of an increase in the threat level can be bifurcated into a threat during working hours, but not during the remainder of the day?

Answer: The determination that the Deputy Secretary warranted protective services was based upon an independent and objective assessment of the facts and circumstances, including: the nature of the threat to the financial services sector, the appropriate security response to that threat, an estimate of the length of time protective services would be necessary, and the extent to which Treasury-provided transportation would be required during the period of protection.

The protective service detail was put in place to deter any possible harm that may come to the Deputy Secretary, detect threatening situations affecting his personal safety and security, defend the Deputy Secretary from physical harm, and quickly and safely remove him from any threatening environment to a more secure location.

The Deputy Secretary's residence, as well as the Main Treasury and White House Complex, were determined to be sufficiently secure to preclude the need for around-the-clock protective services. Official business conducted outside of these locations provided the greatest vulnerabilities that could only be effectively mitigated during the increased threat period by the use of protective services.

Question: Mr. Bell stated that the decision to provide the Deputy Secretary with such services was made on August 3, 2004. However, the Finance Committee has received a memorandum dated July 23, 2004 from the IRS's Chief, Ethics and General Government Law Branch regarding whether IRS Criminal Investigation may provide a protective detail to the Deputy Secretary of the Treasury. The Finance Committee was informed that the July memorandum was requested for a trip to London. However, other information received by the Committee indicates that the Deputy Secretary's trip to London occurred from April 16 to April 19, 2004. Please explain. Additionally, please provide any e-mail or other written correspondence regarding this matter to help explain the discrepancy in the date.

Answer: Extensive research and legal review was prompted by the Deputy Secretary's trip to London in April, 2004, and the security concerns that surround travel generally. The July, 2004 IRS memorandum was the result of this work. Consequently, the authority and ability to provide protective services to the Deputy Secretary by the IRS had been established prior to the determination to do so on August 3, 2004.

Question: Treasury representatives told the Finance Committee that the Secret Service was not asked to provide the "protective service." However, it is the Committee's understanding that the Secret Service was in fact contacted but denied Treasury's request. Please explain.

Answer: Deputy Assistant Secretary Ron Bell did not contact or ask Secret Service to provide protective services to the Deputy Secretary. It was understood by Treasury representatives that there is no authorization for the USSS to provide protection for the Deputy Secretary. Therefore, based on Treasury's own ability to provide protective services, Treasury chose to provide such services.

Question: Has the IRS been reimbursed for the protective services provided to Treasury officials?

Answer: While funds have been allocated and are immediately available for reimbursement, the Treasury has not yet received a reimbursement request from the IRS. However, I can assure you that the IRS will be reimbursed these costs.

It should be noted that the Financial Plan of the Treasury Forfeiture Fund includes numerous initiatives and it is expected that the expenses of the protective detail will be included with all of the other reimbursable items.

Question: What is the basis for the reimbursement of the IRS for the "protective services" for Treasury officials (i.e., the legal authority and the determination of cost)? Please provide documentation of both.

Answer: A line item has been created in the Financial Plan of the Treasury Forfeiture Fund budgeting \$250,000 for Security, Protection and Continuity of Operations. Funding will be used to provide continued support for IRS CI's Security and Protection Detail and the Continuation of Operations Program (COOP) effort. The COOP portion of this effort involves the protection and recovery of critical personnel and information in the event of a catastrophe. Funding provides for maintenance of the communications devices and periodic testing. This initiative also provides travel and operations money for the Commissioner's detail and for other protectees as necessary.

The legal authority to provide funding to IRS for the purpose mentioned above is 31 U.S.C. 9703 (b) and (g) which allow the managers of the Fund, under specified, appropriate circumstances, to allocate resources to the participating bureaus for law enforcement-related purposes.

The amount that has been budgeted for this purpose was estimated based on experience in similar circumstances and resulted from conversations between the IRS CI program officials and managers of the Treasury Forfeiture Fund. For several years, IRS CI has had the responsibilities cited above and provided security for the Commissioner of IRS. Additional agents were added to this function after the decision was made to provide a protective detail for the Deputy Secretary. The amount budgeted was based on the salaries of the agents and additional costs that may be associated with the detail.

IRS OVERSIGHT BOARD

Question: Congress established the IRS Oversight Board in the IRS Restructuring and Reform Act of 1998 to serve as a board of directors for the IRS. In addition to seven private life members, the Treasury Secretary and IRS Commissioner are members of the board, much like having a CEO and COO of a corporation being part of a corporate board of directors. The clear congressional intent was that the Oversight Board would be independent of the IRS, and not just a rubber stamp of IRS management. This position has been made clear to every nominee to the board that has come before the Senate Finance Committee to be confirmed. In today's en-

vironment, where there are frequent examples of boards of directors being less than diligent in exercising their responsibilities, it is absolutely essential that the Oversight Board maintain its independence of the IRS.

To the extent that the Secretary and Commissioner are actively engaged in the deliberations of the board, the governance improvements that RRA 98 sought to achieve through the establishment of the board will be more likely to be achieved. Nonetheless, you have only attended a portion of one board meeting. Given that the IRS affects more than 130 million taxpayers and makes up 92 percent of Treasury's budget (\$10.679 billion out of \$11.647 billion), to what extent do you think the Secretary should personally attend the IRS Oversight Board meetings and become involved in the deliberations of the IRS Oversight Board?

Answer: Congress provided for Treasury Department participation in the deliberations of the IRS Oversight Board, and we believe that such participation is important. Commissioner Everson participates regularly in board meetings and values the board's input. While I have not been able to attend every board meeting given other priorities, former Deputy Secretary Samuel Bodman did regularly attend and actively participated in board deliberations. Until a Deputy Secretary is appointed, I plan to participate in these meetings as my schedule and other priorities permit. If the Senate expeditiously confirms the President's nominee for Deputy Secretary, that will help ensure high-level Treasury Department participation.

Question: What do you see as the role of the Oversight Board in setting long-term strategic direction at the IRS, and has Treasury, as a member of the board, been actively engaged in the operations of the board? If so, please explain in detail.

Answer: In creating the IRS Oversight Board as part of the IRS Restructuring and Reform Act of 1998, Congress directed that the board oversee the IRS in its administration, management, conduct, direction, and supervision of the internal revenue laws. Deputy Secretary Bodman was an active participant in all board deliberations. In addition, other Treasury officials routinely attend board meetings and maintain on-going communications with board members and staff on board operations.

Question: The President's budget request slashes the IRS Oversight Board's operating budget in half—from \$1.5 million to \$750,000. This is extremely troubling for two reasons. First, it exposes an underlying conflict in funding the IRS Oversight Board, in which the board depends upon the Treasury and IRS for funds to operate. In the corporate world, this would never be tolerated. Second, the attempt by the administration to control a board which Congress believes must be independent of the IRS is in direct conflict with the congressional intent in establishing the IRS Oversight Board.

Why is the administration proposing to weaken the IRS Oversight Board, a board that is playing an important role in the oversight of an agency that affects the lives of every taxpayer?

Answer: Published descriptions of the President's budget included a line item entry indicating that the IRS Oversight Board's operating budget had been cut from \$1.5 million to \$750,000. These descriptions were erroneous and have been corrected. The correct appropriation should reflect continued funding at last year's level of \$1.5 million.

Question: To what extent is the administration's budget request for the IRS Oversight Board an indication that it does not support board of director independence?

Answer: Please see response above.

Question: Congress relies on the IRS Oversight Board for independent opinions of issues that affect the IRS. Does the administration intend to limit the board's interaction with Congress and the board's effectiveness?

Answer: Please see the response given above. As indicated in that response, the line item entry indicating that the operating budget for the IRS Oversight Board would be cut was an error.

PRIVATE ACCOUNTS SUBSTANTIALLY INCREASE FEDERAL DEBT

Question: The President has proposed to allow workers to divert 4 percentage points of their Social Security payroll taxes into private savings accounts. The proposal also calls for offsetting the Social Security benefits of these workers by amounts equal to a large portion of the values of their private accounts.

Federal debt held by the public will increase a lot as a result of diverting these payroll taxes and the resulting offsets. Pick any year over the next 75 years. By any year, the cumulative effects of these two changes would increase debt held by the public relative to current law. The White House acknowledges that by 2015, debt held by the public will increase by \$743 billion relative to current law. 2015 is 10 years from now. But the plan doesn't start until 2009. So the plan is only in effect for 6 years by 2015. If we look over the first 10 years the plan would actually be

in effect, the plan would add \$1.4 trillion to debt held by the public. But I think that it gets much worse than that.

Isn't it true that over the first 20 years that this plan would be in existence (2009–2028), Federal debt held by the public would increase by \$4.9 trillion in current dollars?

Answer: Any final legislation will be accomplished in a bipartisan fashion, and will specify how defined benefits prior to PRA offsets are determined. And the administration has been clear that the enactment of personal accounts is an essential part of reforms to fix Social Security's long-term finances.

The Social Security Actuary has scored the effect of the administration's proposed PRAs taken in isolation only through 2015. Beyond 2015, it is impossible to estimate the effects without knowing what a comprehensive reform package will ultimately look like. We can estimate through 2015 because the President has said there will be no changes in Social Security benefits for people who were born before 1950. The first of those people reach age 65 in 2015.

The numbers you cite through 2015 are correct, but incomplete, because any full discussion of debt owed by the Government should be based on total U.S. debt outstanding (*i.e.*, debt held by the public and intra-government debt). We are not familiar with the estimates you cite beyond 2015.

It is important to understand that any debt issued to help finance PRAs has very different economic implications than debt issued to finance current government spending. Current government spending subtracts from national saving; debt issued to finance PRAs will shift government saving into personal saving.

Increases in publicly-held debt that are used to finance the transition to a sustainable Social Security system with personal retirement accounts as outlined by the administration should not be seen as increasing the total indebtedness of the Federal Government. In effect, PRAs would take a financial liability that already exists—a portion of promised future benefits—and convert it into publicly-held debt. PRAs would not increase the total financial promises of the Federal Government.

Publicly-held debt that finances PRAs would not cause national saving to decline because PRAs do not encourage anyone to consume more. By contrast, increases in government spending financed with debt cause national consumption to increase and national saving to decrease.

OFFSETS

Question: Under the proposal for private accounts that the White House announced last week, what would happen to the private account of a worker with a spouse, if the worker died before retirement? If the spouse inherited the private account, would he or she also inherit the hypothetical "shadow account" and thus receive an offset against his or her Social Security benefit upon retirement?

Under the proposal for private accounts that the White House announced last week, what would happen to the private account of a worker without a spouse if the worker died before retirement? If the estate receives the balance of the account, would it also receive the hypothetical "shadow account" used to determine the benefit offset at retirement?

Under the proposal for private accounts that the White House announced last week, what would happen to the account in the case of divorce? If the account was split in some manner, would the spouse also inherit the hypothetical "shadow account" and thus any offset against his or her Social Security benefit upon retirement?

What happens when the benefit offset at retirement exceeds the traditional Social Security benefit?

Answer: You raise some important questions that will need to be addressed in any final bipartisan legislation.

Under the proposals the administration has put forward, an individual worker has the option of receiving a portion of future benefits from their personal account instead of from the traditional system. In effect, they trade a traditional benefit for a personal account benefit, which we expect will be at least as large. But in some instances, there are no benefits to trade for the benefit of a personal account, because there are many families that receive nothing under current Social Security law. Such an example would be a family where the primary wage earner dies, the surviving spouse is not of eligibility age, and the children are older than 18. Such a family might receive nothing from the current Social Security system, but under the President's proposal, they would have the benefit of inheriting a personal account. The administration believes it is important that these inheritance rights be established within the Social Security system, which would indeed provide some families with benefits who now receive none.

Personal accounts create a property right that is available for division in the event of a divorce. In the case of divorce, State law and judicial decisions may play an important role in how this property is divided among a divorcing couple. This can potentially be an important tool towards reducing poverty among the elderly, which tends to be higher among divorced women than among the general population as a whole. Under current Social Security law, divorced women are only entitled to spousal benefits if their marriage lasts for 10 years, and many divorced women experience earnings interruptions during the period of their marriage that disrupts the accumulation of benefits on their own. The establishment of a personal account with property rights provides an additional means by which individuals can receive Social Security benefits in the event of a divorce.

All of these questions should be answered in a fully specified reform plan, agreed to by the administration and Congress.

HEALTH CARE COSTS AND U.S. COMPETITIVENESS

Question: The cost of health care in this country is rising, and this is having an impact on our competitiveness around the globe. The U.S. health system is the most expensive in the world—in 2003, we spent \$5,670 per person on health care. We have 45 million uninsured people, and American companies are struggling. Last month GM announced that they were cutting about 8,000 jobs, in part due to rising health care costs. Other companies are outsourcing jobs abroad in order to avoid paying U.S. health care costs.

Do you believe that health care costs are a strain on the U.S. economy?

How do you propose that we strengthen our competitiveness around the globe, making the U.S. an attractive place for companies to hire workers, cover their employees' health care, and fuel the economy?

How does the President's FY 2006 budget reflect this strategy?

Answer: Rising health care costs have strained everyone—employers, workers, retirees, as well as Federal, State, and local governments.

The President supports expansion of Health Savings Accounts. This innovation, introduced in the Medicare Modernization Act, is being embraced by individuals in both the group and non-group market. By giving individuals more control over their health care expenses, they are finding that they can spend their health care dollars more efficiently.

To that end, the President supports improving health information technology, which has the potential to reduce errors, improve quality, and streamline the administration of health delivery services.

The President also supports medical malpractice reform to reduce the practice of defensive medicine.

The President also supports expansion of Health Savings Accounts.

- This innovation, introduced in the Medicare Modernization Act, is being embraced by individuals in both the group and non-group market.
- By giving individuals more control over their health care expenses, they are finding that they can spend their health care dollars more efficiently.
- The President's FY 2006 budget proposes an above-the-line deduction for high deductible health plans, enabling all Americans to purchase such plans and to contribute to Health Savings Accounts on the same basis as employees with employer-sponsored coverage.
- The budget also proposes a refundable tax credit for small employer contributions to employee Health Savings Accounts.

The President's budget would also assist low income individuals and families by creating a refundable income tax credit for their purchases of health insurance, and it would improve the existing Health Coverage Tax Credit that was created under the Trade Adjustment Assistance Reform Act of 2002.

The President also supports medical malpractice reform to reduce the practice of defensive medicine, thereby lowering health care costs for U.S. workers.

In addition, in the Medicare prescription drug law passed in 2003, there were many changes enacted and that are scheduled to be demonstrated that we believe will have the effect of reducing the costs of benefits being provided by the Medicare system.

OFAC

Question: Please provide the number of FTEs dedicated to terrorist financing activities by country, as well as by terrorist group, within the Office of Foreign Assets Control.

Answer:

1. Table showing "OFAC staffing country programs and terrorist groups."

	Country Programs	Terrorist Programs	Narcotics Trafficking	Proliferation	Other	Support	Management	Total FTEs
Total FTEs	51.5	29.5	16.75	.75	.25	23.25	12	134
	Cuba, Iran, Syria, Sudan, Libya, NK, Liberia, Zimbabwe, Iraq, Balkans, Burma	SDT, SDGT, FTO	SDNT, Kingpin Act	WMD	Diamond Trading	Records, Facilities, IT, HR, Budget, Strategic Planning, Outreach		

*Division Chiefs divide their time among all the program areas but are counted as management.

**OFAC has 3 interns who fill 2 FTE slots (1 works full time, 1 works 16 hours, and 1 works 24 hours).

***There are currently 5 vacancies.

****FTEs assigned to program areas are not represented in whole numbers because personnel in OFAC work multiple programs simultaneously.

Question: Please also provide the total number of OFAC employees that are currently dedicated to the administration and enforcement of the Cuba travel ban, and indicate whether any additional employees have been added or will need to be added in order to implement the June, 2004 regulations on Cuban American and academic travel.

Answer:

FTEs for TFI, broken down by OFAC, FinCEN, etc.¹

	TFI – Under Secretary	TFFC	OIA	OFAC	FinCEN	TOTAL
FY 2005 Positions	8	25	34	138	309	514
FY 2006 Positions	8	28	72	125	330	563

¹ FY 2006 FTE distribution for OIA and OFAC includes the Foreign Terrorist Division (FTD) transfer.

Question: Finally, please provide an analysis, by quarter, of the total number of applications for Cuban American family visits OFAC has received, approved and denied since January, 2002.

Answer:

	Received	Approved	Denied
<u>2002</u>			
Jan. – Mar. ²	5061	5012	0
Apr. – Jun.	6455	6620	0
Jul. – Sept.	4497	4872	0
Oct. – Dec.	7272	7416	0
<u>2003</u>			
Jan. – Mar.	5668	5645	0
Apr. – Jun.	7682	7771	0
Jul. – Sept.	6071	6071	0
Oct. – Dec.	9856	9856	0
<u>2004</u>			
Jan. – Mar.	7118	7118	0
Apr. – Jun.	7566	5241	0
Jul. – Sept. ³	9854	263	857
Oct. – Dec.	7199	7144	2585
<u>2005</u>			
Jan. – Mar. ⁴	6624	2262	380

² From 2002 through June 29, 2004, the regulations permitted the issuance of specific licenses authorizing travel-related transactions incident to visiting a close relative in Cuba for additional trips within a 12-month period after an individual had taken one trip pursuant to a general license (i.e., authorization without the need for approval in advance). The regulations contained no criteria for denying requests for such additional trips, thus, all applications were approved.

³ Effective June 30, 2004, the general license authorizing one trip within a 12-month period with specific licenses available for additional trips was replaced with a policy requiring a case-by-case specific license to authorize travel-related transactions incident to a family visit to Cuba. A license can be issued to visit a member of the traveler's immediate family in Cuba for one trip within a three-year period. Using these criteria, many requests made since the effective date have been denied for failure to qualify. During the last quarter of 2004, OFAC administratively closed an additional 2,950 applications received over the summer because they were incomplete or no longer viable.

⁴ Data covers Jan. 1 – Mar. 10, 2005.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

TAX CUT PERMANENCY

Question: Secretary Snow, again this year, President Bush is asking Congress to make permanent the enormous tax cuts enacted in 2001 and 2003. I have serious concerns about whether our country can afford such a reckless tax policy.

The budget submitted yesterday estimates next year's deficit at \$390 billion. And that figure does not even include many things that we can already predict we will have to pay for next year, including relief from the alternative minimum tax and additional costs for the war in Iraq.

The President has been talking about how this is an austere budget, and I believe he claims to have eliminated 150 domestic discretionary programs. But the President's story simply doesn't add up.

This budget includes approximately \$372 billion in domestic discretionary spending. But again, the deficit is \$390 billion. It seems to me that the administration is not serious about cutting the deficit if all you talk about is cutting domestic programs. If Congress eliminated every single domestic discretionary program this year, would we still have a deficit?

Answer: In that extreme hypothetical world, the answer is no, we would not have a deficit if we eliminated every domestic discretionary program. The President's budget has discretionary outlays excluding defense and homeland security exceeding the deficit throughout the budget horizon.

More realistically, the deficit is not expected to disappear in the near-term but, under the administration's plan, will shrink to just 1.3 percent of GDP by FY 2010.

The greater challenge is the long-term fiscal situation, as unfunded obligations of Social Security and Medicare resulting from demographic and cost pressures jeopardize the fiscal outlook.

Question: Knowing that difficult choices need to be made in order to bring this budget into balance, why is the administration inflexible on making the tax cuts permanent?

Answer: Permanent continuation of EGTRRA's and JGTRRA's tax reductions is essential for promoting and maintaining higher rates of economic growth and higher living standards in the future. Making these tax reductions permanent is essential to maintaining and increasing consumer confidence, business confidence, and spending and investment, all of which are more likely to respond when the tax cut is permanent than when there is uncertainty about its future. To prevent the adverse effects of doubt about the future level of taxes, permanent extension of these tax reductions needs to be accomplished this year.

The higher taxes that would be imposed if these reductions are not made permanent would increase the cost of capital to business and reduce individuals' expected after-tax rewards for working and investing. A higher cost of capital and lower expected rewards to workers and investors dampen long-term economic growth.

Doubts about the permanence of estate tax repeal dampen the positive effects repeal may have on investment, capital accumulation and, in the long run, higher living standards. Uncertainty about the future of the estate tax also leads taxpayers to change plans for the distribution of their estates and may cause many to incur significant, repeated, and unnecessary expenses for tax and estate planning.

All of these tax reductions were intended to be permanent. Sunsets were included only to fulfill technical budget requirements.

SOCIAL SECURITY SHORTFALL

Question: During his State of the Union address, the President argued that the Social Security system was facing a funding crisis. He cited, for example, the fact that the trust fund is expected to be exhausted 37 years from now, in 2042.

Immediately following his dire description of Social Security's finances, he argued that the government should divert payroll taxes into private accounts.

Would you tell me, Mr. Secretary: If the Congress passed reforms to divert Social Security funds into the stock market, but took no other action, would that solve the problem that the President outlined in his speech—the funding shortfall?

How does the administration propose solving the funding problem that the President has described as a crisis?

As I understand the administration's position, the actual funding shortfall in Social Security will be closed by cutting benefits. Specifically, initial Social Security benefits will be indexed to prices, not wages.

Why didn't the President explain this during his speech?

Answer: The President has called for comprehensive reform to strengthen Social Security permanently for our children and grandchildren. As part of that reform, the President believes we should offer younger workers voluntary personal retirement accounts funded with a portion of their payroll taxes. Personal accounts must be an integral part of any solution to Social Security's funding shortfalls to be fair to future generations. Without PRAs, younger workers would unfairly bear the brunt of putting the Social Security system on a sound financial course, and would not have the opportunity to directly own their own stake in the system and an opportunity to get a better rate of return than the current system can provide.

In his State of the Union address, the President called on Congress to work together in a bipartisan fashion to develop the best solutions for the American people. The President straightforwardly listed several specific ideas that have been proposed by members of both political parties and have been reflected in many legislative proposals, and called on members of Congress to bring all their ideas forward so that we can find the best set of reforms to fix Social Security permanently.

The President has consistently noted the need to both address Social Security's finances and to provide for fair treatment of younger workers through the establishment of personal accounts. The administration believes that both elements are vital to the future of Social Security.

MEDICARE FINANCING

Question: You serve as a trustee for the Medicare trust fund, is that correct? What is the Medicare trustees' estimate of the unfunded liability in the Medicare trust fund over the next 75 years?

Notwithstanding the actual crisis in the Medicare program, the administration is proposing that we should borrow trillions of dollars in the next decade or two to fund private accounts within Social Security.

How will the government deal with such a large shortfall in the Medicare trust fund if we have already stretched our borrowing capacity to the limits by borrowing trillions of dollars to finance private accounts in Social Security?

Answer: According to the 2005 Trustees' Report, the 75-year unfunded liability for the Medicare Hospital Insurance program (Part A) is \$8.6 trillion. Considering the entire Medicare program from a budget perspective, the 75-year unfunded liability is \$29.9 trillion, or 4.8 percent of GDP.

The President has announced a set of principles which should guide any final Social Security reform plan. His stated mission is to bring the program into long-run actuarial balance, thus making the Social Security system sound, while at the same time improving the system for younger workers by giving them the opportunity to personally own a portion of the assets they pay into it. This would involve reducing the long-run unfunded liabilities. It is important to understand that publicly-held debt issued to help finance PRAs has very different economic implications than debt issued to finance current government spending. The fact is that the administration's PRAs are designed to be self-financing. In the near term, publicly-held debt increases as PRAs are funded, but this debt is paid down later as PRAs partially replace defined benefit payments. By design, PRA debt is only temporary, and financial markets should therefore have complete confidence that the debt will be repaid. The 2003 Medicare Modernization Act modernized Medicare—focusing on prevention and competition and adding a prescription drug benefit. We now want to modernize Social Security in order to bring it into the 21st century.

In effect, PRAs would take a liability that already exists—a portion of promised future benefits—and convert it into publicly-held debt. PRAs would not increase the total liabilities of the Federal Government.

The financing problems facing Medicare are not entirely program-specific, but are also related to society's projected difficulties in financing health care for everyone. Thus, we will need to look for strategies to reduce overall health care cost growth by reducing waste and improving quality.

The President has an agenda for reducing health care cost growth and improving quality.

- HSAs were an important innovation in the first administration to give consumers more control over their health care dollars. The President supports an expansion of these policies.
- The President supports efforts to expand the use of health information technology, which has the potential to reduce errors, improve quality, and streamline administration.
- The President also supports medical malpractice reform to reduce the practice of defensive medicine.

FY 2006 IRS BUDGET

Question: I have some very serious concerns with the quality of service that average taxpayers receive from the Internal Revenue Service.

The budget presented yesterday calls into question the administration's commitment to fair treatment for taxpayers.

I see that you have proposed to increase your enforcement budget by 8 percent. I certainly appreciate your efforts to ensure that every taxpayer pays his or her fair share.

However, whenever we increase enforcement, we also increase the risk that honest taxpayers will get caught up in the system.

Yet, the budget proposes decreasing funding for taxpayer services. In other words, taxpayers can expect fewer walk-in sites where IRS professionals can answer their questions. They can expect fewer people answering the phones at IRS when taxpayers have a problem.

Can you tell me how the IRS will continue to improve the service it provides to taxpayers while it is cutting the resources for this important function?

Answer: The IRS continues to refine its taxpayer service capabilities, and recent program assessments have found significant improvements in taxpayer service over the past few years. These assessments also identified an opportunity to shift towards greater use of telephone and internet options rather than walk-in service.

The IRS is answering a higher percentage of calls, and electronic filing is growing steadily. The IRS has used new technology—particularly the internet and electronic filing—to improve service and productivity. The IRS will continue to make productivity gains while working to improve overall service to taxpayers. When coupled with productivity gains, less funding does not lead to a decrease in the level or quality of taxpayer service. Moreover, the reductions represent a balanced approach in program delivery and service to taxpayers to enable them to meet their tax obligations.

The FY 2006 budget calls for the IRS to do a modest amount of belt-tightening in the area of taxpayer service. We expect to make selected service cuts, including closing some taxpayer walk-in offices. These walk-in sites are relatively expensive, and the number of visitors has dropped as use of the IRS website has dramatically increased. We will make every effort to minimize the impact on taxpayers by providing alternative means for them to obtain service.

FEDERAL DEFICITS AND PRAS

Question: Experts estimate that the transition to private accounts within Social Security will cost trillions of dollars. Indeed, over the first 2 decades that private accounts are phased in, the government would have to borrow \$4.5 trillion.

It was widely reported in the press that when crafting the administration's tax cut proposals, Vice President Cheney said: "Deficits don't matter. Reagan proved that."

Do you agree with that statement?

If deficits do matter, then how can the government afford to borrow trillions of dollars over then next decade to finance private accounts within Social Security?

Answer: The administration firmly believes that long-term structural budget deficits do matter. A long string of structural and rising budget deficits as a percentage of GDP would strongly suggest that government spending is out of control. Too much government spending for too many years may slow the growth of the economy, by diverting resources away from the private sector, which is the source of the goods and services and jobs that keep our Nation prosperous, strong, and resilient.

We have argued that deficits are sometimes appropriate, and we have been in one of those periods recently. We have had to ramp up defense and homeland security spending to prosecute the war on terror and to improve our domestic security. We have cut taxes to free the economy as it struggled through a recession, the after-effects of the stock market decline, the uncertainty generated by the initial phases of the war on terror and revelations of corporate malfeasance dating back to the 1990s.

In the FY 2006 budget, we've made a strong commitment to spend the public's money appropriately and rein in spending to make long-lasting improvements in the deficit. The FY 2006 budget proposes a 1 percent cut in non-security discretionary spending and holds overall discretionary spending to 2.1 percent—below the rate of inflation.

The President's budget also proposes making the 2003 tax cuts permanent to keep economic prospects high. Those tax cuts increased the American people's rewards for work, saving and investment, and the economy responded by growing at nearly 4 percent since the President first proposed them.

Increases in publicly-held debt that are used to finance the transition to a sustainable Social Security system with personal retirement accounts as outlined by the administration should not be seen as increasing the total indebtedness of the Federal Government. In effect, PRAs would take a liability that already exists—a portion of promised future benefits—and convert it into publicly-held debt. PRAs would not increase the total financial promises of the Federal Government. Publicly-held debt that finances PRAs does not reduce national saving because PRAs do not encourage anyone to consume more.

HEALTH SAVINGS ACCOUNTS

Question: The President's FY 2006 budget includes several purported tax incentives for the purchase of health insurance—individual tax credits, above-the-line premium deductions for individuals with HSAs, tax rebates to employers contributing to HSAs, and grants to States for purchasing pools. How many currently uninsured Americans do you estimate each of these initiatives will cover? What is the basis for your estimates?

Answer: The interactions of a number of key factors are taken into account in the estimation process, including incomes of the uninsured, the sensitivity of individuals at these income levels to insurance prices, the response of employers and employees with respect to employer-provided health insurance, and premiums in the nongroup

market. Not only are there interactions between the tax proposals, but there are interactions with other health initiatives in the budget.

REFUNDABLE HEALTH INSURANCE TAX CREDIT

Question: According to the Kaiser Family Foundation, the average annual premium paid for single individually-purchased coverage was \$1,776 and \$3,331 for family individually-purchased coverage in 2003. How effective do you think a refundable health insurance tax credit of \$1,000 for individuals and \$3,000 for families would be at reducing the ranks of the uninsured given rapidly rising health care costs, particularly since people would have to pay for coverage on the front end and then wait a year for a tax refund?

Answer: There is wide variation in premiums between insurers and across States. Millions of individuals will be able to find policies with premiums that make health insurance affordable once they have a tax credit. Older individuals facing relatively high premiums may be willing to pay more out-of-pocket than younger individuals who may be more optimistic about not needing coverage. Currently young individuals have the highest probability of being uninsured. Because many young individuals are likely to find policies with relatively low premiums, the tax credit is likely to significantly increase coverage for this high-risk group.

As far as having to wait until the end of a year for a tax refund, many will not have to wait. An individual may obtain the tax credit in advance based on the previous year's income. Individuals who qualify based on the previous year's income will know how much the after-tax price of insurance will be at the time of purchase and they will only have to pay that amount. For example, a couple with two children receiving the maximum credit would only have to pay \$500 if they purchase a policy with a \$3,500 premium ($\$3,500 - \$3,000 = \500).

TRADE ADJUSTMENT ASSISTANCE HEALTH COVERAGE TAX CREDIT

Question: The President's budget includes \$68 million over 5 years and \$179 million over 10 years for the Trade Adjustment Assistance Health Coverage Tax Credit (HCTC). As of July, 2004, only 13,194 out of 229,044 who were eligible for the credit were enrolled in the program. That is less than 6 percent, which means that over 94 percent of those eligible are not participating. Can you tell me what the most recent enrollment figures are for the TAA health credit? What steps is Treasury taking to improve enrollment in the program?

Answer: The HCTC has demonstrated the feasibility of providing the tax credit through advance payment. Many said it could not be done. Use of the advance payment option has increased from under 4,000 who participated in September, 2003 to almost 13,500 who participated in November, 2004. There was a steady inflow of new participants—between 550 and 1,400—each month in 2004 through November. As of November, 2004, approximately 20,600 eligible individuals took advantage of the advance credit since its inception. Approximately 30,700 claims for the HCTC were paid for tax year 2002 and 2003 tax returns.

Determining the "take-up" rate, however, is complicated by the fact that the available measure of the potentially eligible population is not reliable. Although data from State workforce agencies and the PBGC suggest that approximately 225,000 workers and retirees were potentially eligible for the HCTC in any month in 2004 based on their receipt of TAA, ATAA or PBGC benefits, many of these people may have other unqualified health insurance coverage through another employer, their spouse or through a government program such as Medicare. We also do not have a reliable estimate of how many may have other coverage not qualified for the HCTC.

The administration is fully committed to maximizing use of the tax credit among those who are eligible and in need of coverage, by increasing awareness and minimizing the timeframe for enrolling individuals for advance payment through education, administrative change, and increased coordination with partner agencies. In addition, the IRS is working aggressively to reduce the operational cost of administering the HCTC. For example, the HCTC Program Office restructured the task orders with its largest contractor, which reduced the cost of this contract from \$43.2 million to \$25.7 million annually beginning June, 2004. Other cost reduction efforts underway also led to additional projected savings in FY 2005 and FY 2006. We continue to strengthen outreach and partnership integration efforts, as well as give high priority to encouraging each State to have at least one qualified plan in addition to the automatic options available in all States.

This year, the administration included in the budget a proposal that would make several changes to improve the HCTC. First, the administration proposes to make the requirements relating to qualified State-based coverage under the HCTC more

consistent with the rules that have been available since 1997 under the Health Insurance Portability and Accountability Act (HIPAA). We believe that this consistency would encourage health plans to offer coverage to the HCTC-eligible population, making qualified plans more readily available and expanding the coverage option. Second, the administration proposes to permit spouses of HCTC-eligible individuals to claim the credit under certain circumstances, when the HCTC-eligible individual is entitled to Medicare. This change would address the sympathetic situation where a younger spouse loses the benefit of the HCTC because their HCTC-eligible spouse becomes entitled to Medicare. Third, the administration's proposal includes a number of technical clarifications that are important to facilitate the administration of the HCTC.

We will continue to assess our own performance and make adjustments as appropriate. We look forward to working with Congress to improve the credit.

HEALTH TAX CREDITS IMPACT ON STATE REVENUES

Question: As you know, States continue to face ongoing budget pressures. Can you tell me what impact the administration's health care tax proposals will have on State revenues?

Answer: We are unable to determine the effect of the President's tax proposals on State budgets. We would note that Federal tax proposals generally will impact both State receipts and State spending. For example, Federal budget proposals that increase health coverage for currently uninsured individuals reduce potential demands for health benefits from State programs. Also, the Federal tax preference for HSAs will increase taxable income as lower premium costs for employers tend to shift compensation to taxable wages. This shift would increase taxable wages for purposes of State income taxes. Other factors, such as the proposed health insurance tax credit, could go in the opposite direction.

To the extent that States rely on the Federal income tax law as a starting point for State taxable income, as many do, States are free to (and, in the past often have) adjust the State tax base by rejecting some Federal inclusions or deductions or incorporating additional changes. Because of these potential adjustments to State tax bases, we cannot predict the impact of Federal budget changes on the State budgets.

NEW MARKETS TAX CREDIT

Question: The New Markets Tax Credit (NMTC) is administered by the Community Development Financial Institutions (CDFI) Fund within the Treasury Department, with the IRS overseeing taxpayer compliance related to the credit.

I applaud the Treasury Department's work in administering the credit, particularly through the start-up phase of the new program, and the manner in which the CDFI Fund, the IRS and the Office of Tax Policy have worked in tandem to ensure that the program was launched in an effective manner and stayed true to its legislative intent—to encourage the investment of private equity capital in economic development and business development in poor communities.

The President's FY 2006 budget proposes elimination of the CDFI Fund's financial assistance programs as part of the plan to consolidate economic development programs at Commerce as part of the Strengthening America's Communities Initiative—but the budget does call for Treasury to continue its oversight of the New Markets Tax Credit program and requests \$8 million in FY 2006 to support NMTC oversight.

Can you comment on the administration's plans to ensure that Treasury has sufficient resources to administer program implementation and compliance?

Answer: We believe that the \$4.3 million for administration of the New Markets Tax Credit (NMTC) Program provided to the CDFI Fund within the proposed \$7.9 million FY 2006 budget is sufficient for the CDFI Fund to administer all aspects of the program, including review of all applications, all necessary site visits, and review of all reports due from prior allocatees, and legal and other administrative support costs for the program.

Question: How does New Markets fit into the administration's Opportunity Zone initiative? How does the NMTC fit into the administration's proposed Strengthening America's Communities Initiative?

Answer: The administration's Opportunity Zone initiative aims to assist America's transitioning neighborhoods—those areas that have lost a significant portion of their economic base as a result of our changing economy, for example, due to loss of manufacturing or textile employment, and are now in the process of transitioning to a more diverse, broad-based, 21st-century economy. Opportunity Zones would ease that transition by targeting Federal resources and encouraging new and existing businesses to invest in these areas through Opportunity Zone tax incentives. In ad-

dition, Community Development Entities (CDEs) within an Opportunity Zone would receive priority designation when applying for New Markets Tax Credits.

The Strengthening America's Communities Initiative, if authorized, would consolidate 18 economic development direct-loan and grant programs across several government agencies into one program at the Department of Commerce. Administration of the New Markets Tax Credit Program will remain at Treasury. The New Markets Tax Credit will not be directly integrated into the Strengthening America's Communities Initiative, but will continue to serve as a complement to this new program.

Question: I understand that the demand for New Markets Tax Credits far exceeded the available allocations for the first and second round of credit allocations. The CDFI Fund received some \$56 billion in requests during those allocation rounds when only \$6 billion in credits were available. I gather, therefore, that the competition for credits is very stiff.

Does this allow the Department to get a bigger bang for its buck in terms of ensuring that credits are awarded to CDEs serving high poverty areas or doing deals with the potential to have the greatest economic impact in poor communities?

Answer: The two issues you highlight above—(a) the degree to which applicants are serving high poverty areas, and (b) the economic impacts that will likely be realized by the applicant—have been central elements of the NMTC program's application materials since the program's inception. The application materials include an entire section dedicated to "Community Impact," and this section accounts for one-quarter of an applicant's overall score. In order to receive an allocation, an applicant must demonstrate that the investments it intends to make with Qualified Equity Investment (QEI) proceeds will have substantial community development and economic impacts (*e.g.*, job creation or retention; wage increases; provision of goods and services) in low-income communities.

As part of the application materials, the CDFI Fund further requires applicants to identify the percentage of their NMTC investments that will be made in "particularly economically distressed or underserved communities"—areas generally characterized by higher levels of distress indicators than what is minimally required under the NMTC program statute. Examples of such areas include: census tracts with a poverty rate of greater than 30 percent; census tracts where the median family income is less than 60 percent of the area median income; census tracts with an unemployment rate of greater than 1.5 times the national average; Brownfield redevelopment areas; and Empowerment Zones, Enterprise Communities and Renewal Communities. An applicant that commits to investing a substantial percentage of its QEI proceeds into such areas is scored more favorably and, if provided with an allocation, is required to fulfill its commitment as part of its allocation agreement with the CDFI Fund. In the 2003–2004 allocation round, over two-thirds of the 63 allocatees indicated that at least 70 percent of their QEI proceeds would be invested in these particularly economically distressed or underserved communities.

For the 2005 allocation round, the CDFI Fund has further refined its selection of applicants so that applications that demonstrate the most innovative business strategies and/or the most significant community impacts will be more likely to receive an allocation. The CDFI Fund anticipates making allocation decision announcements later this spring.

Question: The NMTC is authorized through 2007—with the statute providing for the final allocation worth \$3.5 billion in 2007.

We are starting to see the impacts that the NMTC is having in targeted communities across the country. The first 66 CDEs to be awarded credits worth \$2.5 billion signed NMTC allocation agreements with the Treasury Department in the winter of 2003, which empowered them to begin marketing the credit to investors. In just over 1 year, these CDEs have used the NMTC to raise more than \$1.9 billion in private-sector capital that is now being invested in businesses, community facilities and economic development ventures in poor communities.

Can the Department provide the committee with examples of projects financed with credits?

Answer: Through two NMTC program allocation rounds, the CDFI Fund has made allocations to 118 different CDEs, which are collectively authorized to issue \$6 billion in equity investments for which NMTCs may be claimed. These CDEs are headquartered in 37 different States and the District of Columbia, and have indicated primary service areas that cover 46 different States, the District of Columbia and the Virgin Islands. As of February 15, 2005, these CDEs had raised approximately \$2 billion of QEIs from NMTC investors.

The following are some examples of NMTC-funded projects of which the CDFI Fund is aware. Comprehensive information on these and all investments made by allocatees is required annually by the CDFI Fund's Community Investment Impact System's data collection following the end of each allocatee's fiscal year.

- The West Virginia Community Development Loan Fund, a subsidiary of the The First State Bank in West Virginia, provided \$1.2 million of subordinated debt at a below-market rate to a coal company headquartered in Beckley, West Virginia. The company used this financing to purchase mining equipment and expand operations to coal mines in Pineville, West Virginia. Since the completion of the loan transaction, the company has opened the mining site and currently employs 35 new miners, with 15 more hires anticipated.
- The LA Charter Schools New Markets CDE provided a \$7 million, below-market rate mortgage loan to Camino Nuevo High School in Los Angeles, California to support ownership of its facilities. Camino Nuevo High School will serve 500 students in grades 9 to 12, with 90 percent of the students coming from families with annual incomes of \$35,000 or less.
- Coastal Enterprises Inc, a certified CDFI, provided an investment of \$31.5 million to a timber company to finance the purchase of 300,000 acres of working timberlands in north central Maine. This financing helped enable the re-opening of closed paper mills, preserving and/or re-activating 620 jobs. This project was financed in partnership with the Nature Conservancy. The borrower committed to pursue sustainable forestry practices and other conservation measures in conjunction with the industrial use of the forest.
- The National Trust Community Investment Corporation, a subsidiary of the National Trust for Historic Preservation, provided \$2 million in equity to help finance a \$10 million rehabilitation of a historic property located in a Federal Enterprise Community in Portland, Oregon. The property now provides 33,000 square feet of retail and office space. It is expected to generate 300 new jobs and more than \$2 million in State and local taxes, and to be a catalyst for development in the surrounding area.
- Community Development New Markets I LLC, a subsidiary of the Key Bank Community Development Corporation, provided a \$1.07 million loan for construction and permanent financing as part of a \$6.2 million renovation of a retail center in Cleveland, Ohio. The property is an extremely low-income census tract and is adjacent to a Hope VI public housing development. Seventy-nine jobs were created as a result of this financing, most of which went to low-income people from the neighborhood. The shopping center is anchored by a grocery store and includes restaurants and a Key Bank branch.
- Rural Enterprises Inc., a certified CDFI serving Oklahoma, provided \$14.6 million in loans to a company that manufactures commercial aircraft parts. With this investment, the company expanded operations into Bristow, Oklahoma, and created 500 new jobs in that community.

RESPONSES TO QUESTIONS FROM SENATOR SANTORUM

CARE ACT

Question: One of the noticeable absences from this year's budget proposal is the nonitemizer charitable deduction—for which the President had previously expressed strong support. As you are aware, the Senate passed a charitable package (CARE Act) in the last Congress 95–5, and the House passed a charitable giving bill 408–13. I would appreciate an explanation of the administration's current position on this important provision, since Congress is finally poised to complete a meaningful charitable giving incentives package.

Answer: The administration remains committed to encouraging support for our Nation's charities in their vital work and to encouraging contributions to these charities by all Americans. The administration also remains committed to tax reform and has therefore established the Bipartisan Advisory Panel on Tax Reform.

Consistent with our larger reform agenda, we did not resubmit many of last year's budget proposals, including the non-itemizer charitable deduction, so as not to constrain the newly appointed advisory panel on tax reform as it investigates the most appropriate frameworks for tax reform. The Executive Order establishing the panel directs the panel to recognize the importance of charities and charitable donations in American society when developing their options.

Over the next several months, the panel will engage in an energetic and comprehensive discussion of ways to reform the tax system. The panel will report to the Secretary on revenue-neutral options to reform the tax system by July 31. We will then draw on the panel's work to make recommendations for tax reform to the President.

CHARITABLE GOVERNANCE ISSUES

Question: Do you believe it is necessary to consider sweeping changes to charitable governance issues? What evidence do we have that this is a problem area which cannot be adequately addressed by effective oversight and existing laws?

Answer: The President's budget does not propose sweeping changes in the area of charitable governance. The budget does propose providing more resources to the IRS to enable it to effectively enforce the current tax rules. Tax-exempt charitable organizations are highly regulated and generally must disclose to the IRS and to the public on Form 990 (annual information return) detailed information about their operations and expenditures. The Form 990 provides an effective oversight tool that is used by the IRS, State charities regulators and the general public. The IRS monitors Forms 990 for evidence of problems with specific charities and of trends across the whole area. The IRS recently has undertaken a variety of audit initiatives designed to monitor compliance, including a review of compensation practices and procedures across nearly 2,000 charities.

In an effort to promote good governance practices, the IRS recently revised the standard form of application for recognition of exemption under section 501(c)(3) to add questions relating to governance issues, such as whether the applicant organization has adopted a conflict of interest policy. In addition, many tax exempt organizations have taken voluntary steps to strengthen their internal controls in light of the new governance standards for publicly traded corporations under the Sarbanes-Oxley Act.

Although the results of the IRS audit initiatives may indicate the need for particular governance reforms, it is simply too soon to tell.

WOTC/WTW

Question: I commend the inclusion of the modified Work Opportunity Tax Credit/Welfare to Work provision. Does the administration support its permanency?

Answer: The administration proposed a 1-year extension of the modified Work Opportunity Tax Credit, which would include a new welfare-to-work target group for which the maximum amount of eligible wages would remain at \$10,000 per year and which would remain eligible for the 50-percent second-year credit. The administration believes that continuing review of the effectiveness of the Work Opportunity Tax Credit is appropriate and has not proposed its permanent extension.

SAVINGS INCENTIVES FOR LOW-INCOME TAXPAYERS

Question: I commend the administration for including Individual Development Accounts in the budget this year and look forward to working together to see them implemented. What other incentives for low-income savings is the administration considering and supporting?

Answer: We believe that the President's savings proposals, both the proposal to institute Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs) and the proposal to reform employer plans by instituting Employer-Provided Retirement Savings Arrangements (ERSAs), would benefit lower-income taxpayers.

Lower-income taxpayers are less likely to save in retirement plans or other tax-preferred accounts. Fewer lower-income taxpayers work for employers that offer a retirement plan. They are less likely to be aware of saving opportunities or be financially sophisticated. They are unlikely to save in any account that restricts access to their funds as they place a high value on unrestricted access to invested funds for a variety of unforeseen, but critical needs, such as medical emergencies, unemployment spells, and other contingencies.

Lower-income workers would benefit from the ERSA proposal because it will encourage more employers to adopt a retirement plan, especially the small employers for whom many lower-income employees work.

However, current saving incentives are tailored for high-income taxpayers. Two-thirds of households in the top quartile of income cite qualified purposes—retirement, education, or buying a house—as their primary reason for savings, compared to one-third of households in the bottom income quartile. In contrast, 56 percent of low-income households cite non-qualified purposes—access to funds in an emergency or saving for a big-ticket purchase—as their primary reason for savings, compared to 29 percent of high-income households.

LSAs will encourage savings, particularly among the less financially sophisticated and lower-income taxpayers. First, LSAs are much easier to understand. Second, because lower-income taxpayers have fewer resources to devote to savings, they are more likely to face a penalty if they need the funds in an emergency and they have saved in an IRA. Lower-income taxpayers would be more likely to contribute to a

tax-preferred savings account if they can have penalty-free access to funds at any time and for any purpose, without fear of incurring tax or penalties. Thus, we believe low-income taxpayers stand to benefit greatly from the changes.

RESPONSE TO A QUESTION FROM SENATOR SCHUMER

STRUCTURAL BUDGET DEFICITS

Question: Mr. Secretary, the director of the Congressional Budget Office, Douglas Holtz-Eakin, testified before this committee last week. As you know, he is a Bush appointee, and as a former professor and editor of *National Tax Journal*, also a very reputable economist. His view is that the deficits we now face are structural, not cyclical, and that we won't be able to grow our way out of them. Do you disagree with him, and why?

Answer: I agree with the CBO budget director that if we don't hold the line on spending, and revenue grows as projected, then budget deficits will remain with us for a very long time. In that sense, our deficits are structural, and not just related to the recent weakness in the economy.

However, it is still true that we're seeing the effects of the recent recession on the budget deficit. Using conventional techniques, the administration estimates that of the projected \$427 billion FY 2005 deficit, about \$30 billion is due to the business cycle. In other words, the deficit would be about \$30 billion smaller in FY 2005 if the economy weren't still recovering from the recent recession and the variety of shocks that have occurred in the last few years.

However, we think that conventional techniques for estimating the contribution of the weaker economy to the budget deficit are missing some of the factors that were unique to this cycle. As a result, we also think there is a greater scope for lowering the deficit naturally as the economy hits its long-run stride. For example, the sharp rise in tax receipts that resulted from the booming stock market of the late 1990s and the equally sharp decline in receipts when the market fell are counted in the structural part of the deficit. We think that receipts swings have a large cyclical component, but estimating the precise figure is problematic, so the entire receipts effect of the stock market is in the structural part of the deficit. Thus, it made our structural budget balance look artificially good in the late 1990s and the structural deficit too big now.

Regardless of the exact numbers, though, we all agree that we've got to make a strong commitment to spend the public's money appropriately and rein in spending if we're going to make long-lasting improvements in the deficit. The FY 2006 budget proposes a 1 percent cut in non-security discretionary spending and holds overall discretionary spending to 2.1 percent—below the rate of inflation.

RESPONSES TO QUESTIONS FROM SENATOR SMITH

ENERGY TAX

Question: Mr. Secretary, the administration's budget proposes extending a number of energy taxes, such as the Section 45 production tax credit for the generation of electricity from renewable sources. Does the administration support the inclusion of an energy tax title in national energy legislation? And, if so, how large a tax bill would the administration support?

Answer: The President's budget proposal includes a number of tax incentives to increase energy production and promote energy conservation. The specific proposals are an extension of the tax credit for producing electricity from wind, biomass, and landfill gas; modification of the credit for electricity produced from biomass; a tax credit for residential solar energy systems; modification of the treatment of nuclear decommissioning funds; a tax credit for purchase of certain hybrid and fuel cell vehicles; and a tax credit for combined heat and power property. The administration fully supports the enactment of these proposals either as the tax title in national energy legislation or as part of other legislation.

The President's energy proposals would result in revenue losses of approximately \$4.5 billion over the period FY 2006–10 and \$6.7 billion dollars over the period FY 2006–15. An energy tax title with revenue losses that exceed these amounts would imperil the President's goal of cutting the deficit in half by 2009.

DIVIDENDS RATE

Question: Mr. Secretary, I am pleased that one of the budget proposals is to extend the 15 percent top dividends tax rate. The 2003 bipartisan tax relief plan reduced the rate of tax on dividends from 38.6 percent to 15 percent—and we have seen amazing results in the economy. Since the lower rate became law, according

to the National Bureau of Economic Research, there has been a trend towards higher dividend payouts and, in some cases, higher share prices. A recent *Wall Street Journal* article states that the level of dividend payments are at an all time high following 2 decades of declining dividend payments. Last year, companies paid out a record \$181 billion in dividends. It is expected that the dividends paid out this year may rise 12 percent above the 2004 levels. Clearly, companies are responding to shareholder demand created by this rate cut. And, this increased demand is perhaps best demonstrated by the fact that S&P 500 companies announced 421 dividend increases, and, among the three major stock exchanges, 1,288 companies increased their dividends last year. For individuals saving for retirement and especially our senior citizens—who depend on retirement investment income—this is great news.

Unfortunately, this 15-percent rate cut expires in 2008. The administration, however, has called for making the dividend rate cut permanent. Mr. Secretary, would you kindly comment on the economic effect of the rate cut over the past 2 years? In addition, what do you foresee as the economic consequences if the 15-percent rate is allowed to climb back up to 35 percent?

Answer: As you stated in the preamble to your questions, there is a mounting body of evidence indicating the dividend tax rate cut has encouraged firms to increase their dividend payments.

Higher dividends provide a desirable source of cash to investors.

By subjecting new investment to the test of the market, higher dividend payments help to encourage a more productive allocation of investment funds.

By reducing the double tax on corporate profits, a lower tax rate on dividends can be expected to encourage additional productive investment in the corporate sector of the U.S. economy.

By reducing the overall tax burden on investment, the lower tax rate on dividends (and capital gains) can be expected to help encourage saving, investment, and growth in the U.S. economy.

Raising the tax on dividends would be expected to reduce dividend payout, perhaps reduce share values, discourage desirable investments in the corporate sector of the U.S. economy, and discourage overall saving, investment and growth in the economy.

AFFORDABLE HOUSING TAX CREDIT

Question: Mr. Secretary, I was pleased to see that the President proposed a tax credit for the construction of affordable housing that qualified individuals and families could purchase. Last Congress, I sponsored legislation that would have instituted a credit nearly identical to what the President proposed. I am currently working with my colleagues on this panel, Senator Santorum and Senator Kerry, on a bipartisan bill that works toward the same objective outlined in the President's proposal. I appreciate the President's leadership on this issue, and I am curious as to what the administration's plans are to assure that the credit is enacted this year?

Answer: As you know, the administration is committed to promoting an "ownership society" in America, and one of the President's primary goals is to increase home ownership rates among all Americans. To this end, remarkable progress has been made: Data for the fourth quarter of 2004, the latest available data, showed the U.S. home ownership rate at a record 69.2 percent. The number of homeowners in the United States reached 74.4 million, the most ever. And, for the first time, the majority of minority Americans own their own homes.

The President has also set a goal to increase the number of minority homeowners by 5.5 million families by the end of the decade. The Single Family Affordable Housing Tax Credit that you are supportive of is a vital component of this overall effort.

The Single-Family Housing Tax Credit will have the following essential elements:

- The credit would be effective beginning in calendar year 2006.
- The tax credit authority for a State (including U.S. possessions) would be equal to the credit authority available for the low-income housing tax credit (LIHTC), which is indexed to inflation: in 2004 the LIHTC authority for a State was the greater of \$2.075 million or \$1.80 per resident;
- State or local housing credit agencies would award the credits;
- Eligible housing units would be those constituting a project for the development of single-family housing in census tracts with median incomes of 80 percent or less of area median income;
- Units in condominiums and cooperatives could qualify as single-family housing;
- Eligible home buyers would not have to be first-time buyers.

We look forward to working with you, Chairman Grassley, Senator Baucus and other members of the committee, to advance this legislation in the upcoming ses-

sion. In addition to discussing this legislative priority with Senate and House leadership, we expect to follow a parallel track in the House and will work with the Ways & Means Committee to address this issue. Increasing home ownership opportunities in distressed neighborhoods and helping to revitalize these areas remains a critical policy objective of the administration.

BONUS DEPRECIATION

Question: Mr. Secretary, I believe the bonus depreciation deduction enacted in 2003 was instrumental in stimulating investment in equipment and ultimately helping turn the economy around. An increase in the rate of bonus depreciation provides an immediate stimulus—it encourages companies to invest, grow and expand their business. In the future, would you recommend we revisit bonus depreciation deductions as a viable catalyst for economic stimulus?

Answer: Your points about bonus depreciation helping to turn the economy around are right on the mark. After declining by 2.2 percent over the 4 quarters of 2002, bonus depreciation was a useful tool in helping growth in equipment and software investment to rise by 12.1 percent over the 4 quarters of 2003 and 13.6 percent over 2004.

Currently the economy and investment appear to have a considerable amount of sustainable forward momentum, eliminating the need of further support from bonus depreciation at this time.

The tax code's current bonus depreciation provision biases investment decisions in favor of specified types of business property (*e.g.*, tangible personal property, computer software, and certain kinds of real property), possibly reducing the relative demand for other types of investment (notably, commercial and residential buildings). The President's Advisory Panel on Federal Tax Reform and the Treasury Department will likely consider more neutral and simpler methods of removing or reducing the current tax burden on investment within the context of overall tax reform. Whether bonus depreciation has a role under a reformed tax code will depend on the nature of that reform.

However, should the necessity arise again for stimulating investment under the current tax system, I would recommend that a policy such as bonus depreciation be given careful consideration.

SALE AND LEASEBACK TRANSACTIONS

Question: Mr. Secretary, I have a question regarding leasing transactions on public transit rail vehicles. In 2003, the Treasury Department expressed concern that these transactions be carefully examined to ensure they were indeed proper. In turn, the Department of Transportation—which is required to approve these transactions—placed a moratorium on such transfers. The moratorium applied to domestic and cross-border leases. It also applied to future transactions, as well as those already pending as of the moratorium. A public transportation agency in my State, Tri-Met, had two transactions that were pending at the time of the moratorium. One is a domestic lease and the other is a cross-border lease. Together, they would generate \$12–15 million of benefit for Tri-Met. In particular, the cross-border transaction—which I am told has no impact on the Treasury—might be a candidate for release at this point. Is it possible that the transactions that were pending at the time of the moratorium can now be released?

Answer: On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004 (the Act), which contains provisions designed to curb the leasing transactions that the Treasury Department expressed concern about in 2003. The Act specifically states that the provisions designed to curb these leasing transactions will not apply to Qualified Transportation Property, as described in section 849(b) of the Act, which includes property subject to a lease with respect to which a formal application was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004.

On February 11, 2005, the Treasury Department and the Internal Revenue Service issued Notice 2005–13, which designates “sale-in/lease-out” or “SILO” arrangements as abusive tax avoidance transactions. Notice 2005–13 provides, however, that leases or purported leases of Qualified Transportation Property are not subject to the terms of the Notice.

We understand that the Department of Transportation is now reviewing a number of transactions related to Qualified Transportation Property, including domestic and cross-border lease transactions. In addition, we have begun discussions with the Department of Transportation regarding future applications for approval of cross-border leases.

LETTER REGARDING THE SALEM-KEIZER SCHOOL DISTRICT

Question: Mr. Secretary, I am inquiring about the status of my November 17, 2004, letter to the Department of Treasury regarding a bond issue with the Salem-Keizer School District in Oregon. The letter requested Treasury's assistance to right an injustice that, if not corrected, would impose an unnecessary hardship on the children of Oregon. I believe existing regulations give the Treasury Department the discretion to take the corrective action necessary for the District and its bondholders to be made whole. Would you kindly provide me with the progress of my request for assistance on behalf of the Salem-Keizer School District?

Answer: Timothy S. Bitsberger, Assistant Secretary for Financial Markets at the Treasury Department, responded to your letter on April 7, 2005.

RESPONSE TO A QUESTION FROM SENATOR WYDEN

Question: One other area that I wanted to ask you about is, what is your sense of the current amount of the employment tax gap that is owed, but not collected, for Social Security, Medicare, and other programs that are funded by employment taxes? This is a different aspect of the wider under-reporting issue. I am talking about a ballpark. I realize you do not run around with exact figures.

Answer: The latest estimates from IRS are for tax year 2001, and they are subject to some revision as the data on which they are based are further processed.

IRS estimates that the gross tax gap in 2001 from the under-reporting of employment taxes is between \$66 billion and \$71 billion. Of that total, \$14 billion is from FICA taxes, \$51 billion to \$56 billion is from self-employment tax, and \$1 billion is from unemployment tax (FUTA). Another \$7.2 billion of employment tax liability is admitted but not paid on a timely basis.

COMMUNICATION

STATEMENT
OF THE
INVESTMENT COMPANY INSTITUTE

ON

THE PRESIDENT'S PROPOSALS
FOR FISCAL YEAR 2006

SUBMITTED TO THE
COMMITTEE ON FINANCE
U.S. SENATE

FEBRUARY 22, 2005

Chairman Grassley, Senator Baucus, Members of the Senate Finance Committee, I am Paul Stevens, President of the Investment Company Institute, the national association of mutual funds. On behalf of our many members who manage more than eight trillion dollars on behalf of nearly 90 million individual investors, I thank you for the opportunity to address the important tax, savings and retirement policy proposals the President has put forward for the coming year.

I. The Mutual Fund Industry's Role in Expanding Americans' Access to Ownership

Nearly half of all U.S. households -- and nearly two-thirds of middle-income households -- invest in mutual funds. Individuals from every walk of life choose to invest in mutual funds for the diversification, professional management and varying investment objectives that funds provide. Americans may invest in mutual funds through taxable accounts, retirement accounts, or qualified tuition programs (more commonly known as "529 Plans").

The powerful impact that mutual fund popularity has had on the economy, on jobs, and on access to the markets for workers and small business is equally significant. Several years ago, *The Economist* reported that mutual funds had emerged as "the biggest source of capital for American companies . . . giving small and medium-sized businesses unprecedented access to capital markets and thereby financing nearly all of America's employment growth."¹

In its 2002 study of the mutual fund industry, Congress' Joint Economic Committee found that mutual funds provide increased savings opportunities for Americans and ready and stable sources of capital for America's financial markets:²

The size and flexibility of mutual fund complexes, and of some individual funds, enable them to choose among a much wider range of

¹ "The Seismic Shift in American Finance: Mutual Funds," *The Economist*, October 21, 1995.

² *The Mutual Fund Industry: An Overview and Analysis*, Joint Economic Committee, United States Congress, February 2002.

investments than individual investors can. Mutual funds make markets in those investments more efficient by allocating capital so its marginal product tends to be substantially the same for different users. Mutual funds are just one of a few institutions that can, at the margin, bring supply and demand together for different types of financial instruments to maximize the aggregate real return on capital in society.³

In short, mutual funds are both an essential vehicle for enabling middle-income Americans to reach their long-term savings goals and an important source of capital and growth for the American economy.

II. The Mutual Fund Industry's Role in Preparing for Retirement

Mutual funds play a particularly important role in helping millions of Americans prepare for a financially secure retirement. Funds are an important investment medium for employer-sponsored retirement programs (*e.g.*, section 401(k) plans) as well as for individual savings vehicles (*e.g.*, individual retirement accounts ("IRAs")). Of the \$2.9 trillion in 401(k) plan and other defined contribution assets accumulating for American workers as of December 31, 2003, \$1.4 trillion – almost half – was invested in mutual funds. Similarly, of the \$3 trillion in IRAs, \$1.3 trillion was invested in mutual funds. In addition to their role as important savings and investment vehicles, mutual fund companies also provide a broad range of services to defined contribution plans, such as 401(k) plans, and individual account plans, such as IRAs. These services include recordkeeping, tax compliance and reporting and participant education services.

Intertwined as we are with Americans' retirement savings, the mutual fund industry believes it can offer a helpful perspective on the urgent retirement security issues now central to so many challenges – challenges facing Washington lawmakers, regulators, businesses and working families.

The President has launched a historic debate on both Social Security reform and retirement security proposals needed to strengthen the other legs of the retirement income stool – private pensions and individual savings. The President's budget sets forth a number of specific provisions that we believe hold great promise for encouraging the growth and retention of individual savings, strengthening the economy, promoting the adoption and continuation of employer-sponsor pension plans to supplement savings and Social Security, and much more. We welcome the opportunity to assist policymakers in addressing these issues. With the growth of defined contribution pension plans, retirement planning increasingly involves individual decisions and individual education about alternatives that can seem quite complex and overwhelming. In fact, an ICI household survey found that about a third of those offered but not participating in a 401(k) plan did not participate because of confusion about plan features. We want to work with you to break through the complexity and to expand savings opportunities as the President has challenged us all to do together.

³ Ibid, page 22.

III. Social Security

To set our comments on specific tax initiatives in context, let me begin by addressing Social Security. The Institute believes it is imperative to ensure the permanent solvency and sustainability of the Social Security system. To this end, ICI commends the Bush Administration's effort to develop and propose appropriate reforms of the system. And the Institute commends the Chairman's leadership in encouraging all parties to be broad and creative in analyzing this challenge and seeking constructive solutions.

The Institute strongly supports maintaining Social Security as a universal system, and one that provides a floor benefit to those many Americans who rely principally on Social Security for retirement income. Preserving the fiscal soundness and fairness of the Social Security system will help ensure Americans' continued faith in and support of the program.

The Institute thus strongly supports the Administration's close and timely attention to Social Security reform. All credible reform options should be considered carefully. Under one such proposal, younger workers would have the option to place a portion of their Social Security contributions into a personal account invested in a government-sponsored fund or funds similar to those available to federal employees under the Thrift Savings Plan ("TSP"). The Institute believes that any proposal for personal accounts should be judged by whether they will bolster the permanent solvency and sustainability of the Social Security system.

Personal accounts could provide other benefits in addition to retirement income. They would introduce many more Americans to basic principles of saving and investing. Encouraging American workers to focus more broadly on these basic principles could have very positive effects – including, for example, prompting them to make additional provisions for their retirement security through individual savings and employer-sponsored plans.

If reform of the Social Security system entails opportunities for younger workers to invest in personal accounts, then care must be taken to protect them as investors, through measures similar to those in the federal securities laws, and to educate them about investing. The Institute has substantial expertise concerning such issues. Several federal agencies have important and intersecting roles to play in these areas and are hard at work with them currently in various initiatives aimed at improving disclosure to investors, making more comparable the information pension plan managers must analyze, and strengthening the tracking systems that will restore and enhance investor confidence in complicated systems needed to implement individual decisions in today's changing retirement plan landscape. We look forward to working with the Administration and Congress as they consider a range of proposals to enhance retirement security.

We welcome the ongoing efforts of Congress and the Administration to expand private retirement programs and savings opportunities and to simplify the rules governing them. As noted above, these private programs, such as IRAs and employer-sponsored plans, are also essential to Americans' retirement security. The greater their success and the more widespread their use, the less pressure the Social Security system will be under in the future.

Million of retirees today receive income above Social Security thanks to their employer-sponsored pensions and their savings. We know, too, that IRAs have been a tremendous

success, particularly in the years in which decisions to save were not inhibited by the complexity of changing deduction and eligibility limits. However, we also know that much more is needed. Of the 151 million Americans working today, only 63.5 million, or less than half, are earning benefits under an employer's retirement plan. We also know that savings opportunities through IRAs and other options have been constrained over time, often for revenue raising reasons, and in time those constraints may appear increasingly costly, so to speak. The President proposes several important initiatives promoting greater retirement security for the future and we welcome the opportunity to work with the Committee to bring them to fruition.

IV. EGTRRA Permanence

The Institute strongly supports the President's proposal to make permanent the retirement and education savings provisions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Among the important improvements to our retirement system, EGTRRA:

- Increased contribution limits to IRAs - limits that had not been increased (even for inflation) since 1981;
- Increased the contribution limits to employer-sponsored retirement plans, such as 401(k) plans, 403(b) arrangements, and governmental 457 plans;
- Provided for "catch-up" contributions to be made by individuals age 50 and over to employer-sponsored plans and IRAs;
- Made retirement assets significantly more portable, especially among different types of retirement plans, such as 401(k) plans, 403(b) plans, 457 plans, and IRAs; and
- Created additional long-term savings incentives for education savings vehicles such as section 529 Plans and Coverdell education savings accounts (formerly, education IRAs).

Unless EGTRRA's retirement and education savings provisions are made permanent, the restrictive savings rules that applied in 2001 will once again be law in 2011. Making EGTRRA's provisions permanent will promote economic growth and individual savings and financial security. For individuals to plan appropriately for their retirement years, they must be able to rely on predictable rules -- rules that apply now and throughout their career and retirement.⁴ The future termination of these provisions could affect the long-term savings strategies of working Americans, undermining the purpose of these reforms and jeopardizing saving and long-term growth.

⁴ Americans will be better positioned to build adequate retirement plans if they know now whether, for example, they will be able to contribute \$2,000 or \$5,000 to an IRA in 2011 and whether they will be able to make catch-up contributions.

V. JGTRRA Permanence

The Institute strongly supports the President's proposal to make permanent the important savings and investment provisions enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), including reduced tax rates on capital gains and qualifying dividends. JGTRRA reduced the tax rate on long-term capital gains. The 20 percent rate has been reduced to 15 percent; the 10 percent rate has been reduced to 5 percent through 2007 and will be reduced to zero in 2008. Unless the changes enacted by JGTRRA are made permanent, the higher rates will be reinstated for tax years beginning in 2009. JGTRRA also reduced the tax rate on qualified dividend income (as defined in the Act) to the 15 percent and 5 percent capital gains rates. These lower rates expire after December 31, 2008.

Just as employer plans and individual retirement savings habits are best served by consistent and predictable retirement laws, corporations and individuals are also best served by consistent and predictable expectations. Both individual investors and the financial markets need certainty in order to plan for the future. It is therefore imperative that the provisions of JGTRRA be made permanent.

VI. Simplifying & Strengthening Private Savings Opportunities

The Institute has long supported initiatives to enhance financial security by advocating efforts to encourage retirement savings through employer-sponsored plans and IRAs, to simplify the rules applicable to retirement savings vehicles, to enable individuals to better understand and manage their retirement assets, to encourage college savings, and to reduce the tax burden on other long-term investing through mutual funds.

The President's budget includes several important savings incentives. One bold initiative is the proposed creation of Retirement Savings Accounts, Lifetime Savings Accounts and Employer Retirement Savings Accounts. These three new retirement and savings vehicles would both enhance the ability of Americans to save for their future and simplify the current rules governing retirement plans. The Institute strongly supports savings and simplification initiatives that would bring long-term savings and investment opportunities within the reach of every working American.

Comprehensive reform like the President's proposals will significantly reduce the overwhelming complexity of our current savings system. Today's rules governing retirement and education saving are simply too difficult to understand and too unwieldy and costly to administer. Simple universal savings vehicles, without age and income limits and other burdensome restrictions, will give Americans of all income levels and in all workplaces greater opportunities to achieve retirement security.

There are other important retirement savings proposals that can enhance the effectiveness of those discussed above. They include proposals to automatically enroll employees in 401(k) plans, to offer new ways of efficiently managing small accounts for missing accountholders, to expand access to the investment advice that defined contribution plan participants need as their choices expand in number and complexity, and more. On many of these initiatives, the Administration has already taken the lead and we welcome the

opportunity to work with the Congress as the entire retirement security discussion moves forward.

VII. Clarifying Section 529 Qualified Tuition Programs

Helping American families save for the ever-increasing cost of college is a longstanding and important policy goal. Congress furthered this goal by enacting Code section 529 as part of the Small Business Job Protection Act of 1996 and granting certain federal tax benefits to these state-sponsored "529 Plans." In 2001, EGTRRA significantly enhanced 529 Plans by allowing tax-free treatment of distributions used to pay for qualified higher education expenses.

Congress' efforts, particularly the EGTRRA enhancements, increased investor awareness and participation dramatically. Assets in 529 Plans more than doubled since 2002, increasing from \$26.8 billion at year-end 2002 to \$57 billion by September 2004. During the same period, the number of 529 Plan accounts rose to more than 7 million, and the average account balance was approximately \$8,000.⁵ Although these statistics are encouraging, many Americans who want to save for college still do not save enough.⁶ Legislation making permanent the tax-free treatment of qualified deferrals from section 529 plans will remove uncertainty, encourage long-term savings for education, and enhance economic growth and productivity. The Institute supports prompt enactment of legislation making permanent this important savings program.

The President's budget includes proposals to clarify the gift and estate tax consequences of contributions to 529 Plans. Among other things, the Administration's proposal would impose an excise tax of as much as 50% on certain distributions above \$50,000 (computed on a cumulative, lifetime basis for each designated beneficiary). While the proposed clarifications are intended to eliminate transactions designed to avoid gift and estate tax consequences, they have the unintended effect of making 529 Plans significantly less attractive for American families saving for college. We look forward to continuing our dialogue with the Treasury Department to address its concerns without significantly compromising this important college savings tool.

VIII. Deferring Taxation of Reinvested Mutual Fund Capital Gains Distributions

The Institute strongly supports legislation that would permit the deferral of the payment of tax on capital gains realized by a fund until the fund shareholder receives the gain in cash, such as by redeeming fund shares. This proposal would remedy the result, misunderstood by many fund shareholders, that capital gains realized by the fund are taxed currently to the fund's long-term shareholders -- who continue to hold, rather than sell, their shares.

If this type of legislation were enacted, the millions of fund shareholders investing in taxable accounts would benefit. These investors are mainly middle-income investors who are providing capital necessary for continued economic growth -- their own and the country's. At a time when the retirement community is struggling to prevent leakage of retirement savings, to encourage portability among retirement investments, and to address tax provisions that present obstacles to the retention of sufficient retirement savings to last through the much longer

⁵ *ICI Memorandum 18530.*

⁶ *See Profiles of American Households Saving For College, ICI Research Series, Fall 2003.*

retirement many Americans now experience, it's right that this idea, too, should be put forward in the tax and retirement debate.

By reducing current tax bills and allowing earnings to grow tax-deferred, this change would boost long-term savings. The proposal would not result in these gains being excluded from tax. Instead, the gains would merely be deferred, albeit, in some cases, outside the relevant budget-scoring period. The proposal's boost to long-term savings would have little, if any, long-term cost and would provide benefits to the economy in both the short run and the long run. It would eliminate an event that threatens to prematurely interrupt long-term savings, as would proposals to delay the minimum required distribution "start-date" that forces savings out of IRAs .

IX. Conclusion

The Investment Company Institute thanks you, Mr. Chairman, and the Members of the Committee for this opportunity to be heard. The Institute is proud of its research capacity, its expertise in economic analysis and its educational efforts to reach special populations with savings and investing tools, and we welcome the opportunity to work with you on the challenges ahead. Thank you for the opportunity to present our views.

