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PRESIDENT'S FISCAL YEAR 2008 BUDGET (REVENUE PROPOSALS)

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

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PRESIDENT'S FISCAL YEAR 2008 BUDGET (REVENUE PROPOSALS)

TUESDAY, FEBRUARY 6, 2007

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

The hearing was convened, pursuant to notice, at 2:45 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Lincoln, Wyden, Schumer, Stabenow, Cantwell, Salazar, Grassley, Lott, Snowe, Smith, and Roberts.

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

The CHAIRMAN. The hearing will come to order.

In his *Poetics,* Aristotle wrote, "Beauty depends on . . . symmetry." What is true of poetry is also true of policy: attractiveness depends on balance.

The budget before us today is badly off balance. The budget is not on the level because it omits major costs. Beyond the current year, the budget includes nothing to fix the Alternative Minimum Tax. We know that fixing the Alternative Minimum Tax will cost at least $60 billion next year, and will cost more than that every year thereafter.

Already the AMT forces 5,000 Montana families to pay higher taxes, but this number is slated to multiply many times over. We obviously need to stop this stealth tax once and for all.

The budget shows an incoherent path for military spending apart from Iraq. The budget asks for 10-percent growth for military spending for the upcoming year, but then the budget proposes average growth of just 2.25 percent for each of the 4 years thereafter. That amounts to a shaky assumption.

The budget omits most of the cost of the wars in Iraq and Afghanistan in 2009, and the budget omits all those costs in 2010 and 2012.

And the budget is literally unbalanced. The budget claims to reach a surplus of $61 billion 5 years from now, but if all of those omitted costs are included the budget will not be balanced 5 years from now.

The administration's proposals actually worsen the deficit in every year. Compared to doing nothing at all, the budget increases total deficits from 2007 to 2012 by more than $1 trillion. The budget makes, at best, a shaky attempt to collect the taxes that people owe, but do not pay.

According to IRS, this tax gap is $345 billion a year, and the proposals that I see so far, which I have pressed the Secretary and IRS Commissioner Everson to come up with, are very shaky, very paltry. I want Congress to do its part by passing legislation where needed. The Congress needs to appropriate sufficient funds for the IRS to do its job.

Secretary Paulson has committed that he will come before this committee soon for a hearing devoted entirely to the President's plan to reduce that gap. The administration has tried, but the budget does not make a significant dent in it. The administration, I think, needs to do much better.

The budget makes an unequal effort to address long-term deficits. The administration appears to blame long-term deficits on spending in just three programs: Social Security, Medicare, and Medicaid. The administration seems to imply that we need to significantly cut benefits in these programs.

But the budget has the wrong diagnosis, and so proposes the wrong cure. The primary cause for long-term deficits is rising costs throughout our health care system, and the budget is uneven in its effort to address those costs.

Our new CBO Director, Peter Orszag, made that point quite well when he recently said, "It's a mistake to look at containing health care costs just within the Federal programs themselves, Medicare and Medicaid. The underlying driver of the cost of those programs is the underlying rate of cost growth in the health sector as a whole, and tackling that problem is perhaps the fundamental fiscal challenge, and an important economic challenge facing the Nation."

Nearly 1 in 5 Montanans is struggling to get by without health insurance. Health care premiums have nearly doubled since the year 2000. We must do better to control health care costs.

And the administration's reasoning ability must be unbalanced, insofar as Social Security is concerned. The budget proposes the administration's failed privatization boondoggle one more time. Americans said no to privatizing Social Security, and I think that will stand.

I want to work together with the White House on positive ideas that will help Social Security without raising taxes and without cutting benefits. That should be our beginning.

There are things we can do to rescue Social Security without cutting benefits and without raising taxes. But if the administration once again tries to privatize Social Security, I will fight it again and we will win again.

The budget makes an unstable commitment to maintain America's economic leadership. The budget needs to do more to make sure that all American families have a chance at the American dream. We must support education—support it—and encourage businesses to innovate—encourage them. Those are the keys to creating a cutting-edge workforce and new jobs here in America.

We need to expand quality education for students of all ages. We need to give teachers the moral and financial support they deserve. We should boost research with incentives as innovative as the ideas that we wish to support.

Then we should promote the export of innovative American products into foreign markets under trade rules that are fair and firm.

We should work to increase savings for families, increase savings in the government. We should leave our grandchildren a financial boost, not a burden. We should work toward energy independence with the fuels that we know today, and we should work to develop those fuels yet undiscovered. We should reform our tax code to reflect our economic strengths and our priorities.

So, let us restore balance to the Nation's fiscal policy. Let us straightforwardly report the true costs that lie before us. Let us steadily collect the taxes that people owe but do not pay. Let us equitably address rising health care costs, and let us lay a solid, level foundation on which to build a stronger America.

Senator Grassley?

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

Senator GRASSLEY. Thank you very much for holding this, what I think has become kind of a traditional budget hearing that we have with various members of the Cabinet. We welcome you, Mr. Secretary.

Before I give a few remarks, there are a couple of things that I would like to compliment you about, personally, unrelated to policy. One of those is, I think we are seeing that it is beneficial to the country to have a person like you who is willing to take a slight pay cut and come back into public service.

Second, I have followed a lot of things you have said in the newspaper and other media. I think it is very beneficial to have somebody with a bottom-line approach like yours and with key financial market experience, very much an asset, not only with what goes on here in the United States, but in the international arena as well.

Today we focus, of course, on the revenue side of the budget. It is almost entirely in this committee's jurisdiction. The President's budget acknowledges that the bipartisan tax relief has not gutted the tax base. In fact, we have been, and are projected to continue for the mid-term, on the revenue glide path, above the historic average of revenue to Gross Domestic Product.

And if I could remind people that we have had a policy that, regardless of what the marginal tax rates are over the last 40 to 50 years, somewhere between 18 and 19 percent of Gross Domestic Product ought to be run through the Federal Treasury as Federal taxation.

I think we continue down that road for two basic reasons. One, it is a level of taxation that there is not a revolt by the American people against, and accepted by people. Second, just think how the economy has done so well over that period of time: more money left in the pockets of people will do more economic good than if 535 members of Congress spend it. So, we have continued that policy. The President, right now, is in that historic level of taxation.

Now some on the other side would argue that better-than-historic average taxation is not enough to fund the government. But that is, in fact, a different debate. That is a debate about higher taxation as a deficit-reduction matter. It is a fair debate to have, but we ought to be intellectually honest about it.

What is clear today is that the bipartisan tax relief, with the Alternative Minimum Tax accounted for, has a track record of maintaining the Federal revenue base. That is good news for Democrats, and Republicans ought to celebrate.

Democrats from the bluest of the so-called blue States ought to be most appreciative, because it is families in those high-income, high-cost, and high-tax areas that have benefitted greatly from the bipartisan tax relief plans.

I am referring to the marginal tax rate, the marriage tax relief, increased child tax credit, retirement savings incentive, education tax relief, death tax relief, and, yes, Alternative Minimum Tax relief.

It always amazes me then how members from these high-tax States complain the loudest about the common-sense tax relief that eases the burden of taxation felt most heavily in those very States. I can assure you that we will hear hostility to tax relief from those bluest of blue State members.

I raise this point because the main reason for the partisan opposition to these bipartisan plans has been based on concerns about the effect of tax relief on the Federal revenue base.

So today I would ask my friends, anybody who wants to call themselves liberals in this body, Republican or Democrat, to take a "chill pill" and accept the good news of the track record.

Now, of course we do have fiscal crises coming. The baby boom generation will be retiring in big numbers in the next decade. That is an entitlement problem. It is not derived from the current or future State of the Federal revenue base.

The revenue base is fine unless the predilection of a particular member is to solve the entitlement program with record levels of Federal taxation. That is a separate debate, but we ought to be transparent about it.

The President's budget continues this good news and keeps the burden of taxation in check. In addition, the President's budget contains a comprehensive set of initiatives on the tax gap, which is very much an interest of people on this committee, and the Congress generally.

The President's budget also lays bare the defects in the tax treatment of health insurance, which has something to do about not only the cost of health care to the taxpayers of this country through Medicare and Medicaid, but the cost of health care generally, as my Chairman has pointed out. I would not disagree with him on what he said on that point.

Mr. Secretary, this committee has a long history of bipartisanship, civility, and problem-solving. I want to pledge to continue to work with you on the big problems the budget may tackle.

I will certainly let you know my views in clear terms, but I also give you alternatives and revisions if there is disagreement. I hope that everyone here, Republican and Democrat, can agree with me on that point.

As I take a look at the President's budget, I would like to challenge every member of the bipartisan committee to take a bipartisan, constructive approach. I will use a couple of examples. One, if members have reservations about the proposals on tax treatment of health insurance, then let me hear an alternative.

Or another example. If the tax gap proposals on information reporting are not comprehensive enough, the critics ought to propose a more comprehensive result.

This would be a fair way to engage this budget discussion, to be constructive, if you in turn propose an alternative or a modification. We have that responsibility.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley, very, very much.

Secretary Paulson, we are honored to have you here. Thank you very much. I know you are pretty busy. I am sure you have to go to a lot of committees, and I know it takes time sometimes from your work, your job. But thank you very much for coming before us. We would very much like to hear your statement on the President's budget.

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

Secretary PAULSON. Thank you. Again, thank you very much, Mr. Chairman.

Let me, first of all, thank you and Senator Grassley. I will give you a brief opening statement and then I hope, during the course of the discussion, we will have an opportunity to answer some of the questions that you raised.

First of all, I am very pleased to be here today to provide an overview of the President's budget for fiscal year 2008. As the Secretary of the Treasury, my top priority is keeping America's economy strong for our workers, our families, and our businesses, and the President's budget supports that goal.

Let me also apologize a little bit for my voice. I have a cold and I testified this morning, also.

But anyway, we start from a position of strength.

The CHAIRMAN. Actually, warm water is better than cold water.

Secretary PAULSON. All right.

The CHAIRMAN. Could we get you some water?

Secretary PAULSON. I have some water.

The CHAIRMAN. Do you want some hot water? We will give you some here.

Secretary PAULSON. I have some water, and I am fine.

The CHAIRMAN. All right.

Secretary PAULSON. We start from a position of strength. Our economy appears to be transitioning from a period of above-trend growth to a more sustainable level of about 3-percent growth.

More than 7.4 million jobs have been created since August of 2003. Our unemployment rate is low at 4.6 percent, and over the last 12 months real wages have increased 1.7 percent. Economic growth is finding its way into workers' paychecks as a result of lower inflation. That means family budgets are going further.

Strong economic growth also benefits the government's fiscal position. In the first quarter of fiscal year 2007, budget receipts totaled $574 billion, an increase of 8 percent over the same period in fiscal year 2006. As a result of increased revenues over the last 2 years, we have brought the Federal budget deficit down to 1.8 percent of GDP.

The President has submitted a budget that reflects our strong economy and our Nation's priorities: continued job creation and wage growth, vigorous prosecution of the war on terror, increased access to affordable health insurance, improved energy security, and a strong fiscal position from which we can address our long-term challenges such as strengthening Social Security and Medicare for future generations.

The budget supports a strong economy by maintaining fiscal discipline. It maintains our current tax policy, which has helped our economy rebound from recession to its current robust health. With a steadily growing economy, tax revenues, combined with fiscal discipline, should bring the Federal budget into balance in 5 years.

In fact, we are submitting a budget that includes a surplus in 2012, which is achievable if we keep our economy growing. While no one has a crystal ball, our economic assumptions are close to the consensus of professional forecasters.

The President's budget addresses important domestic priorities. Health care is high on the list. Under current law, the tax subsidy for health insurance purchased through employers will average more than $300 billion a year over the next 10 years. For that huge expenditure, we get a system in which rising costs are a burden to families and business and in which millions of people have no insurance at all.

The President's proposal would make health care more affordable and more accessible. It would give all taxpayers who buy health insurance, whether on their own or through their employer, and no matter what the cost of the plan, the same standard deduction for health insurance: $15,000 for a family or $7,500 for an individual.

The President's proposal would help hold down health care costs by removing the current tax bias that encourages over-spending. Costs would become clear, giving patients more power to make informed choices about their health care spending.

The proposal would also jump-start the individual insurance market so consumers have more choices than are available today. Health care would become more consumer-driven, more affordable, and more accessible for millions of Americans.

Energy security is another concern of the American people, and it is a priority addressed in the President's budget. President Bush has put forth an ambitious goal of reducing America's projected gasoline consumption by 20 percent over the next 10 years. We can achieve this goal by dramatically increasing the supply and use of alternative fuels and improving fuel efficiency by reforming and increasing the CAFE standard.

The expanded fuel standard will provide entrepreneurs and investors a guaranteed demand for alternative fuels, which will accelerate private investment and technological development.

Reforming CAFE will allow us to increase the fuel economy of our automobiles as fast as technology allows. With a more diverse supply and better fuel efficiency, we can make our economy less vulnerable to supply disruptions and confront climate change through technologies that reduce carbon dioxide emissions.

Finally, the President's budget, by emphasizing fiscal discipline and economic growth, lays the right foundation for dealing with entitlement reform—a challenge we all have a responsibility to address.

Strengthening Social Security and Medicare is the most important step we can take to ensure the retirement security of our children and grandchildren, the long-term stability of the Federal budget, and the continued growth of the American economy.

I look forward to sitting down with Democrats and Republicans without preconditions and finding common ground on these critical issues.

Mr. Chairman, the President's budget priorities—a strong economy, national security, fiscal discipline, health care, energy innovation, and laying the groundwork for entitlement reform—are the right priorities for America and for the workers, businesses, and investors who drive our economy.

I am confident that working together we will keep our economy strong and chart a course for maintaining our global economic leadership in the years ahead.

Thank you for the opportunity to discuss this today. I now welcome your questions. Thank you.

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

The CHAIRMAN. Well, thank you, Mr. Secretary.

Clearly, we need to—and I am trying to avoid this overworked phrase—work together. I think nothing of consequence ever occurs without cooperation, without all of us working together.

After all, we are a democracy and everyone has a stake in the outcome. We have two ends of Pennsylvania Avenue. The rules of the Senate and House, although a bit different, still try to provide for some kind of resolution.

And to achieve the kind of budget we want to reduce the deficits, it is very helpful if a budget that is proposed to us is very much in good faith. I think many parts of this budget are helpful, but a few parts jump out at me and make it difficult for us to negotiate in good faith with the same starting place, that is, with facts we all agree on.

And two that come to mind are AMT and war costs, Iraq costs. The budget includes only 1 year of AMT. I do not think there is anybody in this room who thinks this Congress and this administration are going to agree in only 1 year over the next 5 years, the next 10 years. There is not anybody in this room—I might dare say, presumptuously, yourself. I think you know that we are going to have to address AMT for a period longer than 1 year.

As you also know better than the rest of us, because after all you are the Treasury Secretary, that it is very expensive. It is $60, $70 billion a year in the out years, fixing the AMT. That is pretty expensive. Those numbers add up. Yet, they are not in the budget. The budget does not address subsequent years, other than the first year.

If we are going to work together to find solutions here, it seems to me that the budget should reflect reality. That is not in the budget.

Another is the war cost and the Iraq costs. The budget says, the administration's budget, that it will increase defense spending, I think, 10 percent in the next year or two, and then at 2.25 percent increase in defense spending in the next years after the next couple. I do not think anybody here thinks that is realistic. We are going to spend more. After all, that is the fate that has been assigned to us as the United States of America.

Then take the Iraq costs. The administration includes no Iraq war costs, as I see it, near as, I think, 2009, 2010, 2011, 2012. Maybe a little bit in 2009, I have forgotten. But virtually none. I know a lot of us want to get out of Iraq and Afghanistan, but I think the truth of the matter is, we are probably going to have to spend something in those years.

So let us assume those are added back in a reasonable way. If that is the case, it seems to me that we have a budget that is not in balance. That is not good. But the main thing is, we need to know what the facts are here so we all know what we are dealing with here so we can work together.

So, I would just like your reactions to that. That is, AMT, defense, as well as Iraq not being included in this budget.

Secretary PAULSON. Right. Well, let me deal with them one at a time. I started off saying this is a very credible, very transparent budget.

Let us start with AMT. I think we are all in agreement here. I have not heard anybody say that we think the Alternative Minimum Tax should go into effect without extending the current patch. It is a cruel and unintended tax on the middle class. As a matter of fact, I think it will be a surprise tax on some of them if we let it go into effect, which we will not.

Now, what we have done in the budget is put forward an additional year of AMT tax relief, which is the so-called 1-year patch. I have not been here for the last 6 years, but I understand that is what Congress has generally done every year for the last 6 years.

What we are saying in this budget, and what we are essentially saying to all of you, is this is a major issue. It is not an easy problem. It is a tough issue. We have put forward a 1-year patch, and it is very transparent. Then this will give us time to work together to come up with a permanent solution.

The CHAIRMAN. I understand. Everybody has numbers and estimates, but one figure I saw was between three-quarters of a trillion and $1 trillion for a 10-year period to “fix” AMT, depending upon whether the tax cuts are extended or not. It is very expensive. Not to include that, or at least a nod to that, I think, is not helpful.

Secretary PAULSON. I am acknowledging that it is a tough issue, that it is expensive, and it is something that we want to work on with all of you.

The CHAIRMAN. All right.

Secretary PAULSON. It is something for which Congress, every year for the last number of years, has proposed the so-called 1-year patch.

The CHAIRMAN. Right.

Secretary PAULSON. We have put forward an additional 1-year patch. With it, we have more than a year or two to work on this.

Now, in terms of Iraq, again, if people say to me the costs of the war in Iraq are uncertain looking ahead, I agree with you. But what we have is a supplemental of $170 billion this year. There is

$145 billion next year, laid out transparently. In 2009, there is $50 billion, which is a placeholder because it is so uncertain.

We need to keep this economy growing and keep the revenues coming in. Again, we are forecasting that our revenues are going to grow at 5.4 percent a year over the budget window. The last quarter, they grew at 8 percent. Last year, they grew at 11.8 percent.

So, again, if you are saying to me it is a challenge to deal with AMT and some of these other costs——

The CHAIRMAN. Right.

Secretary PAULSON [continuing]. I agree with you. But to say it is not transparent or it is not credible, I would take exception.

The CHAIRMAN. I appreciate that. My time has expired. I am encroaching on my colleagues' time here.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. Secretary, I am not going to go through this history that I gave you, about 40 or 50 years' history of where the policy of taxation has been between 18 and 19 percent of Gross Domestic Product, but it did get up to 21 percent before we reduced taxes. Individual income taxes got to a high of 10.3 percent of Gross Domestic Product. We brought revenues down to about 16 percent of GDP. Two years ago they were at 17 percent, today they are about 18.2 or 18.4, and I think the 40-year average is about 18.2.

So I bring this up because a lot of people around here think that increasing taxes is the only way of getting the deficit down. The allegation is that somehow the bipartisan tax relief bills that we passed in 2001, and to some extent 2003, gutted the Federal revenue base.

So, a simple question. Really, one question, but let me say it in three questions: whether or not you agree with the critics; is the only path to fiscal discipline to maintain record levels of Federal 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 we return to record levels of Federal taxation?

Secretary PAULSON. Thank you very much, Senator Grassley. I agree with your proposition. If you look back over a 40- or 50-year period of time, taxes as a percentage of GDP have been in the area of 18 percent.

Since the President's proposals brought taxes down in terms of the rate of taxes, we have seen revenues coming in at a record level, and it is now at 18.4 percent of GDP. We have also seen big declines in the fiscal deficit.

I think the reason people are raising questions about the deficit right now really has to do not with the fiscal deficit immediately, but looking to the longer term and the need for entitlement reform.

So, to that extent I concur with people saying it would be great to come to the table and deal with these longer-term entitlement issues, but I do not concur with people who say that what this economy needs is a tax increase, because it does not.

This economy is doing very, very well, and all of us should hope that we keep this expansion growing and growing. I think one of the real keys to our budget forecast really is that we keep the economy growing. Fiscal discipline, but a growing economy.

Senator GRASSLEY. Thank you.

Let me ask a question on the issue that the Chairman brought up about AMT. There are all sorts of statistics I could give you, but if we do not do something this year, and the administration is doing it, 23 million people would be hit by it. That something may be temporary, as the administration has proposed. But that all aside, I want to bring up the issue that many people feel that the only way to deal with the AMT is to insist that you cannot reform AMT unless we offset the revenue loss from this unintended tax with a tax increase on other taxpayers.

So, for example, their basic position is that the harm of those 23 million people is secondary to retaining the Federal revenue from this unintended, broadly applicable tax. The President's budget, like the Congressional budgets advocated by those on the other side, also count the vast amount of revenue from this unintended tax over the long term.

My question: is it fair to condition AMT reform on the substitution of revenue when we never intended the AMT to generate the projected revenue in the baseline from these very people who are going to be paying it who were never intended to pay it, and we think we can collect it? It seems idiotic to me. Why should AMT reform be secondary to the maintaining of the unintended stream of revenue?

Secretary PAULSON. Senator, AMT reform is very important. It should not be secondary. You are absolutely right. If we did not patch AMT this year, we would have an additional 21 million taxpayers hit by AMT, and that number will rise over time.

So, clearly, we need to reform the AMT. I also agree with you that this economy does not need a tax increase right now. It just is unnecessary, and it would be unhelpful.

The CHAIRMAN. Thank you very much, Senator.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. We have enjoyed our conversations that we have had. I think you are very sincere about wanting to tackle these long-term fiscal imbalances.

But I think we have to be brutally frank with each other, with the American people, and with our colleagues on the question of revenue and spending and the relationship with growth of deficits and debt.

Everybody is entitled to their opinion, but they are not entitled to their own facts. The revenue base of the country is really very clear. We had a revenue base in this country in 2000 of just over $2 trillion. It took us 6 years to get back to that revenue base.

So I know people want to just talk about the revenue growth of the last couple of years. They do not want to talk about the steep revenue decline that occurred before the last 2 years.

The combination of cutting the revenue base and increasing spending—and let us go to that chart that talks about spending, because our colleagues have been in charge of the spending of the country the last 6 years, and the spending has gone up, up and away.

Spending is up 40 percent. Revenue is down. Spending was up. What is the result? Let us go to the debt chart that shows the result: revenue down, spending up. Guess what happened? The debt exploded.

Now, we can sit around here and say, well, tax cuts pay for themselves. But it did not prove to be the case. It did not prove to be the case in the real world. The Treasury's own analysis showed that tax cuts do not pay for themselves.

I would go further and ask the Secretary, do you not have built into this budget a large tax increase? Is there not a large tax increase built into this budget? I would be very specific. If you only have an AMT fix for 1 year, the estimated AMT revenue for the following 4 years is over $320 billion. Is that not the case?

I would ask the Secretary, is the revenue that you anticipate from the increased AMT revenues over the 4 years where there is not a fix in this budget for the AMT, do you not anticipate $320 billion?

Secretary PAULSON. Senator, I thought I was pretty clear in my last statement in saying that what we have done is propose an AMT patch for 2008. I have said that this is a tax, if it goes into effect without the patch, which would be unacceptable to the President, unacceptable to me and this administration. I think it is unacceptable to you and others. I said this is a tough issue.

Senator CONRAD. Well, Mr. Secretary, the only way this budget balances, is you have a $320-billion tax increase built into these budget assumptions.

Secretary PAULSON. What we have done right here with the AMT, what we have done with this budget, is the same thing, as far as I can see, that Congress has done about it every year for the last 6 years.

Senator CONRAD. Well, that is why the debt has exploded.

Secretary PAULSON. If we get back to the debt and the deficit again—I heard your question, or I guess it was a comment. I started off by saying I really respect the fact that you are a deficit hawk and that you care so much about fiscal discipline. I would say, when I saw your first chart on the revenues, that I was on Wall Street when the stock market bubble burst.

I looked at the economy in 2000, and it was a little bit like an Alice in Wonderland economy. The stock market bubble burst. We went into a recession. We were hit with September 11. We had the corporate scandals. The tax rates were cut, and cut significantly, and I think that played a big role in getting us back where we are right now.

I have never argued that tax cuts, in terms of a fiscal deficit, pay for themselves entirely, but I am very encouraged, and I think everybody should be encouraged.

Senator CONRAD. Can I just ask on that question, according to Treasury's analysis, how much of a tax cut is paid for?

Secretary PAULSON. It would depend. Let me tell you, this is not an exact science. It would depend on which tax.

Senator CONRAD. Is the rough conclusion of Treasury not that roughly 10 percent of a tax reduction is offset by the economic growth that is developed by that?

Secretary PAULSON. I would not come to that conclusion.

Senator CONRAD. Well, is that not Treasury's own analysis? Have you not done an analysis down at Treasury that reaches that very conclusion?

Secretary PAULSON. I would say Treasury has done an analysis on a variety of things, on different taxes, looking at dynamic effects. But the point I was trying to make, Senator, is that the tax cuts have been fundamental to where we are today.

When you looked at the total debt—and again, I look at the public debt outstanding very, very closely. I saw that it averaged 46 percent of GDP in the 1990s, and right now we are in the area of 37 percent, with the projection going down as a percentage of GDP over the next couple of years.

Senator CONRAD. Sir? Sir, honestly. Be honest with people, now.

Secretary PAULSON. I am talking about public debt.

Senator CONRAD. The gross debt. What I put up here is the gross debt of the United States.

Secretary PAULSON. Oh, gross debt.

Senator CONRAD. The gross debt of the United States, if you put back the things that you have left out, is approaching 70 percent, and headed nowhere but up. I am sorry we cannot continue. My time has expired.

Secretary PAULSON. Excuse me, because I stand corrected. I was looking at the public debt outstanding. With the gross debt, of course, 44 percent of the debt is in the Medicare and Social Security trust funds.

Again, there you and I are on the same page. I think what we really need to do is come to the table and deal with the real problem, which is the longer-term issue we have staring us in the face with entitlements.

The CHAIRMAN. All right. Thank you very much, Senator.

Senator Bingaman?

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

Let me ask you, on the energy security issue, we have on the books today several tax credits that are intended to move us away from our addiction to oil and traditional fuels to the use of new alternative energy sources, alternative fuels. Many of those are scheduled to expire at the end of 2008.

We have written to you and to the President, I believe several of us have, urging that those be extended for at least 5 years, probably longer, because without that there is not the confidence. You know better than I do that the investment community needs to know that those tax credits are there or else they are not going to invest in projects. That is not in the administration's budget to extend those tax credits. They are all scheduled to expire at the end of next year.

Do you favor extending those tax credits for at least 5 years so that we can give people some confidence that they are going to be there? The production tax credit on wind energy and solar energy, in particular.

Secretary PAULSON. I know what you are referring to, Senator. Let me say to begin with, I really appreciate your leadership on this issue because you and the President are in the same place in terms of the need for alternative fuels.

Now, with regard to those tax credits, we extended them last year. We are very pleased to talk with you about this some more. What we were getting at with the President's energy proposal was to lay out something that was bold in terms of a proposal that would greatly increase the demand when you are looking at all of the renewables and alternative sources of fuel to replace $35 billion of gasoline over the next 10 years. We thought that would have a very big impact on the demand and do much of the same things we are looking to do with the tax credits. But I understand your point on the tax credit, and we will be talking to you about it.

Senator BINGAMAN. From my perspective, at least, they sort of address different parts of the problem. What the President said is, renewable fuels need to be expanded dramatically.

Secretary PAULSON. Right.

Senator BINGAMAN. And let us set higher targets for that. He has also said we need more efficient CAFE standards.

But as far as renewable energy production: wind power, solar power, geothermal, those types of things——

Secretary PAULSON. We should look at those together.

Senator BINGAMAN. Yes. Those are all scheduled to expire the end of next year. I think it is crazy to just keep running right up to the deadline and then extending them for another year or 18 months like we did last year.

Secretary PAULSON. I have your point. We extended them last year. I look forward to talking to you about it.

Senator BINGAMAN. Let me ask, just to be sure I am understanding it, part of the revenue you are counting on in this budget is $3.5 billion into the Treasury in the first 5 years after you open ANWR for leasing. Is that right?

Secretary PAULSON. Three and a half billion.

Senator BINGAMAN. In bonus bids or something once ANWR is leased.

Secretary PAULSON. I worked with Rob Portman on the budget very broadly, but in terms of that portion of it, you will have to ask Secretary Bodman or Rob when he is testifying here.

Senator BINGAMAN. All right. Well, I would just suggest that that is not a realistic revenue stream, given the changes in Congress.

This is not directly on the budget, but I wanted to take the opportunity to ask you about it since you are the key player in the administration on this issue. You talked about the importance of fiscal discipline, plus a growing economy.

Part of our challenge in having a growing economy is the current account deficit. As I understand it, as I see it, the current account deficit, as it is currently growing, is unsustainable.

The portion of the current account deficit attributable to our trade with China is the fastest-growing part of the current account deficit. I just wondered what you could tell us, if anything, about prospects for dealing with this current account deficit. Or is it your view that it is not one of the threats to our growing economy?

Secretary PAULSON. Well, let me tell you, Senator, this is something near and dear to my heart. It is something I am very focused on. I would say the good news with the current account deficit and with the deficit with China—and I will give you the good news first—is that we have hit what looks like a cross-over point. In the last 4 quarters, our exports were greater than our imports.

With regard to China, in the last quarter our exports increased. Last year, our exports increased 33 percent, our imports were 19 percent. So when you looked at the most recent GDP numbers, we had 1 percent over GDP growth that was attributable to the fact that our exports were growing. I see a very, very important part of my job as fighting to open up markets, advocating opening up markets, for U.S. products and services overseas.

Now, with regard to China, that is a big part of it. Yes, I believe we can make progress, and substantial progress, over time with China. I see Senator Schumer looking carefully at me, and he and I have talked about this a lot.

But the currency flexibility in the short-term is something we are pushing on, getting to a fully market-determined currency in the intermediate term. But then the real way we are going to make the most progress here is going to have to deal with structural changes and real structural reforms in China, because they are saving at 50 percent and they do not have balanced growth in their economy. There is not consumption-led growth. Meanwhile, we have a low savings rate, and in our economy we are growing.

So, a lot of what we are working on with the Strategic Economic Dialogue with China are reforms that are going to take longer to put in place, but we need to make progress, which will, in turn, open up their economy to a greater extent for U.S. products and services.

The CHAIRMAN. Thank you very much, Senator.

Senator BINGAMAN. My time is up. Thank you.

The CHAIRMAN. Thank you.

Senator Wyden? He is not here. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. In general, as I look at this budget, I think its priorities are not in sync with the American people. So much goes to the war in Iraq and tax cuts for the very wealthy, that there is almost nothing left for the meat-and-potato issues like health care and education and transportation. But I do not want to have a debate on priorities of that broad nature.

Let us talk, even, about priorities within the tax cuts. I have to say that I am saddened by those priorities as a New York Senator, as an American, although as DSCC chair you are making my job a whole lot easier.

Let me say why. There are $2 trillion in new tax cuts in the budget. Yet, one of the most popular, one of the most important, one of the most effective tax cuts for the middle class, which is tuition deductibility for people making up to $150,000 a year, is eliminated in this budget.

How can the administration find room for $2 trillion in new tax cuts and not find $2 billion a year to pay to make it easier for middle-class families to send their kids to college? We are not talking about tax cuts versus spending. We are right within the realm of tax cuts. I think it shows how misplaced the priorities of this administration are. They are so eager to help people at the very high end of the spectrum, that even when it is a tax cut, they ignore the middle class.

Just one example. There is $800 billion to reduce that top rate, to continue to reduce the top rate from 39 to 35. Do you not think, Mr. Secretary, it would be in sync with the country's priorities, with the country's needs, to make that a tiny little bit less and help middle-class people deduct the costs of tuition for college?

Explain to me the reasoning that went behind the elimination of the college tuition tax deduction, while at the same time keeping just about all of the tax cuts on the wealthiest people who can afford college easily on their own?

Secretary PAULSON. Well, I would say, in terms of the tax cuts and their effect overall, Senator Schumer, I think when the American people look at what has been accomplished through the tax cuts at the low end and look at the fact that there are now 5 million people in America——

Senator SCHUMER. Mr. Secretary, I am sorry to interrupt, but we only have 5 minutes. I am not asking about tax cuts in general. I am asking the priorities. Why did the administration eliminate it? I have pride of authorship here. I wrote this provision with Senator Snowe.

Secretary PAULSON. All right.

Senator SCHUMER. So it was bipartisan. Why did the administration propose to eliminate the college tuition tax deduction? Do you think it does not work? Do you think middle-class families do not need the help?

Secretary PAULSON. On that one, you would have to talk with Secretary Spellings. I know how important the education programs are to her and to the President. I think there is a record that they can all be proud of.

Senator SCHUMER. Just off the top of your head, does it make any sense?

Secretary PAULSON. In terms of that, I do not think the Treasury Secretary should go off the top of his head.

Senator SCHUMER. You have a pretty good head. I have known it for years.

Secretary PAULSON. It does not have a lot of hair on it right now. [Laughter.]

Senator SCHUMER. No. It does not have a lot on it for people paying for college.

Secretary PAULSON. I take your point.

Senator ROBERTS. Can we not make these comments about hair?

Secretary PAULSON. I am sure the Secretary will call you right away.

Senator ROBERTS. Mr. Chairman, parliamentary inquiry. Can we agree that the follicly challenged caucus can be respected here? [Laughter.] I am a new member so I would like to——

The CHAIRMAN. I think that is right, because it is growing in number. [Laughter.]

Secretary PAULSON. I see a number of perfect heads.

The CHAIRMAN. Yes.

Senator SCHUMER. All right. Next question. Tax gap. Now, the President's budget proposes 16 changes to the tax code to increase compliance and reduce the tax gap. The budget also includes additional resources for IRS enforcement.

However, the budget only chips away at a tiny percentage of the enormous tax gap. You estimate you will raise about $2 to $3 billion a year. To me, this is the best way to raise revenues to make sure people who owe taxes actually pay them when they are not complying. Should we not do much more to close the tax gap than we are doing in this budget?

Secretary PAULSON. Well, Senator, let me tell you, this is something I focused on a great deal because, after arriving in Washington, Chairman Baucus let me know how important it was to him. I know it is important to you, and it is important to others. As someone who has paid plenty of taxes in my lifetime, the idea that people are not paying taxes is not appealing to me, and it is not appealing to the American people.

Now, I would say to you that we have asked for increased resources for the IRS, and there are 16 legislative proposals on the tax gap. I just urge everyone who thinks we should do more to, first of all, let us pass these proposals, pass the ones we had up here last year. Then the other thing is, I will spend time working with Senator Baucus at his hearings, but I will tell you what I have learned in looking at this. I have spent a fair amount of time looking at it.

I have learned, first of all, we need more information. We need to do more research. But based upon the research we have done, the conventional wisdom has always been more enforcement—of course, we are increasing enforcement—and simplification. Simplification helps.

But the biggest reason for the tax gap, by far the biggest reason, is under-reporting of income, and it is individual income.

Senator SCHUMER. Yes. Agreed.

Secretary PAULSON. And it is business and farm income and the related self-employment taxes. So when you look at it, it is small businessmen, it is farmers, and it is under-reporting Schedule C filers.

When I have looked at what needs to be done, I concluded that there is not a pot of gold to pay for AMT to balance the budget, unless we sign on for specific reporting provisions, increased reporting that I would recommend against. I would bet you, if we talked about it, you would not be supportive of some of these things yourselves.

So I think one of the things we can do as part of the hearings is to sort of educate the American people and figure out how to go after that part of the tax gap we can get, and, boy, we will go after it very enthusiastically.

The CHAIRMAN. Thank you. Thank you, Mr. Secretary and Senator Schumer.

Senator Lott?

Senator LOTT. Thank you, Mr. Chairman. Boy, I have been interested in some of this discussion today, particularly with regard to AMT. I was in hopes that the chairman of the Budget Committee would still be here, because I wondered if perhaps he was going to build into his budget an AMT fix.

In the past we have had this 1-year patch, done in a bipartisan way. But at least once I went to the floor with an extensive repeal of the AMT and panic set in all over the place; everybody ran for the hills.

So it is easy to talk about doing it, but as a matter of fact, when I actually laid down an amendment one time on the floor, everybody took off. So, this is a responsible way to deal with it. If we are ready to go with a big fix, I would like to see it in the budget resolution.

Now, with regard to the college deduction, I will say to my colleague from New York, is middle-income now up to $150,000 a year?

Senator SCHUMER. When you have to pay $35,000 of tuition each year, it sure is.

Senator LOTT. I just wanted to make sure. I did not realize that the middle-income level had gone up to $150,000. But also, I would note that on at least one or two occasions last year I thought when we had a chance to pass the college deduction language, the Senator from New York voted against it.

Senator SCHUMER. We passed it because of my efforts and those of others. It is now law for this year. But they are proposing to eliminate it for next year.

Senator LOTT. Did we not have a discussion on this last year in which there was resistance to this?

Senator GRASSLEY. Well, first of all, I would give Senator Toricelli credit for getting it passed in 2001.

Senator LOTT. Well, I do think that this is something that perhaps we can work on, but I do think also maybe there should be some more reasonable limits on it. Yes?

Secretary PAULSON. Excuse me, Senator Schumer. Let me say what I learned from my colleagues behind me is that it is currently in law, and it just was not one of the extenders in the budget, so it is scheduled to expire in 2007.

Senator SCHUMER. I would just say, all the others were in extenders, including the rate reduction.

Secretary PAULSON. Well, let me tell you, sir, this is one where it is still there, and we will have plenty of time to talk with you about extending it.

Senator LOTT. And for whom. I think that is an important question, too.

Let me just say this, Mr. Secretary. Thank you for being here. Thank you for what you are doing. I think this is a case where we have the right man for the right job at the right time.

I appreciate the fact that you have been coming up here, talking to members of the Senate, Republican and Democrat, talking about, can we do some big things together? Can we address some of the fundamental issues that are a problem for our country's future? I hope you will continue to do that.

Now, with regard to the budget and the tax provisions, I have language here. I believe the economy, perhaps, is as strong now as it has ever been in history when you look at all the numbers. When you look at the inflation rate, the unemployment rate, wages and salaries are up, and productivity, right across the board.

I will make it, since we have a time problem here, two quick questions together. Do we not have an exceedingly strong economy, and have the tax cuts we put in place not led dramatically to that result?

Secretary PAULSON. Well, Senator, I clearly believe, and I have said before, that the tax cuts laid a very strong foundation for this economy in many ways, small business, large business, individuals. So, it has made a big difference in the economy.

Second, in terms of the economy, as I have said a good number of times, if you had asked me last January if I thought we would be sitting here with the economy as strong as it is and that we would have made the transition as successfully, appeared to make the transition from a growth rate that was unsustainable to one that really seems sustainable, the so-called "soft landing", I——

Senator LOTT. And what was the growth rate the last fiscal year?

Secretary PAULSON. Well, the growth rate for the last fiscal year was, I believe, 3.6 percent.

Senator LOTT. And what is it projected to be for the coming year?

Secretary PAULSON. Well, I think it will be something in the neighborhood, we would hope, close to 3 percent. But remember, we were growing at a level, in the fourth quarter of last year and the first quarter of this year, that just seemed unsustainable.

Senator LOTT. Right.

Secretary PAULSON. And we had a housing market that was clearly growing at an unsustainable level. So to be able to have it weather that correction and have the kind of GDP growth number that we had for the fourth quarter, I think it is very encouraging.

Senator LOTT. Well, let me just say that we got it in this great shape before you got here and we just expect that you would keep it growing like that. That was humor. [Laughter.]

Now, one other thing in this budget I do like. I do not think it is all we need to do, but I do think one of those big issues we need to talk about and try to find a way to work together on, is health care delivery. Affordability and accessibility is a problem in America.

Secretary PAULSON. Yes.

Senator LOTT. In rural States, in cities, middle-income families. I mean, it is getting to be a big problem. Yet, we have not been able to find a way to come together. I think the President's proposal is an interesting one. Perhaps we need to do more. We can expand it.

I would like, Mr. Chairman, to ask that, as soon as is reasonably possible, that you would schedule a full-blown hearing on what the President has proposed and other options that might be out there.

Because if you look at any kind of polling or just ask individuals, tell me your top three issues or problems that you really have a problem with, they would say, well, maybe energy, and health care clearly would be in the top three. So, I would urge you to do that.

The CHAIRMAN. Well, I say to my friend, we plan to have several, in fact. This is so important. The main goal of the hearings is to try to get to the underlying costs of health care. It is not just Medicare and Medicaid, which are going up because health care costs are going up. But the underlying costs affect everybody.

Senator LOTT. Well, a number of us have worked on this in the past in a bipartisan way. John Breaux had some interesting ideas, I think Olympia Snowe and Senator Wyden. I mean, we all should get together on this and try to see if we cannot pick up what the President has proposed and build on that and produce a result.

Secretary PAULSON. Right. I thank you because I do believe that the proposal gets at the underlying cost of health care.

The CHAIRMAN. Senator Snowe? Thank you. Thank you, Mr. Secretary.

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. To follow up on a number of issues here, and something that Senator Schumer raised as well in terms of balancing priorities.

We are in an entirely different context today in talking about extending all of the tax cuts, making them permanent. I was here in 2001. We obviously did it for the reasons that Senator Grassley mentioned, that taxes, as a percent of GDP, had risen to their highest level since World War II, about 21 percent. Now we know it obviously has done much good.

On the other hand, does it really make sense at this point in time to extend all the tax cuts at a cost of $1.7 trillion when you consider the fact that, according to Joint Committee on Taxation, approximately 88 percent of capital gains go to those earning more than $200,000, and about 22 percent of the 2001 and 2003 tax cuts go to those who earn more than $1 million?

At a time when we are talking about the widening income gap in America, is it not worth preserving our options and making some changes and alterations? Isn't that especially true at a time when we are talking about significant spending reductions in programs such as Medicare and Medicaid, totaling $102 billion, or the SCHIP program to help insure the uninsured children in America, in which there is a gap even as we speak? With the current level of funding, there are more than 9 million uninsured children across this country. That is what I do not understand.

Why are we replaying the debate from the past? We are in 2007. We have enormous challenges. When we passed that tax cut back in 2001, I can well remember everybody talking about the projected surpluses as far as the eye can see of $5.6 trillion.

Now, I always say, they are here today but could be gone tomorrow. They are all projections, and they are theoretical. So why talk about extending all of the tax cuts so that we can enhance the wealthy in America?

Yet at the other end, if you look at the disparities according to the latest census data in 2005, a household in the 90th income percentile earned $114,000, or 11 times as much as a family in the 10th income percentile.

So as we see, the income for households at the top has grown over the last 30 years, while the incomes of households at the bottom remain flat, so we are just exacerbating that with the proposals that have been presented in this budget.

Senator Schumer mentioned the tuition tax deduction. Again, it does help middle-income Americans, two people struggling. The cost of higher education is $40,000 plus. So I do not know why we have to insist on this debate of the past.

Recognize where we are today and do something different and be discerning about which tax cuts are extended. Why do it now when they are not expiring for another 3 years? Why not look at it very carefully?

Secretary PAULSON. Senator, first of all, thank you for your comments. You dealt with a number of things. You dealt with the underlying increase in income disparity, which is a 30-year trend in this country and is, in my judgment, related a great deal to technological advancement to a much greater extent, and also to globalization.

Now, I do believe, and I know you know this, when you look at the President's tax cuts, on the low end of the income scale, they clearly helped. There are 5 million taxpayers who now are no longer paying Federal income tax. When you look at any of the data there, it has helped.

Now, in terms of your question about whether we should not be considering raising taxes right now, again, I would look at it and say that the tax cuts worked. We have an economy that is quite strong. As Senator Grassley said, we have taxes that are now 18.4 percent of GDP. They are back up above the 40-year average.

This puts us in a position of strength so we can now deal with what are going to be the major, major issues. The major economic issues of the next 25 years are going to be entitlements and the need for entitlement reform, and we can approach that from a position of strength.

Even your comments about Medicare, again, I just take those in the spirit in which they were put out here. The Medicare proposal, which we would like to talk to members of the committee about, at least takes a small step in slowing down the trajectory of that growth over a 10-year period, from 7.4 to 6.7 percent, slowing it down, introducing means testing, for instance. So, I understand how deeply you feel about these issues. I look forward to talking to you more about it.

Senator SNOWE. I appreciate that. I hope we can, because I think we have to focus on middle-income America. Even on the AMT, by making the tax cuts permanent, it is going to cost more. The AMT is going to capture more people—as I understand it, up to 30 million—by making the tax cuts permanent. So, I think we have to be looking at these issues, not just giving a Band-Aid approach.

Secretary PAULSON. No. On AMT, make no mistake about it, we need a long-term resolution there, and we are focused—and I am really focused—on the average worker. Right now with the economy growing, the average American worker/taxpayer is doing much better than he or she would be doing in a no-growth or a slow-growth economy. So they are starting to see some real gains. We can keep this economy going, and they will see more.

The CHAIRMAN. All right. Thank you, Senator.

Senator SNOWE. I appreciate it. Thank you.

The CHAIRMAN. Next on the list is Senator Roberts.

Senator ROBERTS. Well, thank you, Mr. Chairman. How is your cold, Mr. Secretary? Are you getting over that damn cold?

Secretary PAULSON. Doing better.

Senator ROBERTS. Good. I am glad you are feeling well.

How many people did you bring with you behind you over there? What is that, five, six, seven, eight, nine? What?

Secretary PAULSON. You know, it is interesting. This is the second or third time they get to hear me testify.

Senator ROBERTS. And there are how many? Five? Six? I am not complaining about it, I just want to know how many.

Secretary PAULSON. It looks like there are several people here to watch.

Senator ROBERTS. All right. I want them to take their pen out and I want them to write the word "R-E-L-I-E-F," and I want them to put "tax" in front of it. Then I want them to take their erasers, if they have erasers with pens—and that does not make much sense, but at any rate—quit talking about tax cuts, talk about tax relief. There is a whole different connotation.

If you say "tax cuts" we get a chorus from the other side, more especially Senator Schumer and the DSCC and all that—he brought it up, I did not. And I like Chuck Schumer. We used to play basketball together in the House gym, very slowly. [Laughter.]

So, I respect his views. He is the only person in the Senate who calls me "Patty." That is what they do in New York. If anybody else called me "Patty," I would probably pop him in the nose, being from Dodge City.

But if you say "tax cuts," he will say—he is not here right now, I can say this—"for the rich." Then he defines who is rich. Senator Snowe just made a good attempt at that. Ten percent of the highest-paying rich people pay about 50 percent of the taxes. I have never quite understood that. But if you said "tax relief," sir, it would be a whole other connotation. So tell all your people, just do not say "cuts." You say "tax relief," it affects everybody.

Now, let me tell you who I am interested in.

Secretary PAULSON. Yes. Five percent will pay 56.5 percent of the taxes.

Senator ROBERTS. Oh. Five percent, 56.5 percent. I am even low on my estimates, so thank you for correcting me, sir.

I set up something when I first became a Senator some time ago called Committee on Technology and the Future. Everybody thought, all right, we are going to take a look at agriculture, we are going to take a look at aviation, we are going to take a look at the Life Science initiative in Kansas City, we are going to take a look at oil and gas and see what we can do for Kansas to prevent the out-migration of our young people.

From the tax code standpoint, from the State standpoint, and from the emphasis standpoint of the State legislature, guess what? We were wrong in terms of trying to list them all. You know who led the charge in regards to Kansas and trying to pull ourselves out of the economy? Small business. Small business. And you know what the catalyst was there? Technology. Information technology.

Now, my question is, in that pile of books over there in the budget that Trent Lott has abdicated or given back to the committee, you have doubled the small business expensing limit to $200,000, you have doubled the phase-out threshold to $800,000.

Given that small businesses are responsible for the majority of jobs that are created in this country—that is not only in Kansas, it is everywhere—I would like to know if you can tell me what impact this is making, or what impact you are making in making this tax relief permanent—note, I said "relief"—at a higher level will have on our economy, because I think the small business benefit is a very important provision.

And in addition, since I am running out of time already, a follow-up question. I know what the question will be on the other side from somebody. Raising taxes for those in the highest tax bracket. Is it not true that an increase in this tax rate would impose a greater tax burden on the small business than on a Fortune 500 company that could somehow work around it? I am talking about the marginal tax rate on small business.

Secretary PAULSON. Right.

Senator ROBERTS. Two questions.

Secretary PAULSON. Yes. Thank you very much. I am going to do the last one first because there is no doubt that bringing the top rate down really benefitted small businesses.

Many, many small business filers are Schedule C filers, so that made a big difference. Small businesses have been a real engine of growth in this economy and in this country, so that is very, very fundamental.

Your first question also had to deal with small businesses and tax relief for small businesses and the need to make that permanent. Again, I am with you.

Senator ROBERTS. Well, basically I am asking the same question Senator Bingaman said in terms of making it permanent under the banner of consistency and predictability, because a small business man and/or woman would like to have that.

My time is up. Thank you for yours.

The CHAIRMAN. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Secretary, I wanted to talk to you about the administration's health proposal. I think it is very obvious now that economists on both sides, Democrats and Republicans, are saying that the Federal tax rules on health both promote inefficiency and disproportionately reward the most affluent.

You have a high-flying CEO, he can write off the costs in his taxes of getting a designer smile, but a hardworking gal in a hardware store does not get much of anything.

So I very much want to work with you and the administration—we can talk about the details—to fix these policies that are outdated. I was very pleased that Senator Lott mentioned working on these issues in a bipartisan way.

But fixing the tax code on health alone does not fix the broken health care marketplace and does not expand coverage. Until we get everybody covered, the people who are uninsured, in effect, send their bills to those who are insured.

So my question is, is the administration open to expanding its health care proposal to consider additional coverage and steps that would fix the broken marketplace, which go hand in hand?

Secretary PAULSON. Right. Senator, thank you very much for your comment. Let me begin by saying that I totally agree with you on the current system. I think one thing we should all agree on, and we can all agree on, is that the current tax preference, which goes only to those who get insurance provided by their employer, is biased, it is unfair, it leads to distortions. So, your question really gets at accessibility.

Clearly, we put this proposal forward, not to say this is, in and of itself, the solution. As you will hear when Secretary Leavitt is up here testifying, his Affordable Choices Initiative, working at the State level, is really aimed also at access.

One of the big drivers of this proposal is access for the 47 million people who do not have health insurance, and also fairness to the 17 million who are getting insurance through individual markets and getting no tax benefit. So, we in the administration are concerned about access, and we are very open to working with you and others to build on this proposal, to improve upon it, and make it more inclusive.

We do recognize this, in and of itself, is not the whole solution. We just think it is a big step forward. To those who do not welcome it, we would say, why is it you would prefer the current system? But let us take it, let us build on it, and let us talk about ways to increase access.

Senator WYDEN. I appreciate your answer, Mr. Secretary. I just hope, because this is going to be a short year, certainly by the fall, a presidential campaign—rumor has it, it has already started—is going to be under way.

I hope that very soon there will be bipartisan efforts in the Senate, working with the administration, to look at tax policies that made sense for the 1940s and do not make sense now, but that the administration, as we get Senators to come to work with you, will also see that there is a clear linkage—a clear linkage—between expanding coverage and fixing the broken marketplace and what the administration wants to do.

You are nodding, and I think I will just state for the record that I was pleased with the nod. If all we do, if all the Congress does is make the tax changes, then what will happen is citizens in Senator Stabenow's State or my State will go out in the marketplace, for example, and they will face insurance company cherry picking and healthy people will get covered and sick people will not. So, there are other pieces to the puzzle.

Secretary PAULSON. There are other pieces to the puzzle. Developing the insurance market, the private insurance market, is a key part of this. I would just note that the administration has another part, too. It is not just the tax change. The tax change is critical because that cannot be done at the State level. Only the Federal Government can remove that bias and free up that money for more equitable use and to create access.

But the Affordable Choices Initiative, which you will hear about from Secretary Leavitt, is a big initiative to increase access and do other things at the State level. We look forward to working with you and figuring out how to improve all of these proposals.

Senator WYDEN. My time has expired. I happen to think the tax reforms are also critical. But even more critical is putting the pieces of the puzzle together. I am glad that you acknowledged that, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus and Senator Grassley, and thank you, Secretary Paulson, for your service to our country.

I have two questions. My first question is about energy. We have had conversations before, including conversations that I have had with President Bush on the importance of energy, and I happen to think that there is probably nothing that is more important for us in this country than to get our way towards getting rid of the addiction on the importation of oil, as Senator Bingaman was talking about earlier.

So my own concern, as I looked at the budget, as I went through it last night, is we seem to have a lot of great statements being made by the President and others about our move to get rid of the addiction on the importation of oil, and then on the other hand we have a budget that does not walk the talk.

When I go through parts of the budget—and I will not go through the whole thing. I visited the National Renewable Energy Lab with the President and many of his people last year. It has a 3-percent decrease in funding. It seems to me that that is going the opposite way of where we ought to be going on technology and research.

The wind energy program—we have the wind energy industry that has taken off all over this country—has a 26-percent cut in the budget. The solar budget, where we are now covering lots of ways in which we can capture that energy, is down 10 percent. I could go on and on down the list in terms of what I think is a budget that does not match the President's statement in the State of the Union, or other conversations that we have had.

So I would like you to respond how, from your point of view, this budget squares up with this vision of energy independence that the President has spoken about.

Secretary PAULSON. Right. Let me say, Senator, I know the President shares your objective. I do, also. I would say one of the things that has been most encouraging to me when I have spent time at the Department of Energy with Sam Bodman and his people, talking to some of the scientists there, is where we are with some of the technologies and some of the advancements that are not that far away.

Secretary Bodman will be able to talk to you about this, but I really believe that in a number of these areas that are so crucial, more money, in and of itself, is not the answer. They are making real progress. They have the money they need. I know you are not suggesting that we just throw money at problems, but I do think you will see we have made progress.

In terms of this energy security, the President and his team looked at this issue and found that we are dependent upon foreign sources of oil for two-thirds of our oil. And guess what? Where are we the most dependent? The transportation sector. So getting more diversity of fuel for the transportation sector was a big emphasis. So this is really quite bold.

Senator SALAZAR. Let me just say, Secretary Paulson, I appreciate that comment. I appreciate learning a lot more about the budget and the pieces that are in there in energy.

I will tell you that in a hearing that we had on biofuels just within the last week in the Energy Committee, the experts from around the country—not Republicans and not Democrats, but experts—are simply telling us that the 2017 Renewable Fuel Standard that the President spoke about is simply not achievable with the current level of investment. If we are going to make achievement on that goal, it is going to take a lot more in terms of investment, on research, on a whole host of things.

So we will carry on our conversation about energy, because I do think that is an area where there can be some more bipartisan movement as we move forward.

I have another question for you, though, because I know my time is limited. That is on the deficit. Some people worry about the deficit more than others, but it seems to me that at the first step of understanding the deficit we need to have a very realistic picture of what our budget situation is.

I echo the comments that Senator Conrad made to you earlier, that the budget really does not present the full fiscal picture of our country because it does not account for the out-year costs of the war in Iraq and Afghanistan.

I anticipate, in Afghanistan, we are going to be there for a number of years. The debate is going on about Iraq, but I presume we are going to be investing significant resources even beyond 2008. Yet, those are not accounted for.

The AMT issue, which is a multi-billion dollar issue, also is not accounted for beyond this year. So, one of the things that I would ask you, as Secretary of the Treasury, is to help us lay out that candid fiscal picture on the table so we can look forward in a bipartisan fashion to try to address the issue of the deficit.

Secretary PAULSON. Senator, let me say, I am just going to give you one sentence on energy, which is, the 35 billion gallons of alternative fuels, the fuels that are going to substitute for 35 billion gallons of gasoline by 2017, will create real demand. I know some people think we are too aggressive, some not aggressive enough.

Now, in terms of the budget question——

The CHAIRMAN. That is two sentences.

Secretary PAULSON. What?

The CHAIRMAN. I am sorry. I am just teasing. That was two sentences.

Secretary PAULSON. All right. Sorry.

And in terms of the budget question, I think it was a very similar question to what Senator Conrad asked, and the Chairman made a similar point. With regard to the budget, I am very focused when we look out a number of years at what we have staring us in the face in terms of entitlement.

In terms of the war costs, we have been as transparent as we know how. Again, to get into more detail, you will have to deal with Rob Portman and Secretary Gates; that is in the middle of their lane.

But I can tell you, from the budget perspective, we have the supplemental for this year. You have the $145 million for next year in the budget, for 2008. I would just say to you, it is impossible to know right now what the cost of Iraq will be in 2009. That is why I would think about that $50 billion number as a placeholder. So, that is as transparent as we know how to be. I know people would like more certainty, but it just is not possible.

With regard to the Alternative Minimum Tax, again, I think I have been very clear in saying there is a need to come up with a permanent solution.

What we have done is, we have gone ahead and put a 1-year patch, 1 year of relief in the budget for this year, while we work with you on a permanent solution. That has been the approach that Congress has generally taken for the last 6 years. This is a tough one.

The CHAIRMAN. Thank you, Senator.

Secretary PAULSON. This is one that we will work on together.

The CHAIRMAN. Thank you very much. Thank you, Mr. Secretary. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, very much. And thank you, Mr. Secretary, for being here.

When I listen to all the comments of good news, I have to tell you that it does not, unfortunately, filter down to middle-class families in my State, and I think in most States right now, who are feeling tremendous unease. We have heard numbers about real GDP growth up over 32 percent and real corporate profits up, increasing by 36 percent; S&P 500, adjusted for inflation, increased by 58 percent.

But real wages for real people have declined over a decade. I know that your response will probably be, there is a slight little increase now. But the reality is that, for most people, they are feeling squeezed on all sides right now. That is the reality for most families.

And when we look at the fact, in addition to that, that the personal savings rate has been negative for an entire year only twice before now, 1932 and 1933, that is the reality for most people that are trying to make it.

When I look at your budget from the context of a middle-class family, particularly related to manufacturing—and I am not talking about your father's factory. I would welcome your coming and taking a look at the most high-tech facilities with the most highly trained workers in the world working there, and, in fact, their engineers, middle-class, and upper middle-class partners also are feeling greatly squeezed as it relates to what is happening in a global economy.

Here is what I see in the budget, which is deeply concerning to me, related to manufacturing. We see on very specific programs, like the Manufacturing Extension Partnership, it is proposed to be cut in half again, a major support for small- and medium-sized businesses that has actually created jobs. The Advanced Technology Program is going from $73 million to $6 million. This is a partnership with industry on cutting-edge technology in manufacturing almost totally eliminated.

Then I am just going to run through a bunch of things and then let you respond. The alternative fuels tax credits that Senator Bingaman talked about that expire at the end of next year. If we are going to have confidence, if the marketplace is going to have confidence, those need to be extended much farther out, as you have already discussed with Senator Bingaman.

And the baby steps in research and development. When Senator Salazar was talking about research and development, with all due respect, given the extent to which the President talked about this in the State of the Union, I expected something very big and very bold, not something in the tens of millions. I would have expected something much bolder when we are talking about moving forward in research and development, which we desperately need to do.

Then I would say two other things. One, your health care deduction that the President has proposed will actually require large manufacturers and other large businesses to pay taxes on the part of the health care that they provide because it caps it at $7,500, and our benefits are oftentimes higher than that. So we look at that and then we look at the fact that it is hard to find trade enforcement dollars of any extent in here.

Finally, I would say, simply, this: trade adjustment authority which is in here, trade adjustment assistance for people who are benefitted or who are hit by all of this global economy and trying to compete in a world where we do not have a level playing field and we are not adequately, in my judgment addressing that, we are placing $13 million—the President is—into the budget for retraining people caught in the middle of all of this. Yet, the trade-related job losses are calculated to be $54 billion, and the benefits of trade are estimated to be $1 trillion.

If the benefits are $1 trillion, I would like to know what percentage you believe we should be giving workers who are impacted by this and caught in a situation not of their making, that is absolutely squeezing the middle class of this country.

Secretary PAULSON. Senator, wow. That is a lot to respond to. Let me be brief and start with the fact that your focus on the working men and women in this country and the average taxpayer is a good one. It is one I know the President cares a lot about, and it is one that I care a lot about.

So I am going to start by saying something that may sound obvious, but we just cannot forget it. That is, the most important thing we can do for all of these men and women is keep the economy growing, because, trust me, they will all do better with an economy that is growing strongly than one that is growing very slowly or one that is in decline.

I think you know what the President's tax cuts did at the low end, so I think you are aware of that. I do not need to tell you about the people who are no longer paying Federal income taxes and what has happened on the low end.

In terms of small business, perhaps we could do more. But I will tell you, when you look at what has happened with taxes for small businesses, there has been a lot that has been done. If there is more that you think should be done, I would like to talk with you about it, because there is a lot that has been done and that is absolutely key.

On the standard deduction for health care, you said one thing that I may have misunderstood, but I just want you to know that all of those expenses are deductible to the business. So all the President is proposing here is that everyone who gets health insurance, if they get a basic health insurance policy, whether it is provided by an employer, or whether they are the waitress who does not get health insurance, or the construction worker, they all are going to get the same standard deduction.

So, that is really all there is to that, and it is very, very powerful in terms of bringing access to those who do not have it, including a big part of the American public that does not have access to health care, and dealing with fairness.

The CHAIRMAN. Thank you very much.

Senator STABENOW. If I might, just one quick follow-up.

The CHAIRMAN. Senator, your time has expired. Quickly.

Senator STABENOW. I thank you, Mr. Chairman. Just on that point.

So you are saying that an amount above $7,500 for a worker is still deductible by the business?

Secretary PAULSON. I am saying the business can pay whatever they want and that is a deduction for the business. That is an expense. So what the President's proposal deals with is the income, the tax preference. So what happens is, if I am buying insurance in the individual market, not in the employer market, I pay for it, and I do not get a tax deduction. If my employer pays for that, that income is excluded from my taxable wages.

The CHAIRMAN. Thank you, Senator.

Senator STABENOW. Thank you.

The CHAIRMAN. Thank you.

Senator Lincoln, you are next.

Senator LINCOLN. Oh. I thought Senator Smith was next.

The CHAIRMAN. He is our patient, last person.

Senator LINCOLN. Goodness. All right. Well, thank you, Mr. Chairman.

The CHAIRMAN. Penultimate patience.

Senator LINCOLN. There you go.

I have several questions I would like to get to, so I will try to ask as many of them as I can so you can respond in total.

First of all, however, is a compliment. I want to quickly extend my thanks to you for the Treasury's work on section 181 and the guidance there. I told you the other day when you came to the committee that we had been working 2 years with Treasury to get an answer in terms of guidance.

You gave me your word in that meeting that something would be forthcoming. We have had a call from Treasury that it will be forthcoming. I have not had the ability to see it or review it, but I am anxiously awaiting that opportunity, and I appreciate you being a man of your word. I am assuming it is down the road shortly. Is that correct?

Secretary PAULSON. It is.

Senator LINCOLN. I see your staff shaking their heads.

Secretary PAULSON. It very much is.

Senator LINCOLN. Thank you.

Secretary PAULSON. We were aware that this hearing was coming up, and we wanted to move quickly.

Senator LINCOLN. Well, I appreciate that very much.

One of the other things, the individual development accounts. You were certainly well aware that the Nation just posted another negative personal savings rate, the lowest it has been since the Great Depression. In so many recent years the administration has included the IDAs in their budget proposal, and they did not in this one.

Secretary PAULSON. Well let me be very quick here. We put it forward—it was complex—for a number of years. It got no traction in Congress.

Senator LINCOLN. It passed the Senate in the 107th and 108th.

Secretary PAULSON. Yes, but we did not get it passed into law.

Senator LINCOLN. I would say that is pretty good traction.

Secretary PAULSON. So we have emphasized other programs. We are happy with the budget's approach because it is surely the right objective, addressing low savings.

Senator LINCOLN. Well, I hope that you will. The administration has indicated their support for it, and I hope that has not waned. But if it has passed the Senate in two previous Congresses, I think we can certainly work something out there.

One of the others is the bigger picture, actually, Mr. Secretary. That is, the need to look at the whole ledger, not just entitlement reform. That is certainly a critical issue that we have before us.

We had, also, the Chairman of the Federal Reserve, Chairman Bernanke, and he has stated publicly in recent weeks that a dip this year in the annual Federal budget deficit to $248 billion was the calm before the storm, realizing that with ballooning entitlement payments that are looming before us in the next 20 years as baby boomers retire and medical costs skyrocket, we have a problem ahead of us.

So I hope that we would have some kind of an agreement that there, indeed, is a problem looming out there and you cannot solve that problem simply by cutting domestic programs or looking at one side of the ledger.

And I do not know where you stand on that, but certainly would like to give you the opportunity to give your thoughts on needing to look at the whole picture, tax revenues and outlays on entitlements. There are two sides of the ledger in this equation and we are not going to solve entitlement problems by simply cutting domestic programs. So, I think that gives us a little bit of room for discussion there.

I would also like to align myself with Senator Salazar and Senator Bingaman in terms of renewable fuels incentives. I do not know, but you come from the investment world, and I cannot believe that you would not agree that if we are going to ask America's businesses to make the investment, the million-dollar investments that we need to get the kind of up-and-running industry in renewable fuels that we need, we cannot be lackadaisical in the incentives that we offer them.

If all we do is renew those incentives through 2008 when we are making permanent so many other incentives, it just indicates to them we are not serious about really moving to renewable fuels and lessening our dependence on foreign oil. So, I would just align myself with those two Senators who really did try to make that point, and I thought they did very well.

Then, last, on the health care deduction, just some clarifications, perhaps. There are many of us on this committee who have worked long and hard over the last several, 4 or 5 years to come up with some types of answers to deal with the 47 million who are uninsured.

If you could just kind of help me, why you chose a flat deduction rate as opposed to a percentage of cost, because I want to understand what your goal was in terms of, if it is to impose a cap to disincentivize Cadillac plans, it seems we could have done that through a percentage structure that was capped, if that is what your goal was.

But the deduction that is proposed does raise some concern for some of us. I am, again, trying to better understand what your objective is and what the plan is, but want to make sure that we do not end up encouraging people to just buy the cheapest of plans, and we end up with maybe perhaps more people covered, but covered more poorly. I do not think that really meets the overall objective that we want.

Secretary PAULSON. Well, I would say that the objective—and I am going to get to your specific question—really was fairness, eliminating biases toward Cadillac plans, and growth in health care costs.

Senator LINCOLN. You mean, reducing the growth?

Secretary PAULSON. Costs going up. I will explain why in a minute. But the goal was accessibility, affordability, and portability. The goal was to give people a standard deduction no matter what your income is or where you purchase your policy—now, there has to be a basic policy that meets certain requirements.

Senator LINCOLN. But for sustainability, you have indexed it to inflation, not the inflation of medical costs.

Secretary PAULSON. Right.

Senator LINCOLN. So over the course of 10 years, you are going to lose probably half of those people whom you actually get covered, will you not?

Secretary PAULSON. Well, I would look at it as the glass half full. I would say that if we are going to have some impact on bringing down the rate of growth of health care costs, that will be a positive result.

I think if you have a program that is meaningful and where it is indexed to the cost of inflation, the people will look a lot more carefully at the cost. I would say that the current system is, in many cases, just nothing but prepaid health costs.

Senator LINCOLN. Well, I do not disagree that responsibility has to be a part of it. But if you diminish the quality of the health care that you are making available to them, then your long-term costs are going to be greater because you are going to have——

The CHAIRMAN. You have to wrap up, Mr. Secretary, on that question.

Secretary PAULSON. One way to do it is through deductibility. If there is a deductible nature to these policies——

Senator LINCOLN. Is it refundable?

Secretary PAULSON. No. This is not a credit.

The CHAIRMAN. Thank you.

Secretary PAULSON. But this applies to——

The CHAIRMAN. Thank you.

Senator LINCOLN. But is it deductible from payroll?

The CHAIRMAN. Thank you. Thank you.

Secretary PAULSON. Yes. Yes.

The CHAIRMAN. We will have the next round if you want the next round.

Senator Smith?

Senator SMITH. Thank you, Mr. Chairman. Secretary Paulson, thank you for your presence here.

I just simply want to highlight that we have unemployment at a historically low level of 4.6 percent, the economy has averaged more than 3 percent growth over the last 5 years, the deficit is shrinking rapidly, and all that has occurred in the midst of a tax cut. It is much maligned and I wonder if it is much misunderstood.

As I listen to the clash of ideas between my colleagues, it really seems like a contest between trickle-down economics and trickle-down government. You were a businessman, now you are in government. What helps the middle class most, trickle-down government or trickle-down economics?

Secretary PAULSON. Well, I have to tell you, I would not use either one of those terms. But what I really believe helps the middle class the most is an economy that is growing, that is creating jobs, and that is open to trade, open to competition, and is a dynamic, growing economy.

Senator SMITH. Of all the tax cuts that were involved in the two or three that we did with President Bush, which of the three have made the most difference in terms of all the good news that we enjoy today in our economy?

Secretary PAULSON. Wow.

Senator SMITH. Is it the marginal rate, dividend cut, capital gains?

Secretary PAULSON. I would say a couple of things. One of the earlier questioners talked about small business. I would say that the cuts, which were individual cuts to some of the small businessmen, the Schedule C filers, were very, very vital.

I do not know how many small businessmen you know, but very many of them put every extra penny they have back into the business.

Senator SMITH. Back in the business.

Secretary PAULSON. That makes a huge difference.

As someone who has watched capital markets, I thought the capital gains cut and the equalization with the tax rate on dividends dealt with a very big distortion in our system, which biased corporate behavior, and not in a positive way. I think the lower rates on dividends and capital gains will add to productivity and growth longer-term, but those are two that I would cite.

Senator SMITH. Mr. Secretary, is it not true that while the top rate went down, what, 3 percent, or 3 percentage points, the dollars that the top 2 percent actually pay went up as a percent of GDP?

Secretary PAULSON. Yes. What has happened over time, as we talked about earlier, is that the system is becoming more and more progressive so this year the top 5 percent will pay 56.5 percent of the income taxes.

Senator SMITH. Which is an increase after the Bush tax.

Secretary PAULSON. Yes. And the bottom 50 percent will pay 3.4 percent.

Senator SMITH. I think the thing that is most significant to me is that, for the first time in a very long time, the wage growth is going up faster than the rate of inflation. Is that correct?

Secretary PAULSON. Yes, it is.

Senator SMITH. When was the last time that occurred in our economic history?

Secretary PAULSON. Boy, I do not have the answer to that.

Senator SMITH. It was in the Reagan administration.

Secretary PAULSON. All I know was that it was the biggest thing I looked at when I came here, and it has turned and is positive.

Senator SMITH. Is it a small blip or is it actually significant that wages are rising faster than inflation?

Secretary PAULSON. Oh, I think it is significant. I always thought—and you saw this—that if you can keep the productivity up and keep creating new jobs, that ultimately real wage growth should follow, and it has.

Senator SMITH. If you could suggest to us any corporate tax policies that would be important for American competitiveness in the global economy, what would they be?

Secretary PAULSON. Well, I do not have a specific idea to throw out, Senator. But one thing that I look forward to doing is having conversations at Treasury and talking with this committee about ideas that will lead to competitiveness and what can be done on the corporate tax code to make us more competitive.

Senator SMITH. A question on health care. As I have listened to the President's plan, one of the questions I have had is, what is it that is being over-bought by people with health care that the administration wants to eliminate?

Secretary PAULSON. Well, I would say that we have a system right now that, in certain instances, incentivizes what we would call Cadillac health insurance plans, which are plans that are really prepaying your health costs.

You go if you want to get a new pair of eyeglasses or get cosmetic surgery, or whatever, and the first dollar will be paid by insurance, and all of that benefit is tax-deductible to one group of people that happens to be working for corporations that provide that kind of benefit.

There is nothing wrong with the corporation providing that benefit and taking a tax deduction for that benefit, but for the individual it is very unfair for one group of individuals to get the tax benefit and another group to get nothing at all.

Senator SMITH. Well, thank you, Mr. Secretary. My time is up. I just want to note for the record that the last time that wages went up faster than inflation was in the administration of Ronald Reagan.

Secretary PAULSON. Thank you.

The CHAIRMAN. Isn't that a coincidence? All right.

Senator Grassley?

Senator GRASSLEY. Yes. I thank you for letting me go ahead on a second round, Mr. Chairman, so I can do another meeting.

Mr. Secretary, one of the President's tax gap proposals is to require brokers to report cost basis on publicly traded securities. Obviously I congratulate you on that.

Earlier, Senator Baucus and I asked the Government Accountability Office to study these issues, and they recommended basis reporting as a way to close the capital gains tax gap. We also have support for that from the staff of the Joint Committee on Taxation and from the Taxpayer Advocate of IRS.

The IRS has estimated the capital gains tax gap to be $11 billion per year. Some academics have predicted that basis reporting would bring in $250 billion over 10 years. But the President's basis reporting proposal is estimated to raise only about $6.7 billion over a 10-year period of time. Now, that is a considerable gap.

So my question is about whether or not the President's proposal goes far enough. So could you explain why the President's basis reporting proposal brings in less than 10 percent of the capital gains tax gap, as estimated by the IRS?

And would you be willing to work with members of this committee, like Senator Schumer, so that we can do more about closing this tax gap? Particularly, I think we have heard from Senators today, and Senator Schumer is one of them who has complained, about that not being an aggressive enough proposal.

Secretary PAULSON. Well, Senator, first of all, thank you for your comment. And you are right in saying that 1 of the 16 legislative proposals to get greater reporting to deal with the tax gap deals with basis as it relates to capital gains.

Let me answer your question why there could be this discrepancy in the numbers. People have been buying securities for many, many years, so there is a big stock right now of built-in capital gains. Our proposal deals with it prospectively. So it would go into effect, if you pass it into law, in 2009, and then it would be basis reporting on securities that are bought after it goes into effect.

So, those securities would be bought, the basis reporting would be done, then when those securities are sold, we would reap the benefits of that proposal. It was our judgment that it would be really quite a considerable burden, and it would be very difficult to do something like that looking backwards at it. So, this is a prospective proposal, but we look forward to talking about it with you.

The CHAIRMAN. Thank you. Senator Grassley, if you want to pipe in later, just jump in here.

I appreciate that answer. I appreciate Senator Grassley raising the subject. Am I correct in saying that the administration's proposals to address this gap yields only one cent on the dollar?

That is, the gap is roughly—the last estimate we saw included payroll as well as income tax—$345 billion a year. The administration's proposal intends to reduce that by $29 billion over 10 years, which calculates to less than one cent on the dollar.

Secretary PAULSON. Well, here is the way I would answer that, Mr. Chairman. First of all, this tax gap was last estimated in 2001. The number that I would use would be $290 billion.

The CHAIRMAN. One percent.

Secretary PAULSON. Because that is the net tax gap.

The CHAIRMAN. Even using that number, it is one percent.

Secretary PAULSON. Number one. Let me say to you——

The CHAIRMAN. One cent on the dollar. Excuse me. One cent on the dollar.

Secretary PAULSON. I think what we need to do, and the way we are going to be able to address this together, because I know you have been thinking about it for a long time——

The CHAIRMAN. Yes. I see Secretary Sullivan sitting behind you, too. He is very much involved in this subject.

Secretary PAULSON. Yes. He has been thinking about it. He is working on it. I know you will have ideas, and we will have ideas. But we have put forward 16 legislative proposals that will make progress.

But what I said earlier is, I do think when we look at the nature of this, we really need to ask what percentage of this can we get, and what can we get through proposals that we all think are reasonable and are not going to be burdensome or be bad policy to the American taxpayer.

Because remember, just as the American taxpayer who pays all of his or her taxes feels a great burden of those who do not pay, to the extent that we impose greater reporting requirements, very onerous reporting requirements in some instances, to try to get at that tax gap, we will be imposing them all on the honorable and honest men and women who do pay.

The CHAIRMAN. I appreciate that. But, Mr. Secretary, I will try to be very diplomatic and courteous here, because generally that works better than not.

Secretary PAULSON. Yes?

The CHAIRMAN. I am very disappointed. Very. You and I have had many, many discussions on this subject. Many. Secretary Sullivan and I have had many, many discussions on this subject. Many. I have with Commissioner Everson. I have with your predecessor, Secretary Snow. I think I have been too nice. I have been saying to all of you for almost a year now, give us an estimate, some benchmarks on how to reasonably address this gap.

We, the committee, will work with you. I remember I gave the administration until the end of last fiscal year, September 30, many months prior to September 30, trying to be helpful here, trying to work with the administration, be cooperative. I was stonewalled. I was stonewalled by the administration. So, finally I said, all right, Mr. Sullivan is not going to get confirmed until we get a good understanding between myself and you, Mr. Secretary, that we are going to address this in an honest, good-faith way.

It was based on good faith. I said, as you know, all right, Mr. Sullivan can get confirmed, but that is on the understanding that after the budget submission, the administration will come back with a very strong, good-faith effort to address the so-called tax gap.

I see now the administration proposing $647 million. Half of that is current services. The only new spending is half of that, really. The administration's estimate is $29 billion of the $345 billion, the $290 billion, will be collected under the administration's proposals. Again, that is about one cent on the dollar. That is totally unacceptable.

I am just saying, Mr. Secretary, when you come to appear before this committee, I am looking forward to you and the administration having much, much better, more sound efforts to address this problem.

I do not think it is fair for you to say, all right, Congress, you solve it. You are the Treasury Secretary. Commissioner Everson is the Tax Commissioner. You know better than anyone else how to address this. And this committee will work with you. We will be very fair with you. This committee has been more than fair with you in the past many, many months.

So I am just saying, I hope when we have this hearing that you, Mr. Secretary, will come back, and Secretary Sullivan will come back with some very solid ideas. We are not asking for the moon, but we are asking for more than one cent on the dollar.

Secretary PAULSON. I would say several things. First of all, I want to start where you ended up because you have been very fair to me, and very fair overall to work with.

On this particular issue I think both of us owe it to the American people to take some of the mystery out of this, because I do not think it does anybody a service to let the American people think there is a big pot of gold there and that we can tap into that gold to fund all sorts of things without there being a big cost to that. So, the first benchmarks I think we should have—and I really mean this, and I mean this with all due respect—should be passing the information-reporting legislative proposals we made last year, passing those, and passing the 16 proposals in this year's budget. That will be important.

In terms of the enforcement budget for the IRS, I spent a lot of time with Mark Everson on this, and he will talk with you directly. He has invested very heavily over the last 4 years; the administration has invested over the last 6 years to increase enforcement.

He has said to me that this is as much money—he got every cent he needed—because he said this is as much money as he can use in terms of the IRS's ability to hire, train, and assimilate the auditors. So, I think you will see that is very credible.

So what this is going to come down to when you look at this is that there is no mystery here—a big, big chunk, by far the biggest chunk of this tax gap is individuals and it is business income, and it is the related self-employment income.

So, you are talking about small businesses, you are talking about farmers, and we can just go through all the different things we could do. I think it would be bad policy for everybody——

The CHAIRMAN. And that is what I am suggesting, that you come back to us and say, all right, X percent is this category, Y percent is another category. We can achieve A percent with this, A amount with this, B amount with that, and so forth. You just start down the line, which is a lot farther than I have heard from the administration thus far.

Secretary PAULSON. And another thing is—I really do say this with all due respect—you have been studying this for a long time, and this has been a major issue for you and this committee for 6 years. So we will lay out why we have done what we have done, and we will talk with you about any other reasonable proposals to help you. If you would like to do it, we will work with you. We will help price it out for you. But again, I do think the things we have put out are important proposals.

The CHAIRMAN. I do not want to belabor all of this now. But my interest in this is still getting greater and greater and greater.

Secretary PAULSON. All right.

The CHAIRMAN. At the hearing, let us do us both a good favor by coming up—you coming up—with more solid ideas. No one says that we are looking for a pot of gold here, but instead of one cent on the dollar, what about five cents on the dollar? What about 10 cents on the dollar? Ten cents on the dollar, you are starting to get into real money. But so far you are just suggesting we can get one cent on the dollar out of that gap, and that is not acceptable.

Secretary PAULSON. What I am trying to do is focus on real, credible proposals.

The CHAIRMAN. Good.

Secretary PAULSON. If we can enact them——

The CHAIRMAN. You bring them up here.

Secretary PAULSON [continuing]. They will make a difference.

The CHAIRMAN. We will have our hearing.

Secretary PAULSON. And a number of them are like the ones that Senator Grassley asked about.

The CHAIRMAN. All right. Well, that is fine.

Secretary PAULSON. You have to get them in place for a while to let them work.

The CHAIRMAN. You bring them up here. We will have this hearing, and we will have a great opportunity to address this.

Secretary PAULSON. All right. Thank you.

The CHAIRMAN. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

Mr. Secretary, I just wanted to touch briefly on an issue that I did not get in on my first round. I am becoming more and more alarmed about the issue of the growing economic inequality in this country, and I think other members have expressed that. I know I have heard Senators on both sides of the aisle concerned about it.

There was a recent article in the *Tax Notes* which outlined the growing economic disparity that we are facing. In fact, I think the article even contained a quote or two from you, which actually was quite promising. You did agree there that income distribution and wage growth is one of the major economic challenges facing our country, so I was pleased to see those quotes from you.

But an important point in the article is that the distribution of labor income, specifically in the U.S., has gapped widely in recent years. To the point that Senator Smith was making about the top percentage paying more taxes, they are also making more money. I mean, with the top 10 percent receiving about 50 percent of the total increase in labor income, it creates, obviously, that dynamic. The problem is, we are squeezing the middle class out.

For me, I represent a State where 50 percent of the people I represent have an adjusted gross income of less than $25,000, and 80 percent of them have an adjusted gross income of less than $50,000. If you are raising a family, that is tough.

If you are getting squeezed out in terms of where those income dollars are going, there is a real problem, particularly if you are seeing cuts in the programs that reinforce you, whether it is the availability of college, or even just good K–12 that gives you the opportunities.

So I guess my real question is, first, does the administration recognize this as a growing problem? Do you see it as a concern? If so, what kind of steps do you think that are proposed in this budget are going to turn this kind of thing around?

Secretary PAULSON. Well, Senator Lincoln, thank you for the comment. Clearly the administration recognizes what is happening in terms of the income divergence in this country—you have heard me speak about it, the President spoke about it the other day in New York, a number of people have thought about it. This has been a trend, as I said, that has been going on for some time.

Senator LINCOLN. And the middle class, I think—to Senator Lott's question—was $135,000. Was that correct?

Secretary PAULSON. In terms of how you define the middle class, I cannot put a dollar number on it. I would just tell you that this trend has been going on for a long time. And I think you are focused on the right thing, which is what is happening at the bottom, and what is happening with the middle class. We would like to see more progress there.

Senator LINCOLN. I mean, is there something specific in the budget that you want to point to?

Secretary PAULSON. I would say the most important thing in the budget, and I know this is not exactly what you want to hear——

Senator LINCOLN. You are going to say building the economy.

Secretary PAULSON [continuing]. Is keeping this—and you are seeing this—economy growing. Let me just tell you, if this economy were not growing or if it were in decline, just think what the issue would be. We are seeing positive movement right now.

Senator LINCOLN. I do not disagree, necessarily, with that. But if the top 10 percent are receiving 50 percent of the total increase in the labor income, is there not something we can do in your budget suggestions—we will certainly be looking for them up here—in ways to make sure that we are assisting in the growth of the middle class as opposed to its demise?

Secretary PAULSON. Well, I have to say that the best, the most important thing there is, you just ask anybody in the middle class, is a good job. That is key to everything.

Central to that is making sure that the American people have access to education, and quality education, quality training so that they have the skills they are going to need in this 21st century economy. I read with interest Chairman Bernanke's speech, I think maybe it was yesterday—it was quite recently—on that topic.

Senator LINCOLN. But we also see that No Child Left Behind has never been fully funded. We are talking about good education. If we are talking about incentivizing in terms of college education for middle-income families, I mean, raising children on $50,000 a year is tough.

I mean, talk about savings. If you want to talk about savings for this income category, where are the extra dollars every month that they are going to be able to put aside if they are still trying to provide for children and, in most instances, taking care of aging parents?

Secretary PAULSON. Boy, I understand. It is not easy. I would just say that, hopefully, the tax relief has helped. Hopefully——

Senator LINCOLN. Well, not many of those actually get a huge benefit out of a dividend deduction.

Secretary PAULSON. No. I would say the new lower rate and other rates coming down, some of them, the EITC, the child tax credit.

Senator LINCOLN. If we had made it refundable and de-indexed it, we would be making sure that all of those low-income workers were really making a benefit.

Well, I appreciate it. My time has expired, and I went way over last time. But I do hope you will work with us, because there is an important part of creating a very strong fabric in this country. And it does not just come from the top or supporting the bottom, it means making sure that every inch of that fabric is strong.

Secretary PAULSON. I think that is the key. I think what all of us are focused on is getting the bottom up through real growth there.

The CHAIRMAN. Thank you, Senator.

Mr. Secretary, just one little fine point on this difference between the income tax that is collected and the taxes owed but not collected. Senator Grassley and I were over at the IRS just last week. We just got in the car and went over there and met with Commissioner Everson and his top people, maybe about 20 of them or so, on this subject.

Secretary PAULSON. Yes.

The CHAIRMAN. It was helpful. My goal essentially was to impress upon them how important it is for them to begin to address this problem, and that we want to work with them.

But I got the distinct impression that they need help in several ways. One, is resources. I know there are some resources in this budget, but just 1 year. It is not multi-year.

Secretary PAULSON. We got everything we needed.

The CHAIRMAN. Yes. But I am just saying what my impression is.

Secretary PAULSON. All right.

The CHAIRMAN. It is computers, it is hardware, it is software. It is a lot of stuff they need.

Secretary PAULSON. You are not going to get me to defend the computers and hardware in the government, or in Treasury, or in the IRS.

The CHAIRMAN. Yes. Exactly. So you know.

Secretary PAULSON. We have more to do there.

The CHAIRMAN. Yes, we definitely do.

Secretary PAULSON. When we have money.

The CHAIRMAN. Also, there was a little sense of, everyone over there is so siloed and so focused on their own little areas, that they are not really thinking about how to get at the tax gap.

I have talked to personnel over there who said they did not even hear about the tax gap, they did not even know about it, working there, until they came to the Congress and worked in the Congress. Did not even know about it.

So I am saying to you, as a very successful, creative man, I am sure when you were at Goldman, your prior job, that you instructed your people to be pretty creative and to come up with some new ways of doing things, not the old ways, but the new ways, because we have to find a way to attack this problem in a very solid, creative way.

The ideas that have come forth in the President's budget, and you have enumerated one of them, come across as kind of off-the-shelf stuff. The agency has not been challenged enough by you to say, "Come on, let us solve this thing. Come up with ways to solve it. You come back to me with ways to solve it," and just a lot more firm direction from you to the agency.

I think that would go a long way. We in the committee are trying to help that process by meeting with them and saying we want to help you, we will work on legislation that you think is needed. But we need a lot more from you, that is you personally, as well as from the Commissioner at the IRS and the people over there, to address it. We are not going to let this go away.

Secretary PAULSON. Right.

The CHAIRMAN. I am sure we can do a lot better than one cent on the dollar. Much better.

Secretary PAULSON. Mr. Chairman, I understand your comment. I just want to let you know that this is something that we have been focused on. In terms of enforcement and in terms of going after the corporate side, in going after tax shelters, abuses and so on. I think you will find that Mark Everson has been very aggressive and creative in doing this.

In terms of the legislative proposals we have, I actually think that some of the ones that have not been passed before may be difficult to get passed. When I have looked at some of the ones that have come forward, I have proposed them because we want to make a difference. But each one of them on the reporting side creates a burden that there will be one sector, one group that will not like it.

The CHAIRMAN. I understand. I understand.

Secretary PAULSON. I wish I could report to you that when it came to the tax gap, the under-reporting, that there was a way to deal with under-reporting of income other than legislative proposals that require us to go further. There is a whole list of things we could do, a whole list of things that we have talked about, but most of them have to do with asking everyone to bear unacceptable burdens. Who knows why people do not pay? Some may not pay because they do not understand, some may not because they want to avoid taxes.

But we would have to ask everyone, for example, when there is a cash transaction, whether it is to pay the plumber, whether it is the farmer's wife selling eggs, or whatever, to fill out a 1099, give it to the other side, and send it to the IRS. These things all have a cost to them.

I know you are creative too, and I know you have a creative staff and committee, and you have been thinking about this for a long time. I think we should roll up our sleeves. We will look at all of the ideas you have. We will give you the things we are considering.

But I do think, whether they are off the shelf, which I do not think they are, I would say a really good start would be passing into legislation the proposals we have, and then doing more. Let us just keep working on it as we find things that make sense.

The CHAIRMAN. You will find this committee will receive your ideas in more than good faith.

Secretary PAULSON. Good.

The CHAIRMAN. More than good faith. We just need to get them.

Secretary PAULSON. You have 16 of them.

The CHAIRMAN. Yes. But it is only one cent on the dollar. That is not very far.

Secretary PAULSON. Well, let me tell you something.

The CHAIRMAN. That is $29 billion.

Secretary PAULSON. We are talking about real money. Let us go get that real money and then we will keep——

The CHAIRMAN. But I think your suggestions will be in better faith if they do not dribble in—something that is fairly significant rather than something that is pretty paltry.

Secretary PAULSON. I think you will find what has been done on the enforcement side and what has been done over the last 4 years is significant. I think we are going to have to do more work on this with you for you to see that this could not be in better faith, and if there are other things that we could see that would not be more harmful than helpful and would not be, in our judgment, bad policy, we would be proposing them.

The CHAIRMAN. Right. Correct me if I am wrong here, I think the current compliance rate on the individual side is about 83 percent. Commissioner Everson said they can reach 90 percent by the year 2010. I do not know if that is with new proposals or just doing a better job.

Secretary PAULSON. I have talked with Commissioner Everson a lot about this, and you should talk with him. I will tell you what I know: he has brought in about $15 billion through direct efforts. He believes, and I know some other people believe, that there is an indirect effect; there is a behavioral effect that results from that. So he would say that there are billions of additional dollars that have come in as a result of what he has done.

What we are proposing to you are other steps. He has done that through enforcement efforts, and he is going to keep doing that. We are putting money in the budget. But what we are talking about now is going after the big percentage of this, which involves underreported income, and it is going to mean more reporting.

It is going to be greater reporting, and there is just a list of things. We could say that every transaction has to be done with a credit card or electronically, keep the receipt, send it to the IRS. There is a whole host of things you could do.

The CHAIRMAN. Good. We are making progress here.

Secretary PAULSON. Well, I would say that I do not want to do those things, because I think it is going to be onerous and bad policy. But, as we lay it out, you may want to.

The CHAIRMAN. Oh, no, no. That is not fair. I mean, I want you to come up—I think most American taxpayers are not happy that they are paying taxes and a lot of other people are not paying their taxes.

Secretary PAULSON. Including this one.

The CHAIRMAN. Right. So I think that is the challenge to both of us, but especially to you because you are the one who has the resources and knows what works and does not work to come up with——

Secretary PAULSON. Our resources are available to you, Mr. Chairman.

The CHAIRMAN. No, that is not fair.

Secretary PAULSON. Yes, it is. Any idea you have, we will give you the numbers. This is not rocket science.

The CHAIRMAN. We are asking you to come up with some ideas. This next hearing is going to be a really good hearing.

Secretary PAULSON. I look forward to it.

The CHAIRMAN. I hope it is good in the positive sense, not a good hearing in the negative sense.

The hearing is adjourned.

Secretary PAULSON. Thank you.

The CHAIRMAN. Thank you.

[Whereupon, at 5 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON BEFORE THE SENATE FINANCE COMMITTEE ON THE PRESIDENT'S FISCAL YEAR 2008 BUDGET

WASHINGTON, D.C. – Chairman Baucus, Senator Grassley, Members of the Committee:

I am pleased to be here today to provide an overview of the President's budget for fiscal year 2008. As the Secretary of the Treasury, my top priority is keeping America's economy strong for our workers, our families, and our businesses. And the President's budget supports that goal.

We start from a position of strength. Our economy appears to be transitioning from a period of above-trend growth to a more sustainable level of about three percent growth. More than 7.4 million jobs have been created since August 2003. Our unemployment rate is low at 4.6 percent. And over the last 12 months, real wages have increased 1.7 percent. Economic growth is finding its way into workers' paychecks as a result of low inflation. That means family budgets are going further.

Strong economic growth also benefits the government's fiscal position. In the first quarter of fiscal year 2007, budget receipts totaled $574 billion, an increase of 8 percent over the same period in fiscal year 2006. As a result of increased revenue over the last two years, we have brought the federal budget deficit down to 1.8 percent of GDP.

The President has submitted a budget that reflects our strong economy and our nation's priorities: continued job creation and wage growth, vigorous prosecution of the war on terror, increased access to affordable health insurance, improved energy security, and a strong fiscal position from which we can address long-term challenges such as strengthening Social Security and Medicare for future generations.

This budget supports a strong economy by maintaining fiscal discipline. It maintains our current tax policy, which has helped our economy rebound from recession to its current robust health. With a steadily growing economy, tax revenues combined with fiscal discipline should bring the federal budget into balance in five years. In fact, we are submitting a budget that includes a surplus in 2012, which is achievable if we keep our economy growing. While no one has a crystal ball, our economic assumptions are close to the consensus of professional forecasters.

The President's budget addresses important domestic priorities. Health care is high on this list. Under current law, the tax subsidy for health insurance purchased through employers will average more than $300 billion a year for the next ten years. For that huge expenditure we get a system in which rising costs are a burden to families and businesses, and in which millions of people have no insurance at all.

The President's proposal would make health care more affordable and more accessible. It would give all taxpayers who buy health insurance, whether on their own or through their employer, and no matter the cost of the plan, the same standard tax deduction for health insurance – $15,000 for a family, or $7,500 for an individual. The President's proposal would help hold down health care costs by removing the current tax bias that encourages over-spending. Costs would become clearer, giving patients more power to make informed choices about their health care spending. The proposal would also jumpstart the individual insurance market, so consumers have more choices than are available today. Health care would become more consumer-driven, more affordable, and more accessible for millions of Americans.

Energy security is another concern of the American people, and it is a priority addressed in the President's budget. President Bush has put forth an ambitious goal of reducing America's projected gasoline consumption by 20 percent over the next 10 years. We can achieve this goal by dramatically increasing the supply and use of alternative fuels, and improving fuel-efficiency by reforming and increasing CAFE.

The expanded fuels standard will provide entrepreneurs and investors a guaranteed demand for alternative fuels, which will accelerate private investment and technological development. Reforming CAFE will allow us to increase the fuel economy of our automobiles as fast as technology allows. With a more diverse fuel supply and better fuel efficiency, we can make our economy less vulnerable to supply disruptions and confront climate change through technologies that reduce carbon dioxide emissions.

Finally, the President's budget, by emphasizing fiscal discipline and economic growth, lays the right foundation for dealing with entitlement reform – a challenge we all have a responsibility to address. Strengthening Social Security and Medicare is the most important step we can take to ensure the retirement security of our children and grandchildren, the long-term stability of the federal budget, and the continued growth of the American economy. I look forward to sitting down with Democrats and Republicans, without pre-conditions, and finding common ground on these critical issues.

Mr. Chairman, the President's budget priorities – a strong economy, national security, fiscal discipline, health care and energy innovation, and laying the groundwork for entitlement reform – are the right priorities for America and for the workers, businesses, and investors who drive our economy.

I am confident that, working together, we will keep our economy strong and chart a course for maintaining our global economic leadership in the years ahead.

Thank you for the opportunity to discuss this today – and I now welcome your questions.

RESPONSES TO QUESTIONS FOLLOWING THE TESTIMONY OF SECRETARY PAULSON BEFORE THE SENATE FINANCE COMMITTEE ON THE PRESIDENT'S FISCAL YEAR 2008 BUDGET

Department of the
Treasury
March 30, 2007

Baucus Question 1

What assurances can you give American taxpayers that you are committed to finding solutions to the tax gap that are commensurate with the size of the problem - so the honest taxpayer who pays what he owes, when he owes, believes he is being treated fairly?

Answer

The tax gap is an important issue that the Treasury Department takes seriously. The failure by some taxpayers to pay what they owe results in a de facto tax increase on compliant taxpayers, who must make up for the shortfall. The Administration's fiscal year 2008 Budget request includes significant additional funds for increased IRS enforcement efforts to address willful non-compliance. As in Fiscal Year 2007, the Administration proposes to include IRS enforcement increases in Fiscal Year 2008 as a Budget Enforcement Act program integrity cap adjustment. We urge this committee to support that request. The Budget also includes additional funds for improved taxpayer services, which will help taxpayers to understand and comply with their obligations under the tax law, thereby improving compliance. In addition, the Budget includes a series of legislative proposals that, if enacted, would reduce opportunities for evasion. Although more can always be done to improve compliance, the Budget demonstrates the Administration's strong commitment to addressing the tax gap. As Congress considers the IRS's fiscal year 2008 budget and the Administration's legislative proposals, we look forward to working with you to consider what additional steps can be taken to improve compliance and reduce the tax gap in ways that strike a proper balance between taxpayer burden and improved compliance.

Baucus Question 2

The IRS says the enforcement return on investment is at least 4-1. The GAO says some collection activities yield a 13-1 ROI. To what extent does the IRS budget take into consideration that the IRS collects much more money than it spends?

Answer

Some IRS enforcement initiatives yield a higher direct return on investment (ROI) than others. In addition to this direct yield, IRS enforcement efforts provide a powerful deterrent to non-compliance. This deterrent effect is difficult to measure, but generally considered to be larger than the direct ROI. In order to ensure that it has an appropriate deterrence presence in all sectors of the economy, the IRS must allocate its resources across all types of enforcement activities. For example, based on the deterrent effect and to emphasize the fundamental fairness of our tax system, the IRS ensures that high income and corporate tax returns are examined, even though auditing these returns can be resource intensive and therefore not provide a high direct ROI relative to more streamlined examination and collection activities.

The funding request for the IRS included in the Administration's fiscal year 2008 Budget identifies the direct revenue expected from enforcement initiatives and acknowledges that these investments contribute toward increased voluntary compliance and additional revenue. The funding request is based both on our expectation about the deterrent effect of enforcement activities and on the direct ROI impact. Pursuant to convention, our revenue forecast does not reflect or assume any revenues from these activities, so our revenue forecast is a cautious one to the extent these enforcement efforts would result in significant revenue gains.

Baucus Question 3

The FY '08 budget includes $23 million in funding to implement all 16 of the proposals to improve tax compliance - including the 7 new information reporting requirements. The IRS spent $20.5 million alone on the failed Electronic Fraud Detection System to identify fraudulent refunds. To what extent does the budget provide funding to adequately equip the IRS with the technology it needs to process the increase in information reports?

Answer

The $23 million in the Administration's fiscal year 2008 Budget covers programming and start-up expenses for the legislative proposals that, if enacted, would require additional IRS funding. These include the following seven proposals:

- Information reporting on payments to corporations
- Basis reporting on security sales
- Broker information reporting
- Information reporting on payment card transactions
- Information reporting for certain government payments for property and services
- Increased information return penalties
- Allow IRS to access information in the National Directory of New Hires for tax administration purposes.

If enacted, these seven proposals would require the IRS to process a significant number of additional information returns and other information. The costs reflected in the budget request are necessary to increase current capacity to cover these additional returns and include costs associated with acquiring additional hardware and software. In addition, these funds would cover appropriate start-up costs for the development of programming functions necessary to process and match additional information returns.

Baucus Question 4

The IRS already receives information reports that it doesn't use. TIGTA reported that the IRS stored paper foreign-sourced information reports in boxes without looking at them, and that the IRS has told us that they still don't use these reports now that they are coming in electronically because it lacks the technology and people to do so.

a. If the IRS doesn't make use of information it already receives, what assurances can you give that increasing the numbers and types of information reports will help the IRS to close the tax gap?

b. How will you ensure that the new information reporting is properly used to help close the tax gap?

Answer

Information provided under the information reporting proposals set forth in the fiscal year 2008 Budget will conform to current information reporting requirements, thereby allowing the IRS to use the information in its current information matching processes and compliance programs. For example, the recommendation to require reporting of credit card sales information will utilize existing IRS information reporting processes and will have a significant impact on the IRS's ability to verify credit card sales and match the information to a specific taxpayer via the tax identification number. Because the new information reporting is carefully crafted to fit within our matching and compliance programs, it will not suffer from the deficiencies we have previously identified in many foreign source information documents. We believe this new reporting capability will have an impact on the tax gap and will improve voluntary compliance.

Baucus Question 5

The Administration's FY08 Budget does not include extension of renewable energy tax incentives. While the Budget does provide for permanent extension of reductions and capitals gains and dividends cuts, passed in 2001 and 2003, respectively, as well as charitable provisions and other traditional extenders such as the teacher deduction for out-of-pocket classroom expenses, the Budget contains no extension of renewable energy provisions, including the Section 45 production tax credit, the Section 54 clean renewable energy bonds, and the Section 48 clean coal tax credits. What is the Administration's position on these provisions? Why doesn't the Administration propose extending these provisions in its FY08 Budget?

Answer

The Administration supports the use of renewable power and will continue to examine the role incentives play in supporting renewable power. Further extension of the renewable power provisions was not necessary at this time, however. The Section 45 renewable electricity production tax credit is generally available for facilities placed in service before January 1, 2009, and the clean renewable energy bonds (CREBs) may be issued through December 31, 2008.

The Administration also supports the use of clean coal. Not all of the clean coal investment credits authorized in the Energy Policy Act of 2005 have been allocated. The Administration will determine the optimal way to continue its support of clean coal after these investment credits have all been allocated.

Baucus Question 6

The primary cause of long-run deficits is that per-capita health-care cost in the whole health-care system are growing faster than per-capita GDP. This drives up Medicare and Medicaid costs by a huge amount. The increase in costs from the retirement of the baby boom generation, while significant, are dwarfed by the costs generated by high growth rates for per-capita health care costs. Analysts from across the full political spectrum agree with this assessment that the growth rate of per-capita health-care expenditures is the primary cause of the huge long-run deficits. This includes Stuart Butler of the Heritage Foundation, Robert Bixby from the Concord Coalition, Isabel Sawhill of Brookings Institution, and Peter Orszag, the new Director of the non-partisan Congressional Budget Office. Do you agree that the primary cause of the long-run deficits is that per-capita health-care costs in the whole health-care system are growing faster than per-capita GDP?

Answer

A primary cause of long-run unfunded obligations in the Medicare and Medicaid programs is the rapid growth rate of health care spending, which is a combination of factors including cost, utilization, and population. If per capita health spending growth equaled that of per capita GDP, Medicare and Medicaid would still face increasing shortfalls because the population is aging and relying more on Medicare and Medicaid. But the problems would be much smaller than under the current scenario in which per capita health spending grows considerably faster than per capita GDP. It is for this reason that Medicare's long-run solvency will, in part, be dependent on changes in the health care system as a whole to increase the efficiency of health care spending. That said, the Fiscal Year 2008 Budget includes proposals that help to reduce the growth in Medicare and Medicaid spending, and long-term budget impact of the Medicare program.

Baucus Question 7

Secretary Paulson, I think you agree that we must make investments today to safeguard our economic competitiveness in the future. Some investments payer higher returns than others. Given our difficult budget situation, what investments can we make today that will yield the highest returns tomorrow?

Answer

To ensure our future economic competitiveness we need to encourage capital formation, keep our markets open, and foster entrepreneurship and improve the skills of our current and future workforce.

The most important thing we can do to maintain a strong economy is to keep taxes low. This is the best way to reward education and hard work and promote investment. We also need to ensure that the students who will be in tomorrow's workforce have the education and skills so that they can contribute to our economic future.

Additionally, we need to reduce our vulnerability to disruptions of oil on which we are so dependent for transportation fuel. The goal of the President's proposals is to promote biofuels and other alternative energy sources.

Baucus Question 8

The health tax proposal provides a flat standard deduction for health insurance. As I understand it, the goal is to encourage consumers to shop wisely. The reward for shopping wisely is an excess deduction - a deduction that exceeds actual expenses. With your proposal in mind, I went shopping online for health insurance. I requested quotes as a 30-year old and a 60-year old. The first policy on the quote list would cost the 60-year old about $380 per month more than the 30-year old - that's $4,560 more per year. An HSA-compatible policy with a $5,000 deductible was still about $300 more per month - $3,600 more per year - for the older individual. That means your proposal would give an extra deduction of $3,600 to $4,600 per year to the younger taxpayer just for being young. Why is that good health policy?

Answer

Older individuals tend to have higher premiums, incomes, and marginal tax rates. Younger individuals are more likely to be uninsured. The amount of regulation in the individual insurance market varies greatly from state to state. Under current law, individuals with more expensive health coverage get a greater tax benefit than those with leaner plans and individuals, who are not fortunate enough to work for an employer that offers coverage, do not get any tax benefits at all. The intent of the proposal is to equalize the tax benefits for health coverage, regardless of whether provided by an employer or through the group market and regardless of the generosity of the plan or the health status and age of the individual.

But because insurance markets vary from state to state and are heavily shaped by state-based regulation, the Administration believes that working with states is the best way to address affordability in the insurance market. Thus, Secretary Leavitt's Affordable Choices plan takes that approach.

Kerry Question 1

The President in a speech on the economy on January 31st said that following: "We have an obligation to help ensure that every citizen shares in this country's future. The fact is that income inequality is real; it's been rising for more than 25 years. The reason is clear: We have an economy that increasingly rewards education, and skills because of that education." According to the Center on Budget Policies and Priorities, the cost of the tax cuts for individuals with incomes over $1 million will exceed the total amount the federal government devotes to K-12 and vocational education. Wouldn't it be better to invest in education than to continue to give the wealthiest few tax relief?

Answer

I agree with the President's belief that every citizen should share in this country's future and that tax relief has played an important role in securing that future. Tax relief has contributed to our economic recovery and has benefited taxpayers at all income levels.

Tax relief also has helped stimulate investment, including a family's investment in education. The Economic Growth and Tax Relief Reconciliation Act of 2001 included expanding Coverdell Education Savings Accounts and the Student Loan Interest deduction, as well as expanding and making permanent the tax benefits for Qualified Tuition Programs (i.e., section 529 plans) and for employers who provide educational assistance to their employees.

Kerry Question 2

This year's budget would essentially be balanced were it not for those tax cuts. According to the Joint Committee on Taxation, the total cost of the tax cuts enacted since January 2001 is about $250 billion. I realize the budget projects a surplus in 2012, but I do not realistically believe this can happen if the tax cuts are made permanent. Do you believe making the tax cuts permanent is more important that balancing the budget? Do the Medicare cuts partially cuts partially offset the tax cuts?

Answer

As the President's Budget demonstrates, we believe that making permanent the tax relief enacted over the past six years is critical to maintaining economic growth, which, in turn, provides the tax revenues necessary to balance the budget. Accordingly, the objectives of permanent tax relief and balancing the budget are interdependent and equally important.

As to the reductions in the rate of growth in Medicare spending, these are not necessary to balance the budget, but they are necessary to begin to restore this important program to solvency. As numerous commentators have said, Medicare is not a sustainable program in its current form. The Medicare proposals in the President's Budget represent an important step in moving Medicare toward sustainability.

Kerry Question 3

What portion of the debt can be attributed to the tax cuts?

Answer

For a variety of reasons it is not possible to assign the portion of the increase in Federal debt attributable to particular policies. For example, several years after the fact, it is not possible to say what spending and revenue would have been without the tax relief, especially in light of the intervening events – the bursting of the stock market bubble, attacks on 9/11, recession, war on terror, revelations of corporate malfeasance, and unprecedented natural disasters.

Kerry Question 4

The budget only addressed the AMT for 2007. We have had several opportunities over recent years to make changes to the AMT, but it was repeatedly decided to make tax cuts a priority. Back in 2001 during the tax cute debate, I offered an amendment that would have exempted those with income of less that $100,000 from the AMT. If this passed, we would not be in this current situation. Also, I believe that the AMT results in "taking back" some of the benefits of the tax cuts. Why was the AMT merely addressed for 2007 when the tax cuts that expire in *2010* were made permanent?

Answer

I believe very strongly that the President's tax relief has played an important role in the economic recovery over the past five years. 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. 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. That would dampen long-term economic growth.

To prevent the adverse impact of uncertainty about the future level of taxes, permanent extension of EGTRRA's and JGTRRA's tax reductions should be enacted this year. Investment and many other economic decisions are based on long-term considerations. Thus, taxpayers need to know now that future tax rates will not increase after 2010 when the EGTRRA and JGTRRA tax reductions are currently scheduled to sunset.

The Administration is very concerned about the adverse impact of the AMT, including its economic impact, its enormous complexity for millions of taxpayers, and the frustrations for taxpayers who have to calculate their taxes twice. We all recognize that the AMT was never intended to hit middle-income families, but because the AMT was not indexed when the regular income tax was indexed in 1984, the AMT threatens to become an unintended and unwarranted burden on millions of taxpayers.

We strongly support finding a long-term solution to the AMT problem. We are committed to working with the members of this Committee and all others in the Congress on this issue. Congress has chosen to deal with the AMT problem every year on a temporary basis, and our budget proposal reflects that experience.

Kerry Question 5

Instead of making the tax cuts permanent, wouldn't it benefit more taxpayers to reform the AMT and make appropriate adjustments to the marginal tax rates?

Answer

As I have indicated in response to the previous question, making the 2001 and 2003 tax relief permanent is essential for promoting and maintaining higher rates of economic growth and higher living standards in the future. I also indicated that we are very concerned about the AMT problem, and we look forward to working with the Congress to develop a solution. That solution, however, should not involve adjustments to marginal tax rates. Higher marginal tax rates would erode the incentives to work, save, and invest that have resulted from the 2001 and 2003 tax relief and have been so important to small businesses, family farms, and the economic growth generally we have experienced over the last five years.

Kerry Question 6

Nina Olson, the National Taxpayer Advocate, cites the AMT as the number one problem facing taxpayers. Furthermore, she has often stated that the AMT is left to punish taxpayers that engage in such "classic tax-avoidance behavior" as having children or living in a high-tax state. Do you agree with this?

Answer

The problems that Ms. Olson has been discussing are well-recognized problems with the AMT. We look forward to working with the Congress on a solution to those particular issues as we seek a long-term solution to the AMT problem.

Kerry Question 7

Do you think that the AMT should be repealed without making any other changes to the tax code? If so, how would this impact the budget?

Answer

The Administration is committed to working with the members of this Committee and all others in the Congress to find a long-term solution to the AMT problem.

Kerry Question 8

In your testimony, you mention the importance of strengthening Social Security. In the budget documents, it mentions the President's commitment to Social Security reform through a bipartisan process. The President has identified three goals for reform: to strengthen permanently the safety net for future generations without raising payroll tax rates; to protect those who depend on Social Security the most; and to offer every American a change to experience ownership through voluntary personal retirement accounts. How does this differ from the Administration's proposal in 2005?

Answer

The President and I very much want to put Social Security on a sound fiscal footing so that Americans can plan their financial futures with confidence. This requires engagement by both Republicans and Democrats.

For the last several years, the President has included in the budget a limited proposal for individual accounts. The proposal is essentially the same, reflecting only updates to starting dates and initial threshold levels.

The President has asked me to reach out to all interested parties and start a dialogue about solutions to our entitlements problem. To date, I have spoken personally with many Members of Congress. The President and I have both said that we want people to bring their proposals to the table without preconditions. I am hopeful that our dialogue will help us identify where we agree. Identifying this common ground and our shared goals will help shape a bipartisan solution to the Social Security problem.

Kerry Question 9

The budget includes a $637 billion proposal to carve out private accounts from Social Security funds beginning in 2012. It is my understanding that the creation of these accounts would harm the solvency of the Social Security trust fund. A plan that includes these accounts would result in the diversion of large sums from Social Security to the accounts. Such a plan would accelerate the year in which trust reaches exhaustion. How can the accounts improve solvency?

Answer

The FY2008 Budget reflects the President's proposal from 2005. Long-term government finances would be roughly the same—Trust Fund accumulations would be smaller, but the need for Trust Fund accumulations would also be smaller because of the reduction in obligations to pay defined benefits. In addition, public debt issued to help fund personal retirement accounts would not reduce national savings and would not significantly affect interest rates.

Solving the entitlement challenge requires a bipartisan solution, and we are eager to engage lawmakers on both sides of the aisle to discuss all proposals that can strengthen Social Security for future generations.

Kerry Question 10

Currently, there are 47 billion uninsured Americans. Treasury estimates that the new standard deduction for those who have health coverage would increase coverage between 3 to 5 million. I am concerned that employers may choose to shift all of their premium costs to workers, offer only high-deductible health plans with no contribution, or simply tell their workers to take their tax deduction to the individual market. I think this proposal could lead to less coverage. How do you determine that coverage will increase?

Answer

Because health coverage is an important method of compensating employees, there will still be a strong incentive for employers to continue coverage. Employer-provided health insurance is better able to spread risks across the entire group of employees and has a lower administrative cost than the individual market. For these reasons, employer coverage will still be less expensive than individually purchased insurance for the risk pool as a group for any benefit package, making employer coverage a powerful factor for attracting and keeping good employees. As a result, the majority of employers are expected to continue providing coverage. Moreover, many of those employees whose employers stop offering insurance will decide to purchase health insurance in the individual market. In addition, the $15,000 standard deduction for family health insurance ($7,500 for single coverage) provides a strong incentive for the millions of currently uninsured taxpayers to purchase health insurance. These standard deduction amounts were chosen to achieve the goal of revenue neutrality over the ten-year budget window. Overall, Treasury estimates that this proposal reduces the number of uninsured individuals by as many as 5 million.

Kerry Question 11

This proposal could result in small employers not offering benefits to their employees. Small employers would be able to get a tax deduction for coverage for themselves and their family without offering a similar benefit to their employees. In addition, small businesses that currently offer health insurance to their workers would be less able to do so under the President's plan. If just one of their employees gets sick, the insurance premium would easily exceed the cap, thereby imposing tax penalties on all the workers or causing the small business to drop coverage all together. Doesn't this proposal make it harder to improve health coverage for small businesses? Wouldn't this proposal force employees of small business into the individual market?

Answer

If we do nothing, many small employers likely would drop coverage and their employees would have no access to tax subsidized health insurance in the individual market. The offer rate of health insurance at firms with 3-199 workers declined from 68 percent in 2000 to 60 percent in 2006. Although some small employers may not offer benefits to their employees, the proposal is estimated to *increase* coverage by as many as 5 million individuals.

Your example illustrates what happens under current law. We recognize that affordable health insurance for a sick employee can be difficult to find in the individual market. That is why Secretary Leavitt is developing the Affordable Choices proposal, creating a partnership between the federal government and states to help ensure access to health insurance on the individual market.

Kerry Question 12

Many of the uninsured cannot get coverage of pre-existing health conditions, and two-thirds are poor. This proposal does not address the discriminatory individual market and will not help low-income workers that have little or no taxable income. I realize that the deduction is allowed against payroll taxes, but how will this proposal specifically help those with pre-existing health conditions that have very little income?

Answer

The Administration shares your concern about access to health insurance on the individual health insurance market. As you know, state-level regulation plays a critical role in determining access and affordability for vulnerable populations. We are witnessing some innovative proposals at the state level, for instance in your home state of Massachusetts, to improve access to health insurance. But I think it would be a mistake to assume that the federal government has all the right answers on how to improve access to health insurance, or that a policy that works in one state will work equally well elsewhere. This is why I believe the Affordable Choices proposal is a promising way of addressing the problem of access at the federal level. It is a way for the federal government to support states in their efforts to expand access to affordable health insurance.

Kerry Question 13

In addition to the new standard deduction, the budget includes a $10 billion expansion of health savings accounts (HSAs). The proposal would expand the eligibility of HSAs. What affect would the HSA proposal and the new standard deduction combined have on increasing the number of uninsured that work for small businesses? Wouldn't a targeted refundable credit provide more assistance to small businesses?

Answer

Many uninsured individuals, including many who work for small businesses, are predicted to buy health insurance as a result of the proposal. Also taking into account that some employers may drop coverage, the combined proposal is estimated to *increase* coverage by 3 to 5 million individuals. The effect on the uninsured who work for small business has not been separately estimated. However, if we do nothing, many small employers are likely to drop coverage and their employees currently have no access to tax subsidized health insurance in the individual market. The offer rate of health insurance at firms with 3-199 workers declined from 68 percent in 2000 to 60 percent in 2006. A targeted refundable credit is an alternative approach. Whether it would provide more or less assistance to small business would depend on the details of the proposal.

Kerry Question 14

Won't this new standard deduction result in less Social Security benefits for some taxpayers?

Answer

While it is true that lowering payroll taxes for some today may result in lower benefits later for some individuals, it is important to remember that this is what occurs under current law whenever an employer provides health insurance to workers in lieu of wages. Under current law, a worker who receives health insurance in exchange for wages will pay less in payroll taxes, which translates into lower future Social Security benefits. The main effect of the President's proposal is simply to treat all workers the same in this regard.

Bunning Question 1

Current Treasury regulations deny flow-through treatment to banks that are organized as LLCs. This denial apparently was based on federal banking rules which were subsequently changed in 2003. The Treasury regulations have not yet been modified to reflect this change and to allow flow-through treatment to bank LLCs. Several states now allow banks to organize as LLC, and this flow-through treatment would be particularly beneficial to small banks. I wrote to Treasury about this matter in December 2005 and I understand that Treasury has been reviewing the issue.

Do you anticipate that Treasury will be updating the regulations to provide flow-through treatment for banks organized as LLCs? If so, is there a timeframe when such changes could be expected?

Answer

Current regulations require most banks to be subject to a corporate level of tax rather than being treated as flow-through entities for federal tax purposes. These regulations (sometimes referred to as "the bank per se rule") are part of a broader set of "check the box" regulations promulgated in 1996, which generally allow a limited liability company (LLC) other than a bank to choose whether to be treated for federal tax purposes as a corporation or as a partnership. The Treasury Department and IRS have received several requests for amendments to be made to the bank per se rule that would permit banks to be treated as flow-through entities for federal tax purposes.

Under section 581 of the tax code, the term "bank" is defined to mean an entity that, among other things, is "incorporated ... under the laws of the United States ... or of any

State." For banks organized as LLCs, this requirement is satisfied because the bank per se rule requires them to be treated as corporations. If the bank per se rule were to be removed or modified, there would be a question as to whether LLC banks that choose to be taxed as partnerships would fall within the statutory definition of a bank, which requires "incorporat[ion]."

In addition, the tax code contains numerous provisions governing the tax treatment of banks, some of which are perceived as favorable and others that impose restrictions or limitations on banks. These provisions were enacted at a time when banks were organized and taxed as corporations, and are, therefore, premised on an assumption that tax will be imposed at the entity level, rather than owner level as would be the case if the banks were taxed as partnerships.

Permitting flow-through treatment for banks would raise a number of policy concerns, including the following:

- Non-Application of Special Bank Rules. As noted above, falling within the tax code's definition of "bank" triggers numerous special bank rules including, for example, section 582(c)(2), which gives ordinary character to gain or loss from a "bank's" sale or exchange of debt. By statute, entities engaged in the banking business satisfy that definition only if they are "incorporated." Removal of the bank per se rule could turn off all of the special bank rules (both favorable and unfavorable) for banks electing to be taxed as partnerships. It is unclear whether the Treasury Department and the IRS have the statutory authority to apply the special bank rules to entities that are not "incorporated," nor is it clear which rules should or should not apply to such entities notwithstanding the fact that they are not, as originally contemplated by Congress, incorporated.

- Precedent for Legislative Action. In 1996, Congress made pass-through tax treatment available to a prescribed class of smaller banks, which are now allowed, by statute, to elect to be S corporations. Administrative action to extend eligibility for pass-through tax treatment broadly to LLC banks could be seen as inconsistent with the narrow focus of Congress' action in expanding pass-through treatment to smaller banks.

- Competitive Considerations. For most existing banks, converting from a corporation to a partnership would trigger a prohibitively high toll charge from the taxable gain that results from corporate liquidation. Thus, elimination of the bank per se rule could give a competitive advantage to new or historically unprofitable banks (for which there would be either little built-in gain, or little that could not be offset by historic losses). This issue raises significant non-tax policy considerations that should be considered by Congress, rather than implemented through an amendment to administrative guidance.

Recognizing that the bank per se rule imposes a second, corporate level of tax on banks, permitting banks to be treated as flow-through entities would raise significant policy concerns and would not be consistent with prior Congressional action in this area. Accordingly, we have determined not to amend the "check the box" regulations at this time to allow flow-through treatment for banks organized as LLCs

Bunning Question 2

I noticed that the President's FY08 budget did not included a proposal for tax changes related to Individual Development Accounts that had been included in recent years. Can you tell me why this proposal was not included in the budget this year and if the Administration still supports the changes to the IDA program?

Answer

The Administration's prior proposal regarding Individual Development Accounts (IDAs) reflected the President's desire to increase savings by low-income households, an important continuing objective. The proposals in the President's Fiscal Year 2008 Budget to simplify and encourage saving reflect the same desire but would be less complex and easier to administer. The simplicity of these proposals would provide an attractive savings incentive to low- and moderate-income households. Meanwhile, existing IDA programs administered by the Department of Health and Human Services will continue to encourage lower-income Americans to save by matching deposits into an IDA.

Grassley Question 1

Mr. Secretary, we have recently passed a minimum wage bill that also included a tax package that kills two birds with one stone - it provides incentives for small businesses facing the burden of an increased minimum wage and also has some important reforms that deal with tax scams and also the tax gap. In fact, the tax legislation in the minimum wage bill includes one of the administration's proposals dealing with the tax gap - reforming collection due process rights that have been abused by tax protesters.

This committee has great interest in the tax gap and Chairman Baucus should be commended for his work here. I am pleased that the administration's budget included serious recommendations regarding the tax gap and the ball is no in Congress' court.

My question to you, Mr. Secretary is this: Isn't it logical that if Congress wants to make progress in closing the tax gap - Congress should pass NOW the tax gap measure supported by the administration which is part of the administration's budget -- that we have already included in the minimum wage bill?

To delay enacting tax gap legislation, for instance if Congress drops the tax gap provision supported by the administration contained in the minimum wage bill - as has been proposed by House Democratic leadership - to drop this tax gap provision only serves to make the tax gap worse and to leave the door open for those who want to abuse the tax code.

Answer

The Administration's fiscal year 2008 Budget makes 16 targeted legislative proposals to improve compliance, including a proposal to amend existing collection due process procedures for employment tax liabilities. Each of the 16 proposals balances the need to improve compliance against a concern over unduly burdening honest taxpayers. While the 16 legislative proposals only begin to address the tax gap, their prompt enactment would be an important step in the right direction.

Grassley Question 2

Mr. Secretary, I'd like to explore the effects that the lower capital gains tax rate has had on the level of federal tax revenues. According to the nonpartisan Congressional Budget Office, tax receipts in 2006 were $253 billion higher that in 2005, and tax receipts in 2005 were $274 billion higher than in 2004. Some of these increases came from non-withheld taxes, which include taxes on dividends and capital gains. In its latest Economic Outlook, the CBO reports that realizations of capital gains grew by about 13 percent in 2006, 29 percent in 2005, and 54 percent in 2004.

In January, 2004, CBO forecasted that tax liabilities from capital gains, for calendar years 2003 through 2006, would be $197 billion. Now, with actual figures in for 2003, 2004 and 2005, CBO expects those tax liabilities to be $330 billion, that's $133 billion more than previously projected. This rising revenue pattern is good news for the federal budget, but it probably doesn't tell the whole story, as these tax cuts have also contributed to shareholders receiving more dividends and to a growing economy that is producing more tax revenues. Now, I wouldn't say that these tax cuts have quote "paid for themselves," but the correlation between lower tax rates and increasing capital gains realizations can't be denied.

Under current law, the 15% capital gains rate is scheduled to go back up to 20% at the end of 2010, and dividends will be taxed at ordinary income rates as high as 35% (or 38.6% after 2010). The Administration has called for making the lower rates permanent, and has estimated the cost over the next ten years to be $90 billion for dividends and $79 billion for capital gains. Mr. Secretary, would you comment on the effect the lower dividends and capital gains rates has had on the federal budget deficit over the past 4 years, the effect of making the rate cut permanent, and the consequences of allowing it to expire?

Answer

At the time the rate reductions were introduced, Treasury estimated the tax rate reductions for dividends and capital gains would cost approximately $60 billion over the four fiscal years 2004-2007. Currently, we estimate that the Fiscal Years 2008 through 2017 cost of extending the dividend and capital gains rate reductions permanently is roughly $170 billion.

Allowing the dividend and capital gains tax rate reductions to expire would increase several tax-induced distortions that encourage firms to use debt rather than equity finance, to adopt unincorporated rather than corporate structures, and to retain earnings within the firm rather distributing them. Each of these distortions would contribute negatively to economic growth, and may also induce higher bankruptcy risks during economic downturns.

Making the tax rate reductions on capital gains and dividends permanent – rather than simply extending them by a few years – likely would reduce these distortions further because firms would expect a permanently changed tax structure.

Historically, capital gains realizations and their associated tax receipts have been volatile, and have had a strong relationship to asset market prices. Because of this, forecasting tax receipts from capital gains accurately is quite difficult, and it is not generally possible to determine how much realizations have been affected by tax rates or many other factors. We do believe that the tax rate reductions affecting capital gains and dividends have caused higher levels of gains realizations and dividend payouts. Nevertheless, non-tax factors, such as the run-up in asset values, which itself may have been encouraged by the tax relief, also are likely to have contributed to the large increases in capital gains realizations observed over past few years.

Bingaman Question 1

As I indicated during your testimony before the Senate Finance Committee, I believe that the U.S. trade deficit is not sustainable at its current level, and by extension, I remain extremely concerned about low levels of domestic savings. Under current law, taxpayers 18 or older who are not dependants or full-time students may receive a non-refundable credit of up to $2,000 for amounts of compensation contributed to employer-sponsored qualified retirement plans and IRAs. The administration proposed to extend this credit to contributions to qualified tuition programs, which allow taxpayers to save for higher education expenses. My question about the savers' credit is broader, however. In your view, is there a correlation between owing taxes and dissavings? That is, are people who owe taxes less likely to save a portion of their income - and therefore need more encouragement to save than those without a tax liability? If there is no such correlation, shouldn't the savers' credit be refundable, so that it is available to both those who owe taxes and those who are due a refund?

Answer

It can be difficult to use the tax code to encourage those with very little income to be significant savers. We agree that changes to the Saver's Credit are one possible approach toward increasing savings among lower-income Americans. That is why we are proposing to make the credit available for contributions to college savings plans and other qualified tuition programs to provide an incentive to save for higher education. Promoting additional investment in human capital through this proposal helps promote the competitiveness of our economy by making U.S. workers more productive. At the same time, providing the additional subsidy for lower income American's through the

Saver's Credit may be helpful in addressing longer-term concerns related to income inequality.

The Administration is committed to encouraging all Americans to save. The Administration's Fiscal Year 2008 Budget includes two other savings proposals to simplify the rules governing tax-preferred savings and expand opportunities to participate in a savings account to all Americans and for any reason. We believe that many lower-income and less financially sophisticated individuals will be encouraged to save by these proposals. We look forward to working with the Congress to find new ways to encourage Americans to save, including possible changes to the Saver's Credit.

Hatch Question 1

Mr. Secretary, we welcome you there this afternoon. I appreciated your opening statement about the strength of the economy. Its strength really does seem quite remarkable. Yet even more remarkable is that a significant number of people do not seem to recognize how well things are going, including some in this room. Do you think that Americans' unease about the war is spilling over to taint their view on the economy, or why is it that so many are failing to see all the good things this economy is delivering?

Answer

Our economic performance is remarkable in light of the events we have faced in the past few years: the bursting of the stock market bubble, attacks on 9/11, recession, war on terror, revelations of corporate malfeasance, and unprecedented natural disasters.

Even with these as a backdrop, the economy has created more than 7.4 million jobs since August 2003, and the unemployment rate of 4.6 percent is lower than the average for any decade since the 1950s. Over the past year, GDP has grown by 3.3 percent and is expected to moderate to a sustainable pace that will continue to support job creation and rising incomes.

While hard to quantify, it is reasonable to believe that the global war on terror and the conflict in Iraq negatively affect people's perceptions about the economy and about the future. As the President has said, the war on the terrorists is not going to be resolved quickly, and no one can say with confidence how it will evolve. On the other hand, failure to prosecute the war on terror fully would give the terrorists breathing room with which to plan and execute new attacks on Americans at home. This possibility, too, would affect perceptions about the economy and the future. Nevertheless, Americans are resilient and fundamentally optimistic about future prospects—a trait that is demonstrated by the behavior of American families, who have continued to spend for their needs and to invest in their children, their homes, and their futures. This is the best evidence that the economic outlook remains positive.

Hatch Question 2

Secretary Paulson, critics of the President often characterize the current expansion as one that has benefited only the rich. When looking at the wage data over the past decade I'm struck by the fact that the strong wage gains we experienced in the last expansion, which cut across all income levels, really didn't become evident until 1997, when that expansion was entering its sixth. Many commentators lamented that THAT expansion did not benefit the poor until that point. We are now entering our sixth year of the current economic expansion and the unemployment rate today of 4.6 percent is a bit lower than it was at the same period during the last expansion. Mr. Secretary, given the similarities between the current and previous expansion, do you believe we should anticipate the same pattern of wage growth that we saw in the latter years of the previous expansion? Would you say that there's anything more important to the financial health of middle and lower-income workers than continued strong economic growth.

Answer

The key to long-run increases in the standard of living for all income groups is strong economic growth, and the key to strong economic growth is strong productivity growth. Productivity and real wages grow together over long periods of time, but they do not grow at the same rate all the time.

We have seen this over the past five years, as productivity growth accelerated after 2001, but real wages did not rise apace. Over the past year, however, we have seen wages rise in accordance with the productivity gains—reaffirming the long-run relationship noted above. In the past 12 months, real wages have risen 2.1 percent. This pattern is familiar from the expansion of the late-1990s: productivity growth accelerated in 1995 but wage growth did not begin to accelerate apace until 1997.

Hatch Question 3

Mr. Secretary, you mentioned the strong growth in federal revenues over the past couples of years. By my calculation, we collected over a *half trillion dollars* more in FY2006 than we did in FY2004. In your view, how much of that remarkable growth is attributable to the pro-growth economic policies, such as the tax cuts that were put in place by the President and Congress in the early part of this decade?

Answer

The most important thing we can do to make sure that revenues remain strong is to ensure that we have a healthy economy. It is safe to conclude that pro-growth policies have made a considerable contribution to ensuring strong economic growth. And in turn, strong economic growth is essential for generating strong revenue growth.

The 2001 tax relief helped the economy avoid a deeper recession and the 2003 tax relief helped jump start a solid recovery. In Fiscal Year 2004, receipts as a share of GDP were at a post World War II low of 16.3 percent of GDP, their lowest level since 1959. Propelled by strong economic growth, receipts soared to 18.4 percent of GDP in Fiscal Year 2006, right at their average for the 25 years before the President took office, even with lower tax rates.

Hatch Question 4

Along these same lines, what total effect on the economy and its growth would an increase in taxes bring? Of course, advocates of such an increase would say that it would help us balance the budget by increasing revenues, but wouldn't such a tax increase risk our economic growth and end up being counterproductive to balancing the budget?

Answer

The Department of the Treasury released a report last summer titled, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief." This report found that permanently extending the 2001 and 2003 tax cuts would raise economic activity over the budget window. Put another way, allowing the 2001 and 2003 tax cuts to expire at the end of 2010 would lead to an increase in tax rates on capital gains, dividends and ordinary income and lower national output than otherwise over the budget window. This report estimates that real Gross National Product (GNP) would be on average 0.5 percent lower for the years 2011 through 2016 if these tax cuts are not extended.

This reduced economic activity would lower the expected amount of revenue from the tax increase that would result from letting the 2001 and 2003 tax cuts expire. The Treasury report did not specifically estimate to what extent revenues would be affected by the reduced economic activity. The President's Fiscal Year 2008 Budget shows that a balanced budget can be attained by 2012, without increasing taxes, by supporting pro-growth policies and holding the line on spending increases.

Moreover, the Treasury report also highlighted that some tax changes would have a significant impact on economic incentives, while other tax changes would have a small impact. For example, extending the lower rates on dividends and capital gains would spur savings and investment and increase national output with only a small net impact on the budget, while doubling the child tax credit, extending the 10 percent rate bracket and extending marriage penalty relief would largely result in an increase in the budget deficit, but have very little impact on incentives to work, save and invest.

Hatch Question 5

Mr. Secretary, I applaud you and the President for including the proposal to replace the unlimited exclusion for employer-provided health insurance with a standard deduction for health insurance. It is a bold and big idea that would greatly increase fairness in our country. There seems to be some misunderstanding, however, about its effect on lower-income employees who don't pay much or any income tax. As I understand it, this proposal gives substantial payroll tax relief as well as income tax relief. Could you expand on this and explain how this proposal would help employees at different income levels?

Answer

You are correct. The proposal provides income and payroll tax relief to all individuals and families covered by health insurance that meets minimum requirements. The amount of the standard deduction for health insurance is $7,500 for single coverage and $15,000 for family coverage. These standard deduction amounts were chosen to achieve the goal of revenue neutrality over the ten-year budget window. Low-income workers who do not pay income taxes will be able to benefit from the proposal through a reduction in their payroll taxes. The proposal also reduces the phase-out rate of the earned income tax credit (EITC) for families with children, thereby increasing the credit for many families. In addition, the Affordable Choices Initiative included elsewhere in the President's Fiscal Year 2008 Budget will redirect existing resources in a budget neutral manner to help vulnerable Americans—including low-income individuals and higher cost individuals—purchase health insurance.

The following three examples illustrate how the proposed standard deduction for health insurance would help uninsured families at different income levels:

- A single mother with two children earning $20,000 in 2009 would be able to deduct $15,000 if she were to purchase qualifying health insurance for the family. The proposal would not only reduce the mother's payroll taxes by $2,295 but also increase the EITC by $236. The total tax savings for this family would be $2,531.

- A married couple with two children earning $40,000 in 2009 would be able to deduct $15,000 if they were to purchase qualifying health insurance. The proposal would reduce their payroll taxes by $2,295 and income tax by $2,721 (including an increase in the EITC by $1,261). The total tax savings for this family would be $5,016.

- A married couple with two children earning $60,000 in 2009 would be able to deduct $15,000 if they were to purchase qualifying health insurance. The proposal would reduce their payroll taxes by $2,295 and income tax by $2,250, resulting in a total tax savings of $4,545.

Hatch Question 6

A number of my colleagues have supported tax credits for health insurance. As important as the payroll tax relief in the President's proposal will be for the working poor, if our goal is broader coverage, there will be a gap between the tax benefit under the deduction and the cost of health insurance. What are the thoughts of the Administration in providing some tax credits for this population?

<u>**Answer**</u>

For several years, the Administration's budgets have included tax credits for health coverage for low-income people, but Congress never acted on the proposals. This year, we are proposing the new standard deduction for health insurance and the HHS Affordable Choices plan as ways to expand access to insurance coverage to those who do not currently purchase it. We predict that the standard deduction will reduce the number of uninsured by as many as 5 million people. We also believe that the HHS Affordable Choices plan is a good way to reduce the uninsured, because it would allow states to experiment with ways that are appropriate for their states to expand access to insurance coverage.

However, since the President announced the standard deduction for health insurance, we have heard a number of proposals including the use of tax credits to provide greater benefits for lower-income workers and to provide greater incentives for the uninsured. We continue to review these ideas and other proposals designed to expand coverage without encouraging inefficient consumption of health care.

Hatch Question 7

What are the Administration's assumptions about behavioral changes that will result from the proposed changes to the tax treatment of health insurance?

<u>**Answer**</u>

The new SDHI will remove the tax bias for expensive health insurance. Some individuals with employer-based insurance will switch to less expensive plans in exchange for higher wages. This in turn will help contain rising health care cost by making consumers more sensitive to health care prices.

Hatch Question 8

Mr. Secretary, current Treasury regulations prohibit banks that are organized as limited liability companies (LLCs) from being treated as a flow-through entity for tax purposes. These regulations were based on prior federal banking rules which were reversed in 2003. Several states, including Utah, now allow banks to organize as LLCs, and this flow-through treatment would be particularly beneficial to small banks. Several Finance Committee members joined me in writing to Treasury two separate times urging Treasury to consider updating the regulations to allow banks organized as LLCs to be taxed on a flow-through basis. Treasury's Office of Tax Policy sent replies in 2004 and again in February 2006 indicating that Treasury was reviewing the issue, but Treasury has not yet acted. Can you tell me when Treasury will make a decision about updating the regulations to provide flow-through treatment for banks organized as LLCs?

Answer

Current regulations require most banks to be subject to a corporate level of tax rather than being treated as flow-through entities for federal tax purposes. These regulations (sometimes referred to as "the bank per se rule") are part of a broader set of "check the box" regulations promulgated in 1996, which generally allow a limited liability company (LLC) other than a bank to choose whether to be treated for federal tax purposes as a corporation or as a partnership. The Treasury Department and IRS have received several requests for amendments to be made to the bank per se rule that would permit banks to be treated as flow-through entities for federal tax purposes.

Under section 581 of the tax code, the term "bank" is defined to mean an entity that, among other things, is "incorporated ... under the laws of the United States ... or of any State." For banks organized as LLCs, this requirement is satisfied because the bank per se rule requires them to be treated as corporations. If the bank per se rule were to be removed or modified, there would be a question as to whether LLC banks that choose to be taxed as partnerships would fall within the statutory definition of a bank, which requires "incorporat[ion]."

In addition, the tax code contains numerous provisions governing the tax treatment of banks, some of which are perceived as favorable and others that impose restrictions or limitations on banks. These provisions were enacted at a time when banks were organized and taxed as corporations, and are, therefore, premised on an assumption that tax will be imposed at the entity level, rather than owner level as would be the case if the banks were taxed as partnerships.

Permitting flow-through treatment for banks would raise a number of policy concerns, including the following:

- Non-Application of Special Bank Rules. As noted above, falling within the tax code's definition of "bank" triggers numerous special bank rules including, for example, section 582(c)(2), which gives ordinary character to gain or loss from a "bank's" sale or exchange of debt. By statute, entities engaged in the banking business satisfy that definition only if they are "incorporated." Removal of the bank per se rule could turn off all of the special bank rules (both favorable and unfavorable) for banks electing to be taxed as partnerships. It is unclear whether the Treasury Department and the IRS have the statutory authority to apply the special bank rules to entities that are not "incorporated," nor is it clear which rules should or should not apply to such entities notwithstanding the fact that they are not, as originally contemplated by Congress, incorporated.

- Precedent for Legislative Action. In 1996, Congress made pass-through tax treatment available to a prescribed class of smaller banks, which are now allowed, by statute, to elect to be S corporations. Administrative action to extend eligibility for pass-through tax treatment broadly to LLC banks could be seen as inconsistent with the narrow focus of Congress' action in expanding pass-through treatment to smaller banks.

- Competitive Considerations. For most existing banks, converting from a corporation to a partnership would trigger a prohibitively high toll charge from the taxable gain that results from corporate liquidation. Thus, elimination of the bank per se rule could give a competitive advantage to new or historically unprofitable banks (for which there would be either little built-in gain, or little that could not be offset by historic losses). This issue raises significant non-tax policy considerations that should be considered by Congress, rather than implemented through an amendment to administrative guidance.

Recognizing that the bank per se rule imposes a second, corporate level of tax on banks, permitting banks to be treated as flow-through entities would raise significant policy concerns and would not be consistent with prior Congressional action in this area. Accordingly, we have determined not to amend the "check the box" regulations at this time to allow flow-through treatment for banks organized as LLCs.

Hatch Question 9

Mr. Secretary, I have a growing concern that some of the policies being promoted by some of my colleagues are going to soak small businesses and the middle class. We all know that small businesses are going to get hit by the minimum wage increase. Yet some Democrats refuse to accept even the modest tax cuts for small businesses that the Finance Committee and the full Senate supported with near unanimity. And we continue to hear grumblings about raising the top marginal rate, a tax hike that would sock small businesses with a 13 percent tax increase. Let's put this in perspective. A hike in these rates would mean that a small business would be paying almost 40 percent of its profits in federal income taxes, while international corporations would be paying only 35 percent. My question is what might these changes do to employer-provided health coverage? In the rush to condemn the President's health care proposal, some of my colleagues have suggested that the proposal would harm the employer-provided system. I imagine, however, that a tax increase on small businesses and entrepreneurs would have a far greater detrimental impact on health coverage offered by small enterprises. What are your thoughts on the relationship between labor and tax policies impacting these businesses and health coverage offered to employees?

Answer

The Administration is concerned about the effects that an increased minimum wage would have on small businesses, including on their ability to offer health insurance to their employees. Businesses employing workers at or near the minimum wage, many of which are small businesses, could react in a variety of ways: some would absorb the higher costs by reducing profits, other expenses including investment, or the size of their operations. Others might simply hire fewer workers. And some others who are providing health insurance as part of the compensation packages they offer employees would keep their compensation constant by eliminating health insurance coverage or reducing benefits to offset the higher wages. The Administration applauds the congressional support so far for pairing a minimum wage increase with tax relief for small businesses, in particular the extension and expansion of small business expensing. However, the Administration's Fiscal Year 2008 Budget would go even further by nearly doubling both the current law deduction limit and the beginning of the phase-out range and making the higher small business expensing permanent. The Administration's health proposals also would provide a significant incentive to employees who found their employers ending their health insurance, either as a response to higher minimum wages or to the continuing increase in premium costs to employers, to purchase insurance on their own.

As for the effect of higher top individual income tax rates, you are correct that many small businesses operating as sole proprietorships, partnerships, or S corporations face taxes at individual not corporate rates. The Administration strongly opposes any increase in top marginal rates for the harm it would do to entrepreneurial activity and the economy. Higher individual income tax rates reduce the likelihood that entrepreneurs and small businesses would invest or hire workers. As a result, small businesses, which are the source of two-thirds of the economy's net job growth, would be less likely to grow. Higher tax rates also would encourage small businesses to restrain labor costs by limiting the costs of fringe benefits such as employee health insurance

Hatch Question 10

Mr. Secretary, as you know, Congress passed a provision a few years ago to provide temporary incentive to film producers to make movies in our country to help offset the economic incentives offered by other nations. This is the so-called runway film provision. Unfortunately, the provision is set to expire at the end of 2008 and regulations giving necessary guidance on using this benefit are just now being released, or so I understand. I am told that Utah has lost the economic benefits of movies being produced in the state because of the high cost relative to some other jurisdictions. I know the film industry is frustrated and the economic development people in my state and in other states are frustrated that this provision has not been effective because of lack of guidance, and now it has so little time left before expiration. Does the Administration agree that it is very important to provide economic and tax incentives to keep important activities such as filmmaking in the U.S., and will you work with us to develop a longer term solution to this problem?

Answer

On February 9, 2007, the Treasury Department and the Internal Revenue Service issued a comprehensive set of regulations interpreting section 181. Issuing these regulations was made difficult by the complexity of the statute and the unique nature of the industry that the statute applies to. Nevertheless, the temporary and proposed regulations should assist taxpayers in their understanding and implementation of the provision, and should allow taxpayers to take fuller advantage of the incentives provided by the statute.

In general, highly targeted tax incentives, such as section 181, tend to create complexity for both taxpayers and tax administrators. While such incentives may provide short term aid to industries in transition, they do not generally produce a permanent solution to underlying cost problems. Nevertheless, we recognize the economic problem that section 181 was designed to address.

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