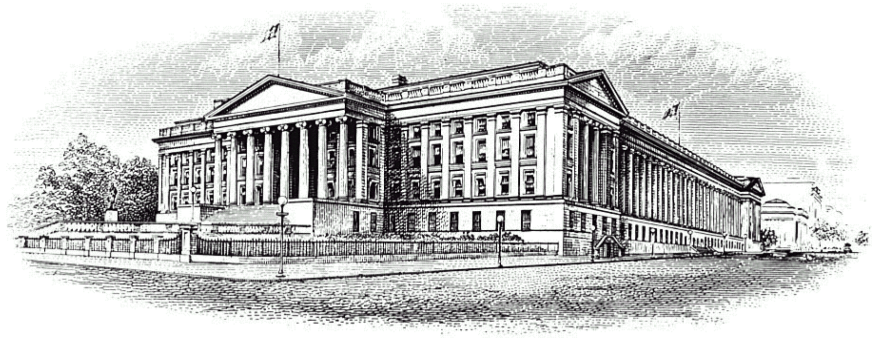

DEPARTMENT OF THE TREASURY

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Testimony of
Treasury Secretary Paul O'Neill
Before the
Senate Budget Committee
February 7, 2002

Good morning Chairman Chairman Conrad, Senator Domenici and members of the committee. Thank you for inviting me to testify today. Now that we've had a year to work together, you should know that I am an optimist about the US economy. I believe we always have untapped potential that can be unleashed to spread prosperity throughout the nation. Never has that been more true than right now. Even after a difficult year, my optimism about the fundamentals of the US economy has not changed. I believe we were on the verge of recovery before the September 11 terrorist attacks, and that our resilience and determination have brought us back to the early stages of recovery today. We see more and more signs every day indicating that the seeds for a recovery are there, and only need nourishing to speed the process of putting Americans back to work. I believe we will return to prosperous economic growth rates of 3 to 3.5 percent, as soon as the fourth quarter of this year. I'm disappointed the Senate was not able to vote out a bill to speed job creation to more quickly return Americans to work.

Strengthening our economy must be our primary goal. It is the focus of the President's budget. That must be our goal, because a return to our normal growth rates means jobs for the 1.4 million Americans who have lost jobs during this recession. Just as a strengthening economy means greater prosperity for our nation's people, it also means greater strength for our government. It means greater revenues going into the Treasury, without raising taxes, giving us resources to address the nation's needs, and the retirement of even more federal debt – leading to long-term economic security for our children. Even with all that must be done to enhance our security, we expect that a return to economic growth will bring us back to government surplus in 2005.

The economy's slowdown began in mid-2000, when GDP and job-growth slowed sharply. Business capital spending began to plummet in late 2000, and accelerated its decline in 2001, dragging down the economy. In August we were beginning to see the evidence of an economic rebound. I firmly believe that had it not been for the terrorist attacks of September 11th, that we would have seen an end to the economic downturn and would perhaps have avoided a recession. The September 11 attacks created shockwaves that rippled throughout all sectors of the economy. Financial markets were shut down for almost a week. Air transportation came to a standstill. As a result, GDP fell 1.3 percent at an annual rate in the third quarter.

By late November, the National Bureau of Economic Research declared that the US was in a recession. They designated the end of the previous expansion to be March 2001, but they observed that the slowdown might not have met their qualitative standards for recession without the sharp declines in activity that followed the terrorist attacks.

In sum, the scorecard for the economy in 2001 reflected a combination of adverse events:

- The private sector lost more than 1.5 million jobs.
- The unemployment rate rose 1.8 percentage points.
- Industrial production was off nearly 6 percent during the year.
- Industry was using less than 75 percent of its capacity.

As bad as these numbers are, they could have been worse. Our well-timed bipartisan tax relief package put $36 billion directly into consumers' hands in the late summer and early fall, providing much needed support as the economy sagged. It was the right thing to do, at just the right time.

It's not surprising then that both the Congressional Budget Office and the Office of Management and Budget project deficits for this year and next as a result of the economic slowdown and the response to the September 11 attacks. Last April's budget forecast a fiscal 2002 surplus of $283 billion. The Mid-Session review figures, released in August, took account of the impact of the President's tax relief package and projected a $195 billion surplus in fiscal 2002. The new budget forecasts a fiscal 2002 deficit of $9 billion, assuming no policy action to stimulate the economy. The reduced surplus estimates are the result of the economic downturn and the response to the September 11 attacks. CBO's projections confirm that tax relief played a minor role in the surplus decline in the next few years – accounting for less than 12 percent of the decline in 2002 and less than 28 percent in 2003.

	FY02 surplus (in billions)
April 2002 budget baseline:	$283
Changes from:	
weaker economy/technical changes	-197
enacted spending	-54
tax relief	-40
February 2003 budget baseline:	-9

The CBO budget projects a 10-year surplus of $1.6 trillion. Last August, after factoring in the tax relief package, the CBO projected a $3.4 trillion surplus for the next 10 years. The recession and the war on terrorism depleted the 10-year projections by $1.8 trillion. The lesson from these numbers is simple – 10-year projections are a useful discipline but they do not predict the future. None of last year's 10-year estimates foresaw the events of September 11 or a negative $660 billion worth of "technical changes" that are now included in the new 10-year estimates by agreement among the technical experts. We do know about the here and now, and we should deal with the here and now, reigniting growth to restore long-term surpluses.

The Administration's growth projections are similar to the consensus of private forecasts. Over 90 percent of the Blue Chip Economic Indicators panel members say the recession will end before April of this year. We share that assessment. Personally, I am optimistic that the economy will do even better than our budget assumptions suggest. For the near term, we expect the economy to grow 2.7 percent during the four quarters of 2002. That projection includes the foreseeable effects on the economy of the President's economic security package.

The lesson is clear. A strong economy is crucial to restoring budget surpluses. Some would suggest that we need surpluses to improve our economy. They have the logic backwards. Growth creates surpluses, not the other way around.

The federal budget was in deficit every year from 1970 through 1998. From 1970 through the early 1990s, government spending growth exceeded government revenue growth by ¾ of a percentage point a year, on average. Fiscal discipline was imposed by the historic *Omnibus Budget Reconciliation Act*, signed in 1990 by President Bush. With fiscal restraint made an integral part of the budget process, once the economy took off in the 1990s, revenue growth was double the pace of spending growth. It was the rapid economic growth of the 1990s that generated the burgeoning budget surpluses, which appeared even as federal outlays grew about 3.5 percent a year from 1993 through 2000.

Today the economy is recovering. The tax cut of last May helped to keep the economic downturn shallow and it will continue to help. Energy prices have retreated. The Federal Reserve has reduced short-term interest rates 11 times since the beginning of 2001. Measures of consumer confidence are bouncing back. The index of leading indicators increased sharply in December for the third straight gain. Motor vehicle sales have remained strong. And initial filings for unemployment benefits are in decline. But we all know that unemployment itself is a lagging indicator. Although the current trend is positive, too many people will remain out of work. And given the choice, they'd rather have a regular paycheck than an unemployment check.

The President has presented a budget to speed our recovery. First, the budget includes tax relief to stimulate job creation as a crucial tool to speed our recovery and put Americans back to work. The President's proposals – accelerated depreciation, speeding up the reduction in the 27 percent income tax rate, reducing the corporate AMT, and checks to those who didn't benefit from last summer's tax rebates – enjoy bipartisan support in both houses of Congress. I'm eager to work with all of you to complete work on a package to create jobs and assist dislocated workers with extended unemployment benefits and temporary assistance with health care.

Second, the President's budget proposes strict fiscal discipline – increasing spending for national security and homeland defense, and holding the line on other spending. His management agenda calls for performance measures to be used to determine where budget increases are allocated – so that our resources go into the projects and programs that make the biggest difference in people's lives. As the experience of the 1990s shows, this discipline in crucial to ensuring we do not return to systemic deficits of the past. But fiscal discipline alone will not guarantee budget surpluses. We must return to 3 to 3.5 percent annual growth to ensure surpluses for years to come.

The focus must be on restoring growth. Surpluses will then follow naturally. Raising taxes would stifle the process of getting Americans back to work. This is a bad idea, as our recovery is struggling to take hold. According to 1999 data, the most recent available, 33 million small business owners and entrepreneurs pay taxes under the individual income tax rates. They have made business plans that assume that the tax relief enacted last summer will take place as scheduled. Eighty percent of the benefit of cutting the top two rates goes to small business owners and entrepreneurs. These are the engines of job creation in our economy.

Tax relief should be accelerated, as the President has proposed to boost job creation. Such relief will have minimal, or no, effect on long-term interest rates. According to a recent analysis by the CEA, an expected $1 trillion change in the public debt over 10 years would tend to raise the long-term interest rate by 14 basis points. Since the tax cut last year, the 10-year nominal rate has averaged 4.93 percent, which is substantially below the 6.16 percent averaged from 1993 through 2000.

Restoring growth is the key to America's future. Restoring growth is the key to ensuring we have the resources in Washington to fight the war on terrorism, provide for homeland defense and provide the services the American people demand. The President's budget will help to ensure that both peace and prosperity are restored to the American people as soon as possible.