94-139989

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

*** CLOSE HOLD ***

November 23, 1994

MEMORANDUM FOR TROIKA-1: LLOYD BENTSEN, Treasury
LAURA TYSON, CEA
ALICE RIVLIN, OMB

FROM TROIKA-2: MARTIN BAILY, CEA M.N.B.
JOE MINARIK, OMB
ALICIA MUNNELL, Treasury

SUBJECT: Economic Assumption Forecasts for the 1996 Budget

An integral part of the current budget review involves an update of the Administration's economic outlook for the remainder of the decade. Economic events since our Mid-Session Review forecast (made in May, published in July) have turned out to be somewhat different from what we envisioned at that time. Therefore, T2 recommends several changes to bring the forecast in line with market expectations and our own outlook for the future. Specifically, we recommend (see Table 1):

- A moderate softening of output growth relative to the momentum of the second half of 1994 toward a sustainable path consistent with stable rates of inflation.

- Technical revisions to the inflation forecasts made in the Mid-Session Review.

- Interest rate forecasts that reflect the economic growth we experience during the second half of 1994 and a more traditional view of the spread between real short and long-term yields.

- A lower level of the NAIRU based on a better understanding of the recent revisions to the household survey of unemployment.

One area of consideration among TROIKA-2 members centers on their desirability of including an additional Federal Reserve rate increase in 1995.

CURRENT TRENDS & THE OUTLOOK FOR 2000

Perhaps the best word to describe the macroeconomy during 1994 is resilient. In the face of rising interest rates and a widening trade deficit the economy showed remarkable momentum. Based on our estimates, the gap between potential output and real GDP closed during the second half of 1994. Fortunately, this was accomplished without a noticeable increase in inflation. Nevertheless, the economy necesssarily will slow down soon, or else inflation will begin to creep upwards.

Real Growth

Our best estimates put real GDP growth in the second half of 1994 at an annual rate of 3.3 percent. Consistently strong spending on consumer durables, a buildup in inventories, and robust business spending on capital equipment have offset declining Federal purchases and increases in the trade deficit. The only sector which appears to be showing signs of slowing due to higher interest rates is residential investment.

Our forecast sees fourth-quarter real GDP growth of about 3-1/4 percent, with momentum carrying over into the first quarter of 1995. By late Spring the economy will slow moderately toward its potential output path. Thus, while we still foresee the soft landing of the Mid-Session Review, we have changed the timing so that real output grows by 2.3 percent in 1995, picks up slightly in 1996, and settles in on a path consistent with stable inflation of about 2.5 percent annually for the remainder of the decade (see Table 1).

Employment

The unemployment rate dipped to 5.8 percent in October and is likely to fall a little farther in the coming months as initial reports for November indicate continued strength in payroll employment. The current rate is near the lower end of the range of reasonable estimates for the NAIRU. While there is a range within which the economy can grow without an increase in inflation, the lower the unemployment rate falls, the less likely it becomes that the economy can achieve a "soft landing" onto its potential output path.

Our forecast for the unemployment rate includes some slight improvement early in 1995 in response to the recent growth momentum, but ends the year at about 6.0 percent due to the slowing which occurs in the middle of 1995. According to our projections, the unemployment rate should average 5.8 percent in 1995, rise slightly to an average of 5.9 in 1996, and settle on a level of about 5.8 percent for the remainder of the decade.

Inflation & Productivity

The investment-led expansion of the past 20 months seems to have allowed the economy to operate without inflation despite current estimates of capacity utilization of about 85 percent. While raw materials prices (excluding food and energy) have increased somewhat, these increases have not shown up at the consumer level at this time. Furthermore, unit labor costs have shown very little increase in the face of sharp gains in employment. Most measures of inflation are currently running at or below 3 percent, and have consistently done so throughout 1994. In short, inflation is just not a problem in 1994.

The primary difference between our current outlook for inflation and that contained in the Mid-Session Review reflects technical revision to the CPI due to take place over the forecast horizon. The BLS is scheduled to make some modest modifications to the CPI at the beginning of 1995 which should reduce estimates of inflation by about 0.1 percentage point. Then, in 1998, the CPI is scheduled for a rebenchmarking of the market basket, which is expected to reduce reported inflation by an estimated 0.3 percentage point. Offsetting these declines is a modest uptick in inflation early in 1995 due to some tightening of labor markets and the introduction of reformulated gasoline in compliance with new environmental regulations.

Interest Rates

The Fed began raising short-term interest rates in February 1994, and since that time has increased the target rate on Fed funds by 250 basis points. Short-term interest rates are forecast to rise early in 1995 in response to another round of Fed tightening. The Fed is then assumed to reverse the tightening at the end of the year, returning monetary policy to a more neutral stance. (Treasury TROIKA 2 dissents from this assumption.)

Long-term interest rates are forecast to fall by roughly 100 basis points over the forecast horizon as the inflation premium built into current long-term rates wears off. This forecast is consistent with the soft-landing scenario described above and the belief that the spread between long and short-term real rates should return to historical norms after a sustained period of stable inflation.

Policy Assumptions

Fiscal Policy. The results of the November 1994 election created considerable uncertainty about the stance of fiscal policy over the next several years. We have assumed no change in current fiscal policy over the forecast horizon. The "pay-go" provisions of OBRA93 are assumed to be maintained and the current rules for scoring discretionary spending caps are expected to be followed. We assume also that the GATT trade agreement will be passed by Congress.

Monetary Policy. A further 50 basis-point increase in short-term interest rates, in addition to the 75 basis point hike of November 15, 1994, is assumed to occur during the first quarter of 1995. The Fed then maintains a 6.0 percent target rate on Federal funds for the next two quarters. At the end of 1995, the Fed is assumed to reduce its target by 50 basis points in order to bring the economy back to potential in 1996 and return monetary policy to a more neutral stance. The Treasury representative to the Troika has dissented from this view.

Risk to the Forecast

One alternative scenario, which is gaining popularity among forecasters [and the Fed staff], is a "mini-cycle" forecast. In this scenario, GDP growth slows more sharply in 1995, pushing the unemployment rate higher than in our proposed forecast. In part, this slower growth outcome would be because consumers slow their purchases of autos and other durables and businesses cut back on the growth of investment spending. These would both be normal responses in a maturing expansion. In addition, real long-term interest rates are already high and the Fed is expected to raise short-term rates again.

SPECIAL ISSUES

NAIRU Estimate

Based on studies carried out in the Treasury and CEA, T2 believes that 5.8 is a reasonable point estimate for the NAIRU, together with an annual growth rate for potential output in the range of 2.4 to 2.5 percent. We recommend that publicly we refer to the NAIRU only in terms of a range.

Forecasting Interest Rates

T2 chose not to follow the "random walk" rule for forecasting interest rates used for the Mid-Session Review. Real longer-term interest rates today are quite high and are not consistent with the growth of the economy along its potential path. Moreover, assuming a continuation of such high real rates would result in an unreasonably high debt burden in our budget forecasts. Thus, T2 decided to build some decline in real rates into our forecast, and hence we rejected the assumption of no change in nominal rates (the assumption used in the Mid-Session Review).

Monetary Policy in 1995

We all agreed that the likely continuation of strong real growth in the fourth quarter of 1994 and the first quarter of 1995 will lead the Federal Reserve to make another interest rate hike early in 1995. Given the uncertainty, however, the question remains as to the desirability of including a projected rate hike in our forecast scenario. The Treasury representative to the Troika judged that by incorporating the rate hike, we could be seen as endorsing it, a position that we do not wish to take. The CEA and OMB representatives argued that since the rate increase was likely to occur, including it would be more accurate and would ease our communications task later.

Ten-Year Forecast

In order to meet the needs of long-term budget projections, T2 is preparing a ten-year forecast of the economy.

Table 1
1995 Proposed Administration Forecasts
Annual Detail

	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP, 4Q/4Q growth (%)	3.1							
CBO Summer (Aug)...............		3.6	2.7	2.2	2.1	2.1	2.3	NA
Blue Chip (Nov)................		3.4	2.5	NA	NA	NA	NA	NA
Mid-Session Review (July)......		3.0	2.7	2.6	2.5	2.5	2.5	2.5
T2 Forecast....................		**3.5**	**2.3**	**2.6**	**2.5**	**2.5**	**2.5**	**2.5**
Difference from MSR............		+0.5	-0.4	0.0	0.0	0.0	0.0	0.0
Real GDP, year/year growth (%)	3.1							
CBO Summer (Aug)................		4.0	3.0	2.4	2.1	2.1	2.2	NA
Blue Chip (Nov/Oct)[1]............		3.8	2.7	2.2	2.2	2.3	2.6	2.4
Mid-Session Review (July)......		3.6	2.8	2.6	2.5	2.5	2.5	2.5
T2 Forecast....................		**3.9**	**2.7**	**2.4**	**2.5**	**2.5**	**2.5**	**2.5**
Difference from MSR............		+0.3	-0.1	-0.2	0.0	0.0	0.0	0.0
GDP Deflator, 4Q/4Q growth (%)	1.8							
CBO Summer (Aug)...............		2.5	2.5	2.7	2.7	2.7	2.7	NA
Blue Chip (Nov)................		2.6	3.1	NA	NA	NA	NA	NA
Mid-Session Review (July)......		2.7	2.8	2.9	3.0	3.0	3.0	3.0
T2 Forecast....................		**2.6**	**2.9**	**2.9**	**3.0**	**3.0**	**3.0**	**3.0**
Difference from MSR............		-0.1	+0.1	0.0	0.0	0.0	0.0	0.0
GDP Deflator, year/year growth (%)	2.2							
CBO Summer (Aug)...............		2.2	2.5	2.6	2.7	2.7	2.7	NA
Blue Chip (Nov/Oct)............		2.2	2.9	3.3	3.3	3.1	3.1	3.0
Mid-Session Review (July)......		2.3	2.8	2.9	3.0	3.0	3.0	3.0
T2 Forecast....................		**2.1**	**2.7**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
Difference from MSR............		-0.2	-0.1	+0.1	0.0	0.0	0.0	0.0
CPI-U, 4Q/4Q growth (%)	2.7							
CBO Summer (Aug)...............		2.8	3.2	3.3	3.4	3.4	3.4	NA
Blue Chip (Nov/Oct)............		2.9	3.6	NA	NA	NA	NA	NA
Mid-Session Review (July)......		2.9	3.2	3.3	3.4	3.4	3.4	3.4
T2 Forecast....................		**2.8**	**3.3**	**3.2**	**3.2**	**3.2**	**3.1**	**3.1**
Difference from MSR............		-0.1	+0.1	-0.1	-0.2	-0.2	-0.3	-0.3
CPI-U, year/year growth (%)	3.0							
CBO Summer (Aug)...............		2.6	3.1	3.3	3.4	3.4	3.4	NA
Blue Chip (Nov/Oct)............		2.7	3.4	3.7	3.7	3.6	3.5	3.4
Mid-Session Review (July)......		2.7	3.2	3.3	3.4	3.4	3.4	3.4
T2 Forecast....................		**2.6**	**3.2**	**3.2**	**3.2**	**3.2**	**3.1**	**3.1**
Difference from MSR............		-0.1	0.0	-0.1	-0.2	-0.2	-0.3	-0.3

Table 1, continued
1995 Proposed Administration Forecasts

Annual Detail

	1993	1994	1995	1996	1997	1998	1999	2000
Civilian Unemployment Rate (%)[2]	6.8							
CBO Summer (Aug)...............		6.2	5.8	5.9	6.0	6.1	6.1	NA
Blue Chip (Nov/Oct)............		6.2	5.9	6.0	6.2	6.3	6.2	6.1
Mid-Session Review (July)......		6.3	6.2	6.1	6.1	6.1	6.1	6.1
T2 Forecast.....................		**6.1**	**5.8**	**5.9**	**5.8**	**5.8**	**5.8**	**5.8**
Difference from MSR............		-0.2	-0.4	-0.2	-0.3	-0.3	-0.3	-0.3
Three-month T-bill	3.00							
CBO Summer (Aug)...............		4.10	5.50	5.10	4.90	4.90	4.90	NA
Blue Chip (Nov/Oct)............		4.20	5.60	5.40	5.20	4.90	4.90	5.00
Mid-Session Review (July)......		4.00	4.66	4.80	4.80	4.80	4.80	4.80
T2 Forecast.....................		**4.21**	**5.88**	**5.50**	**5.50**	**5.50**	**5.50**	**5.50**
Difference from MSR............		+0.21	+1.22	+0.70	+0.70	+0.70	+0.70	+0.70
Ten-year T-note	5.87							
CBO Summer (Aug)...............		6.80	6.80	6.50	6.50	6.50	6.50	NA
Blue Chip (Nov/Oct)[3]............		7.38	7.95	7.66	7.38	7.18	7.18	7.18
Mid-Session Review (July)......		6.84	7.10	7.10	7.10	7.10	7.10	7.10
T2 Forecast.....................		**7.10**	**7.90**	**7.25**	**7.00**	**7.00**	**7.00**	**7.00**
Difference from MSR............		+0.26	+0.80	+0.15	-0.10	-0.10	-0.10	-0.10

[1] Blue Chip forecasts for 1994 and 1995 are from the monthly update for November; forecasts for 1996 and beyond are from a special issue published in October.
[2] 1993 unemployment figures are on the old CPS basis; following years are on the new basis.
[3] A Blue Chip forecast for the 10-year rate has been constructed from Blue Chip the forecast of the corporate bond yield.

94-141261

DEPARTMENT OF THE TREASURY
WASHINGTON

STANT SECRETARY

December 6, 1994

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

From: Alicia Munnell
Economic Policy

Subject: BUDGET BASELINE AND OPTIONS

SUMMARY

This afternoon at 3:30, CEA Chair Tyson will lead a discussion on the appropriate path for the Federal deficit over the five-year budget horizon. The discussion will be based on the revised updated Mid-session Review baseline. This baseline shows a slight upward movement in the deficit, but much less than the numbers that caused the crisis last week.

DISCUSSION

Six changes have been made to the Mid-Session Review, which -- together -- should have had only minor effects:

o Updating the growth path of the economy for the difference between MSR assumptions and actual growth in the second and third quarters of 1994.

o Adjusting the growth path for the changed cyclical outlook.

o Raising the path of interest rates.

o Adjusting the CPI to better correspond to BLS intentions.

o Altering the path of "other labor income" to conform to OMB estimates.

o Reducing the rate of growth of productivity and compensation to better correspond to the current CEA staff's view.

Last week OMB distributed a baseline that contained a $27 billion hole in year-2000 revenues. No one could convincingly explain how the changes in economic assumptions had produced such a revenue loss.

Extensive discussions with OMB and CEA, slight revisions to the economic assumptions, and use of Treasury OTA preliminary assessments of revenue changes has produced the following revision.

Alternative Deficit Paths

	1995	1996	1997	1998	1999	2000
	$Billions					
MSR	167	179	190	192	207	--
Fall Update MSR (Technical Updates)	169	182	198	195	222	243
New Projection	176	201	217	213	237	253
	Percent of GDP					
MSR	2.4	2.4	2.4	2.3	2.4	--
Fall Update MSR (Technical Updates)	2.4	2.4	2.5	2.4	2.5	2.6
New Projection	2.5	2.7	2.7	2.5	2.7	2.7

interest rates

This baseline deficit path is still $10 billion higher than the MSR estimate in 2000 as a result of higher interest rates. A more careful accounting of the CPI effects should reduce this even further in the final budget projections. For the time being, however, these are fine numbers to work with.

POLICY OPTIONS

This Administration could seek to meet any of a number of bottom line goals:

o Hold the 1996 deficit at its fiscal 1995 nominal level.

o Keep the deficit below $200 billion through the end of the budget window.

o Hold the deficit at its current share of GDP.

The upward pressure on the budget bottom line will be increased because of welfare reform, the extenders, and middle class tax cut. On the other hand, some additional defcit reduction would result from extension of some medicare provisions and extension of discretionary caps.

Holding the nominal deficit below $200 billion through the end of the budget window would enhance our credibility with financial markets, but would require about $120 billion over the forecast horizon.

In a brief discussion on the topic, Alan Blinder said that the Fed was not really looking for any additional deficit reduction. Apparently, the FED is more or less convinced that we have the budget situation under control.

An appropriate budget policy would contain not only short-term savings in reduced expenditures in areas like housing and energy, but also long-run savings in crucial fast-growing areas like health care. As the attached chart shows, the very long-term outlook is almost as grim as the Kerrey-Danforth Commission maintains.

CEA's VIEW

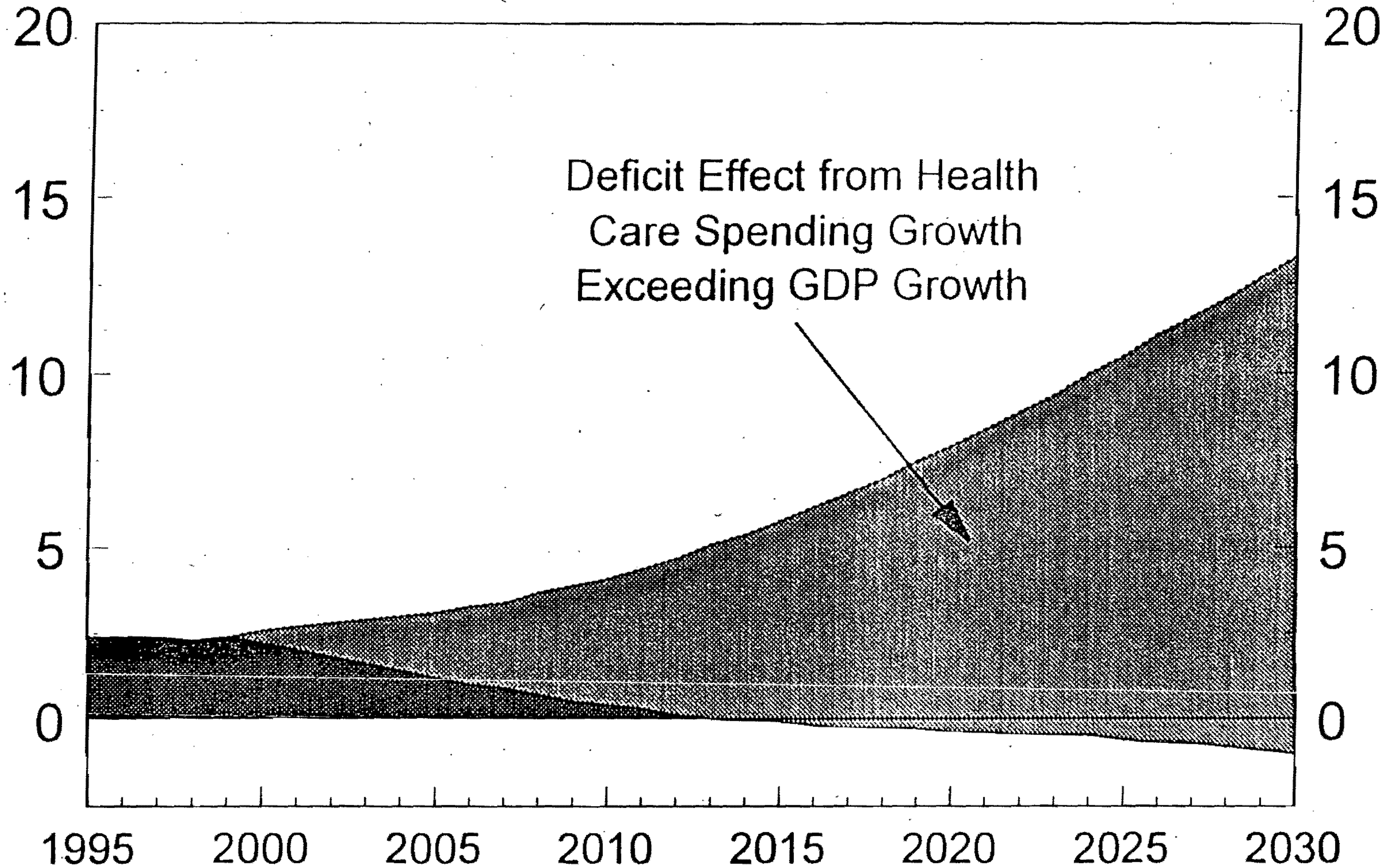
At this afternoon's meeting, Laura Tyson is likely to argue that the Administration must propose a "credible" budget policy, in part because of the fear of adverse financial market reaction to any hint that the Administration is about to take part in bidding up the deficit to fund popular policies. She is likely to argue that (a) substantial discretionary spending reductions from HUD, Energy, and so on are necessary, and that (b) a cap on federal medical program expenditures are also necessary to create savings in the outyears large enough to allow the Administration to argue that its budget policy is prudent.

Attachmen90

Deficits and Health Care Spending

Alternative: Health Care Spending Grows at Same Rate as GDP

Percent of GDP



Certain OBRA '93 Provisions

Provision	1994-1998 ($'s in billions)
Increase tax rates paid by high-income individuals	
Add fourth bracket at 36% rate for taxable income over $140,000 (joint returns), $127,500 (head of household) & $115,000(single)	65.3
Impose a 10% surcharge on regular taxable income over $250,000 (not applicable to capital gains; 39.6% rate)	28.1
Increase tax rate to 26% for AMTI of less than $175,000 and 28% for AMTI over $175,000; increase AMTI exemption to $45,000 (joint) and $33,000 (single)	3.9
Extend itemized deduction limitation scheduled to expire in 1996	12.7
Extend personal exemption phase-out scheduled to expire in 1997	4.7
Repeal HI wage base cap	33.4
Total	148.0

out of
approx 240

Changes in Marginal Tax Rates in 1994 from OBRA-1993 Changes in Tax Rate Schedules and Removal of the HI Cap

(Assumes Pease and PEP Would Have Expired under Pre-OBRA Law)

Family's Income		Marginal Tax Rates	
AGI	**Taxable Income (Current Law)**	**Pre-OBRA 93 Law (%)**	**Current Law (%)**
135,000	112,400	33.9	34.8
150,000	126,350	31.0	34.8
170,000	145,150	31.0	42.8
250,000	225,800	31.0	42.8
300,000 (or more)	275,650	31.0	43.7

Office of Tax Analysis
U.S. Treasury Department

December 5, 1994

Notes:

- Marginal Tax Rates include Federal Income tax and both employee and employer shares of social security and Medicare taxes.
- Income tax deductibility of employer shares of social security and Medicare tax would lower marginal rates in affected examples by approximately 0.5 percentage points below levels shown above.

400 business CEOs push them over the edge

Assumptions:

- Four-person family filiesa joint income tax return.
- All income is is from salary of one earner.
- Family livies in state without a state income tax.
- Family has itemized deductions equal to 10 percent of AGI. Itemized deductions consist of mortgage interest, proprety tax, and/or charitable contributions.
- No Pease (limitation on itemized deductions) or PEP (phaseout of personal exemptions) under pre-OBRA 1993 law for tax year 1994.

TALKING POINTS FOR NEC MEETING

I. General Points

- In this environment, it will be **extremely difficult to finance the Administration's initiatives with tax increases.** This is especially true with regard to tax proposals affecting middle income taxpayers. The Democrats should not be talking about tax increases when the Republicans are talking about tax cuts.

- Moreover, even if we were to identify and propose **acceptable revenue increases** (and I'm not sure there are any) to finance initiatives in the Administration's 1996 budget submission, you can rest assured that the Republican Congress will simply seize the proposals, and finance <u>their</u> initiatives, thank you very much. And we will be held responsible for the tax increases.

- In short, proposing tax increases at this time is a **no-win proposition** for this Administration, and I strongly urge that we restrict our focus to spending cuts or else scale back the initiatives that require financing.

- Recognize also what this Administration has already done on revenues. Last year, we enacted the **Omnibus Budget Reconciliation Act** that raised <u>gross</u> revenues of $268 billion over 5 years. That was an extraordinary accomplishment. In the **NAFTA** bill, we used almost $2 billion in revenue offsets to comply with the budget rules. In the **Uruguay Round** legislation coming up for a vote this week, we will use a further gross $7 billion in revenue offsets. All this is to say that we have cleaned the cupboard fairly thoroughly and whatever tax increase proposals may remain are highly controversial.

II. Proposals Raised at Monday's Meeting

When we met on Monday we discussed a wide variety of revenue offsets and tax expenditures. Let's turn to some of the new proposals that were raised at that meeting.

1. <u>Require amortization of advertising expenses</u>.

- <u>There is no rational tax policy for this proposal</u>. Under present law, the rationale for current deductibility has been that advertising expenses typically do not benefit the corporation beyond the current year. This proposal is an <u>arbitrary deferral of an ordinary and necessary business expense</u>. Proper matching of income and expenses requires a current deduction.

- <u>This proposal would be a nonstarter on the Hill</u>. It would reverse longstanding positions of the Treasury and would <u>impact virtually every corporate taxpayer</u> subject to U.S. tax. Thus it would encounter significant political opposition.

- Last week Treasury issued a study to Ways and Means and Finance that rejected a capitalization approach for marketing expenditures (including advertising). In this report to Congress, we recommend against capitalization of assets created by marketing expenses -- including advertising -- in the context of the taxation of controlled foreign corporations. The study concludes that assets attributable to advertising expenses generally have an economic life of less than less than one year. The study also concluded that capitalization of these expenses would further complicate the tax law and create administrative problems.

2. Disallowing a deduction for corporate-owned life insurance.

- Proposed by Bush Administration. Disallowance of the interest deduction on new and existing loans was in the FY 93 Budget, along with deferred annuity proposal.

- Bush proposal died quickly. Retroactively disallowing future interest deductions on existing loans drew political heat. Administration backed off retroactivity within days. But without retroactivity, the proposal raised little revenue so it was abandoned.

- Agents will kill this proposal. The agents would mount an intense, organized and effective lobbying effort against this proposal because it would shut down future sales.

- Scoring differences. The Bush proposal was estimated to raise $2.6 billion over 5 years. Our preliminary estimate of this proposal indicates a revenue increase of less than $250 million over 5 years.

3. Extending OASDI to newly hired state and local employees.

- Doesn't count for pay-go purposes. OMB has estimated that this proposal will raise about $8.5 billion over five years. We believe our estimates would be about the same. The important issue here is that none of the $8.5 billion counts for pay-go purposes, because these are increased Social Security taxes that go into the Social Security Trust Fund.

- The increased revenue comes with a long-term cost. Many of these State and local government employees will get greater benefits from Social Security over the long haul.

4. Capital gains at death (or carryover basis).

- We've been down this path before. I remember what happened when we passed the carryover basis rules in the 1976 Tax Reform Act. We delayed the effective date in 1978 and in 1980 we repealed the provision retroactively. Taxing gains at death or requiring carryover basis would encounter serious political opposition from strong constituencies--small business, farmers, and the elderly just to name a few.

- Republicans and many Democrats will not support this proposal. You wouldn't get any support from Republicans. In addition, Democrats from rural states would oppose it. In fact, they would attack this as an anti-middle class, anti-savings, anti-investment proposal.

- Transfer taxes need comprehensive reform not piecemeal modifications. In 1986 we reformed the income tax significantly--lowered the income tax rates and broadened the tax base. However, we never got around to reforming the estate tax. The maximum current estate tax rate can be as high as 60% for large estates. (The rate is even higher if the transfer is subject to the generation-skipping transfer tax.) If we're going to start reforming the estate tax rules it should be comprehensive reform and not piecemeal modifications.

- Additional exceptions would decrease the revenue raised. For example, in order to deal with the administrative and political problems we could be pressured to allow all taxpayers to set the basis of their assets at the fair market value on the date of enactment. As a result, the five year revenue pick-up would be quite small. In essence, when all is said and done the revenue raised will not justify the political cost.

5. Limit value of itemized deductions to 28 percent rate.

- The proposal would be characterized as a tax on middle-income families. This proposal would affect ~~only [illegible]~~ 4.6 percent of all families -- married couples with taxable income above $94,000 and single filers with taxable income above $56,000. Opponents, however, will focus on the lower number -- $56,000 -- and the distinction between gross and taxable income will be lost in the debate. Republicans predicted that the 1993 rate increase was just the "first step" and this would confirm their prediction.

- Charities and states would oppose this proposal. Museums, educational institutions and a wide array of charities would oppose this provision because it reduces the tax incentive for charitable contributions. In addition, states -- particularly high tax states like California and New York -- would oppose this proposal because it reduces the deduction attributable to state taxes. Moreover, the proposal is layered on top of the current phaseout of itemized deductions.

- Proposal would add complexity. This proposal would require taxpayers to perform complex calculations to determine their tax liability.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

December 12, 1994

INFORMATION

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell
Assistant Secretary
for Economic Policy

LHB

SUBJECT: Budget Estimates Beyond 2000

In recent discussions of budget projections, OMB has presented deficit estimates for 1995-2004. The estimates for 1995-2000 are based on the Troika's recent revisions to the Administration's economic assumptions. However, the estimates for 2001-2004 come from the OMB's Fall Update; they are not based on revised economic assumptions. The Troika currently is examining the extension of the economic assumptions beyond 2000. Once there is agreement on those economic assumptions, OMB will make budget projections (for internal Administration use) for the years 2001-2005 and perhaps a longer extension to 2030.

cc: Alan Cohen

EXECUTIVE SECRETARIAT

TREASURY CLEARANCE SHEET

NO. 94-140630
Date December 12, 1994

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Alicia H. Munnell, Assistant Secretary for Economic Policy

THROUGH:

SUBJECT: Budget Estimates Beyond 2000

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
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- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
John Kitchen	JK	12/12	Policy Analysis	622-2340
REVIEWERS				
John Hambor	JCH	12/12	Director, Office of Policy Analysis	622-2350
Robert Gillingham	RG	12/12	Deputy Assistant Secretary for Economic Policy	622-2220

SPECIAL INSTRUCTIONS

☐ Review Officer   Date   ☐ Executive Secretary   Date

DO F 80-02.1 (04/89)

95-141920

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

January 24, 1995

MEMORANDUM FOR SECRETARY RUBIN

FROM: Alicia Munnell AHM
Alan Cohen AC

SUBJECT: Second Five-Year Budget Projections

As Alicia indicated in her earlier memo, she is concerned about including the deficit estimates for the second five years in the budget document, because it opens us up to the possible rosy scenario charge. Alan, on the other hand, views these numbers as potentially very helpful in responding to the charge that the Administration is failing to deal with a growing deficit beyond the year 2000.

While we have different initial reactions to whether the second five years of deficit projections should be included in the budget, we both are concerned at the speed and lack of consultation surrounding this decision by OMB.

We think that it might be useful for the NEC to call a meeting immediately of Administration health, economic and budget experts to discuss our confidence in the post-2000 estimates.

EXECUTIVE SECRETARIAT

TREASURY CLEARANCE SHEET

NO. 95-141920
Date 1/24/95

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ________

FROM: Alicia Munnell
THROUGH: ________
SUBJECT: Second Five-Year Budget Projections

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Alicia Munnell			Economic Policy	622-2200
Alan Cohen			Senior Advisor to Secretary	622-0056
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

95-142266

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN

From: Alicia Munnell AHM

Subject: OMB Deficit in 2030

Our best estimate, though preliminary, suggests that if we used last year's economic assumptions in the Social Security Trustees Report the deficit in 2030 would be about 11 percent of GDP, not 6.7 percent. This is largely because OMB's GDP growth rate averages 0.2 to 0.3 percent per year higher than the rate used by the Social Security Trustees.

95-1422 54

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 23, 1995

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell
Assistant Secretary for Economic Policy

SUBJECT: Long-Term Budget Deficit Projections

Summary:

Several versions of long-term budget deficit projections existed as of last fall. All projections showed a relatively flat deficit over the short- to medium-term but then a steady increase over the longer-term projection period to 2030. This memo shows the projections and discusses the reasons for the differences.

Discussion:

One of the first products of the Bipartisan Commission on Entitlement and Tax Reform (Entitlement Commission) was a set of budget projections showing the long-term outlook for the deficit through 2030. Both OMB and Treasury produced similar projections for internal use. (OMB's projections were for internal OMB use and were not circulated within the Administration other than in simple graph form.)

* The attached chart shows the different projections. By 2030, as a percent of GDP, the deficit reaches 18.9 percent under the Entitlement Commission projection, 13.3 percent for the Treasury projection, and 11 percent for the OMB projection. The difference in projections is attributable to the different economic and budgetary assumptions employed.

- All projections assumed revenues remained relatively flat as a share of GDP. Hence, the different deficit projections result from factors that affect spending relative to revenues.

- Both the Entitlement Commission and Treasury used the economic and demographic assumptions of the 1994 Social Security Trustee's Report. The difference between the Entitlement Commission and Treasury projections appears to result primarily from different assumptions about discretionary spending. The Entitlement Commission maintained the discretionary spending share (as a percentage of GDP) throughout the projection period to 2030. Treasury estimates assumed that

EXECUTIVE SECRETARIAT

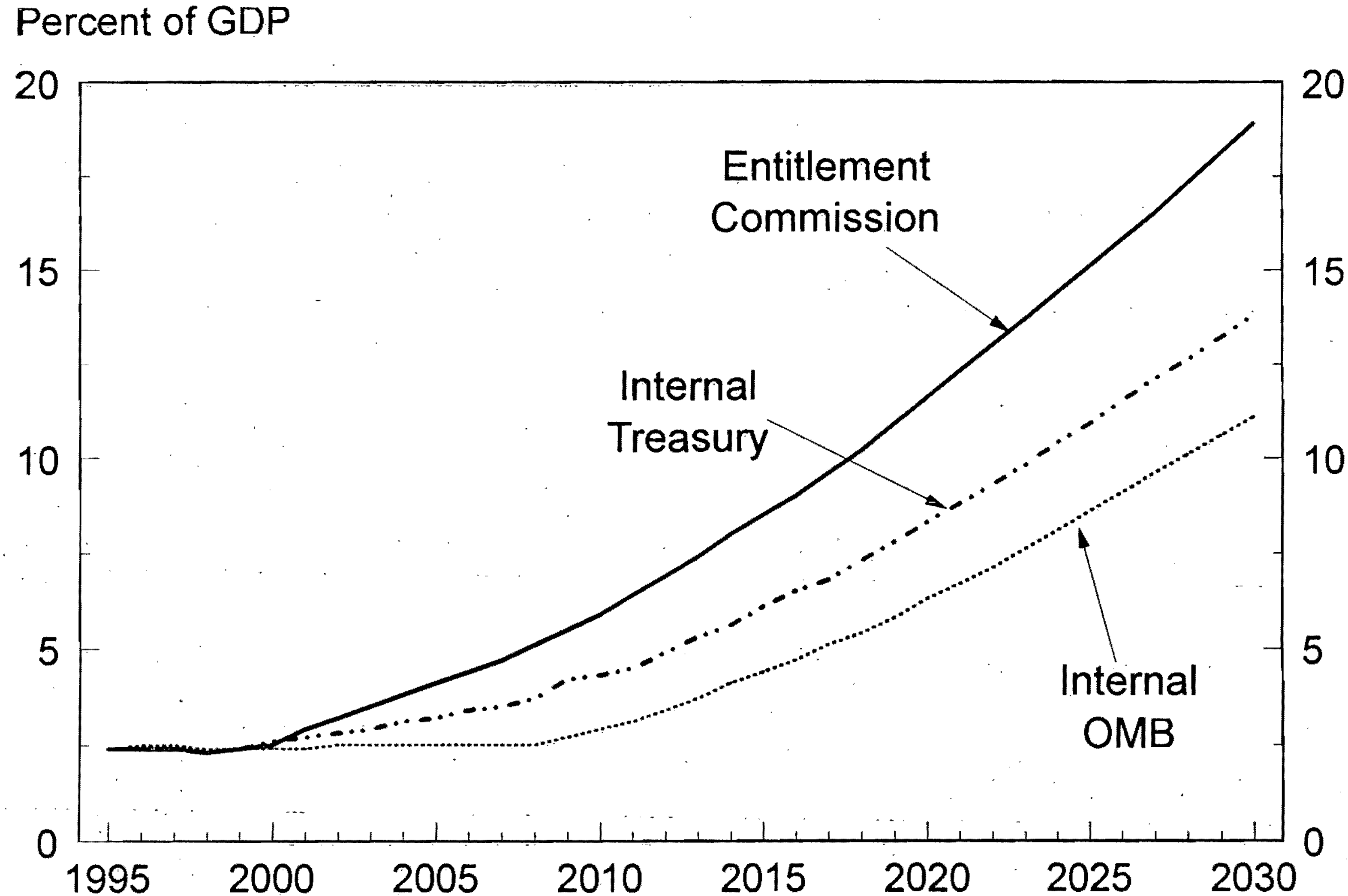
discretionary spending would grow at the rate of inflation after 1998. The lower discretionary spending in the Treasury projection generates lower deficits and debt and lower interest costs.

o OMB, like Treasury, assumed that discretionary spending increased with inflation after 1998. The difference between the Treasury and OMB projections results from several different sets of assumptions. OMB assumed higher real GDP growth, lower GDP deflator and CPI inflation, and lower interest rates. Also, the OMB projections were based on different population assumptions. Total population and the population aged 65 and over were lower for the OMB projections than for the Social Security assumptions. OMB also used an assumption of a steadily declining poverty rate and hence had a declining share of the population receiving Medicaid payments.

We are in the process of updating the system used to generate the long-term projections and we will incorporate the new short-term OMB budget data and projections from the FY96 budget when they are available. When the update is complete, we will present long-term projections showing the effects of various budget and spending cut proposals.

Attachment

Long-Term Federal Budget Deficit Projections



95-142818

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

February 14, 1995

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell

SUBJECT: Long-Term Budget Projections

SUMMARY:

Several alternative long-term deficit projections recently have given distinctly different impressions of the severity of the outlook for Federal budget imbalance. The difference in the projections highlights the sensitivity of such long-term estimates to small changes in the economic and technical assumptions used to produce them. An understanding of that sensitivity produces an awareness that such projections should only be used with extreme caution.

DISCUSSION:

Last fall, the Bipartisan Commission on Entitlement Reform released long-term Federal budget projections showing the deficit rising to 18.9 percent of GDP in 2030. At the same time, OMB produced long-term projections for internal use showing a much smaller deficit in 2030 of 10.2 percent of GDP. More recently, in preparation for the FY 96 budget presentation, OMB produced updated long-term budget projections (on a current-services basis) showing a relatively flat deficit in the 2.0 to 2.5 percent range as a share of GDP through 2010, but a steadily increasing deficit after 2010 that reaches 6.7 percent of GDP in 2030.

This memo is intended to provide some explanation for the large differences in these estimates. The most important point to recognize about the long-term projections is that they are **extremely** sensitive to what might otherwise appear to be small changes in the assumptions used to produce them. The estimates were produced internally, based on a system we developed to monitor the long-term budget outlook. The methodology used to construct the system is very similar to that used by OMB for their long-term projections.

EXECUTIVE SECRETARIAT

I. Entitlement Commission vs. New OMB Projections

Chart 1 shows the Entitlement Commission projection, the new OMB current services projection, and the new OMB projection using Social Security economic assumptions instead of OMB's economic assumptions. The difference in the Entitlement Commission projection from the OMB projection results largely from two key assumptions:

- o About 4 percentage points of the 12 percentage point difference comes from the Entitlement Commission's use of the Social Security economic assumptions which are less optimistic about the long-run potential real growth rate for the economy--by about 0.3 percentage points on average each year. Although there are some other differences between the Social Security and OMB economic assumptions (inflation, interest rates, unemployment rate), the real growth rate accounts for the bulk of the difference.

- o About 7 percentage points of the difference in the deficit projection in 2030 results from the Entitlement Commission's assumption that discretionary spending would grow at the rate of nominal GDP, hence keeping discretionary spending constant as a share of GDP (Chart 2). The new OMB projection assumes that discretionary spending grows at the rate of inflation.

II. Old OMB vs. New OMB Projections

Chart 3 shows that the OMB's new long-term deficit projection is lower than last fall's projection largely because of the change in the inflation rates used in the economic assumptions. Specifically, the spread between the CPI inflation rate and the GDP implicit price deflator rate was assumed to be much smaller--0.1 percentage point instead of 0.4 percentage point--as a result of the planned revisions to the index that will occur in 1998. A lower rate of CPI inflation relative to GDP deflator inflation results in lower deficits because indexed spending programs grow slower relative to growth of the tax base.

III. Current Sensitivities

The remaining charts show the sensitivity to the long-term deficit projections to changes in economic assumptions.

- o Chart 4 shows that a relatively small, sustained increase in real GDP growth of 0.2 percentage points would cut the deficit projection in 2030 by nearly 3 percentage points of GDP.

- Chart 5 shows that an assumption of higher inflation rates--both CPI inflation and GDP deflator inflation--would cut the deficit projection as well; a sustained higher rate of CPI and GDP deflator inflation by 0.5 percentage point would cut the deficit projection by about 1 percentage point of GDP in 2030. The smaller amount here relative to chart 3 illustrates the sensitivity of the projections to changes in inflation vs. changes in the spread between CPI and GDP deflator inflation.

- Chart 6 shows that a sustained 50 basis point reduction in interest rates would cut the deficit projection in 2030 by about a percentage point of GDP.

- Chart 7 shows that a 1/2 percentage point reduction in health care inflation would cut nearly 3 percentage points off the deficit projection in 2030.

Attachments

Chart 1--Long-Term Federal Budget Deficit Projections

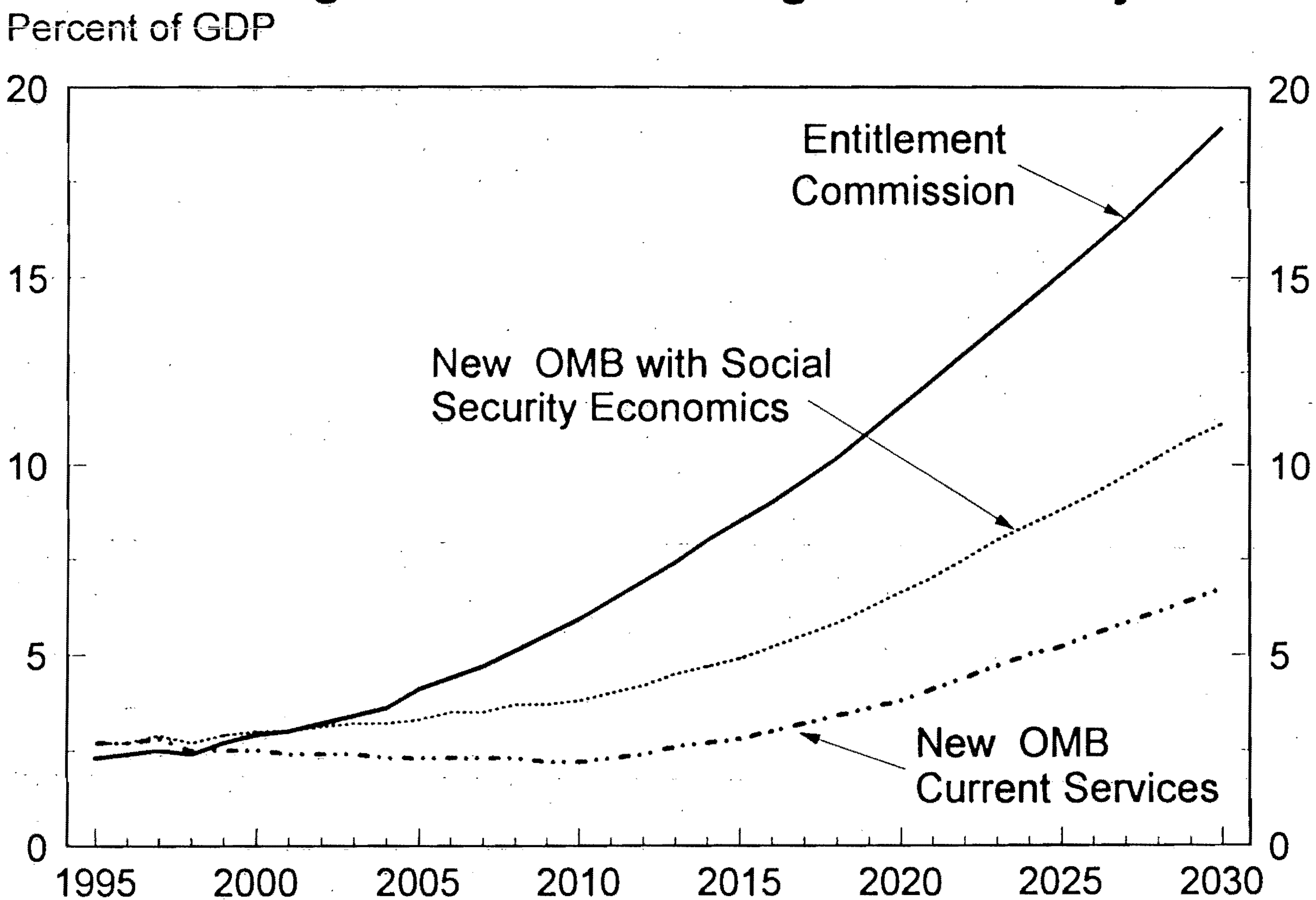


Chart 2--OMB Economics and Entitlement Commission Discretionary Assumption

Discretionary Spending Growth at Nominal GDP Growth

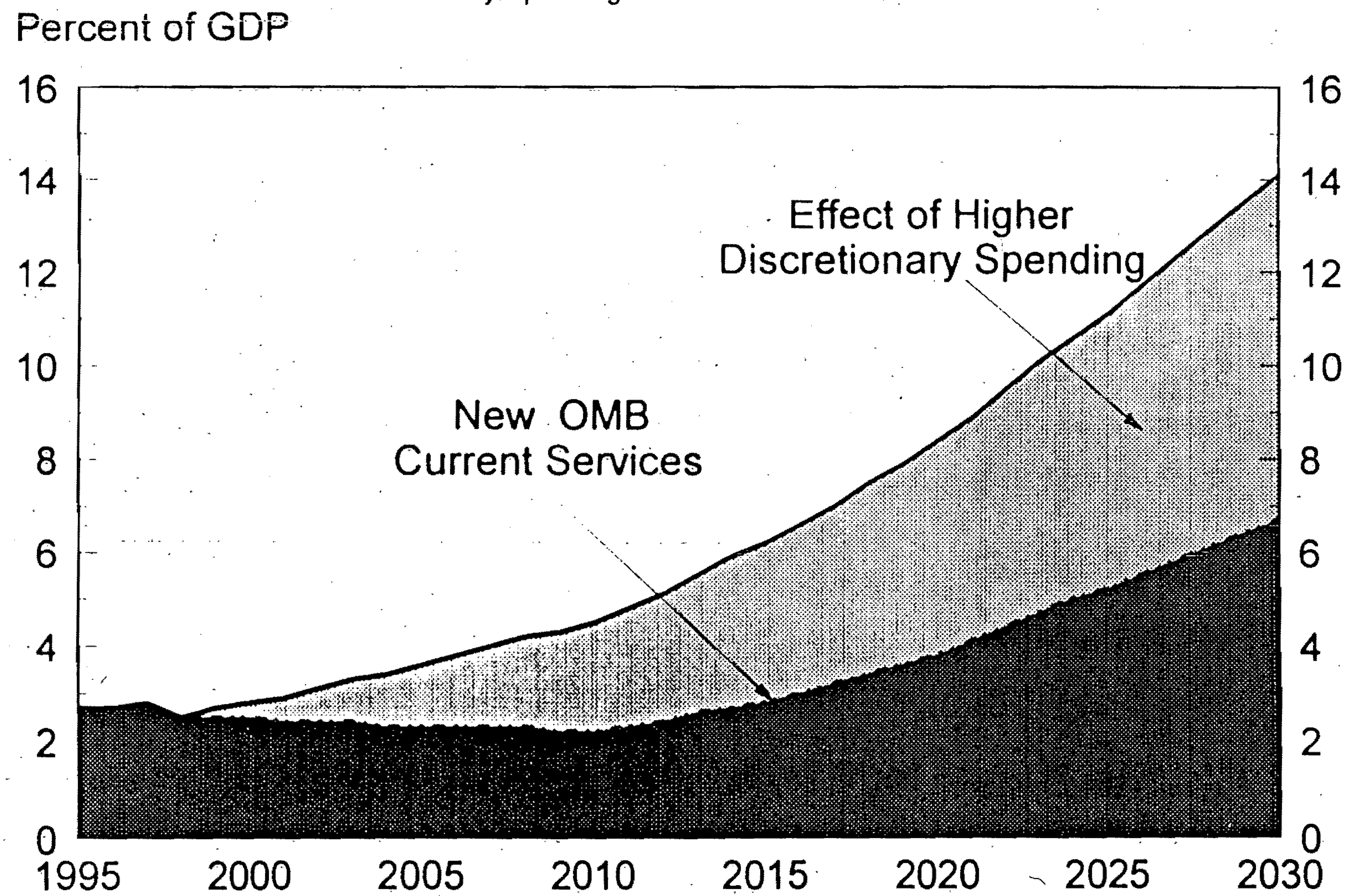
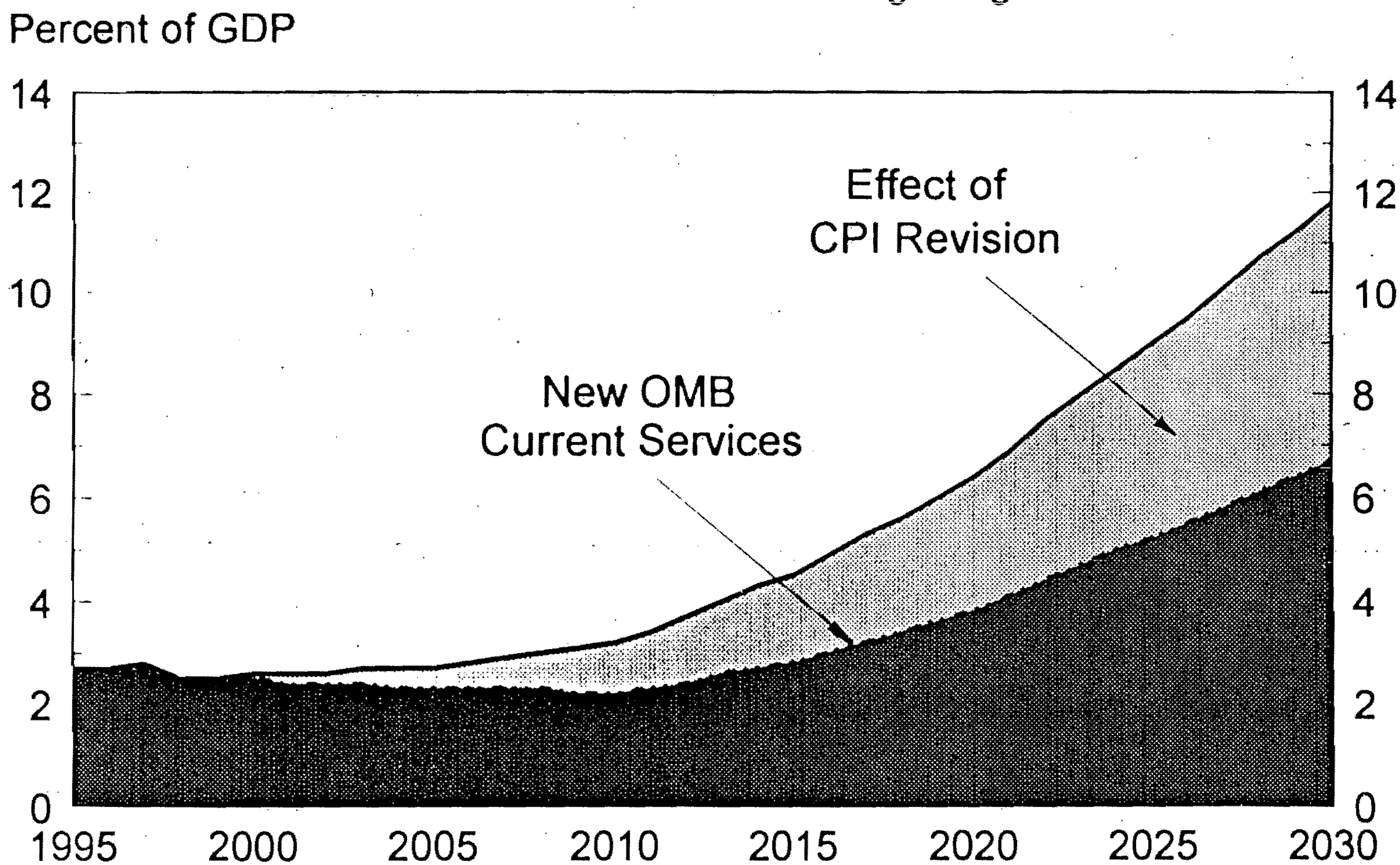


Chart 3--Effect of CPI Revision on Long-Term Deficit Projection

CPI Inflation 0.3 % Point Lower Beginning 1998



Note: New OMB economics and discretionary assumptions

Chart 4--Sensitivity to Real GDP Growth Assumptions

Alternative: Real GDP Growth Raised by 0.2 % Point Beginning 1996

Percent of GDP

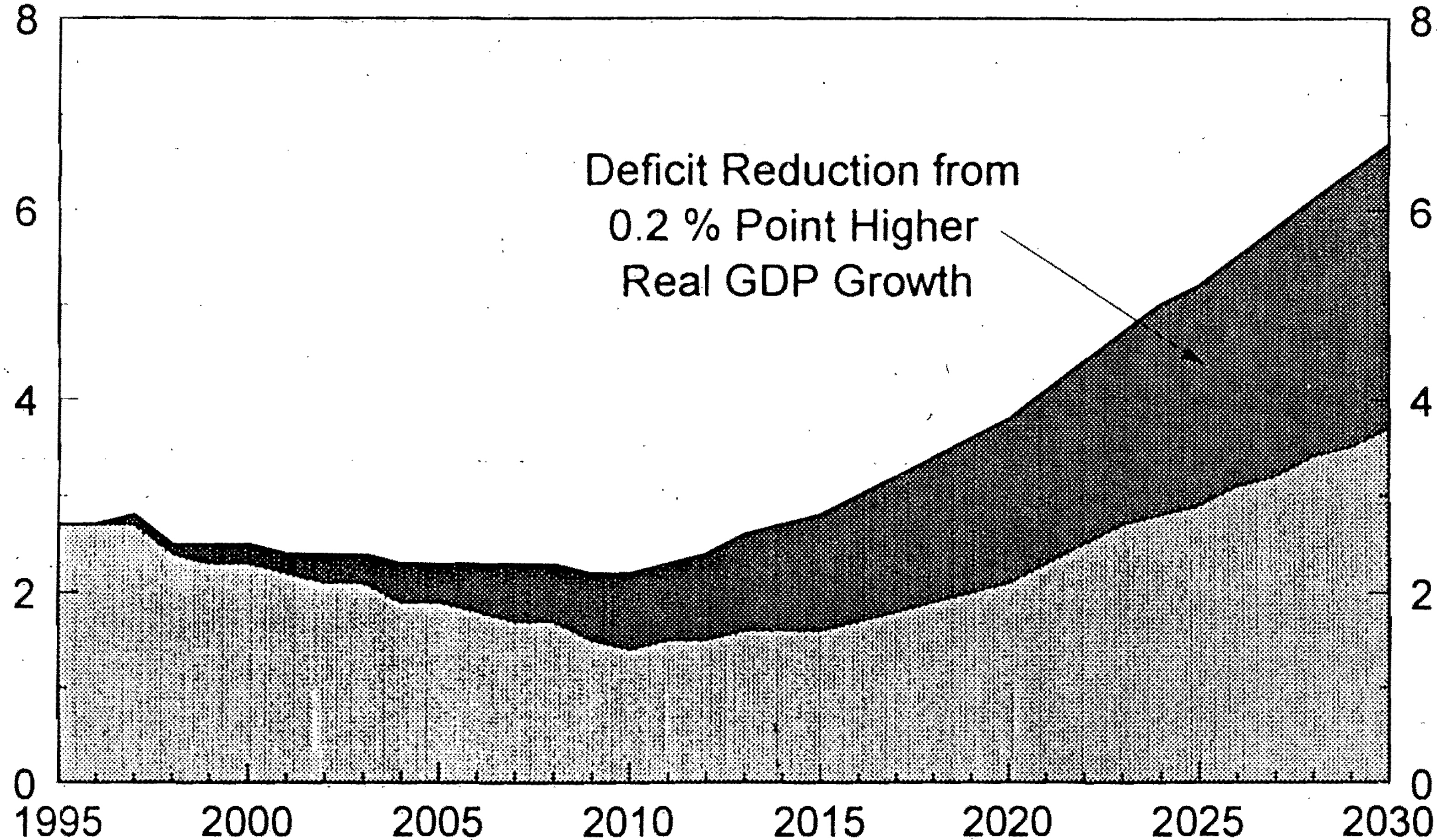


Chart 5--Sensitivity to Inflation Assumptions

Alternative: Inflation Raised by 0.5 % Point Beginning 1996

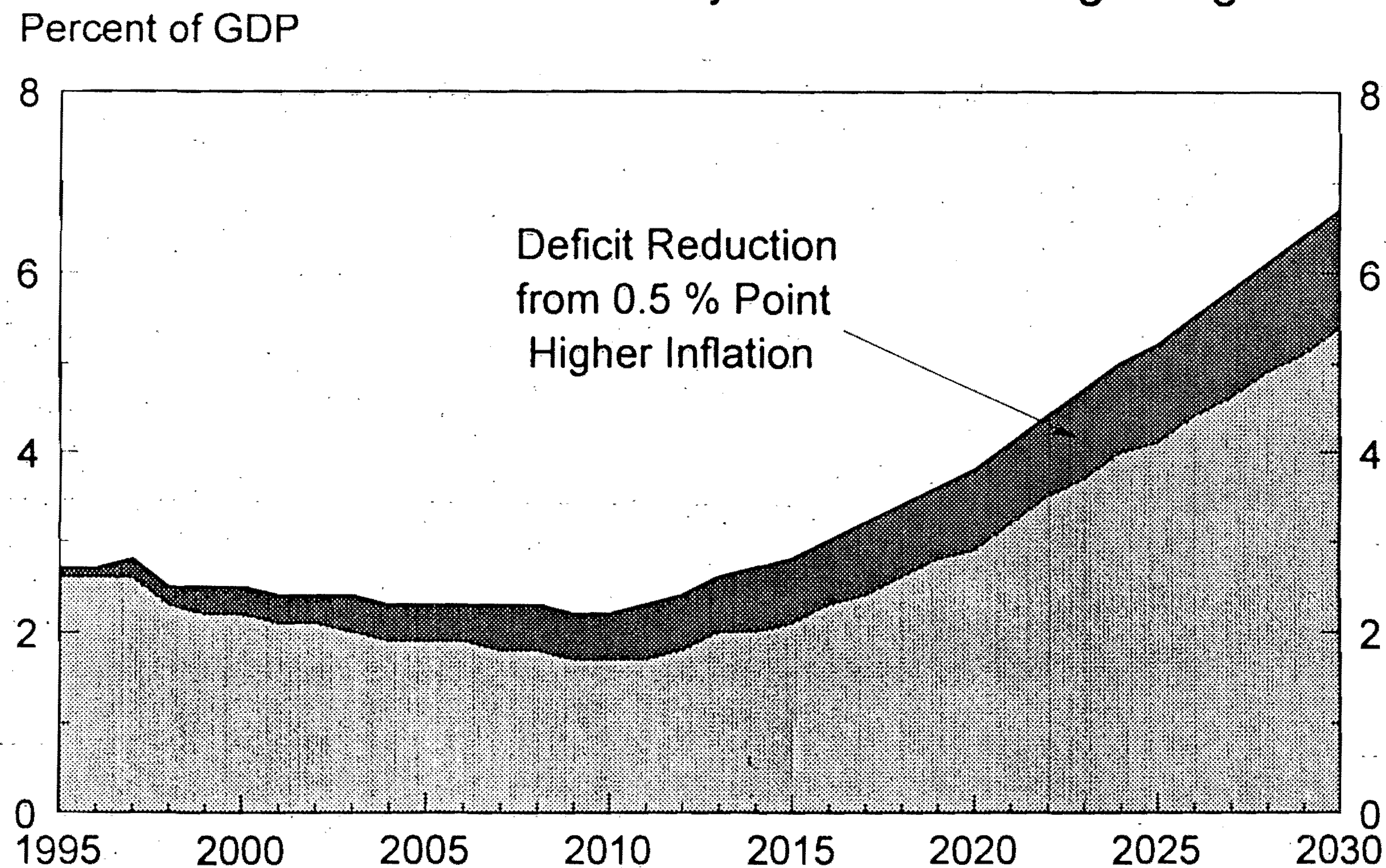


Chart 6--Sensitivity to Interest Rate Assumptions

Alternative: Interest Rates Lowered by 1/2 % Point Beginning 1996

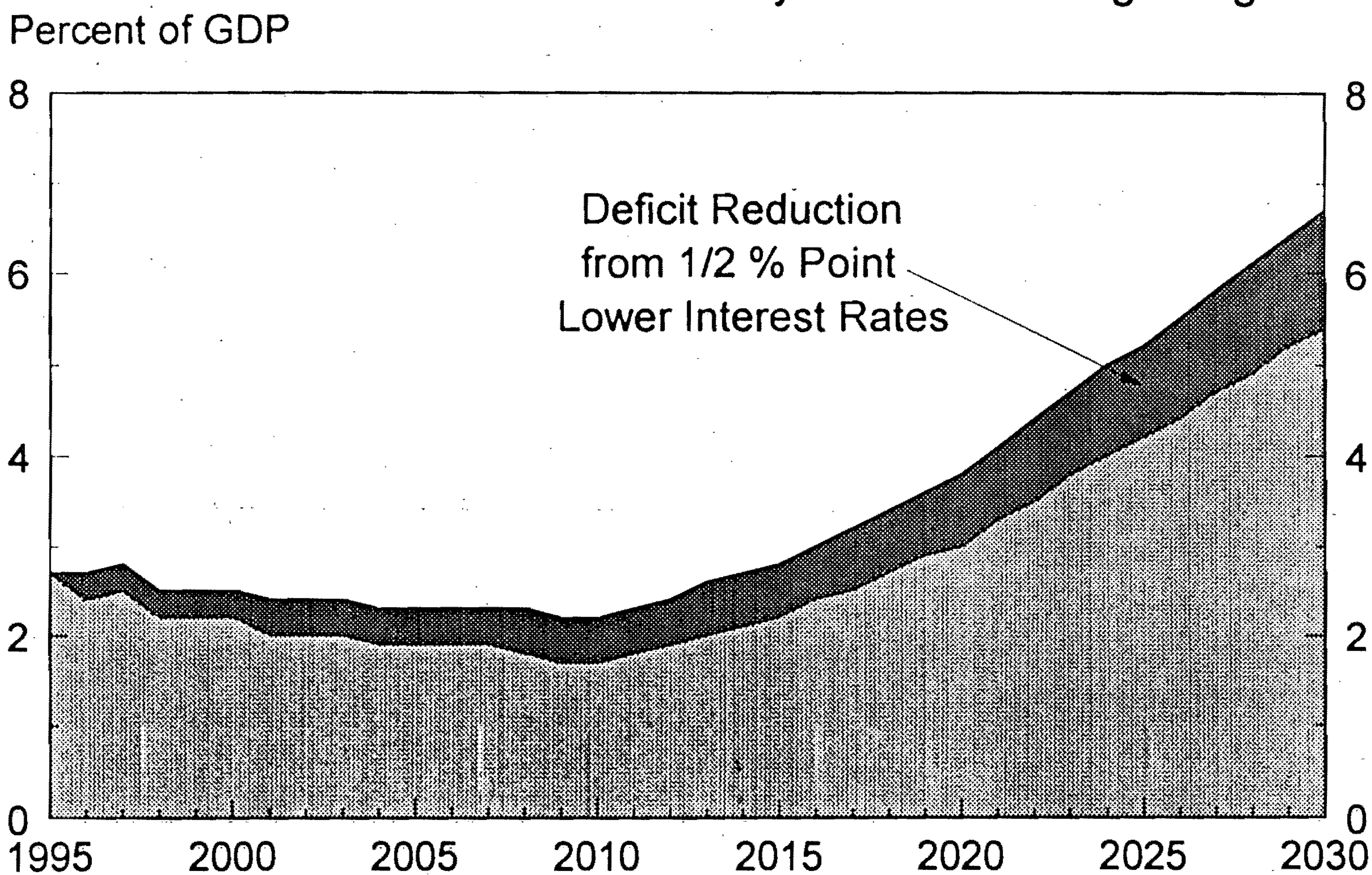
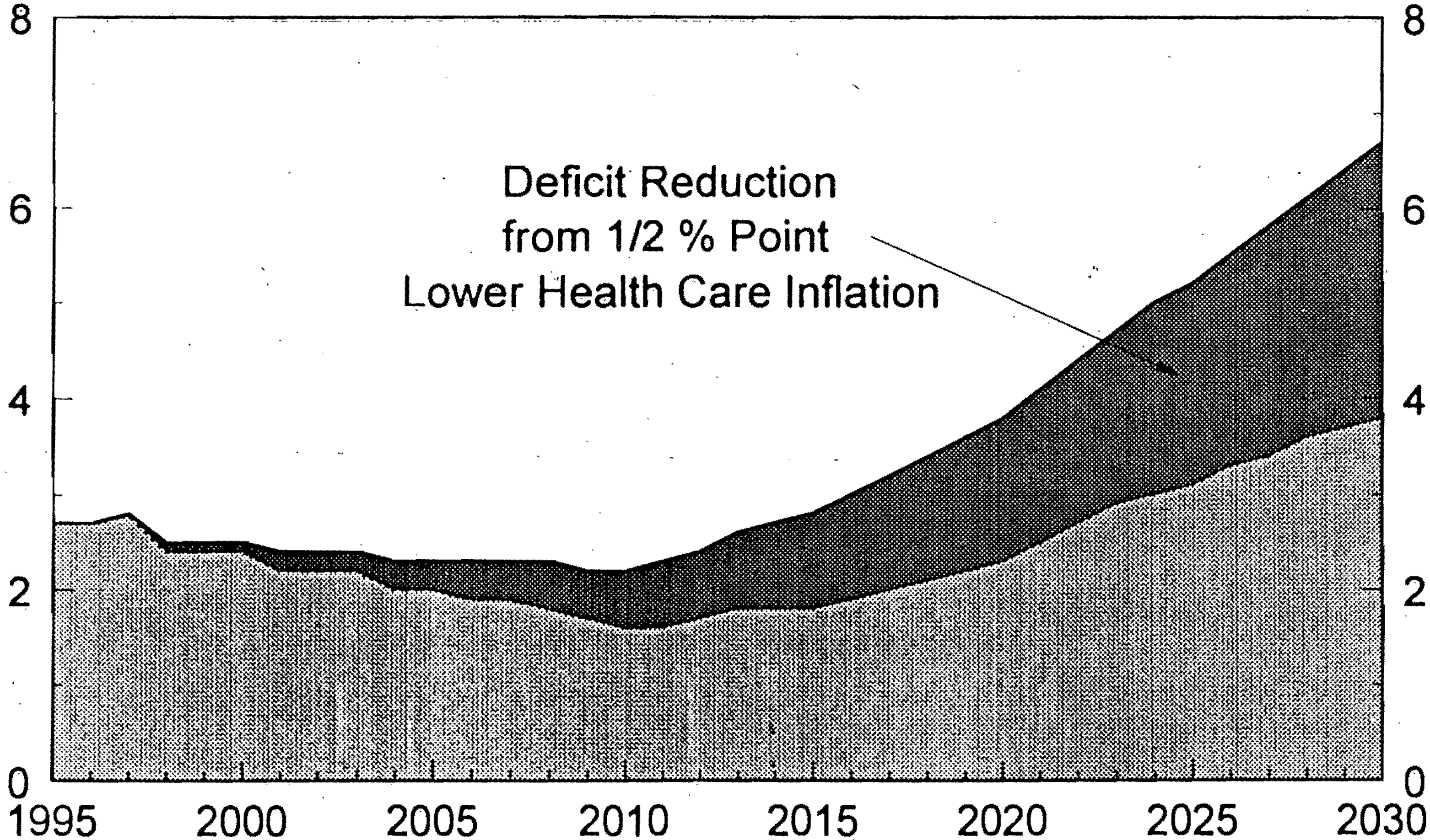


Chart 7--Sensitivity to Health Care Inflation Assumptions

Alternative: Health Care Inflation Lowered by 1/2 % Point Beginning 1996

Percent of GDP



TREASURY CLEARANCE SHEET

NO. __________

Date February 10, 1995

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER __________

FROM: Alicia H. Munnell, Assistant Secretary for Economic Policy
THROUGH: __________
SUBJECT: Long-Term Budget Projections

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
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☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other __________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
John Kitchen	JK	2/10/95	Policy Analysis	622-2340
REVIEWERS				
John Hambor	JCH	2/14	Director, Policy Analysis	622-2350
Robert Gillingham	RG	2/16	Deputy Assistant Secretary for Economic Policy	622-2220

SPECIAL INSTRUCTIONS

☐ Review Officer __________ Date __________

☐ Executive Secretary __________ Date __________

DO F 80-02.1 (04/89)

14305?

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

February 27, 1995

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Robert E. Rubin REA

SUBJECT: Analysis of Tax Proposals

You asked for Treasury's analysis of five proposed economic initiatives. The proposals would:

- Eliminate Federal income taxes on dividends of new stock issues, held for more than one year, of corporations with assets under $50 million;
- Simplify the SEC process for securities offerings under $50 million;
- Expand tax credits to employers who hire people on welfare and who are unemployed;
- Eliminate Federal income taxes on interest from any savings account under $100,000 or from medical or college savings accounts; and
- Provide a tax credit on the employer share of medical expenses and/or premiums by employers for employee health coverage for basic health care benefits.

The attached paper provides a brief discussion of the five proposals and how they relate to current law and the Administration's overall objectives. The discussion suggests how much the proposals may potentially cost, but more precise revenue estimates cannot be made without more specifics on how the proposals would be structured.

I will be happy to provide additional analyses of any of these proposals.

Attachment

ANALYSIS OF FIVE PROPOSED ECONOMIC INITIATIVES

Small Business Dividend Tax.

Proposal. The proposal would permit no federal taxes on the dividends of new stock issues, held for more than one year, issued by new corporations with assets under $50 million.

Current Law. Under current law, dividends paid by corporations are taxed under both the corporate income tax (at rates up to 35 percent) and the individual income tax (at rates up to 39.6 percent). But small businesses do not pay the corporate-level tax if they organize themselves as sole proprietorships, partnerships, or subchapter-S corporations. (The income of these business entities is allocated directly to owners of the business and taxed once at the individual level.)

Administration Policy. The Administration has favored increased incentives for small business. In OBRA-93, the Congress, in response to Administration proposals, increased the annual amount of equipment purchases that small businesses can deduct immediately from $10,000 to $17,500 (the Administration originally favored raising the limit to $25,000) and provided a 50 percent exemption for capital gains on sales of new stock in small businesses held for over 5 years.

Analysis. The proposal would provide additional tax incentives for small businesses. Providing an exemption for dividends, but not capital gains, however, would favor companies that distribute income instead of retaining it for reinvestment and could reduce overall investment. In addition, the proposal would encourage firms to subdivide into smaller units to qualify for the $50 million exemption. This could lead to inefficient forms of business organization. Rules to prevent artificial recharacterizations of firms (either as separate firms or as new firms) to take advantage of the tax break could be complex and difficult to administer.

One reason to provide additional assistance for small business is a belief that they create most of the new jobs. But recent studies suggest that small businesses do not create proportionally more jobs than larger businesses.

Potential Costs. In 1992, about $8 billion or 5 percent of dividend income was distributed by companies with assets below $50 million. Less than $300 million was distributed by new corporations with assets under $50 million. Assuming a 25% average tax rate on dividend income, the annual revenue loss could thus range from $75 million to $2 billion. The loss would approach the larger figure to the extent firms are able to redeem existing shares and reissue them as new stock.

SEC Approval

Proposal. Simplify the SEC approval process for securities offerings under $50 million.

Current Law. The SEC is authorized to provide simplified registration of offerings of up to $5 million per issuer during any 12-month period. Under the SEC's aggregation rules, a company using the simplified registration procedure could raise up to $11 million in capital annually.

Administration Policy. To our knowledge, this Administration has not taken a position on raising the ceiling. The SEC, however, has endorsed legislation increasing the statutory ceiling from $5 million to $10 million.

Analysis. Applying the aggregation rules to a $50 million ceiling would enable a company to raise over $100 million per year from the capital markets using the simplified procedure. This suggests the proposal may go far beyond what is needed to achieve the objective of helping small businesses. An alternative approach would raise the upper limit to $50 million, but give the SEC discretion to approve a lesser amount based on its assessment of balancing the objectives of providing more regulatory relief for small business and protecting investors. This is consistent with SEC's current legal authority, which is permissive, but not mandatory.

Opponents of an increase of the current ceiling to $50 million argue that an increase merely increases the SEC's exemptive authority since the benefits are not necessarily targeted to small businesses. Moreover, increasing the ceiling at the federal level would not by itself provide full relief without amendments in state securities laws to conform to the change in federal law.

Welfare Tax Credits

Proposal. Expand tax credits to employers who hire people on welfare and who are unemployed.

Current Law. There is no general employment tax credit for employers under current law. The targeted jobs tax credit (TJTC), which expired on December 31, 1994, was available for hiring individuals from nine targeted groups, including economically disadvantaged groups and those with special needs. Targeted groups included recipients of Supplemental Security Income (SSI) and Aid to Families with Dependent Children (AFDC). The credit was equal to 40 percent of the first $6,000 of qualified first year wages paid to a member of a targeted group. The maximum credit, therefore, was $2,400 per employee in any year.

Administration Policy. The FY 1996 budget supports the objectives of the TJTC, but states that the Administration favors its extension only with major reforms. A 1994 report by the Department of Labor's Inspector General (IG) criticized the current credit and recommended against its extension. The principal criticisms in the IG Report were that 1) TJTC jobs are generally low-wage and short-term, with little or no evidence of any impact on earning power and 2) the credit is largely a windfall to participating firms because employers do not make special efforts to recruit workers from target groups.

Analysis. The TJTC, originally enacted in 1978, was intended to encourage employment of groups with special needs. It replaced a more general new jobs tax credit. The Congress believed at the time that growth in the overall economy had reduced the employment rate enough that incentives were only required for those with special needs. A similar conclusion may be warranted today, since unemployment has declined to 5.7 percent -- about 2 percentage points less than at the trough of the recession. In any event, the experience with the TJTC, as reflected in the IG Report, indicates that if this type of credit is not well targeted, it can be wasteful and not help those to whom it is intended.

Potential Costs. Treasury has estimated that a two-year extension of the TJTC (through December 31, 1996) would reduce revenue by $0.7 billion in the budget period. If welfare reform contains a work requirement, however, the eligible TJTC population would increase, raising the potential revenue loss substantially. Extension of the TJTC to those currently unemployed would further increase the revenue loss. In 1994, almost 8 million people were unemployed, compared with an estimated 450,000 participants in the TJTC program.

Expand Tax Exemption for Savings

Proposal. Exempt from tax income on any savings account under $100,000 or any medical or college savings account.

Current Law. In general, interest income from savings accounts is taxable. Individuals may, however, accumulate interest income tax-free through qualified retirement plans and qualified salary reduction plans (401k plans and 403b plans) established by employers or through individual retirement accounts (IRAs). Taxpayers may contribute up to $2,000 per employee ($250 for non-working spouses) to deductible IRAs either if they have no employer pension plan or their income is below specified limits.

Administration Policy. The Administration is proposing an expansion of IRAs in the FY 1996 budget to help boost private saving of middle income individuals and families. The Administration's IRA proposals would raise the income limits for which taxpayers qualify for deductible IRAs, 2) allow qualified taxpayers to establish back-loaded IRAs, and 3) allow penalty-free withdrawals for non-retirement purposes, including educational expenses, first home purchases, extraordinary medical expenses, and care for an aged relative. But the Administration does not support a general exemption from taxes on investment income for high income individuals.

Analysis. The proposal as described would be less effective than the Administration's proposed expansion of IRAs in increasing saving and more likely to provide windfall benefits for taxpayers with existing assets. Unlike IRAs, the proposal has no limit on annual contributions. This would provide an incentive for some taxpayers (those who would otherwise save more than $2,000 annually) to save more, but it would also provide a large tax benefit to wealthy taxpayers without increasing their saving by enabling them to transfer all their interest-bearing assets immediately into tax-exempt accounts and to incur tax deductible debt (by, for example, taking home equity loans) to acquire tax-free interest-bearing assets. (To prevent unlimited funds transfers, the law would have to set the limit at $100,000 per taxpayer instead of $100,000 per account.)

Potential Costs. In 1996, 81.9 million tax returns reported taxable interest income of $205.8 billion. If all of this interest income were exempt from tax, the revenue loss would be $40.2 billion per year. If the proposal limited the exclusion to $100,000 per taxpayer, instead of $100,000 per account and the average interest rate on all accounts was 5 percent, the annual revenue loss would be $18.3 billion per account. By contrast, the Administration's proposal to expand IRAs reduces revenue by $3.8 billion over the 5-year FY 1996-2000 period.

Employer Medical Tax Credit

Proposal. Provide a tax credit on the employer share of medical expenses and/or premiums paid by employers for employee health coverage in an approved plan providing basic health care benefits.

Current Law. The tax code provides preferential treatment for employer contributions for health insurance benefits. Employer-provided insurance premiums are deductible to employers, but tax-free to employees. In combination, this means that compensation employees receive in the form of employer-paid health insurance is tax-free. In contrast, most other forms of employee compensation (both cash and fringe benefits) are taxable.

Administration Policy. The Administration's proposed Health Security Act (HSA) would have achieved universal coverage by requiring employers and individuals to purchase health insurance. HSA proposed premium discounts (e.g., subsidies) to low-wage firms and small firms to offset the costs of mandated health insurance benefits. Under HSA, these subsidies would have cost about $30 billion per year. The HSA also proposed including employer-provided supplemental benefits (in addition to those defined in the standard benefits package) in taxable income of employees, beginning in 2004.

In this year's State of the Union address, the President recommended that Congress enact an incremental health reform plan, which would include subsidies to help low-income families with children and the unemployed purchase health insurance.

Analysis. Expanding health insurance coverage continues to be an important policy objective. With limited resources, however, the most cost-effective way to expand coverage is to target subsidies directly to low-income families with children instead of providing credits to employers. Employers will generally not have complete information about family income and other eligibility criteria for subsidies and some people in the target population are unemployed. In addition, to minimize subsidies paid to those who would otherwise be insured, the Administration is considering options to limit eligibility to children who have not been covered by an employer plan for the previous 6 months.

Potential Costs. The current exclusion for employer-provided health insurance reduces income tax revenues by about $60 billion per year. An unlimited tax credit could increase costs by a comparable amount, depending on the credit rate. Targeting credits to low-income families with children would reduce the additional subsidy costs substantially.

95-1413057

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 14, 1995

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: ERIC J. TODER
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

THROUGH: LESLIE B. SAMUELS LBS
ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Memorandum to President Clinton on Five Proposed Economic Initiatives

ACTION FORCING EVENT: The President requested that Treasury prepare analyses of five economic initiatives. The proposals would:

- Eliminate Federal income taxes on dividends of new stock issues, held for more than one year, of corporations with assets under $50 million;
- Simplify the SEC process for securities offerings under $50 million;
- Expand tax credits to employers who hire people on welfare and who are unemployed;
- Eliminate Federal income taxes on interest from any savings account under $100,000 or from medical or college savings accounts; and
- Provide a tax credit on the employer share of medical expenses and/or premiums by employers for employee health coverage for basic health care benefits.

The attached paper responds to the President's request.

RECOMMENDATION: That you sign the attached memorandum to President Clinton and transmit the attached paper.

Approve _________ Disapprove _________ Let's Discuss _________

Attachment

cc: Sylvia Mathews
Cynthia Beerbower
Lowell Dworin
Gerry Gerardi
Jim Nunns
Janet Holtzblatt
Bob Carroll

EXECUTIVE SECRETARIAT

TREASURY CLEARANCE SHEET

NO. 95-143057
Date 2/14/95

MEMORANDM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☒ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Eric J. Toder
THROUGH: Leslie B. Samuels
SUBJECT: Memorandum to President Clinton on Five Proposed Economic Initiatives

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for International Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ AFT
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
- ☐ Inspector General

☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affaiars/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other ______

NAME (Please Print)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Eric Toder		2/14/95	Office of Tax Analysis, Room 3108	622-0120
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

95-145403

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 26, 1995

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia Munnell
Alan Cohen
Glen Rosselli

SUBJECT: Budget Simulations

Attached are the results of a series of budget simulations showing the path to zero for alternative years, with a) Administration and CBO baselines, and (b) health care cuts over five years of $75 billion, $100 billion, and $125 billion. All simulations also assume permanent saving from the government rescission package; the remaining savings come from unspecified discretionary and entitlement cuts.

These simulations--which are consistent with Alan Cohen's earlier calculations--show a couple of interesting things.

- It matters very much whether the starting point is the Administration or CBO baseline.
- Delaying the year of balance is very helpful. For the Administration deficit projections, moving from 2002 to 2005 lowers the five-year cost by $100 billion over five years; from 2002 to 2007, by $150 billion over five years.
- These deficit reduction figures are in addition to the net $80 billion ($144 billion less $63 billion tax cut) in the Administration budget.
- Postponing the balance date to 2007 enables all the deficit reduction to be achieved through health care cuts and extended rescissions--no need to further cut domestic discretionary or to cut other entitlements. With balance in 2002, however, the additional required cuts in 2002 for these programs would be $82 billion.

In order not to overwhelm you with paper, only one set of simulations is attached--Administration baseline and $100 billion of health care cuts over five years. Other packets are available if you are interested.

Attachment

April 25, 1995

ALTERNATIVE PATHS TO A BALANCED BUDGET

Illustrative Non-Interest Cuts Required to Get to a Balanced Budget

($Billions)

Year of Balance	Administration 5-year	Administration 7-year	Administration 10-year	CBO 5-year	CBO 7-year	CBO 10-year
2002	310	585	975	496	959	1741
2003	280	518	922	444	853	1659
2004	232	438	841	410	784	1578
2005	210	392	760	366	714	1475
2006	190	350	676	358	707	1441
2007	160	294	570	329	661	1368
2008	160	294	570	315	629	1308
2009	160	294	557	194	583	1204
2010	160	288	529	278	557	1163

CBO deficits used in the analysis include President's Budgetary Proposals.
Cuts determined by arbitrary path to balance.
Net interest determined from CBO and OMB interest matrices.
Baseline deficit paths beyond 2005 based on extrapolations.

Notes on the Illustrative Paths to Balance

1. Deficits for the Administration FY96 budget policy baseline and the Congressional Budget Office (CBO) Presidential Budgetary Proposals baseline were used in the analysis.

2. Fixed amounts of health care spending cuts and "recissions" spending cuts were used in the comparisons for alternative years of achieving a balanced budget. Three alternative health care spending cut scenarios were examined: $75 billion over 5 years; $100 billion over 5 years; and $125 billion over 5 years. Note that those cuts are in addition to the cuts specified in the Administration FY96 budget policy proposals which would produce an additional $9.5 billion over 5 years and $76 billion over 10 years.

Administration Health Care Spending Cuts in FY96 Budget Proposals

Fiscal Year, $Billions

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Health Cuts	-0.2	-0.6	-0.7	-3.0	-5.0	-7	-9	-12	-16	-22

3. Other cuts required to achieve a balanced budget were determined by an arbitrary path that generates a lower level of 5-year cuts than required by a linear path to balance.

4. Net interest savings determined from relevant OMB or CBO interest matrix.

5. Baseline deficit paths beyond 2005 determined from extrapolations.

Balance 2002

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190
Savings											
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23
Other--Entitlements		-5	-10	-15	-20	-25	-30	-41	-30	-19	-8
Other--Discretionary		-5	-10	-15	-20	-25	-30	-41	-30	-19	-8
Total noninterest cuts		-23	-43	-61	-81	-102	-122	-153	-141	-131	-118
Net interest		-1	-3	-6	-11	-18	-26	-37	-48	-60	-72
Total Deficit Reduction		-24	-46	-67	-92	-120	-148	-190	-190	-191	-190
Remaining deficit		173	167	129	105	75	45	-0	0	0	-0
				5-year non-interest cut		-310			10-year non-interest cut		-975
Deficit Target		169	141	112	84	56	28	0			

Balance 2003

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190
Savings											
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23
Other--Entitlements		-4	-8	-12	-16	-20	-24	-28	-32	-22	-10
Other--Discretionary		-4	-8	-12	-16	-20	-24	-28	-32	-22	-10
Total noninterest cuts		-21	-39	-55	-73	-92	-110	-128	-146	-135	-123
Net interest		-1	-3	-6	-10	-16	-24	-33	-44	-55	-67
Total Deficit Reduction		-22	-42	-61	-83	-108	-134	-161	-190	-191	-190
Remaining deficit		175	171	136	114	86	60	29	0	0	-0
			5-year non-interest cut			-280		10-year non-interest cut			-922
Deficit Target		172	148	123	98	74	49	25	0		

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Balance 2004

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190
Savings											
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23
Other--Entitlements		-2	-4	-7	-10	-13	-16	-20	-24	-25	-14
Other--Discretionary		-2	-4	-7	-10	-13	-16	-20	-24	-25	-14
Total noninterest cuts		-17	-31	-45	-61	-78	-94	-112	-131	-143	-130
Net interest		-1	-2	-5	-8	-13	-20	-27	-37	-48	-60
Total Deficit Reduction		-18	-33	-50	-69	-91	-114	-139	-168	-191	-190
Remaining deficit		179	180	147	128	103	80	50	22	-0	0
				5-year non-interest cut		-232			10-year non-interest cut		-841
Deficit Target		175	153	131	109	87	66	44	22	0	

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Balance 2005

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190
Savings											
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23
Other--Entitlements		-1	-3	-5	-7	-9	-11	-13	-14	-15	-17
Other--Discretionary		-1	-3	-5	-7	-9	-11	-13	-14	-15	-17
Total noninterest cuts		-15	-29	-41	-55	-70	-84	-98	-110	-122	-136
Net interest		-1	-2	-4	-8	-12	-18	-25	-33	-42	-53
Total Deficit Reduction		-16	-31	-45	-63	-82	-102	-123	-143	-164	-190
Remaining deficit		181	182	151	135	112	91	67	47	26	0
			5-year non-interest cut			-210		10-year non-interest cut			-760
Deficit Target		177	157	138	118	98	79	59	39	20	0

Balance 2006

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190	190
Savings												
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79	-88
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23	-24
Other--Entitlements		-1	-2	-3	-4	-5	-6	-7	-8	-8	-9	-10
Other--Discretionary		-1	-2	-3	-4	-5	-6	-7	-8	-8	-9	-10
Total noninterest cuts		-15	-27	-37	-49	-62	-74	-86	-98	-108	-120	-131
Net interest		-1	-2	-4	-7	-11	-16	-22	-29	-38	-48	-59
Total Deficit Reduction		-16	-29	-41	-56	-73	-90	-108	-127	-146	-168	-190
Remaining deficit		181	184	155	141	121	103	82	62	45	22	0
			5-year non-interest cut			-190		10-year non-interest cut			-676	
Deficit Target		179	161	143	125	107	89	72	54	36	18	0

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Balance 2007

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190	190	190
Savings													
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79	-88	-97
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23	-24	-25
Other--Entitlements		0	0	0	0	0	0	0	0	0	0	0	-4
Other--Discretionary		0	0	0	0	0	0	0	0	0	0	0	-4
Total noninterest cuts		-13	-23	-31	-41	-52	-62	-72	-82	-92	-102	-112	-130
Net interest		-0	-2	-3	-6	-9	-13	-19	-25	-32	-40	-49	-60
Total Deficit Reduction		-13	-25	-34	-47	-61	-75	-91	-107	-124	-142	-161	-190
Remaining deficit		183	188	162	150	133	118	99	83	67	48	29	0
			5-year non-interest cut			-160		10-year non-interest cut			-570		
Deficit Target		180	164	148	131	115	98	82	66	49	33	16	0

Balance 2008

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190	190	190	190
Savings														
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79	-88	-97	-106
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23	-24	-25	-26
Other--Entitlements		0	0	0	0	0	0	0	0	0	0	1	3	7
Other--Discretionary		0	0	0	0	0	0	0	0	0	0	1	3	7
Total noninterest cuts		-13	-23	-31	-41	-52	-62	-72	-82	-92	-102	-110	-115	-119
Net interest		-0	-2	-3	-6	-9	-13	-19	-25	-32	-40	-49	-60	-71
Total Deficit Reduction		-13	-25	-34	-47	-61	-75	-91	-107	-124	-142	-160	-175	-190
Remaining deficit		183	188	162	150	133	118	99	83	67	48	30	15	0
			5-year non-interest cut			-160		10-year non-interest cut			-570			
Deficit Target		182	166	151	136	121	106	91	76	61	45	30	15	0

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Balance 2009

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190	190	190	190	190
Savings															
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79	-88	-97	-106	-115
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23	-24	-25	-26	-27
Other--Entitlements		0	0	0	0	0	0	0	1	2	4	6	9	12	16
Other--Discretionary		0	0	0	0	0	0	0	1	2	4	6	9	12	16
Total noninterest cuts		-13	-23	-31	-41	-52	-62	-72	-81	-89	-94	-100	-104	-108	-110
Net interest		-0	-2	-3	-6	-9	-13	-19	-25	-32	-39	-48	-58	-68	-80
Total Deficit Reduction		-13	-25	-34	-47	-61	-75	-91	-105	-120	-134	-148	-162	-176	-190
Remaining deficit		183	188	162	150	133	118	99	84	70	56	42	28	14	0
				5-year non-interest cut		-160			10-year non-interest cut		-557				
Deficit Target		183	169	155	141	126	112	98	84	70	56	42	28	14	0

Balance 2010

Administration Policy Deficits and alternative paths to balance--$100 billion over 5 years in Health spending cuts

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Admin Policy Deficit	193	197	213	196	197	194	193	190	190	191	190	190	190	190	190	190
Savings																
Health Care		-8	-13	-19	-26	-34	-43	-52	-61	-70	-79	-88	-97	-106	-115	-124
"Recission"		-5	-10	-12	-15	-18	-19	-20	-21	-22	-23	-24	-25	-26	-27	-28
Other--Entitlements		0	0	0	0	0	0	3	4	5	8	10	13	16	20	24
Other--Discretionary		0	0	0	0	0	0	3	4	5	8	10	13	16	20	24
Total noninterest cuts		-13	-23	-31	-41	-52	-62	-66	-74	-81	-86	-92	-96	-99	-102	-104
Net interest		-0	-2	-3	-6	-9	-13	-18	-24	-31	-38	-46	-55	-65	-75	-86
Total Deficit Reduction		-13	-25	-34	-47	-61	-75	-85	-98	-112	-124	-138	-151	-164	-177	-190
Remaining deficit		183	188	162	150	133	118	105	92	79	66	52	39	26	13	-0
				5-year non-interest cut		-160			10-year non-interest cut		-529					
Deficit Target		184	170	157	144	131	118	105	92	79	66	52	39	26	13	0

TREASURY CLEARANCE SHEET

NO. ____________
Date 4/25/95

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM: Alicia Munnell
THROUGH: ____________
SUBJECT: Budget Simulations

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
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- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ____________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Alicia H. Munnell	AHM	4/26/95	Economic Policy	622-2200
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer ____________ Date ____________

☐ Executive Secretary ____________ Date ____________

DEPARTMENT OF THE TREASURY
WASHINGTON

INFORMATION

95-147324

ASSISTANT SECRETARY

June 19, 1995

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell AHM
Assistant Secretary for Economic Policy

SUBJECT: Assumptions Underlying the President's Balanced Budget Initiative

Summary

This memo is to make sure that you are aware that the baseline budget projections underlying the President's budget proposals were based on the economic assumptions used to prepare the FY-1996 budget. The economic assumptions to underlie the forthcoming Mid-Session Review are fairly similar, but differ by enough to more than wipe out the $18 billion surplus projected in the President's proposal for the year 2005. The difference largely relates to (1) the wider wedge in the Mid-Session assumptions between rates of growth of the CPI and the GDP deflator and (2) lower income shares as a percent of GDP.

Discussion

Preparations for the Mid-Session Review of the Budget are still in process. Economic assumptions were only transmitted to the agencies early last week, and it is far too soon to have even preliminary budget projections consistent with those assumptions. Because more up-to-date figures were unavailable, the President's budget initiative released last week was based on the budget projections and economic assumptions associated with the FY-1996 budget released in February.

- Note that budget projections and economic assumptions for the out years (2001 through 2005) were never published. In fact, a proposed chapter on long-term budget projections was killed from the budget because of uneasiness in regard to the underlying economic assumptions, specifically the narrow 0.1 percentage point wedge between rates of growth of the CPI and the GDP deflator.

In the Mid-Session economic assumptions, that wedge was widened to 0.2 percentage point by reducing the rate of growth of the GDP deflator by 0.1 percentage point for the years beginning in 1997. Along with a markdown of inflation in 1995, the result was a level of nominal GDP for the year 2005 that was lower by about $140 billion. Nominal GDP provides the base from which taxable incomes are calculated. In addition, there were some revisions to income shares which reduced the taxable income base even more. Finally, short-term interest rates for the years 2001 and beyond were raised slightly.

- As a net result, the Mid-Session baseline should contain larger deficits than the January baseline, particularly for the out years. Based on the economic assumptions alone, we should not be surprised to see a swing for the year 2005 from a surplus of $18 billion, assuming implementation of the President's proposals, to a deficit at least as large or even larger.

- It is far too early to have any feel for the size or even direction of any technical adjustments that agencies may make to budget projections.

TREASURY CLEARANCE SHEET

NO. ____________
Date ____________

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM: Alicia Munnell, Assistant Secretary, Economic Policy
THROUGH: ____________
SUBJECT: Assumptions Underlying the President's Balanced Budget Initiative

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
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  - ☐ International Affairs
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- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ____________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
James Russel	JMR	6/19	Economic Policy	2-1681
John Kitchen	JK	6/19	Economic Policy	2-1757
REVIEWERS				
John Auten	ja	6/19	Economic Policy	2-2070

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☐ Executive Secretary ____________ Date ____________

DO F 80-02.1 (04/89)

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MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Assistant Secretary Shafer
THROUGH: ______
SUBJECT: Letter to Greenberg on Financial Services Negotiations

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
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☐ Fiscal
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☐ Public Debt

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☐ Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
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IMMantel			OASIA/ITN	20010
REVIEWERS				
EKnight	LShafer	6/9	G	20205
MSmith			PA	22930

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☐ Executive Secretary ______ Date ______

1996-SE-002171

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 29, 1996

~~INFORMATION~~

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: LESLIE B. SAMUELS GNT lo-485
ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Memorandum to President Clinton on Capital Gains Proposals in FY 1997 Budget

Attached is a memorandum to President Clinton explaining the capital gains proposals in the Administration's FY 1997 Budget. Laura Tyson requested this memorandum at the time of the budget rollout (March 19).

If you approve the memorandum, we should send it to Laura Tyson, who will transmit it to the President.

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 29, 1996

MEMORANDUM FOR PRESIDENT CLINTON

FROM: LESLIE B. SAMUELS ~~~~for LBS
ASSISTANT SECRETARY (TAX POLICY)

THROUGH: SECRETARY RUBIN

SUBJECT: FY 1997 Budget Loophole Closers

This memorandum discusses proposed tax loophole closers that may affect individuals. As you recall, the Administration's December 7, 1995, budget offer included proposals to raise about $28 billion from reducing "corporate" subsidies and closing loopholes. The proposals in that package receiving the most public comment involved eliminating "tax arbitrage" benefits in certain innovative financial products and other financial transactions.

Later in December, as part of the on-going budget negotiations, additional revenues were needed. In meeting that requirement, additional revenue raisers of about $11 billion were selected, including two proposals to eliminate loopholes that permit sophisticated investors (both corporations and individuals) to defer or eliminate gain on asset sales. These two proposals (which were first made public by the Administration on March 19, 1996) are described briefly below.

I. <u>Closing investment-oriented loopholes</u>

The two proposals taken together end taxpayers' ability to defer (and sometimes eliminate) the payment of capital gains tax on the sale of appreciated securities through superficial techniques that do not in any way alter the economics of the sale. Treasury estimates that these provisions would raise $4.5 billion over seven years.

A. Eliminate "short against the box" sales and similar strategies

Investors who hold stock that has appreciated may reach a point where they want to sell the stock but don't want to pay tax on the gain. If, instead of selling the stock directly, the investor "borrows" identical shares from his broker and sells the borrowed shares while retaining his own shares, he is not subject to tax because he hasn't transferred his own stock. He is, however, obligated to pay back the "borrowed" shares at some point in the future. Until he actually transfers his own shares, however, he doesn't have to pay tax on his gain. These "short sales" can be used by sophisticated investors to defer the gain on the stock for a long time. If the investor is an individual, he avoids the gains tax completely at death because his heirs are deemed to have acquired the stock at its current market value. (See attached article describing a recent high profile example of this loophole.)

The FY 1997 Budget would prevent investors (both corporations and individuals) from locking in gains in this manner, or in any comparable manner. This "short against the box" proposal was included in Senator Daschle's January 1996 budget and has been supported by the New York State Bar Association.

B. Require average-cost basis for identical securities

The FY 1997 Budget would also close a loophole used by some investors who buy and sell the shares of a company over time. (Investors who buy or sell all of their stock at once are not affected.) Currently, well-advised investors can designate that their higher-cost shares have been sold, thereby minimizing the gain they must report for tax purposes. By contrast, poorly advised investors, who do not designate which shares they sold, can be deemed to sell their low-cost shares first. The proposal (which was reported in the New York Times) would require investors selling only part of their stock to average their cost of the shares over all of their shares. The proposal thus ends the trap for the uninformed and equalizes treatment of all investors by requiring averaging.

This proposal reflects economic reality. The cost of fungible property (such as stock in the same corporation) should be averaged since it is impossible to distinguish economically between different pieces of that investment. (A large volume of securities are now held in "street name" by brokers who simply maintain pools of these identical securities. In fact, $10 trillion of securities are held at Depositary Trust Company of New York. as custodians for securities brokers) In addition, some mutual funds currently report average cost basis for transactions for accounts opened in recent years. Taxpayers then have the option to use this information in calculating their capital gains from sales of shares in the fund. Accordingly, the proposal treats all investors in the same manner as many existing holders of mutual funds. Finally, since we announced this proposal, a national accounting firm informed us that only about 10 percent of its clients use this loophole.

II. Tax compliance measures and other loophole closers from the Republicans' Balanced Budget Act

In mid-January1996, the revenue-raising target in our budget negotiations was raised from about $39 billion to $46 billion. Thus, additional revenue raisers were required. To fill this need, a handful of tax compliance measures and loophole closers that were contained in the Republicans' Balanced Budget Act were included in the budget. For example, the package included the provision that requires insurance companies to report to the IRS damage award payments that they make to attorneys. While some of these measures predominantly affect individuals, they were not controversial. Those proposals that affect individuals the most are described briefly in Attachment A. Treasury estimates that these provisions would raise less than $300 million over seven years.

Attachment

ATTACHMENT A

Summary of Balanced Budget Act Compliance Measures Affecting Individuals That Are Included in the '97 Budget

- **Require tax information reporting of payments to attorneys**

  Currently, while a person engaged in a trade or business generally is required to report to the IRS that it has made types of payments to particular taxpayers, there is no requirement to report payments made to an attorney if either the recipient law firm is a corporation or the payment is a lump sum and the payor cannot determine the portion of the payment that is the attorney's fee. There is a perception that some attorneys are not properly including their share of these payments in their income. To address this concern, the '97 Budget would require these payments to be reported to the IRS. If the insurance company or other payor cannot determine the portion of the payment that is the attorney's fee, the gross amount would be reported.

- **Apply failure-to-pay penalty to "substitute" returns**

  If a taxpayer files a return but does not pay the tax due on the return, a penalty equal to a percentage of the tax due generally runs from the due date of the return until the tax is paid. If, however, a taxpayer fails to file a return, so the Commissioner prepares a "substitute" return for the taxpayer, then the penalty begins to run only after the IRS notifies the taxpayer and demands payment of the tax. There is no reason to treat a taxpayer for whom the Commissioner prepares a substitute return any better for purposes of this penalty than taxpayers who pay late but who at least filed their returns. Therefore, the '97 Budget would require that this penalty apply to equally to "substitute" returns; i.e., that it commences running from the due date of the return.

- **Extend withholding on certain gambling winnings**

  Currently, the proceeds of most wagers with odds of less than 300 to 1 are exempt from withholding, as are all bingo, keno, and slot machine winnings. The principal objection to withholding on relatively small or scattered gambling winnings is the difficulty of administering a withholding system. The '97 Budget would require withholding at 28 percent (the same rate as other major gambling winnings) on proceeds of bingo or keno, regardless of the odds of the wager, but only on amounts in excess of $5,000. We continue to exempt slot machine winnings because of the difficulty of administration. This provision thus will improve compliance and enforcement in this area without imposing any undue recordkeeping burdens.

- **Extend requirement, on gains in excess of $100,000, that involuntarily converted property be replaced with property acquired from an unrelated person**

Currently, taxpayers generally can defer gain on destroyed property if the proceeds from the destruction (for example, insurance proceeds or damages) are used to purchase similar replacement property. However, corporations generally are not entitled to defer this gain if the replacement property is purchased from a related person. The concerns regarding the acquisition of replacement property from a related party generally apply to non-corporate taxpayers as well as to corporate taxpayers. Accordingly, the '97 Budget would extend this rule to other taxpayers, including individuals, that acquire replacement property from a related person, unless the taxpayer has aggregate realized gain of $100,000 or less during the year as a result of involuntary conversions. The $100,000 threshold was included in the proposal to accommodate situations where an individual may not have many options regarding sources of replacement property (e.g., a farmer has a tractor destroyed and the only tractor dealership in the area is owned by a relative).

- **Require gain recognition on sale of a principal residence to the extent of post-1996 depreciable use of the residence**

Currently, an individual does not recognize gain on the sale of a principal residence if the sales price of the old residence is reinvested in a new residence. In addition, a taxpayer 55 years old or older generally may (once in a lifetime) exclude from income up to $125,000 of gain from the sale of a principal residence. While these deferral and exclusion rules do not apply to the extent that the residence is used for a business purpose (for example, a home office), and thus depreciation deductions claimed, at the time it is sold, this exception does not capture previous depreciation deductions claimed if the residence is no longer used for that purpose at the time of the sale. This has led to gaming, where individuals claim to terminate the depreciable use of the residence shortly before selling it. To prevent this gaming potential, the '97 Budget would require gain to be recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to the residence after December 31, 1996.

DEALS

Passing the Smell Test?

Here's how the first family of fragrance put on a holiday-season tax-loophole clinic

BY ALLAN SLOAN

THIS MUST HAVE BEEN ONE OF the sweetest-smelling Thanksgivings ever for the Lauder family, the folks who control the Estée Lauder fragrance, skin-care and makeup empire. Most of us consider Thanksgiving a success if we get to sink our teeth into an enormous meal or two. But the Lauders got to chow down on something rather more substantial: some $125 million of tax savings created by the clever way they sold a piece of their own business to the investing public.

The company's two biggest-selling shareholders—Estée Lauder and her son Ronald—will likely never pay capital-gains taxes on the combined $340 million they recently pocketed selling stock in Estée Lauder Cos. The third largest seller, Ron's brother, Leonard, did his own maneuvering to defer taking a gain on his $25 million sale until next year—that's when the federal capital-gains rate is expected to be much lower than it is now. By my math, clan matriarch Estée saves $49 million in federal, state and local income taxes, son Ron saves $74 million and son Leonard saves a couple of mill. That will pay for a lot of turkey. Or a lot of tax lawyers. Sure, public investors did well on the Nov. 17 offering, with the stock currently up around 30 percent from the $26 offering price. But the Lauders made out better than anyone. They not only got a sweet tax deal, they still own 100 million of the company's 115 million shares.

The tax-saving numbers, by the way, are my own estimates. No one from Lauderland would talk about the family's tax games, and my normal tax mavens don't want to offend the Lauders or their multitudes of lawyers and investment bankers. So this article is based on my reading of the company's filings at the Securities and Exchange Commission, some Tax Court cases involving the Lauders and a Nov. 8 Wall Street Journal story about them. I'm assuming the Lauders' cost of stock for tax purposes is zero, and that they're in the top federal, New York state and New York City income-tax brackets.

Now that we've established the foundation, on to the tax clinic. Ron and Estée atomized their tax bills with a move that I've never seen in an initial public offering before. Instead of selling their own stock, Estée and Ron Lauder borrowed stock

You'd be happy, too, with his sweet tax bill: *Leonard Lauder with company model Elizabeth Hurley*

from other family members and sold the borrowed shares. As security, they pledged to the lenders the same number of shares they borrowed. Why go through this? Taxes. Selling shares that you own produces a capital gain. Selling shares that you borrow doesn't produce a gain or loss until you close out the transaction by replacing the borrowed shares. Ron and Estée probably won't replace the shares for years, and probably plan to take advantage of the ultimate federal gains loophole—death—to duck capital-gains taxes forever.

Let's look at Estée's deal, which is part of the tax-avoidance games the Lauders have been playing almost since Estée and her late husband, Joseph, founded the company in 1946. Something called the EL 1994 Trust borrowed 5.5 million shares from Leonard Lauder and sold them to the public, netting $24.57 a share after expenses. If Estée had sold 5.5 million of her own shares, it would have generated $135 million in taxable income. Selling borrowed stock generated no taxable income. If Estée—said to be at least 87—dies with the stock at, say, $35, she gets to use the death loophole. Her cost of the shares for tax purposes now is zero, as we said. If she dies with the stock selling at $35, the shares' cost for tax purposes becomes $35. So her estate could turn over 5.5 million shares to Leonard, and generate a tax loss of $57 million—the difference between $35 and the $24.57 Estée pocketed on the Nov. 17 sale. Pretty slick.

Death loophole: Ron's deal is pretty sweet, too. He borrowed 8.33 million shares from family members and sold the borrowed stock, netting some $205 million. As long as the lenders don't get antsy, Ron never has to repay the borrowed shares, as best as I can tell. So he never has to pay tax on the $205 million. Assuming the tax laws don't change, Ron, 51, can play the death-loophole game, too, and wait until he dies to close out the sale. His estate would get a deduction equal to the stock's price the day he dies, less the $24.57 he pocketed.

Not to be outdone, Leonard also saved a few bucks. He didn't play the borrow-and-sell game, for reasons that aren't clear. Leonard, no powder puff, settled for deferring his profit until next year, when federal capital-gains rates are expected to be lower than the current 28 percent. He did this by swapping 1.04 million shares for a promissory note that comes due next March. You can't defer gains by selling stock in a public company through a so-called installment sale like this one. So Leonard sold just before the offering, when the company was still private. As you see, the real road to riches isn't owning Estée Lauder stock—it's hiring the family's tax advisers.

All these transactions have been lawyered to the nth degree, and are doubtless legal. But when you look at the big picture, such as your obligation to pay some taxes because of your duty as a citizen, you have to wonder whether the Lauders are engaging in overkill. Think of tax avoidance as spraying an Estée Lauder fragrance on yourself. A few dabs can be really attractive, but putting on a bucketful makes you smell to high heaven.

SLOAN is NEWSWEEK'S *Wall Street editor. His e-mail address is sloan@panix.com.*

TREASURY CLEARANCE SHEET

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Date 3/29/96

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☐ ACTION ☐ BRIEFING ☒ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM: Leslie B. Samuels
THROUGH: ____________
SUBJECT: Memorandum to President Clinton on Capital Gains Proposals in FY 1997 Budget

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
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☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

1996-SE-003021

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 26, 1996

MEMORANDUM FOR SECRETARY RUBIN

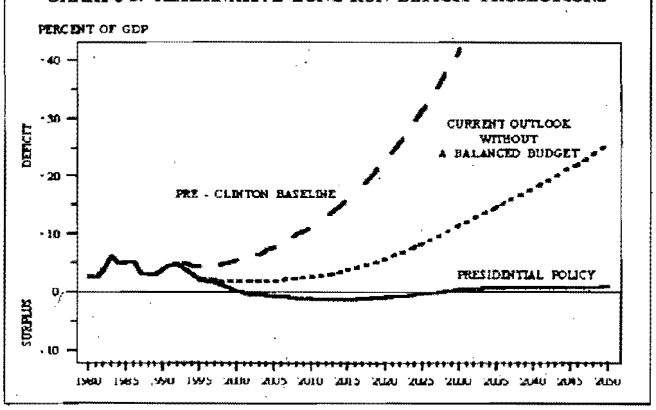
From: Alan Cohen
Senior Advisor to the Secretary

Joshua Gotbaum
Assistant Secretary for Economic Policy

Re: **Long-Range Deficit Projections in FY97 Budget**

As Alan noted at Senior staff meeting last week, the President's 1997 budget included a set of long-term projections. If the President's balanced budget plan were adopted—*and if key assumptions in the analysis held up*—the deficit would remain under control through 2050.

CHART 2-2. ALTERNATIVE LONG-RUN DEFICIT PROJECTIONS



As you would expect, the assumptions are critical. Especially important are the assumed continuation of the Medicaid per-capita cap on a permanent basis and the use of reduced Medicare growth rates that the actuaries assume after 2006. OMB also assumed that discretionary spending will be held constant in real terms (even though population increases).

The attached memo describes the analysis and major assumptions. We have also attached the excerpt from the Budget itself. Let us know if you have any questions.

CBO plans to analyze this issue in their May report. We will send you a summary when it is available.

c: Larry Summers

Prepared with Glen Rosselli and John Kitchen, EP

lngtrm-r

Background and Analysis:

The presentation of long-range budget projections in the Analytical Perspectives volume of the FY-1997 President's Budget is a continuation of the effort in recent years to focus on the long-run imbalance in the Federal budget if no change is made in current policies. Fundamentally, the problem is that demographic changes will lead to more older beneficiaries of key entitlement programs (Social Security, Medicare, Medicaid) relative to the number of younger working taxpayers.

- Two years ago, the Bipartisan Commission on Entitlement and Tax Reform (the Kerrey Commission) examined the long-run imbalances in detail; the Commission's projections showed the baseline deficit reaching 18 percent of GDP in 2030.

- The projections by OMB in the FY 1997 President's budget show the deficit rising under the current outlook (i.e., **without** adoption of our balanced budget proposals) to 12 percent of GDP in 2030 and 26 percent of GDP in 2050.

If, however, the President's FY 1997 budget proposals are enacted, the effect on long-run deficits would be dramatic improvement:

- **The budget stays in surplus from 2002 to sometime in the decade of 2020.**

- **After that point, the budget goes into deficit but only by a small amount as a percent of GDP. By 2050, the budget deficit has risen to only 1 percent of GDP, below where it is today.**

Clearly, the results of the analysis are dependent upon assumptions made for key parameters. Of particular importance are the assumptions for the long-range growth rates for Medicare and Medicaid if the President's balanced budget plan were enacted.

The President proposed a permanent per-capita cap for Medicaid which limits per-capita growth in every year to an average of 3.3% over the period from 2006-2050. This is 2-3 percentage points below baseline growth over this period. The Republicans propose even deeper reductions. OMB assumed the President's proposal for its long-run projections. This is a key assumption in the analysis.

For Medicare, OMB assumed that the **level** of spending in 2002 would be lower because of the President's proposals, but that after 2002, the **spending growth rates** would return to those used by the Medicare actuaries. However, the actuaries had assumed that current per-capita growth rates in Medicare were not sustainable over the long-term and that these growth rates would somehow be reduced in later years. This could occur through policy changes or through some type of cost containment affecting the entire health-care sector.

Medicare Part B premiums are not an issue; OMB assumed the President's policy of setting premiums equal to 25% of Part B costs. For spending for Part A and B of

Medicare combined (but not including premium increases), the actuaries assume per-capita growth rates are 4.0-4.5 percent after 2015, whereas they assume they are about 2.5 to 3.0 percentage points higher between 2000 and 2002. Some portion of this drop could be made to occur by extending the President's proposals beyond 2002, but to determine exactly how much would require more analysis. The remainder could come from enactment of some new proposals or the occurrence of new health-care sector developments that would bring down Medicare growth rates as well.

The other key assumptions made by OMB are as follows:

- The economic assumptions underlying the President's balanced budget plan are extended after 2002.
- Productivity increases at about 1.2% per year on a chain-weighted basis.
- Discretionary spending is held constant in real terms in every year, even though population is increasing.
- The demographic assumptions are the same as the intermediate assumptions used by the Social Security Trustees.

The chapter contains graphs that show what would happen if each of these assumptions were made more optimistic or more pessimistic. Not surprisingly, the projected deficit is very sensitive to changes in assumptions.

Last week, CBO director June O'Neill also presented projections, which are very sensitive to the assumptions used:

- Under one set of assumptions, if no balanced budget plan is adopted, the deficit rises to 10 percent of GDP in 2025 and 20 percent of GDP in 2050.
- If discretionary spending is allowed to rise with the rate of growth of GDP rather than just inflation, the deficit reaches 12 percent of GDP in 2025 and 25 percent of GDP in 2050.
- Changes in other assumptions can alter the results very significantly.

CBO will provide long-range estimates which assume enactment of the President's proposals in its annual report which is to be issued next month.

THE BALANCE OF RESOURCES AND RESPONSIBILITIES

The data summarized in Table 2–1 are useful in showing the consequences of past Government policies, but Government's continuing commitments to provide public services are not reflected there, nor can the Government's broader resources be displayed in a table limited only to the assets that it owns. A better way to examine the balance between future Government obligations and resources is by projecting the overall budget. The budget offers the most comprehensive measure of the Government's financial burdens and its resources. By projecting total receipts and outlays, it is possible to examine whether there will be sufficient resources to support all of the Government's ongoing obligations.

The Federal Government's responsibilities extend well beyond the five-year window (or the expanded seven-year window) that has been the focus of recent budget analysis and debate. There is no time limit on Government's constitutional responsibilities, and programs like social security are clearly expected to continue indefinitely.

This part of the presentation shows some alternative long-run projections of the Federal budget that extend through the year 2050. Forecasting the economy and the budget over such a long period is highly uncertain. Future budget outcomes depend on a host of unknowns—constantly changing economic conditions, unforeseen international developments, unexpected demographic shifts, the unpredictable forces of technological advance, and unknown future political preferences. Those uncertainties increase the further projections are pushed into the future. Even so, long-run budget projections are needed to assess the full implications of current action or inaction.

It is evident even now that there will be mounting challenges to the budget after the turn of the century. The huge baby-boom generation born in the years after World War II is aging and will begin to retire in little more than a decade. By 2008, the first baby-boomers will become eligible for social security. In the years that follow there will be serious strains on the budget because of increased expenditures for both social security and Medicare. Long-range projections can offer a sense of the seriousness of these strains and what may be needed to withstand them.

The Long-Range Outlook for the Budget.—Since the Administration took office there have been major changes in the long-run budget outlook. In January 1993, the deficit was clearly on an unsustainable trajectory. Had current policies continued unchanged the deficit would have steadily mounted not only in dollar terms, but relative to the size of the economy.[4] The Omnibus Budget Reconciliation Act of 1993 (OBRA) changed that. Not only did it produce a decline in the near-term deficit, but it also brought down the long-term budget deficit as well. The policies in OBRA were sufficient to maintain the deficit as a stable share of GDP into the next century. This was a marked improvement over the long-term outlook that the Administration inherited.

Despite this improvement, the long-run picture for the budget has remained threatening. A GAO study released in 1992 concluded that, "the economic and political reality is that the nation cannot continue on the current path" of increasing long-run deficits. More recently, the 1994 report of the Bipartisan Commission on Entitlement and Tax Reform found that there exists a "long-term imbalance between the Government's entitlement promises and the funds it will have available to pay for them." On a narrower front, the annual trustees' reports for both the social security and Medicare trust funds project a long-run actuarial deficiency for these programs, and have for some time.

Economic and Demographic Projections.—Long-run budget projections must be based on a long-run demographic and economic forecast. Otherwise, it is impossible to estimate either future resources or the potential claims on them. The forecast used here is an extension of the Administration's economic projections described in the first chapter of this volume. Inflation, unemployment and interest rates are assumed to hold stable at their values in the year 2006. The real rate of economic growth is determined by the expected growth of the labor force and labor productivity. Productivity is assumed to continue rising at the same rate as in the Administration's medium-term projections, approximately 1.2 percent per year.[5]

Population growth is expected to slow over the next several decades. This is consistent with recent trends in the birth rate and an expected decline in the proportion of women in their childbearing years. The slowdown is expected to lower the rate of population growth from over 1 percent per year to about half that rate by the year 2020.[6] Labor force participation is also expected to decline as the population ages. Together these trends imply a slowdown in real economic growth beginning around the year 2005. The rate of real GDP growth slows to less than 1.5 percent per year after 2020 because of these trends.

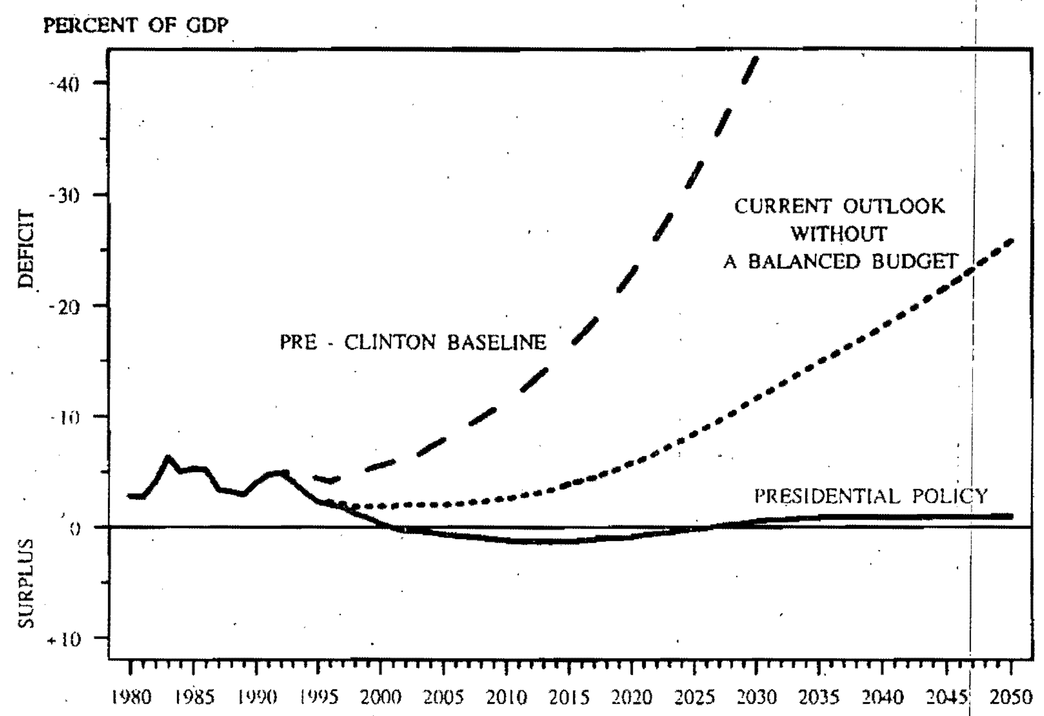
The Deficit Outlook.—Chart 2–2 shows three alternative deficit projections: a projection based on the policies in place prior to enactment of OBRA, the current outlook before incorporating the President's proposals to balance the budget, and a projection that shows the long-run outlook assuming those proposals are adopted.

[4] Over very long periods when the rate of inflation is positive, comparisons of dollar values are meaningless. Even the low rate of inflation assumed in this budget will reduce the value of a 1995 dollar by over 60 percent by 2030, and by almost 80 percent by the year 2050. For long-run comparisons, it is much more useful to examine the ratio of the deficit and other budget categories to the overall size of the economy as measured by GDP.

[5] This projection is stated in terms of the new chain-weighted measures for GDP introduced by the Bureau of Economic Analysis in January. On the unrevised basis, the projected growth rate is about one-half percentage point higher.

[6] The population growth assumptions in these projections are based on the intermediate assumptions in the 1995 social security trustees' report for the period after 2006.

CHART 2-2. ALTERNATIVE LONG-RUN DEFICIT PROJECTIONS



The chart clearly illustrates the dramatic improvement in the deficit that has already been achieved and shows that more is possible, not only in the short run but also in the long run. If the budget were balanced by 2002, the task of achieving fiscal stability when the demographic bulge hits after 2005 would be substantially reduced.

Along the pre-OBRA baseline, the deficit reaches over 40 percent of GDP by the year 2030. OBRA reduced the deficit by extending the caps on discretionary outlays; reforming Medicare; changing the rules for other entitlement programs; and raising tax rates on upper-income taxpayers, among other measures. A strengthening of the economic outlook also improved the deficit projection following the enactment of OBRA. In the current context, it is notable that OBRA lowered the deficit in the long term as well as in the short term. This would require that the discretionary savings achieved in 1994–1998 be preserved by holding the level of real discretionary spending constant thereafter. A return to the prior spending trajectory would partially undo these savings. Similarly, the savings in Medicare and other entitlements would need to be preserved.

Despite the improvement in the outlook after the passage of OBRA, serious long-run problems remain. Beginning around the year 2010 and continuing throughout the next several decades, the deficit would rise, eventually reaching unsustainable levels. The initial increase is caused by the expected retirement of the baby-boom generation that puts new strains on social security and Medicare. By 2030, the deficit reaches 12 percent of GDP, and by 2050, it is 26 percent. Table 2–2 shows alternative long-range budget projections for the major spending categories. The table shows that the entitlement programs are the major driving force behind the rise in the deficit in the long run.

Social security benefits, driven by the retirement of the baby-boom generation, rise from around 5 percent of GDP in 2000 to over 7 percent in 2030. The rise in Federal health care is even greater. Without the President's policies, Medicare and Medicaid together would reach 4 percent of GDP in 2000 and then continue to rise to 11 percent by the year 2030. As entitlement spending rises, if no corrective action is taken, the deficit grows rapidly. Initially, the programmatic spending is responsible for the increase, but as time passes a vicious spiral takes hold in which more bor-

Table 2–2. ALTERNATIVE BUDGET PROJECTIONS

(Percent of GDP)

	1995	2000	2005	2010	2020	2030	2040	2050
Current outlook without a balanced budget:								
Receipts	19.3	19.3	19.2	19.2	19.2	19.4	19.4	19.5
Outlays	21.7	21.3	21.2	21.8	25.0	30.9	37.4	45.3
Discretionary	7.8	6.5	5.8	5.3	4.5	4.0	3.4	3.0
Mandatory	10.6	11.7	12.4	13.4	16.4	19.7	21.5	22.5
Social security	4.8	4.7	4.7	4.8	6.0	7.1	7.6	8.0
Medicare and Medicaid	3.5	4.3	5.2	6.2	8.3	10.7	12.3	13.0
Net interest	3.3	3.1	3.0	3.1	4.1	7.3	12.5	19.8
Deficit	–2.3	–1.9	–2.0	–2.6	–5.8	–11.6	–18.0	–25.8
Federal debt held by public	51.4	50.8	49.5	50.5	68.4	121.0	207.8	327.0
Presidential policy (balanced budget):								
Receipts	19.3	19.4	19.4	19.3	19.4	19.5	19.5	19.6
Outlays	21.7	19.7	18.7	18.1	18.5	20.0	20.5	20.6
Discretionary	7.8	6.0	5.4	4.9	4.2	3.7	3.2	2.8
Mandatory	10.6	11.1	11.4	12.0	14.0	16.1	16.8	17.1
Social security	4.8	4.7	4.7	4.8	6.0	7.1	7.6	8.0
Medicare and Medicaid	3.5	3.9	4.3	4.9	6.0	7.2	7.7	7.7
Net interest	3.3	2.6	1.9	1.2	0.3	0.2	0.4	0.7
Deficit	–2.3	–0.3	0.7	1.2	0.9	–0.5	–0.9	–1.0
Federal debt held by public	51.4	47.0	35.6	24.1	6.5	3.7	9.5	14.2

rowing leads to higher Federal interest payments on the growing debt, which is financed in turn by yet more borrowing. The spiral is unstable in that if it continued unchecked it would eventually drive the debt and the deficit to infinity. Long before that point, a financial crisis would surely be triggered that would force some type of action on the Federal Government—action that was certain to be drastic and painful.

The long-run deficit outlook would be much improved if the President's budget proposals were enacted. Balancing the budget would set it on a solid footing for several decades. There is no justification in these projections for the concern sometimes expressed that a balanced budget would be a transitory phenomenon, to be followed quickly by a return of large and growing deficits. Under the Administration's economic and demographic assumptions that would not happen. The additional savings projected for the entitlements and the further reduction in discretionary spending leave the budget in a much improved position compared with the outlook in the absence of these changes. The lower level of Federal debt and interest that result from a balanced budget also help to maintain a budget surplus in these projections in the period beyond 2006.

Even with the improvements caused by a balanced budget, a very long-run deficit problem would remain as a result of the expected strains on social security and the health programs in the period following the retirement of the baby-boom generation. Balancing the budget would enable the Government to run a surplus over the following decades without further major policy initiatives. Eventually, the surplus would dissipate to be followed by a reappearance of the unified budget deficit.[7] By the year 2050, however, the deficit would still be lower, as a percentage of GDP, than it was in 1992. To prevent the reemergence of a deficit, policies would have to be changed to reform social security and check the growth of Medicare and Medicaid.

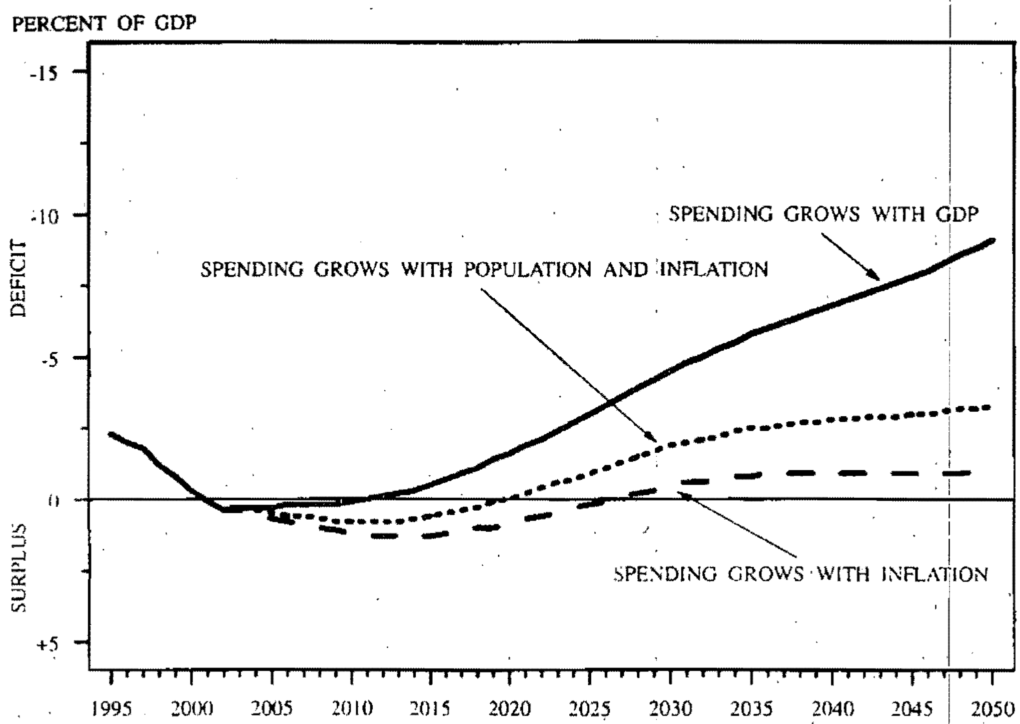
Alternative Scenarios.—Budget projections are uncertain, and long-run projections are especially so. Therefore, it is essential to study how such projections can vary under reasonable variations in assumptions. A number of such alternative scenarios have been developed for these projections. Each alternative focuses on one of the key uncertainties in the outlook. Generally, the scenarios highlight negative possibilities rather than positive ones to show the risks in the outlook.

1. *Discretionary Spending.* The projections assume that discretionary spending is held constant in real terms once budget balance is reached. This is a strong assumption in a long-run context, although it is the usual assumption when current services projections are made, and currently discretionary spending is only half as large as a percent of GDP as it was 30 years ago. What makes it questionable is the fact that with real economic growth occurring and population rising, the public demand for Government services—more national parks, better transportation, additional Federal support for scientific research—might be expected to increase as well. It also assumes that the Nation's real defense needs will not vary from the proposed levels at the end of the current budget period. Alternative assumptions that allow for these programs to grow with population or overall economic activity are shown in Chart 2–3. These alternative assumptions worsen the deficit outlook.

2. *Health Spending:* The most volatile element of recent budgets has been Federal health spending. Expenditures for Medicare and Medicaid have grown faster than other entitlements, and even after the reforms

[7] These projections assume that any surplus is used to reduce the debt. This depends on political choices in future years.

CHART 2-3. DISCRETIONARY SPENDING ALTERNATIVES



in the President's budget, which go a long way toward reining in their growth, they continue to rise more rapidly. In the long-run projections, the growth of real per capita spending for Medicare, following the Medicare trustees' assumptions, is assumed to slow down gradually. Per capita Medicaid spending is constrained by the proposed cap on per capita spending. The beneficiary populations vary with the demographic assumptions. The alternative scenario shows what would happen instead if faster trends in spending for these programs resumed after 2006. Chart 2–4 shows the resulting deficit outlook from such assumptions.

3. *Productivity:* The slowdown in productivity growth in the U.S. economy that began in 1973 is responsible for much of the weaker performance of U.S. income growth since that time. Indeed, over the long run, productivity gains are the principal source of higher incomes, so slower growth of productivity necessarily means a slower rise in living standards. Productivity can be affected by changes in the budget deficit, but many other factors influence it as well. Educational achievement, R&D, energy prices, regulation, changes in business organization, and competition all affect productivity. The alternative scenarios illustrate what would happen to the budget deficit in the long run if productivity growth were higher or lower. A higher rate of growth would make the task of preserving a balanced budget much easier; a lower growth rate would have the opposite effect. Chart 2–5 shows how the deficit varies with changes of one-half percentage point of average productivity growth.

4. *Population:* In the long-run, demographics dominate the projections. Changes in population growth feed into real economic growth through the effect on labor supply and employment. Changes in demographics also affect spending under the entitlement programs. Much of the long-run problem that remains even with a balanced budget is due to expected demographic shifts. Chart 2–6 illustrates how important these are by showing what would happen to the deficit under the alternative demographic assumptions used by the social security trustees in their most recent report.

Conclusion.—OBRA improved the long-run deficit outlook dramatically, but even so the deficit is still projected to increase beginning around the year 2010, and to rise to unacceptable levels by mid-century. The President's current budget proposals would not only balance the budget, but go some distance toward resolving the long-run deficit problem as well. The long-run budget problem is not the result of irresponsible discretionary spending, and while it is necessary to control discretionary spending, and while it is necessary to con-

CHART 2-4. ALTERNATIVE HEALTH SPENDING ASSUMPTIONS

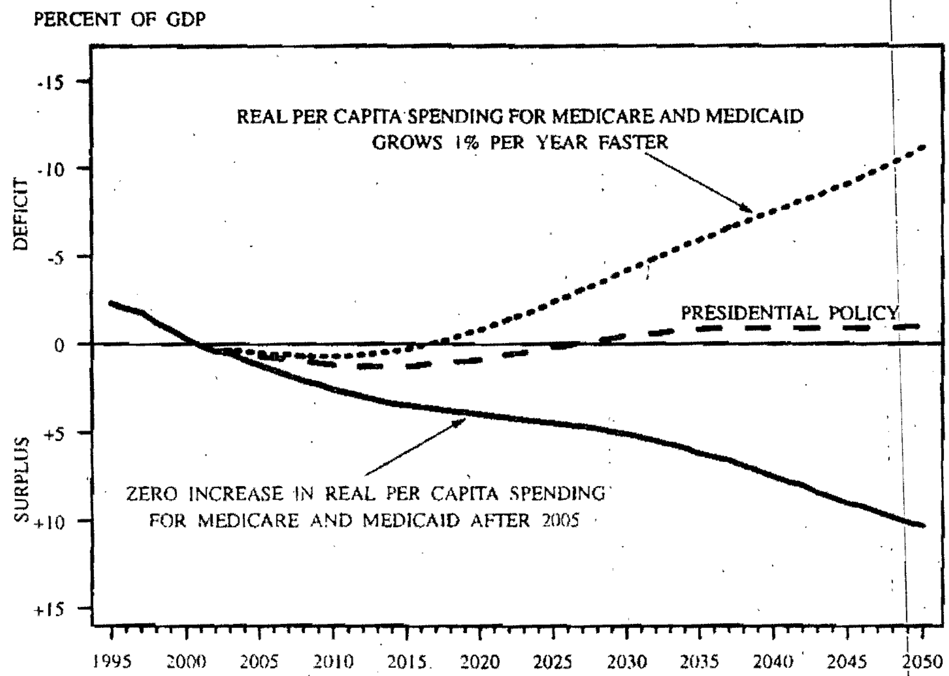


CHART 2-5. ALTERNATIVE PRODUCTIVITY ASSUMPTIONS

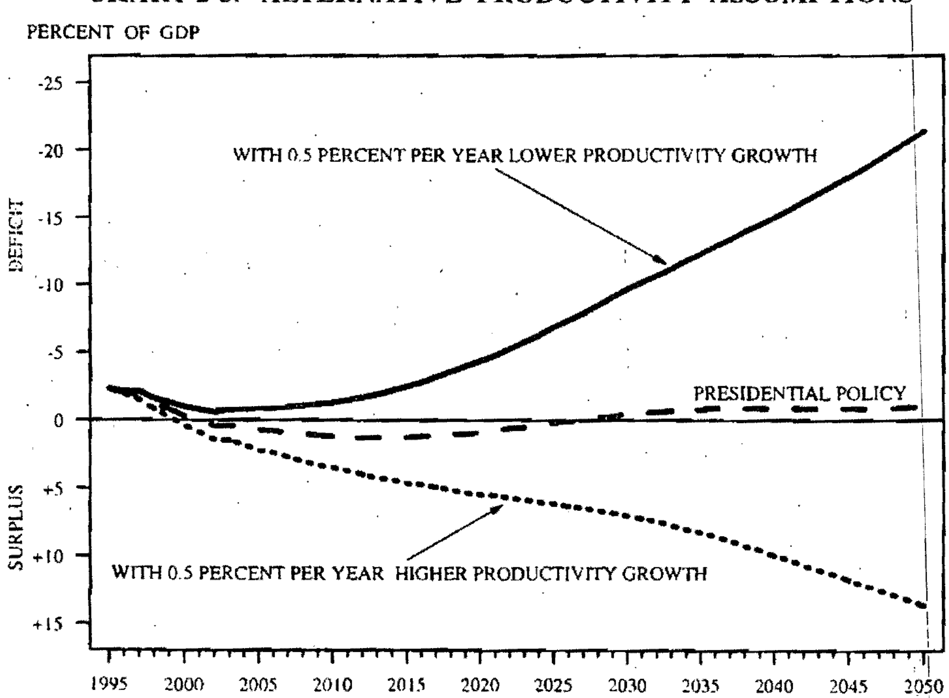
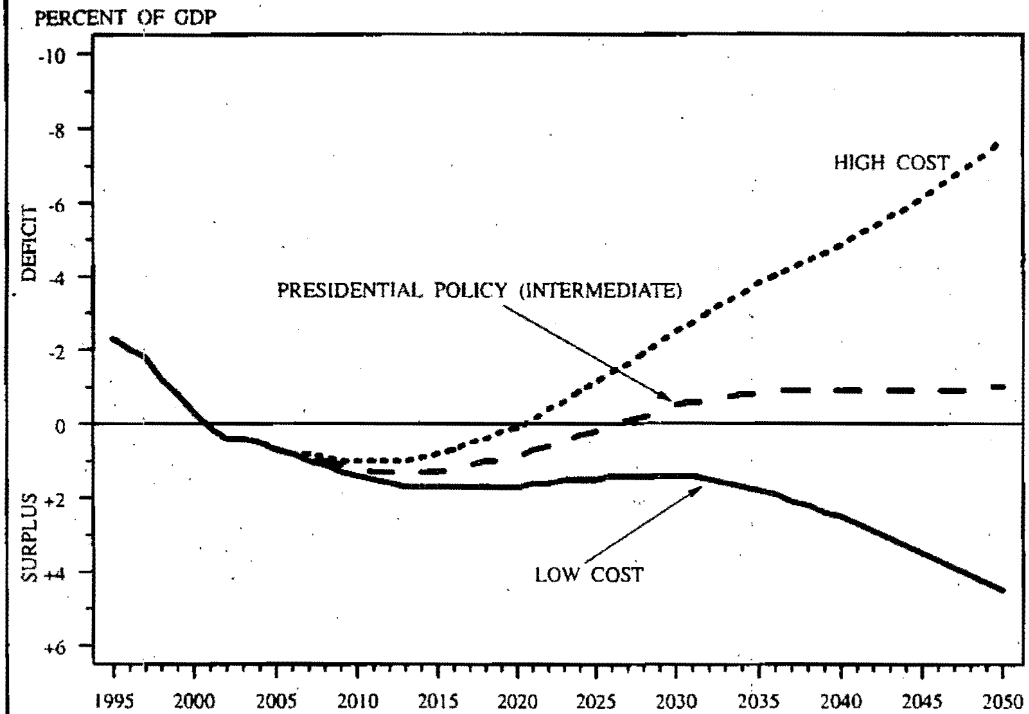


CHART 2-6. ALTERNATIVE DEMOGRAPHIC ASSUMPTIONS



trol discretionary spending, doing this alone will not be enough to solve the long-run problem.

Actuarial Balance in the Social Security and Medicare Trust Funds.—Because of the critical role of the social security and Medicare programs to the long-range budget outlook, it is worthwhile to examine the status of these programs more closely. Table 2–3 shows the changes in the 75-year actuarial balances of the social security and Medicare Trust Funds since 1994. There was only a small change in the consolidated balance for the OASDI Trust Funds which combines the separate funds set up for retirement and disability insurance. Legislation to shift resources from the retirement fund to the disability fund prevented the latter from becoming insolvent. The combined OASDI fund is not projected to become depleted until 2030. In 1995, the trustees for the Hospital Insurance Trust Fund projected that under intermediate assumptions, the HI trust fund would be insolvent in 2002, one year later than projected in 1994. More recent data has shown, however, that outlays exceeded income in 1995, sooner than was expected. In addition, baseline spending for HI has slightly increased from Mid-Session Review baseline estimates, primarily to reflect anticipated growth in home health spending. The trustees are expected to revise the projected exhaustion date for HI later this Spring in their 1996 Report. Because the trustees' analysis considers a wide range of factors, including additional experience in the current fiscal year, new analyses of the factors affecting HI benefit growth during fiscal years 1990–95, updated projections of HI payroll tax income and current interest rate expectations, it is not possible to accurately predict the exhaustion date until the Report is completed. Furthermore, the trustees' estimates do not take account of possible legislative changes, such as those proposed in this budget, that would postpone the date at which the fund is depleted.

TABLE 2–3. CHANGE IN 75-YEAR ACTUARIAL BALANCE FOR OASDI AND HI TRUST FUNDS (INTERMEDIATE ASSUMPTIONS)

(As a percent of taxable payroll)

	OASI	DI	OASDI	HI
Actuarial balance in 1994 report	**–1.46**	**–0.66**	**–2.13**	**–4.14**
Changes in balance due to changes in:				
Valuation period	–0.06	–0.01	–0.07	–0.10
Economic and demographic assumptions	0.13	0.01	0.14	0.01
Disability assumptions	0.00	–0.05	–0.05	0.00
Legislation	–0.40	0.40	0.00	0.00
Methods	–0.06	–0.01	–0.07	0.00
Hospital costs	0.00	0.00	0.00	0.64
Other	0.00	0.00	0.00	0.07
Total changes	–0.40	0.35	–0.05	0.62
Actuarial balance in 1995 report	**–1.87**	**–0.31**	**–2.17**	**–3.52**

NATIONAL WEALTH AND WELFARE

Unlike a private corporation, the Federal Government routinely invests in ways that do not add directly to its own assets. For example, Federal grants are frequently used to fund capital projects by State or local Governments for highways and other purposes. Such investments are valuable to the public which pays for them with taxes, but they are not owned by the Federal Government.

The Federal Government also invests in education and research and development (R&D). These outlays contribute to future productivity and are in that sense analogous to investments in physical capital. Indeed, economists have computed stocks of human and knowledge capital to reflect the accumulation of such investments. Nonetheless, these capital stocks are not owned by the Federal Government, nor would they appear on a business balance sheet.

Table 2–4 presents a national balance sheet. It includes estimates of total national wealth classified in three categories: physical assets, education capital, and R&D capital. The Federal Government has made contributions to each of these categories, and these contributions are also shown in the table. Data in this table are especially uncertain because of the assumptions needed to prepare the estimates. Overall, the Federal contribution to the current level of national wealth is about 7½ percent, which is down from around 8 percent at the end of the 1980s, and from over 12 percent in 1960.

Physical Assets

These include stocks of plant and equipment, office buildings, residential structures, land, and Government's physical assets such as military hardware, office buildings, and highways. Automobiles and consumer appliances are also included in this category. The total amount of such capital is vast, amounting to around $26 trillion in 1995; by comparison, GDP was about $7 trillion.

The Federal Government's contribution to this stock of capital includes its own physical assets plus $0.6 trillion in accumulated grants to State and local governments for capital projects. The Federal Government has financed about one-quarter of the physical capital held by other levels of Government.

Education Capital

Economists have developed the concept of human capital to reflect the notion that individuals and society invest in people as well as in physical assets. Investment in education is a good example of how human capital is accumulated.

For this table, an estimate has been made of the stock of capital represented by the Nation's investment in education. The estimate is based on the cost of replacing the years of schooling embodied in the U.S. population aged 16 and over. The idea is to measure how much it would cost to reeducate the U.S. workforce at today's prices.

This is a crude measure, but it can provide a rough order of magnitude. According to this measure, the stock of education capital amounted to $28 trillion in 1995, of which about 3 percent was financed by the Federal Government. The total exceeds the Nation's stock of physical capital. The main investors in education capital have been State and local Governments, parents, and the students themselves who forgo earning opportunities in order to acquire education.

Even broader concepts of human capital have been considered. Not all useful training occurs in school, or formal training programs at work. Much informal and yet invaluable learning occurs within families or on the job. Labor compensation amounts to about two-thirds of national income. Therefore, it is conceivable that the total value of human capital might be as large as three times the estimated value of physical capital. Thus, it can be seen that the estimates offered here are in a sense conservative, because they reflect only the costs of acquiring formal education.

TABLE 2–4. NATIONAL WEALTH

(As of the end of the fiscal year, in trillions of 1995 dollars)

	1960	1965	1970	1975	1980	1985	1990	1993	1994	1995
ASSETS										
Publicly owned physical assets:										
Structures and Equipment	2.0	2.3	2.8	3.4	3.7	3.7	3.9	4.0	4.0	4.1
Federally owned or financed	1.1	1.2	1.3	1.3	1.4	1.5	1.6	1.6	1.6	1.6
Federally owned	1.0	1.0	1.0	0.9	0.8	0.9	1.0	1.0	1.0	1.0
Grants to State & Local	0.1	0.2	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.6
Funded by State and local Governments	0.9	1.1	1.5	2.1	2.4	2.2	2.3	2.4	2.4	2.5
Other Federal assets	0.7	0.7	0.6	0.9	1.4	1.4	1.1	0.9	0.9	0.9
Subtotal	2.7	3.0	3.5	4.3	5.2	5.1	5.0	4.9	4.9	4.9
Privately Owned Physical Assets:										
Reproducible Assets	5.4	6.2	7.9	10.2	13.0	13.6	15.0	15.3	15.8	16.2
Residential Structures	1.9	2.2	2.7	3.6	4.9	4.9	5.4	5.7	5.9	6.1
Nonresidential Plant and equipment	1.9	2.3	3.0	4.0	5.0	5.6	6.0	6.0	6.1	6.3
Inventories	0.7	0.7	0.9	1.1	1.3	1.2	1.3	1.2	1.2	1.3
Consumer Durables	0.9	1.0	1.3	1.5	1.7	1.9	2.3	2.4	2.5	2.6
Land	1.9	2.3	2.6	3.4	5.1	5.9	5.9	4.5	4.5	4.4
Subtotal	7.3	8.5	10.5	13.6	18.1	19.4	20.9	19.8	20.3	20.7
Education Capital:										
Federally Financed	0.1	0.1	0.2	0.3	0.4	0.5	0.7	0.8	0.8	0.8
Financed from Other Sources	6.1	7.9	10.6	12.3	15.0	18.1	22.8	25.0	25.9	26.7
Subtotal	6.1	8.0	10.8	12.6	15.4	18.6	23.5	25.8	26.7	27.5
Research and Development Capital:										
Federally Financed R&D	0.2	0.3	0.5	0.5	0.6	0.7	0.8	0.8	0.8	0.9
R&D Financed from Other Sources	0.1	0.2	0.3	0.4	0.4	0.6	0.8	0.9	1.0	1.0
Subtotal	0.3	0.5	0.7	0.9	1.0	1.3	1.6	1.8	1.8	1.9
Total assets	16.5	20.1	25.5	31.3	39.7	44.4	51.0	52.3	53.7	55.0
LIABILITIES:										
Net Claims of Foreigners on U.S.	(0.2)	(0.2)	(0.2)	(0.2)	(0.5)	(0.2)	0.3	0.6	0.7	0.9
Balance	16.7	20.3	25.7	31.5	40.2	44.6	50.7	51.7	52.9	54.1
Per capita (thousands of 1995 dollars)	92.2	104.4	125.5	145.8	176.1	186.5	202.1	199.7	202.6	205.1
ADDENDA:										
Total Federally funded capital	2.1	2.3	2.6	3.0	3.8	4.1	4.2	4.1	4.1	4.1
Percent of national wealth	12.3	11.3	10.2	9.5	9.4	9.1	8.2	8.0	7.8	7.6

Research and Development Capital

Research and Development can also be thought of as an investment, because R&D represents a current expenditure for which there is a prospect of future returns. After adjusting for depreciation, the flow of R&D investment can be added up to provide an estimate of the current R&D stock.[8] That stock is estimated to have been about $1.9 trillion in 1995. Although this is a large amount of research, it is a relatively small portion of total National wealth. About half of this stock was funded by the Federal Government.

Liabilities

When considering the debts of the Nation as a whole, the debts that Americans owe to one another cancel out. This does not mean they are unimportant. The buildup in debt largely owed to other Americans was partly responsible for the sluggishness of the recovery from the 1990–1991 recession in its early stages. Indeed, the debt explosion in the 1980s may have helped to bring on the recession in the first place.

However, these debts do not belong on the national balance sheet. If they were included, there would have to be offsetting entries. Only the net debt that is owed to foreigners belongs on the national balance sheet. America's foreign debt has been increasing rapidly in recent years, as a consequence of the U.S. trade deficit, but the size of this debt is small compared with the total stock of assets. It amounted to about 1½ percent of the total in 1995.

Most of the Federal debt held by the public is owned by Americans, so it does not appear in Table 2–4. Only that portion of the Federal debt held by foreigners is included. Even so, it is of interest to compare the imbalance between Federal assets and liabilities with national wealth. The Government will have to service the debt or repay it, and its ability to do so without disrupting the economy will depend in part on the wealth of the private sector. Currently, the Federal net asset

[8] R&D depreciates in the sense that the economic value of applied research and development tends to decline with the passage of time which leads to movement in the technological frontier.

imbalance, as estimated in Table 2–1, amounts to about 5½ percent of total U.S. wealth as shown in Table 2–4.

Trends in National Wealth

The net stock of wealth in the United States at the end of 1995 was about $55 trillion. Since 1980 it has increased in real terms at an annual rate of 2.2 percent per year—about half the 4.5 percent rate it averaged from 1960 to 1980. (All comparisons are in terms of constant 1995 dollars.) Public capital formation slowed down markedly between the two periods. The real value of the net stock of publicly owned physical capital was actually lower in 1995 than in 1980—$4.9 trillion versus $5.1 trillion in the earlier year. Since 1980, Federal grants to State and local governments for capital projects have grown less rapidly, while capital funded directly by State and local governments has grown at an average rate of only 0.1 percent per year.

Private capital formation in physical assets has also grown more slowly since 1980. The net stock of nonresidential plant and equipment grew 1.6 percent per year from 1980 to 1995 compared with 4.9 percent in the 1960s and 1970s, and the stock of business inventories actually declined. Overall, the stock of privately owned physical capital grew at an average rate of just 0.9 percent per year between 1980 and 1995.

The accumulation of education capital, as measured here, also slowed down in the 1980s, but not nearly as much. It grew at an average rate of 4.7 percent per year in the 1960s and 1970s, about the same as the average rate of growth in private physical capital during the same period. Since 1980, education capital has grown at a 4.4 percent annual rate. This reflects the extra resources devoted to schooling in this period, and the fact that such resources were rising in relative value. R&D stocks have grown at about the same rate as education capital since 1980.

Other Federal Influences on Economic Growth

Many Federal policies have contributed to the slowdown in capital formation shown here. Federal investment policies obviously were important, but the Federal Government also contributes to wealth in ways that cannot be easily captured in a formal presentation. Monetary and fiscal policies affect the rate and direction of capital formation. Regulatory and tax policies affect how capital is invested, as do the Federal Government's credit assistance policies.

One important channel of influence is the Federal budget deficit, which determines the size of the Federal Government's borrowing requirements. Smaller deficits in the 1980s would have resulted in a smaller gap between Federal liabilities and assets than is shown in Table 2–1. It is also likely that, had the $3 trillion in added Federal debt since 1980 been avoided, a significant share of these funds would have gone into private investment. National wealth might have been 2 to 4 percent larger in 1995 had fiscal policy avoided the buildup in the debt.

Social Indicators

There are certain broad responsibilities that are unique to the Federal Government. Especially important are the Government's role in fostering healthy economic conditions, promoting health and social welfare, and protecting the environment. Table 2–5 offers a rough cut of information that can be useful in assessing how well the Federal Government has been doing in promoting these general objectives.

The indicators shown here are only a limited subset drawn from the vast array of data available on conditions in the United States. In choosing indicators for this table, priority was given to measures that were consistently available over an extended period. Such indicators make it easier to draw valid comparisons and evaluate trends. In some cases, however, this meant choosing indicators with significant limitations.

The individual measures in this table are influenced in varying degrees by many Government policies and programs, as well as by external factors beyond the Government's control. They are not outcome indicators, because they do not measure the direct results of Government activities, but they do provide a quantitative measure of the progress or lack of progress in reaching some of the ultimate values that Government policy is intended to promote.

Such a table can serve two functions. First, it highlights areas where the Federal Government might need to modify its current practices or consider new approaches. Where there are clear signs of deteriorating conditions, corrective action might be appropriate. Second, the table provides a context for evaluating other data on Government activities. For example, Government actions that weaken its own financial position may be appropriate when they promote a broader social objective.

An example of this occurs during economic recessions when reductions in tax collections lead to increased Government borrowing that adds to Federal liabilities. This deterioration in the Federal balance sheet provides an automatic stabilizer for the private sector. State Government, local government and private budgets are strengthened by allowing the Federal budget to run a deficit. More stringent Federal budgetary controls could be used to hold down Federal borrowing during such periods, but only at the risk of aggravating the downturn.

The Government cannot avoid making such tradeoffs because of its size and the broad-ranging effects of its actions. Monitoring these effects and incorporating them in the Government's policy making is a major challenge.

An Interactive Analytical Framework

No single framework can encompass all of the factors that affect the financial condition of the Federal Government. Nor can any framework serve as a substitute for actual analysis. Nevertheless, the framework presented above offers a useful way to examine the financial aspects of Federal policies. Increased Federal sup-

Table 2-5. ECONOMIC AND SOCIAL INDICATORS

	Specific measures	1960	1965	1970	1975	1980	1985	1990	1991	1992	1993	1994[1]	1995
	Real GDP per person (1992 dollars)	12,512	14,792	16,521	17,896	20,252	22,345	24,559	24,058	24,447	24,728	25,335	25,591
	Average annual percent change	0.4	3.4	2.2	1.6	2.5	2.0	1.9	−2.0	1.6	1.2	2.5	1.0
	Median family income (1994 dollars):												
	All families	25,866	30,147	35,407	36,177	37,857	38,200	40,087	39,105	38,632	37,905	38,782	NA
	Married couple families	27,030	31,482	37,735	39,204	41,671	42,835	45,237	44,607	44,249	44,106	44,959	NA
	Female householder, no husband present	13,660	15,305	18,276	18,048	18,742	18,814	19,199	18,163	17,984	17,890	18,236	NA
	Income share of middle three quintiles (%)	54.0	53.9	53.6	53.5	53.4	52.0	51.2	51.4	51.0	43.9	49.0	NA
	Poverty rate (%)[2]	22.2	17.3	12.6	12.3	13.0	14.0	13.5	14.2	14.8	15.1	14.5	NA
	Economic security inflation and unemployment:												
	Civilian unemployment (%)	5.5	4.5	4.9	8.5	7.1	7.2	5.5	6.7	7.4	6.8	6.1	5.6
	CPI-U (year over year % change)	2.0	1.3	4.3	6.8	8.9	5.5	4.0	4.2	3.0	3.0	2.6	2.8
Employment prospects	Increase in total payroll employment (millions, Dec. to Dec.)	−0.5	2.9	−0.5	0.4	0.2	2.5	0.3	−0.9	1.2	2.8	3.5	1.7
	Managerial or professional jobs (% of civilian employment)	NA	NA	NA	NA	22.2	24.1	26.0	26.5	26.5	27.1	27.5	28.3
Wealth creation	Net national saving rate (% of NNP)	11.4	13.3	9.3	6.8	7.3	6.2	4.2	4.1	2.7	2.8	3.9	4.7
Innovation	Patents issued to U.S. residents (thous.)	42.0	53.6	50.1	51.4	40.8	43.4	53.0	57.8	58.7	61.1	64.2	64.4
	Multifactor productivity (average percent change)	1.1	3.2	1.1	1.3	0.7	0.6	0.3	−1.0	1.4	0.5	0.8	NA
Social:													
Families	Children living with a single parent (% of all children)	9.2	10.2	12.9	16.4	18.6	20.2	21.6	22.4	22.8	23.3	23.1	NA
Safe communities	Violent crime rate (per 100,000 population)[3]	160	199	364	482	597	557	732	758	758	746	716	NA
	Murder rate (per 100,000 population)	5.1	5.1	7.8	9.6	10.2	7.9	9.4	9.8	9.3	9.5	9.0	NA
	Juvenile crime (murders per 100,000 persons age 14–17)	NA	NA	NA	NA	8.2	7.1	15.8	17.3	17.5	18.6	NA	NA
Health and illness	Infant mortality (per 1,000 live births)	26.0	24.7	20.0	16.1	12.6	10.6	9.2	8.9	8.5	8.4	7.9	NA
	Low birthweight (<2,500 gms) babies (%)	7.7	8.3	7.9	7.4	6.8	6.8	7.0	7.1	7.1	7.2	NA	NA
	Life expectancy at birth (years)	69.7	70.2	70.8	72.6	73.7	74.7	75.4	75.5	75.8	75.5	75.7	NA
	Cigarette smokers (% population 18 and oover)	NA	42.4	39.5	36.4	33.2	30.1	25.5	25.6	26.5	25.0	NA	NA
	Bed disability days (average days per person)	6.0	6.2	6.1	6.6	7.0	6.1	6.2	6.5	6.3	6.7	NA	NA
	National health expenditures (% of GDP)	5.2	5.8	7.2	8.1	9.0	10.4	12.1	12.8	13.1	13.5	NA	NA
Learning	High school graduates (% of population 25 and older)	44.6	49.0	55.2	62.5	68.6	73.9	77.6	78.4	79.4	80.2	80.9	NA
	College graduates (% of population 25 and older)	8.4	9.4	11.0	13.9	17.0	19.4	21.3	21.4	21.4	21.9	22.2	NA
	National assessment of educational progress[4].												
	Mathematics	NA	NA	NA	304	298	302	305	NA	307	NA	NA	NA
	Science	NA	NA	305	296	283	288	290	NA	294	NA	NA	NA
Participation	Voting for President (% eligible population)	62.8	NA	NA	NA	52.6	NA	NA	NA	55.2	NA	NA	NA
	Voting for Congress (% of eligible population)	58.5	NA	43.5	NA	47.4	NA	33.1	NA	50.8	NA	36.0	NA
	Individual charitable giving per capita (1994 dollars)	199	238	286	304	331	349	427	423	422	419	NA	NA
Environment:													
Air quality	Population living in counties with ozone levels exceeding the standard (millions)	NA	NA	NA	NA	NA	76	63	70	43	51	50	NA
Water quality	Population served by secondary treatment or better (millions)	NA	NA	NA	NA	NA	134	155	157	159	162	164	166

[1] Data are preliminary for infant mortality and life expectancy.
[2] The poverty rate does not reflect noncash government transfers such as Medicaid or food stamps.
[3] Not all crimes are reported, and the fraction that go unreported may have varied over time.
[4] Dates shown in table for the national educational assessments are approximate.

port for investment, the reduction in Federal absorption of saving through deficit reduction, and other Administration policies to enhance economic growth are expected to promote national wealth and improve the future financial condition of the Federal Government. As that occurs, the efforts will be clearly revealed in these tables.

TECHNICAL NOTE: SOURCES OF DATA AND METHOD OF ESTIMATING

Federally Owned Assets and Liabilities

Assets

Financial Assets: The source of data is the Federal Reserve Board's Flow-of-Funds Accounts. Two adjustments were made to these data. First, U.S. Government holdings of financial assets were consolidated with the holdings of the monetary authority, i.e., the Federal Reserve System. Second, the gold stock, which is valued in the Flow-of-Funds at a constant historical price, is revalued using the market value for gold.

Physical Assets

Fixed Reproducible Capital: Estimates were developed from the OMB historical database for physical capital outlays. The database extends back to 1940 and was supplemented by data from other selected sources for 1915–1939. The source data are in current dollars. To estimate investment flows in constant dollars, it is necessary to deflate the nominal investment series. This was done using BEA price deflators for Federal purchases of durables and structures. These price deflators are available going back as far as 1940. For earlier years, deflators were based on Census Bureau historical statistics for constant price public capital for-

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mation. The capital stock series were adjusted for depreciation on a straight-line basis, assuming useful lives of 46 years for water and power projects; 40 years for other direct Federal construction; and 16 years for major nondefense equipment and for defense procurement.

Fixed Nonreproducible Capital: Historical estimates for 1960–1985 were based on estimates in Michael J. Boskin, Marc S. Robinson, and Alan M. Huber, "Government Saving, Capital Formation and Wealth in the United States, 1947–1985," published in *The Measurement of Saving, Investment, and Wealth*, edited by Robert E. Lipsey and Helen Stone Tice (The University of Chicago Press, 1989).

Estimates were updated using changes in the value of private land from the Flow-of-Funds Balance Sheets and in the Producer Price Index for Crude Energy Materials. The Bureau of Economic Analysis is in the process of preparing satellite accounts to accompany the National Income and Product Accounts that will report on changes in mineral deposits for the Nation as a whole, but this work is not yet completed.

Liabilities

Financial Liabilities: The principal source of data is the Federal Reserve's Flow-of-Funds Accounts.

Contingent Liabilities: Sources of data are the OMB Deposit Insurance Model and the OMB Pension Guarantee Model. Historical data on contingent liabilities for deposit insurance were also drawn from the Congressional Budget Office's study, *The Economic Effects of the Savings and Loan Crisis*, issued January 1992.

Pension Liabilities: For 1979–1994, the estimates are the actuarial accrued liabilities as reported in the annual reports for the Civil Service Retirement System, the Federal Employees Retirement System, and the Military Retirement System (adjusted for inflation). Estimates for the years before 1979 are not actuarial; they are extrapolations. The estimate for 1994 is a projection.

Long-Run Budget Projections

The long-run budget projections are based on long-run demographic and economic projections. A model of the Federal budget developed at OMB computes the budgetary implications of this forecast.

Demographic and Economic Projections: For the years 1996–2006 the assumptions are identical to those used in the budget. As always, these budget assumptions reflect the President's policy proposals, in this case that the budget be balanced. The long-run projections extend these budget assumptions by holding inflation, interest rates, and unemployment constant at the levels assumed in the budget for 2006. Population growth and labor force participation are extended using the intermediate assumptions from the 1995 social security trustees' report and Bureau of Labor Statistics projections. The projected rate of growth for real GDP is built up from the labor force assumptions and an assumed rate of productivity growth. The assumed rate of productivity growth is held constant at the average rate of growth implied by the budget's economic assumptions. The economic forecast used to project the budget in the absence of the President's balanced budget proposals is altered to reflect the higher interest rates and lower profits that would be expected to prevail under these circumstances.

Budget Projections: For the years 1996–2006, the projections follow the budget. After 2006, receipts are projected using simple rules of thumb linking income taxes, payroll taxes, excise taxes, and other receipts to projected tax bases derived from the economic forecast. Outlays are computed in different ways. Discretionary spending grows at the rate of inflation. Social security, Medicare, and Federal pension outlays are projected using the most recent actuarial forecasts available at the time the budget was prepared (April 1995 for social security). These projections are repriced using Administration inflation assumptions. Other entitlement programs are projected based on rules of thumb linking program spending to elements of the economic and demographic forecast such as the poverty rate.

National Balance Sheet Data

Publicly Owned Physical Assets: Basic sources of data for the federally owned or financed stocks of capital are the investment flows computed by OMB from the budget database. Federal grants for State and local Government capital were added together with adjustments for inflation and depreciation in the same way as described above for direct Federal investment. Data for total State and local Government capital come from the capital stock data prepared by the BEA.

Privately Owned Physical Assets: Data are from the Flow-of-Funds national balance sheet. Preliminary estimates for 1995 were prepared based on net investment from the National Income and Product Accounts.

Education Capital: The stock of education capital is computed by valuing the cost of replacing the total years of education embodied in the U.S. population 16 years of age and older at the current cost of providing schooling. The estimated cost includes both direct expenditures in the private and public sectors and an estimate of students' forgone earnings, i.e., it reflects the opportunity cost of education.

For this presentation, Federal investment in education capital is a portion of the Federal outlays included in the conduct of education and training. This portion includes direct Federal outlays and grants for elementary, secondary, and vocational education and for higher education. The data exclude Federal outlays for physical capital at educational institutions and for research and development conducted at colleges and universities because these outlays are classified elsewhere as investment in physical capital and investment in R&D capital. The data also exclude outlays under the GI Bill; outlays for graduate and post-graduate education spending in HHS, Defense and Agriculture; and most outlays for vocational training.

Data on investment in education financed from other sources come from educational institution reports on the sources of their funds, published in U.S. Department of Education, *Digest of Education Statistics*. Education capital is assumed not to depreciate, but to be retired when a person dies. An education capital stock computed using this method with different source data can be found in Walter McMahon, "Relative Returns To Human and Physical Capital in the U.S. and Efficient Investment Strategies," *Economics of Education Review*, Vol. 10, No. 4, 1991. The method is described in detail in Walter McMahon, *Investment in Higher Education*, 1974.

Research and Development Capital: The stock of R&D capital financed by the Federal Government was developed from a database that measures the conduct of R&D. The data exclude Federal outlays for physical capital used in R&D because such outlays are classified elsewhere as investment in federally financed physical capital. Nominal outlays were deflated using the GDP deflator to convert them to constant dollar values.

Federally funded capital stock estimates were prepared using the perpetual inventory method in which annual investment flows are cumulated to arrive at a capital stock. This stock was adjusted for depreciation by assuming an annual rate of depreciation of 10 percent on the outstanding balance for applied research and development. Basic research is assumed not to depreciate. The 1993 Budget contains additional details on the estimates of the total federally financed R&D stock, as well as its national defense and nondefense components (see *Budget for Fiscal Year 1993*, January 1992, Part Three, pages 39–40).

A similar method was used to estimate the stock of R&D capital financed from sources other than the Federal Government. The component financed by universities, colleges, and other nonprofit organizations is based on data from the National Science Foundation, *Surveys of Science Resources*. The industry-financed R&D stock component is from that source and from the U.S. Department of Labor, *The Impact of Research and Development on Productivity Growth*, Bulletin 2331, September 1989.

Experimental estimates of R&D capital stocks have recently been prepared by BEA. The results are described in "A Satellite Account for Research and Development," *Survey of Current Business*, November 1994. These BEA estimates are lower than those presented here primarily because BEA assumes that the stock of basic research depreciates, while the estimates in Table 2–4 assume that basic research does not depreciate. BEA also assumes a slightly higher rate of depreciation for applied research and development, 11 percent, compared with the 10 percent rate used here.

Social Indicators

The main sources for the data in this table are the Government statistical agencies. Generally, the data are publicly available in the President's annual *Economic Report* and the *Statistical Abstract of the United States*.

1996-SE-011890

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 19, 1996

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DONALD LUBICK *DCL*
ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Tax Issues for Budget Meeting with President

Following up on yesterday's meeting with Chief of Staff Panetta, attached are a list of tax issues that will require Presidential decisions. The budget meeting with the President may take place today.

1. Effective Date for Tax Cuts. The President's proposed tax cuts will have a very large effect in FY 1998 (almost two year's worth) because they will be retroactive to January 1, 1997 (assuming an August 1, 1997 date of enactment). The gap between the date of enactment and the effective date pushes the revenue losses for calendar year 1997 into FY 1998 (because they will all be claimed in 1998 tax return filings), while a substantial portion of the revenue losses for calendar year 1998 will also occur in FY 1998 (because they will be reflected in reduced withholding). To deal with the resulting FY 1998 budget problem, OMB would like to delay the effective date until date of enactment. This would save about $3.6 billiion for the child credit in FY 1998 ($4.0 billion in FY 1997-2002) and about $3.0 billion for the tuition credit/deduction in FY 1998 ($3.2 billion in FY 1997-2002), but would create political problems for the Administration. For example, delaying the effective date of the child credit until August 1, 1997 means that the credit amount for 1997 would be only $125 instead of $300 (5/12ths of the full year amount).

2. Hope Scholarship. This issue was not discussed at the meeting with Panetta, but needs to be raised at some point with the President. OMB/Treasury/Education staff have agreed on an option that simplifies the administration of the credit/deduction considerably and reduces its cost slightly. Gene Sperling has approved the changes. In addition, OMB/Education is developing (has developed?) an option for a targeted expansion of Pell Grants that would compensate those who would lose if the credit were no longer refundable. Treasury has preliminarily estimated the revenue loss of the revised proposal (simplifying changes plus elimination of refundability) at $38.2 billion over the 1997-02 period and $9.4 billion in FY 2002. (This estimate assumes the

credit is stacked before the EITC.) Compared with last year's proposal, the modifications save $5.5 billion over FY 1997-2002 and $1.5 billion in FY 2002. Another $0.5 billion in 5 years and $0.1 billion in FY 2002 could be raised by stacking the credit behind the EITC, but this would deny more of the credit to some EITC recipients.

3. Extension of Employer-Provided Educational Assistance (Section 127). The President proposed permanent extension of Section 127 and a new 10 percent education credit for small business in a speech last summer. OMB has objected to this on grounds of cost and suggested that Section 127 only be extended for one year (or at most three years) instead of permanently. (Other participants in the meeting were sympathetic to the OMB position, but the Secretary of Labor was not at the meeting.) Section 127 plus the credit costs about $650 million per year at 1997 levels and more in subsequent years. Permanent extension costs $3.8 billion in FY 1997-2002 and $834 million in FY 2002. A temporary extension would therefore reduce the deficit by $834 million in FY 2002 and would place Section 127 on an equal footing with other incentives the President has strongly supported and previously sought to extend permanently, including the R&E credit. But a temporary extension could be seen as going back on a Presidential commitment. Labor's top legislative assistant seemed to think that Secretary Reich would not object to a temporary extension, but has yet to confirm this with him.

4. Equitable Tolling. At the request of the President, Treasury promised last fall to include in the FY 1998 budget an "equitable tolling" proposal to extend the statute of limitations for tax refund claims. The option favored by the President would have provided retroactive relief to taxpayers who had used up the allowable time period before the date of enactment. If the effective date is changed to make the proposal prospective only (i.e., for taxable years ending after the date of enactment), the revenue loss of the proposal would decline by about $490 million over the FY 1997-2002 budget period. Participants in the Panetta meeting were favorably disposed towards making the relief prospective only, but agreed that the decision would need to be cleared with the President. If the President is not willing to go this far, an intermediate option that would still reduce the costs by about $150 million in FY 1997-2002 would be to make the proposal applicable to claims for which the statute of limitations expires after the date of enactment.

5. International Departure Tax. As one of the payfors for the HOPE scholarship proposal introduced in June 1996, the Administration proposed to increase the international airline departure tax from $6 per passenger to $16 per passenger. International aviation agreements limit the allowable tax any country can impose based on an agreed-upon formula. Based on its review of the data, OMB claims that the agreements limit the allowable tax to $13 per passenger. According to rough OMB estimates (Treasury will rescore, if the change is agreed to), reducing the proposed tax from $16 per passenger to $13 per passenger (e.g., increasing the tax by $3 per passenger less) will lose about $0.8 billion over the FY 1997-2002 budget period and about $0.2 billion in FY 2002.

6. Tax Simplification. Participants in the meeting agreed that it would be desirable, both on policy and message grounds, to include language in the Budget document announcing that the Administration will propose a tax simplification package, with details to be supplied shortly

thereafter, but outside of the budget document. The budget might discuss a few of the most significant items. The simplification package would be designed to be revenue-neutral (excluding increases or decreases from simplifying proposals already included in the budget). A brief discussion of the simplification proposals is attached.

7. <u>Expatriate Departure Tax.</u> Participants in the meeting discussed whether the Administration should re-introduce its proposal (included in the last two budgets) to impose a tax on the unrealized capital gains of wealthy individuals who relinquish their U.S. citizenship. The Senate supported the Administration approach, but Congress in 1996 enacted an alternative House proposal (which the Treasury considers ineffective) to taxing expatriates as one of the payfors in the Kennedy-Kassebaum health bill. Reintroducing the Administration bill as a substitute for the newly enacted provision would raise about $0.4 billion in Fiscal Year 2002 by last year's Treasury scoring, but lose $0.1 billion in FY 2002 according to last year's estimate by the Joint Committee on Taxation (JCT). Because the JCT scoring is used in the Congressional budget process, Congress is unlikely to enact the Administration bill. For this reason, most participants in the meeting did not favor reintroducing the proposal. But Gene Sperling argued for the proposal on message grounds. A counter- argument for leaving the proposal out of this year's budget is that we may have more data in a year or two in support of the case that the House approach was ineffective.

Overview of Possible Tax Simplification Package

It is anticipated that a revenue-neutral tax simplification package would be alluded to in the FY98 Budget document and released at a time to be determined thereafter. The package is expected to propose approximately 60-70 different simplification measures that, while in most cases not that significant individually, would collectively provide substantial simplification to the tax code for a wide range of taxpayers. Of the 60-70 provisions, approximately 40 have previously been included in simplification bills on the Hill. The major new proposals that would be announced in this package are briefly described below.

Taxpayer Bill Of Rights "3"

This is actually a subset of 10-15 proposals, which pick up where the Taxpayer Bill of Rights 2 (TBOR2), signed into law this summer, left off. The Administration can get out front on this very popular initiative by proposing a new "installment" of measures that will continue to improve the tax system with respect to taxpayer's dealings with the IRS. This package is expected to include -- in addition to the equitable tolling proposal that will be included in the budget -- such high-profile measures as the recommendations that will come from the joint-return/innocent spouse and interest-netting studies mandated by TBOR2, a joint fed-state initiative, improved Tax Court jurisdiction and procedures, and a more consistent regime for "reasonable cause" exceptions to various penalties.

The Administration should consider having IRS Commissioner Richardson highlight this aspect of the upcoming package as part of the 1997 tax filing season roll-out in mid-January.

Independent Contractors

This proposal addresses the long-standing struggle to classify workers properly for tax purposes as employees or independent contractors. Consistent with testimony presented this summer, the proposal would provide that businesses that do not meet the existing rules for independent contractor status would be permitted to reclassify their workers as employees voluntarily without exposure for any past employment tax liability, provided that they satisfy certain conditions. In addition, Tax Court jurisdiction (when the taxpayer does not have to pay the asserted deficiency to contest it) would be expanded to allow determinations of these disputes, giving the taxpayer a greater opportunity to obtain an independent review of the IRS decision. Finally, the IRS would be permitted to issue guidance to simplify the current overly complicated and confusing classification rules.

Dependent Filers

Current law requires dependents with at least $650 of earned income to file a tax return and have some tax liability if they have as little as $1 of unearned income (typically interest on a savings account). The proposal would significantly simplify the rules by increasing the standard deduction for dependent filers, indexing that amount, rationalizing the rules for parents who elect to include the unearned income of dependents under age 14 (as under current law), and eliminating all ties between the parent's and the dependent's alternative minimum tax calculations. This simplification would reduce the number of taxable dependents by over 2 million, and could also be viewed as encouraging savings for the dependent's education or other needs. This proposal would cost approximately $200 million in 2002 and $1.2 billion over the FY1997-2002 period.

Like-Kind Exchanges

The proposal would combine two significant elements that, in combination, will provide substantial simplification while also raising some revenue through 2002 that will contribute to making the entire package revenue-neutral. The proposal would greatly simplify the rules that permit taxpayers to defer recognition of gain when they exchange their business or investment property for "like kind" property. Currently, taxpayers who want to acquire suitable replacement property, but the timing is such that there is a short gap between the disposition of the original property and the acquisition of the replacement property, must comply with complex rules that permit "three party" or deferred exchanges through the use of an intermediary (such as a title company). The proposal would convert the provision to a simple rollover rule, so that the taxpayer can achieve deferral simply by reinvesting the proceeds in suitable replacement property within the same time-period as permitted under current law. This will eliminate the need for the escrow agent/intermediary.

The second element of the proposal would restrict the range of allowable replacement property to property of a similar or related use. Thus, the taxpayer could no longer exchange real estate for any other type of real estate as under current law (such as farmland for an apartment building or an oil deposit for an office building). However, the common situation involving a rollover from one parcel of residential rental property to another would still be permitted (and made easier with the first part of the proposal). Nevertheless, this element of the proposal will be very controversial and vigorously opposed, in particular by real estate business interests.

Corporate Alternative Minimum Tax (AMT) Reform

Like the like-kind exchange proposal, this proposal would combine two elements that together will provide broad simplification while also raising some revenue to contribute to the overall package. The proposal would provide dramatic simplification for small businesses by simply excluding from the corporate AMT all corporations with average annual gross receipts of less than $15 million during the preceding three years. This would limit the application of the corporate AMT to only the largest 2 percent of all corporations, and would reduce the number of corporations that otherwise would pay AMT by 75 percent.

The second element of the proposal would, for those large corporations remaining in the AMT system, increase the current law inclusion for AMT purposes of the "adjusted current earnings" (ACE) adjustment from 75 to 100 percent. Thus, this component of the proposal will be criticized by those remaining large corporations.

* * * * * * *

The simplification package is not expected to include a proposal to simplify the AMT for individuals. It is evident that this area is a rapidly growing problem (it is anticipated that an additional 2.2 million, mostly upper-middle income and largely unsuspecting, individuals will be brought into the AMT by 2002) that should be dealt with as soon as possible, but its cost is viewed as prohibitive (or else would impinge upon sacred cow deductions like home mortgage interest). We expect to continue to educate Members and the public of this impending problem.

1996-se-011962

1942

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

MEMORANDUM FOR PRESIDENT CLINTON

THROUGH: SECRETARY RUBIN R.E.R.

FROM: DEPUTY SECRETARY SUMMERS

SUBJECT: Tax Issues in FY 1998 Budget

This memorandum reviews seven tax issues in the FY 1998 budget for your decision.

1. Effective Date for Tax Cuts. The proposed tax cuts -- especially the child credit and the tuition credit/deduction -- will have a large revenue effect in FY 1998 if they are made retroactive to January 1, 1997. This occurs because the gap between the assumed date of enactment (August 1) and the effective date doubles up revenue costs for FY 1998 to include both those claimed retroactively for tax year 1997 on returns filed in 1998 and those claimed for tax year 1998 through withholding in 1998. Delaying the effective date of the child credit and the tuition credit/deduction to July 1, 1997 would save approximately **$6.1 billion** in FY 1998 ($3.1 billion for the child credit and $3.0 billion for the tuition credit/deduction) and $6.7 billion in fiscal years 1997-2002. But this would also mean that the tax benefits would be much smaller in the first year. The child credit for 1997 would be only $150 (instead of $300) and the tuition credit/deduction would apply only to costs incurred after July 1, 1997, instead of costs for the entire year.

RECOMMENDATION: Delay the effective date of the child credit and tuition credit/deduction until July 1, 1997.

Approve July 1, 1997 Effective Date ____

Retain January 1, 1997 Effective Date ____

Other ____

2. Extension of Employer-Provided Educational Assistance - Section 127. In a speech last summer, you proposed permanent extension of the tax exemption for employer-provided educational assistance (Section 127) and a new 10 percent tax credit for education assistance provided by small businesses. Permanent extension costs **$3.8 billion** in Fiscal Years 1997-2002 and **$834 million** in 2002 alone. Limiting the proposed extension in the budget to 3 years would reduce the 1997-2002 cost to **$2 billion** and FY 2002 cost to zero. A 3-year extension would still place employer-provided educational assistance on a higher footing than other incentives you have strongly supported and previously sought to extend permanently. (See item 3 below).

RECOMMENDATION: Extend Section 127 for three years and propose the new 10 percent tax credit for educational assistance by small business for the same time period.

Approve 3-Year Extension ____

Extend Permanently ____

Extend for Only One Year ____

Other ____

3. Other Expiring Provisions. Other tax incentives that will expire in 1997 include the research and experimentation (R&E) tax credit, the orphan drug credit, the work opportunity tax credit (WOTC), and the deduction for contributions of appreciated stock to private foundations. The FY 1997 budget document included language that supported working with Congress to achieve the "revenue-neutral" extension of these incentives, but did not include costs of extension within the budget totals. This year, maintaining credibility may require explicitly including at least a one year extension of these incentives in the budget. Failure to do so, especially in light of the longer-term extension of Section 127, could upset supporters of these incentives (the high tech community for R&E; Congressman Rangel and urban/low income constituencies for the WOTC) and, in the case of the WOTC, would be hard to justify in light of the proposed three year expansion of the WOTC to new categories of welfare and food stamp recipients. A one-year extension of all the expiring provisions would cost **$2.7 billion** in Fiscal Years 1997-2002. Most of this cost ($2.1 billion) is for the R&E Credit.

RECOMMENDATION: Propose extending the R&E tax credit, the work opportunity tax credit, the orphan drug credit, and the deduction for contributions of appreciated stock to private foundations for one year past the current expiration dates.

Approve 1-Year Extension ______

Support in Concept, But Do Not Include in Budget ______

Other ______

4. Equitable Tolling. You requested that an "equitable tolling" proposal to extend the statute of limitations for tax refund claims be included in the FY 1998 Budget. The issue is what effective date to use. Compared to an option that would provide retroactive relief for all pending claims at a cost of **$550 million** over the budget period, making the proposal prospective only (i.e., for taxable years ending after the date of enactment) would cost about **$55 million**. An intermediate effective date limiting relief to claims for which the statute of limitation expires after date of enactment would cost $400 million. Delaying the effective date would still deliver the message, but would not benefit some taxpayers who are currently litigating.

RECOMMENDATION: Make the proposal prospective.

Approve Making Prospective ____

Make Fully Retroactive ____

Intermediate Effective Date ____

5. Tax Simplification. The theme of simplification of administration for taxpayers and the IRS is timely and important to improve the lives of both. We have designed a package of close to 70 items designed to be revenue neutral. Most are not of great significance individually, but the totality is consequential. Generally they are non controversial and about 40 are accepted from prior Congressional packages. An illustrative table of the major ones is attached.

RECOMMENDATION: Include a general statement in the budget that Treasury will release a revenue neutral package of simplification proposals for enactment this year, including a new Taxpayer Bill of Rights 3. Avoid cluttering the budget document with an extensive listing of minor proposals.

Approve Statement in Budget ____

Defer Entirely to Post-budget ____

Other ____

6. Expatriation Departure Tax. We proposed to tax unrealized gains of wealthy persons who give up their U.S. citizenship. Our proposal was accepted by the Senate last summer, but the House prevailed in a conference with a much weaker version. Part of the reason for the House version's success was that JCT scored the revenue raised from their proposal higher than ours. We are confident that our method of scoring is accurate. A reproposal now that the House version is law would raise $0.4 b. in 2002 under our estimate from last year, but would lose $0.1 b. under JCT scoring. CBO will use JCT and our reproposal will have virtually no chance of passage.

RECOMMENDATION. Do not repropose. Wait one or two years to see our experience under the enacted version.

Approve Omitting from Budget ____

Reintroduce 1996 Proposal ____

Other ____

7. FSC Software. During the summer we tried very hard to get the Congress to amend the export trade incentive of current law, which covers movies, recordings, etc., to include export of software that enables the purchaser to produce the same intangible product. Including this item in our budget would fulfill a position we took (not publicly announced). The revenue cost is $90 mm in 2002 and $340 mm for the five year period ending in 2002.

RECOMMENDATION. Include proposal in budget.

Approve _____

Disapprove _____

Other _____

HIGHLIGHTS OF SIMPLIFICATION PACKAGE

Proposals already announced by the Administration

Exclusion for Capital Gains on Sale of Principal Residence replacing existing law rollover of basis to succeeding residences

Equitable tolling of the Statute of Limitations for taxpayer under disability (part of new Taxpayer Bill of Rights)

Require Average Cost Basis to determine gain from sale of a portion of holdings of substantially identical securities

Interest on extended payment arrangements on estate tax attributable to closely held business assets would be made non deductible but at a lower rate

Determining the classification of workers as employees or independent contractors (proposed by Treasury last year after last year's budget)-permits waiving of back years' liability for taxes due because of misclassification if taxpayer corrects prospectively and allows Tax Court to resolve such issues as independent arbiter, also on a prospective basis for good faith errors; enable IRS to provide simplified guidance to prevent errors.

Selected illustrative new proposals

Taxpayer Bill of Rights 3-a set of 10-15 proposals continuing the popular TBOR 2 signed last summer, including equitable tolling and independent contractors described above and

A consistent regime of reasonable cause penalties

Global interest netting of interest on under and over-payments

Innocent spouse protection expansion for liability of errant spouse on joint return

Corporate alternative minimum tax reform to eliminate the tax from small corporations with gross receipts under $15,000,000 a year

Increase standard deduction for dependent filers to eliminate filing for 2.4 currently taxable dependents

Simplify rules applicable to tax free real estate swaps that now require complex 3 party arrangements to permit rollover by direct sale and reinmvestment, but limit reinvestment to similar properties (protecting common middle class residential rental property)

Simplified Rules for Child Dependency Exemption(subject to revenue cost)

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

20-Dec-96

PROFILE #: 1996-SE-011962

DATE CREATED: 12/20/96

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Summers, Lawrence
Deputy Assistant Secretary

SUBJECT: Tax Issues In FY 1998 Budget

ABSTRACT: Tax issues in FY 1998 budget

RM 3419

TO REVIEWERS

IN: To NA 12/20/96 cc SS

TO EXECUTIVE SECRETARY

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TO THE SECRETARY

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

February 18, 1997

ASSISTANT SECRETARY

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Joshua Gotbaum JG

SUBJECT: Budget Estimates Using Blue Chip Economics

OMB staff have estimated the budget effects from using Blue Chip economic assumptions. However, the estimates are not that useful for several reasons:

- No Blue Chip income shares are available -- Administration income share assumptions are used.

- Blue Chip economic assumptions are not balanced budget policy assumptions; they aren't even pre-policy. The Blue Chip assumptions actually represent some average of individual subjective views about the path of fiscal policy.

Because of the above difficulties, the results are difficult to interpret.

- In 2002, using Blue Chip economics generates a budget deficit that is $52 billion higher than Administration estimates. About $34 billion of that results from the effect of higher interest rates in the Blue Chip path.

- It is impossible to say what the effect of income share differences would be for Blue Chip economics -- and the income share difference is the bulk of the difference between the Administration and CBO.

TREASURY CLEARANCE SHEET

NO. ______

Date February 18, 1997

MEMORANDUM FOR: ☐ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Joshua Gotbaum, Assistant Secretary for Economic Policy

THROUGH: ______

SUBJECT: Budget Estimates Using Blue Chip Economics

REVIEW OFFICES (Check when office clears)

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INITIATOR(S)				
John Kitchen	JK	2/18	Policy Analysis	622-2350
REVIEWERS				
John Hambor	JHA	2/18	Director, Policy Analysis	622-2350

SPECIAL INSTRUCTIONS

☐ Review Officer ______ Date ______

☐ Executive Secretary ______ Date ______

DO F 80-02.1 (04/89)

THE WHITE HOUSE
WASHINGTON

FROM THE CHIEF OF STAFF
Erskine B. Bowles

Doc Number
327

Author / Source
Blinfer, Alan

Short Description
Budget Strategy proposal

Description
Blinder Memo on problems relating to seniors in budget negotiations and his proposed solution.

Send to 1	Send to 2	Send to 3	Send to 4	Send to 5
Bob Rubin	Frank Raines	Gene Sperling		

Send to Comments
FYI

Bob Rubin
Frank Raines
Gene Sperling
Bob Rubin
Frank Raines
Gene Sperling FYI

1997 MAR 14 PM 5:12

MEMORANDUM FOR ERSKINE BOWLES, JANET YELLEN

FROM: Alan S. Blinder

RE: The budget negotiations

DATE: 14 March 1997

Motivation: Two Problems in the Budget Negotiations

-- The budget deal will be hard to complete without some sort of "CPI fix." But potential political objections are strong, especially from seniors.

-- Opening the capital gains loophole even wider is bad tax policy, but some sort of capital gains relief may be necessary to close the budget deal.

The Proposed Solution to Both Problems: General Idea

I am and always have been opposed to preferential tax treatment for capital gains. But if yet more tax preferences must be offered, there are better and worse ways. My suggestion is to cut the capital gains tax only for seniors. This would:

-- compensate seniors (in many cases, quite generously) for their COLA losses

-- minimize possibilities for gaming the tax system and for abusive tax shelters (though we can never eliminate such possibilities)

-- reduce the "lock in effect" now caused by forgiving capital gains taxes at death (stepup of basis). [Of course, constructive realization at death would be even better; but that is not in the cards.]

-- possibly raise revenue.

The Proposed Solution: Details

As an example, the current 28% top rate of capital gains could be reduced by one percentage point for each year of age (not holding period, nor size of business, etc.) beyond age 64. Thus:

Age	Top Rate
65	27%
70	22%
75	17%
80	12%
85	7%
92 and over	0

Obviously, other schedules could be used. I offer this one just to make the idea concrete.

This plan has two obvious economic advantages over other plans now on offer:

-- Capital gains are now forgiven at death, creating an incentive to hold assets until death. A tax rate that declines with age would reduce that incentive, thereby probably increasing realizations, and hence tax revenue. (However, the declining tax rate does create a small incentive--1 percent per year--to postpone realization.)

-- Since you cannot change your age, gaming the tax law would be very hard (compared, say, to transforming ordinary income into capital gains or creating "small businesses").

- Some decision would have to be made on how to define the "age" of joint filers. Older of the two?

- The one problem I have thought of is this: You could gift an appreciated asset to granny, who would then sell it and gift the proceeds back to you. But this loophole is easily plugged: just make assets acquired by gift ineligible for the favorable tax treatment.

In Sum

-- This plan might raise rather than lose revenue. (I don't know how it would be "scored.")

-- It might improve rather than reduce the efficiency of the tax code.

-- It would offer seniors a tangible benefit in return for a reduction in their COLAs.

-- It would mute (and perhaps end) the charge that seniors are being asked to fund a tax cut for the rich.

Not bad.

Let me know what you think. I am thinking of "going public" with the idea soon.

1997-SE-003880

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

April 11, 1997

INFORMATION

MEMORANDUM TO THE SECRETARY

FROM: Lawrence Summers

SUBJECT: Priorities in Budget Negotiations

Sheryl Sandberg, Michael Barr and I met with Bob Greenstein yesterday to discuss the Administration's priorities in budget negotiations. I came away from the meeting with the following main points:

1. Treasury has rightly been taking the position that we need to protect non-defense discretionary spending as a matter of sound governance, realistic budgeting, and as a bulwark against gimmickry. That argument also argues in favor of Treasury taking the position that high-priority mandatory add-ons -- for example, the immigrant and food stamp fixes to the welfare bill -- should fall within that protected circle.

2. Treasury should take a strong position in favor of fighting to enact most of the President's proposed fixes to immigrants and food stamps, rather than $70 billion or so of other mandatory add-ons, such as the school construction initiative or the child health block grants. Although we are unlikely to get all of the President's proposed immigrant and food stamp fixes, we can probably get a good portion of them if we fight hard.

3. Treasury should argue that the Administration should either (a) come up with a real legislative proposal implementing the President's call for a $3 billion welfare to work initiative based on serious economic thinking, or (b) abandon the idea so that those funds can be used for higher priority items, such as immigrants and food stamps. We should strongly resist gimmickry. Getting the White House to agree to come up with legislation will require your intervention with Erskine.

4. Our child health initiative is of a lower priority than the Medicaid fixes we have proposed. Moreover, we can achieve a targeted child health initiative by re-labeling certain of the "welfare fixes" having to do with child health as a "child health" effort.

5. Within non-defense discretionary, we should also fight hard for sufficient budget authority for section 8 housing voucher renewals. (Section 8 vouchers let a low-income person rent affordable housing wherever he wants.) A freeze in B.A. for section 8 vouchers could cut available housing vouchers by as much as 1/3 over the budget window. These cuts would be devastating for low-income families.

6. We need to continue to vigilant against proposals to (

NC CTO RER (reading)

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MF

4/11/97

1997-SE-004315

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

April 11, 1997

INFORMATION

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6. We need to continue to vigilant against proposals to cut the EITC.

EXECUTIVE SECRETARIAT

The Secretary of the Treasury

April 21, 1997

NOTE FOR LARRY SUMMERS

FROM: BOB RUBIN

What is this? -- Number 5.

Attachment