ADMINISTRATION HISTORY APPENDIX
CHAPTER ONE: FISCAL DISCIPLINE

DEFICIT

93-116232

DEPARTMENT OF THE TREASURY
WASHINGTON

INFORMATION

January 29, 1993

MEMORANDUM TO: SECRETARY BENTSEN

THRU: DEPUTY SECRETARY ALTMAN

FROM: Alicia Munnell
Alan Cohen

SUBJECT: Reconciliation of the Transition (OMB/Bush) Deficit Assumption ($357 billion) and CBO Published Deficit ($319 billion)

This memo is designed to explain the difference between the CBO's published FY 1997 deficit figure of $319 billion and the Administration's transition (OMB/Bush) deficit estimate of $357 billion. The attached table summarizes the conceptual, economic, and technical adjustments required to move from one number to another.

The table shows that the CBO figure for 1997 based on a comparable concept to the transition (OMB/Bush) $357 billion would be $319.7 billion, a difference of $37 billion. Only $1 billion of the $37 is attributable to differing economic assumptions; the remaining $36 billion discrepancy is due to technical differences. The most important technical difference arises in estimating revenues, particularly "differing interpretations of recent trends in corporate income tax collections."

The discrepancy between the CBO and transition (OMB/Bush) deficit numbers on a comparable basis has implications for the selection of the appropriate assumptions to underlie the budget projections. The decision to adopt the CBO economic assumptions was apparently made to provide the tougher baseline. As it turns out, because of the CBO technical assumptions, the baseline budget deficit is actually more favorable under CBO than under the transition (Bush/OMB).

Additional Background Information

The transition (OMB/Bush) $357 billion deficit for 1997 did not assume in advance cuts needed to meet the 1994 and 1995 Budget Enforcement Act (BEA) discretionary caps. Rather, it was an attempt to reflect uncapped current services spending for all discretionary programs, with the exception of defense. That is, non-defense discretionary spending was estimated by increasing 1993 appropriations in line with inflation; defense was held at the levels presented in the Bush budget.

In contrast, the published CBO deficit of $319 billion assumes that the BEA caps are effective in 1994 and 1995. Thereafter, it assumes that all discretionary expenditures (defense and non-defense) increase with inflation.

The first step in reconciling the two figures is to increase the published CBO $319.0 billion deficit by eliminating the expenditure savings, including interest savings, that results from meeting the BEA caps in 1994 and 1995. The elimination of these savings brings the 1997 CBO unconstrained deficit to $347.0 billion. The next step is to subtract from this amount an estimate of the savings ($27.3 billion) from maintaining the Bush defense estimate. This yields a CBO estimate of the FY 1997 deficit on the transition conceptual basis of $319.7 billion, which, by coincidence, is almost identical to the CBO published deficit of $319.0 billion.

Once the conceptual differences are eliminated, the remaining discrepancy is due to economic and technical assumptions. The Bush/OMB economic assumptions had higher inflation which produced $47.8 billion of additional revenues and roughly equivalent additional outlays and interest costs, yielding only $1 billion difference. Technical differences between CBO and Bush/OMB, however, raise the deficit by $36.1 billion to bring the Bush/OMB unconstrained baseline with Bush defense to $356.8 billion.

cc: Larry Summers
Marina Weiss

CBO PUBLISHED DEFICIT VS TRANSITION (BUSH/OMB) DEFICIT
(dollars in billions)

	93	94	95	96	97	98
CBO Capped Deficit	310.2	291.5	283.9	286.5	319.2	357.5
Cuts to meet '94 and '95 Caps	0.0	12.6	24.9	23.8	23.1	23.0
Net Interest	0.0	0.4	1.5	3.1	4.7	6.4
CBO Unconstrained Baseline Deficit \a	310.2	304.5	310.2	313.4	347.0	386.9
Savings from Bush Defense \b	-0.8	-6.7	-12.9	-17.7	-23.7	-30.4
Net Interest \c	-0.1	-0.3	-0.8	-2.1	-3.6	-5.7
CBO Unconstrained with Bush Defense \b	309.3	297.5	296.5	293.6	319.7	350.8
Economic Differences						
Revenues \d	-5.4	-17.2	-23.3	-32.9	-47.8	-75.2
Benefit Programs	0.2	1.3	6.0	13.3	21.3	29.7
Discretionary Outlays	0.0	1.2	3.7	7.7	12.6	17.9
Net Income (including Debt Service)	1.8	7.8	12.4	13.0	14.9	16.7
Subtotal	-3.4	-6.9	- 1.2	1.0	1.0	-10.9
Technical Differences						
Revenues \d	0.4	2.2	8.3	10.7	21.8	33.5
Deposit Insurance	12.7	6.4	-17.6	-13.5	2.4	3.0
Discretionary Outlays	0.7	1.3	3.5	3.9	4.0	4.7
Net Interest	2.9	1.9	1.6	4.1	6.2	9.3
Other Outlays	3.8	-0.2	2.2	4.8	1.8	-0.0
Subtotal	20.5	11.6	-2.0	9.9	36.1	50.4
Total Differences	17.1	4.7	-3.2	11.0	37.2	39.5
OMB Unconstrained with Bush Defense	326.4	302.1	293.3	304.7	356.8	390.3

Details may not add due to rounding.

a\ Excluding 1994-1998 projected spending from 1993 emergency appropriations.
b\ This estimate is somewhat inconsistent in that it uses a CBO estimate of an OMB concept of savings from retaining Bush defense projections.
c\ Implicit based on defense savings and reported deficit.
d\ Larger revenues are shown with a negative sign because they reduce the deficit.

1/28/93

93-116793

DEPARTMENT OF THE TREASURY
WASHINGTON

February 5, 1993

INFORMATION

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY ALTMAN

FROM: ALAN COHEN
SAM SESSIONS

SUBJECT: Achieving $145 Billion in Deficit Reduction

This memo discusses significant problems that threaten the goal of generating $145 billion of savings in 1997. It then describes a possible alternative for reaching $145 billion of deficit reduction.

Background: The Problem

The most recent baseline deficit from OMB is $356 billion in 1997. Very preliminary estimates from the Office of Tax Policy suggest that increases in the baseline for revenues might lower the baseline deficit to $348-349 billion, although this $7-8 billion reduction is by no means certain. If we could achieve $145 billion of deficit reduction in that year relative to this baseline (including the increased baseline revenues), we would lower the deficit to $203-204 billion.

The budget plan presented in the latest OMB document contemplates a total of $145 billion of deficit reduction in 1997. **But this plan has several large holes in its spending savings:**

-- The plan includes $6 billion of unspecified spending savings.

-- The plan includes $14.5 billion of savings from COLA reductions which are likely to be dropped from the package.

-- The plan includes $2.3 billion of savings from shortening debt maturities which it is our understanding will be excluded from the plan at this time.

-- The plan includes $17 billion of Medicare savings; Marina feels that $12 billion approaches the political feasibility limit. Therefore, we would lose about $5 billion of savings.

-- $8 billion of additional spending savings are needed, in addition to plugging the spending holes just mentioned (which total about $28 billion), in order to make the spending and revenue percentage split be equal to 50 percent and 50 percent.

Therefore, our spending savings are short by $36 billion in 1997. We think it is very unlikely that any significant new spending savings will be generated that we are not already aware of.

Therefore, the plan would appear to have a maximum of $109 billion of feasible savings and revenue increases. There is a risk that the plan will not gain sufficient credibility with only $109 billion of savings and would expose the President to the charge that he has reneged on his promise to cut the deficit by $145 billion. Furthermore, such a plan would be heavily tilted toward revenues relative to spending cuts. Moreover, the revenue package would include $22 billion in FY 1997 revenues for the broad-based energy tax which will be widely regarded as inconsistent with the President's campaign posture that he would not raise taxes on the middle class (and indeed would cut them). This general approach is not feasible from our viewpoint.

Escaping these problems, however, would require cutting COLAs, hitting Medicare far too hard politically, and coming up with significant new savings that no one has yet been able to identify. This outcome is equally unappealing.

Possible Solution

There is an alternative to this set of outcomes. In order to present this alternative, some background regarding the baseline is needed.

The OMB baseline deficit tentatively assumes the cuts needed to execute President Bush's five-year defense plan. Since defense appropriations are done one year at a time, the cuts for 1994 through 1997 have not been yet been enacted. But at this point, they are tentatively assumed in the OMB baseline.

These Bush defense cuts are not painless, especially in combination with the further Clinton defense cuts:

-- The **Bush** plan cuts 140,000 troops over a four-year period - 82,000 in the first year.

-- The **Bush** plan would require about a $6 billion cut in Operations and Maintenance which includes ammunition, fuel, and training.

The Clinton Administration will have to secure enactment and implementation of the defense cuts in the Bush plan for 1994 through 1997. Therefore, we believe that these savings can justifiably be counted as part of our effort to reach $145 billion of deficit reduction.

The latest estimates from OMB for the Bush plan are that it will save $31 billion in outlays in 1997 and an additional $4.4 billion in debt service, for a total of about $35.5 billion. By coincidence, the $35.5 billion of savings in 1997 from enacting the Bush defense cuts are almost exactly equal to the $36 billion spending savings shortfall discussed above. Therefore, the

alternative that we believe you should consider is to count the Bush defense savings toward the $145 billion of deficit reduction.

In order to count the savings from the Bush defense plan, we would have to raise the defense and debt service baselines by a total of $35.5 billion. Relative to this baseline, the Clinton plan would generate $150 billion of total savings in 1997. The resulting deficit would be about $233 billion in 1997. (This is only about $8 billion higher than the $225 billion deficit target we have been discussing previously). In summary, we believe that the proposal described above is an option which would meet our deficit reduction goal of $145 billion and meet a reasonable deficit target.

There is a downside to this approach. The Bush defense cuts are sufficient to bring total discretionary spending in 1994 and 1995 within the discretionary cap totals for those years. Some people will argue that since these defense cuts are needed to meet the obligations of the 1990 Budget Enforcement Act, assuming them as savings in the Clinton plan is double-counting (counting them under the 1990 Act and the new legislation).

This point is valid. It is also true, however, that these cuts have not been enacted yet and that these are real cuts: the troops that leave the military and the munitions that are not bought are quite real, not an artifact of some baseline. We believe that Wall Street wants real cuts and it is at least possible that these would be perceived by Wall Street as real cuts (the question is what Wall Street currently thinks the future deficits will be). We think that some, but not all, in the media could be persuaded of the same thing, as long as we do not try to hide the approach from them. (If you try to hide it, and if they find it, they will feel they have "uncovered" something and they will present it to the public that way.) **Some in the media, however, will not buy our argument.** But in our view, the media fallout from this problem is substantially less than the media and political fallout from proposing to cut only $109 billion or from proposing to cut COLAs, to cut Medicare too deeply, to make deep cuts in other spending programs that are so difficult to find that we have not yet identified them, or to construct a package that leans too heavily on taxes, including taxes on the middle class.

The double-counting problem with the alternative option is a significant weakness. But the weaknesses of the other alternatives are far greater. When this comparison is made, we believe the new alternative is the option to select.

Can we eliminate the energy tax from the package?

In order to keep the package with at least 50 percent spending cuts (other than debt service savings) in a $145 billion package, we cannot have net revenues which are greater than about $65 billion. (Note: $15 billion of the $145 billion would derive from debt service savings, and the media have not tended to count debt service savings as true spending cuts when it compares the proportion of spending cuts and revenues in a package).

The package as currently constituted includes $73 billion of net revenues in FY 97. This consists of $83 billion of gross revenue increases, including $7 billion from additional taxation of Social Security benefits, and $10 billion or so (the amount has not been finally determined) of "investment" revenue losses. Therefore, if we maintain the $10 billion of revenue losses, we need to remove at least $8 billion of revenue increases from the package to reduce net revenues to $65 billion. If we were to incorporate lower 1997 revenue losses of, perhaps, only $7 billion, we would need to reduce gross revenues by $11 billion to keep net revenues at $65 billion.

Eliminating approximately $11 billion of gross revenues suggests the possibility of removing the broad-based energy tax from the package entirely, since it raises $22 billion in 1997. The energy tax would then be replaced with other revenue increases that total only $11 billion in 1997. While it is not clear that $11 billion of acceptable new revenue raisers can be found (drawing from the list of possible replacements for the energy tax shown to you yesterday and other options we are working on), we believe that it is at least possible, and thus that this alternative should be seriously considered.

93-11789

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON, D. C. 20220

February 23, 1993

Memorandum for: Gene Sperling
White House

From: Roger Altman

Since our deficit reduction plan began to take shape, long term interest rates have fallen to a sixteen year low. And, for the first time since 1977, the Treasury's long term borrowing cost has fallen below 7%.

On Election Day, the Treasury was borrowing around 7.70% on a long term basis. That rate, as of today, is down below 6.90%.

These reductions enable Americans to refinance their mortgages, to buy cars and trucks on better terms, to obtain cheaper consumer credit, student loans and small business loans.

For years, many have said that our huge budget deficits were keeping real term interest rates at excessively high levels. These recent and encouraging reductions suggest that true deficit reduction really will bring rates down to the benefit of all Americans.

cc: Secretary Bentsen
Robert E. Rubin

93-121231

ESK

DEPARTMENT OF THE TREASURY
WASHINGTON

May 5, 1993

MEMORANDUM FOR: SECRETARY BENTSEN

FROM: Alicia Munnell
Assistant Secretary-Designate, Economic Policy

SUBJECT: Timing of Proposed Tax Increases in the Deficit Reduction Plan

Proposal

Now may be an opportune time for Treasury to get out front in recommending that the effective date of proposed tax increases on corporations and high-income individuals be slipped to January 1994. This could give the economy a needed lift, just when it appears to be getting a little soggy, by removing some of the uncertainties facing businesses and households and by freeing up some of the funds now being set aside for tax payments next year.

Discussion

Slipping the effective date of proposed tax-rate increases from the January 1993 in the original proposal would have several advantages:

- The economy appears to have hit another soft spell. Weakness in the recent economic statistics extends well beyond what can be explained by unfavorable weather alone. We had counted on the stimulus package to give the economy a lift, but it was killed. Currently, affected individuals and corporations are putting away funds to meet this year's expected increased tax liability. (Because there will be no penalty for underpayment of liability, the Treasury won't receive the bulk of those funds until next year.) Slipping the date might free up some of those funds to enter the spending stream.

- Decision makers are faced with a number of uncertainties currently -- the impact of health care reform on compensation costs, likelihood of Congressional action on investment incentives, etc. Setting a firm target of January 1994 as the effective date of tax increases would eliminate one of the uncertainties that may be inhibiting business activity and household spending.

- Congress is likely to slip the date to January 1994 no matter what we propose.

The most serious objection to this proposal relates to appearances -- that people might be led to believe the Administration is not fully committed to deficit reduction, that we can be diverted from our long-term goals by what may be a short-term shift in the economy. Any proposal to slip the tax date should be accompanied by word and deed to make clear that deficit reduction remains our overriding goal, for it is the fundamental element in any program to put the economy back on a solid growth track over the longer term.

- Slippage of the date would also mean some revenue loss. Earlier calculations of the Office of Tax Analysis placed that loss at about $23 billion in FY-1994 and $3-1/2 billion in FY-1995. Those estimates assume announcement of any change is made well in advance so that there would be a large shift of income into CY-1993.

ESK
Edward S. Knight

TREASURY CLEARANCE SHEET

NO. _____

Date 5/5/93

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

FROM: Alicia Munnell, Assistant Secretary-Designate, Economic Policy

THROUGH: _____

SUBJECT: Timing of Proposed Tax Increases in the Deficit Reduction Plan

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
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- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
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  - ☐ Savings Bonds
- ☐ Other _____

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
James Russel	JMR	5/5	Economic Policy	2-1681
REVIEWERS				
John Auten	JA	5/5	Economic Policy	2-2070

SPECIAL INSTRUCTIONS

☐ Review Officer _____ Date _____

☐ Executive Secretary _____ Date _____

93-121389

DEPARTMENT OF THE TREASURY
WASHINGTON

May 10, 1993

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY ALTMAN

FROM: Alicia Munnell

SUBJECT: Long-run Deficit Reduction

SUMMARY:

In a little noticed comment two weeks ago, President Clinton stated publicly that he would like to bring the Federal Budget deficit "down to zero" in 8 years (see attached Knight-Ridder report). Before the Administration gets locked into this position, it might be useful to explore the feasibility of such a goal.

Recent numbers prepared by OMB suggest that, with current policies, a deficit $80 billion, 0.9 percent of GDP, could be obtained only under the following four optimistic assumptions: 1) health care reform required no new money; 2) health care reform produced significant savings beginning in 1994; 3) the economy performed more in line with the CEA forecast than with the less optimistic CBO projections; and 4) Congress passes all the deficit reduction proposals in the Budget Resolution.

If health care does not produce net savings by FY 2000, the deficit will be $178 billion and rising, even under the CEA's upbeat economic forecast. If the CBO economics turn out to be correct, the deficit will be closer to $283 billion and rising.

DISCUSSION:

Table 1 shows the long-range budget deficit projections under various policy and economic assumptions:

o Baseline (CBO economics): A current services estimate based on CBO economics as of January 1993; actual deficits will be somewhat lower due to fall in interest rates.

o Budget (CBO economics): April Budget based on CBO economics but OMB pricing of receipts and outlays.

o Resolution (CBO economics): The Hill passed 1994 Budget Resolution, with stimulus package deleted.

o Resolution (CEA economics): Administration's economic

o Resolution (CEA economics): Administration's economic assumptions, which are more optimistic than CBO's.

o Resolution with Health Care Reform (CEA economics): Starting in FY 1994, Medicare and Medicaid growth are capped at beneficiary growth plus CPI + 2 percent.

A quick glance at Table 1 shows the projected deficit approaches zero by FY 2000 only under the assumptions of a policy incorporating the 1994 Budget resolution, capped health care outlays, and the more optimistic CEA economic assumptions. Under these assumptions, the deficit in FY 2000 would be $80 billion or 0.9 percent of GDP, a figure close enough to zero to declare victory.

How realistic are these assumptions? The more optimistic CEA real economic growth is not unreasonable. Capping health care outlays so that they grow by only 7.5 percent beginning in 1994 represents a sharp slow down from the approximately 10 percent average growth rate over the last decade. Also, assuming that Congress will pass the program cuts necessary to meet the 1994 Budget resolution may be optimistic.

The bottom line is that zero is probably not a realistic goal by FY 2000, even with major health care reform. Furthermore, it is an unnecessarily restrictive goal. A second memo will explore the options of stabilizing the deficit in terms of a dollar amount, stabilizing the ratio of deficit to GDP, and stabilizing the ratio of debt to GDP.

Attachments

KNIGHT-RIDDER MoneyCenter News #11285 Received at 1:17P on 27-Apr-93

Clinton sets goal of eliminating US budget deficit within 8 years

Knight-Ridder

Washington--Apr 27--President Bill Clinton today told an audience of real estate agents that he would like the US budget deficit brought "down to zero" in 8 years through budget cutting coupled with health care reform.

In his speech, Clinton reviewed the economic program he offered in February and emphasized that without serious health care reform, the US budget deficit will not be under control for the long-term.

A health-care reform plan is supposed to be submitted to Congress by Clinton in mid-May.

While Clinton spoke of the need for a "disciplined plan to bring this deficit down to zero" in 8 years, he provided no new details on

He also said the budget deficit this year is "going to be much smaller" than expected because of lower interest rates. But he did not state a revised figure. End

(By Richard Cowan, Knight-Ridder Financial News)

Table 1

LONG-RANGE DEFICIT PROJECTIONS
(billions of dollars)

04/21/93
04:35 PM

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
laseline (CBO economics)	-310	-302	-301	-298	-347	-387	-429	-478	-529	-584	-644
ludget (CBO economics)	-322	-264	-247	-212	-214	-250	-277	-311	-346	-389	-431
lesolution (CBO economics)	-308	-250	-231	-197	-205	-227	-252	-283	-316	-356	-395
lesolution (CEA economics)	-302	-240	-211	-166	-160	-162	-164	-178	-200	-222	-244
lesolution w/ health reform (CEA economics)	-302	-240	-201	-144	-125	-110	-91	-80	-76	-68	-59
)eficit as percent of GDP											
Baseline (CBO economics)	5.0%	4.6%	4.4%	4.1%	4.6%	4.9%	5.2%	5.6%	5.9%	6.3%	6.7%
Budget (CBO economics)	5.2%	4.1%	3.6%	2.9%	2.8%	3.2%	3.4%	3.6%	3.9%	4.2%	4.5%
Resolution (CBO economics)	5.0%	3.8%	3.4%	2.7%	2.7%	2.9%	3.1%	3.3%	3.6%	3.8%	4.1%
Resolution (CEA economics)	4.9%	3.7%	3.0%	2.3%	2.1%	2.0%	1.9%	2.0%	2.1%	2.2%	2.3%
Resolution w/ health reform (CEA econ.)	4.9%	3.7%	2.9%	2.0%	1.6%	1.3%	1.1%	0.9%	0.8%	0.7%	0.6%
3DP (CBO economics)	6172	6507	6855	7202	7543	7872	8192	8537	8901	9280	9674
3DP (CEA economics)	6192	6573	6976	7376	7785	8220	8660	9107	9567	10048	10557

Table 2

COMPARISON OF ADMINISTRATION AND CBO FORECASTS
(Calendar Years)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Percent increase, fourth quarter over fourth quarter:											
Real GDP:											
CBO	2.8	3.0	2.8	2.6	2.2	1.8	1.9	2.0	2.0	2.0	2.0
CEA	3.1	3.3	2.7	2.5	2.5	2.5	2.3	2.1	2.0	2.0	2.0
GDP deflator:											
CBO	2.5	2.4	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.3	2.2
CEA	2.8	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Unemployment rate:											
CBO	7.1	6.6	6.2	6.0	5.8	5.7	5.6	5.6	5.6	5.6	5.6
CEA	6.9	6.4	6.1	5.9	5.7	5.5	5.5	5.5	5.5	5.5	5.5

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

CLOSE HOLD

December 12, 1993

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY ALTMAN

FROM: Alicia H. Munnell
Assistant Secretary
for Economic Policy

SUBJECT: Revised Budget Deficit Estimates

Estimates from OMB show that the Administration's new economic assumptions for the FY 1995 budget (agreed to by the Troika in early December) will result in higher estimated deficits than indicated in the OMB Budget Preview from November.

- The estimates are preliminary because they are based on a simple model rather than estimates from Treasury's Office of Tax Analysis and detailed agency reports. They have tended to be fairly accurate in the past. The information should be treated as **CLOSE HOLD** with no release or discussion in public.

- Rather than the deficit coming in lower in 1998 than in the MSR estimates, the new estimates indicate that the deficit will be higher in 1998 than estimated in the MSR:

Deficit Estimates

	1994	1995	1996	1997	1998
MSR	259	200	179	184	181
Preview (Nov)	243	176	151	155	149
1995 Bud (Dec)	250	193	179	191	194
Change from MSR	-9	-7	0	7	13

Principal Reasons for the Higher Deficit Estimates

- Compared to the Preview assumptions, nominal GDP is slightly lower in the Troika assumptions adopted for the 1995 budget--due to lower GDP deflator inflation in 1994 and 1995. Budget estimates are not inflation neutral--a reduction in projected inflation raises deficit estimates.

- The new "Black Box" detailed economic assumptions had a higher share of "other labor income" from higher fringe benefits (to more accurately reflect the pre-health reform trend of health insurance costs). This change resulted in lower taxable income.

CLOSE HOLD

TREASURY CLEARANCE SHEET

NO. 93-128696
Date December 14, 1993

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
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☐ TESTIMONY ☐ OTHER _____

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

THROUGH: _____

SUBJECT: Revised Budget Deficit Estimates

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
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  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
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  - ☐ E & P
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  - ☐ Savings Bonds
- ☐ Other _____

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
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☐ Review Officer _____ Date _____

☐ Executive Secretary _____ Date _____

DO F 80-02.1 (04/89)

94-128746

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

CLOSE HOLD

December 15, 1993

MEMORANDUM FOR DEPUTY SECRETARY ALTMAN

FROM: Alicia H. Munnell (Initialed)
Assistant Secretary
for Economic Policy

SUBJECT: Revised Budget Deficit Estimates II

Yesterday's memorandum presented the following table showing that the deficit estimates likely will not improve as much as had been indicated in OMB's November Budget Preview.

Deficit Estimates

	1994	1995	1996	1997	1998
MSR	259	200	179	184	181
Preview (Nov)	243	176	151	155	149
1995 Bud (Dec)	250	193	179	191	194
Change from MSR	-9	-7	0	7	13

These estimates should be interpreted as suggestive as they are based on a model run by OMB staff and are not based on complete agency detail.

The December projection for the deficit is higher relative to the November projection primarily for two reasons resulting from changes to economic assumptions:

Lower Inflation

- The Administration economic assumptions adopted by the Troika in early December for the FY 1995 budget had lower inflation than in the economic assumptions used for the MSR and in the November overview.

  - The assumption for GDP deflator inflation was lowered by 0.3 percentage point for 1993, 0.2 percentage point for both 1994 and 1995, and 0.1 percentage point for 1996.

  - Lower inflation reduces the level of nominal GDP in the economic projection. This results in lower tax revenues. A decline in inflation also reduces inflation-sensitive outlays, but the reduction in outlays occurs with a lag

relative to the decrease in tax revenues. As a result, the lower inflation in the Administration's economic assumptions generates a higher deficit projection.

- The inflation assumption change accounts for roughly 1/4 of the change in the deficit projection from the November estimates.

Lower Taxable Income

o The new "Black Box" detailed economic assumptions (produced by CEA and based on the Administration Troika economic assumptions for the major variables) had lower taxable income than used in earlier projections.

  - The November Budget Review used total taxable income shares rising from 76.5 percent of nominal GDP in 1994 to 77.2 percent in 1999 (based on the MSR Black Box detail). The new Black Box detail projects the total taxable income share declining from 76.4 percent in 1994 to 76.0 percent in 1999. Thus, by 1999, $106 billion of taxable income was "lost" due to the 1.2 percentage point weaker taxable income share.

  - More than half of the income "loss" results from the changes to "other labor income" from higher fringe benefits (to more accurately reflect the pre-health reform trend of health insurance costs). The remainder appears to have resulted primarily from lower shares for corporate profits and proprietors' income.

  - The change in income share assumptions accounted for roughly 3/4 of the change in the deficit projection from the November Review estimates.

  - The lower share for other labor income will permit proper estimates to be made for the effect of health care reform on health insurance costs.

CLOSE HOLD

TREASURY CLEARANCE SHEET

NO. 93-128746
Date

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: Revised Budget Deficit Estimates II

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)				
John Kitchen	JK	12/15	Office of Policy Analysis	622-1757
REVIEWERS				
J. Hambor	JH	12/15	Acting Director, Policy Analysis	622-2350

SPECIAL INSTRUCTIONS

☐ Review Officer — Date

☐ Executive Secretary — Date

DO F 80-02.1 (04/89)

94-135510

DEPARTMENT OF THE TREASURY
WASHINGTON

INFORMATION

ASSISTANT SECRETARY

JUN 27 1994

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY ALTMAN

FROM: Alicia H. Munnell
Assistant Secretary for Economic Policy

SUBJECT: Estimates of the FY-1994 Budget Deficit

Summary

A confusing array of deficit estimates has hit the press in the past few days. This week, Leon Panetta has been quoted as expecting a figure of $225 billion or below for the current fiscal year. James Blum of CBO placed the number at about $200 billion. Those figures compare with the projection of $235 billion in our budget released in February.

Our own internal estimate is for a deficit in the area of $205 to $210 billion. That is for background information only. Any public discussion of the deficit probably should come from OMB. Administration budget projections are currently being refined as part of the Mid-Session Review process. Treasury's Office of Tax Analysis is updating revenue estimates and the agencies are reviewing their outlay projections. The Mid-Session Review will be released on July 15.

Discussion

Relative to the receipts forecast prepared last winter by the Office of Tax Analysis for the FY-1995 budget, year-to-date receipts suggest that FY-1994 revenues could exceed projections by approximately $10 billion. Staff of the Fiscal Assistant Secretary track budget developments closely, and they expect outlays will be lower than projected by about $15 billion or perhaps a bit more. Implications for next year of the better-than-expected FY-1994 results are not clear.

- On the outlay side, the bulk of the shortfall this year appears to reflect technical factors or is concentrated in such areas as defense where a repeat is not assured for next year. Projections of interest expense will be raised in the Mid Session.

- The Office of Tax analysis is currently preparing a revised Mid-session Review receipts forecast for the period FY-1994 through FY-1999. It will be completed later this month. Based on the Troika's assessment that the level of economic activity will be stronger than was anticipated last winter, we expect that revenues for FY-1995 will be higher than in the winter projections.

In our budget released in February, a deficit of $176 billion was projected for FY-1995 (assuming passage of health care reform). Leon Panetta has suggested a figure of $170 or below. Results of the Mid-Session Review process will be available in a few weeks, and those will provide a better fix on the likely FY-1995 outcome.

cc: Frank Newman
Les Samuels

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
September 29, 1994

138367

MEMORANDUM FOR SECRETARY BENTSEN
CHAIRMAN TYSON

FROM: Alicia Munnell
Joe Stiglitz

SUBJECT: A Proposal for Deficit Reduction Based on Bias in the Consumer Price Index

SUMMARY

Many analysts claim that the Consumer Price Index (CPI) seriously overstates inflation, and, therefore, reducing the indexation of Government programs is an obvious way to lower the deficit. In order to assess the merits of such proposals, Treasury and CEA met with BLS experts to discuss the nature and magnitude of any bias that might exist in the CPI.

This dialogue revealed that the situation between now and 1998, when a revised index is scheduled to be released, differs markedly from the post-1998 period, when the new index will be available. In the next four years, CPI increases will probably be at least 0.5 percentage points higher per year than they would be if the CPI were based on a more recent market basket, and procedural changes currently under consideration were made in the index. In 1998, when the market basket is revised and when (and if) the procedural changes are made, most of this bias should disappear.

The bias in the current CPI provides justification for reducing indexing markedly in the short-run, but the fact that we can likely reduce the bias in the CPI over the next few years leaves little justification for any long-run proposal, such as permanently indexing by CPI less one percentage point.

PROPOSAL

In order to partially offset the cumulative bias in the CPI of at least 4 percent by 1998, we propose adoption of one of the following two major options:

- Reduce indexing for retirement-income programs (Social Security, civilian and military retirement) and tax brackets (except for the Earned Income Tax Credit) for the next four years by 0.5 percentage points per year (reduces deficit by roughly $60 billion over 5 years).
- Delay both the tax-bracket and retirement-income adjustments for one year (reduces deficit by roughly $100 billion over 5 years).

interest

DISCUSSION

Three possible sources of overstatement of the CPI have been emphasized in recent discussions of bias in the index:

- *Substitution Bias.* As prices of goods and services change, consumers shift away from items that have become relatively more expensive toward those that have become relatively less expensive. Since the CPI is based on a fixed basket of goods and services and is revised only once every ten years, the benefits of such shifts are not reflected in the index. As one would expect, this bias begins at a relatively low level as the CPI is revised to reflect more current expenditure patterns and tends to increase over the life of any given market basket. Since the current CPI is at the end of its cycle and due for a revision, the substitution bias is now relatively high. BLS suggests that this bias may currently be contributing as much as 0.3 percentage points per year to the CPI. Once the revised index is released in 1998, however, the substitution bias should drop substantially, but then gradually increase thereafter. The cumulative bias could be reduced by updating the CPI market basket more frequently. If the market basket were revised every five years instead of every ten years, the bias could probably be held below 0.2 percentage points per year, on average. OK

- *Procedure for Updating Item and Outlet Samples.* The procedure used by the BLS to update the item and outlet samples in the CPI almost certainly introduces an upward bias in the index. The problem stems from the fact the initial price reading for a particular good in the index may not match the average price of the same good in the CPI market basket. The result of this mismatch is that if, for instance, the initial price reading is a sale price, the price increase when the sale goes off will be given too much weight. The BLS is considering a change in index-calculation procedures that would mitigate the problem. According to BLS estimates, making this change would reduce the rate of change in the overall CPI by 0.3 to 0.4 percentage points per year.[1]

  Discussions are currently underway within the BLS about whether to introduce this new method at the time the revised index is introduced. In the meantime, BLS is considering some relatively minor changes that would address at least part of this problem and would probably reduce measured inflation by between 0.1 and 0.2 percentage points per year. The important point here is that between now and 1998, the measured inflation rate is likely to be higher than it will be in the post-1998 period, *ceteris paribus*, if the BLS goes ahead at that time and revises the way in which it averages price changes.

- *Quality Adjustment Problems.* The quality of goods and services changes over

[1] It is important to recognize that this methodological change not only corrects for the problem that causes the bias in the CPI as currently calculated, but also uses a different assumption about how consumers respond to relative price changes. If this assumption is seriously off the mark, the new method could "overcorrect" the index. On the other hand, mitigating against this possibility is the fact, noted above, that the CPI already suffers from a substitution bias, so the contemplated change could possibly reduce this bias as well.

time. Some of the increase in the list prices that consumers pay may represent improved quality and should not show up as an increase in the CPI. The discussion with BLS representatives revealed that the BLS does indeed try to adjust for quality, and that quality adjustments could just as well lead to an understatement of price increases as an overstatement. For example, in the automobile area, they suggested that adjusting the price of cars for the full cost of anti-pollution and safety mandates overstates the quality improvements associated with these regulations. On the other hand, in other areas such as medical care and services, quality improvements are very difficult to measure and almost certainly lead to an overstatement in the CPI. No agreement exists on the magnitude of bias associated with quality adjustment. Most analysts speculate that a positive bias probably exists. CEA and Treasury have suggested 0.4 percentage points per year as a reasonable estimate. The BLS representatives simply reiterated that no solid number existed.

- *Overall Effect.* The possible overstatement or understatement emerging from the various problems associated with creating a price index number cannot simply be added together, since their effects may interact. The consensus that emerged from the group, however, was that in the pre-1998 period, the CPI will very likely overstate the rate of price increase by at least 0.5 percentage points per year. In 1998, with the mitigation of the substitution bias and the introduction of methodological improvements, the bias should drop substantially, and more frequent revisions of the index should keep the bias well below its current level. The question of quality adjustment bias will remain, but so little is known about its magnitude that it would be difficult to base any adjustment on this problem. Thus, little economic justification exists for reducing indexation in the long run based on flaws in the CPI. Rather, increased resources should be put into improving the index itself.

POLICY OPTIONS

We believe it is appropriate to consider alternatives for introducing a CPI adjustment between now and the 1998 revision of the CPI to reflect what we consider to be a clear overstatement of the rate of increase in the CPI. Since the CPI has had a relatively serious upward bias at least since the last revision, and since this bias will get worse over the next four years, the cumulative bias will grow to well over four percent by the time the CPI is next revised. Several options exist:

OK

- Reduce indexing for retirement-income programs (Social Security, civilian and military retirement) and tax brackets (except for the Earned Income Tax Credit) for the next four years by 0.5 percentage points per year.
  - This should cut the deficit by roughly $60 billion over five years, with slightly less than half of the effect in revenue increase and the remainder in outlay reduction.
- Delay both the tax-bracket and retirement-income adjustments for one year. A similar procedure was adopted for retirement and disability benefits when

indexation was delayed for six months in the 1983 Social Security Amendments.

- This should cut the deficit by roughly $100 billion over five years, split in roughly the same way between outlay reduction and revenue increase as a reduction in the indexation factor.

- If less of an adjustment is desired, the two approaches can be combined: delay indexation of benefits for six months, but, since one year is the minimum delay for indexing tax brackets, cut the rate of tax-bracket escalation in half. This could be presented as a way to implement the equivalent of a six-month delay for tax brackets.

  - This would reduce the savings to roughly $50 billion over five years.

We recommend a full-year delay or its equivalent for two reasons. First, with anything less, the benefits in deficit reduction may very well not be worth the effort to get the proposal through. Second, a delay of one year, at today's inflation rate, or even a one percentage point reduction in indexation over the next four years would only partially correct for the overindexation that has occurred and would continue to occur, absent some action, between the last revision in the CPI and the next.

ROUGH ESTIMATES OF THE FIVE-YEAR BUDGET SAVING OF REDUCED INDEXING OF RETIREMENT BENEFITS AND PERSONAL INCOME TAX (PIT) BRACKETS 1995-1999 (EXCLUDING INTEREST)

	Deficit Reduction
Adjust Retirement Income and PIT brackets by CPI-0.5	
COLA	35
Individual Income Tax Bracket Indexing	25
Total	60
Eliminate Retirement Income and PIT Bracket Adjustment for 1 Year	
COLA	55
Individual Income Tax Bracket Indexing	45
Total	100
Eliminate Retirement Income and PIT Bracket Adjustment for 6 Months	
COLA	30
Individual Income Tax Bracket Indexing	20
Total	50

CAVEAT

The above discussion ignores an important factor that could either increase or mitigate any bias in current indexation of retirement programs and could play a large role in any debate over a policy change. Currently, the BLS compiles two all-items CPI's that focus on two population groups. The most widely cited index has been produced only since the late 70s and covers all urban consumers; it excludes only the rural and farm populations that live outside of metropolitan areas. This index is used to escalate individual income tax brackets. The second index, which has a longer history, covers "urban wage earners and clerical workers" and includes only those consumer units in which the primary earner falls into one of these categories. This index is used to escalate social security benefits, despite the fact that it does not cover retired consumers and the all-urban index does. These indexes move very closely together; the all-urban index grew at 3.97% between December 1987 and December 1993, and the index for wage earners and clerical workers grew at 3.86%.

A BLS experimental index reweighted to reflect the expenditure patterns of older Americans, however, grew at 4.29% over this same period. Since it is experimental, it does not correct for other sources of bias, such as in the price indexes for health care, nor does it adjust for the fact that the item and outlet samples are not chosen to represent the elderly population. Despite these shortcomings, any attempt to reduce the indexation of social security benefits because the index *overstates* inflation is likely to be met with the argument that an index that focused on social security recipients would increase *faster* than the index that has actually been used for social security indexation. (More generally, the use of any aggregate index, even if it is correct on average, will shift purchasing power from those families that face above average inflation, either because of location or spending patterns, to those that face below average inflation.)

Serious problem

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 29, 1994

INFORMATION

I was involved in this approach in '83. Its worth a renewed discussion with the loss of much of health care savings.

MEMORANDUM FOR SECRETARY BENTSEN
CHAIRMAN TYSON

FROM: Alicia Munnell AHM
Joe Stiglitz JS(L)

SUBJECT: A Proposal for Deficit Reduction Based on Bias in the Consumer Price Index

Let's evaluate it soon in discussion. I want Mike Levy in it.

SUMMARY

Many analysts claim that the Consumer Price Index (CPI) seriously overstates inflation, and, therefore, reducing the indexation of Government programs is an obvious way to lower the deficit. In order to assess the merits of such proposals, Treasury and CEA met with BLS experts to discuss the nature and magnitude of any bias that might exist in the CPI.

This dialogue revealed that the situation between now and 1998, when a revised index is scheduled to be released, differs markedly from the post-1998 period, when the new index will be available. In the next four years, CPI increases will probably be at least 0.5 percentage points higher per year than they would be if the CPI were based on a more recent market basket, and procedural changes currently under consideration were made in the index. In 1998, when the market basket is revised and when (and if) the procedural changes are made, most of this bias should disappear.

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Edward S ...

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94 138456

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

OCT 3 1994

MEMORANDUM FOR DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell [Initialed]
Assistant Secretary
for Economic Policy

SUBJECT: Additional Charts on Deficit Reduction Options

The attached long-term charts were developed in response to your questions at Thursday's meeting. The first chart analyzes our proposal to temporarily eliminate or lower the CPI indexing factor on entitlement COLAs, and to less than fully adjust the Individual Income Tax bracket amounts for CPI changes. The bulk of the saving reflected in the chart results from our assumption that the CPI is corrected for 0.5 percentage points of upward bias beginning in 1999. Although the chart is based on a temporary reduction of the COLA (by 0.5 percentage points) rather than a one-year delay, the short-term (five-year effects) look essentially the same in the long-term chart for either case. The longer term effects (after 1998) are virtually the same for the two cases. Thus, the long-term impact on the deficit from either policy is captured in the chart.

Two caveats should be noted.

- First, although our proposal is based on the CPI being fully corrected in 1999, eliminating the need for applying a CPI-.5 rule after 1998, we simulated the budgetary effect of the reduced future CPI inflation rate by leaving the rule in place -- directly in the case of indexed pension payments and indirectly in the case of bracket adjustment. In effect, we introduce a change in the differential between the CPI and the GDP deflator. The alternative approach, lowering the overall inflation assumption in the future, would have generated inconsistencies in the estimation of future deficits.

- Second, in the past, Congress has acted to roughly offset the effect of bracket creep by lowering rates. Our estimates are consistent with assuming that, on average, Congress legislates lower marginal rates (every five years) after 2000, while continuing to index the brackets by CPI-.5. This reflects the differential between the growth rate of the tax base (nominal GDP) and indexing the brackets for inflation by a CPI which rises more slowly relative to the GDP deflator. We assume such rate reductions maintain the

average marginal rate in effect in 2000 through 2030. (The effective average rate might not rise at all if substantial amounts of income are sheltered as effective marginal rates increase.)

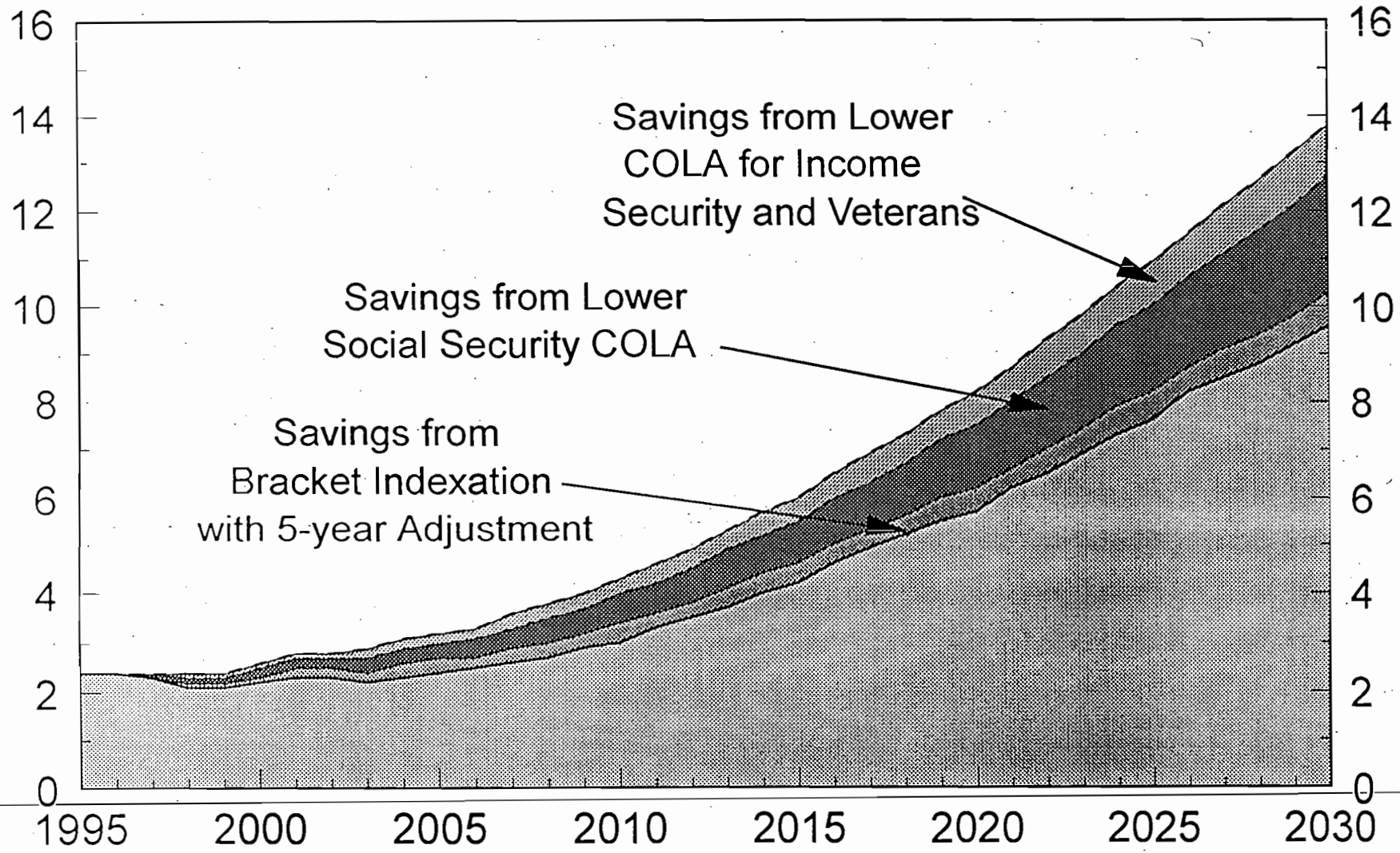
Four additional charts were developed to illustrate the sensitivity of the deficit projections to changes in economic assumptions by comparing the deficit time path under the changed assumption with the base case. Real GDP growth and the inflation rate were raised by 0.2 percentage points. The average interest rate on government bonds and the health care inflation rate were lowered by 0.5 percentage points. Additional analysis suggests that the effect of larger changes would be essentially linear until about 2020 before deviating from proportionality. Deviations would still be very small by 2030. Thus, the effect of larger changes in assumption values, would generally be to increase the deficit (as a percent of GDP) proportionately, e.g., changing an assumption by 0.4 percentage points would essentially double the effect of a 0.2 percentage point change on the long-term deficit.

Attachments

COLA Adjustment and the Long-Term Deficit

COLA lowered by 1/2 % pt but Income Tax Rate Rise Reversed Every 5 Years

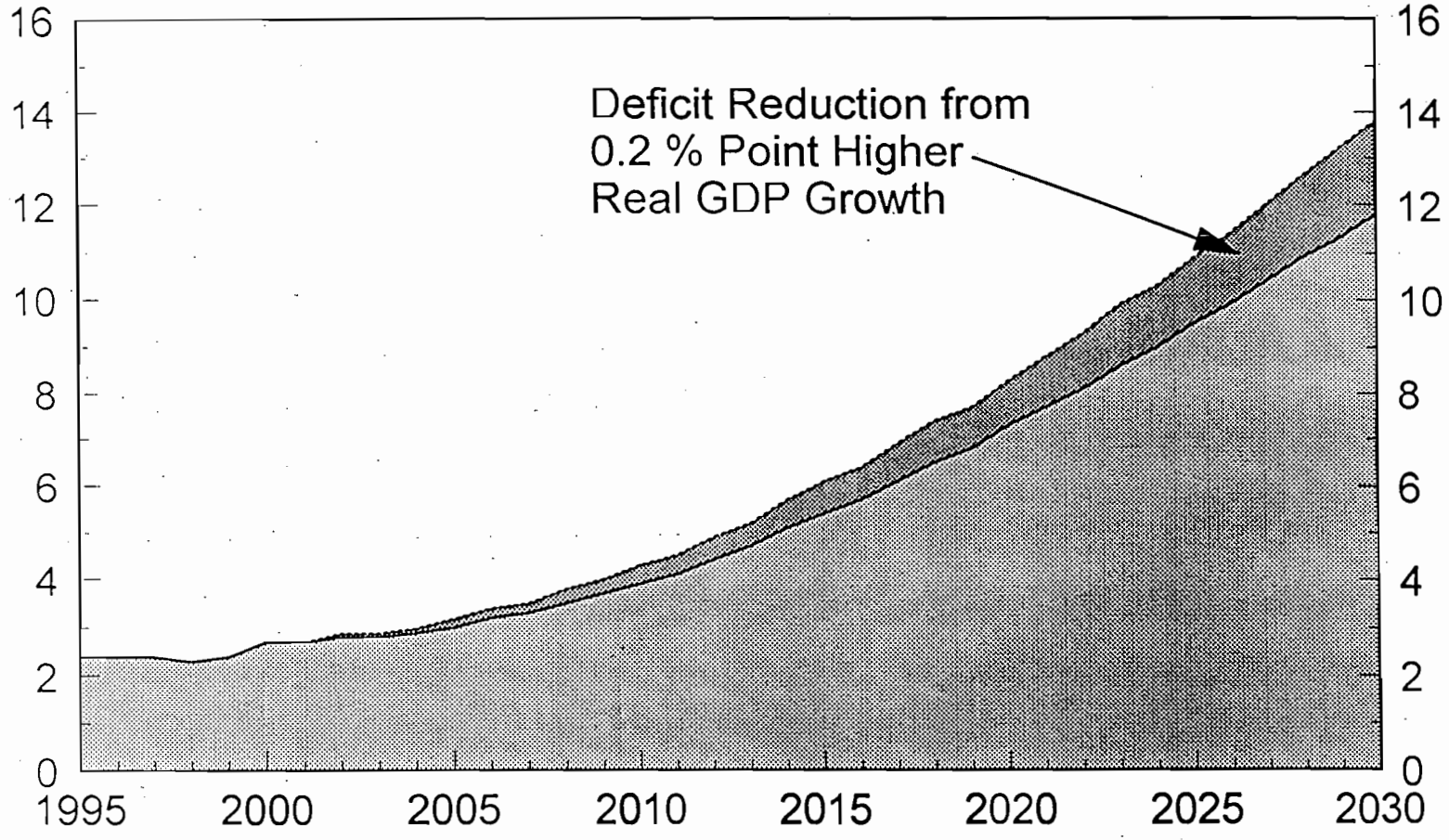
Percent of GDP



Sensitivity to Real GDP Growth Assumptions

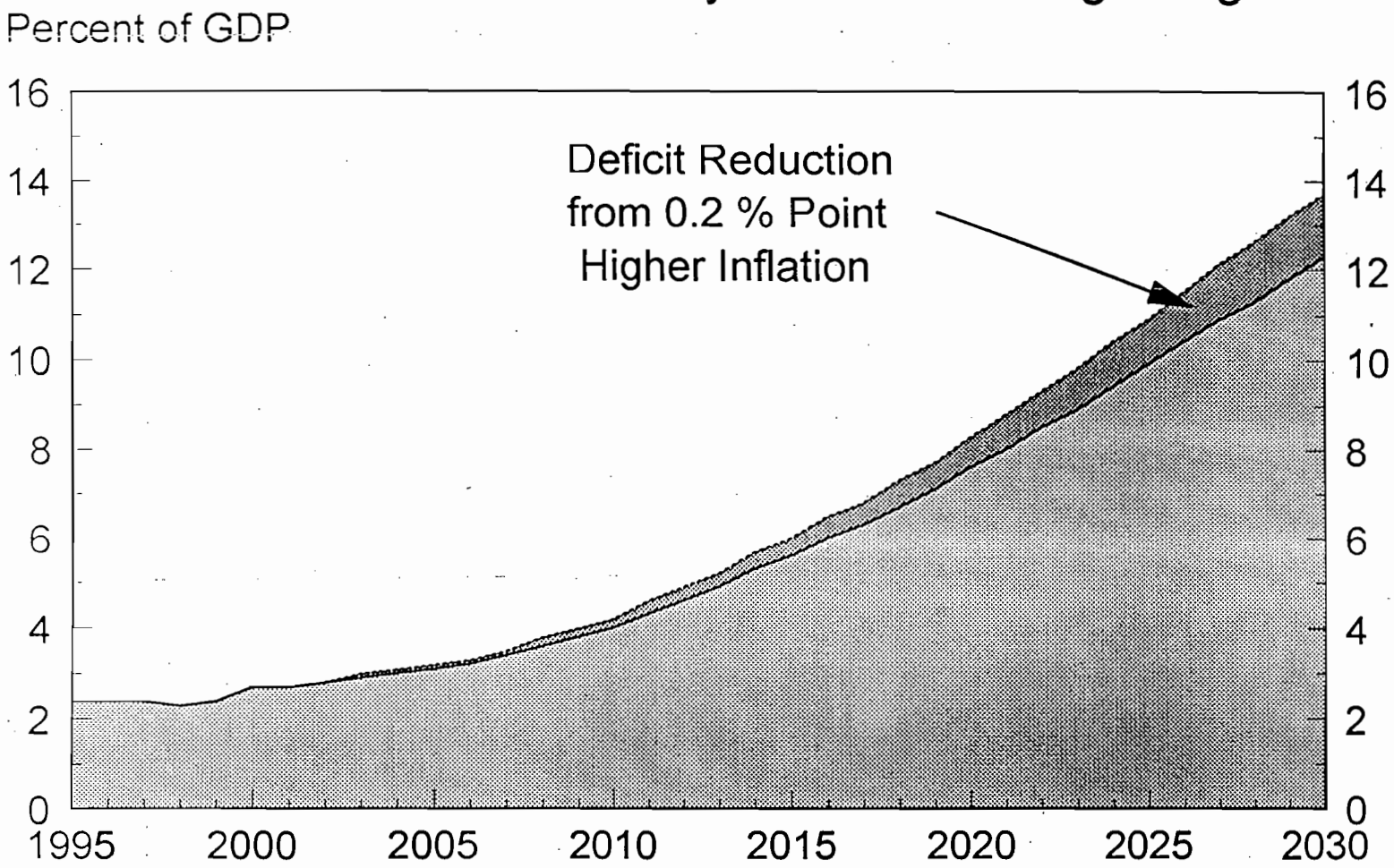
Alternative: Real GDP Growth Raised by 0.2 % Point Beginning 2001

Percent of GDP



Sensitivity to Inflation Assumptions

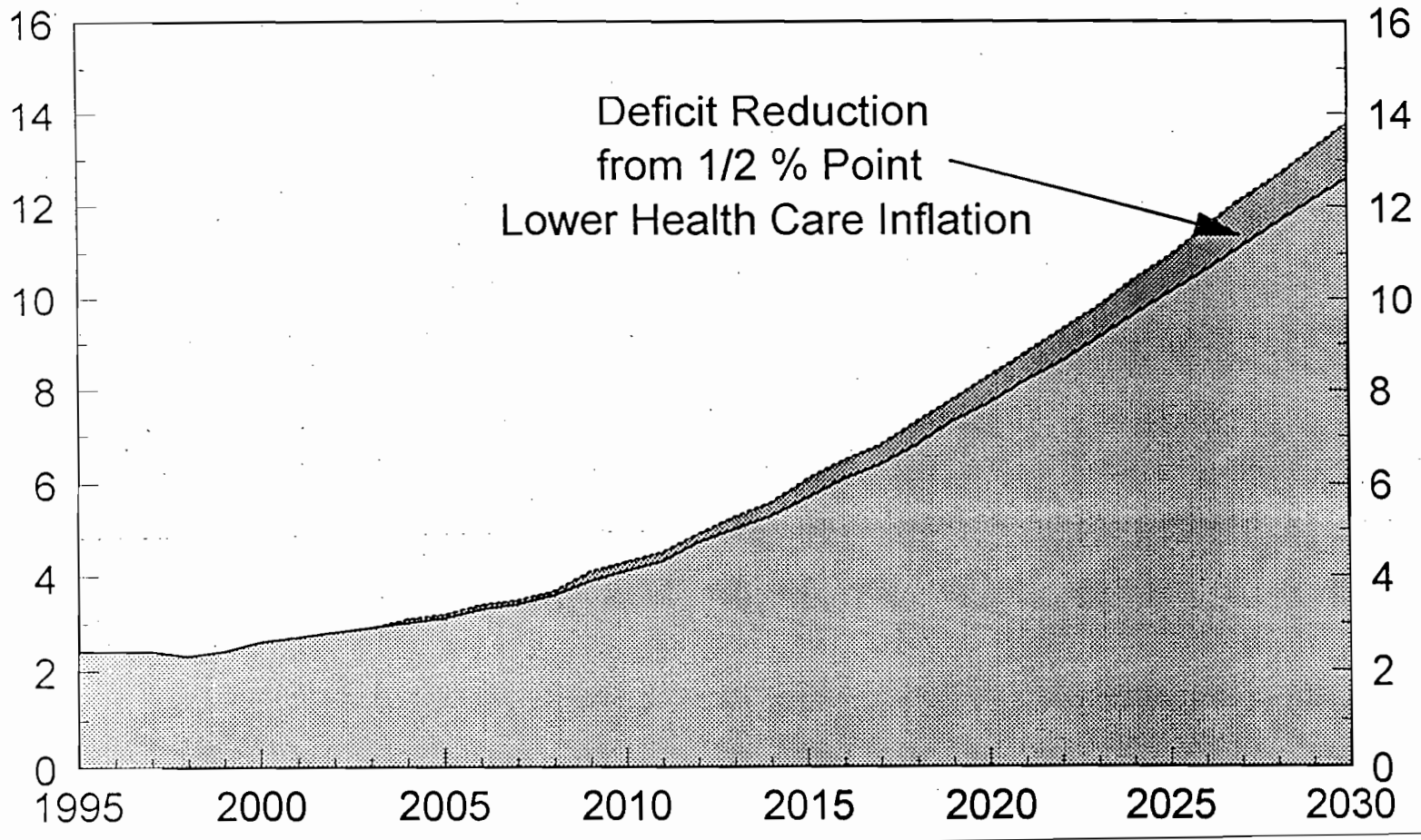
Alternative: Inflation Raised by 0.2 % Point Beginning 2001



Sensitivity to Health Care Inflation Assumptions

Alternative: Health Care Inflation Lowered by 1/2 % Point Beginning 2000

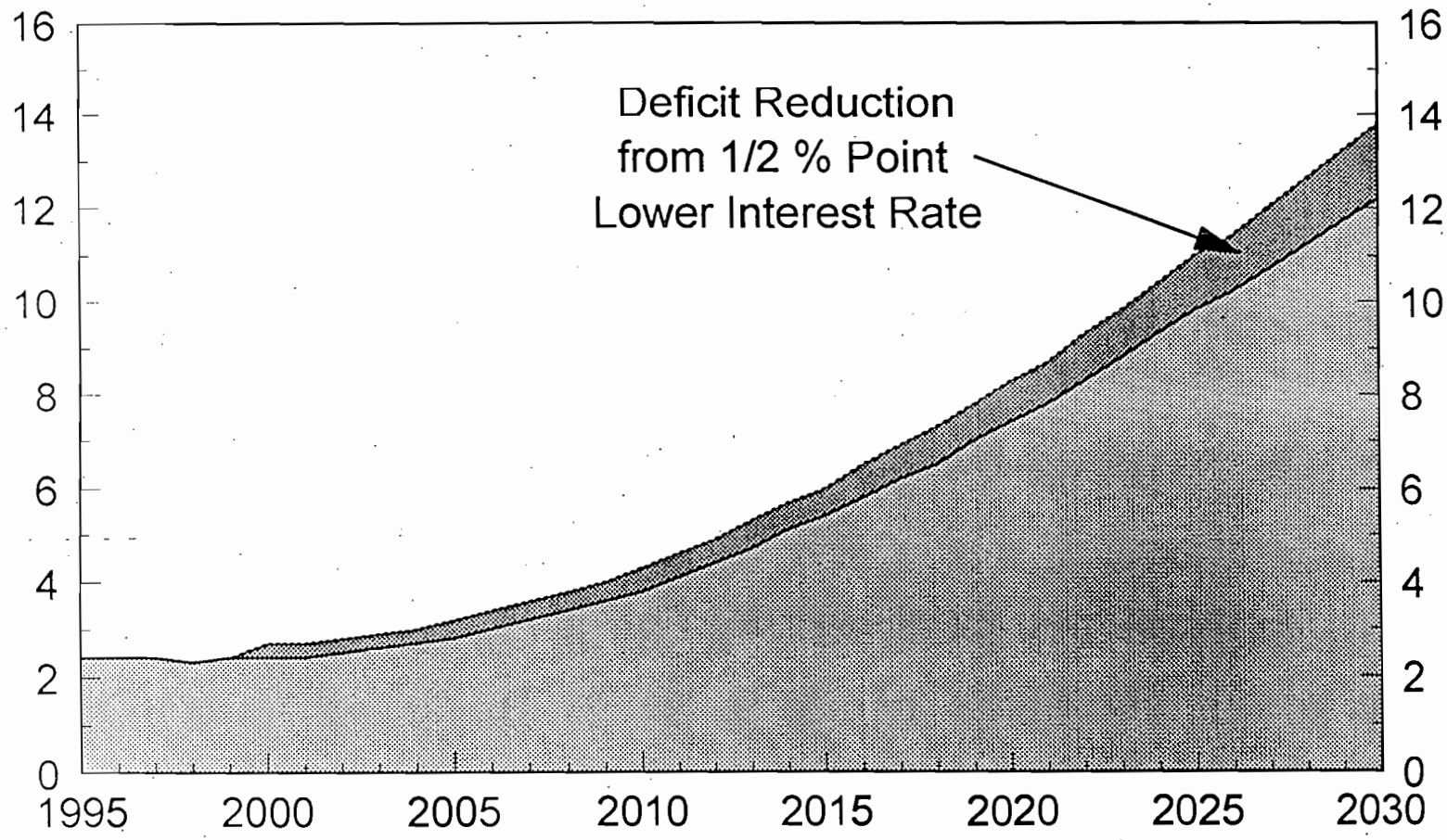
Percent of GDP



Sensitivity to Interest Rate Assumptions

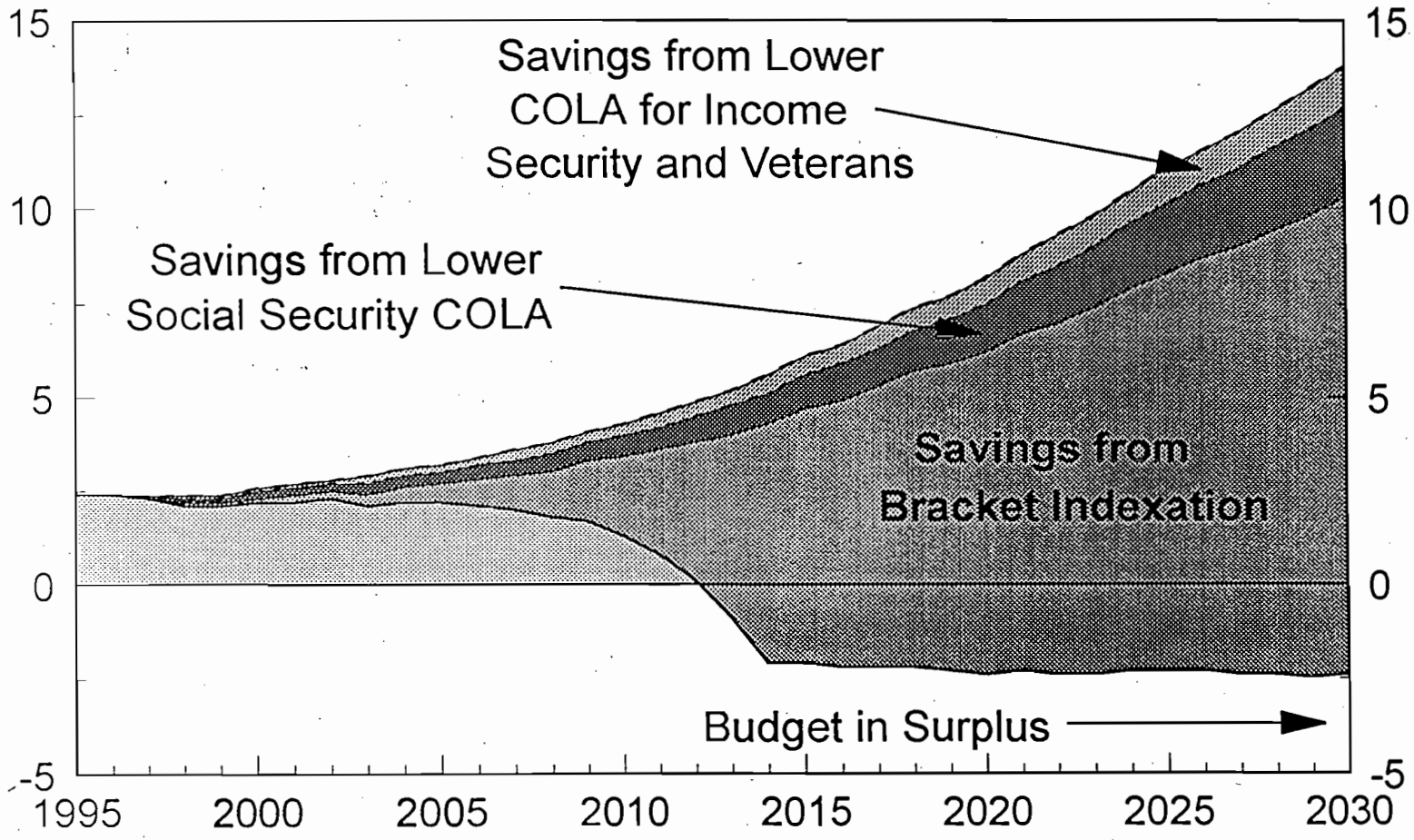
Alternative: Interest Rate Lowered by 1/2 % Point Beginning 2000

Percent of GDP



COLA Adjustment and the Long-Term Deficit

COLA lowered by 1/2 % pt for Inc. Sec., Vets, Soc Sec and Income Tax Brackets
Percent of GDP



TREASURY CLEARANCE SHEET

NO. 94-138456

Date October 3, 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: Additional Charts on Deficit Reduction Options

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)				
John Hambor	JH	10/3	Policy Analysis	622-2350
REVIEWERS				
~~Brad De Long~~			Deputy Assistant Secretary for Economic Policy	622-0563

SPECIAL INSTRUCTIONS

☐ Review Officer _____ Date _____

☐ Executive Secretary _____ Date _____

DO-5 89-93-1 (04/89)

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

138872

October 13, 1994

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

INFORMATION

FROM: Joshua L. Steiner JS
Alan L. Cohen AC

SUBJECT: Presidential Announcement of FY 1994 Deficit

SUMMARY: The White House wants to have the President announce the good news about the final Fiscal Year 1994 deficit in a speech he is giving on Monday, October 24. The preliminary number will be available on a confidential basis on Friday, October 21st. Normally, the final number would not be released until Friday, October 28th. We met today with White House and OMB staff to discuss whether the President could or should release a deficit figure on the 24th. We agreed that he can go ahead on that date as long as the figure was labelled preliminary. The final figures would be released on the 28th as usual.

DISCUSSION:

Fiscal Year 1994 ended on September 30th. What are the drawbacks to releasing a preliminary deficit figure on October 24th? To address that issue, it is useful to review the normal procedure.

Agencies are required to get their final figures for spending and receipts to Treasury by October 7th. Many agencies, however, send in supplemental figures after the 7th to correct mistakes they subsequently find. Normally, on October 21st, Treasury computes a preliminary deficit figure and the Secretary signs off on this figure for release to OMB. During the following week, Treasury and OMB continue to process any additional mistakes supplied by the agencies. A final number is then released to the public on October 28th. Even then, a few errors are not found until after that date. The official number - including the last corrections - is published in the Budget the following February.

By October 24th, almost all mistakes will have been corrected by Treasury. Any remaining errors are likely to be small. Occasionally, however, a large error surfaces after the 24th. One year the error was large as $3 Billion.

The small group of White House, OMB, and Treasury staff that met today is recommending to you that the President could and should release the deficit figure on the 24th, **but that the figure should be labelled as preliminary.** In addition, it was also

Edward S. Knight

agreed that directives should go out to Federal agencies to get all of their figures to Treasury on time.

Please let us know if you think this plan makes sense.

95-151797

CLOSE HOLD UNTIL ANNOUNCEMENT

FY 1995 DEFICIT ANNOUNCEMENT

- **The deficit has fallen three years in a row for the first time since Truman was President.**

  -- In fiscal year 1995, the deficit fell to $163.8 billion, down from $290 billion in 1992.

- **Deficit down by more than half relative to the size of the economy.**

  -- As a share of nominal GDP, the 1995 deficit is now just 2.3 percent, compared to 4.9 percent in 1992.

- **President Clinton's policies have had a dramatic impact on the deficit.** Before the President took office, forecasts called for rapid increases in the deficit. For example, before President Clinton's Economic Plan was put in place in 1993, the 1995 deficit was projected to be over $300 billion, way above the $163.8 announced today.

  -- Of the difference between the forecast and realized deficit for 1995, more than two-thirds reflects President Clinton's new policies and the improved economic environment that these policies created. (About one-third reflects technical changes, such as changes in deposit insurance flows.)

  -- Going back to the 1993 deficit, in early 1993 the prior Administration forecast a deficit of $327 billion; under President Clinton, the actual 1993 deficit was $255 billion, $72 billion below the forecast.

- **Clinton Administration deficit projections have been conservative.**

  -- In February 1994, we projected a deficit for 1994 of $235 billion; the actual deficit was $203 billion.

  -- In February 1995, we forecast a 1995 deficit of $193 billion, substantially higher than the actual deficit of $163.8 billion.

Office of Economic Policy
October 24, 1995

1997-SE-013811

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

December 23, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

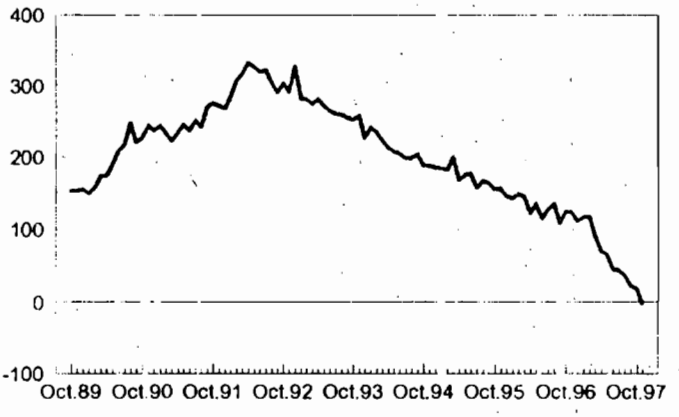
FROM: DAVID W. WILCOX DW
ASSISTANT SECRETARY FOR ECONOMIC POLICY

SUBJECT: Federal Budget Deficit

Growth in receipts has been so consistently strong for the past year and a half that there has been a very sharp improvement in the twelve-month cumulative deficit, as illustrated in the chart below. This has led to ***a small surplus of $2.4 billion over the twelve months ending in November, the first such surplus since 1970.***

Some special factors have contributed to this favorable budget result which may not continue through the entire fiscal year. For example, spectrum auction proceeds and large inflows to the deposit insurance account, which are both treated as negative outlays in budget accounting, are not expected to be as large this year. Calendar effects also reduced outlays this November by shifting a pay period into December, and that will be made up next month. Offsetting that may be strong growth in withheld individual and corporate profit tax receipts in December, as the daily Treasury statements seem to indicate. There may be a chance that the twelve-month cumulative budget will continue to show a small surplus, at least for the next month or so. Thereafter, tax law changes that take effect January 1 are expected to erode receipts.

FEDERAL BUDGET DEFICIT
Cumulative Twelve-Month Total
Billions of Dollars



Prepared by Valerie Personick

TREASURY CLEARANCE SHEET

NO._____
Date_____

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY

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

FROM: David W. Wilcox, Assistant Secretary for Economic Policy

THROUGH:

SUBJECT: Federal Budget Deficit

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☒ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
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  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ 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	TELE. NO.
INITIATOR(s)				
Valerie Personick	VP	12/23	Economic Policy	622-1686
REVIEWERS				
John Auten	Ja	12/23	Economic Policy	622-2070

SPECIAL INSTRUCTIONS

☐ **REVIEW OFFICER** **Date**

☐ **Executive Secretary** **Date**

DO F 80-02.1 (04/89)

1999-SE-010511

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

September 24, 1999

INFORMATION

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

FROM: Assistant Secretary Wilcox BW
Deputy Assistant Secretary Elmendorf DE

SUBJECT: Finessing an On-Budget Deficit

A common misperception is that on-budget deficits take resources away from Social Security. This inaccurate perception is especially troubling as we confront the prospect of running an on-budget deficit in the coming year. An upcoming budget principals meeting will likely consider alternative ways to modify our lockbox legislation in order to rebut this perception. We summarize our own views on these proposals in this memo.

A Common Structure and Its Problems

The common element of most proposals in this area is to create a "marker" equal to the amount of any on-budget deficit and then to "pay down" that marker over a fairly short period of time. Some of the markers are tangible, such as selling a new class of securities to the public or to the Social Security trust funds, with the amount of issuance equal to the on-budget deficit. Future on-budget surpluses would be required to redeem those so-called "red" bonds. Other markers are basically accounting rules, such as keeping a tally of on-budget deficits (perhaps accumulating interest over time), and requiring on-budget surpluses to reduce the tally.

We have made clear your categorical rejection of selling new classes of securities. But we think that even the more subtle approaches have two serious problems.

First, *they come dangerously close to accepting the argument that on-budget deficits deprive Social Security of resources, even though we know that argument to be deeply flawed.* In truth, a drop in the on-budget balance leads to more borrowing from the public but has no effect on Social Security's solvency or bond holdings (which always increase by the amount of the Social Security surplus). Yet, in order to re-assure people that Social Security is not being harmed, many of the proposals promise to "pay back Social Security" in some way. Even if we tried to explain that we were atoning for our sins against national saving and not against Social Security, the "payback" interpretation could be difficult to avoid. (The Administration's own public rhetoric has not always been helpful on this subject, including the draft (at least) of the President's radio address for tomorrow.)

Second, *they impose tighter constraints on fiscal policy over the next 5 years by trying to offset an FY 2000 deficit instead of "letting bygones be bygones."* Requiring that any on-budget deficits be followed fairly shortly by on-budget surpluses may be good for fiscal discipline. This discipline may be too strict, however, because our current projections show very little on-budget resources available through 2003 or 2004, even if most of the President's budget framework is not adopted. Indeed, we see some risk that making the on-budget constraint too binding could encourage some retrogression to a focus on the unified budget. (Also, as long as the fiscal objective is to balance the on-budget account, an on-budget deficit today does not reduce national saving over the very long run.)

The Status Quo

With these arguments in mind, our preference is that no action be taken in this area. Our talking points could continue to note the dramatic improvement in the budget picture during this Administration, and emphasize that the President has now pointed to a higher fiscal standard and has proposed budgets that meet that standard. Our lockbox would extend the paygo rules and discretionary caps that have worked so well.

If further action is deemed necessary, we would urge further consideration of having the Social Security trust fund purchase marketable government securities. This approach would slightly increase the cost of the federal government's financial transactions, as Domestic Finance has argued. But it could have substantial advantages:

- Separating the trust fund's finances from the rest of the government would make it more difficult to return to a unified budget framework.
- Making the trust fund more "real" could facilitate transfers from general revenue and relieve some of the pressure for individual accounts.
- Changing the trust fund's mechanics would represent more Social Security reform than most people expect to occur this year.
- The time needed to set up these institutions provides a natural transition period that could help deflect attention from near-term on-budget deficits.

The Deputy Secretary of the Treasury

October 18, 1999

NOTE FOR DAVID WILCOX
Assistant Secretary for Economic Policy

DOUGLAS ELMENDORF
Deputy Assistant Secretary for Economic Policy

FROM: STUART E. EIZENSTAT

SUBJECT: Finessing an On-Budget Deficit

Your September 24 memo on Social Security is important. I think we need a meeting with Larry ASAP given lockbox proposals about to go to Hill.

We do run a risk of heightening the fallacious argument we are "stealing" from Social Security and will impose even tighter restraints in out years.

Attachment

cc: Karen Kornbluh
Carolyn Keene

Room 3326 **622-1080**

ADMINISTRATION HISTORY APPENDIX
CHAPTER ONE: FISCAL DISCIPLINE

ECONOMIC STIMULUS PACKAGE

93-123806

DEPARTMENT OF THE TREASURY
WASHINGTON

LWB

MEMORANDUM FOR SECRETARY BENTSEN

FROM: Alan Cohen ac
Senior Advisor to the Secretary

SUBJECT: Economic Stimulus that Does Not Need New Legislation and Does Not Raise the Deficit

DATE: June 29, 1993

A strong pace of economic recovery is far from certain at this time and anything that could add a little bit of stimulus would be very valuable. As you know all too well, our attempt to legislate some stimulative Federal spending was stalled earlier by a Republican filibuster in the Senate. Similar attempts to legislate would run the same risk.

Fortunately, there may be an alternative way to provide spending stimulus to the economy beginning October 1st **THAT DOES NOT REQUIRE ANY NEW LEGISLATION OR RAISE THE DEFICIT.**

Appropriated spending for fiscal year 1994 -- which begins on October 1, 1993 -- can be divided into two basic categories. One category of spending includes those items whose spending is spread evenly throughout the year. This includes salaries for Federal workers, grants for programs such as WIC whose caseloads are about even throughout the year, etc.

The second category consists of money for new projects such as highways, new construction, one-time grants to non-profits and to state and local governments etc. This category includes many billions of dollars each year. This category of spending in not spread evenly throughout the year. Under current law, budget authority for such new projects can be spent early in the year, late in the year, or any other time of the year.

Federal agencies currently plan to begin such projects at all different times during the year. Indeed, stories are legendary about significant amounts of money being obligated on the last day of the Fiscal Year.

There are still three months to go before the next fiscal year starts. My proposal is that OMB immediately determine which projects could be started earlier in the fiscal year than was previously planned. OMB would then work with the agencies to ensure that such acceleration actually occurred.

In December of 1991, President Bush announced that $10 Billion of projects would be accelerated within Fiscal Year 1992. However, when this plan was announced, Fiscal Year 1992 was already one quarter over. **IN CONTRAST, UNDER MY PROPOSAL, PLANS TO ACCELERATE FOR FISCAL YEAR 1994 WOULD BEGIN NOW, THREE MONTHS BEFORE FISCAL YEAR 1994 BEGINS.** In effect, this is a full five months earlier relative to the fiscal year than the Bush plan. The Bush plan was a failure because it was begun too late in the fiscal year to accelerate spending. But right now, with the new fiscal year still three months away, I believe that significant efforts by the relevant agencies could result in acceleration of many projects.

If contracts are issued and grants obligated a few months earlier than would otherwise be the case, that should generate some additional economic activity earlier in the fiscal year. With some multiplier effects from such activity, there could be some economic stimulus generated, which would be very beneficial for the country and for the Administration.

This approach would not require any new legislation. It would not be scored as increasing the deficit. As far as the actual deficit is concerned, outlays that are accelerated from later in Fiscal year 1994 into earlier in Fiscal Year 1994 would not change the Fiscal Year 1994 deficit. The only budget effect that this approach might have relates to projects that have outlays in both Fiscal Years 1994 and 1995. Some outlays for 1995 might be accelerated into 1994. This is a relatively subtle point that should not arouse a great deal of controversy. ✓

If this proposal were adopted, the President could announce that he was trying to do something to increase jobs and economic growth right now. Since it would not require new legislation, there would be no controversy about whether he could get it through Congress. I think the President would benefit from an announcement like this at this time. agree

If this approach were successful, some might argue that it would lead to a spending shortfall later, which would hurt the economy at that time. But if this approach were successful, we could do it again in Fiscal Year 1995, which would wash out any negative effects from the acceleration in the previous year.

What do you think of this approach? very interested

ADMINISTRATION HISTORY APPENDIX
CHAPTER ONE: FISCAL DISCIPLINE

EDUCATION

141929

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

February 16, 1995

MEMORANDUM FOR THE PRESIDENT

THROUGH: Gene B. Sperling
Carol H. Rasco

FROM: Robert E. Rubin
Secretary of the Treasury

Richard W. Riley
Secretary of Education

Alice Rivlin
Director, Office of Management and Budget

SUBJECT: Student Loan Program Wage Withholding and Default Reduction Options

I. Issue. Having completed a feasibility study to offer wage withholding for repayment of student loans, we are seeking your approval of our recommended option.

II. Background. The vision for student loan reform introduced during the Presidential campaign was to lower the default rate by offering borrowers a convenient and flexible repayment process. That vision was translated into action with the passage of the Student Loan Reform Act of 1993 and the National and Community Service Act of 1993. The Student Loan Reform Act directed us to study the feasibility of implementing a wage withholding system and involving the Internal Revenue Service in servicing and collecting payments on student loans.

The study identified and evaluated four options using the following criteria: customer service, political considerations, default rate, impact on collections and budget, and burden on business. Appendix A discusses the four options, which are:

Option 1. IRS Student Loan Special Operations. (Using Federal FTE or contractors)

Education would originate the loan. IRS would then provide borrowers the full range of services - from billing through collection. Work would be performed by IRS staff or contractors. A separate system of wage withholding would be established outside the tax system. Employers would be required to offer borrowers wage withholding and would transfer payments to the IRS.

Option 2. Split Servicing: IRS uses the tax system for wage withholding.

IRS would collect loans through the tax system whenever borrowers elected to repay through employer wage withholding. Loans repaid by all methods other than wage withholding would be collected by Education. Education would service all borrower accounts.

Option 3. Education administers loan programs. IRS provides additional information to enhance Education's collection capability.

Education would retain responsibility for all aspects of student loans - origination, collection and servicing. IRS would share additional tax return information to enhance Education's collection capability. Employers would not be required to offer wage withholding, but Education would provide incentives to employers to do so. If employers did offer wage withholding, they would transfer payments directly to Education.

Option 4. Education carries out all functions. Mandatory wage withholding for firms with ten or more employees.

This option closely parallels *Option 3*. The difference is that businesses with 10 or more employees would be required to offer wage withholding.

III. Recommendation and Rationale. Treasury, Education and OMB recommend adopting *Option 3*. Statements from each agency are provided in Appendices B through D. A comparison of estimated costs of the four options is provided in the table at Appendix E.

Option 3 would meet customer service goals by giving borrowers rapid access to account information and allowing them the flexibility to switch repayment plans. It does not have drawbacks of other options, such as overtaxing IRS resources and decreasing tax collections of a higher dollar value. Voluntary employer participation would mean minimal opposition from the business community. This option would add no additional budget costs and does not require additional legislation.

IV. Decision.

Agree_____ **Disagree**_____ **Select Option**_____

APPENDIX A

Feasibility Study of Wage Withholding and IRS Participation in Collecting Student Loan Repayments

I. BACKGROUND

Before passing the Student Loan Reform Act of 1993, Congress deleted an Administration proposal that would have enabled the Internal Revenue Service (IRS) to participate in loan collection if the Secretaries of Education (ED) and Treasury believed it to be feasible. Congress then substituted a requirement that the two Departments study and report on the feasibility of IRS participation. The Administration must therefore determine its position on the feasibility of IRS participation, including whether to offer wage withholding through the tax system.

A. Administration's Vision of the Student Loan Program. The Administration envisioned a Direct Loan program that would:

- Make it easier for hardworking Americans to attend college by making borrowing simpler and repayment less restrictive--so that nobody would be able to say they could not afford a college loan;

- Base one loan repayment option on income (ability to pay or "pay-as-you-can"), enabling borrowers freedom to choose the type of employment desired with the ease of flexible repayment options;

- Give borrowers the flexibility to choose a repayment plan that met their current needs and allowed them to switch among repayment plans throughout the repayment period as their needs changed;

- Provide borrowers with a convenient repayment process, giving them the choice to have their loan repayments--particularly income contingent repayments--automatically deducted from their wages through wage withholding; and

- Reduce borrower defaults.

As discussed below, most of these goals are being achieved through Education's administration of the Direct Loan program. However, the Administration needs to decide how wage withholding may best be implemented. The Administration originally envisioned a Direct Loan program that would provide wage withholding through the IRS tax system. A team from Treasury, ED, OMB, and the White House has sought to determine how this approach could be implemented, identifying its benefits and drawbacks. In considering the issue, the team also examined options for providing wage

withholding outside the tax system. The team evaluated each option according to the following criteria: customer service, political considerations, default rate and collections impact, budget consequences, and burden to businesses.

B. Direct Loan Program. The Student Loan Reform Act of 1993 is to be phased in over five years beginning in FY 1994, with total direct loan volume rising from 5 percent in the first year to at least 60 percent in the fifth year, or nearly $18 billion dollars. The new program will improve loan access and borrower service, simplify administration, reduce defaults, and improve collections. It will also save the taxpayers money by eliminating middlemen and subsidies that do not benefit students.

The program offers borrowers several repayment plans: income contingent, graduated, extended, and standard-fixed. Borrowers get maximum flexibility to switch plans and obtain deferments and forbearances. They are also offered several repayment methods, such as coupon books, checks, and bank debits (which have an automatic repayment feature like wage withholding). In addition, a voluntary employer wage withholding program is under development. Although still in the early stages, student feedback and school participation rates suggest that the loan program is an enormous success. For example:

- At a recent round of national forums, student feedback was clearly enthusiastic, especially with regard to the flexible repayment plans. This was pointedly expressed at the Presidential roundtable at the University of Michigan.

- Currently, 104 schools are participating (representing the loan volume permitted by statute); approximately 2,300 schools applied to participate in the second year, but ED has selected the 1,500 needed to meet the statute's goal of 40 percent of the loan volume. Others must wait for the next round beginning in July 1996. ED cannot require schools to participate. Schools participate because the program is more responsive to students, less burdensome to administer, and permits quicker receipt of funds.

The Direct Loan program improves on the old guaranteed loan program by replacing the inefficient and decentralized bank and state agency structure with a centralized program. Under the new program, ED administers all aspects of loan origination, disbursement, and accounting through the use of contractors. This permits efficient monthly tracking and billing. This frequent contact with borrowers is essential to maximize service and minimize defaults.

Under the old program, 85 percent of borrowers repay on schedule. However, defaults may be further reduced in the Direct Loan program. This may occur through the new income-contingent "pay-as-you-can" plan, which at least 18 percent of borrowers are

expected to select. Payments contingent on the ability to pay should reduce the likelihood of non-payment and increase collections over time. Some of those who now cannot pay will be able to remain in good standing (albeit accruing interest). Wage withholding may also contribute to a decrease in defaults.

Default collection methods that have proved to be particularly successful under the guaranteed loan program will be retained. This includes the most effective method, an ED/IRS Tax Refund Offset program started in 1986, which has increased collections by 43 percent and has yielded over $600 million in annual revenues. Also, an IRS computer matching program has helped ED locate debtors. As a result, overall collections have improved by 5 to 10 percent. Finally, ED is implementing new administrative wage garnishment authority to increase collections.

C. Related IRS Issues. IRS participation in loan servicing has been viewed from several perspectives. The IRS is in the process of modernizing its 1960's tax system and reinventing tax administration. Improving the voluntary compliance rate to 90% is a major IRS goal. Voluntary compliance, tax refund fraud, and the IRS's efforts to deal with these problems will continue to receive intense Congressional review. In spite of Congress's interest in and demands for these improvements, Congress has cut the Administration budget requests for the Tax System Modernization (TSM) program.

Besides resource considerations, the IRS concentrates its collection in higher dollar value cases than does ED (which deals with an average defaulted student loan debt of $2,800). The IRS does not, cannot within its current system, and will not under TSM as presently designed, be able to maintain monthly account data on taxpayer status. To maintain real time data on taxpayers after completing its modernization, employer withholding and reporting requirements would have to be changed. Validation of taxes paid and owed, reflecting reconciliation of employer reported data and individual tax returns, does not occur until some six months after the close of the tax year. Nevertheless, as discussed below, we have identified several approaches that could further involve the IRS in student loan collection to varying degrees.

II. OPTIONS

We considered four options for servicing and collecting direct loans: (1) IRS establishing a special student loan operation; (2) IRS using the current tax system for loans repaid through wage withholding only (ED doing all other functions); (3) ED running its current operation with incentives to business to maximize the availability of wage withholding; and (4) ED running the operation with a mandatory requirement on firms with ten or more employees to offer wage withholding.

Each option addresses two key components of the President's vision: wage withholding and default reduction. The following appendices describe and evaluate each how each option would be implemented.

Option 1. IRS Student Loan Special Operations (Federal FTE or Contractors)

Proposal

Once legislation or other legal authority is obtained, *Option 1* permits IRS involvement in all aspects of student loan collections, including current loans in repayment and default. This option provides all borrowers the full range of service from billing through collection.

As in all the options, ED would originate the loans. IRS would service and collect all repayments through a loan collection system separate from the tax system. This would offer borrowers maximum flexibility in terms of repayment plans and methods, including wage withholding.

This option could be implemented in phases. In Phase I, ED's Direct Loan contract would be transferred to the IRS for program administration. Under Phase II, the IRS either would create a new in-house system separate from the tax system or continue to contract student loan program administration. In Phase II, IRS would assume the old guaranteed loans, whether in repayment or default. All employers would be required to offer wage withholding and report student loan payments to the IRS separate from tax withholding. Employer withholding would be tracked on a real-time basis through frequent reports to both IRS and borrowers. These reports would also ensure a high level of employer compliance. In addition, assuming proper legislative authority, IRS could bolster collections through the use of tax data that it maintains but cannot presently disclose.

Evaluation

Customer Service. In Phase I, would be comparable to that currently being provided by ED; in Phase II, all borrowers would have the option of wage withholding with the same access to information and flexibility to switch plans as other borrowers.

Political Considerations. Positive: For those who believe IRS involvement will enhance collection efforts. Negative: Tax writing committees especially may resist IRS involvement. Employers will resist an additional government mandate regardless of the cost. Student associations have lobbied against IRS participation, doubting IRS efficiency and customer service. Financial institutions offering guaranteed student loans may exaggerate uneasiness about IRS customer service orientation as a tactic to discourage school participation in direct lending.

Default Rate and Collections Impact. Some anticipate requiring borrowers to deal with the IRS may motivate them to repay. However, IRS experience with other non-tax issues, such as tax refund offset programs, indicates that tax compliance declines when the IRS attempts to collect non-tax debts from taxpayers.

Budget Consequences. IRS would need continuing additional resources so that its primary task--the collection of taxes--would not suffer. The estimated cost to IRS is $600 million for Fiscal Year 1999, based on the use of approximately 6,800 FTEs to collect 4.3 million loans in repayment and approximately one million defaulted loans. If IRS administered ED's contract, as in Phase I, the estimated annual cost is $750 million (including $400 million in collection costs paid out of amounts collected). ED estimates that its costs would likewise be reduced by $750 million (of which only $350 million is appropriated). Costs, but not FTE, may be covered within ED's baseline funding for loan administration.

Burden to Businesses. The estimated annual cost is $1.7 billion spread over 1.2 million employers, assuming 30 percent of all borrowers elect wage withholding and 20 million borrowers.

Option 2. Split Servicing: IRS Uses the Tax System for Wage Withholding

Proposal

Legislation for this option would provide that borrowers who earn wages can repay student loans through the IRS tax system. Employers would not need to keep any separate accounting records, or provide any loan information to either IRS or the borrowers.

Under this option, the IRS would collect loans whenever borrowers elect to repay through employer wage withholding. ED would continue to collect loans under the guaranteed loan program and for all other repayment methods, would track borrowers financially unable to make payments, and would perform servicing functions for all repayers (providing loan account data and counseling, processing deferments and forbearances, and approving switches between repayment plans and methods).

Borrowers choosing *Option 2* wage withholding would have to file a tax return to report the loan repayments as a tax. Upon filing, insufficient or delinquent tax payments would be solely an IRS tax responsibility.

Evaluation

Customer Service. This option only benefits borrowers who have jobs and have sufficient taxes withheld from their salary to satisfy their total tax liability, including the loan repayment. Borrowers who were unemployed, self-employed or do not elect wage withholding could not participate and would receive no benefit under this option. Borrowers who elected withholding would not be able to monitor or evaluate, on an ongoing basis, the effect of loan payments on principal and interest. This limited information would alter their ability to change repayment plans, but they would have a

convenient repayment process. The tax returns of borrowers who choose wage withholding would be more complicated and borrowers would be subject to full IRS collection procedures if they underestimated either their loan or tax liabilities.

Political Considerations. Positive: For those who believe IRS involvement will enhance collection efforts from borrowers who choose wage withholding. There is no additional burden on employers. Negative: The same as *Option 1*. In addition, the tax-writing committees may oppose the conversion of defaulted student loans into tax liabilities, which would increase IRS accounts receivables. They may also fear the impact on tax compliance.

Default Rate and Collections. For those electing withholding, the possibility of student loan defaults as currently defined is eliminated. However, these borrowers might owe additional taxes. Low dollar delinquencies, which are now collected by ED, would not be collected because they would fall below the IRS delinquency threshold.

Budget Consequences. The IRS would need continuing additional resources so that its primary task--the collection of taxes--would not suffer. Using the tax system would require approximately 820 additional FTEs at a cost to the IRS of $100 million in FY 1999. ED estimates its costs would be reduced by $50 million. As in *Option 1*, non-FTE costs may be met by a transfer of funds already identified in the ED mandatory loan administration fund.

Burden to Businesses. This option poses no additional burden to employers.

Option 3. ED carries out all loan functions and provides incentives to business to maximize availability of wage withholding. The IRS enhances ED's debt collection capability.

Proposal

This option builds on the current Direct Loan program administrative structure. It would provide all borrowers the full range of service from billing through collection, including complete flexibility in choosing and changing repayment plans and methods. ED would retain responsibility for all aspects of student loan collection and servicing, using its current system regardless of how borrowers elect to repay.

ED would seek additional legislation so that the IRS could share additional tax return information on income-contingent and defaulting borrowers to enhance collections.

As part of *Option 3*, ED would launch a public information campaign encouraging employers to provide voluntary wage withholding as an inexpensive employee benefit, similar to the savings bond program or bank debit option (which remains in effect even

if jobs change). Large employers (covering 80 percent of all employees) would be likely to participate because of existing automated payroll capabilities. ED would provide software and technical support to employers who requested such assistance.

Evaluation

Customer Service. Wage withholding would be available to 80 percent of the borrowers. Wage withholders would gain the same access to information and flexibility to switch plans as all other borrowers.

Political Considerations. Positive: Same as *Option 2*. Negative: Some borrowers would be denied the withholding option, because their employers don't participate.

Default Rate and Collections Impact. Some anticipate that wage withholding may reduce the default rate.

Budget Consequences. Approximately the same as projected cost of current ED system ($850 million in FY 99). Budget neutral; those costs are assumed in current baseline estimates.

Burden to Businesses. Based on the assumption that twenty million borrowers are in repayment, with 4.5 million eligible borrowers electing to repay through voluntary employer withholding, the estimated annual cost is $0.5 billion.

Option 4. ED Carries Out all Functions with Mandatory Participation for Firms with Ten or More Employees.

Proposal

This option closely parallels *Option 3*. The difference is that wage withholding is mandatory for businesses and, as a result, would be available to 85% of the borrowers who are employed as wage earners. Legislation would require businesses employing 10 or more employees to participate.

Employer reporting to ED would remain the same under a mandatory system as under a voluntary system, assuming close to full compliance with the law. Significant instances of noncompliance would require employers to report on compliance and to undergo compliance reviews.

Evaluation

Customer Service. Positive: As in Phase II of *Option 1*, wage withholding would be an available option for an additional 5% of the borrowers than are likely to be covered

under the voluntary system. Wage withholders would gain the same access to information and flexibility to switch plans as all other borrowers. Negative: As in *Option 1*, employers would incur the costs of an unfunded mandate.

Political Considerations. Many employers would oppose an unfunded federal mandate. Payroll associations report widespread dissatisfaction with the increased number of government mandated wage withholdings and the complexity involved. Congress is likely to resist enacting legislation that imposes additional burdens on business.

Default Rate and Collections Impact. The impact is the same as under *Options 1* and *3*.

Budget Consequences. Approximately the same as projected cost of current ED system ($850 million). Budget impact on ED is expected to entail a minimal increase, assuming close to full employer compliance. Employer noncompliance is expected to be modest.

Burden to Businesses. Assuming close to full compliance the estimated annual cost is $1.1 billion.

III. SUMMARY ANALYSES

Customer Service.

- Except for Phase I of *Option 1* and *Option 2*, all options provide comparable borrower service.

- *Option 2* trades off reduced borrower service (no real time access to data) against the reduced cost to employers because of use of the regular tax system. The use of the tax system may be viewed by some borrowers who would otherwise elect wage withholding as a negative customer service factor. Similarly, *Option 1* may be viewed negatively because of IRS involvement, even though in that option loan debt is not tax debt.

- Focus groups indicate borrowers like wage withholding, but are concerned about privacy and employer errors.

Political Considerations.

- Student associations have expressed opposition to any involvement by the IRS, as in *Options 1* and *2*. Those associations and the opponents of direct lending, the banks and secondary markets, could play on student fears and pressure schools to stay out of direct lending.

- All options require legislation in varying degrees and with different potential

reactions. The employer mandate of *Options 1* and *4* would likely arouse the greatest opposition. All options call for the ability of IRS to release or use information on individuals now not made available outside the tax system; privacy and disclosure concerns may be raised.

- Any legislation putting greater control over the program into Treasury (i.e., *Options 1* and *2*) will be resisted by the education community and probably the House Education and Labor and Senate Labor and Human Resources Committees, even under possible new configurations in the 104th Congress.

- *Options 1* and *2* could be viewed by those concerned about the quality of tax administration as detrimental to the IRS' ability to carry out its primary mission.

Default Rate and Collections Impact.

- Some believe that IRS administration of student loan collections in *Options 1* and *2* may reduce loan defaults. On the other hand, IRS (unlike ED) does not focus its limited resources on collecting small debt and voluntary compliance with the tax laws will decline. Under *Option 2*, where loan debt becomes tax debt, it is not likely such debts will be collected. The great majority of defaulters do not have the money to repay, which leaves IRS no better than ED as a debt collector.

- With legislation permitting the additional tax return information on income contingent and defaulted loan borrowers proposed under *Options 3* and *4*, ED would be able to improve default collections.

Political Considerations.

- Under *Options 1* and *2*, IRS requires continued new funding. Those resources would be taken from ED estimates in the mandatory baseline for loan administration.

- If under *Option 1* IRS establishes a separate unit with 6,800 Federal FTE, those FTE are above current estimates and would have to come out of some other agency's allocation to remain within the statutory government-wide FTE reduction rules. If *Option 1* is done by contractor, the FTE requirements are already in ED's ceiling. *Option 2's* FTEs would require ceiling adjustments, reducing other agencies' allotments by 4,500.

- *Option 3* is primarily ED's current system, and requires no new funding or FTE. *Option 4* could require 20 additional FTEs and $500,000 to pay for an incentive program that would encourage employers to offer voluntary wage withholding.

Burden to Businesses.

- Regardless of the relatively small burden imposed under *Options 1* and *4*, the business community will argue that it is an unfunded mandate and will object.

- While *Option 2* is mandatory on businesses because it involves the tax system, no additional burden would be imposed.

- In *Option 3*, there is no mandatory requirement or employer burden. The perception changes from a government mandate to an inexpensive employee benefit.

APPENDIX B

Recommendation of Secretary Rubin

Treasury strongly recommends that the Administration implement *Option 3,* under which ED--with continued assistance from IRS--would retain the responsibility to service and collect student loans through competitive contractors, utilizing a voluntary wage withholding system marketed in the private sector.

This option would meet important customer service goals without presenting serious drawbacks. Wage withholding would be available to 80 percent (or more) of all borrowers. All borrowers would be provided the same rapid access to information and flexibility to switch repayment plans. There would be minimal opposition from the business community, no additional budget costs, and no need for additional legislation to make the program work.

In contrast, direct IRS involvement or compulsory employer participation in a new wage withholding system would present serious drawbacks. Direct IRS involvement would overtax IRS resources, interfere with its primary mission, and decrease higher dollar value tax collections, without improving program administration or customer service. Direct IRS involvement would be opposed by student and higher education groups, and tax writing committees, who are already critical of high IRS accounts receivable. Compulsory employer participation would face stiff opposition from the business community opposed to another costly, unfunded Government mandate. *Option 3* will avoid these problems while meeting the Administration's vision for a model student loan program.

APPENDIX C

Recommendation by Secretary Riley

I strongly recommend Option 3 in which ED carries out all loan functions and aggressively markets a voluntary wage withholding system to employers so that borrowers will have the option to repay loans through their paychecks. This is the only option which gives choices to borrowers, provides clear lines of accountability, maximizes customer service, minimizes employer burden, saves taxpayer dollars, and reduces defaults.

I further recommend strengthening ED'S debt collection capability by proposing legislation authorizing IRS to disclose to ED additional tax return information on borrowers for problem cases and income contingency loans.

Further, many students are concerned that IRS will treat student loans like taxes and borrowers will not be provided the flexibility and customer service they now have under Direct Lending.

Also, I see no reason for the Administration to legally mandate employer participation that we estimate would afford wage withholding to only an additional 5% of the borrowers.

APPENDIX D

Recommendation of Director Rivlin

I believe that the facts do not now support a legislative initiative to transfer loan servicing to IRS, and that the most important aspects of the President's vision - payroll withholding and default collection improvement - can be realized without IRS in a central role. However, the possibility of a stronger IRS role should not be foreclosed. The IRS system is changing and technological advances of the future may make this a more attractive option. Further, ED is several years from being able to appreciate fully whether its system is the optimum for borrowers and the Government. For now, therefore, I recommend Option 3, with the legislative proposal for additional data for default collection, and a public posture saying we will continue to explore the possibilities of IRS role for the future. I believe the software and other employer enticements to be minor and not worth the effort, given the withholding coverage already presumed for firms with 50 or more employees, but I would not oppose if ED wants it.

APPENDIX E

Student Loan Program Options and Estimated Costs: FY 1999

Options and Costs	Service Entity				
	Internal Revenue Service			Department of Education	
	Special Operations[1]		Using the Current Tax System	Voluntary Withholding	Mandatory Withholding
	Using Federal FTEs	Using a Contractor			
Estimated Program Costs:[2]	Dollar Amounts Are In Millions				
- IRS	$600	$750	$100	$ 0	$ 0
- ED	$100	$100	$800	$850	$850
- Total Cost	$700	$850	$900	$850	$850
Budget Consequences:[3]					
- IRS	$600	$350	$100	$ 0	$ 0
- ED	($350)	($350)	($ 50)	$ 0	$ 0
- Net Incremental Cost	$250	$ 0	$ 50	$ 0	$ 0
Burden to Business[4]	$1,700	$1,700	None	$500	$1,100

1. IRS Special Operation costs include the cost of collecting the existing inventory of defaulted student loans from the Federal Family Education Loan Program (FFELP). ED expenses for defaulted loan collection ($400 million) are paid out of collections and are not included in ED's appropriations. The budget consequences to ED for this option are solely attributable to the transfer of Direct Lending activities ($350 million) to the IRS. The budget consequences to the IRS (using FTE's) are attributable to the transfer of Direct Lending collection and servicing as well as the collection of defaulted student loans.

2. Estimated program costs are the costs incurred by each agency for participating in student loan collection.

3. Budget Consequences are the costs incurred by each agency for participating in student loan collection.

4. Burden to Business represents the cost of withholding to business when the direct loan program reaches its capacity 20 million borrowers in repayment. It is assumed that under a mandatory withholding program (affecting 1.2 million employers), 6 million borrowers would elect to repay through payroll withholding. Under the voluntary withholding program (with 800,000 employers participating), 4.5 million borrowers would elect to repay through employer wage withholding.

95 141929

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

JAN 19 1995

- op. 3
- Ed Reins Program
IRS Shares tax info.
and offsets withholding

MEMORANDUM FOR SECRETARY RUBIN

FROM: George Muñoz (sgd) for
Assistant Secretary (Management)

SUBJECT: Education Student Loan Program Withholding and Default Reduction Options for Implementation

ACTION FORCING EVENT:

In response to Title IV of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), the Department of the Treasury in conjunction with the Department of Education studied the feasibility of Internal Revenue Service (IRS) involvement in student loan collection. The study has been completed and a decision memorandum has been prepared for the President.

RECOMMENDATION:

That you sign the Decision Memorandum for the President and support the choice of Option 3 in which Education carries out all functions of the Student Loan Program with increased debt collection capabilities provided by IRS.

✓ Agree _____ Disagree _____ Let's Discuss

BACKGROUND ANALYSIS:

The President envisions a student loan program which includes a convenient and flexible repayment process, enables more individuals to obtain financing for education and lowers default rate. The student loan reform effort was introduced during the campaign, and culminated with the passage of the Student Loan Reform Act of 1993 and the National and Community Service Act of 1993.

As directed by the Student Loan Reform Act, a group composed of representatives of the Departments of Treasury and Education participated in a joint study to examine the feasibility of implementing a wage withholding system and involving the IRS in the servicing and collection of student loans. The group identified four options to realize the President's goals. They are summarized as follows:

EXECUTIVE SECRETARIAT

- **Option 1. IRS Student Loan Special Operations (Federal FTE or Contractors)--** Education originates the loan and the IRS performs all other functions in a newly constituted special unit. Wage withholding is mandatory on the employer.

- **Option 2. Split Servicing: IRS Uses the Tax System for Wage Withholding--** Education does everything except collect loans where the payer has elected to use wage withholding.

- **Option 3. Education Carries out All Loan Functions and Provides Incentives to Business to Maximize Availability of Wage Withholding. IRS Enhances Debt Collection Capability--**Education does everything. Incentives are provided to increase participation in a voluntary withholding system.

- **Option 4. Education Carries out All Functions with Mandatory Participation for Firms with Ten or More Employees--**Education does everything. Wage Withholding is mandatory for employes with over 10 employees.

The IRS and Education support the implementation of option 3 in which Education administers the program with IRS assistance limited to increasing debt collection capabilities.

The IRS, Education, Treasury, National Economic Council, Domestic Policy Council and OMB together have developed the Presidential decision memorandum attached. Each of the work group participants have agreed on the wording of the memorandum. Further, each participant has retained for their agency the right to provide a short written defense of their agency's recommendation for one of the four options contained in the Presidential Decision Memorandum. Treasury's justification for selecting Option 3 is attached (see Tab B).

Attachment: Letter for signature

95-151334

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 18, 1995

CLOSE HOLD

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

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

SUBJECT: Proposed Education Expense Credit

The White House has asked OMB, Treasury, and the Department of Education to analyze a new proposed education expense credit. The new credit would supplement, but also partially replace, the proposal for a tuition deduction that was included in the President's FY 1996 budget.

Under the proposal, college freshman and sophomores (or their parents) could claim a **refundable** tax credit of up to $1,200 for qualified educational expenses. Qualified expenses include tuition and fees less all grants received. The credit is calculated on a per student basis. That is, if a family has two students who are in the first or second year of college, the family could claim up to a $2,400 credit on its Federal income tax return.

The credit phases out over the income ranges $100,000-$120,000 for joint returns and $70,000-$90,000 for single returns. These are the same income phase-outs as in the President's budget proposal. The phase-out ranges are indexed for inflation, beginning in 2000.

The proposal continues to allow a deduction for educational expenses up to $10,000 annually (with the same income limits as the credit) for 3rd, 4th, and 5th year undergraduates. Unlike the credit, the dollar limit on the deduction applies per tax return, not per student. Thus, a family with two students at Harvard could only deduct $10,000, even if both students are paying full tuition.

Unlike the President's proposal, the deduction is not available for graduate study, vocational training, or less than half time students. For both the credit and deduction, qualified students must be enrolled at least half time in a degree program, as defined by the U.S. Department of Education.

The Office of Tax Analysis (OTA) estimates that the proposal would reduce revenue by $60 billion between 1996 and 2002 and by $94 billion between 1996 and 2005. (In contrast, the President's proposal reduces revenue by $39 billion between 1996 and 2002 and by $64 billion between 1996 and 2005.) Most of this cost comes from the new credit. If the proposal included **only** the $1,200 refundable credit for freshman and sophomores and **eliminated the deduction completely**, the 7-year revenue loss would still be about **$45 billion.**

CLOSE HOLD

EXECUTIVE SECRETARIAT

The revenue loss for the new credit exceeds the revenue loss from the President's proposal for the following reasons:

- The credit is more generous than the deduction for most students attending public universities. For students attending a public university with a tuition of $2,000, for example, the deduction is only worth $560 to a taxpayer in the 28% bracket. In addition, because the credit is refundable, it is available to many low-income students who cannot use the deduction.

- The pool of students available to use the credit is very large. A disproportionate number of college students are freshmen due to high dropout rates.

- OTP estimates that there will be a large behavioral response to the credit after the first year. Some of this response would be a genuine increase in college enrollments, but much of it would result from recharacterizing training as degree programs, extending time in the freshman and sophomore year by attending half time instead of full time, and other behavioral adjustments to exploit the availability of the credit.

- Refundable credits give rise to significant compliance problems. OTA's estimates include noncompliance effects, based on experience with the EITC.

- There is currently no third party reporting between the Department of Education and the IRS. Establishing the necessary reporting requirements to monitor the credit will take time and involve large start-up costs.

OTA is currently developing a computer model that will enable us to estimate the effects of variations on the basic proposal and to develop alternatives that fit within a revenue target. Completing the data imputations necessary for this model, however, will take several days and will be delayed until estimates of the Senate Finance tax bill are completed.

Officials and staff in OTA, the Office of Management and Budget (OMB), and the Department of Education have raised a number of policy concerns about the proposal. These concerns are summarized in the attached memorandum prepared by Ken Apfel of OMB, which reflects agency comments.

Attachments

cc: Leslie Samuels
Lowell Dworin
Joel Platt
Ann Parcell
Jim Nunns
Gerry Gerardi
Julie-Ann Cronin
Bruce Davie

Note for Gene Sperling
Mike Smith
Les Samuels
Mark Mazur

From: Ken Apfel

Re: Tuition Tax Credit/Deduction

Date: 10/13/95

Here is the short summary of costs and other issues raised by the current version of the tuition tax credit/deduction proposal. The paper reflects Education and Treasury comments.

10/13/95

Proposal to use tuition tax credits/deductions to guarantee some college education for every American

CURRENT DESIGN

The proposal would modify the pending education tax deduction in the Middle Class Bill of Rights (MCBR) and replace it with one that would target degree-seeking undergraduates enrolled at least half time. The proposal would provide:

(1) 1st- and 2nd-year students with a refundable tax credit for tuition paid, net of any Federal (e.g., Pell) and non-Federal grant a student receives, up to a maximum credit of $1,200; and

(2) 3rd-, 4th-, and 5th-year students with a tax deduction for tuition paid, net of any Federal and non-Federal grant a student receives, up to a maximum of $10,000.

Treasury estimates that it will take a week or more to develop models providing the capability to analyze and estimate the revenue effects of the current proposal or alternative approaches. It is likely that Treasury will be occupied with analyzing and estimating the Senate tax provisions, which may delay the modeling of this proposal.

ISSUES

1) Cost

Preliminary estimates from Treasury indicate that the new proposal would be substantially more expensive than the one in the MCBR. The MCBR tuition proposal would cost approximately $5.9 billion annually when fully phased in at 1996 income levels. Using comparable income data, Treasury's preliminary estimate is that the new proposal would cost $10 billion annually.

- Changing from the MCBR tax deduction to a refundable tax credit of $1,200 for the first two years of schooling would, on average, provide generally larger benefits.

- The recipient population is much larger for a refundable credit than a deduction because it extends benefits to many who would not have any tax liability, or a substantial enough liability to benefit fully from the deduction.

- The MCBR provided the $10,000 tax deduction per family unit, whereas this new proposal would provide the tax credit for the first two years on a per-student basis, and the tax deduction for the later years of schooling on a per-family basis.

- Like the EITC, the refundable nature of the credit would result in scoreable outlays.

- The above cost-increase factors are far larger than the cost reductions that occur from narrowing the scope of the program discussed below in item 3. (We are as yet unable to estimate the effect of program interactions.)

Some of the cost increase could be moderated by alternative phase-in paths for coverage and for size of benefit, benefit phase-out options, or other parameter changes which can be modeled once Treasury's system is available.

2) Tax Policy Issues

- Providing a refundable tax credit will increase the number of returns filed, adding burden and cost to IRS.

- Determination of when an individual is 1st- or 2nd-year will be difficult for the students to determine and very complex for the Federal Government to validate, requiring schools to provide validation and deal with student queries. Schools will not welcome this role.

- The biggest compliance issues encountered with implementing the Earned Income Tax Credit arise from verifying family structure and the existence of children. These same issues would pertain to the tuition tax credit.

3) Coverage of the Proposal Compared to the MCBR

- The proposal targets a smaller number of students than the MCBR by excluding (a) students enrolled less than half time in degree-credit programs and (b) all students at graduate schools and in sub-associate degree and non-degree-credit programs. Treasury will need to model costs for alternative coverage options.

- A major factor in the Administration's job training strategy is financing skill enhancement through grants at the sub-degree level, especially in community colleges. Eliminating eligibility for non-degree students in this initiative could call into question the prior commitment.

4) Effect on Administration's Student Financial Aid Policies

- The Federal Government already guarantees financial access to postsecondary education through a combination of grants, loans, and work study. Grants are now reserved for the needy. Expanding "grants" to the non-needy is a major change in policy and could raise questions about appropriate allocation of benefits between needy and non-needy families.

- All students enrolled half-time or more are currently entitled to a Federal direct or guaranteed loan, regardless of family income. Maximum loan limits are currently well in excess of $1,200. Administration policy has supported direct lending in order, among

other reasons, to provide income-contingent repayment to all borrowers, so that regardless of debt burden, no student pays more than he can afford. A new policy of providing cash benefits through a refundable credit may be taken as a signal that Administration commitment to direct loans with income contingent repayment has changed.

5) Unintended Consequences in School Pricing

- Tuition tax credits could provide an incentive for States and private institutions to increase their tuition and fees, or to mask cost increases for room and board as tuition and fee increases.

6) Higher Education Community Reactions

- The MCBR deduction raised a higher education community concern that it would disproportionately reduce costs for students attending public institutions, compared to those in private institutions -- that is, it covers a larger proportion of public institution costs than costs at the more expensive private institutions. A refundable credit may exacerbate this perception, and thus would be viewed still more adversely by private college associations.

- Associations representing groups excluded from coverage compared to MCBR (non-degree students at community colleges, for-profit trade schools, and elsewhere; graduate students) will likely oppose the proposal.

- The higher education associations in general will probably oppose this proposal or give it only lukewarm support since they will view it as a retreat from need-based aid and, as noted above, will oppose reporting burdens and administration costs.

PROPOSAL FOR AN EDUCATION EXPENSE CREDIT FOR FRESHMEN AND SOPHOMORES,
AND AN EDUCATION EXPENSE DEDUCTION FOR 3RD, 4TH AND 5TH YEAR UNDERGRADUATES 1/
Effective 1/1/96
(FY; in $ billions)
PRELIMINARY ESTIMATES

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	1996-05
REVENUE EFFECT	1.2	8.0	8.7	9.4	10.2	11.1	11.3	11.4	11.4	11.3	94.0

Department of the Treasury
Office of Tax Analysis

Oct. 16, 1995

1/ The proposal includes the following features:

a) Qualified students must be enrolled at least half-time in a degree program (as defined by the Education Department).

b) Qualified expenses include tuition less all grants.

c) The proposal allows for a refundable credit for up to $1,200 in qualified educational expenses (not indexed) for freshmen and sophomores. The credit is calculated on a per student basis and is not prorated for half-time versus full-time enrollment. The credit phases-out as in the President's budget proposal; for single filers, the AGI phase-out range is $70,000-$90,000, and for joint filers, the AGI phase-out range is $100,000 to $120,000. The phase-out ranges are indexed as in the President's proposal. The indexing begins in 2000 and is subject to a $5,000 round-down rule.

d) The proposal allows for an above-the-line deduction for up to $10,000 in qualified educational expenses (not indexed) for 3rd, 4th, and 5th year undergraduates. The deduction is calculated on a tax filing unit basis, and is limited by the same AGI phase-out ranges (and indexing) as in c). Note that the deduction is not phased-in. This differs from the President's proposal which had a maximum deduction of $5,000 in years 1996-1998 and a maximum $10,000 deduction thereafter.

e) When tax filing units have the ability to use both a deduction and a credit, AGI will be adjusted and/or calculated in a manner such that the phase-out of the credit will be unaffected.

f) Third-party reporting (educational institutions and taxpayers must both report to the IRS) is assumed.

The Secretary of the Treasury

October 20, 1995

NOTE TO ERIC TODER

FROM: Bob Rubin

I don't know much about this, but especially given the cost, sounds rather dubious.

TREASURY CLEARANCE SHEET

NO. 95-151334
Date 10/18/95

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

FROM: Eric J. Toder
THROUGH: _____
SUBJECT: Proposed Education Expense Credit

REVIEW OFFICES (Check when office clears)

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

NAME (Please Print)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Eric Toder		10/18/95	Office of Tax Analysis, Room 3108	622-0120
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

95-152650

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
November 3, 1995

MEMORANDUM FOR SECRETARY RUBIN

FROM: Glen Rossell
Deputy Assistant Secretary
(Economic Policy)

SUBJECT: Republican Education Cuts

Attached, find some information on Republican budget cuts in education programs. Howard Schloss relayed the message that you were looking for this material.

Attachment

Glen R
to RER
cc to
NCC
11/3/95 JBN
SMA
pls log
IN

10/25/95

IMPACT OF EDUCATION CUTS ON CHILDREN IN AMERICA

Denies Head Start to 180,000 children nationwide in 2002. The successful Head Start program helped 750,000 preschool children in 1995.

Denies 1.1 million children basic and advanced skills in 1996. The Republican budget cuts Title I by $1.1 billion -- a 17% cut in 1996 -- denying Title I funding for 1.1 million students in our poorest communities nationwide.

Cuts Safe and Drug Free Schools by 55%, denying more than 23 million students services that keep drugs and violence away from children, their schools, and their communities. The Republican budget walks away from the Safe and Drug Free School state grants program, the only federal program solely dedicated to combating alcohol and drug abuse, and violent behavior in our nation's schools.

Eliminates Goals 2000, denying improved teaching and learning for as many as 5.1 million school children in America in 1996. Under the Republican cuts, 12 million children would be denied improved education by 2002, compared to the President's balanced budget.

Eliminates the AmeriCorps National Service program, denying 50,000 young people the opportunity to serve their communities in 1996.

Eliminates summer job opportunities for nearly 4 million youths over the next seven years. The Republican cuts will prevent millions of youths from participating in meaningful summer job experiences that help prepare them to be active contributors in the workforce and the community. The House plan completely eliminates this program, cutting approximately 600,000 job opportunities in 1996 and nearly 4 million summer jobs by 2002.

PRESIDENT CLINTON'S COMMITMENT TO EDUCATION AND TRAINING

President Clinton is fighting for better education and training--from Head Start and school lunches to safe schools, higher standards, and student loans--in order to allow young people to make the most of their lives, and to provide to every American the chance to realize the American Dream. While supporting deficit reduction, open trade, and job creation, and while fighting violence that threatens our society, the President has recognized that nothing is more critical to our nation's future than ensuring that all Americans have the education and skills they need to navigate these changing times. The President has made an unprecedented commitment to strengthening teaching and learning--expanding and improving early childhood education, assisting local communities in improving their schools, instituting bold new reforms of adult education and training programs, and expanding financial aid for deserving college students.

EDUCATION IS THE KEY TO REALIZING THE AMERICAN DREAM

Improving education is important for families, the revival of civic institutions, and economic growth. In an economy where technology is constantly changing, trade is expanding, and capital is mobile, education has become the fundamental fault-line in our standard of living. Most Americans have seen their incomes stagnate over the last 15 years; the real income of the typical family has actually declined. Yet those with the most education and training have bucked the trend. In 1979, a male college graduate earned 39% more than a man with only a high school degree. By 1993, this gap had doubled, and a male college graduate out-earned his high school graduate counterpart by 80 percent. In addition, the availability of health coverage, pension plans, and other work-related benefits has become closely correlated with education levels.

A BIPARTISAN EDUCATION RECORD

While bringing the deficit down by historic amounts--over $600 billion so far--President Clinton has also made investing in education a top priority. During the last Congress, Republicans and Democrats together enacted a historic series of initiatives to assist families, communities, schools, and colleges to have expanded educational opportunity in America. Landmark legislation includes:

- **Head Start Amendments of 1994** (signed 5/18/94; passed House 393-20; Senate 98-1).
- **Goals 2000: Educate America Act** (signed 3/31/94; passed House 306-121; Senate 63-22).
- **Improving America's Schools Act** (signed 10/20/94; passed House 362-132; Senate 77-20).
- **School-to-Work Opportunities Act** (signed 5/4/94; passed House 339-79; Senate Voice Vote)
- **National and Community Service Trust Act** (signed 9/21/93; passed House 275-152; Senate 57-40)
- **Direct Lending and Pay-as-You-Can Loans** (signed on 8/10/93 as part of the Omnibus Budget Reconciliation Act)

This year, President Clinton went a step further by proposing incentives--through expansion of IRAs of up to $10,000--for families to save for their children's college education. In addition, the President has sought to consolidate 70 programs and put Skill Grants directly in the hands of workers seeking to upgrade their education and skills.

DRAWING THE LINE ON EDUCATION

Despite the bipartisan efforts last year to expand the quality and effectiveness of education, the current budget debate points to a divide between the President and the Republican Congress over education--the foundation of our democracy and free enterprise system. Both the President and Republicans believe we must reduce the budget deficit and balance the budget, and both propose deep cuts in discretionary spending to reach this goal. But the President also believes that in order to create more opportunity, we must reduce the education deficit by expanding investment in quality education. Most Republicans disagree. Thus, **while the President's balanced budget proposal launches an all-out effort to expand educational opportunities, the GOP budgets drastically decrease educational opportunity.**

THE EDUCATION GAP BETWEEN THE BUDGETS

The Republican budget resolution slashes education and training by $36 billion for 1995 to 2002 (including $10 billion in loan benefits to students). On July 24, the House Appropriations Committee took the first step towards making this budget resolution a reality, by cutting key education and training initiatives. By contrast, the President's budget increases investment in these same areas by $40 billion over seven years. As a result, there is a major education gap between the President's proposal and the Republicans'.

President Clinton will fight to expand investments in quality education, and he will fight against efforts to reduce, gut, or eliminate key investments in education and job training. Following is a brief outline of the fundamental differences between the President's approach to education and the Republican approaches to education -- from pre-school through post-secondary education.

I. EXPANDING HEAD START

President Clinton has made expanding and improving pre-schooling the starting point for helping families give their children a good start on the right course. Republicans would slash these investments.

- HEAD START. ***President Clinton Adds 50,000 Children; Republicans Cut Up To 180,000 Children.***

  President Clinton already expanded investment in Head Start by $760 million from 1993 to 1995. Now, he proposes to increase annual funding by $1.5 billion by 2002 to reach another 50,000 children. At the same time as he has expanded Head Start, he has also reformed the way the program works to improve teaching and facilities for all the children who participate.

  Republicans: The House Appropriations Committee has approved reducing FY 1996 funding for Head Start to over $100 million below the FY 1995 level and over $500 million below the President's request. Up to 45,000 children would be cut off Head Start in 1996 if HHS is to maintain program quality. Freezing funding at the reduced level would cut off up to 180,000 children in 2002 compared to 1995.

II. IMPROVING ELEMENTARY AND SECONDARY EDUCATION

President Clinton has lent national support to local schools and communities working to improve the quality of their education by rigorously teaching the basics, making schools safe and drug-free, promoting increased parental involvement, raising student achievement and discipline, getting technology into the classroom, and providing opportunities to go from school to college or work. Republicans would eliminate national support for local educational improvement, leaving students without crucial resources and assistance they need to succeed.

- **THE GOALS 2000: EDUCATE AMERICA ACT: ASSISTING LOCAL SCHOOLS.** ***President Clinton Helped To Create This Initiative And Would Provide $896 Million by 2002 To Upgrade 85,000 Schools for 44 Million Children; Republicans Would Eliminate It.***

  President Clinton helped create Goals 2000, which supports state, community, and school efforts to raise standards of achievement and discipline and encourage students to work hard meet them. Forty-eight states are already participating in this program. In his 1996 budget, the President calls for nearly doubling the program, to almost $700 million, with the total level rising to $896 million by 2002. That's enough to support improvements for all 44 million children in the over 85,000 public schools.

  Republicans: The House Appropriations Committee has approved **eliminating** Goals 2000 entirely--undermining what was once a bipartisan effort to spur bottom-up school improvement in schools across the nation.

- **TITLE I: HELPING CHILDREN LEARN THE BASICS.** ***President Clinton Would Expand It Each Year; Republicans Would Freeze Funding, Depriving Over One Million Children of Aid.***

  President Clinton supports Title I Grants to Local Education Agencies, designed to provide needed resources to help students learn the basic subjects in school. The program has been reoriented to give schools more flexibility to support effective innovations that help all students read and write well and meet challenging standards. The President has already increased Title I funding by $573 million over two years, and he proposes an increase of $302 million this year, enough to serve 300,000 additional children, with further increases every year in the future.

  Republicans: The House Appropriations Committee approved a reducing funding by $1.1 billion in 1996, cutting as many as 1.1 million children from the program. These children from our poorest communities would be denied the opportunity they need to reach their full potential.

- **SAFE AND DRUG-FREE SCHOOLS.** ***President Clinton Has Consistently Supported It; Republicans Would Gut It.***

  President Clinton supports this initiative to make our schools safe from drugs and violence. The program funds everything from innovative anti-violence education and after-school programs to metal detectors and security personnel. The President would maintain funding at $500 million per year.

Republicans: The House Appropriations Committee cut this program by 60 percent to $200 million, depriving over 23 million students of services in 1996 alone.

- TECHNOLOGY FOR EDUCATION: GETTING COMPUTERS IN THE CLASSROOM. ***Republicans Would Gut This Clinton Initiative Which Leverages Private Money for Technology in Public Schools.***

  President Clinton has helped initiate this challenge to the private sector to join with schools and colleges to raise student achievement through the use of computers and new learning technology in the classroom. A $50 million federal investment in 1996 will leverage hundreds of millions of dollars in private support.

  Republicans: The House Appropriations Committee cut this program in half to $25 million in FY 1996, denying school districts across the country the ability to participate in this initiative, and drastically slowing the effort to leverage millions more from the private sector.

- SCHOOL-TO-WORK OPPORTUNITIES. ***President Clinton Has Supported A New 50-State Movement; Republicans Would Stop It In Its Tracks.***

  President Clinton, with bipartisan support, signed into law the most important national program ever to help states and localities set up systems to link Federal, state, and local resources in new effective ways that ensure that all young people--including the 70% of young Americans who don't get four-year degrees--get the education they need to obtain good jobs with a future. All states have received planning funds, and eight "leading edge" states are using implementation grants to create systems that are getting positive reviews from companies nationwide. Twenty more states will begin implementation this year. President Clinton has proposed increasing support by 60% for FY 1996 to $400 million, bringing to 43 the number of states implementing school to work systems. Remaining states would start up the following year.

  Republicans: The House Appropriations Committee approved slashing the President's request by over 50 percent to $190 million. This would seriously hamper efforts of 28 states to complete the reforms they started in 1994 and 1995; twenty-two additional states would be denied the chance to implement their reform plans to raise student skills.

- SUMMER JOBS. ***President Clinton Supports Work Experiences for Youth; Republicans Would Eliminate These Jobs.***

  President Clinton recognizes that the summer jobs program is an important first opportunity to get work experience for many low-income youths, especially those in inner cities where jobs are scarce. Without these opportunities, these young people might not otherwise have any chance to learn skills and workplace behavior during their formative years. The President has proposed financing over 550,000 jobs in the summer of 1996 alone.

Republicans: The House Appropriations Committee has approved eliminating this program, with an $872 million cut from the President's request. In the summer of 1996 alone this would eliminate this valuable work experience for over 550,000 urban and rural at-risk youth.

III. INCREASING ACCESS TO POST-SECONDARY EDUCATION

Assistance with financial aid to deserving college students is an investment in America's future and helps families give their children a chance to make the most of their lives. Now more than ever, post-secondary education and job training are the gateway to America's middle class. Studies show that for every year of training a person gets after high school, his or her earnings rise by 6 to 12 percent. After 15 years in which college costs increased far faster than inflation but family incomes stagnated, President Clinton has initiated historic efforts to expand college access. Republican proposals would devastate access to post-secondary grants and loans, and to job training, setting back college access by years if not decades.

- ***AMERICORPS: HELPING STUDENTS WHO HELP THEIR COMMUNITIES. President Clinton Offers Opportunities to Nearly 50,000 Young People in AmeriCorps Next Year Alone plus over 1 Million Other Service Opportunities Each Year for People of All Ages; Republicans Would Eliminate All of AmeriCorps and More Than 750,000 of the Service Opportunities for People of All Ages.***

  President Clinton created AmeriCorps to enable young people to earn money for education by serving their communities--teaching, caring for the sick, making the streets safer. Already 20,000 Americans are serving in AmeriCorps, and nearly 50,000 are expected next year. He also fully supports an additional 1 million service opportunities in Learn and Serve, VISTA, Foster Grandparents, and other programs.

  Republicans: The House Appropriations Committee approved eliminating AmeriCorps and the Corporation for National Service and cut opportunities in other service programs. Over 4.3 million service opportunities for youth in their communities would be abolished over the next seven years. In FY 1996 alone nearly 50, 000 young Americans from hard-working, middle class families will lose the opportunity to serve their communities through AmeriCorps in locally-identified areas of crucial need such as health care, social service, and crime prevention, and to earn an educational award to help pay for college or other training.

- PELL GRANTS: PROVIDING THE LIFELINE TO COLLEGE FOR WORKING FAMILIES. ***President Clinton Raised the Maximum Grant to a Record High and Would Increase Annual Funding by $3.4 Billion by 2002; Republicans Would Eliminate Up To 300,000 Students From The Program.***

  President Clinton has supported the Pell Grant program, and increased the maximum Pell Grant in his 1996 budget by 12%, to its highest level ever, $2,620. In his new budget, he would increase annual funding by $3.4 billion by 2002--enough to reach 960,000 more recipients and increase the maximum award to $3,128.

Republicans: The House Appropriations Committee approved an increase in the maximum Pell Grant by only $100, to $2440. Furthermore, the committee approved eliminating about 300,000 students from the program who would receive awards between $400 and $600 under the President's proposal. For millions of students, grants make the difference between going to college and not going, between staying in school and dropping out. For example, $250 equals approximately 25% of tuition and fees of community colleges.

- **IN-SCHOOL INTEREST EXEMPTION: HELPING STUDENTS AND FAMILIES PAY FOR COLLEGE.** ***Republicans Would Raise College Costs for Up to 4 Million Students.***

  President Clinton supports the in-school interest exemption, under which **four million** need-tested students with Stafford loans do not have to pay interest while enrolled in school and during the grace period (six months) between leaving school and entering repayment.

  Republicans in their budget resolution propose $10 billion in cuts in student loans. In order to achieve that level of savings and preserve unnecessary payments to banks, secondary markets, and guaranty agencies, they will not only have to eliminate any subsidy for graduate or professional students, but also hit college students with higher fees--for example, eliminating the six month grace period for interest after college or raising the origination fees that every student must pay to get their loans.

- **DIRECT LENDING AND INDIVIDUAL EDUCATION ACCOUNTS: MAKING COLLEGE MORE AFFORDABLE.** ***President Clinton Supports Expanding These Initiatives; Republicans Want To Raise the Cost to Students and Reduce Access.***

  President Clinton supports expanding the new direct lending program and individual education accounts. Direct lending eliminates billions of dollars in unnecessary payments to lenders and others and makes student loans cheaper and more efficient for students, schools, and taxpayers. With the passage of the Student Loan Reform Act, 104 schools and over 252,000 students initiated the program in 1995. On July 1, 1995, more than 1,400 schools--representing about 40% of all loans and the maximum allowed under this year's authorization--began the second year on schedule. The President would expand the program to all schools and students. This program is already saving $6.8 billion for taxpayers, lowering interest rates for students, and allowing borrowers to choose flexible repayment arrangements, including pay-as-you-earn plans through Individual Education Accounts. In time, 20 million current borrowers and six million new borrowers per year will benefit.

  Republicans have proposed legislation to reduce funds available for direct lending, prevent more schools from choosing to participate in the initiative, and cap participation at 40 percent of all loans. The committee mark also approved a reduction in direct loan administration funds by over 40 percent in order to cripple implementation and to deny the benefits of direct lending to low and middle income students. These actions will stop the growth of cost-effective, efficient direct lending in order to keep unnecessary payments flowing to wealthy banks and unnecessary middlemen.

- **EDUCATION AND TRAINING TAX DEDUCTION: REWARDING PARENTS WHO INVEST IN THEIR CHILDREN'S EDUCATION.** ***President Clinton Supports A Deduction; With All the Tax Breaks for the Wealthy, Republicans Don't.***

  President Clinton supports a tax deduction for middle-class families with education and job training expenses up to $10,000. This deduction would provide tax-favored treatment to education similar to the benefits for other investments like housing and equipment. It invests in those who invest in themselves and in America.

  Republicans do not support the education and training tax deduction. With its $20,000 tax cut for the wealthiest 1%, the Contract with America includes tax breaks for capital gains, gifts and inheritances in excess of $600,000, and the depreciation of business purchases--but not for education.

IV. LIFELONG LEARNING

In order to maintain good job prospects throughout their lives in a fast-changing economy, Americans need the opportunity to upgrade their education and skills regularly. President Clinton wants to support lifelong learning by reforming job training programs and putting resources and information directly into workers' hands. Republicans just want to slash job training.

- **G.I. BILL OF RIGHTS FOR WORKERS (SKILL GRANTS).** ***President Clinton Supports Skill Grants for America's Workers; Republicans Want a 25% Cut in Job Training Funds.***

  President Clinton: Under the adult reform proposal, low-income or dislocated workers (and others) could go to a One-Stop Center for help to get jobs, and learn about the services and track records of job training programs. Then, they could use Skill Grants at their own choice among those institutions. The President would provide 800,000 Skill Grants in 1996 alone. For youth training programs, the President proposes to build on and intensify the national reform embodied in the School-to-Work system to serve in-school and out-of-school youth. Youth programs would be streamlined and funding would be consolidated in a $2.9 billion State grant, replacing current fragmented efforts under the Perkins Vocational Educational and Job Training Partnership Act. In total, the President proposes to increase funding (excluding Pell Grants) by over $2 billion by 2002.

  Republicans: The House Appropriations Committee cut funding by 50 percent below the President's request, and 25 percent below the FY 1995 level. These cuts would deny reemployment services to 506,100 dislocated workers and deny training opportunities to 84,000 disadvantaged adults compared with the President's request. Republicans also eliminate over 550,000 job opportunities for disadvantaged youth by not funding the Summer Youth Employment Program. Millions of young people will lose the opportunity to develop adequate work preparation skills and obtain good first jobs.

1999-SE-005629

May 18, 1999

Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

We write to express our strong opposition to proposals for education tax incentives (Joint Committee on Taxation, "Description of Chairman's Mark of Proposals Relating to Education Incentives" (JCX-020-99), May 17, 1999), which we understand your committee will consider this week. In the summer of 1997, as Congress was in the final stages of consideration of the Taxpayer Relief Act of 1997, the President stated that he would veto the legislation if it contained a proposal relating to Education Savings Accounts that is similar to the education savings account proposal contained in the Chairman's mark. In 1998, we wrote to inform you that we would recommend to the President that he veto similar legislation, which, after consideration and approval by Congress, he did. If this proposal were to pass the Congress this year, we again would recommend to the President that he veto the bill.

Every American child deserves a high-quality elementary and secondary education. We believe that targeting our limited Federal resources to build stronger public schools will help ensure that all our children receive the education they need to be productive citizens. Public schools serve approximately 90 percent of students in grades K-12 and currently face record-breaking enrollments. By focusing resources on public schools, we can leverage community investment to help parents, teachers, and administrators meet the important educational challenges they face in serving the vast majority of our children: meeting high standards for learning and discipline; fixing school buildings; and providing a safe, drug-free environment for children. For this reason, the President's FY 2000 budget proposals include a school modernization bond initiative that would leverage $25 billion to renovate and build up to 6,000 public schools. In contrast, the Chairman's mark falls far short of adequately addressing the overwhelming problems that States and local communities face in building and modernizing their schools.

The current bill disproportionately benefits the most affluent families and provides little benefit to lower- and middle-income families. Additionally, given the expansion of tax-preferred savings vehicles in the Taxpayer Relief Act of 1997, which the Administration supported, we do not believe that further increasing the contribution limits for Education IRAs will generate much additional savings. Instead, the Chairman's mark would reward families, particularly those with significant means, for what they may do in any case.

We are also concerned that the bill would create significant compliance problems. The legislation allows tax-free withdrawals from Education IRAs for, among other things, tuition, fees, academic tutoring, special needs services, books, supplies and equipment expenses incurred in connection with the child's enrollment or attendance at a public or private elementary or secondary school. Withdrawals would also be tax-free if used for room and board, uniforms, transportation or supplementary items or services required or provided by the school.

Distinguishing between an appropriately tax-free withdrawal and one that should be subject to tax would lead to significant additional record-keeping burdens for families and schools, as well as disputes when discretionary purchases are made.

In addition to the points outlined above, we have other concerns with proposals in the bill that are not described in this letter.

We understand that Senators Robb and Conrad intend to offer a substitute that would replace the education IRA proposals in this bill with school modernization/construction bond proposals similar to those in the President's budget for fiscal year 2000. We strongly prefer that proposal and other alternatives that devote Federal revenue to improving the public schools so that a high-quality education is available to every American child regardless of his or her family income. Therefore, we strongly support the Robb-Conrad substitute.

Thank you for letting us bring our concerns to your attention, and we look forward to working with you on these important budget and tax issues in the days ahead.

Sincerely,

Robert E. Rubin
Secretary of the Treasury

Richard W. Riley
Secretary of Education

May 18, 1999

Honorable Daniel P. Moynihan
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Moynihan:

We write to express our strong opposition to proposals for education tax incentives (Joint Committee on Taxation, "Description of Chairman's Mark of Proposals Relating to Education Incentives" (JCX-020-99), May 17, 1999), which we understand your committee will consider this week. In the summer of 1997, as Congress was in the final stages of consideration of the Taxpayer Relief Act of 1997, the President stated that he would veto the legislation if it contained a proposal relating to Education Savings Accounts that is similar to the education savings account proposal contained in the Chairman's mark. In 1998, we wrote to inform you that we would recommend to the President that he veto similar legislation, which, after consideration and approval by Congress, he did. If this proposal were to pass the Congress this year, we again would recommend to the President that he veto the bill.

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Sincerely,

Robert E. Rubin
Secretary of the Treasury

Richard W. Riley
Secretary of Education

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 25, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN

FROM: **KARL SCHOLZ** KS
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

JON TALISMAN JT
TAX LEGISLATIVE COUNSEL

SUBJECT: Draft Memos for the President

Attached are revised drafts of the two memos to the President. The revisions incorporate comments made by Larry and Gene. Larry read and signed off on the memos this morning. He asked us to send copies to you and Gene.

Have a good holiday.

How next to sell the proposals.

How tactically pursue your objectives

Include: the simplification
Brownfields
K-1 issue
127

Oppose: indexing?

How gracefully retreat Pres. elect [illegible]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 25, 1997

MEMORANDUM FOR THE PRESIDENT
Through Sec. Rubin
FROM: **LAWRENCE SUMMERS**
DEPUTY TREASURY SECRETARY

SUBJECT: Education Packages

This memo presents Treasury estimates of several possible combinations of the HOPE scholarship and tuition deduction as well as several other education proposals. The packages illustrate the tradeoffs necessary to fit the HOPE scholarship and tuition deduction into the $35 billion agreement. These tradeoffs are necessary in order to offset the increased costs of the package that would result from dropping the B- requirement (as requested by the education lobby) and the Pell grant offset (as requested by Congressional Democrats). Dropping these two items is estimated to cost approximately $5.3 billion through 2002.

Each of the options set forth below would eliminate the Pell grant offset and the B-restriction. Each option would fully phase in the complete education package by 2003, so the tuition deduction would be $10,000 and the HOPE Scholarship would be $1,500. The effective date of the options has been moved back to January 1, 1998, which saves roughly $2.5 billion. Please note that the Joint Tax Committee may score these proposals as being more expensive than shown in the table.

Education Packages: Preliminary Treasury Estimates, (Dollar amounts in billions)

	1998-2002	1998-2007
HOPE Scholarship, $1,200; Tuition Deduction, $10,000[1]	35.2	92.8
HOPE Scholarship, $1,000; Tuition Deduction, $10,000[2]	34.1	91.7
HOPE Scholarship, $1,500; Tuition Deduction @15% credit[3]	34.9	92.5
Phased in HOPE Scholarship; Phased in Tuition Deduction[4]	35.0	92.6

[1]The tuition deduction starts at $5,000 through 1999, and increases to $10,000 thereafter.

[2]The tuition deduction starts at $10,000 in 1998.

[3]This variation converts the tuition deduction into a 15 percent credit on expenses up to $10,000 ($5,000 in 1998).

[4]The tuition deduction starts at $5,000 through 2000, and increases to $10,000 thereafter. The HOPE credit starts at $1,200 through 2000, and increases to $1,500 thereafter.

- The crucial design choice that needs your guidance is whether the HOPE scholarship, the tuition deduction, or both should be trimmed to fit the education into the $35 billion agreement.

  ___ Trim the HOPE credit (As in package #1 above) ___ Trim the deduction (as in package #3 above) ✓ Phase in both (as in package #4 above)

  - There are additional possible variations of the packages. Elimination of the Pell offset could be phased in, though this would not save a lot since completely eliminating the Pell offset costs roughly $3 billion through 2002. The income phaseout ranges could also be altered (the credit and deduction phase out for joint filers with incomes between $80,000 and $100,000 and single filers with income between $50,000 and $70,000).

Additional Features of the Education Packages

- With money outside the $35 billion, we propose to make permanent the exclusion of employer-provided educational assistance from taxable income (Section 127). This is a cause that has been championed by Senator Moynihan and others in the House and the Senate. Doing so will cost roughly $3.7 billion through 2002.

- A student loan interest deduction would provide relief to many middle-income students and is politically popular. Adopting the student loan interest deduction in the Republican Leadership education bill (S.1) would cost $1.8 billion under Treasury scoring (and $0.7 billion under Joint Tax scoring).

  - The proposal to deduct student loan interest would provide a $2,500 above-the-line deduction, phased out at $45,000 to $65,000 for single filers and $65,000 to $85,000 for joint filers.

- We are developing proposals to aid school construction (and other activities) in poor neighborhoods, as urged by Congressman Rangel and others.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 23, 1997

MEMORANDUM FOR THE PRESIDENT
Through Sec. Rubin
FROM: **LAWRENCE SUMMERS**
DEPUTY TREASURY SECRETARY

SUBJECT: Capital Gains Relief Package

This memo provides several options for broad-based capital gains tax relief. Our recommended option is a 40 percent exclusion for capital gains (with the AMT rate on capital gains reduced to 20 percent). This leaves room for negotiating a slightly higher exclusion, but holding firm against capital gains indexing. We would also recommend that a capital gains relief package include expansion of the Bumpers targeted capital gains relief presently provided to holdings of small business stock (as described more fully below), and our budget proposal to exclude up to $500,000 of capital gains from the sale of principal residences for married couples filing jointly ($250,000 for other taxpayers). We intend to provide you next week with a memo regarding capital gains indexing, which will detail the problems that would result from allowing indexing.

Broad-based capital gains tax relief

Isn't this too low

The following table provides the cost estimates for various broad-based capital gains options that we have considered:

Preliminary Treasury Estimates, (Dollar amounts in billions)[1]		
	1998-2002	1998-2007
40% capital gains exclusion (w/ 20% AMT rate)	-$2.7	-$15.2
40% capital gains exclusion (w/o AMT preference)	-$10.6	-$34.0
50% capital gains exclusion (w/o AMT preference)	-$18.3	-$55.3
50% capital gains exclusion, plus indexing starting 1/1/97	-$32.3	-$96.9
Separate rate schedule: 10.5% for 15% bracket taxpayers, 20% for other taxpayers; 20% AMT rate	+$13.4	+$15.3
Separate rate schedule: 7.5% for 15% bracket taxpayers, 20% for other taxpayers; 20% AMT rate	+$8.2	+$3.7

[1] All of the estimates shown include the cost of the proposed exclusion for sales of principal residences, which costs $1.4 billion through 2002 and $2.3 billion through 2007. However, they do not include the proposed expansion of the Bumpers targeted capital gains provision

o **Replace the current maximum rate on capital gains with a percentage exclusion.** This provides the same proportional reduction in the rate on capital gains for taxpayers in all tax rate brackets. Thus, in contrast to current law (which provides a maximum capital gains rate of 28 percent benefitting only higher income taxpayers), the proposal would provide capital gains relief for low and middle income taxpayers. A 50 percent exclusion would lower the top rate on capital gains from 28 percent to 19.8 percent. Several current Republican bills include a 50 percent exclusion for capital gains. For AMT purposes, capital gains would be subject to a special 20 percent rate, rather than the regular AMT rates of 26 or 28 percent. This ensures that the top capital gains rate is 20 percent for both regular tax and AMT purposes.

o **Separate rate schedule applicable to capital gains.** An alternative means of providing rate relief would be to tax capital gains under a separate rate schedule. For example, a special rate schedule could be established with a rate of 7.5 percent for taxpayers in the 15 percent bracket and a rate of 20 percent for taxpayers in higher tax brackets. A special AMT rate of 20 percent would apply.

Thus, in contrast to a percentage exclusion, taxpayers in tax brackets ranging from 28 percent to 39.6 percent would be subject to the same special capital gains rate. This causes a separate rate schedule of this type to be much less expensive than a percentage exclusion because the greatest benefits are given to high bracket taxpayers who are more likely to have induced realizations from the proposal. Conversely, less revenue is spent on lower bracket taxpayers who are less likely to change their realization pattern as a result of the proposal. Obviously, this type of separate rate schedule is more regressive than an across-the-board exclusion.

Expand Bumpers targeted capital gains relief for the sale of small business stock.

In 1993, targeted capital gains relief was added under section 1202, largely at the behest of Senator Bumpers, for sales of small business stock. Section 1202 presently provides a 50 percent exclusion for capital gains from the sale of qualified small business stock held for more than 5 years. If additional targeted capital gains relief is desired, Section 1202 could be expanded by: (1) eliminating the $10 million limitation on eligible gain, and (2) increasing the size of qualified businesses from $50 million of gross assets to $100 million of gross assets. Also, if a broad-based capital gains exclusion were adopted, we would recommend that the exclusion under section 1202 be increased correspondingly to 75 percent, i.e., the maximum rate under section 1202 would be reduced to 9.9 percent (15 percent for taxpayers subject to the AMT). Certain technical changes would also be made.

These changes are similar to proposed changes to section 1202 made by Senators Daschle, Lieberman and Hatch and by Congressman Matsui (among others).

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