

INFORMED BUDGETEER: House- Passed Budget Resolution

Fiscal Year 2002 Budget Resolution as Passed by the House: Total Spending and Revenues														
(\$ in Billions, By Fiscal Year)														
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2006	2002-2011
Total Spending	BA	1907.2	1977.3	2035.7	2112.8	2200.9	2264.6	2344.1	2437.8	2532.8	2634.1	2743.6	10591.3	23283.6
	OT	1856.7	1941.2	2007.4	2085.9	2175.8	2236.3	2312.9	2409.8	2505.9	2609.7	2718.3	10446.5	23003.1
On-budget	BA	1557.2	1613.6	1660.5	1723.3	1800.1	1851.5	1918.4	1998.6	2077.3	2161.6	2252.8	8648.9	19057.6
	OT	1508.8	1579.8	1634.5	1698.5	1777.3	1825.6	1889.9	1973.6	2053.6	2139.9	2230.2	8515.7	18803.0
Off-Budget	BA	350.0	363.6	375.3	389.5	400.8	413.1	425.7	439.2	455.5	472.5	490.7	1942.4	4226.0
	OT	347.9	361.4	372.9	387.3	398.5	410.7	423.1	436.2	452.3	469.8	488.1	1930.8	4200.2
Revenues:														
Total		2128.8	2168.1	2260.0	2344.4	2436.7	2521.4	2628.6	2754.2	2889.6	3038.6	3206.2	11730.6	26247.7
On-budget		1624.7	1635.8	1699.0	1755.7	1816.7	1872.2	1948.6	2041.7	2143.2	2256.6	2387.0	8779.4	19556.4
Off-budget		504.1	532.3	560.9	588.7	620.1	649.2	679.9	712.5	746.4	782.0	819.2	2951.2	6691.2
Surplus/Deficit (-)														
Total		272.0	226.9	252.5	258.6	261.0	285.1	315.6	344.4	383.7	428.9	487.9	1284.0	3244.5
On-budget		115.9	56.0	64.5	57.2	39.4	46.6	58.8	68.1	89.6	116.6	156.8	263.6	753.5
Off-budget		156.2	170.9	188.0	201.4	221.6	238.5	256.9	276.3	294.2	312.3	331.1	1020.4	2491.1
Debt *		3,157	2,944	2,710	2,471	2,226	1,955	1,651	1,316	939	878	818	NA	NA

*Debt Held by the Public (end of the year).

FOCUS ON DEBT**Buyback Premiums**

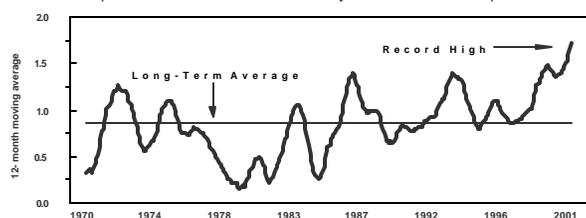
- On March 22, the Senate Budget Committee held a hearing on debt management. At that hearing Gary Gensler, who was Treasury Undersecretary for Domestic Finance in the Clinton Administration, testified that the Treasury has not yet paid penalty premiums in the course of conducting buybacks and that as the public debt declined over time Treasury could find it less expensive to repurchase bonds prior to maturity. Mr. Gensler theorized that bond prices would fall due to a decline in liquidity.
- Mr. Gensler's view runs counter to the views of Federal Reserve Chairman Greenspan and most Wall Street analysts. It also runs contrary to historical experience in the US.
- On March 2 the Federal Reserve Chairman told the House Budget Committee:

"(T)here is a very large component of marketable Treasury securities, to a large extent, held by foreign central banks and foreign businesses and individuals who hold those assets because they perceive them to be an extraordinarily valuable risk-free, dollar-denominated...asset, which, even though they may get, say, 5% on annually, they would be willing to hold them at 3% or less, meaning to get them to discard those securities prior to their maturity would be extraordinarily expensive and obviously undesirable to be done."

- Also, GAO noted in a recent report: "Market analysts have suggested that the Treasury's ability to perform debt buybacks at a reasonable cost could become more difficult as the debt available for repurchasing shrinks and Treasury investors demand higher bond premiums."
- A recent IMF report noted that the widening of interest rate spreads between US Treasury debt and corporate debt seems to be related to "the shrinking supply of Treasuries and the associated rise in their scarcity value."

ALREADY PAYING A PREMIUM?

(Aaa-Bond Yields minus 10-yr. T-Bond Yields)



Source: Federal Reserve Board

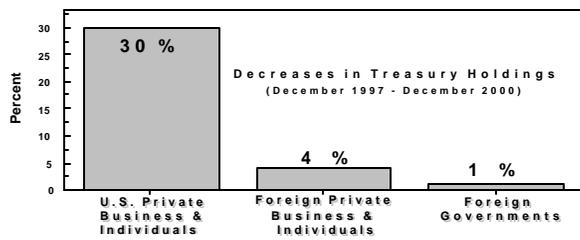
- At the same hearing at which Mr. Gensler testified, Dr. Ward McCarthy of Stone & McCarthy Research Associates testified that buybacks have already made repurchasing debt more expensive and

will continue to do so.

- The announcement of the buyback program in January 2000 prompted a significant increase in long-term Treasury bond prices. Premium estimates based on Treasury prices *on the day* of a buyback overlook the premium built into bonds upon the announcement of the buybacks.
- Additionally, a disproportionate share of the buybacks already conducted have relied on reconstituted STRIPS. (STRIPS are created when private firms separate the individual interest and principal components of a Treasury coupon bond.) Financial firms selling bonds to the Treasury have put these STRIPS back together at prices lower than those sought by holders of bonds that were never stripped. As the pool of STRIPS continues to shrink, more of the buybacks will have to come from bondholders who have thus far been holding out for higher prices.
- The high premiums involved in buying back debt were a source of public concern in the late 1880s as well. Back then, premiums went above 25% as the government chased a dwindling supply of outstanding bonds. In his annual address to Congress in 1887, President Grover Cleveland warned that:

"it should be borne in mind that premiums must of course be paid upon such purchase, that there may be a large part of these bonds held as investments which can not be purchased at any price, and that combinations among holders who are willing to sell may unreasonably enhance the cost of such bonds to the Government".
- Foreigner Debt Ownership**
- Also at the March 22 hearing, Edwin Truman, Assistant Treasury Secretary for International Affairs for President Clinton, testified that "foreign private holders of US Treasury debt behave similarly to domestic private participants in our financial markets. They adjust quiet rapidly to changing market conditions and their recent behavior with respect to Treasury securities supports this view."
- It is very difficult to reconcile Dr. Truman's view with the following facts. From December 1997 to December 2000 total federal debt owned by US individuals, US financial institutions, and US businesses fell by 30%. During the same period total federal debt owned by foreign individuals and foreign businesses fell only 4%. Federal debt held by foreign governments (including central banks) fell only 1%.

Who is Selling Treasury Debt?



- As noted by the Treasury Borrowing Advisory Committee, there has been “virtually no foreign participation” in buyback operations so far. This suggests that as Treasury debt continues to fall, foreign bondholders will be in a superior position to reap penalty premiums.

How Much Debt Can Be Retired?

- Although the witnesses at the debt hearing disagreed on several issues, one idea that was thoroughly discredited was that the federal government could have a 10-year budget surplus of \$3.8 trillion without accumulating unprecedented cash balances or private assets.
- OMB estimates that the maximum amount of debt reduction by 2011 is \$2 trillion. CBO estimates maximum debt reduction of \$2.3 trillion. Although he makes the unrealistic assumptions that Treasury will cease issuing all long-term debt by the end of the summer and will continue buybacks despite the likelihood of paying substantial penalty premiums (as discussed above), Gary Gensler estimates maximum debt reduction of \$2.7 trillion through 2011.
- All of these estimates of debt reduction are much closer to each other than \$3.8 trillion. In fact, all of them are exceeded by the \$2.9 trillion surplus that would result from setting aside the HI-Medicare surplus atop the Social Security surplus.

HERE WE GO: FLOOR PROCEDURES

- The Senate will begin debate on the Committee reported resolution this week. Good budgeteers will remember that there are special rules for the consideration of budget resolutions and especially amendments to the resolution on the Senate floor.
- Amendments to the budget resolution must be germane. The Committee-reported resolution forms the basis for germaneness. Amendments to strike language, change dates or numbers are considered to be per se germane. Note, pursuant to Section 204(g) of the FY 2001 budget resolution, Sense of the Senate Amendments are non-germane. All other amendments are evaluated on a case by case basis. A vote of 3/5ths of the Senators is required to waive the germaneness requirement or to overturn the ruling of the Chair.
- Senate procedures generally provide that a single amendment may not amend the underlying measure in more than one place and an amendment that did so would be subject to a simple majority point of order. However, the Budget Act waives this prohibition for amendments to the budget resolution, if the changes are required to maintain the mathematical consistency of the budget resolution.

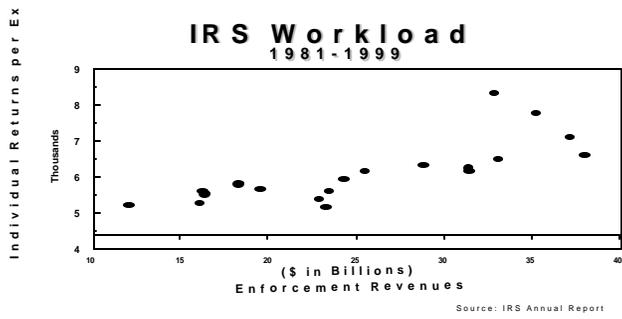
THE TAX MAN COMETH.....

BUT DOES HE AUDIT AND COLLECT ANYMORE?

- As another tax season is quickly drawing to close, the *Bulletin* would like to give its readers a timely overview of America’s tax collector – the Internal Revenue Service (IRS).
- The IRS employs almost 100,000 full-time employees and has a budget of \$8.9 billion. On an annual basis, the IRS processes over 216 million tax returns, receives over 1.1 billion financial information documents,

collects over \$2.0 trillion in revenues, and disburses about \$144 billion in tax refunds. The IRS also offers special advice and assistance to more than 110 million taxpayers over the phone and at 397 walk-in sites.

- It is often tasked with what could be termed as ‘non-core functions.’ For example, Congress has asked the IRS to help eliminate money laundering, assist in the collection of child support and student loan payments as well as assist in the war on drugs.
- The audit rate for individual returns has fallen from 1.68% in 1995 to 0.49% in 2000. The number of individual returns filed has gone up while the number of IRS examiners has fallen in the same time period.
- Furthermore, the most recent IRS estimate of the gross ‘taxgap’ - the difference between income taxes owed and those voluntarily paid, as measured by the Taxpayer Compliance Measurement Program - now totals \$195 billion, up from \$128 billion in 1992. These numbers may suggest that the tax system is hanging by a virtual shoestring. However, these statistics tell an incomplete and misleading story.
- What exactly is an audit? According to Section 7605(b) of the IRS Code, it depends on whether the IRS requires access to the taxpayer’s books and records to compute the proper tax liability. If access is required, then it is an audit. When the IRS sends a simple letter to a taxpayer about their failure to report a capital gains transaction, it is legally treated as an audit for statistical purposes because access to the taxpayer’s records is required to clear up the matter.
- However, if the IRS sends a letter proposing an adjustment based on either the return itself or third-party documents, it is not an audit (known as a Service Center Correspondence Contact or SCCC). Since 1993 the IRS has counted some of these SCCC’s in their audit statistics even though under 7605(b) they are not technically an audit.
- The IRS also runs the Information Reporting Program (IRP) or what is known as “invisible audits.” Under the IRP, the IRS issues nonfiler and IRP notices (sent when the IRS believes the taxpayer has failed to report an income source). Like SCCC, IRP notices use third-party information and “match” it to the taxpayer’s return to determine the correct tax liability; however, the number of IRP notices sent to taxpayers are not counted as an audit but the revenue collected is counted as a result of enforcement activities. Nonfiler notices (the IRS issued almost 2 million in 1999) are usually not treated as audits for statistical purposes, though the IRS has used these notices to assess up to \$1 billion a year in taxes owed.
- Improvements in the IRS’s computer systems have allowed the IRS to change the way they complete “matching” audits. Decades ago, such audits were completed by hand and were counted as official audits for statistical purposes. Nowadays, as a result of the third-party reporting requirements provided by the 1986 Tax Reform Act and the increasing use of computers, the need for full-blown audits of individual tax returns to ensure compliance has fallen.
- Budgeteers should not assume the government would be able to collect every dime of owed taxes if more revenue agents are hired. It is highly unlikely that the IRS could collect every dime assessed. The IRS does not know what portion of unpaid taxes is collectable. Some taxpayers may be unable to pay or simply may settle with the IRS for only a portion of the taxes owed or there may be instances where the costs involved in the collection are prohibitively high.
- There is a very weak, if any, correlation between the number of examiners per individual returns and the amount of revenue collected via enforcement activities (see chart below.). Many other factors such as the strength of the economy play a much larger and more important role in influencing the amount of taxes the IRS collects.



- It appears the current method of measuring compliance takes into account only some types of audit activities; it would be helpful if the IRS would revamp their audit statistics so policymakers and the public at large would be able to see a full and complete picture.