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PRESS RELEASES

Press release number HP-378 was not used.

Numbers HP-375, 376 and 377 are in the May volume.

April 3, 2007
2007-4-3-14-31-27-25992

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $66,448 million as of the end of that week, compared to $66,328 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	March 23, 2007			March 30, 2007		
TOTAL	66,328			66,448		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	12,694	10,807	23,501	12,758	10,831	23,589
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,667	5,267	17,934	12,745	5,279	18,024
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			4,897			4,846
3. Special Drawing Rights (SDRs) [2]			8,956			8,948
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	March 23, 2007			March 30, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	March 23, 2007			March 30, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

April 4, 2007
HP-338

Treasury Assistant Secretary Swagel to Hold Monthly Economic Briefing

U.S. Treasury Assistant Secretary for Economic Policy Phillip Swagel will hold a media briefing to review economic indicators from the last month as well as discuss the state of the U.S. Economy. The event is open to credentialed media:

Who
U. S. Treasury Assistant Secretary Phillip Swagel

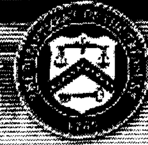
What
Economic Media Briefing

When
Friday, April 6, 2007, 1:00 p.m. (EDT)

Where
Treasury Department
Media Room (Room 4121)
1500 Pennsylvania Ave, NW
Washington, DC

Note: Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov with the following information: name, Social Security number and date of birth.

PRESS ROOM



April 4, 2007
HP-339

Lundsager Sworn In as U.S. Executive Director At The International Monetary Fund

WASHINGTON, D.C.-- Meg Lundsager, appointed by President Bush to serve as U.S. Executive Director at the International Monetary Fund, was sworn in today by Deputy Secretary Robert M. Kimmitt. The Senate confirmed Ms. Lundsager on March 29, 2007. Previously, she served as the Alternate U.S. Executive Director at the IMF since 2000. She has worked for the Treasury Department in numerous capacities, including Deputy Assistant Secretary for International Trade and Investment Policy and Director of the Office of Asian and Near East Nations. She also has served on the National Security Council staff, and was an inaugural Atlantic Fellow at the London School of Economics. She holds degrees from American University and the University of Maryland.

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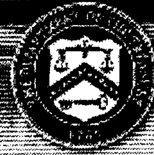

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April 6, 2007
HP-340

Treasury Economic Update

Job Creation Continues:

Job Growth: 180,000 new jobs created in March. In addition, employment estimates for January and February were revised up, adding 32,000 jobs. Nearly 2 million new jobs have been created over the past 12 months. Since August 2003, 7.8 million jobs have been created – more jobs than all the other major industrialized countries combined. Our economy has added jobs for 43 straight months. Employment has increased in 47 states within the past year. *(Last updated: April 6, 2007)*

Low Unemployment: 4.4% unemployment rate – among lowest readings in 6 years. Unemployment rates have decreased or held steady in 40 states over the past year. *(Last updated: April 6, 2007)*

REPORTS

- Treasury Economic Update

U.S. ECONOMIC STRENGTH

TREASURY ECONOMIC UPDATE 4.06.07

Job Creation Continues:

Job Growth: 180,000 new jobs created in March. In addition, employment estimates for January and February were revised up, adding 32,000 jobs. Nearly 2 million new jobs have been created over the past 12 months. Since August 2003, 7.8 million jobs have been created – more jobs than all the other major industrialized countries combined. Our economy has added jobs for 43 straight months. Employment has increased in 47 states within the past year. *(Last updated: April 6, 2007)*

Low Unemployment: 4.4% unemployment rate – among lowest readings in 6 years. Unemployment rates have decreased or held steady in 40 states over the past year. *(Last updated: April 6, 2007)*

The U.S. Economy Remains Healthy and Continues to Grow:

Economic Growth: 2.5% GDP growth in the 4th quarter. Our economy has grown a solid 3.1% over the past 4 quarters. *(Last updated: March 29, 2007)*

Business Investment: Capital investment increased a strong 6.1% over the 4 quarters of 2006. *(Last updated: March 29, 2007)*

Tax Revenues: Tax receipts up 11.8% in fiscal year 2006 (FY06) on top of FY05's 14.6% increase. Receipts have grown another 9% percent so far in FY07. *(Last updated: March 12, 2007)*

Steady Productivity: Labor productivity has grown at an annual rate of 2.8% over the past five years. *(Last updated: March 6, 2007)*

Americans are Keeping More of Their Hard-Earned Money:

Real Wages Increased 1.8% Over the Past 12 Months (ending in February). This translates into an additional $600 above inflation for the average full-time production worker.

Real After-Tax Income Per Person has Risen 10% - an extra $2,950 per person – since the President took office.

Pro-Growth Policies will Enhance Long-Term U.S. Economic Strength:

The Administration proposed a budget that reaches a small surplus in 2012. Economic growth has generated increased tax receipts and dramatically improved the budget outlook. The budget holds the line on spending. The budget reduces the deficit as a percentage of GDP-the most meaningful measure of its size-every year through 2012. The time has come for both political parties to work together on comprehensive earmark reform that produces greater transparency and accountability to the congressional budget process, including full disclosure for each earmark and cutting the number and cost of all earmarks by half.

www.treas.gov/economic-plan

April 6, 2007
HP-341

Debevoise Sworn In as U.S. Executive Director at the World Bank

Washington, D.C.--E. Whitney Debevoise, appointed by President Bush to serve as U.S. Executive Director at the World Bank, was sworn in today by Deputy Secretary Robert M. Kimmitt. The Senate confirmed Debevoise on March 29, 2007. Previously, he served as senior partner at Arnold & Porter LLP where he was the lead partner of the International Practice for more than 10 years. In this role, he was heavily involved in foreign investment and sovereign lending, international trade, arbitration, and international law enforcement. He received his BA from Yale University and his JD from Harvard Law School.

PRESS ROOM

April 7, 2007
HP-342

Statement by Deputy Secretary Kimmitt on the Announcement of the Signing of the International Compact with Iraq

Washington--Treasury Deputy Secretary Robert M. Kimmitt issued the following statement today on the Government of Iraq and the United Nations' announcement that the International Compact with Iraq will be signed in Sharm el-Sheikh on May 3.

"I welcome and applaud this important step and look forward to attending the signing ceremony as a member of the U.S. delegation headed by Secretary of State Condoleezza Rice. I commend the Iraqi authorities for their sustained commitment to the Compact. Iraq, together with the United Nations and the World Bank, has worked diligently since July 2006 to prepare the ambitious economic reform framework outlined in the Compact. The signing ceremony concludes several months of hard work and provides a concrete path of reform to financial self sufficiency. In exchange, the international community will provide continuing political and economic support to help Iraq achieve sustainable, broad-based economic growth. Iraq's leaders have already developed an impressive track record on economic reform under the Compact framework, including Cabinet approval of a hydrocarbons law, fuel import liberalization, and passage of a prudent, transparent and fully financed 2007 budget. The United States fully supports this initiative, as demonstrated by the President's recent request to Congress to approve additional funding for Iraq to help realize the objectives of the Compact."

The Compact is an initiative launched by the UN and Iraq to help Iraq realize its vision of a stable and prosperous nation underpinned by a self-sustaining economy. The Compact embodies commitments by Iraq on a plan to achieve economic self-sufficiency in return for international support. Iraq presented the final Compact documents to the international community at the UN on March 16, 2007. Deputy Secretary Kimmitt serves as the President's Special Envoy for the International Compact with Iraq.

Additional information on the Compact can be found at: www.iraqcompact.org.

April 9, 2007
2007-4-9-13-36-48-14702

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $66,255 million as of the end of that week, compared to $66,448 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	March 30, 2007			April 6, 2007		
TOTAL	66,448			66,255		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	12,758	10,831	23,589	12,770	10,672	23,442
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,745	5,279	18,024	12,759	5,201	17,960
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			4,846			4,853
3. Special Drawing Rights (SDRs) [2]			8,948			8,959
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	March 30, 2007			April 6, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	March 30, 2007			April 6, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

April 9, 2007
HP-343

Treasury Releases Schedule for Spring G7 Meeting

U.S. Treasury Secretary Henry M. Paulson, Jr. will host a meeting of the G7 finance ministers and central bank governors this Friday, April 13, in Washington, D.C. Following is a schedule of events:

Who
Under Secretary for International Affairs Timothy D. Adams
What
Pre-G7 Press Conference
When
Thursday, April 12, 2 p.m. (EDT)
Where
Treasury Department Media Room (4121)
1500 Pennsylvania Avenue, NW
Washington, DC
Note Media without Treasury press credentials planning to attend must contact Frances Anderson in Treasury's Office of Public Affairs at (202) 622-2960 or (202) 528-9086 with the following information: name, Social Security number and date of birth. This information may also be emailed to [illegible]

***

Who
G7 Finance Ministers and Central Bank Governors
What
Ministerial Meeting – Photos at the Top
When
Friday, April 13, 2:30 p.m. (EDT)
Where
Treasury Department Cash Room
1500 Pennsylvania Avenue, NW
Washington, DC
Note This is a pooled photo event – photographers wishing to participate should contact Brittni Aldridge at (202) 622-2591 or [illegible] for more information.

***

Who
G7 Finance Ministers and Central Bank Governors
What
Family Photo
When
Friday, April 13, 5:15 p.m. (EDT)
Where
Treasury Department – Bell Entrance Steps (West Side of Building)
1500 Pennsylvania Avenue, NW
Washington, DC
Note Photographers wishing to participate must contact Frances Anderson at (202) 622-2439 or [illegible]. Photographers may begin setting up at 4:00 p.m. (EDT). Photographers must be in place no later than 4:45 p.m. (EDT).

Who
U.S. Treasury Secretary Henry M. Paulson, Jr.
What
Press Conference
When
Friday, April 13, 7:15 p.m. (EDT)
Where
Office of Thrift Supervision Auditorium
1700 G Street, NW
Washington, DC
Note Media may begin setting-up at 5:30 p.m. (EDT). Treasury, White House and IMF/World Bank Spring Meeting press credentials will be accepted – no additional clearance is needed.

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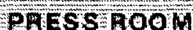
April 10, 2007
HP-344

Statement on North Korean-Related Funds Frozen at Banco Delta Asia

The United States understands that the Macau authorities are prepared to unblock all North Korean-related accounts currently frozen in Banco Delta Asia. Based on previous discussions with Chinese, Macanese, and DPRK officials, as well as understandings reached with the DPRK on the use of these funds, the United States would support a decision by the Macau authorities to unblock the accounts in question. Throughout this process we have appreciated the consistent help, goodwill, and professionalism shown by the Macanese authorities and look forward to continued cooperation between the United States and Macau.

- 30 -



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April 10, 2007
HP-345

Treasury, IRS Issue Final Regulations on Nonqualified Deferred Compensation

WASHINGTON, DC--The Treasury Department and the IRS today issued final regulations on the treatment of nonqualified deferred compensation plans and arrangements under section 409A of the Internal Revenue Code.

"Since the enactment of section 409A in 2004, Treasury and the IRS have worked hard to develop these regulations on the treatment of nonqualified deferred compensation plans," said Treasury Assistant Secretary for Tax Policy Eric Solomon. "These regulations comprehensively address how employers can identify nonqualified deferred compensation plans and arrangements subject to section 409A and provide rules to help employers and employees comply."

The regulations provide guidance regarding the requirements for deferral elections and payment timing under section 409A. Affected plans and arrangements are required to comply with documentation requirements established in the final regulations by December 31, 2007.

The final regulations generally implement the rules provided in the proposed regulations published on September 30, 2005, but include revisions reflecting numerous comments received from the public. The regulations are in response to legislation enacted by Congress in 2004 to address concerns involving reported abuses of nonqualified deferred compensation plans.

Published along with the regulations was Notice 2007-34, which includes additional guidance regarding the application of section 409A to split-dollar life insurance arrangements and provides that certain amendments of such arrangements to comply with section 409A will not be treated as a material modification.

A copy of the final section 409A regulations and a copy of Notice 2007-34 are attached.

REPORTS

- Final Regulations on Nonqualified Deferred Compensation (TD [illegible] pdf)
- Notice 2007-34

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9321]

RIN 1545-BE79

Application of Section 409A to Nonqualified Deferred Compensation Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the application of section 409A to nonqualified deferred compensation plans. The final regulations are necessary to clarify and explain the rules governing the application of section 409A to nonqualified deferred compensation plans. The regulations affect service providers receiving amounts of deferred compensation and the service recipients for whom the service providers provide services.

FOR FURTHER INFORMATION CONTACT: Stephen Tackney, (202) 927-9639 (not a toll-free number).

DATES: Effective Date: These regulations are effective April 17, 2007.

Applicability Dates: For dates of applicability, see §1.409A-6(b).

SUPPLEMENTARY INFORMATION:

Background

Section 409A was added to the Internal Revenue Code (Code) by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat.

1418). Section 409A generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with a nonqualified deferred compensation plan, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

On December 20, 2004, the IRS issued Notice 2005-1 (published as modified on January 6, 2005, in 2005-1 CB 274), setting forth initial guidance with respect to the application of section 409A, and supplying transition guidance pursuant to a statutory directive. A notice of proposed rulemaking (REG-158080-04, 2005-2 CB 786 [70 FR 57930]) was published in the **Federal Register** on October 4, 2005. See §601.601(a)(3). A public hearing was conducted on January 25, 2006. In addition, the IRS received written and electronic comments responding to the notice of proposed rulemaking. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The amendments are discussed in this preamble.

The Treasury Department and the IRS have also issued six additional notices providing transition guidance with respect to section 409A: (1) Notice 2005-94, 2005-2 CB 1208 (transition guidance with respect to 2005 reporting and withholding obligations); (2) Notice 2006-4, 2006-3 IRB 307 (transition guidance

with respect to certain outstanding stock rights); (3) Notice 2006-33, 2006-15 IRB 754 (transition guidance with respect to the application of section 409A(b)); (4) Notice 2006-64, 2006-29 IRB 88 (interim guidance regarding payments necessary to meet Federal conflict of interest requirements); (5) Notice 2006-79, 2006-43 IRB 763 (additional transition relief); and (6) Notice 2006-100, 2006-51 IRB 1109 (transition guidance with respect to 2005 and 2006 reporting and withholding obligations). See §601.601(d)(2). For a discussion of the continued applicability of these notices, see the **Effect on Other Documents** section of this preamble.

Explanation of Provisions and Summary of Comments

I. Structure and Format of Regulations

The final regulations generally adopt the structure and format of the proposed regulations. A table of contents has been included in the final regulations, as well as several additional sets of examples addressing various topics.

II. Definition of Nonqualified Deferred Compensation Plan

A. Excluded plans

The final regulations exclude the types of plans described in section 409A(d)(1) from the definition of a nonqualified deferred compensation plan, as well as certain other arrangements that were also set forth in the proposed regulations. Accordingly, the final regulations generally provide that a nonqualified deferred compensation plan for purposes of section 409A does not

include a qualified plan, a bona fide sick leave or vacation plan, a disability plan, a death benefit plan, or certain medical expense reimbursement arrangements.

The final regulations clarify that the exemption from coverage under section 409A for certain welfare plans does not apply to medical expense reimbursements that constitute taxable income to the service provider. The coverage exemption applies only to arrangements that provide benefits that are excludable from gross income under section 105 or section 106.

Several commentators requested clarification of when a leave program will be treated as a bona fide sick leave or vacation leave plan for purposes of section 409A. Another commentator requested a clarification of the definition of a compensatory time plan. Because the definitions of these terms may raise issues and require coordination with the provisions of section 451, section 125, and, with respect to certain taxpayers, section 457, the final regulations do not address these issues.

Notice 2005-1, Q&A-6 provides that, until further guidance, taxpayers whose participation in a nonqualified deferred compensation plan would be subject to section 457(f) may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for purposes of section 457(f) as also being applicable for purposes of section 409A. Until further guidance, such taxpayers may continue to rely on such definitions for purposes of section 409A.

One commentator requested that a qualified employer plan for purposes of the exclusion from section 409A include certain plans covered by section

402(d) (certain plans with a foreign-situs trust treated as qualified plans with respect to the taxation of the participants and beneficiaries) and retirement plans described in section 1022(i)(2) of the Employee Retirement Income Security Act of 1974, as amended (certain Puerto Rican retirement plans). The final regulations adopt this suggestion.

B. Section 457 plans

The final regulations provide that section 409A is not applicable to an eligible deferred compensation plan under section 457(b), but may be applicable to a deferred compensation plan that is subject to section 457(f). Commentators requested clarification of the application of the exception in the proposed regulations from the definition of deferred compensation referred to as the short-term deferral rule (described in section III.C.1 of this preamble) to a section 457(f) plan. As discussed below, a right to deferred compensation generally refers to a legally binding right in one taxable year to compensation that is or may be payable in a subsequent taxable year. For purposes of determining the time of payment, the term "payment" generally refers to an actual or constructive payment of cash or property. However, the final regulations provide that for purposes of the short-term deferral rule, an amount is treated as paid when it is included in income under section 457(f) whether or not an actual or constructive payment occurs. Accordingly, where the income inclusion under section 457(f) stems from the lapse of a substantial risk of forfeiture that is also treated as a substantial risk of forfeiture for purposes of section 409A, the amount included in income will be considered a short-term deferral for purposes of section 409A.

However, the right to earnings on amounts that have previously been included under section 457(f) will be deferred compensation for purposes of section 409A unless the right to the earnings independently satisfies the requirements for an exclusion.

C. Arrangements with independent contractors

The final regulations provide that section 409A generally does not apply to an amount deferred under an arrangement between a service provider and an unrelated service recipient if during the service provider's taxable year in which the service provider obtains a legally binding right to the deferred amount the service provider is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation), and provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another.

The final regulations retain the safe harbor in the proposed regulations, under which a service provider is deemed to be providing significant services to two or more such service recipients for this purpose if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenues generated by the service provider from the trade or business of providing such services. Commentators expressed concern that the safe harbor did not permit independent contractors to know in advance whether the arrangements under which an independent contractor deferred compensation during a taxable year would be subject to section 409A. Commentators

requested certain look-back periods, including the ability to use averaging over the previous three to five years, or to satisfy the 70 percent threshold over a certain portion of the previous three to five years. The Treasury Department and the IRS are concerned that the suggested rules would allow service providers to engage in strategic behavior to ensure that activity in certain years would be exempt from section 409A. Accordingly, the final regulations adopt an additional safe harbor that provides that a service provider that has actually met the 70 percent threshold in the three immediately previous years is deemed to meet the 70 percent threshold for the current year, but only if at the time the amount is deferred the service provider does not know or have reason to anticipate that the service provider will fail to meet the threshold in the current year.

In response to comments, the final regulations provide that if an independent contractor qualifies for the safe harbor for exclusion from coverage under section 409A with respect to arrangements with unrelated service recipients, an arrangement between the independent contractor and a service recipient related to the independent contractor will not be subject to section 409A if the arrangement, and the practices under the arrangement, are bona fide, arise in the ordinary course of business, and are substantially the same as the arrangements and practices (such as billing and collection practices) applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce a majority of the total revenue that the independent contractor earns from the trade or business of providing such services during the year.

The final regulations further clarify that if at the time the legally binding right to the payment arose, the arrangement was not subject to section 409A because the service provider was an independent contractor that was eligible for this exclusion from coverage under section 409A, the amount deferred under the arrangement during that taxable year (and earnings credited to the deferred amount) will not become subject to section 409A in a later year if the service provider becomes an employee, independent contractor, or other type of service provider subject to the rules of section 409A.

Commentators also requested that a service recipient be permitted to rely upon a representation of an independent contractor that the independent contractor meets the exclusion requirements, so that a service recipient will know whether it is subject to the reporting requirements with respect to amounts deferred subject to section 409A. The Treasury Department and the IRS are continuing to study this issue.

D. Anti-abuse rule

If a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A.

III. Definition of Nonqualified Deferred Compensation Plan

A. In general

The final regulations provide that a nonqualified deferred compensation plan is a plan that provides for the deferral of compensation. The final

regulations further provide that a plan generally provides for the deferral of compensation if, under its terms and the relevant facts and circumstances, a service provider has a legally binding right during a taxable year to compensation that, pursuant to its terms, is or may be payable to (or on behalf of) the service provider in a later year. For this purpose, an amount generally is payable at the time the service provider has a right to currently receive a transfer of cash or property, including a transfer of property includible in income under section 83, the economic benefit doctrine or section 402(b). Accordingly, a taxable transfer of an annuity contract is treated as a payment for purposes of section 409A.

The definition of deferral of compensation in the final regulations excludes the condition that the amount not be actually or constructively received and included in income during the taxable year, because that language might cause confusion with respect to the applicable rules governing deferral elections and the prohibition on the acceleration of payments For example, if a service provider has made an irrevocable election to defer an amount of his or her salary to a future year, that amount is treated as deferred compensation regardless of whether the service recipient actually pays such amount to the service provider during the year in which the services are performed. Any early payment of the deferred compensation (or any right to receive such an early payment) generally would constitute an impermissible acceleration of the payment of the deferred amount.

For this purpose, a plan will be treated as providing for a payment to be made in a subsequent year whether the plan explicitly so provides (including

through a service provider election) or the deferral condition is inherent in the terms of the contract. Where the parties have agreed that a payment will be made upon an event that could occur after the year in which the legally binding right to the payment arises, the plan generally will provide for a deferral of compensation (unless otherwise excluded under a specific exception, such as the short-term deferral rule).

For example, if a plan provides a service provider a right to a payment upon separation from service, the plan generally will result in a deferral of compensation regardless of whether the service provider separates from service and receives the payment in the same year as the grant, because under the plan the payment is conditioned upon an event that may occur after the year in which the legally binding right to the payment arises. Similarly, if an arrangement such as a stock option or stock appreciation right not otherwise excluded from coverage under section 409A provides a right to a payment for a term of years where the payment could be received during the short-term deferral period or a subsequent period but is not otherwise includible in income until paid, the arrangement will provide for deferred compensation even though the service provider could receive the payment during the short-term deferral period (for example, by exercising the stock option or stock appreciation right). However, where a plan does not specify a payment date, payment event or term of years, (or specifies a date or event certain to occur during the year in which the services are performed), the plan generally will not provide for the deferral of

compensation if the service provider actually or constructively receives the payment within the short-term deferral period.

The proposed regulations provided that earnings on deferred amounts are generally treated as deferred compensation for purposes of section 409A. Under the final regulations, whether a deferred amount constitutes earnings on an amount deferred, or actual or notional income attributable to an amount deferred, is determined under the principles defining income attributable to the amount taken into account under §31.3121(v)(2)-1(d)(2).

A commentator requested clarification of whether a payment for a noncompetition agreement could be subject to section 409A. Because such a payment would occur in connection with the performance or nonperformance of services, and a covenant not to compete does not create a substantial risk of forfeiture for purposes of section 409A, a legally binding right obtained in one year to a payment in a subsequent year in connection with a noncompetition agreement generally would constitute deferred compensation.

B. Legally binding right

The regulations define deferral of compensation in the context of a legally binding right to a payment of compensation in a future taxable year. Commentators requested clarification of the standard that would be used to determine whether a service provider has a legally binding right. A legally binding right includes a contractual right that is enforceable under the applicable law or laws governing the contract. A legally binding right also includes an enforceable right created under other applicable law, such as a statute.

One commentator suggested that no legally binding right exists where the payment is made only upon the realization of gain from a particular investment. For example, the commentator argued that a bonus payable based upon the amount that a service provider obtains in selling property should not be treated as granting the service provider a legally binding right to the payment until the property is sold. In such a situation, however, the requirement that the property be sold is a condition to the right to the payment, but the right to the payment is still a legally binding right. The service recipient could not simply revoke the promise, sell the property, and not pay the bonus. However, the condition that the property be sold before the service provider becomes entitled to payment may constitute a substantial risk of forfeiture, depending on the specific facts and circumstances.

C. Short-term deferrals

1. In general

Subject to the modifications described in this section III.C of the preamble, the final regulations generally adopt the short-term deferral rule that was contained in the proposed regulations. Under the short-term deferral rule, a deferral of compensation does not occur for purposes of section 409A if the arrangement under which a payment is made does not provide for a deferred payment and the payment is made no later than the 15th day of the third month following the later of the end of the service provider's taxable year or the end of the service recipient's taxable year in which occurs the later of the time the legally binding right to the payment arises or the time such right first ceases to be

subject to a substantial risk of forfeiture (subject to certain extensions for unforeseeable events). For this purpose, an arrangement provides for a deferred payment if it provides for a payment that will be made or completed after a date or an event that will or may occur later than the end of the 2 ½ month period described in the preceding sentence, either because of an affirmative election on the part of the service provider or service recipient or a deferral condition inherent in the terms of the contract (for example, that the amount will be paid upon the service provider's separation from service, which may occur in a future year).

Several commentators requested that additional flexibility be provided to allow payments to be short-term deferrals. By analogy to the rules in the proposed regulations concerning when payments of deferred compensation amounts are considered timely for purposes of the payment date rules, the commentators suggested that payments should qualify as short-term deferrals if made by the end of the year after the year in which a substantial risk of forfeiture lapses, rather than by the 15th day of the third month of that year. The final regulations do not adopt this suggestion. The short-term deferral rule is based on the historical treatment of certain payments paid within a short period following the end of a taxable year as not constituting deferred compensation. See §1.404(b)-1T, Q&A-2(b). That short period has been defined as ending on the 15th day of the third month following the end of the year, subject to certain extensions for unforeseeable events. Extending the payment date by which a short-term deferral could be paid would be inconsistent with this approach and

the legislative history of section 409A (H.R. Conf. Rep. No. 108-755, at 735 (2004)), and accordingly is not adopted in the final regulations. However, the final regulations liberalize the standard under which a payment can be a short-term deferral even if it is delayed due to unforeseeable events. The proposed regulations provided generally that payment could be delayed if the payment would jeopardize the service recipient's solvency and such insolvency was unforeseeable at the time the service provider obtained the right to the payment. By contrast, the final regulations provide generally that payment may be delayed where the payment would jeopardize the ability of the service recipient to continue as a going concern.

Commentators asked how the short-term deferral rule applies to a series of payments scheduled to commence following the lapse of a substantial risk of forfeiture. The final regulations provide that the short-term deferral rule applies separately to each payment, applying the technical definition of "payment" set out in the regulations, provided that the entire payment is made during the short-term deferral period. Accordingly, where a payment has been designated as a separate payment, it may qualify as a short-term deferral (and thus not deferred compensation) even where the service provider has a right to subsequent payments under the same arrangement. In contrast, where a payment has not been designated as a separate payment (such as, for example, a life annuity payment or a series of installment payments treated as a single payment), any initial payments in the series will not be treated as a short-term deferral even if

paid within the short-term deferral period. For a discussion of the definition of payment, see §1.409A-3.

Commentators suggested that a right to a reimbursement be treated as potentially subject to the short-term deferral rule, arguing that the right to the reimbursement payment is subject to a substantial risk of forfeiture that the service provider will not incur the expense. Commentators argued that the short-term deferral rule then could apply if the reimbursement payment were made within a short period following the occurrence of the expense. Generally, the risk that a service provider will fail to incur a reimbursable expense will not qualify as a substantial risk of forfeiture, so the short-term deferral rule will not be applicable. However, the final regulations provide considerable additional flexibility with regard to structuring reimbursement arrangements to meet the requirements of section 409A. For a discussion of these provisions, see section VII.B.2 of this preamble.

2. Application to event-based payments

Some commentators asked whether any payments based on a legally binding right arising in the year of a separation from service are excluded from coverage under section 409A, if paid by the end of the relevant short-term deferral period. For example, where an employee had accrued benefits under a defined benefit supplemental executive retirement plan (SERP) during his career that was payable immediately upon a separation from service, including an amount accrued in the year of separation from service, commentators asked whether the payment of the portion of the benefits accrued in that final year is

excluded from coverage under section 409A if paid by March 15 of the year following the separation from service, because the amount is paid within a short period following the year the service provider obtains a vested legally binding right to the additional benefit accrual. (This generally would be of most concern to specified employees subject to the requirement of a six-month delay in payment following a separation from service.)

The analysis that applies in this situation is similar to that applied to the general definition of deferral of compensation, discussed in section III.A of this preamble. The short-term deferral rule does not provide an exclusion from the requirements of section 409A for such current-year benefit accruals because the rule does not apply to amounts of compensation subject to a deferral election. For this purpose, an election to defer includes either an affirmative election on the part of the service provider or a deferral condition inherent in the terms of the contract. Where the parties have agreed that a payment will be made upon an event that does not necessarily coincide with the lapsing of the substantial risk of forfeiture, and could occur at a time beyond the short-term deferral period, the arrangement provides for a deferral election such that the short-term deferral rule does not apply. Accordingly, in this example, because the benefits accrued in the final year of the SERP could have been paid upon an event occurring after the short-term deferral period (if, for example, the individual had not separated from service until a later year), the payment of the benefit accrued in the final year is subject to section 409A and is not a short-term deferral, even if paid by March 15 of the year following the separation from service.

Also, for example, if a plan that is not subject to section 457(f) provides that an amount is subject to a substantial risk of forfeiture until the completion of three years of service, and is payable upon a separation of service following the three years of service, the right to the amount is not a short-term deferral even if the service provider separates from service immediately after vesting in the right, because under the plan the payment is based upon an event other than the lapsing of the substantial risk of forfeiture and such event may occur in a year subsequent to the year in which the risk of forfeiture lapses.

Conversely, where a plan specifies no payment date or payment event, or specifies only the date at which the substantial risk of forfeiture lapses, the plan may qualify for the short-term deferral rule if the payment is made within the applicable short-term deferral period. However, such a plan generally would violate section 409A if the payment were made after the short-term deferral period.

As discussed in this preamble with respect to the general definition of deferred compensation, to implement the statutory scheme, including the applicable reporting and form requirements, taxpayers generally must be able to determine whether an arrangement provides for a deferral of compensation at the time the service provider obtains a legally binding right to the compensation. Although a plan need not specify a payment date to be a short-term deferral that is excluded from coverage under section 409A, the short-term deferral exclusion does not apply if the payment event or date is specified and will or may occur after the end of the short-term deferral period.

The preamble to the proposed regulations explained that where a plan requires that a payment be made on a date within the short-term deferral period, but the payment is made after the specified date and after the end of the short-term deferral period, the arrangement will be treated as a nonqualified deferred compensation plan, but the payment date will be treated as a specified date. Thus, under such an arrangement, if the service provider receives the payment after the specified date, but not later than the end of the year in which the specified date occurs, the payment generally will comply with section 409A. However, taxpayers should note that a provision requiring only that a payment be made on or before the end of the short-term deferral period may not qualify as a permissible specified date for this purpose, if under the facts and circumstances the payment could have been made in more than one taxable year. For a discussion of the application of the definition of a specified payment date to this type of plan, see section VII.B of this preamble.

For a discussion of when rights to compensation upon a separation from service for good reason may be treated as rights to compensation upon an involuntary termination, and the potential application of the short-term deferral exception to these arrangements, see section III.J.3 of this preamble.

D. Stock options and stock appreciation rights

1. In general

Subject to the modifications described in this preamble, the final regulations adopt the provisions of the proposed regulations excluding from coverage under section 409A statutory stock options and certain other stock

rights. Generally under the regulations, nondiscounted stock options and nondiscounted stock appreciation rights issued on service recipient stock that do not include any additional deferral feature are excluded from section 409A.

2. Statutory stock options

The final regulations adopt the exclusion from coverage under section 409A for statutory stock options, including incentive stock options described in section 422 of the Code and options granted under an employee stock purchase plan described in section 423 of the Code. This exclusion applies regardless of whether the statutory stock option would be excluded if the same option were not treated as a statutory stock option. For example, an employee stock purchase plan described in section 423 offering a discounted purchase price is not a deferred compensation plan for purposes of section 409A.

Commentators requested clarification, however, of the treatment of a statutory stock option that is modified, or otherwise becomes ineligible to be treated as a statutory stock option. The final regulations adopt the rule set forth in the proposed regulations, and provide that at the time of such modification or event, the modification or other event is treated as the grant of a new option, or causes the option to be treated as having had a deferral feature from the date of grant, as applicable, for purposes of section 409A only if such modification or other event would have been so treated had the option been a nonstatutory stock option immediately before such modification or other event. For example, where an incentive stock option is modified through an extension of the option's term, the extended option will be treated as having had an additional deferral feature

from the date of grant for section 409A purposes only if the same extension of a nonstatutory stock option would have resulted in such treatment.

Commentators also requested that the exclusion from coverage under section 409A for certain stock rights issued under plans meeting the requirements of section 423 (employee stock purchase plans) be extended to employee stock purchase plans offered by foreign employers that do not meet such requirements, where the shares are made available for purchase at a discount and substantially all of the participants are nonresident aliens. The legislative history does not provide a basis for extending the exception applicable to options meeting the requirements of section 423 to grants of discounted stock options not meeting the requirements of section 423. Accordingly, this suggestion is not adopted in the final regulations.

3. Definition of service recipient stock

The final regulations adopt the requirement in the proposed regulations that for the exclusion for certain stock rights to apply, the stock right must relate to service recipient stock. Commentators criticized the definition of service recipient stock contained in the proposed regulations as too restrictive. Generally such criticisms centered on two different aspects of the definition of service recipient stock in the proposed regulations – the classes of stock that may qualify as service recipient stock, and the issuer or issuers whose stock may constitute service recipient stock, where the service recipient is comprised of more than one entity.

a. Classes of stock that may qualify as service recipient stock

Commentators requested clarification and expansion of the classes of stock of a corporation that may constitute service recipient stock. Commentators generally focused on two issues. First, with respect to stock of a particular service recipient corporation, commentators requested that the stock right be permitted to relate to any class of common stock, regardless of whether another class of common stock of that corporation was publicly traded, and regardless of whether that class of common stock had the greatest aggregate value of all classes of common stock issued by that corporate entity. Subject to the restrictions governing certain preferences as to distributions, the final regulations generally provide that any class of common stock may be used, regardless of whether another class of common stock that could qualify as service recipient stock is publicly traded or has a higher aggregate value outstanding, and regardless of whether the class of stock is subject to transferability restrictions or buyback rights (provided such buyback rights reflect the fair market value of the stock at the time of purchase).

Second, commentators suggested narrowing the types of preferences on a class of common stock that would prohibit that class from being treated as service recipient stock. One commentator requested that the classes of stock permitted as service recipient stock include any class of stock that is widely held by non-service recipients. While it may be unlikely that a widely–held class of stock was created to facilitate an abusive avoidance of section 409A, it does not follow that service recipient stock rights issued on such stock necessarily would be consistent with the intended application of section 409A if, for example,

holders of such class enjoyed preferences that would make such stock rights a suitable substitute for nonqualified deferred compensation.

To be treated as service recipient stock under the final regulations, a class of stock must qualify as common stock under section 305 of the Code. Accordingly, the final regulations provide that stock that is not common stock under section 305 is not service recipient stock for purposes of section 409A. However, the mere classification of a class of stock as common stock under section 305 is not sufficient for such stock to be treated as service recipient stock for purposes of section 409A. The Treasury Department and the IRS are concerned that classes of stock that are common stock under section 305 may provide preferences that could permit stock rights with respect to such stock to resemble traditional nonqualified deferred compensation, such that exclusion of such stock rights would permit the avoidance of section 409A.

Commentators suggested that a preference with respect to liquidation rights, without any other preferences such as a preferential right to dividends, should be permitted under the definition of service recipient stock. A holder of this class of stock would not be guaranteed any return, but rather would simply be guaranteed preferred distribution rights upon a complete liquidation of the service recipient. The final regulations generally adopt this suggestion.

With respect to other preferential rights, commentators were unable to provide a workable standard under which permissible preferences could be distinguished from impermissible preferences. Accordingly, the final regulations do not treat any stock including such preferences as service recipient stock.

However, the Treasury Department and the IRS continue to study this area, and the final regulations authorize the publication of other additional guidance, should a workable standard be developed.

b. Entities the stock of which may qualify as service recipient stock

Commentators also requested an expansion of the class of entities the stock of which can qualify as service recipient stock where the service recipient is comprised of multiple entities. The Treasury Department and the IRS believe that the stock right exception under section 409A was intended to cover stock rights directly reflecting the enterprise value of the entity for which the service provider is providing services. Consistent with this approach, the final regulations provide that service recipient stock may include the stock of the corporation for which the service provider was providing services at the date of grant. In addition, the final regulations provide that service recipient stock may include stock of any corporation in a chain of organizations all of which have a controlling interest in another organization, beginning with the parent organization and ending with the organization for which the service provider was providing services at the date of grant of the stock right. Similarly to the proposed regulations, the final regulations provide that the term "controlling interest" has the same meaning as provided in §1.414(c)-2(b)(2)(i), except that where that regulation requires at least an 80 percent interest, the final regulations generally require only a 50 percent interest. In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the final regulations generally require only a 20

percent interest. For purposes of determining ownership of an interest in an organization, the attribution rules of §1.414(c)-4 apply, and the exclusion rules of §1.414(c)-3 also apply. For example, under the final regulations, with respect to an employee of a subsidiary corporation, the common stock of the ultimate parent corporation, or of a subsidiary corporation anywhere in the chain of corporate ownership between the subsidiary that employed the employee and the ultimate parent corporation (a higher tier subsidiary), could qualify as service recipient stock for purposes of determining whether a stock right issued to such employee with respect to such stock was excluded from coverage under section 409A, provided that the 50 percent or 20 percent ownership standard, as applicable, was satisfied by each corporation in the chain.

The proposed regulations contained many requirements for using an ownership level of less than 50 percent. Commentators requested several simplifications of these requirements. In response, the final regulations no longer require a formal election by any corporation. Rather, each individual grant of a stock right is analyzed to determine whether the stock qualifies as service recipient stock with respect to a service provider at the time the stock right is granted. If a corporation owns at least 50 percent of the stock of one corporation and owns less than 50 percent of the stock of another corporation, and it intends to treat its stock as service recipient stock with respect to employees of both corporations, there is no requirement that a legitimate business criteria exist with respect to the issuance of stock rights on the parent corporation stock to service providers of the first such corporation. The legitimate business criteria standard

applies only to stock rights issued to service providers of subsidiaries that are not majority-owned, because the test of legitimate business criteria relates to the actual issuance of a stock right to a particular service provider. Accordingly, a subsidiary may have more than one shareholder corporation the stock of which qualifies as service recipient stock with respect to a subsidiary employee such as, for example, where three entities each own a one-third interest in the subsidiary. However, with respect to each grant of a stock right on stock of a particular non-majority shareholder corporation to a service provider of a particular subsidiary, there must exist legitimate business criteria for issuing such a stock right. Even if legitimate business criteria exist with respect to the issuance of a stock right on stock of a particular shareholder corporation to a particular service provider, legitimate business criteria may or may not exist with respect to the issuance of a stock right to the same service provider on stock of another shareholder corporation.

The legitimate business criteria requirement is a facts and circumstances test, focusing generally on whether there is sufficient nexus between a particular service provider and the entity, the stock of which underlies the stock right granted to the service provider, for the grant to serve a legitimate non-tax business purpose. As provided in the preamble to the proposed regulations, if a corporation issued a stock right on its stock to a current employee of a joint venture in which the corporation was a venturer, and the employee was a former employee of the corporate venturer, generally the issuance would be based on legitimate business criteria. Similarly, if the corporate venturer issued such a

right to an employee of the joint venture who it reasonably expected would become an employee of the corporate venturer in the future, generally the legitimate business criteria requirement would be met. By contrast, where an employee has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient, the use of the investor corporation stock as the stock underlying a stock right grant to that employee generally would not be based upon legitimate business criteria. Similarly, where a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity for which the employee performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation's stock to the employee.

The Treasury Department and the IRS remain concerned that the manipulation of the structure of a related group of corporations may be used to allow stock options or stock appreciation rights to mimic the characteristics of nonqualified deferred compensation, by compensating holders based on predictable amounts and investment returns unrelated to the enterprise value of an operating entity. Accordingly, the exception contained in the proposed regulations under which the stock of a corporation serving as investment vehicle is not considered service recipient stock has been retained. In addition, an anti-abuse rule has been added to address corporate structures, transactions, or stock right grants, a principal purpose of which is the avoidance of the application

of section 409A to an arrangement otherwise providing deferred compensation. These corporate structures, transactions, and stock right grants generally will occur where the structure, transaction, or grant is intended to provide enhanced security for the value of the stock right as a means of providing deferred compensation, rather than as compensation related to an increase in the true enterprise value of the service recipient. The regulations provide that if an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, if any stock rights are issued with respect to such entity it is presumed that such structure was established for purposes of avoiding the application of section 409A.

c. Equity interests in certain non-corporate entities

The final regulations permit certain equity interests in a non-stock mutual company to be treated analogously to equity interests in a corporation. Commentators requested that the definition of service recipient stock be expanded to cover interests in cooperatives and interests in the value of an Indian tribal enterprise. The regulations do not include such interests in the definition of service recipient stock, but provide the IRS authority to provide guidance expanding the definition of service recipient stock. For a discussion of the application of the exclusion for certain stock rights to rights issued on equity interests in entities taxed as partnerships, see section III.G of this preamble.

4. Valuation

a. In general

The final regulations provide that for the exclusion for stock rights to apply, the stock right must specify an exercise price of the stock right that may never be less than the fair market value of the underlying stock on the date the stock right is granted. For purposes of this discussion and the final regulations, the exercise price of a stock appreciation right refers to the base stock value from which the appreciation is measured for purposes of determining the compensation payable under the stock appreciation right (for example, a stock appreciation right providing for a payment of the excess of the fair market value of 100 shares over $100 would have a $1 per share exercise price).

Several commentators expressed concerns regarding the determination of the fair market value of the underlying stock. Some commentators requested that the valuation rules applicable to incentive stock options be applied for purposes of the exclusion from section 409A. Under those rules, if the stock option would otherwise fail to be an incentive stock option solely because the exercise price was less than the fair market value of the underlying stock as of the date of grant, generally the option is treated as an incentive stock option if the issuer attempted in good faith to set the exercise price at fair market value. See section 422(c)(1). The Treasury Department and the IRS believe that this is not the appropriate standard for determining whether stock rights are subject to section 409A. Incentive stock options are subject to strict limitations on the amount of such options that may be granted to a particular employee. See section 422(d). In contrast, there are no such limits applicable to nonstatutory

stock options, and grants of nonstatutory stock options often far exceed the limitation applicable to incentive stock options. In addition, section 422(c)(1) explicitly provides for the good faith standard with respect to incentive stock options, while no such provisions exist within section 409A or its legislative history.

Commentators requested clarification of the consistency standard with respect to the use of a valuation method. Specifically, commentators asked whether one valuation method could be used for purposes of establishing the exercise price while another method could be used for purposes of determining the fair market value of the stock at the time of the payment (for example, to determine the amount of payment in the case of a stock appreciation right or a stock option where the stock is subject to repurchase by the service recipient). The final regulations clarify that consistency is not required, provided that each valuation method used otherwise meets the requirements of the final regulations. Accordingly, a service recipient may use one valuation method for purposes of establishing an exercise price, but another valuation method for purposes of establishing the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback arrangement). However, once an exercise price has been established, the exercise price may not be changed through the retroactive use of another valuation method. In addition, where after the date of grant, but before the date of exercise, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities

market, the service recipient must use a valuation method for stock readily tradable on an established securities market for purposes of determining the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback arrangement).

b. Valuation - stock readily tradable on an established securities market

The final regulations adopt the rules under the proposed regulations governing valuation of stock readily tradable on an established securities market, generally requiring that the valuation of such stock be based upon the contemporaneous prices established in the securities market, subject to the modifications discussed in this preamble. Some commentators requested additional guidance with respect to when a stock will be treated as readily tradable. The final regulations adopt the same standard as that set forth in §1.280G-1, Q&A-6(e), that stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

With respect to the rules governing the valuation of stock that is readily tradable on an established securities market, commentators generally focused on the provision of the proposed regulations permitting the use of an average selling price during a specified period that is within 30 days before or 30 days after the date of grant. Specifically, comments concentrated on the requirement that the commitment to grant the stock right with an exercise price set using such an average selling price be irrevocable before the beginning of the specified period. Commentators questioned both the purpose of the requirement of the

commitment to the valuation method, as well as the actions required to satisfy the rule if averaging were being used.

The rule was intended to prohibit the use of an average price, set on a look-back basis, to ensure a discounted exercise price. For example, if a corporation decided to grant a stock option on July 1, and it could set the exercise price using an average selling price for any period falling within the prior 30 days without having had a prior commitment to a specific averaging period, the corporation could simply look for the lowest price that occurred during the prior June. Furthermore, if the corporation were not committed to grant the stock option on July 1, the corporation could wait until its stock price began to rise and then grant an option using the selling price on a given day during the previous 30 days to provide a particular discount. Accordingly, the final regulations require that the commitment to grant the stock right with an exercise price set using such an average selling price be irrevocable before the beginning of the specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock option, the number of shares the stock option will permit the holder of the stock option to purchase, and the method for determining the exercise price including the period over which the averaging will occur, before the beginning of the specified averaging period.

One commentator stated that the requirement of an irrevocable commitment to the averaging period could not be met under French law, because French law requires that the stock option exercise price be set based on the average trading price over the preceding 20 days and the commitment to the

grant before the beginning of the period may be viewed as violating that requirement. The final regulations provide that where applicable foreign law requires that the compensatory stock right granted by the issuer must be priced based upon a specific price averaging method and period, a stock right granted in accordance with such applicable foreign law will be treated as meeting the requirement, provided that the averaging period may not exceed 30 days.

c. Valuation – stock not readily tradable on an established securities market

i. In general

The final regulations adopt the provisions in the proposed regulations relating to the valuation of stock not readily tradable on an established securities market, subject to the modifications discussed in this section III.C.4.c. Accordingly, a valuation of stock based upon a reasonable application of a reasonable valuation method is treated as reflecting the fair market value of the stock. To meet this standard, it is not necessary that a taxpayer demonstrate that the value was determined by an independent appraiser. Where the taxpayer can otherwise demonstrate that the valuation was determined by the reasonable application of a reasonable valuation method, the standard will be met.

One commentator requested that the factors to be considered in determining the fair market value of the stock should be modified to include consideration of any recent equity sales made by the corporation in arm's-length transactions. The final regulations adopt this suggestion.

The final regulations continue to require that in the case of a stock right issued with respect to stock that was not publicly traded at the time the right was

issued, but becomes publicly traded before the right is exercised, the stock value for purposes of calculating the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback agreement) must be based upon the rules governing stock that is publicly traded. This does not mean that the initial exercise price determined under the rules governing stock that is not publicly traded must be reset. Rather, this means only that the value at the time of exercise used to determine the payment amount or the buyback amount must be determined under the rules governing stock that is publicly traded. For example, if a service provider holds an excluded stock appreciation right with an exercise price of $1 that was fixed based on a valuation of the closely-held corporate stock at the time of grant, and before exercise the stock becomes readily tradable on an established securities market, the amount payable upon exercise must be the excess of the value of the stock based on its trading price over the $1 exercise price.

ii. Safe harbor presumptions

The final regulations adopt a presumption in specified circumstances that, for purposes of section 409A, a valuation of stock reflects the fair market value of the stock, rebuttable only by a showing that the valuation is grossly unreasonable. The presumption applies where the valuation is based upon an independent appraisal, a generally applicable repurchase formula (applicable for both compensatory and noncompensatory purposes) that would be treated as fair market value under section 83, or, in the case of illiquid stock of a start-up

corporation, a valuation by a qualified individual or individuals applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock.

Many of the comments with respect to these presumptions related to the presumption applicable to illiquid stock of start-up corporations. As set forth in the proposed regulations, the start-up corporation presumption would not apply if the service recipient or service provider could reasonably anticipate, as of the time the valuation is applied, that the service recipient would undergo a change in control event or make a public offering of securities within the 12 months following the event to which the valuation is applied. Commentators suggested that a 12-month period is too long, because changes occur so rapidly in the business world that it often is difficult or impossible to predict so far in advance whether such an event will occur. Commentators suggested that the service provider should retain the benefit of the presumption unless the issuing corporation entered into a definitive agreement or filed its registration statement with the Securities and Exchange Commission within a period of 15 or 30 days after issuing the stock right.

The Treasury Department and the IRS believe that a 15-day or a 30-day period is too short. Although there is always a risk that a public offering will fail or that a corporate transaction will not occur, the Treasury Department and the IRS also believe that a person should reasonably be able to anticipate whether such a transaction will occur during a reasonable period before the transaction.

Accordingly, the final regulations provide that the start-up corporation presumption will not apply if at the time the valuation is made, the service recipient or service provider may reasonably anticipate that the service recipient will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days. As under the proposed regulations, the rule in the final regulations is concerned with what the parties may reasonably anticipate at the time the stock right is issued.

Other comments requested examples of persons with sufficient knowledge, experience, and skill in valuing illiquid stock of a start-up corporation. Because knowledge, skill and training may be obtained in different ways, the final regulations do not provide specific examples. However, the regulations clarify that the standard to be applied is whether a reasonable individual, upon being apprised of such person's relevant knowledge, experience, education and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. The final regulations also clarify that significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

With respect to the presumption based upon a generally applicable buyback formula, some commentators requested that the presumption apply where the formula is applicable to all compensatory stock transactions, but not

also applicable to all noncompensatory stock transactions. The final regulations do not adopt this suggestion. However, the final regulations clarify that to meet the requirements of the presumption, the buyback formula is required to be applicable to compensatory and noncompensatory transactions with the issuer or a person owning 10 percent or more of the stock of the issuer, but is not required to be applicable to transactions with other persons or transactions that are part of an arm's length transaction constituting the sale of all or substantially all of the stock of the issuer to an unrelated purchaser.

5. Modification of a stock right

The final regulations continue to apply certain rules addressing modifications, extensions and renewals of stock rights. Although these rules in many respects resemble the rules applicable to statutory stock options, the rules are not intended to incorporate the rules applicable to statutory stock options except where explicitly provided.

The final regulations generally retain the rules in the proposed regulations that generally treat extensions of the exercise period of a stock right as an additional deferral feature as of the date of grant of the right, with an exception for certain limited extensions following a separation from service. Commentators characterized these rules as unnecessarily restrictive. Specifically, commentators argued that the extension of a stock option upon the occurrence of a separation from service (often in connection with a program of layoffs) or a corporate transaction is a common practice, and that often these extensions cover periods longer than the limited period provided in the proposed regulations.

In addition, commentators argued that the same substantive results could be obtained by specifying a longer term for the stock right and providing the service recipient the discretion to shorten the term, rather than providing discretion to extend a shorter term, and that the former approach would be permissible under the proposed regulations. In response, the final regulations provide that the extension of an option exercise period generally is not treated as an additional deferral feature or a modification of the stock option for section 409A purposes if the exercise period is not extended beyond the earlier of the original maximum term of the option or 10 years from the original date of grant of the stock right.

Many commentators also requested that the extension of the exercise period of a stock right not be treated as an additional deferral feature for purposes of section 409A, where at the time of the extension the fair market value of the underlying stock does not exceed the exercise price (an "underwater" option). Because the issuance of an otherwise identical option with an exercise period ending after the end of the exercise period of the underwater option would be excluded from coverage under section 409A, the final regulations provide that such an extension does not constitute an additional deferral feature.

The final regulations adopt the provisions in the proposed regulations regarding substitution or assumption of stock rights due to a corporate transaction, which are generally in accordance with the corresponding provisions governing incentive stock options. The final regulations clarify that the applicable corporate transactions for this purpose include only those transactions described

in §1.424-1(a)(3). One commentator requested that the provision permitting substitutions of stock options be modified to reflect that a holder of a nonstatutory stock option is not required to be employed by the successor entity. The final regulations adopt this suggestion, so that a substituted nonstatutory stock option may be treated as a continuation of the initial option even where the holder of the option is not employed or otherwise providing services to the successor entity, provided the substitution otherwise meets the rules provided in the regulations.

6. Other stock right issues

The final regulations adopt certain definitions from the regulations governing statutory stock options, modified as appropriate for purposes of applying the rules under section 409A. These include the time and date of grant of an option (§1.421-1(c)), and the definitions of option (§1.421-1(a)), stock (§1.421-1(d)), exercise price (§1.424-1(e)), exercise (§1.421-1(f)), and transfer (§1.421-1(g)). These definitions apply by analogy to stock appreciation rights.

The final regulations adopt the rule that a right to a payment of accumulated dividend equivalents at the time of the exercise of a stock right generally will be treated as a reduction in the exercise price of the stock right, causing the stock right to be deferred compensation subject to the requirements of section 409A. The final regulations provide that an arrangement to accumulate and pay dividend equivalents the payment of which is not contingent upon the exercise of a stock right may be treated as a separate arrangement for purposes of section 409A. Such an arrangement generally will be required to comply with section 409A (unless it independently qualifies for an exception from

coverage under section 409A), but will not affect whether the related stock right qualifies for the exclusion from coverage under section 409A. The right to the dividend equivalents may be set forth within the stock right plan or the individual stock right grant, or in a separate document, as long as the payment of the dividend equivalents is not contingent upon the exercise of the stock right.

Commentators also asked whether the exclusion of stock rights from coverage under section 409A would apply to tandem rights, meaning a stock right that combines a stock option right and a stock appreciation right, exercisable on an alternative basis. Similarly, commentators asked whether the substitution of a stock option for a stock appreciation right, or vice versa, where all the terms except the mode of payment upon exercise are similar, would be treated as a modification of a stock right. The application of section 409A generally is not affected by the medium of a taxable payment (for example, cash or stock). Accordingly, whether a stock right is expressed as a tandem arrangement under which the exercise of one right terminates the other right, or there is a substitution of a stock appreciation right for a stock option identical in all respects except for the medium of payment, generally does not impact whether the arrangement is excluded from coverage under section 409A.

Commentators requested further clarification of the application of section 409A to stock option gain deferrals. The ability to defer gain upon the exercise or exchange (including a purported forfeiture) of a stock right is incompatible with the exclusion of certain stock rights from the requirements of section 409A because such exclusion is predicated on the option not having any additional

deferral feature. Accordingly, if an arrangement provides for a potential to defer the payment of cash or property upon the exercise or exchange of a stock right beyond the year the right is exercised or beyond the original term of the stock right, the arrangement provides for a deferral feature and must comply with the requirements of section 409A from the time the legally binding right granted by the award arises.

Because a stock option with a deferral feature is subject to section 409A regardless of whether the deferral feature is actually utilized, an option that includes a provision permitting deferral of option gain generally will not satisfy the time and form of payment rules under section 409A if the service provider can exercise the option in more than one taxable year. If a deferral feature is added to a preexisting option, the option will be treated as having included a deferral feature as of the original date of grant, generally resulting in a violation of section 409A.

However, the final regulations provide that a stock right will not be treated as having a deferral feature where the service recipient delays a payment because the making of the payment would violate applicable Federal, state, local, or foreign law or jeopardize the ability of the service recipient to continue as a going concern. Although these provisions permit the delay for purposes of section 409A, no inference should be drawn as to the Federal tax consequences of such a delay under any other section of the Code or Federal tax doctrine such as section 83, section 451, the constructive receipt doctrine, or the economic benefit doctrine.

Commentators requested that the definition of service recipient stock be expanded to include the stock of a corporation for which a service recipient provides substantial services, at least with respect to a service provider of the service recipient that is providing services to the corporation. The legislative history does not support such a broad interpretation of service recipient stock, and the final regulations do not adopt this suggestion.

E. Restricted property

The final regulations provide, as did the proposed regulations, that a grant of restricted property generally will not constitute a deferral of compensation for purposes of section 409A. Commentators requested that the regulations clarify that a vested right to receive nonvested property in a future year does not constitute deferred compensation. Commentators argued that a right to receive nonvested property is not truly vested. For example, commentators argued that a right to receive restricted stock that will be subject to a substantial risk of forfeiture until the service provider completes three years of future services cannot be a vested right. The final regulations adopt this suggestion, so long as the risk of forfeiture to which the stock is subject constitutes a substantial risk of forfeiture for purposes of section 409A.

Commentators specifically requested clarification of the circumstances under which a service provider may elect to be paid a bonus or other payment in the form of restricted stock, rather than cash. Generally an election between compensation alternatives, none of which provides for a deferral of compensation within the meaning of section 409A, will not cause the election to be subject to

the section 409A timing restrictions. Thus, a choice between an award of restricted stock or stock options that are not subject to section 409A will not be governed by the section 409A election timing rules. However, where any of the alternatives involves a deferral of compensation subject to section 409A, the election must comply with the provisions of section 409A. In addition, no inference should be drawn as to the Federal tax consequences of such an election provision under any other section of the Code or Federal tax doctrine such as section 83, section 451, the constructive receipt doctrine, or the economic benefit doctrine.

F. Section 402(b) trusts

The final regulations continue to except from coverage under section 409A transfers of a beneficial interest in a trust, or a transfer to or from a trust, to the extent such a transfer is subject to section 402(b). The final regulations further clarify that a right to compensation required to be included in income under section 402(b)(4)(A) (alternative taxation of highly compensated employees of a section 402(b) trust that fails to meet the requirements of section 401(a)(26) or section 410(b)) also is not a deferral of compensation. However, a right to receive a benefit formulated as a right to a future contribution to a section 402(b) trust is similar to a right to receive property in a future taxable year, and generally would constitute deferred compensation.

G. Arrangements between partnerships and partners

The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations

also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and section II.E. of the preamble to the proposed regulations.

Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.

Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services described in section 707(c). As stated in that

preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Commentators raised issues concerning the application of the provision in Notice 2005-1, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased partner's successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A. Section 1402(a)(10) provides for an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met. Specifically, the payments must be made pursuant to a written plan of the partnership, must be on account of the partner's retirement and must continue at least until the partner's death. In addition, to qualify for the exception, the partner must not have rendered services during the partnership's taxable year ending within or with the partner's taxable year in which the amounts were received, as of the close of the partnership's taxable year no obligation must exist from the other partners to such retired partner except with

respect to retirement payments under such plan, and before the end of the partnership's taxable year such retired partner's share, if any, of the capital of the partnership must have been paid to him in full.

Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is appropriate for such arrangements to be subject to section 409A because such arrangements are purposefully created to provide deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).

However, further clarification and relief is provided concerning the application of the deferral election timing rules to these payments. Until further guidance is issued, for purposes of section 409A, taxpayers may treat the legally binding right to the payments excludible from SECA tax under section 1402(a)(10) as arising on the last day of the partner's taxable year before the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10), and the services for which the payments are compensation as performed in the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). Accordingly, for purposes of section 409A, the time and form of payment of such amounts

generally may be established, including through an election to defer by the partner, on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). However, this interim relief does not apply a second time where an amount paid under an arrangement in one year has been excluded from SECA tax under section 1402(a)(10), and an amount paid in a subsequent year has not been excluded from SECA tax under section 1402(a)(10) because, for example, the partner performed services in that subsequent year.

H. Foreign plans

1. Plans covered by an applicable treaty

The proposed regulations provided an exclusion from the definition of a nonqualified deferred compensation plan for any scheme, trust, or arrangement maintained with respect to an individual where contributions made by or on behalf of such individual to such scheme, trust or arrangement are excludable for Federal income tax purposes under an applicable income tax treaty. The final regulations retain that exclusion and clarify that the exclusion applies to the extent contributions made by or on behalf of such individual to such scheme, trust, arrangement or plan, or credited allocations, accrued benefits, or earnings or other amounts constituting income, of such individual under such scheme, trust, arrangement or plan, are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention to which the United States is a party.

2. Exclusion for benefits earned under a broad-based foreign retirement plan

The proposed regulations contained an exclusion from coverage under section 409A for amounts deferred under a broad-based foreign retirement plan, subject to certain conditions, including that the service provider not be eligible to participate in a qualified employer plan, and that if the person is a U.S. citizen or lawful permanent resident, the exception only applies to nonelective deferrals of foreign earned income (as defined in section 911(b)(1)) that do not exceed the limits under section 415(b) and (c) that would be applicable if the plan were a qualified plan. Deferrals by participants that are nonresident aliens are not subject to the limitation based on section 415. The final regulations adopt this provision, subject to certain modifications.

Many of the commentators requested expansion of the exclusion for broad-based foreign retirement plans. One commentator requested that the exclusion apply to U.S. citizens working in the United States for a foreign employer. The Treasury Department and the IRS do not believe such an exception is justified. However, the exception for U.S. citizens or lawful permanent residents has been expanded to cover nonelective deferrals of foreign earned income as defined in section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B). Accordingly, the exception may now cover certain participation by a U.S. citizen or lawful permanent resident who works overseas during only part of a year, and therefore is not a bona fide resident of a foreign

country for an uninterrupted period that includes an entire taxable year, or is not present in the foreign country at least 330 full days during a period of 12 consecutive months.

The regulations have also been modified to address nonqualified deferred compensation plans covering bona fide residents of a U.S. possession. Under the regulations a bona fide resident of a possession who participates in a broad-based foreign retirement plan is not subject to section 409A with respect to participation in such plan. In addition, a plan substantially all of the participants in which are bona fide residents of a possession is eligible to be treated as a broad-based foreign retirement plan, so that U.S. citizens and resident aliens (other than bona fide residents of a possession) who participate in such a plan may be eligible for the more limited exclusion for participation in a broad-based foreign retirement plan.

Another commentator requested that the exclusion apply to a plan that otherwise meets the requirements for the exclusion, regardless of whether the plan is sponsored by a foreign or U.S. employer. This suggestion has been adopted in the final regulations.

Other commentators requested further clarification and revision of certain of the requirements to qualify for the exclusion. One commentator requested a safe harbor treating any plan granted favorable tax treatment under the laws of a foreign jurisdiction as qualifying for the exclusion. The Treasury Department and the IRS believe this standard is both too broad and not administrable, and this suggestion has not been adopted in the final regulations.

Another commentator requested that the regulations provide a safe harbor percentage for determining whether substantially all of a foreign plan's participants are nonresident aliens. The final regulations do not adopt such a provision. However, the final regulations clarify that in determining whether substantially all of a foreign plan's participants are nonresident aliens or bona fide residents of a possession, only active participants are considered. For this purpose, active participants include individuals who, under the terms of the plan and without further amendment or action by the plan sponsor, are eligible to make or receive contributions or accrue benefits under the plan (even if the individual has elected not to participate in the plan).

A similar standard applies to the requirement that the individual not be eligible to participate in a qualified employer plan. The final regulations provide that a service provider will be treated as eligible to participate in a qualified employer plan if, under the plan's terms and without further amendment or action by the plan sponsor, the service provider is eligible to make or receive contributions or accrue benefits under the plan (even if the service provider has elected not to participate in the plan).

The final regulations also clarify that the exclusion for United States citizens and lawful permanent residents applies to nonelective deferrals even if elective deferrals are permitted under the same plan, provided that the amounts deferred through nonelective deferrals and earnings on such amounts are distinguishable from amounts deferred through elective deferrals and earnings on such amounts, such as through the use of separate accounts.

3. Tax equalization payments

The proposed regulations excluded from coverage under section 409A certain arrangements, referred to as tax equalization arrangements, that provide for payments intended to compensate the service provider for the excess of taxes actually imposed by a foreign jurisdiction on the compensation paid over the taxes that would be imposed if the compensation were subject solely to United States Federal income tax, subject to certain requirements. The final regulations adopt these provisions, subject to modifications. Based upon the comments received, the final regulations generally expand the exclusion in two respects. First, the final regulations extend the tax equalization payments exception to cover reimbursements of U.S. taxes that exceed foreign taxes. Second, the final regulations provide that the payment must be made by the end of the second taxable year of the service provider following the latest of the deadline for filing a U.S. Federal tax return or the deadline for filing foreign tax returns (or if a foreign return is not required to be filed, the due date for foreign tax payments) reflecting the compensation for which the tax equalization payment is provided.

Commentators also asked how such reimbursement agreements could address the potential for an audit or other tax controversy, both in the U.S. and abroad. The same issue arises with respect to tax gross-up payments in general. For a discussion of the treatment of the right to such payments, see section VII.B.4 of this preamble.

4. Certain Limited Deferrals by Nonresident Aliens

Part III – Administrative, Procedural, and Miscellaneous

Guidance Regarding the Application of Section 409A to Split-Dollar Life Insurance Arrangements

Notice 2007-34

I. PURPOSE

This notice provides guidance regarding the application of section 409A of the Internal Revenue Code (Code) to split-dollar life insurance arrangements. This notice also provides that certain modifications of split-dollar life insurance arrangements necessary to comply with, or avoid application of, section 409A will not be treated as a material modification for purposes of § 1.61-22(j) of the Income Tax Regulations.

II. BACKGROUND

A. Section 409A

Section 409A was added to the Code by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418 (AJCA). Section 409A(a) generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a) also provides rules under which deferrals of compensation will not result in such immediate and additional tax liability, including rules about the timing of initial elections to defer compensation, payments of deferred compensation, and changes to the time or form of a scheduled payment of previously deferred amounts.

Section 885(d) of the AJCA and § 1.409A-6 provide that section 409A of the Code generally applies to amounts deferred after December 31, 2004. Section 885(d) of the AJCA and §1.409A-6 further provide that section 409A applies to earnings on deferred compensation only to the extent that section 409A applies to the deferred compensation. Section 885(d) of the AJCA and § 1.409A-6 also provide, however, that amounts deferred in taxable years beginning before January 1, 2005 are treated as amounts deferred in a taxable year beginning on or after such date if the plan under which the deferral is made is materially modified after October 3, 2004, except as permitted under transition guidance.

Notice 2005-1, 2005-1 C.B. 274, provides certain transition relief with respect to the application of section 409A. This relief was modified and partially extended in the preamble to the proposed regulations regarding the application of section 409A to nonqualified deferred compensation plans (2005-2 C.B. 786, 70 Fed. Reg. 57930 (Oct. 4, 2005)). This relief was again modified and partially extended in Notice 2006-79, 2006-43 I.R.B. 763.

Because certain types of split-dollar life insurance arrangements provide for deferred compensation as defined under § 1.409A-1(b), the requirements of section 409A apply to such arrangements. Split-dollar life insurance arrangements that provide only death benefits (as defined in § 1.409A-1(a)(5)) to or for the benefit of the service provider are excluded from coverage under section 409A under the exception for death benefit plans contained in § 1.409A-1(a)(5). Similarly, arrangements that provide a legally binding right to amounts that are included in income in accordance with the exception for short-term deferrals under § 1.409A-1(b)(4) also do not provide for deferred compensation subject to section 409A to the extent so included.

B. Section 1.61-22 of the Income Tax Regulations

Section 1.61-22 provides rules for the taxation of a split-dollar life insurance arrangement. Section 1.61-22(j)(1)(i) provides that the regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Section 1.61-22(j)(2)(i) provides that, for purposes of the general effective date provision, if an arrangement entered into on or before September 17, 2003 is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

Section 1.61-22(j)(2)(ii) provides a non-exclusive list of changes that are not material modifications for this purpose. Section 1.61-22(j)(2)(iii) provides that the Commissioner, in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin, may provide additional guidance with respect to other modifications that are not material for this purpose. This notice is intended to provide such additional guidance with respect to certain modifications related to split-dollar life insurance arrangements covered by section 409A.

Commentators expressed concerns about the impact of changes to a split-dollar life insurance arrangement to comply with section 409A, where the split-dollar life insurance arrangement was entered into on or before September 17, 2003 and is not otherwise subject to the regulations set forth in § 1.61-22. Commentators suggested that modifications necessary to comply with section 409A may cause the split-dollar life insurance arrangement to be treated as materially modified for purposes of § 1.61-22(j)(2). Comments were requested as to the scope of changes that would be necessary to comply with, or avoid application of, section 409A, and under what conditions those changes should not be treated as material modifications for purposes of § 1.61-22(j)(2). The Treasury Department and the IRS have considered all of the comments submitted in formulating this notice providing guidance under which certain modifications will not be treated as material modifications for purposes of § 1.61-22(j).

C. IRS Notice 2002-8

Notice 2002-8, 2002-1 C.B. 398, provides guidance regarding split-dollar life insurance arrangements entered into before the date of publication of final regulations (*i.e.*, before September 18, 2003). Specifically, Notice 2002-8, Part IV.2 provides that, for split-dollar life insurance arrangements entered into before September 18, 2003, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the IRS will not treat the arrangement as having been terminated (and thus will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement) for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. This treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract.

Notice 2002-8, Part IV.3 also provides that, for split-dollar life insurance arrangements entered into before September 18, 2003, the parties to the arrangement may treat premium or other payments by the sponsor as loans. In such cases, the IRS will not challenge reasonable efforts to comply with the requirements of sections 1271-1275 and section 7872 of the Code. To qualify for this treatment, all payments made by the sponsor from the inception of the arrangement (reduced by any repayments to the sponsor) before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of the first year in which such payments are treated as loans.

III. APPLICATION OF SECTION 409A TO SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

A. Section 409A Grandfathered Benefits

1. In General

Section 409A is not effective with respect to amounts deferred in taxable years beginning before January 1, 2005, unless the plan under which the amount deferred was made is materially modified after October 3, 2004 (section 409A grandfathered benefits). For purposes of determining whether section 409A is applicable with respect to an amount, the amount is considered deferred before January 1, 2005 and therefore grandfathered from application of section 409A if, before January 1, 2005, the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested. See § 1.409A-6(b).

Section 409A is effective with respect to earnings on amounts deferred only to the extent that section 409A is effective with respect to the amounts deferred. Accordingly, section 409A is not effective with respect to earnings on section 409A grandfathered benefits. See § 1.409A-6.

2. Determination of Section 409A Grandfathered and Non-Grandfathered Benefits under a Split-Dollar Life Insurance Arrangement

For purposes of applying § 1.409A-6, earnings on section 409A grandfathered benefits under a split-dollar life insurance arrangement include an increase in the policy cash value, or an increase in any portion of the policy cash value, that is attributable to the section 409A grandfathered benefits. For this purpose, earnings on section 409A grandfathered benefits do not include any increase in the policy cash value attributable to continued services performed, compensation earned, or premium payments or other contributions made on or after January 1, 2005.

Where benefits under a split-dollar life insurance arrangement have a component that is a section 409A grandfathered benefit and a component that is a section 409A non-grandfathered benefit, the calculation of the section 409A grandfathered component of the benefit may be made under any reasonable method that allocates increases in policy cash value attributable to the section 409A grandfathered benefit. For this purpose, a method will not be treated as reasonable if it allocates a disproportionate amount of policy costs and expenses to the section 409A non-grandfathered component.

For purposes of this section III.A.2, the use of the proportional allocation method described in this paragraph will be treated as a reasonable method. The proportional allocation method defines the section 409A grandfathered benefit (including grandfathered earnings) as of any valuation date as equal to the greater of:

(1) the portion of the policy cash value at December 31, 2004 that was earned and vested (as defined in § 1.409A-6(b)) reduced by any amount securing an amount owed to the service recipient; and

(2) an amount equal to the policy cash value on the valuation date multiplied by a fraction, the numerator of which is the sum of the grandfathered premiums actually paid on the policy and the denominator of which is the sum of all premiums actually paid on the policy by the valuation date.

For purposes of this paragraph, grandfathered premiums include both premiums actually paid on or before December 31, 2004 that were earned and vested (as defined in § 1.409A-6(b)) as of such date and premiums paid after such date pursuant to a legally binding right that was earned and vested (as defined in § 1.409A-6(b)) as of such date.

B. Arrangements Subject to § 1.61-22

This section III.B addresses a split-dollar life insurance arrangement, or a portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is subject to the rules under § 1.61-22 (but not § 1.7872-15) (including an arrangement or portion thereof that defers compensation in taxable years beginning before January 1, 2005, if the arrangement is materially modified (within the meaning of § 1.409A-6(d)) after October 3, 2004). Except where such an arrangement provides for only a short-term deferral excluded from coverage under § 1.409A-1(b)(4), a split-dollar life insurance arrangement the taxation of which is governed by the rules of § 1.61-22(d) – (g) generally provides for deferred compensation if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year of the service provider to compensation that, pursuant to the terms of the arrangement, is or may be includible in the income of the service provider in a later taxable year of the service provider.

A split-dollar life insurance arrangement does not constitute a nonqualified deferred compensation plan for purposes of section 409A to the extent the arrangement constitutes a death benefit plan. See § 1.409A-1(a)(5). For purposes of this section III.B, the right to compensation described as the cost of current life insurance protection in § 1.61-22(d)(2)(i) and (3) is treated as provided under a death benefit plan under § 1.409A-1(a)(5) and thus is excluded from the requirements of section 409A, even if additional economic benefits are

available under the arrangement that are subject to the application of section 409A.

Accordingly, a split-dollar life insurance arrangement covered by this section III.B provides for deferred compensation for purposes of section 409A if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year of the service provider to economic benefits described in § 1.61-22(d)(2)(ii) (policy cash value to which the service provider has current access within the meaning of § 1.61-22(d)(4)(ii)) or § 1.61-22(d)(2)(iii) (any other economic benefits provided to the service provider) that, pursuant to the terms of the arrangement, are payable to (or on behalf of) the service provider in a later taxable year of the service provider, and such legally binding right does not qualify as a short-term deferral for purposes of § 1.409A-1(b)(4). For purposes of the application of section 409A, the excess of the policy cash value over the aggregate premium payments is treated as earnings. See §1.409A-3(e) for the treatment of earnings for purposes of satisfying the requirements of section 409A.

C. Arrangements Subject to § 1.7872-15.

This section III.C addresses any split-dollar life insurance arrangement, or portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is subject to § 1.7872-15 (and not § 1.61-22) (including an arrangement or portion thereof that defers compensation in taxable years beginning before January 1, 2005, if the arrangement is materially modified (within the meaning of § 1.409A-6(d)) after October 3, 2004). Split-dollar life insurance arrangements pursuant to which payments are treated as split-dollar loans under § 1.7872-15 generally will not give rise to deferrals of compensation within the meaning of section 409A. However, in certain situations, such an arrangement may give rise to deferrals of compensation for purposes of section 409A, for example, if amounts on a split-dollar loan are waived, cancelled, or forgiven.

D. Arrangements Grandfathered under § 1.61-22(j)

1. In General

This section III.D addresses a split-dollar life insurance arrangement, or a portion of a split-dollar life insurance arrangement, that is not grandfathered under § 1.409A-6, but is grandfathered under § 1.61-22 (and thus is not covered by § 1.61-22 or § 1.7872-15 unless materially modified).

A split-dollar life insurance arrangement addressed by this section III.D provides for deferred compensation for purposes of section 409A if, under the terms of the arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that

pursuant to the terms of the arrangement is payable to (or on behalf of) the service provider in a later year (for example, upon termination of the split-dollar arrangement), and such legally binding right does not qualify as a short-term deferral for purposes of § 1.409A-1(b)(4), and is not treated as provided under a death benefit plan for purposes of § 1.409A-1(a)(5). Notice 2002-8 provides that, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the IRS will not treat the arrangement as having been terminated for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. In such cases, provided that all other requirements of Notice 2002-8 are satisfied, the IRS will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement for purposes of section 409A. In addition, in such cases, the IRS will not treat the right to the economic benefit of current life insurance protection (within the meaning of Notice 2002-8) as deferred compensation for purposes of section 409A.

For split-dollar life insurance arrangements entered into before September 18, 2003, the parties to the arrangement may be eligible to treat premium or other payments by the sponsor as loans under either Part IV.3 or Part IV.4 of Notice 2002-8. In such a situation, the arrangement generally will not give rise to deferrals of compensation within the meaning of section 409A. However, in certain situations, the arrangement may give rise to deferrals of compensation for purposes of section 409A, for example, if all or a portion of the payments on the loans are waived, cancelled, or forgiven.

2. Additional Transition Relief under § 1.61-22(j)

For purposes of § 1.61-22(j), a modification of a split-dollar life insurance arrangement necessary to bring such arrangement into compliance with section 409A, or to avoid application of section 409A, will not be treated as a material modification of such arrangement. For this purpose, a modification of a split-dollar life insurance arrangement is considered necessary to bring such arrangement into compliance with section 409A only if each of the following requirements is met:

(1) The service recipient or service provider participating in the split-dollar life insurance arrangement has made a determination, based upon a reasonable application of section 409A, the regulations, and other guidance, that section 409A is applicable to the arrangement, and that the arrangement does not comply with the requirements of section 409A;

(2) The service recipient or service provider participating in the split-dollar life insurance arrangement has made a determination, based upon a reasonable application of section 409A, the regulations, and other

guidance, that the modification causes the arrangement to comply with section 409A or results in section 409A no longer being applicable to the arrangement, or that the modification is a necessary part of a number of actions that together cause the arrangement to come into compliance with section 409A or result in section 409A no longer being applicable to the arrangement;

(3) The modification to the arrangement consists solely of changes to the applicable definitions (such as, the definition of a separation from service or a disability) or changes to the payment timing requirements, including election provisions related to the time and form of payment, or changes to the conditions under which all or part of the benefit under the arrangement will be forfeited (such as, an acceleration of a vesting requirement), reasonably intended to conform the arrangement to the requirements of, or to qualify for an exclusion from, section 409A;

(4) The modification establishes a time and form of payment, or establishes potential times and forms of payment that are consistent with times and forms of payment under which the benefits could have been paid under the terms of the arrangement before the modification (including through the exercise of service recipient or service provider discretion in accordance with the terms of the arrangement before modification); and

(5) The modification does not materially enhance the value of the benefits to the service provider under the arrangement.

IV. CONTINUED APPLICATION OF SECTION 409A

This notice does not affect the application of section 409A, including the application of the treatment of certain plans that are materially modified after October 3, 2004 as subject to section 409A. In addition, this notice does not affect the application of any transition relief under section 409A. Final regulations under section 409A were released on April 10, 2007. The final regulations generally are applicable for taxable years beginning on or after January 1, 2008. However, taxpayers may rely on the final regulations for purposes of applying this notice to prior periods.

V. DRAFTING INFORMATION

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding the application of section 409A, contact Stephen Tackney at (202) 927-9639 (not a toll-free call).

April 11, 2007
hp-346

Prepared Remarks of Pat O'Brien
Assistant Secretary Terrorist Financing and Financial Crimes
Before the U.S.-Latin America Private Sector Dialogue on Combating

Money Laundering and Terrorist Financing

Bogotá, COLOMBIA – Good afternoon. I first want to welcome and thank Vice-President Francisco Santos and FIU Director (Mario) Aranguren of Colombia. I would also like to thank U.S. Deputy Chief of Mission (Milton) Drucker for your encouragement and support of this initiative. Colombia is a regional leader in the fight against money laundering and we are honored to be here today in your country. I also would like to thank the members of the private sector who have chosen to attend and participate in the inaugural Private Sector Dialogue between the United Status and Latin America starting today here in Bogotá. The audience represents an extremely capable and diverse group of financial industry leaders.

As you know, today marks an important chapter in what we would like to be a continuing dialogue between the U.S. and the Latin American financial sectors. Our objective is to establish better relations between financial institutions from our respective regions and to encourage joint efforts aimed at controlling money laundering, drug trafficking, and terrorist financing activities. Your participation is a testament to your belief in and willingness to see through this important initiative.

We want this dialogue to build on the United States' continued commitment to supporting the economic development of Latin America, including developing engines of growth, opportunity, and reducing poverty. During Secretary Paulson's speech to the Governors of the Inter-American Development Bank in Guatemala last month, he elaborated on President Bush's commitment to your region, outlining three central economic priorities for the U.S. and Latin America: working together to promote more opportunity and prosperity for all people, creating an environment that nourishes the growth of small and medium-sized businesses, and developing the region's infrastructure.

Economic development requires the free movement of capital and a strong, transparent financial system. Central to achieving this goal is the importance of continued cooperation between the public and private sectors in our collective effort to promote the continued strength, safety, and integrity of the global financial system. Our work to maintain a sound financial system must include efforts to stem transnational threats such as drug trafficking, money laundering, terrorist financing, and proliferation. All of us here today have an obligation to mitigate these very real threats.

At the U.S. Treasury Department, we recognize how strong relationships and multilateral efforts such as this dialogue further strengthen our abilities to detect and disrupt illicit financial activity. A sound financial system means that our businesses and our citizens have a stronger economy and have greater access to opportunity. A sound financial system also guards against potentially devastating economic, security, and social consequences worldwide. Cooperation among nations' public and private sectors can help guarantee the continued health of the global financial system.

Safeguarding the integrity of the financial system is now more complicated than

ever. Globalization creates an environment of great efficiency for legitimate commerce, however, it just as easily aids those involved in illicit financial activity. For example, online and remote banking, stored value cards, electronic payment systems, and other mechanisms can be of immense value to the public, but they also pose a regulatory and enforcement challenge. This challenge, wherever it exists, must be overcome to ensure a sound global financial system which in turn ensures safe, transparent, efficient, free flows of capital within and across borders. Unchecked, illicit activity can erode the integrity of a nation's financial institutions regardless of the size of the market in question – leaving in its wake serious long-term consequences.

The ever present threat of illicit financial activities has pushed finance ministries and other government authorities to re-examine, and in some cases to examine for the first time, their economic and financial security infrastructure both in their respective countries and as a part of the global community. In the U.S., the Treasury Department marshals its policy, enforcement, regulatory, and intelligence functions with the twin aims of safeguarding the financial system against illicit use and combating terrorist facilitators, proliferators, money launderers, drug kingpins, and other national security threats.

To date, international efforts to cooperatively identify and combat illicit finance have seen significant results – but most relevant to this group, we have seen important successes in Latin America. A key example is GAFISUD. As a Financial Action Task Force – or FATF – Style Regional Body, GAFISUD plays a critical role in coordinating anti-money laundering/combating the financing of terrorism (AML/CFT) training and improving implementation of the FATF AML/CFT standards across the region. Moreover, GAFISUD has been a leader in identifying and addressing emerging threats to the region, such as trade based money laundering. GAFISUD's newly released typology report on complex money laundering schemes is important in that it highlights money-laundering/terrorist financing vulnerabilities particular to the region. We applaud GAFISUD's continued efforts.

Our international cooperation is also yielding operational successes. For example, as a result of deep and longstanding cooperation with the Colombian authorities, the Treasury Department's Office of Foreign Assets Control (OFAC), in consultation with the Departments of Justice, State, and Homeland Security designated five individuals and twenty entities all associated with SDNT principal individuals Raul Alberto Grajales Lemos and Carlos Alberto Renteria Mantilla last year. The individuals and companies comprised an international financial network for Colombia's North Valle drug cartel and are located in Colombia (8), Panama (5), the British Virgin Islands (1) and the United States (6). The 20 companies encompass a wide range of services including real estate, investment, construction, property management and manufacturing. Simultaneous with OFAC's action, Colombian authorities arrested the five designated individuals under Colombian money laundering charges. This is an example of how our regions can work together to combat a significant threat.

The development of effective and long-term AML/CFT regimes ultimately requires collaboration not only between governments, but also between the public and private sectors. Government-to-government engagement on illicit financing has been a central pillar of Treasury's policy for many years. That ongoing conversation has been beneficial and has set the stage for increased coordination in our public sectors. However, it is our private sectors – including this group that sits before me today - that serve on the front lines, protecting in the first instance our financial systems from the threats we face. Our financial sectors must continue to further integrate with one another and work seamlessly to make our respective efforts as effective and efficient as possible. Recognizing the need for greater outreach and collaboration, the Treasury Department has engaged in a number of efforts to provide outreach to the private sector. These efforts are both formal and informal.

Last summer, the U.S. Treasury hosted an initial roundtable event for private sector representatives and senior U.S. regulatory officials and their counterparts from Latin America. Roundtable participants spent the day discussing private sector perspectives on AML/CFT implementation. The roundtable identified a number of issues for further work and discussion and participants agreed to cooperatively plan

conferences and seminars dedicated to addressing core areas of mutual interest and concern.

Today represents the first fruits of that roundtable, the U.S.-Latin America Private Sector Dialogue (US-LA PSD) and is a significant milestone for the private sectors of Latin America and the United States. This event has brought together leaders from the Latin American and U.S. financial sectors to discuss timely issues related to the sound implementation of AML/CFT measures. It has also set the stage for future dialogue and long-term cooperation.

The goal of the inaugural US-LA PSD is to encourage direct dialogue between the financial sectors in the United States and Latin America in order to:

- Raise awareness of money laundering and terrorist financing risks;
- Facilitate a better understanding of effective practices and programs to combat such risks;
- Strengthen implementation of effective AML/CFT controls; and
- Exchange information and improve understanding of business cultures and norms.

Over the next three days, four United States/Latin America plenary sessions will be held to advance a variety of critical issues stemming from the initial roundtable discussions. These issues include:

- Supervision and AML/CFT Compliance: Including regulations, liability, and cross-border barriers in both regions:
- Correspondent Banking: Including due diligence, correspondent relations, and shell bank situations;
- Non-Bank Financial Institutions: including aspects of payment systems and the management and risk of those systems; and
- Cross-Border Transfers/Economic Sanctions: Including aspects of due diligence, know your customer (KYC), and economic sanctions and financial measures.

This event has been made possible through the work of last summer's roundtable and through the dedication, hard work, and fine leadership of Asobancaria, FELEBAN, the Florida International Bankers Association, and the American Bankers Association, as well as government entities throughout Latin America and especially the Government of Colombia and others, such as Argentina. We deeply appreciate your efforts.

In sum, I look forward to our time together over the next couple of days. Dialogues like this are vital as we strive to always stay one step ahead of the threat, and I would again like to thank you for your strong participation. Ultimately, our progress will be measured in part by our commitment to collaborate and create highly effective and integrated AML/CFT regimes. May we all be equal to this task and achieve the desired success of a more secure, prosperous region and world.

Thank you.

April 9, 2007
HP-347

Deputy Secretary Kimmitt To Deliver Speech on the U.S.-Japan Economic Relationship

Washington--U.S. Treasury Deputy Secretary Robert M. Kimmitt will deliver a speech next week on the U.S.-Japan economic relationship. The speech, entitled "Japan and the United States: Indispensable Partners, in Asia and Beyond," will focus on issues that are critical to the continued success of the U.S.-Japan economic relationship.

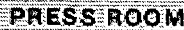
Who
Deputy Secretary Robert M. Kimmitt

What
Speech on U.S.-Japan Economic Relationship

When
Tuesday, April 17, 12 p.m. EDT

Where
Senate Russell 325
Washington, D.C.

Note Media must pre-register for this event. Please contact Ann Marie Hauser at 202-622-2960 or Mary-Jane Atwater at matwater@mansfieldfdn.org or 202-347-1994.



April 12, 2007
HP-348

Prepared Statement by Treasury Under Secretary Timothy D. Adams in Advance of the Spring Meetings of G-7 Finance Ministers and Central Bank Governors, the International Monetary Fund, and the World Bank

Washington, DC – Welcome. We have a very busy set of meetings over the next several days, and I would like to lay out some of the key items on the agenda.

As you know, Secretary Paulson will host the G-7 Finance Ministers and Central Bank Governors here at the Treasury on Friday. They will discuss the global economy, capital markets issues, trade, and IMF reform, among other things. This G-7 meeting will include an outreach dinner with China and counterparts from Russia, Saudi Arabia, and the United Arab Emirates to discuss investment flows from oil exporters.

The IMF's International Monetary and Financial Committee (IMFC) will meet Saturday, and the World Bank's Development Committee will meet Sunday. Also on Sunday, G-7 Finance Ministry Deputies will have an educational outreach meeting on hedge fund industry practices and developments with representatives from the hedge fund industry.

At the G-7 and IMFC meetings we will be able to share views with our colleagues from around the world on a wide range of issues – global imbalances, IMF reform, capital market developments, debt sustainability in low-income countries, combating terrorism financing, and the Doha round. Additionally, the Development Committee will discuss countries' progress towards meeting development goals and assess the Bank's work in Africa. Let me just make a few comments on some of these issues.

The global economic environment continues to be very favorable, but our colleagues will be interested in the health of the United States economy, especially against the background of developments in the sub-prime mortgage sector. We will emphasize that the United States economy continues to perform well, with solid growth of 3.1% over the past 4 quarters and a healthy labor market. Unemployment has declined to 4.4% while real wage growth is strong. Inflation appears contained. The deficit has shrunk by half in two years. That is three years ahead of schedule.

- We are reaching a critical time on reform of the IMF. The IMF needs a package of meaningful reforms to safeguard its relevance and legitimacy. The IMF has a unique and serious responsibility for exchange rate surveillance, and the Managing Director's proposals to revise the IMF's 30-year old principles make great sense. The rise of dynamic emerging markets along with a static governance structure means the IMF no longer reflects the global economy. We will urge the major shareholders to be bold and follow through with fundamental reform of IMF quotas. In this regard, the United States will reiterate our offer to forgo any increase in our pre-Singapore voting share that might result from a new formula; we continue to call upon all similarly-situated industrial countries to join us.
- And there is clear interest among major emerging markets for a new reserve augmentation facility. I want to welcome the Malan Report on IMF-World Bank Collaboration for its recommendations on sharpening the IMF's short-term financial role in low-income countries. Lastly, we will discuss the IMF's

longer-term finances and the Crockett Report, though with ample reserves to cover shortfalls in the medium-term the Fund need not rush to action. If revenues do not rebound, expenditure measures – and difficult choices on priorities – will require serious consideration.

- We will be discussing hedge funds and highlighting the approach of the U.S. President's Working Group on Financial Markets (PWG) to private pools of capital. The PWG guidelines are intended to guide all market participants – counterparties and creditors, private pool managers, investors, fiduciaries, and financial regulators – in addressing issues associated with the growth and dynamism of these investment vehicles. They do so through a flexible, principles-based treatment of systemic risk and investor protection issues. We will discuss how robust domestic bond markets are necessary for the growth and stability of all economies, including the emerging markets. The weekend's agenda also addresses the interesting idea of mutual recognition of comparable regulatory regimes, which we continue to discuss with our securities regulators.
- We will be urging our colleagues to reinvigorate the Doha Round of trade negotiation, especially in the area of financial services, which play a critical role in facilitating economic development. We will also be promoting responsible lending practices, such as the IMF/World Bank Joint Debt Sustainability Framework, to enhance debt sustainability among developing countries.
- Finally, we will of course be eager to collaborate with our colleagues on ways to more vigorously counter money laundering, terrorist financing, and other illicit finance to promote the stability and integrity of the international financial system.

Also, on Monday, Treasury will host a meeting of the U.S.-China Joint Economic Committee (JEC), an important forum for discussing macroeconomic and financial issues in our two countries. These issues will play a central role in the upcoming Strategic Economic Dialogue meeting in May. To achieve sustained growth, China needs to rebalance its economy. Creating an efficient and competitive financial sector is a key component of this rebalancing and is critical to ensuring future growth in China, as well as the global economy.

I am happy to take your questions on any of these points or anything else that will arise this weekend. Thank you.

April 13, 2007
HP-349

**Statement by Treasury Secretary
Henry M. Paulson, Jr.
Following Meeting of G-7 Finance Ministers and
Central Bank Governors**

Washington, DC--I was pleased to host the G-7 Finance Ministers and Central Bank Governors today here in Washington. We addressed many important issues on a very full agenda.

The current global expansion provides a positive backdrop to our discussions. The U.S. economy is healthy and is making a transition to a sustainable expansion. GDP growth in the 4th quarter was 2.5 percent and U.S. output is up by 3.1 percent over the past 4 quarters. Inflation remains moderate and the U.S. labor market is healthy, with low unemployment, steady job gains, and strong real wage growth. The overall strength of the U.S. economy has led to an improved federal budget situation over the past two years. The deficit, which was 1.9 percent of GDP in FY2006, has been cut in half three years ahead of schedule and the Administration's budget projects a return to a surplus by 2012. We continue to watch developments in the subprime mortgage market. While challenges in this market do not appear to pose a serious risk to the overall economy, many families have been affected. As I testified before Congress earlier this month, we are working closely with housing sector regulators on this issue.

Nevertheless, we remain aware of risks to the world economy. Fuel prices remain high and volatile. Protectionist pressures are rising. Global financial markets are vulnerable to reversals, as we saw earlier this year, though the system has proved to be resilient and adjustments orderly. My colleagues and I discussed the initial progress made towards implementing policies to help reduce global imbalances, including some rebalancing of global demand. However, more needs to be done. We need global demand to be underpinned by strong domestic demand in major economies such as Japan and Europe, and the cyclical upswings need to be translated into lasting improvements in potential growth. Greater exchange rate flexibility and stronger domestic demand in China are critical parts of rebalancing, and it is crucial that China move now with greater urgency. Oil exporters also need to undertake measures to increase investment and consumption. Tonight I will have a working dinner with my G-7 and Chinese colleagues. We will be joined by our counterparts from Russia, Saudi Arabia, and the United Arab Emirates to discuss investment flows from oil exporters to gain a sharper understanding of this increasingly important issue.

I have emphasized that our capital markets in the United States and abroad are vital to global economic growth. At our meetings today, I talked with my colleagues about the United States' approach to private pools of capital, including hedge funds, provided by the U.S. President's Working Group on Financial Markets (PWG). The PWG recognized the rapid growth of this industry and the increasing complexity of the financial instruments that hedge funds use. The U.S. federal regulators and policymakers unanimously moved in February to give unified, forward-leaning guidance for market participants for enhanced vigilance and market discipline. The PWG will continue to encourage market participants to take up this guidance. In our meetings today, we also discussed how robust domestic bond markets are necessary for the growth and stability of all economies, including the emerging markets. We continued our discussion about securities and mutual recognition among comparable regulatory regimes. In today's global marketplace, I believe this is an idea well worth considering and I will be supportive of our regulators' efforts to make progress in this area.

We are at a critical juncture for progress on the Doha Development Round of trade negotiation, and we had a serious discussion on the way forward. I urged my fellow Finance Ministers to encourage their trade ministers to achieve an ambitious deal because of the Round's potential to stimulate growth and economic development. Substantial progress on services, including financial services, must be integral part of a development round, so Finance Ministries need to work together to reinvigorate the financial services negotiations. Progress must be based on a substantive break-through.

As major shareholders of the IMF, the G-7 have a strong interest in safeguarding the legitimacy and effectiveness of that institution. To do so, we must make the IMF look more like the world economy in which it operates. The rise of emerging markets needs to be reflected in the IMF's governance structure. That is why it is essential, first and foremost, that we be bold and follow through with fundamental reform of IMF quotas. I think there is a path forward that could achieve this objective, but doing so will require a rededication by many countries to the understanding that a strong IMF benefits us all. A more representative IMF, however, will mean little without significant improvements in the institution's surveillance over exchange rate policies. For this reason, the G-7 reaffirmed our strong support for quick action to update the IMF's 30-year-old principles and procedures for exchange rate surveillance.

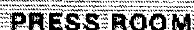
We had a good discussion on policies to promote development in low-income countries, especially ways to address debt sustainability concerns. Responsible lending policies and practices are fundamental to our efforts to enhance support to low-income countries. The key to preserving debt sustainability is to build upon and support the work reflected in the IMF/World Bank Joint Debt Sustainability Framework, and for all creditors to incorporate the framework into their lending practices.

We reaffirmed our commitment to vigorously counter money laundering, terrorist financing, and other illicit finance to promote the stability and integrity of the international financial system. We called on the Financial Action Task Force (FATF) to address emerging threats, including the threat of WMD proliferation finance, and to enhance implementation of FATF standards around the world.

Energy efficiency and security were also on the agenda. The United States is committed to improving energy security and tackling the important issue of climate change, as evidenced by the Administration's January announcement of the "Twenty in Ten" initiative. I urged my colleagues to explore creative policies to address these issues that will engage developing countries. We also need to explore options for accelerating market penetration of low-carbon energy technologies. Solving climate change is fundamentally a technology challenge, so we must consider how best to achieve this goal.

Thank you.

PRESS ROOM



April 13, 2007
HP-350

Statement of G-7 Finance Ministers and Central Bank Governors

Washington, DC- We, Finance Ministers and Central Bank Governors, met today to evaluate the global economic outlook. Although risks remain, the global economy is having its strongest sustained expansion in more than 30 years and is becoming more balanced. In our economies, U.S. economic activity remains solid even as domestic demand moderates to a more sustainable growth path. The euro-area is experiencing a healthy upswing. UK growth remains robust and Canadian growth is accelerating. Japan's recovery is on track and expected to continue. We remain confident that the implications of these developments will be recognized by market participants and will be incorporated in their assessments of risks.

Further strengthening and rebalancing of domestic demand is desirable to help ensure the global economic expansion remains robust. We continue to be committed to maintaining price stability as the best contribution that monetary policy can make to sustained global growth. We will do more to increase trend economic growth rates, especially through structural reforms such as improving labor markets and long-term fiscal sustainability. We are confident that the continuation of our policies will support economic growth and contribute to reduce international imbalances. We will continue to work together to support the global adjustment process and urge others to do likewise.

We reaffirm that exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. We continue to monitor exchange markets closely, and cooperate as appropriate. In emerging economies with large and growing current account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments will occur.

We believe that a successful conclusion of the Doha Development round is imperative. We are committed to resisting protectionist sentiment. Substantially lowering tariffs and other barriers is essential to spur new growth in global trade and reduce poverty. We welcome recent steps to intensify engagement, recognizing that substantive movement towards a comprehensive final outcome requires all parties to make additional efforts. We expect spending on Aid for Trade to increase to $4 billion, including through enhancing the Integrated Framework. We support initiatives to enhance cooperation to enforce intellectual property rights and combat counterfeiting which are crucial to our knowledge-based economies.

We continued our discussions on how to develop local currency bond markets to enhance the contribution of financial markets to sustainable economic growth and to reduce emerging market economies' vulnerability to external shocks and financial crises. We look forward to the results of the high level conference on May 9-10 in Frankfurt, which will help to identify concrete recommendations to sustain the momentum of reform.

We discussed recent developments in global financial markets, including hedge funds, which along with the emergence of advanced financial techniques such as credit derivatives, have contributed significantly to the efficiency of the financial system. We will continue to monitor the implications of these developments. Market-led and official initiatives focused on issues around private pools of capital intended to strengthen market discipline, risk management, market infrastructure, information and valuation practices, are essential contributions to global financial

stability. In this context, we welcomed the work of the United States' President's Working Group on Financial Markets and its "Principles and Guidelines Regarding Private Pools of Capital" and look forward to the Financial Stability Forum's update of its 2000 Report on Highly Leveraged Institutions. We discussed the issue of mutual recognition of comparable regimes and look forward to further progress being made on cross-border access by investors to our securities markets.

We agree to push forward the ambitious package of bold and fundamental reforms in order to retain the IMF's relevance and legitimacy. Reforms should ensure that actual IMF quota shares, especially those of the most dynamic members, many of which are emerging markets, better reflect relative weights and roles in the global economy. We agree that the voice of low-income countries should be enhanced. A necessary element of IMF reform is improved surveillance over exchange rates. Surveillance must focus on external stability and be applied equally and even-handedly without creating new obligations. In this context, we welcome the Managing Director's proposals to update the 1977 Decision on Surveillance over Exchange Rate Policies and to develop a surveillance remit. We look forward to finalizing these proposals rapidly after the Spring Meetings. We took note of the work of the External Review Committee on IMF-World Bank Collaboration as well as of the report of the Committee to Study Sustainable Long-term Financing of the IMF. We agreed to consider the latter proposal in time alongside measures to further reduce administrative expenditures.

We encourage the use of the debt sustainability framework by all borrowers and creditors. We welcome continued work on principles for responsible lending and seek to involve other interested parties. We advocate a rapid resolution to Liberia's arrears to the international financial institutions. Available internal resources should be fully used to this end. We are prepared to make additional financial contributions. We look forward to the forthcoming International Conference on Education in Brussels.

In order to ensure energy security and to address climate change, we consider energy efficiency and the promotion of energy diversification to be important issues for both developed and developing economies. Diversification can include advanced energy technologies such as renewable, nuclear, and clean coal. We agree that market based policy measures should be effectively designed to meet specific conditions in each country.

We commit to continue the fight against money laundering, terrorist financing, and other illicit finance that risks the stability and integrity of the global financial system. We call for the effective and timely implementation of UN Resolutions 1540, 1718, 1737 and 1747. We commend the Financial Action Task Force on its commitment to examine the risks of weapons of mass destruction proliferation finance. We urge that as it reviews its strategic direction, the FATF consider expanding its mandate, enhancing global implementation of its standards, improving its strategic surveillance, and examining ways to bolster accountability and outreach activities.

We look forward to the successful launch of the International Compact for Iraq in Sharm El Sheik on May 3. We discussed economic prospects in the West Bank and Gaza Strip, and agreed to keep this under review.

April 14, 2007
HP-351

Statement by U.S. Treasury Secretary Henry M. Paulson, Jr. at the International Monetary and Financial Committee Meeting

WASHINGTON, DC--Today's meeting is taking place against the backdrop of a continued strong and resilient global economy, which provides a favorable setting for overcoming the challenges we face. Both advanced and emerging economies have put in place improved policy frameworks that are underpinning sustained growth. With global growth expected to be near 5% this year, the past five years mark the strongest period of world growth since the early 1970s. Recent bouts of moderate financial turbulence, in mid-2006 and again in early 2007, have tested the system, but it has performed well. While ongoing vigilance is required, inflation risks appear contained and international trade continues to expand.

Prospects for the U.S. economy are good. While economic activity slowed below potential in late 2006, we expect GDP growth to rebound to 3% by the end of this year. Inflation risks appear to be contained, while the labor market is healthy – with 7.8 million new jobs created since mid-2003, low unemployment and strong real wage growth. I am happy to report that the U.S. continues to make excellent progress in steadily shrinking our federal fiscal deficit, which fell from 3.6% in FY2004 to 1.9% in FY2006, a pace faster than most thought likely. We are committed to keeping the U.S. economy open to trade and investment, which underpins our economic strength, and to opposing protectionism whenever and wherever it arises.

Trade liberalization remains essential to economic growth for all countries and a key catalyst for poverty reduction in the less developed countries. Now that Doha Round negotiations have resumed, we must seize the opportunity to reach agreement. All countries will benefit from an agreement, and all countries – both developed and developing – must contribute through real market access commitments in agriculture, manufacturing, and services, including financial services. The financial sector in particular is the backbone of a modern economy with virtually every other sector of the economy depending on its services.

Over the last several months, the United States has been a participant in the IMF-sponsored Multilateral Consultations on global imbalances. While these consultations were never intended to produce joint policy commitments, they have still contributed importantly to improved understanding about the participants' shared responsibilities for promoting adjustment of imbalances. Indeed, there has been some re-balancing of global demand over the last year, but it is important to ensure that the cyclical upturn now underway in many countries is translated into lasting improvements in underlying potential growth. Looking forward, we hope for faster sustained demand growth from Europe and Japan, more demand growth from major surplus countries, and greater exchange rate flexibility in Asian emerging economies, especially China. The counterpart to a falling U.S. trade deficit, by definition, is falling trade surpluses in other economies.

Progress on IMF Reform

The IMF is an essential organization for international monetary cooperation. It has proven this since its inception – fostering growth and integration in the wake of World War II; strengthening international surveillance after the breakdown of the Bretton Woods System; helping the global financial system overcome the debt crises of the 1980s and 1990s; and facilitating the transition of command economies. In serving the global economy, the Fund has adapted to changing times

while adhering to its basic principles. The world is fast changing again. For the IMF to remain modern and relevant, it must re-invent itself. That is what our discussions on the Medium Term Strategy are all about.

First and foremost, the IMF must fundamentally reform its approach to surveillance over exchange rates. Let us be clear: exercising firm surveillance over members' exchange rate policies is the core function of the institution. The 1977 Decision on Surveillance over Exchange Rate Policies must be updated to reflect the dramatic rise of capital flows and the wider use of market-determined floating exchange rates, and to sharpen the focus on fundamental exchange rate misalignment. This should enable firmer surveillance in areas where market forces are not the prevailing paradigm, such as insufficiently flexible exchange rate regimes, or areas where macroeconomic policies and performance are poor even if the exchange rate freely floats. The updating should be accomplished in a manner that creates no new obligations under the IMF Articles. It should also incorporate the realities of how surveillance is actually undertaken in this day and age, and ensure that the conduct of surveillance is even-handed and candid. If exchange rate issues are not debated critically and openly at the Fund, alternative venues and approaches will necessarily emerge. For us, reform of the IMF's foreign exchange surveillance is the lynchpin on which other reforms depend, and we look forward to action in this important area very soon after these meetings. Moreover, it is not simply enough to revise the 1977 Decision. The IMF staff must do a better job in addressing foreign exchange surveillance on a day-to-day basis, particularly in Article IV reports.

Second, as part of the modernization and re-invention process, the IMF's governance structure needs to be overhauled. The Fund no longer looks like the world economy in which we live. Marginal reforms that do not fundamentally alter relative quota shares are insufficient – bold action is needed to boost the share of dynamic emerging market countries. Major emerging markets are producing an increasing share of global output, assuming greater responsibility for the functioning of the system, and will increasingly drive global growth. We continue to support protecting the shares of the poorest countries through an increase in basic votes. We reiterate the commitment of the United States to forgo the additional quota due us in the second stage ad hoc increase beyond what we need to maintain our pre-Singapore voting share and we reiterate our as of yet largely unheard call on other similarly situated countries to join us in doing this.

As part of this broader reform package, we have listened to our colleagues in emerging markets and we will support a new liquidity instrument to promote further reduction of vulnerabilities to capital account crises, provided the instrument is well-designed. We expect the instrument to include a high standard for qualification and provide that a country, which fully draws its funding under the instrument and subsequently requires additional resources, do so under a new IMF program. Policy actions to deepen domestic local currency capital markets should be an important part of efforts to mitigate the risks to national balance sheets.

Two important external reports have been issued since we last met, both of which have provided useful insights on key issues facing the Fund.

The Malan Report on Bank/Fund Collaboration provides recommendations on sharpening the focus of the IMF's work in low-income countries. We very much agree with these recommendations. The Fund has a very important role to play in poor countries, through surveillance, technical assistance, and financing when appropriate. But the IMF is not a development agency, and we strongly concur with the report's recommendation that the IMF's financing role in low-income countries should focus on actual balance of payments needs, as it does in emerging market members.

The Crockett Report will help catalyze the Executive Board's thinking on the important issue of how the IMF finances itself in the longer-term. The IMF has ample reserves to cover shortfalls in the immediate term, permitting time to fully consider the merits of the Report's recommendations. In parallel, options for further budget restraint must also be fully explored. If low levels of credit persist, the Board will need to give serious consideration to the appropriate role and size of the IMF going forward. The Report puts forward a number of financing options, and we are

prepared to consider each on their merits in time.

Since we last met, there has been important progress on strengthening the joint World Bank/IMF Debt Sustainability Framework and Debt Sustainability Analyses (DSAs) for low-income countries. Vigilance will be required to deter the rapid re-accumulation of debt for post-MDRI countries, and we urge emerging bilateral creditors to exercise good judgment and lend responsibly. To this end, we hope that lenders and borrowers will use the DSAs as a tool for analysis and decision making.

Vigorous global efforts to combat terrorist financing, WMD proliferation financing, and other forms of illicit financing are necessary to promote international financial stability and global security. We must continue to assist countries in implementing the Financial Action Task Force's (FATF's) international standards on money laundering and terrorist financing. The IMF and World Bank have been major partners in this vital global effort, and we look for their continued close collaboration with FATF going forward. We also call on all countries to fulfill their UN obligations by implementing UN Security Council Resolutions 1540, 1718, 1737, and 1747 against WMD proliferation, particularly the economic and financial provisions of those resolutions. We commend FATF's effort to examine the risks of WMD proliferation financing and to enhance surveillance of emerging threats to the financial system.

Thank you.

April 15, 2007
HP-352

Prepared Statement by Secretary Henry M. Paulson, Jr. at the Development Committee Meeting

Washington, DC--Over the past five years the world economy has grown at a pace not seen in over three decades. This robust growth has been particularly strong in low income countries and has helped reduce poverty. The world is well on its way to halving the share of people living in extreme poverty. While this is a remarkable accomplishment, progress is neither great enough nor balanced enough for us to congratulate ourselves. The Global Monitoring Report appropriately highlights the difficulties with progress in fragile states, many of which are located in sub-Saharan Africa, and draws attention to the need to ensure that the benefits of growth are equally open to all members of society, both male and female.

While the community of donors recognizes the need for continuing substantial aid flows, one of the most critical of the many lessons we have learned in the 60-year history of the World Bank is that higher aid flows by themselves do not guarantee less poverty. Assuring that our assistance is directed to effective, efficient, well-coordinated projects that can make lasting changes in people's lives remains a key and daunting challenge. It requires intellectual vigor, the willingness to constantly reassess and question the effectiveness of our approaches, and a true hard-nosed dedication to the pursuit of measurable results at all levels of our programs. It also means that resources need to be applied to their most efficient use, and that institutions focus on their core competencies.

Sub-Saharan Africa

We are heartened by the early indications of success with the Bank's Africa Action Plan (AAP). It is too early to determine the long-term effectiveness of the AAP, but there is sufficient evidence that results are moving in the right direction. We are particularly pleased with positive country policy performance, a key ingredient for development results. One area highlighted in the AAP where more work should be done is statistical capacity building. Without data, African countries will always be at a disadvantage in policy creation and adaptation, and private sector firms will be less confident in investing.

As we think about a post-2015 Africa, many areas of activity, such as infrastructure, the private sector, and governance deserve significant attention. While we support the IDA-IFC micro, small and medium-size enterprise facility, the AAP needs a greater focus on private sector support and improving financial sector access. It is the financial sector that provides a loan to start an enterprise, grow a business, or buy a house. Access to capital helps people acquire assets that give them a foothold in the economy – personal financial wherewithal they can leverage into greater prosperity and economic security.

Trade

Reducing trade barriers is also essential for providing people opportunities. The best way to alleviate poverty and raise living standards is through greater openness, so more people can benefit from the expanding global economy. The most important driver for poverty reduction has been the rapid growth of developing countries that opened to trade, notably in several Asian economies. For instance, Mexico's poverty rate fell by more than 20% and its rate of extreme poverty fell by more than 30% between 1994 and 2005 – the years following the passage of NAFTA.

We need to continue pushing forward on the trade agenda, including a successful Doha Round of negotiations, to keep all our economies growing. The case for trade liberalization is clear and compelling. And if we want more people to support it, we need to ease anxieties and help more people realize the benefits of trade. The Aid for Trade agenda launched at the Hong Kong Ministerial can help allay these fears.

Fragile States

Fragile states pose a special development challenge because they are frequently unable to sustain any forward momentum on reforms and growth. As such, fragile states do not typically respond to standard development interventions and require a rethinking of donor engagement to ensure positive results. Paramount among these is careful consideration of resource investment. Due to weak governance and weak institutional capacity, the ability of fragile states to absorb and effectively utilize resources is limited. This is particularly relevant given the potentially negative macroeconomic implications of scaling up in low-capacity countries.

Given the challenges posed by fragile states and the limited applicability of standard development tools to their situations, a new framework needs to be developed to assist donor institutions to engage effectively. Key elements of such a framework include: (1) developing a cohesive definition of fragility that focuses on the sources of fragility and not its outcomes; (2) developing and adopting an approach of selective intervention; and (3) developing a high quality and integrated monitoring and evaluation system.

Governance

Finally, we welcome and support the updated version of the World Bank Group's Governance and Anticorruption (GAC) strategy. We applaud the Bank for an extensive public consultation process, which has helped to sharpen the GAC's approach and has opened the door to new partnerships.

We are confident that the strategy will strengthen the Bank's role in helping borrowing countries promote good governance and fight corruption and in playing a leadership role with global partners. We believe the GAC rightly focuses on the most important issues: building effective and accountable institutions; country ownership; and government commitment to governance and anti-corruption. Further, we support the call to help countries address the problem of asset seizure and repatriation and greater disclosure of assets by public officials. The core proposal to revamp the country assistance strategy (CAS) process to systematically address governance issues in country strategies assumes a continuing framework for fighting corruption in a way that applies central principles to country-specific circumstances. Going forward, we would like to see more use of the Public Expenditures and Financial Accountability indicators within the Bank fiduciary diagnostics and their link to the preparation of country assistance strategies.

Conclusion

The challenge of global poverty can be overcome only when the appropriate resources are married to the right policies. The MDGs intentionally set a very high bar, and achieving them will require that we remain focused in our purpose and efficient in our methods. We look forward to working closely with all our partners to achieve our common goal: to create the conditions and opportunities for the world's poor to improve their livelihoods and overcome poverty.

FROM THE OFFICE OF PUBLIC AFFAIRS

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April 16, 2007
HP-353

Treasury International Capital (TIC) Data for February

Washington, DC - Treasury International Capital (TIC) data for February are released today and posted on the U.S. Treasury web site The next release, which will report on data for March, is scheduled for May 15, 2007.

Net foreign purchases of long-term securities were $58.1 billion.

- Net foreign purchases of long-term U.S. securities were $77.9 billion. Of this, net purchases by foreign official institutions were purchases by private foreign investors were $65.3 billion.
- U.S. residents purchased a net $19.8 billion in long-term foreign securities.

Net foreign acquisition of long-term securities, taking into account adjustments, is estimated to have been $43.2 billion.

Foreign holdings of dollar-denominated short-term U.S. securities, including Treasury bills, and other custody liabilities increased $20.8 holdings of Treasury bills increased $5.3 billion.

Banks' own net dollar-denominated liabilities to foreign residents increased $30.4 billion.

Monthly net TIC flows were $94.5 billion. Of this, net foreign private flows were $61.6 billion and net foreign official flows were $32.9 bil

TIC Monthly Reports on Cross-Border Financial Flows

(Billions of dollars, not seasonally adjusted)

		2005	2006	12 Months Through Feb-06	Feb-07	Nov-06	Dec-06
	Foreigners' Acquisitions of Long-term Securities						
1	Gross Purchases of Domestic U.S. Securities	17157.5	21104.2	17713.0	21744.8	1925.6	1849
2	Gross Sales of Domestic U.S. Securities	16145.9	19966.0	16690.6	20603.2	1807.2	1788
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**1011.5**	**1138.2**	**1022.4**	**1141.6**	**118.5**	**61**
4	**Private, net /2**	**891.1**	**941.6**	**896.6**	**958.7**	**112.4**	**37**
5	Treasury Bonds & Notes, net	269.4	128.0	212.3	162.3	32.3	4
6	Gov't Agency Bonds, net	187.6	196.9	205.4	167.3	11.8	12
7	Corporate Bonds, net	353.1	472.2	369.4	490.8	59.1	32
8	Equities, net	81.0	144.5	109.4	138.2	9.2	-11
9	**Official, net /3**	**120.4**	**196.6**	**125.9**	**183.0**	**6.1**	**24**
10	Treasury Bonds & Notes, net	68.7	69.6	69.4	46.4	1.0	6
11	Gov't Agency Bonds, net	31.6	92.6	33.1	100.8	4.0	15

12	Corporate Bonds, net	19.1	28.6	21.7	30.4	3.2	2
13	Equities, net	1.0	5.8	1.7	5.3	-2.1	-0
14	Gross Purchases of Foreign Securities from U.S. Residents	3700.0	5572.2	4016.8	5894.6	536.9	521
15	Gross Sales of Foreign Securities to U.S. Residents	3872.4	5819.4	4193.4	6152.6	571.0	570
16	**Foreign Securities Purchased, net** (line 14 less line 15) /4	**-172.4**	**-247.1**	**-176.6**	**-258.0**	**-34.1**	**-48**
17	Foreign Bonds Purchased, net	-45.1	-139.8	-46.9	-145.0	-14.2	-29
18	Foreign Equities Purchased, net	-127.3	-107.4	-129.7	-113.0	-19.9	-19
19	**Net Long-Term Securities Transactions** (line 3 plus line	**839.1**	**891.1**	**845.8**	**883.6**	**84.4**	**13**
20	**Other Acquisitions of Long-term Securities, net /5**	**-140.0**	**-153.3**	**-150.2**	**-159.5**	**-20.4**	**-13**
21	**Net Foreign Acquisition of Long-Term Securities** (lines 19 and 20):	**699.1**	**737.8**	**695.6**	**724.1**	**64.1**	**6**
22	**Increase in Foreign Holdings of Dollar-denominated Short-U.S. Securities and Other Custody Liabilities: /6**	**-47.6**	**134.4**	**-42.1**	**168.8**	**15.5**	**6**
23	**U.S. Treasury Bills**	**-58.9**	**-9.0**	**-30.3**	**-18.8**	**9.5**	**-4**
24	Private, net	-15.6	16.0	-10.6	14.8	1.8	4
25	Official, net	-43.3	-25.0	-19.8	-33.7	7.7	-9
26	**Other Negotiable Instruments and Selected Other Liabilities: /7**	**11.4**	**143.4**	**-11.8**	**187.6**	**6.0**	**11**
27	Private, net	10.6	163.2	-13.0	192.3	7.1	6
28	Official, net	0.8	-19.8	1.2	-4.6	-1.1	5
29	**Change in Banks' Own Net Dollar-Denominated Liabilities**	**16.4**	**166.6**	**148.0**	**130.0**	**39.5**	**-18**
30	**Monthly Net TIC Flows** (lines 21,22,29) /8	**667.9**	**1038.8**	**801.5**	**1023.0**	**119.0**	**-11**
	of which						
31	Private, net	580.6	897.2	688.2	848.2	108.8	-41
32	Official, net	87.3	141.6	113.3	174.7	10.3	29

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/2 Includes international and regional organizations

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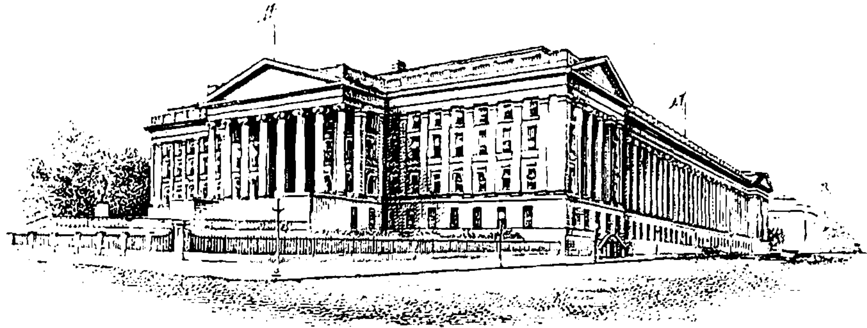
REPORTS

- (PDF) TIC Monthly Reports on Cross-Border Financial Flows (Billions of dollars, not seasonally adjusted)



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 9a.m. (EDT), April 16 2007
CONTACT Ann Marie Hauser, (202) 622-2920

TREASURY INTERNATIONAL CAPITAL DATA FOR FEBRUARY

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PRESS ROOM

April 16, 2007
HP-354

G-7 Deputies Exchanged Views With the Private Sector on Hedge Funds

Washington, DC- In the follow up of G-7 Finance Ministers' discussion in Essen on the role of hedge funds, G-7 Deputies had an exchange of views with hedge fund managers, prime brokers and counterparties at the margins of the spring meeting of the Bretton Woods institutions in Washington DC.

The meeting was co-chaired by the G-7 presidency, State Secretary Thomas Mirow and Under Secretary of the Treasury, Tim Adams.

After hearing a presentation by Under Secretary of the Treasury, Robert Steel, on the "Principles and Guidelines Regarding Private Pools of Capital" of the President's Working Group on Financial Markets, a progress report was given by the chairman of the Financial Stability Forum, Mario Draghi, on the update of the institution's 2000 report on Highly Leveraged Institutions. In addition, the chairman of the "Counterparty Risk Management Policy Group II", E. Gerald Corrigan, briefed participants on the implementation of the group's 2005 report's findings. The discussion with private sector participants focused on best practices on risk management, current hedge fund and private equity regulations and disclosure issues, including a discussion of best practices.

G-7 Deputies agreed to keep the matter under further consideration.

April 16, 2007
2007-4-16-15-28-59-18278

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $66,618 million as of the end of that week, compared to $66,255 million as of the end of the prior week.

I. Official U.S. Reserve Assets (in US millions)						
	April 6, 2007			April 13, 2007		
TOTAL	66,255			66,618		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	12,770	10,672	23,442	12,893	10,678	23,571
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,759	5,201	17,960	12,900	5,204	18,104
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			4,853			4,884
3. Special Drawing Rights (SDRs) [2]			8,959			9,018
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	April 6, 2007			April 13, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	April 6, 2007			April 13, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

April 17, 2007
HP-355

Under Secretary Steel to Discuss Domestic Finance Priorities

U.S. Treasury Under Secretary for Domestic Finance will give luncheon remarks before the Exchequer Club in Washington, D.C. Wednesday. The Under Secretary will discuss Treasury's domestic finance agenda, including capital markets competitiveness, government sponsored enterprise reform and other issues critical to U.S. capital markets, financial institutions and federal finance. The following event is open to credentialed media:

Who
U. S. Treasury Under Secretary for Domestic Finance Robert K. Steel
What
Keynote Address
When
Wednesday, April 18, 12:30 p.m. (EST)
Where
The University Club
1135 16th Street, NW
Washington, DC

April 17, 2007
HP-356

Deputy Secretary Robert M. Kimmitt's Remarks on Japan and the United States: Indispensable Partners, in Asia and Beyond

Thank you, Charlie. It is a pleasure to be with you today, and especially to be hosted by the Maureen and Mike Mansfield Foundation. In the late 1930's, my father, Stan Kimmitt, was majoring in football and minoring in bartending at the University of Montana. Fortunately, he did attend relatively regularly the Asian History course taught by a young professor named Mike Mansfield. That began an almost 60-year relationship between these two Montanans, which included working closely together for over a decade in the Senate. And my father was later a strong supporter of the Mansfield Foundation.

I want to thank Gordon Flake and his entire team for arranging today's event. Since its inception, I have both observed and benefited from the work of the Mansfield Foundation, and during my years in the private sector I had the honor of being a member of the Mansfield Foundation Board. The programs of the foundation are rich and varied, and two in particular are especially beneficial. First, the foundation takes Members of Congress from both sides of the aisle to Asia -- not for quick visits but rather for in-depth conversations on areas of concern in the trans-Pacific relationship. And, second, perhaps the most important program developed by the Foundation is their Mansfield Fellowships. Over the years, the program has helped to strengthen the U.S.-Japan relationship by providing 70 officials from 20 U.S. government agencies with an opportunity to spend a year working in Japanese government offices. I am very pleased that we are joined today by seven Mansfield fellows, two of whom, Chris Winship and Logan Sturm, now serve at the Treasury Department.

My first visit to Japan was in April 1970, when the military transport aircraft on which 200 soldiers and I were passengers stopped at Yokota Air Force Base en route to combat duty in Vietnam. I returned in October 1983 as a passenger on Air Force One, when I accompanied President Reagan during his historic visit to Japan to meet with Prime Minister Nakasone. And I traveled frequently to Japan from 1989 – 1991 when I was Under Secretary of State for Political Affairs, as Japan and the United States worked in especially close cooperation as the Cold War came to an end. To this day, I stay closely in touch with my Japanese colleagues from those years. My teachers, or sensei, have included important Japanese government officials named Owada, Utsumi, Arima, Kuriyama, Murata, Satoh, and, of course, Kato, as well as private sector leaders like Hiroshi Okuda and Jack Murofushi. And I speak today as a friend and admirer of these men and the great country and people they represent and serve.

Over four decades, I have seen the relationship between Japan and the United States change in significant ways, and both the Asia-Pacific region and the world today look very different than they did when I first visited Japan. But one fundamental fact has remained constant: the U.S.-Japan partnership is and will continue to be the strong foundation for a more peaceful and prosperous Asia-Pacific region, and an essential contributor to peace and prosperity in regions far from Asia.

Indispensable Partners: Economic Priorities in the U.S.-Japan Economic Relationship

The indispensable partnership between Japan and the United States is built on

mutual interests and common values. Our security relationship has been rock solid and constant, promoting peace and stability in the East Asian region and beyond. Our economic relationship, on the other hand, has gone through cycles, and this fact is particularly evident to those of us who remember the trade tensions of the 1980s. For today and the future, both security and economic relations must be integral, active, and strong components of our partnership and alliance.

Although bilateral issues remain in our economic relationship, today that relationship is more cooperative and less confrontational than in the past. The economic relationship remains critical to our mutual success and that of the global economy, and we must ensure that the relationship remains vital and active. In order for Japan and the United States to realize the full potential of our partnership, we must set our sights higher. Within our own borders and across the Pacific, we must take steps toward reform in order to reinvigorate our economic relationship and work together to address bilateral and global priorities.

The economic situation in the United States serves as a solid basis for enhanced cooperation. Even though growth has slowed to a more moderate pace, the prospects for the U.S. economy remain good. Our economy continues to perform well, and we expect GDP growth to rebound to 3 percent by the end of this year. Although the residential housing market has been sluggish, it appears to be stabilizing, and continued job creation and wage growth should prevent the housing market from spilling over significantly into consumer spending, which remains strong. And the rest of the economy is in good shape – unemployment is low, manufacturing production is up, and inflation risks appear to be contained.

One of our greatest economic assets is our flexible labor market: it fosters an innovative and productive workforce, motivated by healthy competition and merit-based compensation. Data on labor demand in the United States show that during 2006, hires exceeded separations by the widest margin since the U.S. government began tracking this information in 2000. In fact, 7.8 million jobs have been created in the United States since August 2003 – more jobs during that period than all the other major industrialized countries combined. I might note, since today is Tax Day, that August 2003 is when the economy began to feel the effects of the tax reform signed earlier that year. That reform reduced personal tax rates and cut taxes on capital gains and dividends. To continue the country's solid economic growth, it is important that this tax relief be made permanent.

The role of the United States as an engine of global growth is well-established. Still, the global economy clearly benefits from multiple engines running strongly. The recovery of the Japanese economy, and its continued growth in the future, is of utmost importance in sustaining strong global growth.

Japan is now experiencing the longest economic expansion in its post-war history, thanks in part to the reforms launched by former Prime Minister Koizumi. There are signs that domestic demand -- consumption in particular -- is beginning to serve as a stronger driver of growth. Prime Minister Abe described his economic agenda earlier this year, saying that Japan is seeking to "strongly advance a new growth strategy," with reform goals for the next five years designed to ride the wave of Asian growth and innovation. We welcome Prime Minister Abe's commitment to press forward with economic reform in Japan that seeks to raise productivity growth; create new investment opportunities; stimulate competition; and foster a stronger business climate. The challenge now is specifying and carrying out concrete reform measures that will ensure strong growth for the long term.

In our view, these reforms should include the following areas, which are now being actively discussed in Japan:

1. Japan needs to make it easier for workers to change jobs and re-enter the labor force during their careers. Full and efficient utilization of Japan's labor resources and the ability to shift workers to more productive occupations are critical in light of Japan's demographic challenges and a rapidly changing global economy. As Prime Minister Abe said in his policy speech last fall, Japan should aim to be "a society...where everyone has the opportunity to take on a new challenge." Greater labor force mobility would increase earning potential and raise the employment

security of Japanese workers. Measures that could help create greater flexibility and more second chances include expanding the use of portable, defined-contribution pension plans and more rapid vesting of company-defined benefit pensions.

2. To raise productivity, the government of Japan should encourage competition, the entry of new firms, and the introduction of new technologies and products. We are all familiar with manufactured products in which Japanese technology leads the world. Yet some Japanese industries maintain surprisingly low levels of productivity relative to their foreign counterparts. In many cases, these are industries with extensive regulations on entry, products, and technologies. These regulations have sheltered industries from foreign and domestic competition, even though many of these regulated industries – such as business services, communications, and health care – offer the greatest potential for growth in today's economy. To raise productivity and realize the growth potential of these industries, Japan should implement structural reform and deregulation to remove barriers to competition, new entry, and new product introduction.

3. Both Japan and the United States recognize that efficient capital markets are the lifeblood of a strong economy, and investor confidence and appropriate regulation are necessary to ensure competitiveness in a rapidly changing global economy. The key is striking the right balance between market integrity and entrepreneurship – a balance that must be continually reviewed as markets evolve. In the United States, Secretary Paulson recently hosted a conference to examine issues affecting U.S. capital markets competitiveness. Japan has made progress in advancing financial market reform since the late 1990s and in improving the financial regulatory environment since the creation of the Financial Services Agency. But Tokyo still has a way to go to be competitive with other major financial markets. We welcome the goal of the Abe Administration to have Tokyo take its rightful place as a global financial center.

Greater regulatory transparency and predictability could help encourage financial services providers to introduce new savings and investment products that benefit Japanese consumers. Using regulatory safeguards rather than enforcing specific institutional structures would reduce compliance costs, allow for better risk management by firms, and enhance the ability of financial groups to provide comprehensive services to their clients. Lower costs and improved operations of exchanges would help attract more domestic and foreign listings, providing more choice for domestic and international investors.

4. Reduction of the government's role in financial intermediation is also critical for more efficient and competitive Japanese financial markets. The government of Japan has taken important steps in this regard with its plans to privatize Japan Post and to streamline or privatize a number of other government financial institutions. Since Japan Post operates the world's largest savings and life insurance operations, postal privatization will have an enormous impact on the Japanese economy -- and the manner in which this process unfolds is critical. In making this transition, it is important that Japan establish a level playing field for the privatized postal financial institutions before they introduce new products so that private sector firms from all countries can compete fairly.

The preceding points are not to suggest that only Japan needs to take action. The United States must do its part, especially regarding our low saving rate. Like Japan, we need to reduce our fiscal deficit in light of an aging population. In the United States, we have made substantial progress in cutting the U.S. fiscal deficit -- it has already been cut in half three years ahead of President Bush's 2009 goal. The deficit was 1.9 percent of GDP in 2006 and is expected to come down further this year. The President's 2008 budget envisions further declines in the deficit over the next five years to produce a balanced budget by 2012.

But the recent progress on the budget deficit and efforts to boost private saving will have a limited impact if more is not done to address the long-term growth in spending on entitlement programs: Social Security, Medicare, and Medicaid. Without fundamental reform, entitlement spending as a percent of GDP is set to rise by nearly half from 2010 to 2040, thereby significantly impairing our fiscal

sustainability by crowding out all discretionary spending over the next several decades. Without reform, these programs will also erode our competitiveness by placing massive obligations on the backs of 21st Century American workers and their families.

The Importance of Open Investment and the U.S.-Japan Relationship

As we work to address these important reforms in our economies, our common interests make Japan and the United States natural partners in advancing the fundamental principles of a healthy world economy: free and fair trade; flexible exchange rates set in open, competitive markets based on underlying fundamentals; and the free flow of capital across borders, based on open investment policies. But we must also confront the threat of growing protectionist sentiment and new obstacles to trade and investment. We often discuss protectionism in the context of trade. But since investment flows are many times larger than trade flows, we must also pay close attention to cross-border capital flows and maintaining open investment policies. We must come together to make clear on both sides of the Pacific that we are open to investment and trade, and actively reject the rise of investment protectionism across the Pacific or elsewhere in the world.

The United States greatly benefits from strong foreign direct investment inflows, which have averaged 1.6 percent of GDP over the past decade. Our cumulative stock of foreign investment now exceeds 28 percent of our GDP on a market value basis. That foreign investment translates into high-paying jobs for American workers, while promoting innovation and generating increases in productivity. In the United States, over five million Americans work for companies headquartered overseas. Although these jobs comprise only around five percent of our workforce, they account for 10 percent of our capital investment, 15 percent of our annual research and development, and 20 percent of our exports. And over 30 percent of these jobs are in manufacturing, roughly three times the overall U.S. workforce level in this sector.

Foreign direct investment flows into Japan, by comparison, have averaged just 0.1 percent of GDP over the same period, and the Finance Ministry estimates the stock value of foreign direct investment at just 2.4 percent of GDP. We welcome Prime Minister Abe's pledge to double incoming foreign direct investment by 2010. One tool that would help realize this goal is Japan's implementation of legislation to allow foreign firms to use their own stock as consideration in cross-border mergers and acquisitions, as they can do in the United States and other markets. Continued deregulation and structural reform to remove barriers to entry will also encourage foreign direct investment.

In the United States, we are focused on maintaining our open investment policy while addressing national security concerns, and we believe we are making significant progress in striking that important balance. Even in the wake of controversial cases like CNOOC and Dubai Ports World, the vast majority of foreign investments reviewed by the Committee on Foreign Investment in the United States (CFIUS) continue to be processed expeditiously and without controversy within the initial 30-day review period. In fact, since Dubai Ports World, more than 100 transactions have been reviewed by CFIUS without objection and notified to Congress.

Toshiba's acquisition of the Westinghouse Electric Company and its 6,000 U.S. workers is a good example. This transaction went through the CFIUS process just months after Dubai Ports World. Especially since the case involved U.S. commercial nuclear power, the companies understood the importance of discussing the implications of this transaction on both ends of Pennsylvania Avenue. The companies spent a significant amount of time informing lawmakers about the transaction as soon as it was publicly announced, and the CFIUS review was completed in a first-stage, 30-day investigation period. We are working to ensure that proposed changes to the process for reviewing foreign investments do not create unnecessary and counterproductive barriers to participation in the U.S. market. Let me make my message crystal clear: the United States is open to investment from abroad, and we hope Japan will become more open to investment

as well.

Indispensable Partners: In Asia and Beyond

As both Japan and the United States strengthen the economic foundation of our relationship, we create increased opportunities for partnership around the world. One such opportunity for partnership is the Doha Round. As Secretary Paulson said following this weekend's meeting of G-7 Finance Ministers and Central Bank Governors, we are at a critical juncture for progress on the Doha Round. We believe that trade expansion is one of the most important catalysts for economic growth, and all countries must contribute through real market access commitments in manufacturing, services, and agriculture. Both Japan and the United States would benefit from an agreement, and, in some sectors, Japan has even more to gain from global trade liberalization than the United States.

While both countries will benefit strongly from freer trade in services, one study suggests that global free trade in manufacturing and agriculture would generate annual economic gains of more than $54 billion for Japan, compared to $16 billion for the United States. In spite of these potential benefits, domestic opposition to agricultural reform has prevented Japan from playing a leading role in the Doha Round negotiations and in other international trade liberalization efforts. Japan has taken some steps toward agricultural reform, but its agricultural sector still remains heavily subsidized and highly protected. This imposes a heavy burden on Japanese consumers, who pay much more for food and other basic daily necessities than citizens in other highly-developed economies. Japan's unique conditions on imports of U.S. beef are most prominent, and we continue to discuss ways that we can mutually agree upon scientifically valid and internationally recognized standards.

Even as we push for a successful conclusion of the Doha Round, we are also reviewing existing structures to reduce regulatory burdens in both Japan and the United States – and then converge, harmonize, and mutually recognize the lower level of regulation that remains. The Regulatory Reform Initiative launched by President Bush and Prime Minister Koizumi several years ago has been a good step in this direction, but more can be done. We have a number of other very important dialogues with Japan, and we need to ensure that these dialogues are active and results-oriented.

On global issues of concern to both our countries, such as energy security and climate change, Japan and the United States have taken a number of important steps. We recognize that tackling global climate change will require global solutions that include fast-growing countries such as India and China. This is why we together launched the Asia-Pacific Partnership on Clean Development and Climate with Australia, China, India, and South Korea – countries that represent 50 percent of the world's economy – to speed up the transfer of clean energy technologies. We have also recently made significant efforts to broaden and strengthen the U.S.-Japan nuclear energy partnership in support of global expansion of nuclear energy and specifically in support of a healthy, sustainable, and growing nuclear commercial sector. Japan was also one of the first countries to endorse our Global Nuclear Energy Partnership initiative, and will be the first to sign a joint action plan that supports the safe and secure expansion of nuclear energy in a manner that is commercially sustainable, proliferation resistant, and environmentally sustainable.

As the second-largest donor to the United Nations, the World Bank, and the International Monetary Fund, Japan leads the international community in action through multilateral organizations. The United States and Japan have worked closely together on bold and fundamental reform of the International Monetary Fund, to ensure that IMF governance reflects the changes in the global economy and that the IMF remains relevant in today's international financial system. The IMF Managing Director's decision to revise the 1977 Decision on Exchange Rate Surveillance – a decision welcomed by the G-7 last week – is a very important step in this process.

Japan is also poised starting next year to play a particularly important leadership

role in multilateral organizations -- as the chair of the G-7 and the G-8 in 2008, and as the host of APEC in 2010. When I first starting working on these issues, there was a G-5. Subsequently, it expanded to a G-7, then to a G-8, and now we also have important institutions like APEC and the G-20, which provide excellent forums for us to reach out to increasingly influential countries with strong emerging economies – Brazil, Russia, India, and particularly, China.

As leaders in the global economy, both Japan and the United States have recently intensified the dialogue with China. Premier Wen Jiabao was in Tokyo last week, reciprocating Prime Minister Abe's visit immediately after he took office. And next month multiple Chinese ministers in a delegation led by Vice Premier Wu Yi will visit Washington for the second meeting of the new U.S.-China Strategic Economic Dialogue. It is in both our interests for bilateral relations with China to improve, for the benefit of both Asia and the rest of the world. But these initiatives with China proceed with a clear understanding that Japan and the United States are and will remain indispensable partners in Asia and throughout the world. And we must invest as much energy and initiative in the U.S.-Japan relationship as each of us will invest in our growing relationships with China.

Foreign Minister Aso has described his government's international efforts by saying that the Japanese are now "viewed as people who will stand alongside and undertake efforts hand-in-hand..." Japan continues to work hand-in-hand with countries such as Afghanistan – where it has contributed more than $1.45 billion since 2002 to enhance domestic security and promote economic development. This assistance has helped to build roads and airports, bolster health and education services, and implement the disarmament and demobilization of combatants.

In Iraq, Japan's C-130s provide vital airlift missions, and when Prime Minister Abe met last week in Tokyo with Prime Minister Maliki, he committed to extend the airlift activities by two years. Japan also continues to be an active partner in the reconstruction effort in Iraq, providing assistance to Iraqis on essential infrastructure such as water purification and electricity generation. Since 2003, Japan has pledged a total of $5 billion to Iraq, and this financial assistance will help Iraq to establish an economic foundation built upon good governance, the rule of law, a solid budgetary framework, and strong, credible institutions. We expect that Japan will be represented at the ministerial level at next week's launch in Sharm El Sheikh of the International Compact with Iraq, and that Japan will join us in making a significant new pledge of support for Iraq.

Japan has also joined forces with the international community in the fight against terrorist and proliferation financing. At the United Nations, we have worked together to pass critical resolutions to cut off the flow of illicit finance to weapons proliferators. Not only did Japan push for tough measures in UN Security Council Resolutions 1695 and 1718 on North Korea's proliferation network, the government followed through on its diplomatic commitments by implementing targeted financial sanctions. Japan is now in a unique position to exercise the same kind of leadership in the fight against Iranian proliferation activities. Iranian state-owned Bank Sepah, now designated under UN Security Council Resolution 1747, has facilitated business between North Korea's chief ballistic missile-related exporter, KOMID, and Iran's Aerospace Industries Organization, which we have designated under U.S. authorities.

Japan can again demonstrate its global leadership by taking swift action to implement UN Security Council Resolution 1747, which obligates states to freeze the assets of entities and individuals associated with Iran's nuclear and missile programs.

In the United States, we have worked hard, particularly since 9-11, to put into place the legal authorities and operational capacity to allow us to take prompt action both to respond to threats to our financial system and also to implement quickly UN Security Council resolutions and other international obligations. To help prevent the flow of illicit finance to terrorists and proliferators, Japan should ensure that it, too, can take action to freeze assets related to terrorism, proliferation, and other illicit activities. Japan should also improve its efforts to investigate and prosecute financial crimes-related offenses when its institutions knowingly launder money.

We cannot allow terrorists and proliferators to gain any advantage because of a failure to enact laws and procedures that target illicit finance, the lifeblood of their dangerous activities.

Ladies and gentlemen, let me close by reiterating that our common values, convergent interests, and combined weight in the global economy make Japan and the United States indispensable partners for good in Asia and beyond. But our security and economic relationship is one that requires careful tending, active management, and continuous renewal. An important milestone in this ongoing effort will take place next week when President Bush and Prime Minister Abe meet in Washington. But all of us – both in government and the private sector – must complement the work of our leaders by doing our part to broaden and deepen this partnership, to the benefit of our two countries, the region, and the rest of the world.

Thank you for your attention.

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April 17, 2007
HP-357

Secretary Paulson to Speak at Committee of 100 16th Annual Conference in New York

Treasury Secretary Henry M. Paulson, Jr. will deliver remarks at the Committee of 100's 16th Annual Conference in New York City Friday. Secretary Paulson's remarks will focus on the importance of the U.S.-China economic relationship and both countries' efforts to strengthen that relationship through the U.S.-China Strategic Economic Dialogue (SED). The second meeting of the SED will occur in Washington next month.

When
Friday, April 20, 12:00 p.m. EDT

Where
Waldorf Astoria
Grand Ballroom
301 Park Avenue
New York, NY

Note
Media must RSVP by filling out the attached form and emailing it to ping_an@committee100.org or faxing it to (212) 371-9009. For more information contact An Ping at (212) 371-6565.

REPORTS

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For more information, contact Ms. An Ping, Director of Public Relations, at 212-371-6565 or ping_an@committee100.org.

Thursday, April 19,2007

___ noon-2:00pm Luncheon Keynote #1: Henry R. Kravis
___ 2:15-3:30pm Panel: On the Ground: Doing Business in China
___ 3:45-5:00pm Panel: Investing in China: Opportunities and Risks

Friday, April 20, 2007

___ 8:00-9:00am Breakfast Keynote #2: William R. Rhodes
___ 9:00-10:15am Panel: Attracting the Best and Brightest in China
___ 10:30-11:45am Panel: The Changing Face of China's Consumers
___ noon-2:00pm Luncheon Keynote #3: Henry M. Paulson, Jr.
___ 2:10-3:45pm Panel: China & Energy – Working Toward Common Solutions
___ 3:50-5:00 Panel: China Going Green?
___ 7:45-9:30 Awards Program (limited seating offered to journalists)

Saturday, April 21, 2007

___9:00-10:15am Panel: Just One Click – New Media in China
___10:30-11:30am Panel: Technology and Partnership – NVIDIA and TSMC

11:45-1:15pm	Luncheon Conversation: Personal Journey with Steve Chen, Co-Founder & Chief Technology Officer of YouTube

PRESS ROOM

April 17, 2007
HP-358

Treasury Hosts State, Local Governments to Discuss US Financial Education

Washington, DC- The Treasury Department today hosted the first meeting of the National Financial Education Network, a coalition of federal, state and local governments working to improve financial education at the local and regional level.

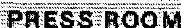
"All of us in government are in the business of helping people achieve their life goals. When we equip those we serve with financial knowledge we enable them to do just that," said Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr., who led the meeting.

"We also try to help them protect themselves from financial products and services that may not be in their best interests," Iannicola continued. "This is why financial literacy matters. By launching this national network of federal, state and local governments we hope to pool our efforts to help Americans learn more about their money and improve their own lives."

The conference was part of the continuing implementation of the Financial Literacy and Education Commission's National Strategy for Financial Literacy. The meeting served as a venue for sharing financial education programs, ideas, and resources so that governments and local organizations may better help the constituents of their state, region, or locality.

State and local governments that participated in today's conference included representatives from Alabama, Pennsylvania, New York City, New York state, New Jersey, Florida, Texas, Oregon, Maryland, Kansas, Tennessee, Illinois, Delaware, Washington state, Virginia and Wisconsin. Non-profit organizations attending included the National League of Cities, National Association of Government Defined Contribution Administrators, the United States Conference of Mayors, National Association of Insurance Commissioners, North American Securities Administrators Association and the National Association of Attorneys General.

The Financial Literacy and Education Commission, headed by the Treasury and comprised of 20 federal agencies, released its strategy report in 2006. The report is a blueprint for improving Americans' understanding of issues like homeownership, credit management, and retirement savings and can be found at www.mymoney.gov.



April 18, 2007
hp-359

Testimony of Treasury Secretary Henry M. Paulson, Jr. Before the Senate Finance Committee On Ways to Reduce the Tax Gap

Chairman Baucus, Senator Grassley, Members of the Committee, thank you for considering this important topic and for inviting me to speak about it. It is very appropriate that we have this conversation the day after tax day. Over the last few months, millions of Americans have collected their W-2's, their 1099's, their home mortgage interest statements, and countless other pieces of paper to fill out their tax returns. This is an annual ritual for Americans, completed without great enthusiasm, but with remarkable honesty and effort. The vast majority of Americans pay their taxes without additional prodding by the IRS, out of a sense of fairness and civic duty. They understand the importance of paying what they owe, and they know that when people fail to pay their taxes, it serves as a de facto tax increase on everyone else.

While the current compliance rate is high, it can and should be improved. Our objective must be to increase tax compliance without over-burdening the tens of millions of taxpayers who already pay their taxes honestly and on time.

The amount of taxes that are owed but not paid is commonly referred to as the tax gap. An important part of addressing the tax gap is to understand not only the types of taxpayers – individuals, small businesses, corporations – that don't comply, but also why these taxpayers fail to comply. Answering these questions will help us improve taxpayer service and better target our enforcement efforts.

In September of last year, we released a comprehensive seven-point strategy to address the tax gap. The budget we put forward for 2008 is critical to implementing that strategy. It requests new funding for taxpayer services, research, improved technology, and targeted enforcement. We ask for your help in working with the Appropriations Committee to make sure the IRS has the resources it needs to improve compliance while maintaining its commitment to taxpayer service.

The budget also includes 16 legislative proposals that, if enacted, will help to narrow the tax gap without imposing excessive burdens on compliant taxpayers. Since I last appeared before this committee, my staff has been meeting with your staff on a regular basis to review the 16 legislative proposals. Treasury's Assistant Secretary for Tax Policy, Eric Solomon, and IRS Commissioner Mark Everson are here with me today to provide more detail about these proposals and the IRS's budget request.

Our legislative proposals attempt to balance the burden they impose on taxpayers against the impact they will have on improving compliance. Even so, some of the proposals have generated concern from those who could be affected by them. We must consider the impact of any new rules on the vast majority of Americans who already pay what they owe, and better target our enforcement efforts to minimize additional burdens.

Since I last testified before you, Treasury has explored ways to improve compliance. We held a public discussion a few weeks ago, and heard from a broad cross-section of stakeholders, including a former IRS Commissioner, tax preparers, and business representatives. Several insights emerged: first, we need to know more about the specific sources and causes of the tax gap so we can focus our efforts more precisely; second, great care must be given to ensure that those efforts

do not impose unreasonable burdens on already compliant taxpayers; third, simplification of the tax code, as well as taxpayer education and services, would help improve compliance; and fourth, we need to manage expectations, recognizing that every potential solution carries consequences.

I know you have spent a great deal of time exploring this issue. And since I came to Washington, I have taken a hard look as well. The most recent data we have on the tax gap comes from 2001. It indicates that the vast majority of the tax gap was attributable to underreporting of income. Most of the underreporting is attributable to individuals with business income and corresponding self-employment tax liabilities. This includes small businesses, farms, and ranches. It's unclear whether this underreporting is the result of deliberate deception or a simple misunderstanding of what needs to be reported and how to do it.

To substantially improve compliance in this regard, Congress would have to mandate additional requirements, which would affect not only those who don't report all of their income, but also those who already do. I have come to the conclusion that there is a big part of the tax gap we simply won't be able to reach without adding draconian and painful requirements on all taxpayers. And I don't believe any of us really want to do that. We must remember that the tax gap is simply not a pot of gold that we can dip into every time we want to pay for a new or expanded program. Nor should it be viewed as an easy solution to existing challenges, such as the alternative minimum tax.

As you know, narrowing the tax gap is about improving compliance. It is not about changing the baseline to raise more revenue. The budget resolution passed by the Senate assumes revenue collections are raised by hundreds of billions of dollars. Some believe this level of revenue can be achieved largely through measures to reduce the tax gap. I believe it is unrealistic to assume that reducing the tax gap will yield that level of additional revenue.

In developing our 16 proposals, we focused on changes that would narrow the tax gap with minimal additional burdens. Some have suggested that far more expansive proposals should be put forward. Most of these proposals would require steps that I would not recommend because they are bad tax policy and would be unnecessarily painful, expensive, and time-consuming for taxpayers – for example, requiring individuals to file 1099's reporting their transactions with service providers, such as their doctor, auto mechanic, and dry cleaner; eliminating cash transactions in favor of electronic transactions, with card issuers and banks providing statements to the IRS so the payments can be matched with a business's reported income; or doubling or tripling the number of IRS agents and audits. In theory, each of these measures could bring in some additional revenue, but the cost of compliance for individuals and businesses – most of whom already pay what they owe – would far outweigh the gains. In many cases, such measures would also raise privacy concerns due to the government's heavier focus on the daily transactions in each of our lives.

I hope we can all agree that such extreme measures are not the approach we should take. Instead, as a strong first step toward narrowing the tax gap, I hope you will work with us to approve the additional IRS funding and enact the legislative proposals the President has requested. I am pleased that Congress has recently taken up a number of these proposals. By capitalizing on the direct and indirect effects of IRS enforcement, and by making focused legislative changes, I am confident we can make measurable progress toward reducing the tax gap without adversely affecting already compliant taxpayers.

We should also look for ways to reduce the complexity of the U.S. tax code. Making the tax code simpler and fairer for the average American could help to improve compliance by reducing the number of honest mistakes, removing incentives for cheating, and providing fewer places for tax cheats to hide.

It is critical that we manage expectations and view efforts to reduce the tax gap over the long-term and with a clear understanding of both the costs and the benefits of any action. Making significant progress will require a sustained, focused effort by the Administration, Congress, and the American people. Honest American

taxpayers are our allies in this effort, and we must always put their interests first.

Thank you, and I now welcome your questions.

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April 18, 2007
HP-360

**Testimony of Treasury Assistant Secretary For Tax Policy
Eric Solomon
Before the Senate Finance Committee on
Ways to Reduce the Tax Gap**

Mr. Chairman, Ranking Member Grassley, and distinguished Members of the Committee, thank you for the opportunity to discuss our strategy to reduce the tax gap, including the legislative proposals included in the President's Fiscal Year (FY) 2008 Budget request to Congress.

The vast majority of Americans pay their taxes voluntarily and on time. The voluntary compliance rate is approximately 85 percent. Nonetheless, there remains a substantial difference between what taxpayers should pay and what they actually pay. The IRS estimates that the tax gap was $290 billion in 2001, after accounting for late payments and enforcement activities. Each year, compliant taxpayers are required to make up for this shortfall.

The Administration is committed to reducing the tax gap without unduly burdening honest taxpayers who currently meet their tax obligations. In September 2006, the Office of Tax Policy released a comprehensive strategy (the Treasury Strategy) to reduce the tax gap. This strategy forms the basis for our legislative and IRS appropriation proposals in the FY 2008 Budget, while also emphasizing that any strategy must take into account additional components such as a commitment to research, improvements to information technology, and strengthening taxpayer service.

Magnitude and Source of Tax Gap

In recent months, there has been a significant level of discussion about the tax gap. Much of this discussion has focused on the IRS's release last February of estimates of the tax gap in 2001. These estimates included the results from the 2001 National Research Program (NRP), which examined compliance with the individual income and self-employment (SECA) taxes. The estimates of compliance with other types of taxes were projections derived from older studies.

Before focusing on our proposals, it is important to differentiate between the gross tax gap and the net tax gap. The "gross tax gap" is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time. The IRS estimates that the gross tax gap was $345 billion in tax year 2001, resulting in a voluntary compliance rate of 83.7 percent. This estimate, however, does not take into account taxes that were paid voluntarily but late, or recoveries from IRS enforcement activities. Taking these factors into account, the "net tax gap" was an estimated $290 billion in tax year 2001, which represents a net compliance rate of 86.3 percent. Thus, $55 billion of the gross tax gap for 2001 is in the government coffers.

These compliance rates are consistent with historical patterns. IRS estimates of voluntary compliance rates have ranged between 80 and 85 percent for over two decades, although research limitations generally prevent us from measuring fluctuations during this time period. The tax gap is not a new problem, and it will not be eliminated overnight.

The tax gap results from a variety of errors, including non-filing, underreporting of

taxes, or underpayment of taxes. It is estimated that over 80 percent of the gross tax gap is attributable to underreporting of tax (including underreported income or overstated deductions and credits). Over 40 percent of the gross tax gap is attributable to underreporting of net business income by individuals (affecting both individual income and self-employment taxes).

Noncompliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements. For 2001, it was estimated that 54 percent of net income from proprietors (including businesses, farms, and ranches), rents and royalties was misreported. In contrast, only one percent of tax due on wage income, which is reported by employers and subject to withholding, was not reported to the IRS by return filers in 2001.

IRS data do not reveal the extent to which the tax gap results from intentional evasion rather than unintentional errors by well-meaning taxpayers who are confused by the increasing complexity of the tax law. Determining taxpayer intent during a regular examination is very difficult. For obvious reasons, taxpayers do not concede that their erroneous reporting is intentional, and any analysis of the nature of the error by IRS examiners is inherently subjective. Moreover, complexity provides those taxpayers who are predisposed to taking aggressive positions the opportunity to argue that their errors were unintentional.

It is safe to assume that both intentional and unintentional errors contribute to the tax gap and that any strategy to reduce the gap must address both intentional evasion as well as taxpayer confusion due to the complexity of the tax code.

Treasury's Tax Gap Strategy

These findings suggest the need for a targeted response designed to address the most significant sources of noncompliance. Four key principles have guided the development of our tax gap strategy:

- Unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Sources of noncompliance should be targeted with specificity.
- Enforcement should be combined with a commitment to taxpayer service
- Tax policy and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

These principles point to the need for a comprehensive, integrated, multi-year strategy to improve tax compliance. Components of this strategy must include: (1) legislative proposals to reduce opportunities for evasion; (2) a multi-year commitment to compliance research; (3) continued improvements in information technology; (4) improvements in IRS compliance activities; (5) enhancements of taxpayer service; (6) simplification of the tax law; and (7) coordination between the government and its partners and stakeholders.

Since release of the Treasury Strategy last September, the Administration has taken a number of steps to implement each of its seven components. The FY 2008 Budget requests $409.5 million in new funding for initiatives aimed at reducing the tax gap. These initiatives include additional compliance research, investments in information technology, enhancements of front-line enforcement activities, and improvements in taxpayer service aimed at increasing voluntary compliance. The Budget also includes 16 legislative proposals designed to reduce opportunities for evasion. In addition, the FY 2008 Budget contains legislative proposals to simplify the tax treatment of families and savings incentives which, if enacted, would help to eliminate some of the complexity that gives rise to unintentional noncompliance.

We have also been working with our partners and stakeholders to develop and refine our tax gap strategy. Commissioner Everson and I held a public roundtable at the IRS last month to discuss ways to address the tax gap. Panelists at the roundtable included a former IRS Commissioner and a former Assistant Secretary for Tax Policy, researchers, and members of organizations representing businesses

and preparers. In addition, we have been meeting regularly with Finance Committee staff to discuss and refine our legislative proposals to reduce the tax gap.

Legislative Proposals

As outlined above, development of legislative proposals to reduce opportunities for evasion is one element of our broader strategy to increase taxpayer compliance, improve tax collection, and reduce the tax gap. As presented in the FY 2008 Budget, our compliance legislative proposals fall into four categories: (1) expand information reporting; (2) improve compliance by businesses; (3) strengthen tax administration; and (4) expand penalties. On the front end, the legislative proposals would help to apprise the IRS of the payment of income through third-party information reporting, one of the most effective tools in improving compliance. On the back end, the legislative proposals would increase incentives to comply with existing law through strengthened penalties. The package of legislative proposals includes targeted provisions that, if enacted, would assist the IRS in enforcing the tax law more efficiently and effectively in targeted areas that present risks of noncompliance.

The legislative proposals are designed to reduce the tax gap, not to raise revenue through a change in the baseline against which compliance is measured. In addition, the legislative proposals attempt to reduce the tax gap by making compliance more efficient while balancing the burden placed on compliant taxpayers. If, on the other hand, draconian measures were to be enacted, they could become so burdensome as to detract from voluntary compliance, compounding rather than reducing the tax gap.

Although the legislative proposals set forth an approach toward improved tax compliance, we recognize that they do not come close to eliminating the tax gap. Making collection of the entire tax gap a reality, however, would require universal audits followed by draconian collection practices, imposing prohibitive costs and burdens on taxpayers as well as the IRS, and fundamentally changing the relationship between taxpayers and the government. Through the multi-pronged approach set forth in the Treasury Strategy, however, we can make significant progress in improving compliance.

In addition to the sixteen legislative proposals, the FY 2008 Budget indicates that the Treasury is continuing to develop proposals to improve compliance and reduce the tax gap. In particular, the Budget mentioned that IRS coordination with State governments could be improved. Under current law, State tax agencies may adjust taxpayer returns in response to an IRS audit. A proposal under development would permit reciprocal adjustments by the IRS in response to a State audit determination. This proposal raises technical issues relating to the assessment limitations period that we are currently working to resolve. Another aspect of Federal-State tax coordination could involve expanded information sharing. In particular, State governments maintain databases in connection with numerous licenses issued pursuant to State law, such as driver's and professional licenses. In some cases, States may suspend certain licensing privileges in connection with State tax noncompliance. Access to such State data could assist the IRS in improving Federal tax compliance. The Treasury Department continues to consider the advantages and disadvantages of these additional proposals to improve tax compliance.

Technical Issues

The President's FY 2008 Budget recommends sixteen changes to the tax code that, if enacted, would improve compliance and reduce the tax gap. Since the Budget was released in early February, members of my staff and I have been meeting regularly with Finance Committee staff to discuss and refine the Administration's proposals and to address a number of technical issues that they present. Those discussions have been useful both in improving the proposals and in helping to highlight the challenges that we face in reducing the tax gap through targeted changes to the tax law. A brief description of some of the technical issues arising under several of the legislative proposals will help to frame the issue and illustrate

the limitations of legislative solutions to this problem.

Basis Reporting. One of the Budget proposals would require that brokerage firms report to their customers basis information in connection with the sale of certain publicly traded securities. This proposal builds on section 6045 of the Code, which requires reporting of gross sale proceeds, which must be combined with basis information to determine the tax treatment of the sale. The proposal also builds on a growing trend in the securities industry to provide basis information voluntarily to customers.

The basis-reporting proposal raises a number of technical issues that are derived from the complex treatment of securities sales under our tax laws. Those issues include, for example: (1) defining the universe of "securities" subject to basis reporting; (2) putting mechanisms in place to ensure that brokers subject to the proposal have relevant basis information from both their customers and from issuers of securities; (3) determining basis for so-called "transferred-in" securities that were not purchased through the broker, including securities purchased separately and transferred into a brokerage account, gifts and inheritances; (4) addressing the interaction of the proposal with taxpayer-specific basis adjustment provisions that operate independently of the broker, such as the wash-sale rules in section 1091, the straddle rules in section 1092, and rules requiring capitalization of certain interest and carrying costs under section 263(g); and (5) determining an appropriate effective date to ensures a smooth transition to the new basis reporting regime.

Payment Card Reporting. Technical issues presented by the Budget proposal regarding information reporting on merchant payment card reimbursements also highlight the challenges of our work in this area. Proprietors, merchants, and other business taxpayers frequently receive income through their customers' use of credit or debit cards. While the use of such payment cards creates a paper trail, that trail does not lead to the IRS, unless a revenue agent were to seek it on a case-by-case basis. At the same time, that existing paper trail would make it relatively easy to generate information reports to the IRS, systematically addressing the possibility of unreported income. Because the existing payment-card system routinely delivers exact dollar and cents amounts to the correct payees, often at the speed of electronic dispatch, it is certain that the information that the IRS needs is accessible. Information reports regarding payment-card reimbursements would result in better compliance by merchants who accept these cards.

Nevertheless, there are numerous technical issues to be addressed. The payment-card system is complex, involving payment-card organizations, merchant acquiring banks, various service providers, and other entities. In the case of a payment card branded with the name of a particular retail chain, the bank may reimburse the retail chain, which in turn may reimburse a franchise proprietor. In this situation, who should obtain the merchant's Taxpayer Identification Number and generate an information report? We have met with representatives of the payment card industry to understand their concerns with the proposal. Many in this industry are concerned with the incremental burden of reporting, including potential duplication of reporting responsibilities, and have requested greater clarity regarding the party responsible for the reporting when there are other agents involved as intermediaries between the banks and the merchants. Others are concerned about how the IRS will use the data. We recognize these concerns and, while the gross reimbursements reported would not be an equivalent to gross income, the proposed information reporting would assist the IRS by providing the merchant's overall volume of payment card sales in relation to expenses claimed and cash transactions reported. The reporting would also assist the IRS in analyzing the accuracy of reporting for payment card sales.

There are also other technical issues presented by the proposal, such as treatment of "charge backs," in which a merchant is debited for the amount that a credit-card company refunded to a consumer attributable to a defective item, as well as payment-card transactions in which a merchant may sell some goods but also provide "cash back" to consumers. The Budget proposal would grant explicit authority to promulgate administrative rules that address such technical complications, by eliminating duplication of reporting requirements and creating

exceptions to reporting of amounts that are not useful for compliance purposes.

Erroneous Refund Penalty. Another legislative proposal raising some technical questions is the erroneous refund penalty. Under current law, the accuracy-related penalty that a taxpayer might pay generally would depend on the amount of underpayment of tax. If a taxpayer wrongfully claims a refund, however, there may be no penalty as long as no additional tax liability is attributable to the wrongful claim, as often happens when there has been overwithholding. Consequently, the IRS has observed aggressive behavior that is undeterred by the tax code's current accuracy-related penalty framework, which is geared toward deterrence of reported tax deficiencies. As a practical matter, some taxpayers and their advisors may be taking advantage of the existing penalty structure by aggressively claiming credits that generate refunds, in an effectively risk-free gamble. To address this problem, our proposal would impose a penalty on an unreasonable claim for refund or credit.

The proposal seeks to create a parallel system of deterrence applicable even if the taxpayer is in a refund, rather than a deficiency, procedural posture, thus stemming the tide of aggressive claims that are made without reasonable basis or reasonable cause, regardless of the procedural context. There remain open questions about the scope of this proposal. In addition to refunds, should the proposal cover erroneous claims that purport to reduce tax liability? Should there be a threshold amount below which the proposed penalty would not apply? If a taxpayer were subject to penalties in addition to the proposed penalty, in which stacking order should the multiple penalties apply? Should the proposed penalty apply to excise or other types of taxes in addition to income taxes? The goal of the Treasury proposal would be to assert the highest applicable penalty, without duplication of penalties. In this regard, the Treasury proposal's creation of the new penalty would carve out Earned Income Tax Credit (EITC) refund claims from the scope of the penalty because these claims are already governed by their own compliance regime.

Prison Scam Disclosure Authorization. The Treasury Department's proposal for disclosure of certain tax violations by Federal and State prisoners would allow the IRS to disclose limited information about such violations so that prison officials could deter such conduct through administrative sanctions. Under existing law, when the IRS discovers that prison inmates are making fraudulent refund claims, taxpayer privacy laws do not permit the IRS to share this information with prison officials, who may be most proximately positioned to address this misconduct. While cooperation among law enforcement officials would appear to be reasonable, numerous technical questions have arisen. What information should be disclosed? When would be the proper time for disclosure, during or after an investigation? To whom should a disclosure be made, Federal officials, State employees, or local wardens? What limitations should be imposed on further use of the IRS information? Does the proposal properly preserve prisoner rights?

Collection Due Process. Similar questions may arise regarding the Treasury Department's proposal to amend the Collection Due Process (CDP) procedures as they apply to employment taxes. Employment taxes include employer and employee shares of Federal Insurance Contribution Act (FICA) tax as well as Federal Unemployment Tax Act amounts and income tax withheld from employee wages. Employee FICA shares and withheld income tax constitute the largest portion of employment taxes. These taxes are often referred to as "trust fund" taxes, because employers are supposed to hold them in trust for the government after they are withheld from employee wages. These amounts include Social Security Trust Fund taxes credited to employees, whether or not actually paid to the Treasury.

Unpaid employment tax liabilities are some of the most difficult taxes for the IRS to collect. In some cases, an employer may be able to retain employees and stay in business by paying only net wages, even if he or she cannot pay employment tax. Employment taxes are due quarterly and, when there are successive failures to pay quarterly employment tax installments, they continue to accrual over successive periods resulting in a "pyramid" of liability. In a case like this, employment taxes often pile up while the IRS attempts to collect, ultimately by imposing a levy. Under the CDP provisions in the Code, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative hearing, with judicial review, before

levy. In the employment tax context, an opportunity for a CDP hearing must be provided for every quarter that there are unpaid taxes the IRS seeks to collect. By the time this CDP procedure is completed, the employment taxes may have become uncollectible, even if determined to be due by the end of the review.

The Treasury Department's proposal would add employment taxes to the exception that allows a CDP hearing to be held within a reasonable time after, rather than before levy. While collection of employment taxes would be in the best interest of employees and the Federal Trust Fund, there nevertheless may be concerns that amendment to the CDP provision might abridge taxpayer rights. On the other hand, the opportunities available to the taxpayer who in good faith seeks to address an unpaid employment tax balance prior to levy and the urgency of the pyramiding problem are factors that support the adoption of the proposal. To be clear, under the proposal, employment tax returns showing a balance due would not be subject to levy until after the IRS has made several attempts to correspond with the taxpayer regarding the balance due a process whereby taxpayers have several opportunities to contact the IRS and enter into a voluntary payment arrangement prior to enforced collection. Those taxpayers who fail to address payment would be subject to a levy, and would have the opportunity for a post-levy CDP hearing.

We are pleased that a number of the Budget proposals have been introduced and considered in different legislative vehicles this year. We look forward to working with the Committee to address the technical issues so these proposals can achieve their intended purposes.

Regulatory Projects and Other Initiatives

The Treasury Strategy identified our published guidance program as an important component of the multi-pronged strategy to improve compliance. Published guidance clarifies ambiguous areas of the law, increasing voluntary compliance. With the increasing complexity of the tax law, it is more important than ever for us to publish timely guidance to give direction to those taxpayers who make a good faith effort to comply with the law, but have difficulty doing so because of uncertainty in its application. Published guidance is also an important tool to target specific areas of noncompliance and prevent abusive behavior.

Each year, the Treasury Department and the IRS publish a Priority Guidance Plan. The 2006-2007 plan includes 264 guidance projects scheduled for completion between July 2006 and June 2007. Numerous projects are added during the year as new tax laws are enacted or new compliance issues are identified.

Recent published guidance projects that will improve compliance and that target potential areas of abuse include:

Transfer Pricing: We have produced, and continue to produce, significant guidance in the area of transfer pricing. In an increasingly globalized economy, cross-border transactions between controlled entities present significant compliance challenges, making guidance in the transfer pricing area an important part of our administrative efforts to address the tax gap. In August 2006, we issued temporary and final regulations addressing the treatment of cross-border services, and followed them up with additional guidance in December 2006. We issued proposed transfer pricing regulations addressing cost-sharing in August 2005. We intend to finalize both sets of regulations, with appropriate modifications.

Foreign Tax Credit: We have taken strong steps to halt misuse of the foreign tax credit. Last month we issued proposed regulations that would disallow foreign tax credits tied to participation in certain artificially engineered, highly structured transactions. In August 2006, we issued proposed regulations that would address the inappropriate separation of creditable foreign taxes from foreign source income. We intend to make appropriate modifications and finalize both sets of regulations as soon as possible.

Information Sharing: We continue to update and expand our network of tax treaties and tax information exchange agreements ("TIEAs"). We are also renegotiating tax

treaties that do not have sufficient limitation on benefits or exchange of information provisions. We are entering into new TIEAs, such as the one signed with Brazil in March 2007, and bringing signed TIEAs into force, with jurisdictions such as the Netherlands Antilles, the British Virgin Islands, and the Cayman Islands. These information-sharing agreements are critical tools for the IRS to combat cross-boarder aspects of compliance.

Private Annuities: In October 2006, we published proposed regulations regarding the Federal tax treatment of private annuity contracts. Recent Congressional hearings have highlighted how taxpayers were applying prior law treatment of these contracts to facilitate abusive private annuity arrangements, often involving off shore issuers. The proposed regulations, when adopted as final, will shut down those arrangements.

Trust Information Reporting: In 2006, we published a series of regulations that provide a comprehensive set of information reporting rules for grantor trusts where ownership interests in those trusts are held indirectly. Historically, taxpayers who held such interests were often unable to comply fully with their tax obligations because they lacked necessary information about the activities of the trust. This project highlights work that can be done administratively to ensure that taxpayers who make every effort to meet their obligations have the information they need to determine and report their liability accurately.

Reportable Transaction Rules: In the American Jobs Creation Act, Congress enacted a number of changes to the statutory rules requiring disclosure to the IRS of potentially abusive transactions, strengthening the IRS' hand in this area. In October 2006, we published proposed regulations that follow prior interim guidance and, when adopted as final, will build on the expanded statutory provisions to ensure that the IRS knows about and is able to react quickly to, emerging problematic transactions.

Conclusion

An effective approach to dealing with the tax gap requires multiple, interrelated strategies. I have discussed the work that the Treasury Department is doing with regard to the legislative and regulatory components of the Treasury Strategy. Each of the multiple components of the strategy is necessary, but none is sufficient in isolation. We look forward to continuing our work with this Committee and others in Congress to implement our strategy and looking for new ways to reduce the tax gap.

Thank you again, Mr. Chairman, Ranking Member Grassley, and other Members of the Committee for the opportunity to appear before you today. I would be pleased to answer any questions you may have.

April 18, 2007
HP-361

Joint Testimony
Daniel Glaser, Deputy Assistant Secretary for Terrorist Financing and Financial Crimes
Adam J. Szubin, Director of the Office of Foreign Assets Control

Before
The Foreign Affairs Subcommittee on Terrorism, Nonproliferation, and Trade
The Financial Services Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

U.S. House of Representatives
Isolating Proliferators and Sponsors of Terror: The Use of Sanctions and the International Financial System to Change Regime Behavior

Chairmen Sherman and Gutierrez, Ranking Members Mr. Paul and Mr. Royce, and distinguished members of the Subcommittees, thank you for this opportunity to discuss the use of sanctions and other financial tools as a means of combating proliferation and terrorism – two of the most deadly threats of our time.

The United States has marshaled its full range of powers to stop the proliferation of weapons of mass destruction and to isolate and undermine terrorist groups. As the past few years have demonstrated, sanctions and other financial measures administered by the Treasury Department can play a meaningful role in isolating and pressuring national security threats, when applied in an aggressive and targeted manner. Sanctions can have a powerful impact but they are not a silver bullet and cannot be pursued in isolation. These measures work best when applied in concert with the diplomatic, intelligence, law enforcement, export, and military measures that our colleagues across the government are pursuing in such a dedicated manner.

Our testimony today will focus on the use and impact of financial measures, particularly in countering the threats posed by Iran and North Korea. We thank both of the Committees present for your strong leadership in confronting these threats and safeguarding our national security.

I. The Office of Terrorism and Financial Intelligence

Congress established the Office of Terrorism and Financial Intelligence (TFI) following the September 11, 2001 terrorist attacks, to marshal the Treasury Department's unique regulatory, enforcement, intelligence, and policy capabilities against threats to our financial system and national security. It is the only office of its kind in the world. Under the leadership of Under Secretary Stuart Levey, TFI incorporates five components. Appearing at this hearing are representatives of the Office of Terrorist Financing and Financial Crime (TFFC) and the Office of Foreign Assets Control (OFAC). We work closely with our TFI colleagues – the Office of Intelligence and Analysis (OIA), the Financial Crimes Enforcement Network (FinCEN), and the Executive Office of Asset Forfeiture (TOEAF) – to identify and disrupt the financial networks of our enemies as well as to safeguard the U.S. and international financial systems.

OFAC, with approximately 135 staff, is charged with administering and enforcing economic and trade sanctions in furtherance of U.S. foreign policy and national security goals. OFAC administers approximately 30 economic sanctions programs

against international terrorists, proliferators of weapons of mass destructions (WMD), state sponsors of terrorism, narcotics traffickers, and other threats to our national security. Although these programs differ in terms of their scope and application, they all involve the exercise of the President's constitutional and statutory wartime and national emergency powers to impose controls on transactions and trade, and to regulate or freeze foreign assets that come within the jurisdiction of the United States.

TFFC, with a staff of approximately 30, is TFI's policy and outreach apparatus on terrorist financing, money laundering, financial crime, and sanctions issues. It develops and implements strategies, policies and initiatives to identify and address vulnerabilities in the U.S. and international financial system and to disrupt and dismantle terrorist and WMD proliferation financial networks, and it formulates and promotes policies domestically and internationally to combat terrorist financing and financial crime.

We in TFI collaborate on a regular basis with our counterparts across the Treasury Department, and with a broad range of federal agencies, including the Departments of State, Commerce, Homeland Security, Defense and Justice, including the Federal Bureau of Investigation and the Drug Enforcement Administration; the bank regulatory agencies; and other law enforcement and intelligence agencies. We also work very closely with the private sector and our foreign counterparts abroad to identify and address threats to our collective security and the international financial system.

II. General Overview of Sanctions and Their Impact

Applying effective economic measures requires careful strategic, economic, legal, and policy analysis to ensure that the measures are calibrated to meet their goals and minimize unintended consequences. The objectives for these measures are typically to isolate the target as a means of inducing it to abandon harmful or threatening policies. Sanctions should not be expected to empty a regime's coffers and bring it to its knees. But they can alter the decision-making calculus of a regime by illustrating the costs that it faces in pursuing a dangerous or confrontational policy.

Because our tools are aimed at isolating our targets, we are most effective when we proceed multilaterally, either with a coalition or with the consensus of the United Nations. We work closely with the State Department and with our fellow finance ministries and central banks abroad to build consensus on financial measures.

At times, though, it is necessary for us to adopt unilateral sanctions. As it turns out, even when we initially act alone we can have a dramatic impact. There are two main reasons for this. First, because the United States is the world's leading banking and financial center and the dollar is the world's dominant currency, funds transfers often pass through U.S. banks. If a U.S. bank tries to send U.S. dollars somewhere in the world, the chances are that the money will pass through a U.S. bank. The result will be a funds freeze and a call to OFAC's compliance office. In this regard, it is important to remember that U.S. persons and U.S. branches situated abroad are subject to U.S. law and must comply with OFAC's sanctions as if they were in the United States.

The second contributor to our sanctions' effectiveness is that non-U.S. international financial institutions frequently implement our targeted sanctions voluntarily, even when they are under no legal obligation from their host countries to do so. These institutions may implement our sanctions because they do not want to engage in business with terrorist organizations or WMD proliferators, even if it is legally permissible. They may cooperate because of the reputational and business risks involved. Whatever the reason, this cooperation can provide a decisive "force multiplier."

We have learned that the key to obtaining such voluntary cooperation is directing our sanctions in a "targeted" fashion – namely, against those individuals or entities that have violated international codes of behavior, whether they be counter-

proliferation, counter-terrorism, or anti-money laundering norms. This is why we take such pains to build the evidentiary packages needed to effectuate targeted sanctions as well as to provide a public explanation of the basis for our actions for the benefit of governments and private institutions around the world.

We are frequently asked how we measure the impact of sanctions or financial measures. Metrics can be difficult to come by, and can vary by context. An important measure of impact is our success in disrupting or disabling key support nodes, such as key financial institutions, trade partners, or donors. Another metric may be the extent to which foreign financial institutions and centers take similar steps to isolate the target. Ultimately, the most revealing indicator will be how the target itself sees our measures. Although such information can be fragmentary and highly classified, we have seen high-ranking officials within terrorist or criminal organizations or regimes subject to our sanctions programs struggling to manage the effects of our measures and worrying about what may be coming next.

III. North Korea and Iran

In the aftermath of the September 11, 2001 attacks, the prospect of WMD falling into the hands of terrorists or state sponsors of terrorism has become an inescapably real threat. The Treasury Department has drawn upon its full range of authorities and influence to combat these threats.

Counter Proliferation Actions

President Bush issued Executive Order 13382 in 2005, adding powerful tools – a broad-based transactions prohibition and an asset freeze – to the array of options available to combat WMD trafficking. By prohibiting U.S. persons from engaging in transactions with entities and individuals targeted by the order, we can effectively deny proliferators and their supporters access to the U.S. financial and commercial systems, cutting them off from the benefits of our economy. These prohibitions have a powerful effect, as the suppliers, financiers, transporters, and other facilitators of WMD networks tend to have commercial presences and accounts around the world that make them vulnerable to exactly this kind of financial action, particularly since so many of the transactions are denominated in dollars.

In issuing Executive Order 13382, the President identified and targeted eight entities in North Korea, Iran, and Syria, thereby prohibiting U.S. persons from engaging in transactions with them and requiring any assets of those entities within their control to be frozen. The North Korean entities listed in the Annex to the order include Korea Mining Development Trading Corporation (KOMID); Korea Ryonbong General Corporation; and Tanchon Commercial Bank. Iranian entities in the Annex include the Atomic Energy Organization of Iran (AEOI); Aerospace Industries Organization (AIO); Shahid Hemmat Industrial Group (SHIG); and Shahid Bakeri Industrial Group (SBIG). The President then authorized the Secretary of State and the Secretary of the Treasury to designate additional proliferators of WMD and their supporters under the authorities provided by the Order.

Treasury has to date designated fifteen Iran-related and ten North Korea-related individuals and entities supporting Iran and North Korea's WMD and missile programs. One of the recent Iran-related designations was the fifth-largest Iranian state-owned financial institution, Bank Sepah, in January of this year. Bank Sepah has provided extensive financial services to Iranian entities responsible for developing missiles capable of carrying weapons of mass destruction. It has been a key provider of financial services to SHIG and SBIG, two Iranian missile firms listed in the Annex to UN Security Council Resolution 1737 for their role in advancing Iran's ballistic missile programs. Bank Sepah also provides financial services to SHIG's and SBIG's parent entity, AIO, which has been designated as a proliferator by the United States for its role in overseeing all of Iran's missile industries.

Since at least 2000, Bank Sepah has also provided a variety of critical financial services to Iran's missile industry, arranging financing and processing dozens of multi-million dollar transactions for AIO and its subordinates. The bank has also

facilitated business between AIO and North Korea's chief ballistic missile-related exporter, KOMID. The financial relationship between Iran and North Korea, as reflected in the business handled by Sepah, is indeed of great concern to the United States.

Our designation of Sepah under E.O. 13382, and the subsequent imposition of sanctions on Sepah by UN Security Council Resolution 1747, has had a significant impact. By cutting off Sepah from the U.S. and the international financial system, we have commercially isolated Bank Sepah and may have made it more difficult for Iran to finance some of its proliferation-related activities.

Counter Terrorism Actions

Treasury took action late last year to cut off a second Iranian bank from the U.S. financial system because of its ties to terrorist support – Bank Saderat Iran, one of the largest Iranian state-owned financial institutions. Saderat is used by the Government of Iran to transfer money to terrorist organizations, most notably Hizballah. Since 2001, for example, a Hizballah-controlled organization received $50 million directly from Iran through Saderat. Iran and Hizballah also use Saderat to transfer money to other designated terrorist groups, such as Hamas, the PFLP-GC, and the Palestinian Islamic Jihad.

Treasury has also utilized Executive Order 13224 to target Iran's terrorist support networks. This Executive Order, issued immediately after September 11 attacks, has proven to be a powerful and flexible tool – it allows us to designate and block the assets of individuals and entities controlled by, or acting on behalf of, or providing support to named terrorist organizations, freezing any of the target's assets that are held by U.S. persons and preventing U.S. persons from having any future dealings with them. To date, the United States has designated approximately 460 individuals and entities pursuant to E.O. 13224. We have use this tool, in close coordination with colleagues in Departments of State and Justice, to expose and disrupt the financial networks of terrorist groups including al Qaida, Hizballah, Hamas, Jemmah Isalmiyya, and the GSPC, and to designate financiers and supporters in Southeast Asia, the Persian Gulf, the Horn of Africa, South America's Tri-Border Area, Europe, and the United States.

Engaging the Financial Community

In concert with the targeted measures we have taken, Treasury has engaged in unprecedented, high-level outreach to the international private sector that is focused on the potential for abuse of the financial system by Iran. Treasury officials have met with more than 40 banks worldwide to discuss the threat Iran poses to the international financial system and to their institutions. Secretary Paulson kicked off this effort last fall in Singapore, in discussions during the annual IMF/World Bank meetings, where he met with the executives from major banks throughout Europe, the Middle East, and Asia. Secretary Paulson, Deputy Secretary Kimmitt, Under Secretary Stuart Levey, and Assistant Secretary Patrick O'Brien have continued to engage with these institutions abroad, as well as in Washington and New York.

Through this outreach, we have shared information about Iran's deceptive financial behavior and raised awareness about the high financial and reputational risk associated with doing business with Iran. We share common interests and objectives with the financial community when it comes to dealing with threats to the financial system. Financial institutions want to identify and avoid dangerous or risky customers who could harm their reputations and business. And we want to isolate those actors and prevent them from abusing the financial system.

By partnering with the private sector, including by sharing information and concerns with financial institutions, we are increasingly seeing less of a tendency to work around sanctions. We are finding that even those institutions that are not formally bound to follow U.S. law pay close attention to our targeted actions and often adjust their business activities accordingly, primarily for two reasons. First, most bankers truly want to avoid facilitating proliferation, terrorism, or crime. These are responsible corporate citizens. Second, avoiding government-identified risks is

simply good business. Banks need to manage risk in order to preserve their corporate reputations. Keeping a few customers that we have identified as terrorists, terrorist supporters, or proliferators and their supporters is not worth the risk of facing public scrutiny or a regulatory action that may impact on their ability to do business with the United States or the responsible international financial community.

As evidence of Iran's deceptive practices has mounted, financial institutions and other companies worldwide have begun to reevaluate their business relationships with Tehran. Many leading financial institutions have either scaled back dramatically or even terminated their Iran-related business entirely. They have done so of their own accord, many concluding that they did not wish to be the banker for a regime that deliberately conceals the nature of its dangerous and illicit business. It has been reported that many global financial institutions, have curbed dealings with Iran. In addition to complying with the global sanctions imposed against Bank Sepah through UN Security Council Resolution 1747, certain foreign banks have also stopped handling dollar transactions for Saderat, forcing Saderat to conduct its foreign exchange transactions in euros. Regardless of the currency, the core risk with Iranian business – that you simply cannot be sure that the party with whom you are dealing is not connected to some form of illicit activity – remains the same. Scaling back dollar-business reduces, but does not eliminate, the risk.

As further evidence of the change in tide, a number of foreign banks are refusing to issue new letters of credit to Iranian businesses. And in early 2006, the OECD raised the risk rating of Iran, reflecting this shift in perceptions and sending a message to those institutions that have not yet reconsidered their stance. Additionally, many other companies have scaled back on their investments or projects in Iran, concluding that the risks of expanding operations in the country are too great. Multinational corporations have held back from investing in Iran, including limiting investment in Iran's oil field development. These companies have done their risk analyses, and they have realized that the Iranian regime's behavior makes it impossible to know what lies ahead in terms of Iran's future and stability. All of these developments have a mutually-reinforcing effect, producing a worldwide reevaluation of dealings with Iran.

This extensive and innovative private sector outreach, combined with our targeted sanctions and other diplomatic efforts of the U.S. Government, has paved the way for international pressure on the Iranian regime to stop its illicit activities. International partners who originally resisted the idea of applying pressure to Iran have reversed this position and now support pressuring the Iranian regime to renounce its support for terrorism and WMD proliferation and to comply with its international obligations. This reversal only occurred through balanced and targeted sanctions against Iran, coupled with strong and persistent diplomacy.

United Nations Security Council Resolutions 1737 and 1747

The impact of these efforts has been amplified and reinforced with the passage of UN Security Council Resolutions 1737 and 1747. Thanks to the tireless efforts of our State Department and other concerned countries, the UN Security Council unanimously passed Resolution 1737 on December 23, 2006, requiring governments worldwide to take steps to combat Iran's illicit activities, including freezing the assets of named entities and individuals associated with Iran's nuclear and missile programs, as well as the assets of entities owned or controlled by them. The resolution also requires states to prevent the provision to Iran of any financial assistance, or the transfer of any financial resources or services, related to the supply, sale, transfer, manufacture, or use of prohibited items associated with Iran's nuclear and missile programs. Several of the entities named in UN Security Resolution 1737, including the AEOI, SBIG, SHIG, Mesbah Energy Company, and Kalaye Electric Company, have already been designated by the United States.

UN Security Council Resolution 1747, unanimously adopted on March 24, 2007, builds upon the asset-freezing provisions found in UN Security Resolution 1737. The new resolution identifies additional Iranian entities and individuals for designation, some of which have already been publicly designated by the Treasury Department. Significantly, among these entities was Bank Sepah.

articulates standards in the form of recommendations, guidelines, and best practices. These standards aid countries in developing their own specific anti-money laundering and counter-terrorist financing laws and regulations that protect the international financial system from abuse.

Since before the terrorist attacks of September 11, 2001, we have consistently engaged the FATF to expand and strengthen these international standards to address the systemic vulnerabilities that terrorists and other criminals exploit, including through the development of Nine Special Recommendations on Terrorist Financing and the revision and strengthening of the FATF 40 Recommendations. Most recently, we have successfully engaged the FATF to adopt a new international standard to combat the illicit use of cash couriers, and we have enhanced the international standard for combating terrorist abuse of charities. We have also recently finalized a number of technical but critical aspects to the international standard governing the availability and integrity of originator information on cross-border wire transfers.

Reinforcing AML/CFT Framework to Isolate WMD Proliferators and their Support Networks

In February, we launched a discussion within the FATF of how the existing Anti-Money Laundering/Counter-Terrorist Financing (AML/CFT) international standards should be supplemented, amended or applied to address the vulnerabilities associated with WMD proliferation finance. Although there are a number of long-standing instruments and organizations to prevent and counter the proliferation of WMD, their means of delivery and related materials, as well as numerous export control regimes, there is a lack of international focus and no international standards related to preventing financing of illicit proliferation activity and to isolating WMD proliferators from the international financial system. A FATF working group charged with matters related to terrorist financing and money laundering decided in February to hold a special session in May to discuss the issue of proliferation finance, and to consider whether the FATF should adopt guidance to assist countries in their efforts to counter WMD proliferation finance. This urgent work will focus, in particular, on guidance for countries on the implementation of sanctions and finance-related provisions in a growing number of UN Security Council Resolutions related to proliferation activities in North Korea and Iran, as well as the threat of non-State actors' ability to procure and use WMD. In addition, we will explore in the FATF the broader potential of applying the existing framework of the AML/CFT international standards against WMD proliferation finance, beginning with a focus on "typologies" to better understand the nature of this threat. This study will provide the foundation for a broad assessment of the types of actions countries could take to isolate WMD proliferators from the financial system.

These standard-setting efforts at the FATF create an international obligation and framework for countries to implement AML/CFT regimes that promote transparency and effectively protect the international financial system from various forms of illicit finance, including terrorist financing and WMD proliferation finance. This framework provides a basis for multilateral consideration of additional ways that we can effectively degrade WMD proliferators' ability to access and use the financial system, crippling their ability to finance their pursuit of WMD.

Taking Protective Action against Systemic Vulnerabilities

In those instances where jurisdictional or institutional deficiencies present ongoing systemic vulnerabilities that create substantial money laundering or terrorist financing threats to the international financial system, Treasury can take appropriate protective action under Section 311 of the USA PATRIOT Act. Section 311 authorizes Treasury to designate a foreign jurisdiction, foreign financial institution, type of account or class of transactions as a primary money laundering concern, thereby enabling Treasury to impose any one or combination of a range of special measures that U.S. financial institutions must take to protect against illicit financing risks associated with the designated target. These special measures range from enhanced due diligence, recordkeeping, and reporting requirements up to and including termination of any and all correspondent accounts or activities with the designated target.

money laundering and terrorist financing, including the laundering of proceeds from the illicit sale of Iraqi oil and the channeling of funds to terrorists and terrorist financiers. In March 2006, Treasury issued a final rule, pursuant to Section 311, designating CBS as a primary money laundering concern and requiring U.S. financial institutions to close correspondent relationships with CBS. Consequently, prominent international financial institutions have begun to reassess their relationships with Syria and a number of Syrian entities.

Conducting Private Sector Outreach

In addition to the targeted economic sanctions and protective measures discussed above, Treasury has launched a comprehensive outreach campaign that includes efforts to educate the private sector about the potential for abuse by terrorists, state sponsors of terror and WMD proliferators.

Treasury launched this international private sector outreach effort by initiating private sector AML/CFT dialogues linking the U.S. banking sector together with those from the Middle East/North Africa (MENA) region and the Latin American region, with the support of relevant financial and regulatory authorities. The purpose of these dialogues is to:

- raise awareness of domestic and regional money laundering and terrorist financing risks, international AML/CFT standards and regional developments, and U.S. government policies and private sector measures to combat terrorist financing and money laundering;
- assess the impact of AML/CFT international standards and U.S. law and regulation on AML/CFT development and implementation in the U.S. and foreign banking and financial service industries; and
- strengthen development and implementation of effective AML / CFT measures, particularly in regions of strategic importance and jurisdictions that lack fully-functional AML/CFT regimes.

In collaboration with its interagency and regional partners, Treasury successfully facilitated the launch of the U.S.-MENA Private Sector Dialogue on AML/CFT with an initial AML/CFT Conference in Cairo in March 2006. Bankers and financial and regulatory authorities from the U.S. and the region discussed a range of challenges associated with the development and implementation of effective AML/CFT jurisdictional and institutional measures. A follow-on conference at the Federal Reserve Bank of New York in December 2006 was equally successful.

Treasury has initiated a similar dialogue with the Latin American banking community, hosting a roundtable discussion of U.S. and regional interests at Treasury in June 2006 to help frame this initiative. Based on this roundtable discussion, Treasury assisted in organizing an inaugural United States-Latin America Private Sector Dialogue conference on AML/CFT in Bogota, Colombia last week. Private sector participants and regulators from both regions participated in the conference, where challenges in AML/CFT implementation were discussed.

This direct private sector outreach to the international financial community complements our other work to address vulnerabilities in the international financial system by providing a mechanism to explain our money laundering and terrorist financing concerns, assess and facilitate AML/CFT progress and implementation, and receive feedback on the effectiveness of our efforts from key regional participants in the international financial system.

Encouraging Multilateral Action

A significant part of Treasury's mission is also devoted to U.S. government efforts to secure international support and implementation of targeted economic sanctions and financial actions like those we have described. As we noted above, the effectiveness of these authorities is significantly enhanced when other countries support U.S. efforts by freezing terrorist assets in their own jurisdictions, and prohibiting their nationals from dealing with terrorists. In coordination with the Department of State, Treasury facilitates such action through a variety of activities,

U.S. financial system, along with outreach to the private sector, are indeed having an impact, particularly on the ability of Iran and North Korea to misuse the financial system to carry out their dangerous activities. Together with my colleagues at this table and throughout the government, we will continue to employ all of our resources and authorities to keep our country safe.

I look forward to working closely with you, other members of the Subcommittees, and your staff on these important issues. Thank you again for the opportunity to testify today.

PRESS ROOM

April 18, 2007
HP-362

Statement by Treasury Secretary Paulson on IRS Commissioner Mark Everson

"Over the past four years Mark Everson has held one of the toughest jobs in the country: Commissioner of the Internal Revenue Service-the nation's tax collector.

"In those four years Commissioner Everson has taken up the challenge of both increasing enforcement activities to deal with those who don't pay their fair share of taxes, while, at the same time, significantly improving the services and outreach activities the IRS provides to taxpayers.

"I want to thank Commissioner Everson for his hard work and service over the past four years. I wish him well in his new position at the American Red Cross."

April 19, 2007
HP-363

Treasury Secretary Paulson to Host Press Briefing on the Social Security and Medicare Trustees Reports

Treasury Secretary and Managing Trustee Henry M. Paulson, Jr. will be joined by members of the Social Security and Medicare Trustees Board for a press briefing to discuss the release of the annual trustees reports on Monday.

Who
Secretary of Treasury and Managing Trustee Henry M. Paulson, Jr.
Secretary of Labor and Trustee Elaine L. Chao
Secretary of Health and Human Services and Trustee Michael Leavitt
Commissioner of Social Security and Trustee Michael J. Astrue
Public Trustee John Palmer
Public Trustee Thomas Saving

What
Press Conference to discuss Social Security and Medicare Trustees Reports

When
Monday, April 23, 2007, 3:15 p.m. EDT

Where
Treasury Department
Media Room (Room 4121)
1500 Pennsylvania Ave., NW
Washington, DC

Note:
Copies of the Social Security and Medicare Trustees Report will be available at the briefing.

A pen and pad background briefing will follow the press conference at 3:45 p.m. in the same room.

Media without Treasury press credentials should submit full name, Social Security number, and date of birth to Frances Anderson at 202-622-2960 or frances.anderson@do.treas.gov

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April 19, 2007
HP-364

Statement by Under Secretary Levey on Transparency in Payment Message Standards

Treasury Under Secretary Stuart Levey made the following statement today in response to a call by leading international financial institutions to enhance transparency regarding parties to transactions in international payments:

Today's announcement by the Wolfsberg Group and the Clearing House Association, LLC to enhance transparency in international payments is a welcome step in ongoing efforts to ensure the global financial system is safe, sound, and secure from abuse.

The financial community's expertise places it in an ideal position to identify vulnerabilities in the financial system with respect to money laundering, terrorist financing, and other illicit activity, and to develop efficient solutions.

By enhancing transparency in international wire transfers, institutions will have greater insight into the parties that are on the sending and receiving ends of transactions, helping banks to better understand possible risks associated with the underlying transactions and helping to ensure that they are not engaged in transactions involving terrorists, money launderers, WMD proliferators, and others involved in criminal activity.

The Treasury Department and federal banking regulators applaud the groups' proactive efforts, and encourage financial institutions worldwide to take steps to adopt this robust proposal. In turn, we pledge to work with our international counterparts to help bolster support for the initiative as we continue our joint effort with the industry to develop standards to strengthen the financial system.

Please visit the following link to read the announcement by the Wolfsberg Group and the Clearing House Association, LLC: http://www.wolfsberg-principles.com/pdf/Cover-Payments-Press-Release-April-19-2007.pdf.

-30-

THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

the Wolfsberg Group

For Immediate Release

PRESS RELEASE

Banks Endorse Measures to Enhance Transparency in International Payments

New York – April 19, 2007 – The Wolfsberg Group and The Clearing House Association L.L.C. today issued a statement endorsing measures to enhance the transparency of international wire transfers to promote the effectiveness of global anti-money laundering and anti-terrorist financing programs. The measures include both the development of an enhanced payment message format, which would include more detailed information about those conducting wire transfers in certain instances, as well as calling for the global adoption of basic messaging principles aimed at promoting good practice with respect to the payment system.

Over the last 30 years, the world's banks have developed an efficient and effective international payment system. The smooth functioning of this system is vital to global financial stability. The steps outlined above will both better protect the integrity of the system and help ensure its continued efficient functioning.

With the support of the global regulatory community and subject to acceptance by the membership of the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the co-operative supplying secure standardized messaging services and interface software, it is anticipated that an enhanced payment message format will be developed.

The statement, including the messaging principles, is available on www.wolfsberg-principles.com

Members of the Wolfsberg Group are ABN AMRO, Banco Santander Central Hispano, Bank of Tokyo – Mitsubishi UFJ, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Société Générale, and UBS.

Members of The Clearing House Association L.L.C. are Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank, National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

Media contact: For the Wolfsberg Group
David Bagley, Co-Chair, davidbagley@hsbc.com, (44) (20) 7991 8645
Philipp von Turk, Co-Chair, philipp.von.turk@jpmorgan.com, Telephone: 212.464-1226

Media contact: For The Clearing House Association L.L.C.
Greg Berardi, Office: 415.239.7826, Mobile: 415.672.2377, greg@bluemarlinpartners.com
Chip Savidge, Office: 212.613.9896, Mobile: 917.576.0957, chip.savidge@theclearinghouse.org

April 20, 2007
HP-365

Secretary Paulson to Visit Mexico City

Treasury Secretary Henry M. Paulson, Jr. will travel to Mexico City next week to meet with President Calderon, Finance Minister Carstens, and Foreign Affairs Secretary Espinosa to underscore his support for their strong economic policy agenda. While in Mexico, he will receive a briefing from the Mexican Financial Intelligence Unit (FIU). The briefing will focus on information sharing between the Treasury Department's Financial Crimes Enforcement Network (FinCEN) and the Mexican FIU that is designed to help combat money laundering and financial crimes. Secretary Paulson also will meet with small businesses and students to discuss how to expand opportunity. The following event is open to credentialed media:

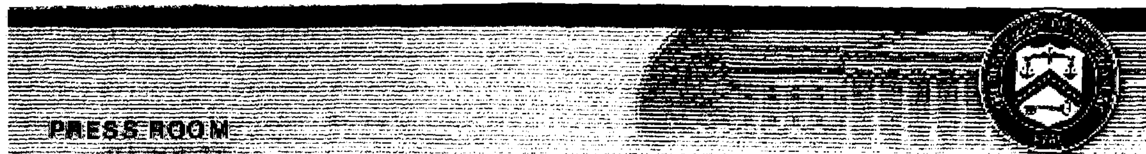
Who
Treasury Secretary Henry M. Paulson, Jr.

What
Conversation with Small Business Owners and Finance Providers

When
Tuesday, April 24, 11:30 a.m. (EDT)

Where
Bebidas Sanas SA de CV
Avenue Popocatepetl 421 L-7B
Colonia Pedro Maria Anaya
CP 03340 Mexico

-30-



April 23, 2007
HP-366

US Treasurer to Deliver Remarks at Native Financial Education Briefing

U.S. Treasurer Anna Escobedo Cabral will deliver keynote remarks at the 3rd Annual Native Financial Education Coalition Policy Briefing Thursday. Treasurer Cabral's remarks will focus on Treasury's efforts to improve financial literacy in Native communities. The following event is open to credentialed media:

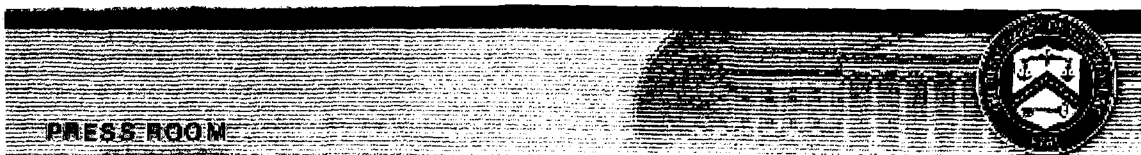
Who
Treasurer Anna Escobedo Cabral

What
Keynote Remarks on Financial Literacy in Native Communities

When
Thursday, April 26, 9:15 a.m. EDT

Where
Mashantucket Pequot Tribal Nation
101 Constitution Ave.
Chamber Room, 9th Floor
Washington, DC

Note
Media must RSVP by contacting Joanna Donohoe at (561) 762-8237 or email joanna@oweesta.org .



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April 23, 2007
HP-367

Treasury Secretary Henry M. Paulson, Jr. Statement on the 2007 Social Security and Medicare Trust Fund Reports

WASHINGTON--The Social Security and Medicare Board of Trustees met this afternoon to complete their annual financial review of the programs and to transmit the Trustees Reports to Congress. I welcome my Cabinet colleagues and the Public Trustees, Tom Saving and John Palmer, two well-respected experts in their field. The nation is indeed fortunate to have your service.

For decades, Social Security and Medicare have provided vital support for Americans. As the baby boom generation moves into retirement, these programs face progressively larger financial challenges. If we do not take action soon to reform Social Security and Medicare, the coming demographic bulge will jeopardize the programs' ability to support people who depend on them. Without change, rising costs will drive government spending to unprecedented levels, consume nearly all projected federal revenues, and threaten America's future prosperity. I urge my friends in Congress to join me in a bipartisan effort to strengthen both programs for future retirees.

This year's Social Security report again demonstrates that the Social Security program is financially unsustainable and requires reform. In just 10 years, cash flows are projected to turn negative, and the Trust Funds are projected to be exhausted in 2041. Reform is needed and time is of the essence. The longer we delay, the larger the required adjustments will be – and the burden of making those adjustments will fall more heavily on future generations.

Social Security's unfunded obligation - the difference between the present values of Social Security inflows and outflows less the existing trust fund - equals $4.7 trillion over the next 75 years and $13.6 trillion on a permanent basis. The actuarial imbalance expressed as a percent of taxable payroll is 1.95 percent over 75 years and 3.5 percent over the indefinite future. This means that, to make the system whole on a permanent basis, the combined payroll tax rate would have to be raised immediately by about one-third from 12.4 percent to about 15.9 percent, or benefits reduced immediately by 22 percent.

This report confirms the need for action; the sooner we take action to strengthen Social Security's financial footing, the less drastic the needed reforms will be. President Bush has called for solutions that generate a permanently sustainable Social Security system through bipartisan efforts. The President has put forward a number of well-considered ideas. And he has asked me to reach out to lawmakers in both parties and listen to all ideas. We need serious and thoughtful engagement from all sides to make sure Social Security is strengthened and sustained for future generations.

The 2007 Medicare Trustees Report shows even greater financial challenges. Medicare faces the same demographic trends as Social Security, and, in addition, the system must cope with large increases in health care costs.

Cash flow for the Hospital Insurance (HI) Trust Fund is projected to be negative this year and for all subsequent years. The HI Trust Fund is projected to become insolvent in 2019, one year later than projected in last year's report, and the 75-year estimated actuarial imbalance as a percent of payroll is 3.55, a slight deterioration

from last year's report. On a permanent basis, the imbalance is unchanged at 5.8 percent of payroll.

The Supplementary Medical Insurance (SMI) Trust Fund, which includes Part B for outpatient services and the new Part D prescription drug benefit, is financed in large part by general revenues as well as beneficiary premiums. SMI expenditures are projected to increase rapidly, resulting in growing pressures on future federal budgets and, in turn, the U.S. economy. General revenue financing for SMI is expected to increase from about 1 percent of GDP in 2006 to nearly 5 percent in 2081.

Today, seniors all over America have guaranteed access to affordable prescription drug coverage. The market-based structure of the new prescription drug benefit appears to be working. Average premiums for Part D have come down this year.

The facts are clear: reforms to both Medicare and Social Security are urgently needed. The serious concerns raised by the Trustees Reports demand the attention of America's policymakers and the public. Americans who depend on Social Security and Medicare are relying on those of us in public to address the long-term funding issues. Successful long-term reform of these programs is a shared responsibility and we all have to rise to the challenge.

LINKS

- Medicare Report
- Social Security Report
- Summary of Reports

2007 ANNUAL REPORT OF THE BOARDS OF TRUSTEES OF THE FEDERAL HOSPITAL INSURANCE AND FEDERAL SUPPLEMENTARY MEDICAL INSURANCE TRUST FUNDS

COMMUNICATION

From

THE BOARDS OF TRUSTEES,
FEDERAL HOSPITAL INSURANCE AND
FEDERAL SUPPLEMENTARY MEDICAL INSURANCE
TRUST FUNDS

Transmitting

THE 2007 ANNUAL REPORT OF
THE BOARDS OF TRUSTEES OF THE
FEDERAL HOSPITAL INSURANCE AND
FEDERAL SUPPLEMENTARY MEDICAL INSURANCE
TRUST FUNDS

LETTER OF TRANSMITTAL

BOARDS OF TRUSTEES OF THE
FEDERAL HOSPITAL INSURANCE AND
FEDERAL SUPPLEMENTARY MEDICAL INSURANCE TRUST FUNDS,
Washington, D.C., April 23, 2007

HONORABLE Nancy Pelosi
Speaker of the House of Representatives
Washington, D.C.

HONORABLE Richard B. Cheney
President of the Senate
Washington, D.C.

DEAR MADAM SPEAKER AND MR. CHENEY:

We have the honor of transmitting to you the 2007 Annual Report of the Boards of Trustees of the Federal Hospital Insurance Trust Fund and the Federal Supplementary Medical Insurance Trust Fund, the 42nd such report.

Respectfully,

Henry M. Paulson, Jr., *Secretary of the Treasury, and Managing Trustee of the Trust Funds.*

Elaine L. Chao, *Secretary of Labor, and Trustee.*

Michael O. Leavitt, *Secretary of Health and Human Services, and Trustee.*

Michael J. Astrue, *Commissioner of Social Security, and Trustee.*

John L. Palmer, *Trustee.*

Thomas R. Saving, *Trustee.*

Leslie V. Norwalk, Esq., *Acting Administrator of the Centers for Medicare & Medicaid Services, and Secretary, Boards of Trustees.*

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I. INTRODUCTION

The Medicare program has two components. Hospital Insurance (HI), or Medicare Part A, helps pay for hospital, home health, skilled nursing facility, and hospice care for the aged and disabled. Supplementary Medical Insurance (SMI) consists of Medicare Part B and Part D.[1] Part B helps pay for physician, outpatient hospital, home health, and other services for the aged and disabled who have voluntarily enrolled. Part D initially provided access to prescription drug discount cards and transitional assistance to low-income beneficiaries. In 2006 and later, Part D provides subsidized access to drug insurance coverage on a voluntary basis for all beneficiaries and premium and cost-sharing subsidies for low-income enrollees.

The Medicare Board of Trustees was established under the Social Security Act to oversee the financial operations of the HI and SMI trust funds.[2] The Board comprises six members. Four members serve by virtue of their positions in the Federal Government: the Secretary of the Treasury, who is the Managing Trustee; the Secretary of Labor; the Secretary of Health and Human Services; and the Commissioner of Social Security. The other two members, John L. Palmer and Thomas R. Saving, are public representatives initially appointed by President William J. Clinton on October 28, 2000, and reappointed by President George W. Bush on April 18, 2006. The Administrator of the Centers for Medicare & Medicaid Services (CMS) is designated as Secretary of the Board.

The Social Security Act requires that the Board, among other duties, report annually to the Congress on the financial and actuarial status of the HI and SMI trust funds. This 2007 report is the 42nd to be submitted.

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[1]Medicare also has a Part C, which provides Part A and Part B coverage and, optionally, Part D coverage through private health insurance plans.
[2]Technically, separate boards are established for HI and SMI. Because both boards have the same membership, for convenience they are collectively referred to as the Medicare Board of Trustees in this report.

II. OVERVIEW

A. HIGHLIGHTS

The major findings of this report under the intermediate set of assumptions are summarized below.

In 2006

In 2006, 43.2 million people were covered by Medicare: 36.3 million aged 65 and older, and 7.0 million disabled. Total benefits paid in 2006 were $402 billion. Income was $437 billion, expenditures were $408 billion, and assets held in special issue U.S. Treasury securities grew to $339 billion.

Short-Range Results

The HI trust fund is not adequately financed over the next 10 years under the intermediate assumptions. From the beginning of 2007 to the end of 2016, the assets of the HI trust fund are projected to decrease from $305 billion to $221 billion, which would be less than the recommended minimum level of 1 year's expenditures.

The SMI trust fund is adequately financed over the next 10 years and beyond because premium and general revenue income for Parts B and D are reset each year to match expected costs. Progress has been made toward rebuilding Part B assets, following significant declines in 1999-2004. Part B costs have been increasing rapidly, however, having averaged 11.0 percent annually over the last 6 years, and are likely to continue doing so. Under current law, an average annual growth rate of 6.6 percent is projected for the next 10 years. This rate is unrealistically constrained due to multiple years of physician fee reductions that would occur under current law. If Congress continues to override these reductions, as they have for 2003-2007, the Part B growth rate would instead average roughly 8 to 9 percent. For Part D, the average annual increase in expenditures is estimated to be 12.6 percent through 2016. The U.S. economy is projected to grow by 4.8 percent on average during this period, significantly more slowly than either Part B or Part D.

The difference between Medicare's total outlays and its "dedicated financing sources" is estimated to reach 45 percent of outlays in fiscal year 2013, the seventh year of the projection. As a result, under section 801 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (also known informally as the Medicare

Modernization Act, or MMA), the Board of Trustees is issuing a determination of projected "excess general revenue Medicare funding" in this report. Since this is the second consecutive such finding, a "Medicare funding warning" is triggered, which will require the President to submit to Congress, within 15 days after the release of the *Fiscal Year 2009 Budget*, proposed legislation to respond to the warning. Congress is then required to consider the legislation on an expedited basis.

Long-Range Results

Under the intermediate assumptions the HI trust fund is projected to be exhausted in 2019, 1 year later than in last year's report, due to slightly higher projected payroll tax income and slightly lower projected benefits than previously estimated. For the 75-year projection period, the actuarial deficit is little different from that in last year's report, at 3.55 rather than 3.51 percent of taxable payroll.

The HI annual cost rate is projected to increase from 3.01 percent of taxable payroll in 2006 to 11.79 percent in 2081—8.38 percent of taxable payroll more than the projected income rate for 2081. Expressed in relation to the projected Gross Domestic Product (GDP), HI cost is estimated to rise from the current level of 1.4 percent of GDP to 5.0 percent in 2081.

Part B outlays were 1.3 percent of GDP in 2006 and are projected to grow to about 4.0 percent by 2081. These cost projections, however, are understated as a result of the substantial reductions in physician payments that would be required under current law. Actual future Part B costs will depend on the steps Congress takes to address the situation but could exceed the current-law projections by 7 to 9 percent in 2010, growing to roughly 25 to 40 percent for 2030 and later.

Part D outlays are estimated to increase from 0.4 percent of GDP in 2006 to about 2.4 percent by 2081. Initially, these outlay projections are significantly lower than those shown in last year's report. The primary reason for the reduction is that the 2007 prescription drug plan bid submissions were about 10 percent lower than in 2006. In the long range, the outlay projections return to, and eventually exceed, the prior projected level.

Conclusion

The financial outlook for the Medicare program continues to raise serious concerns. In particular, a "Medicare funding warning" is triggered by the findings of this report. Total Medicare expenditures were $408 billion in 2006 and are expected to increase in future years at a faster pace than either workers' earnings or the economy overall. As a percentage of GDP, expenditures are projected to increase from 3.1 percent in 2006 to 11.3 percent by 2081 (based on our intermediate set of assumptions). Growth of this magnitude, if realized, would substantially increase the strain on the nation's workers, Medicare beneficiaries, and the Federal Budget.

HI tax income is estimated to fall short of HI expenditures in 2007 and is projected to do so in all future years. The HI trust fund does not meet our short-range test of financial adequacy, and fund assets are projected to be exhausted in 2019. In the long range, projected expenditures and scheduled tax income are substantially out of balance, and the trust fund does not meet our test of long-range close actuarial balance. Currently, this imbalance is relatively small, with tax income is estimated to cover 99 percent of costs in 2007, but will grow rapidly in the absence of changes to current law: taxes would cover 79 percent of estimated costs in 2019, and only 29 percent at the end of the long-range period. Closing deficits of this magnitude will require very substantial increases in tax revenues and/or reductions in expenditures.

The Part B and Part D accounts in the SMI trust fund are adequately financed under current law, since premium and general revenue income are reset each year to match expected costs. Such financing, however, would have to increase rapidly to match expected expenditure growth under current law and to finish rebuilding Part B assets to an appropriate level.

These projections demonstrate the need for timely and effective action to address Medicare's financial challenges. Consideration of such reforms should occur in the relatively near future. The sooner the solutions are enacted, the more flexible and gradual they can be. Moreover, the early introduction of reforms increases the time available for affected individuals and organizations—including health care providers, beneficiaries, and taxpayers—to adjust their expectations. We believe that prompt, effective, and decisive action is necessary to address these challenges—both the exhaustion of the HI trust fund and the anticipated rapid growth in HI, SMI Part B, and SMI Part D expenditures.

B. MEDICARE DATA FOR CALENDAR YEAR 2006

HI and SMI have separate trust funds, sources of revenue, and categories of expenditures. Table II.B1 presents Medicare data for calendar year 2006, in total and for each part of the program. The largest category of HI expenditures is inpatient hospital services, while the largest SMI expenditure categories are physician services and prescription drugs.

Table II.B1.—Medicare Data for Calendar Year 2006

		SMI		
	HI or Part A	Part B	Part D	Total
Assets at end of 2005 (billions)	$285.8	$24.0	—	$309.8
Total income	$211.5	$177.3	$48.2	$437.0
Payroll taxes	181.3	—	—	181.3
Interest	15.7	1.8	0.0	17.5
Taxation of benefits	10.3	—	—	10.3
Premiums	2.6	42.9	3.5	48.9
General revenue	0.5	132.7	39.2	172.4
Transfers from States	—	—	5.5	5.5
Other	1.0	0.0	—	1.0
Total expenditures	$191.9	$169.0	$47.4	$408.3
Benefits	189.0	165.9	47.1	402.0
Hospital	121.0	27.2	—	148.2
Skilled nursing facility	19.9	—	—	19.9
Home health care	6.0	7.2	—	13.1
Physician fee schedule services	—	58.4	—	58.4
Managed care	32.9	31.5	—	64.4
Prescription drugs	—	—	47.1	47.1
Other	9.3	41.7	—	51.0
Administrative expenses	$2.9	$3.1	$0.3	$6.3
Net change in assets	$19.6	$8.3	$0.8	$28.7
Assets at end of 2006	$305.4	$32.3	$0.8	$338.5
Enrollment (millions)				
Aged	35.9	34.1	n/a	36.3
Disabled	7.0	6.1	n/a	7.0
Total	42.9	40.3	27.9	43.2
Average benefit per enrollee	$4,410	$4,121	$1,690	$10,221

Notes: 1. Totals do not necessarily equal the sums of rounded components.
2. "n/a" indicates data are not available.

For HI, the primary source of financing is the payroll tax on covered earnings. Employers and employees each pay 1.45 percent of wages, while self-employed workers pay 2.9 percent of their net income. Other HI revenue sources include a portion of the Federal income taxes that people pay on their Social Security benefits, and interest paid on the U. S. Treasury securities held in the HI trust fund.

For SMI, transfers from the general fund of the Treasury represent the largest source of income, currently covering about 79 percent of program costs. Also, beneficiaries pay monthly premiums for Parts B and D that finance a portion of the total cost. As with HI, interest is paid on the U. S. Treasury securities held in the SMI trust fund.

C. ECONOMIC AND DEMOGRAPHIC ASSUMPTIONS

Actual future Medicare expenditures will depend on a number of factors, including the size and composition of the population eligible for benefits, changes in the volume and intensity of services, and increases in the price per service. For HI, future trust fund income will depend on the size and characteristics of the covered work force and the level of workers' earnings. These factors will depend in turn upon future birth rates, death rates, labor force participation rates, wage increases, and many other economic and demographic circumstances affecting Medicare. To illustrate the uncertainty and sensitivity inherent in estimates of future Medicare trust fund operations, projections have been prepared under a "low cost" and a "high cost" set of assumptions as well as under an intermediate set.

Table II.C1 summarizes the key assumptions used in this report. Many of the demographic and economic variables that determine Medicare costs and income are common to the Old-Age, Survivors, and Disability Insurance (OASDI) program and are explained in detail in the report of the OASDI Board of Trustees. These variables include changes in the Consumer Price Index (CPI) and wages, real interest rates, fertility rates, and mortality rates. ("Real" indicates that the effects of inflation have been removed.) The assumptions vary, in most cases, from year to year during the first 5 to 30 years before reaching their so-called "ultimate" values for the remainder of the 75-year projection period. Other assumptions are specific to Medicare.

As with all of the assumptions underlying the Trustees' financial projections, the Medicare-specific assumptions are reviewed annually and updated based on the latest available data and analysis of trends. In addition, the assumptions and projection methodology are subject to periodic review by independent panels of expert actuaries and economists. The most recent such review was conducted by the 2004 Medicare Technical Review Panel, which issued its findings in December 2004.

Table II.C1.—Ultimate Assumptions

	Intermediate	Low Cost	High Cost
Economic:			
Annual percentage change in:			
Gross Domestic Product (GDP) per capita[1]	4.1	3.5	4.6
Average wage in covered employment	3.9	3.4	4.4
Consumer Price Index (CPI)	2.8	1.8	3.8
Real-wage differential (percent)	1.1	1.6	0.6
Real interest rate (percent)	2.9	3.6	2.1
Demographic:			
Total fertility rate (children per woman)	2.00	2.30	1.70
Average annual percentage reduction in total age-sex adjusted death rates from 2031 to 2081	0.70	0.33	1.21
Health cost growth:			
Annual percentage change in per beneficiary Medicare expenditures (excluding demographic impacts)[1]	5.1[2]	[3]	[3]

[1]The assumed ultimate increases in per capita GDP and per beneficiary Medicare expenditures can also be expressed in real terms, adjusted to remove the impact of assumed inflation growth. When adjusted by the chain-weighted GDP price index, assumed real per capita GDP growth is 1.5 percent, and real per beneficiary Medicare cost growth is 2.5 percent.
[2]Cost growth assumptions in the last 50 years of the projection vary year by year and follow a smooth downward path that generates the same 75-year HI actuarial balance as a level growth assumption of GDP plus 1 percent for the last 50 years (5.1 percent).
[3]See section III.B for further explanation.

The assumed long-range rate of growth in annual Medicare expenditures per beneficiary is one of the most critical determinants of the projected cost of Medicare-covered health care services in the more distant future. Prior to last year's report, the increase in average expenditures per beneficiary for the 25th through 75th years of the projection was assumed to equal the growth in per capita GDP plus 1 percentage point.[4] This assumption was recommended by the 2000 Medicare Technical Review Panel. With the inclusion of infinite-horizon projections starting in the 2004 Trustees Report, per beneficiary expenditures after the 75th year were assumed to increase at the same rate as per capita GDP. The 2004 Technical Review Panel recommended that these assumptions continue to be used, given the limits of current knowledge, but that further research also be conducted.

Starting with last year's report, the Board of Trustees adopted a slight refinement of the long-range growth assumption that provides a more gradual transition from current health cost growth rates, which have been roughly 2 to 3 percentage points above the level of GDP growth, to the ultimate assumed level of GDP plus zero percent just after the 75th year and for the indefinite future. The year-by-year growth assumptions are based on a simplified economic model and

[4]This assumed increase in the average expenditures per beneficiary excludes the impacts of the aging of the population and changes in the gender composition of the Medicare population, which are estimated separately.

are determined in a way such that the 75-year actuarial balance for the HI trust fund is consistent with that generated by the "GDP plus 1 percent" assumption. An independent group of experts in health economics and long-range forecasting reviewed the model and advised that its use for this purpose is appropriate. Consistent with the recommendations of this group and the 2000 and 2004 Technical Panels, further research is being conducted on long-range health cost growth trends.

As in the past, detailed growth rate assumptions are established for the next 10 years by individual type of service (for example, inpatient hospital care, physician services, etc.), reflecting recent trends and the impact of specific statutory provisions. Under the economic model, in 2031 the growth rate for all Medicare services is assumed to be about 1.4 percentage points above the level of GDP growth for that year. This differential gradually declines to about 0.8 percent in 2051 and to 0.2 percent in 2081.[4] Compared to the assumptions used in several reports prior to last year, the new growth assumption is initially higher but subsequently lower than the constant "GDP plus 1 percent" assumption. Beyond 75 years, the assumed growth rate of GDP plus zero percent is essentially unchanged.

In HI, for the high cost assumptions, the annual increase in aggregate costs (relative to increases in taxable payroll) during the initial 25-year period is assumed to be 2 percentage points greater than under the intermediate assumptions. Under low cost assumptions, the increase during the same period is assumed to be 2 percentage points less than under intermediate assumptions. The 2-percentage-point differentials are assumed to decline gradually until 2056, when the same rate of increase in HI costs (relative to taxable payroll) is assumed for all three sets of assumptions.

Because of its automatic financing provisions for Parts B and D, the SMI trust fund is expected to be adequately financed into the indefinite future, so a long-range analysis using high cost and low cost assumptions has not been conducted. The 2004 Technical Panel recommended refining the presentation of long-range uncertainty through stochastic techniques or long-range high- and low-cost alternatives for Parts A, B, and D. The trustees and their staffs intend to consider alternative methods to illustrate the long-range uncertainty in the Medicare projections.

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[4]The cost growth assumptions thus follow a smooth, downward path over the last 50 years of the projection rather than remaining constant.

While it is reasonable to expect that actual trust fund experience will fall within the range defined by the three alternative sets of assumptions, no assurance can be given in light of the wide variations in experience that have occurred since the beginning of the Medicare program. In general, a greater degree of confidence can be placed in the assumptions and estimates for the earlier years than for the later years. Nonetheless, even for the earlier years, the estimates are only an indication of the expected trend and the general range of future Medicare experience. For simplicity of presentation, much of the analysis in this overview centers on the projections under the intermediate assumptions.

D. FINANCIAL OUTLOOK FOR THE MEDICARE PROGRAM

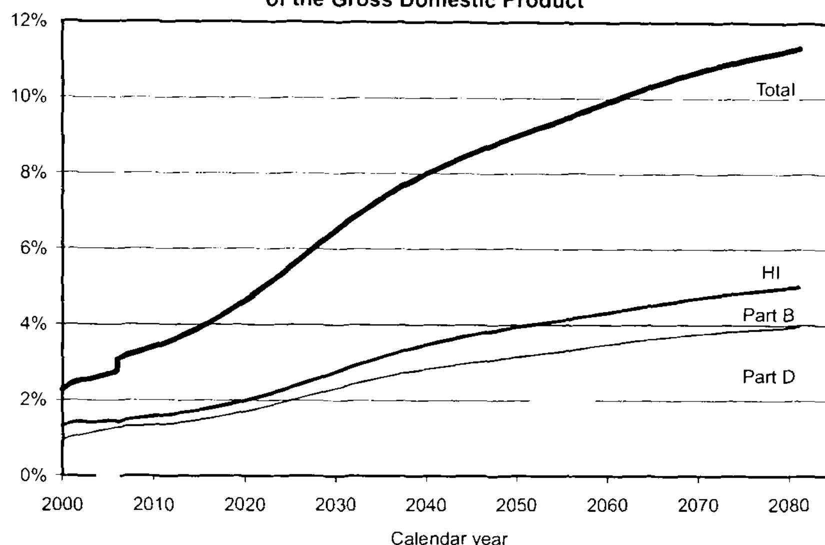
This report evaluates the financial status of the HI and SMI trust funds. For HI, the Trustees apply formal tests of financial status for both the short range and the long range; for SMI, the Trustees assess the ability of the trust fund to meet incurred costs over the period for which financing has been set.

HI and SMI are financed in very different ways. Within SMI, Part B and Part D premiums and general revenue financing are reestablished annually to match expected costs for the following year. In contrast, HI is subject to substantially greater variation in asset growth, since financing is established through statutory tax rates that cannot be adjusted to match expenditures except by enactment of new legislation.

Despite the significant differences in benefit provisions and financing, the two components of Medicare are closely related. Most beneficiaries are enrolled in both HI and SMI Part B, and a majority have enrolled in SMI Part D. Many receive health care services from both HI and SMI in a given year. Thus, efforts to improve and reform either component must necessarily involve the other component as well. In view of the anticipated growth in Medicare expenditures, it is also important to consider the distribution among the various sources of revenues for financing Medicare and the manner in which this distribution will change over time under current law.

In this section, the projected total expenditures for the Medicare program are considered, along with the primary sources of financing. Figure II.D1 shows projected costs as a percentage of GDP. Medicare expenditures represented 3.1 percent of GDP in 2006. Costs increase to about 7.3 percent of GDP by 2035 under the intermediate assumptions and to 11.3 percent of GDP by the end of the 75-year period. However, it is important to note that, after 2007, Medicare expenditures are understated because of unrealistic substantial reductions in physician payments scheduled under current law.

Figure II.D1.—Medicare Expenditures as a Percentage of the Gross Domestic Product

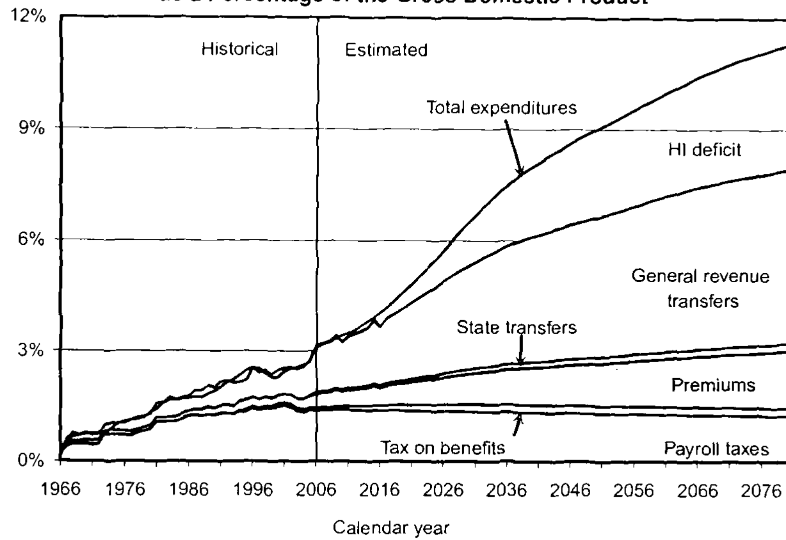


The Medicare projections reflect (i) continuing growth in the volume and intensity of services provided per beneficiary throughout the projection period, (ii) the impact of a large increase in beneficiaries starting in about 2010 as the leading edge of the 1946-65 baby boom generation reaches age 65 and becomes eligible to receive benefits, and (iii) the introduction of the Part D program in 2004, along with the other provisions of the Medicare Modernization Act of 2003, the Deficit Reduction Act of 2005, and the Tax Relief and Health Care Act of 2006. Other key demographic trends are also reflected, including future birth rates at roughly the same level as during the last 2 decades and continuing improvements in life expectancy.

The past and projected amounts of Medicare revenues, under current law, are shown in figure II.D2. Interest income is excluded since it would not be a significant part of program financing in the long range. Medicare revenues—from HI payroll taxes, HI income from the taxation of Social Security benefits, SMI Part D State transfers for certain Medicaid beneficiaries, HI and SMI premiums, and HI and SMI statutory general revenues—are compared to total Medicare expenditures. For the next 3 years, such Medicare revenues are estimated to be slightly above program expenditures, reflecting the automatic financing of SMI Part D plus a surplus in Part B financing (designed to restore assets to a more appropriate level) that is slightly greater than the small but increasing deficit of HI expenditures over tax income. Thereafter, overall expenditures are projected to exceed

aggregate revenues to an increasing extent, as a result of the projected large financial imbalance in the HI trust fund.

Figure II.D2.—Medicare Sources of Non-Interest Income and Expenditures as a Percentage of the Gross Domestic Product



As shown in figure II.D2, payroll tax revenues increased steadily as a percentage of GDP in the historical period, due to increases in the HI payroll tax rate and the limit on taxable earnings, the latter of which was eliminated in 1994. In the future, however, payroll taxes are projected to grow more slowly than GDP.[5] HI revenue from income taxes on Social Security benefits will likely increase as a share of GDP as additional beneficiaries become subject to such taxes.

By comparison, growth in SMI Part B and Part D premiums and general fund transfers is expected to continue to outpace GDP growth and HI payroll tax growth in the future. This phenomenon occurs primarily because, under current law, SMI revenue increases at the same rate as expenditures, whereas HI revenue does not. Thus, as the HI sources of revenue become increasingly inadequate to cover HI costs, SMI revenues are projected to represent a growing share of total Medicare revenues. Within the next 10 years, general revenue transfers are expected to constitute the largest single source of income to the Medicare program as a whole—and would add

[5]Although total worker compensation is projected to grow at the same rate as GDP, wages and salaries are expected to increase more slowly and fringe benefits (health insurance costs in particular) more rapidly. Thus, earnings are projected to gradually decline as a percentage of GDP. Absent any change to the tax rate scheduled under current law, HI payroll tax revenue would similarly decrease as a percentage of GDP.

significantly to the Federal Budget pressures. Although a smaller share of the total, SMI premiums would grow just as rapidly as general revenue transfers, thereby also placing a growing burden on beneficiaries.

The interrelationship between the Medicare program and the Federal Budget is an important topic—one that will become increasingly so over time as the general revenue requirements for SMI continue to grow. While these transfers are an important source of financing for the SMI trust fund, and are central to the automatic financial balance of the fund's two accounts, they represent a large and growing requirement for the Federal Budget. SMI general revenues currently equal 1.3 percent of GDP and would increase to an estimated 4.7 percent in 2081 under current law. Moreover, in the absence of corrective legislation, the difference between HI tax revenues and expenditures would be met for a number of years by interest earnings on trust fund assets and by redeeming those assets. Both of these financial resources for the HI trust fund require cash transfers from the general fund of the Treasury, placing a further obligation on the budget. In 2018, these transactions would require general fund transfers equal to 0.4 percent of GDP. (After asset depletion in 2019, no provision exists to use general revenues to cover the HI deficit.) Appendix E describes the interrelationship between the Federal Budget and the Medicare and Social Security trust funds and illustrates the programs' long-range financial outlook from both a "trust fund perspective" and a "budget perspective."

The Medicare Modernization Act requires the Board of Trustees to test whether the difference between program outlays and dedicated financing sources exceeds 45 percent of Medicare outlays.[6] If this level is attained within the first 7 fiscal years of the projection, a determination of projected "excess general revenue Medicare funding" is required. This determination was made in the 2006 report—the first such finding—since the difference was projected to initially reach the 45-percent level in fiscal year 2012. If such determinations are present in two consecutive Trustees Reports, then a "Medicare funding warning" is triggered. In this year's report, the difference is projected to exceed 45 percent in 2013, once again inside the first 7 years of the projection period (2007-2013). Therefore, a finding of projected "excess general revenue Medicare funding" is again made in

[6]The dedicated financing sources are HI payroll taxes, the HI share of income taxes on Social Security benefits, Part D State transfers, and beneficiary premiums. These sources are the first four layers depicted in figure II.D2.

this report, and a "Medicare funding warning" is triggered. (Section III.A contains additional details on these tests.)

This section has summarized the total financial obligation posed by Medicare and the manner in which it is financed. Under current law, however, the HI and SMI components of Medicare have separate and distinct trust funds, each with its own sources of revenues and mandated expenditures. Accordingly, the financial status of each Medicare trust fund must be assessed separately. The next two sections of the overview present such assessments for the HI trust fund and the SMI trust fund, respectively.

E. FINANCIAL STATUS OF THE HI TRUST FUND

1. 10-Year Actuarial Estimates (2007-2016)

Over the next 10 years, HI expenditures are expected to grow faster than income. Expenditure growth is estimated to average 7.2 percent per year. HI income growth averages 4.9 percent per year over this period. Currently, the HI trust fund is experiencing small annual surpluses of total income over expenditures. If interest earnings and general revenues are excluded from income, then expenditures are expected to exceed tax income in 2007 and thereafter. Therefore, interest and trust fund assets would be needed to pay expenditures in full and on time beginning in 2007. Total expenditures will exceed total income and deficits will begin to emerge in 2011. The HI trust fund is projected to become exhausted in 2019.

Table II.E1 presents the projected operations of the HI trust fund under the intermediate assumptions for the next decade. At the beginning of 2007, HI assets significantly exceeded annual expenditures. The Board of Trustees has recommended that assets be maintained at a level at least equal to annual expenditures, to serve as an adequate contingency reserve in the event of adverse economic or other conditions.

Based on the 10-year projection shown in table II.E1, the Board of Trustees applies an explicit test of short-range financial adequacy, which is described in section III.B of this report. The HI trust fund does not meet this test because assets are estimated to fall below 100 percent of annual expenditures within the next 10 years.

Table II.E1.—Estimated Operations of the HI Trust Fund under Intermediate Assumptions, Calendar Years 2006-2016
[Dollar amounts in billions]

Calendar year	Total income[1]	Total expenditures	Change in fund	Fund at year end	Ratio of assets to expenditures[2]
2006[3]	$211.5	$191.9	$19.6	$305.4	149%
2007	223.6	208.2	15.4	320.8	147
2008	234.3	224.2	10.1	330.9	143
2009	247.8	240.7	7.1	337.9	137
2010	260.9	257.7	3.1	341.0	131
2011	274.4	275.1	−0.7	340.4	124
2012	287.8	293.9	−6.1	334.3	116
2013	301.0	314.5	−13.5	320.8	106
2014	313.9	336.4	−22.5	298.3	95
2015	327.0	359.8	−32.8	265.5	83
2016	340.4	385.4	−44.9	220.5	69

[1]Includes interest income.
[2]Ratio of assets in the fund at the beginning of the year to expenditures during the year.
[3]Figures for 2006 represent actual experience.

Note: Totals do not necessarily equal the sums of rounded components.

A comparison with last year's estimates reveals that actual payroll tax income in 2006 and projected future amounts are slightly higher than previously projected. This results from higher average wages than previously assumed. In addition, projected HI expenditures are slightly lower over the 10-year period. The result is a slower depletion of trust fund assets than previously estimated, as well as increased interest earnings. The cumulative effect of these factors is a higher level of projected HI assets relative to annual expenditures.

2. 75-Year Actuarial Estimates (2007-2081)

Each year, 75-year estimates of the financial and actuarial status of the HI trust fund are prepared. Although financial outcomes are inherently uncertain, particularly over periods as long as 75 years, such estimates can indicate whether the trust fund—as seen from today's vantage point—is considered to be in satisfactory financial condition.

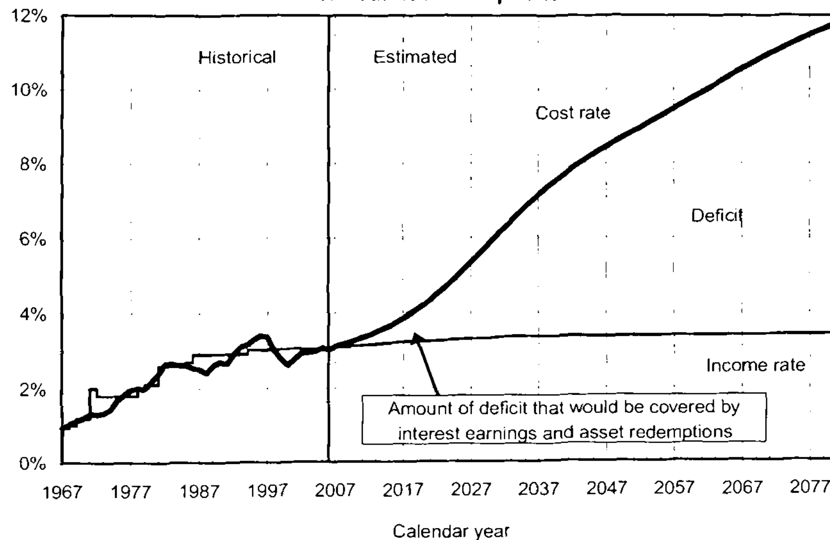
Because of the difficulty in comparing dollar values for different periods without some type of relative scale, income and expenditure amounts are shown relative to the earnings in covered employment that are taxable under HI (referred to as "taxable payroll"). The ratio of tax income (including both payroll taxes and income from taxation of Social Security benefits, but excluding interest income) to taxable payroll is called the "income rate," and the ratio of expenditures to taxable payroll is the "cost rate."

Since HI payroll tax rates are not scheduled to change in the future under current law, payroll tax income as a percentage of taxable payroll will remain constant at 2.90 percent. Income from taxation of benefits will increase only gradually as a greater proportion of Social Security beneficiaries become subject to such taxation over time. Thus, the income rate is not expected to increase significantly over current levels. The cost rate, though, will sharply escalate due to retirements of those in the baby boom generation and continuing health services cost growth, as mentioned in the prior section.

Figure II.E1 compares projected income and cost rates under the intermediate assumptions. As indicated, HI expenditures are projected to continue to exceed tax income by a rapidly growing margin. In 2019, for example, taxes would cover only 79 percent of estimated expenditures and, in 2050, only 38 percent. By the end of the 75-year period, HI costs would be over three times the level of scheduled tax revenues—a substantial deficit by any standard.

The shaded area in figure II.E1 represents the excess of expenditures over tax income that could be met by interest earnings and the redemption of trust fund assets. Both types of transactions occur through transfers from the general fund of the Treasury. Starting in 2007, the fund is expected to begin using interest earnings to cover the excess of expenditures over tax income. Starting in 2011, trust fund assets will begin to be used also, to cover the excess. In the absence of other changes, this process will continue through 2019, at which time the fund is projected to be exhausted. The HI trust fund's projected year of exhaustion often receives considerable attention. In practice, however, the demands on general revenue (to pay interest and redeem the Treasury bonds held by the trust fund) have already begun, some 12 years before the exhaustion date. By 2018, in the absence of legislation to address the HI deficits, an estimated 19 percent of HI expenditures would have to be met by redeeming assets as opposed to being covered by tax income for that year.

Figure II.E1.—Long-Range HI Income and Cost as a Percentage of Taxable Payroll, Intermediate Assumptions



The year-by-year cost rates and income rates shown in figure II.E1 can be summarized into single values representing, in effect, the average value over a given period. Based on the intermediate assumptions, an actuarial deficit of 3.55 percent of taxable payroll is projected for the 75-year period, representing the difference between the summarized income rate of 3.40 percent and the corresponding cost rate of 6.95 percent. Based on this measure, the HI trust fund continues to fail the Trustees' test for long-range financial balance.

Overview

The long-range financial imbalance could be addressed in several different ways. In theory, the 2.90-percent payroll tax could be immediately increased to 6.45 percent, or expenditures could be reduced by a corresponding amount. Note, however, that these changes would require an immediate 122-percent increase in the tax rate or an immediate 51-percent reduction in expenditures.[7] More realistically, the tax and/or benefit changes could be made gradually, rather than immediately, but would ultimately have to reach much more substantial levels to eliminate the deficit throughout the long-range period. At the end of the 75-year period, for example, the tax rate would have to be more than three times its current level, or benefit expenditures would have to be less than one-third of their projected amount (or some combination). These examples illustrate the severe magnitude of the projected long-range deficits for the HI trust fund and the need for reform.

Under the intermediate assumptions, the assets of the HI trust fund would continue decreasing, as a percentage of annual expenditures, from about 147 percent of annual expenditures at the beginning of 2007 until becoming exhausted in 2019, as illustrated in figure II.E2. This date is 1 year later than estimated in the 2006 annual report, due to the slightly higher projected income and lower projected expenditures mentioned earlier.

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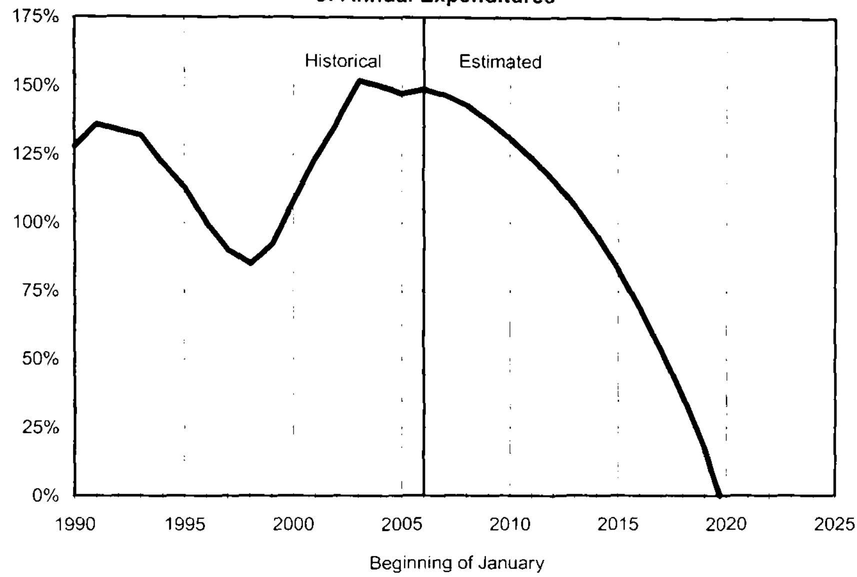
[7]Under either of these two scenarios, tax income would initially be substantially greater than expenditures, and trust fund assets would accumulate rapidly. Subsequently, however, financing would be increasingly inadequate, and assets would be drawn down to cover the difference. At the end of the 75-year period, tax income would cover only about 60 percent of annual expenditures. Level changes in either taxes or benefits, consequently, would not permanently address the long-range financial imbalance and would result in unusual patterns of asset accumulation and redemption.

Figure II.E2.—HI Trust Fund Balance at Beginning of Year as a Percentage of Annual Expenditures



To the extent that actual future conditions vary from the intermediate assumptions, the date of exhaustion could differ substantially in either direction from this estimate. Under the low cost assumptions, trust fund assets would not be depleted until 2042. Under the high cost assumptions, however, asset depletion would occur in 2014.

F. FINANCIAL STATUS OF THE SMI TRUST FUND

SMI differs fundamentally from HI in regard to the nature of financing and the method by which financial status is evaluated. As a result of the Medicare Modernization Act, SMI is now composed of two parts, Part B and Part D, each with its own separate account within the SMI trust fund. The financial status of the SMI trust fund must be determined by evaluating the financial status of each account separately, since there is no provision in the law for transferring assets between the Part B and Part D accounts. The nature of the financing for both parts of SMI is similar, in that the Part B premium and the Part D premium, and the corresponding transfers from general revenues for each part, are established annually at a level sufficient to cover the following year's estimated expenditures. Thus, each account within SMI is automatically in financial balance under current law. For OASDI and HI, however, financing established many years earlier may prove significantly higher or lower than subsequent actual costs. Moreover, Part B and Part D are voluntary (whereas OASDI and HI are generally compulsory), and income is not based on payroll taxes. These disparities result in a financial assessment that differs in some respects from that for OASDI or HI, as described in the following sections.

1. 10-Year Actuarial Estimates (2007-2016)

Table II.F1 shows the estimated operations of the Part B account, the Part D account, and the total SMI trust fund under the intermediate assumptions during calendar years 2006 through 2016. For Part B, expenditures grew at an average annual rate of 10.8 percent over the past 5 years, primarily as a result of significant increases in the volume and complexity of most types of covered services. The Part B growth rate exceeded GDP growth by 5.3 percent annually, on average. Part B cost increases are estimated to average about 6.6 percent for the 10-year period 2007 to 2016, about 1.8 percent per year faster than GDP, in part as a result of unrealistic reductions in physician payments required by current law. Legislative changes to physician payments are likely and could increase the projected Part B growth rates to roughly 8 to 9 percent.

Part B income growth normally matches expenditure growth fairly closely. During the last few years, however, premiums and general revenue financing have been increased at a faster pace than expenditures in an effort to rebuild Part B account assets to an

adequate contingency reserve. Under current law, assets are projected to fall just within the desired range by the end of 2007 (but would not do so if legislation is enacted to address a scheduled 10-percent reduction in physician fees for 2008).*

As noted, the projected Part B expenditure and income growth is unrealistically low, due to the structure of physician payment updates under current law. Future physician payment increases must be adjusted downward if cumulative past actual physician spending exceeds a statutory target. Prior to the Consolidated Appropriations Resolution (CAR), past spending was already above the target level. CAR raised the physician fee update for 2003, but without raising the target. The Medicare Modernization Act and the Deficit Reduction Act again raised the physician fee schedule updates for 2004, 2005, and 2006 without raising the target. The Tax Relief and Health Care Act raised the physician fee schedule update for 2007, increased the target for 1 year, and specified that the 2008 physician fee schedule conversion factor be computed as if the 2007 physician fee schedule update had not been changed. Together, these factors yield projected physician updates of about –10 percent for 2008 and about –5 percent for at least 8 consecutive years, from 2009 through 2016.

Given recent history, multiple years of significant reductions in physician payments per service are very unlikely to occur before legislative changes intervene. Scheduled negative physician fee updates in 2003 through 2007 have already been avoided by legislation, and the negative physician fee update scheduled for 2008 is larger than any of those previously avoided. However, these unlikely payment reductions are required under the current-law payment system and are reflected in the Part B projections shown in this report. Therefore, the Part B, total SMI, and total Medicare estimates shown for 2008 and thereafter are likely understated and should be interpreted cautiously.

The Part B projections, in particular, may be understated by 25 to 40 percent in the long range and thus have limited usefulness. At the request of the Trustees, the Office of the Actuary at the Centers for Medicare & Medicaid Services (CMS) has prepared two illustrative sets of Part B projections under theoretical alternatives to current

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*The traditional measure used to evaluate the status of the Part B account of the SMI trust fund is defined as the ratio of the excess of Part B assets over Part B liabilities to the next year's Part B incurred expenditures. The desired range for this ratio is 15 to 20 percent, and was developed based on past studies which indicated that this level of excess assets is sufficient to protect against adverse events.

law. These projections are available at http://www.cms.hhs.gov/ReportsTrustFunds/05_alternativePartB.asp. No endorsement of these alternatives to current law by the Trustees, CMS, or the Office of the Actuary should be inferred.

Table II.F1.—Estimated Operations of the SMI Trust Fund under Intermediate Assumptions, Calendar Years 2006-2016

[Dollar amounts in billions]

Calendar year	Total income[1]	Total expenditures	Change in fund	Fund at year end
Part B account:				
2006[2]	$177.3	$169.0	$8.3	$32.3
2007	188.0	179.6	8.4	40.7
2008	198.3	190.8	7.5	48.2
2009	223.5[3]	202.9	20.7	68.8
2010	201.0[3]	216.1	−15.2	53.7
2011	232.5	229.3	3.2	56.9
2012	248.6	244.4	4.2	61.1
2013	266.1	261.6	4.5	65.6
2014	284.7	279.9	4.7	70.3
2015	331.8[3]	299.5	32.3	102.5
2016	300.4[3]	321.6	−21.2	81.4
Part D account:				
2006[2]	48.2	47.4	0.8	0.8
2007	50.1	50.1	0.0	0.8
2008	61.9	61.9	0.0	0.8
2009	69.6[3]	69.6	0.0	0.9
2010	78.7[3]	78.6	0.0	0.9
2011	89.1	89.0	0.1	1.0
2012	101.4	101.3	0.1	1.0
2013	112.0	111.9	0.1	1.1
2014	124.8	124.8	0.1	1.2
2015	139.3[3]	139.2	0.1	1.3
2016	155.7[3]	155.6	0.1	1.4
Total SMI:				
2006[2]	225.5	216.4	9.1	33.1
2007	238.1	229.7	8.4	41.5
2008	260.2	252.6	7.5	49.0
2009	293.1[3]	272.4	20.7	69.7
2010	279.6[3]	294.7	−15.1	54.6
2011	321.6	318.3	3.3	57.9
2012	350.0	345.7	4.3	62.1
2013	378.1	373.5	4.6	66.7
2014	409.5	404.7	4.8	71.5
2015	471.1[3]	438.7	32.3	103.8
2016	456.1[3]	477.2	−21.1	82.8

[1]Includes interest income.
[2]Figures for 2006 represent actual experience.
[3]Section 708 of the Social Security Act modifies the provisions for the delivery of Social Security benefit checks when the regularly designated day falls on a Saturday, Sunday, or legal public holiday. Delivery of benefit checks normally due January 3, 2010 is expected to occur on December 31, 2009. Consequently, the Part B and Part D premiums withheld from the checks and the associated Part B general revenue contributions are expected to be added to the Part B account and Part D account, respectively, on December 31, 2009. These amounts are excluded from the premium income and general revenue income for 2010. Similarly, delivery of benefit checks normally due January 3, 2016 is expected to occur on December 31, 2015.

In general, Part B income and outgo will remain in approximate balance as a result of the annual adjustment of premium and general revenue income to match costs. Over temporary periods, it is possible

for these amounts to differ, sometimes significantly. For example, financing rates for 2004 were set with the intention of increasing the assets in the Part B account of the trust fund to a more adequate level. The subsequent enactment of the MMA, however, increased Part B expenditures significantly above the level anticipated when the financing was set. Moreover, other factors in 2004 also raised costs faster than anticipated. As a result, Part B assets declined by $4.5 billion in 2004. This deficit brought the total asset loss during 1999 through 2004 to $26.8 billion, leaving assets at the end of 2004 substantially below the normal level that is optimal for the Part B account.

Therefore, the financing rates for 2005, 2006, and 2007 were set with the intention of taking steps toward restoring the assets to a more adequate level. However, the financing rates for 2004, 2005, and 2006 were determined before actual costs were known for these years. In addition, the Deficit Reduction Act (DRA) increased Part B costs for 2006 and later after the 2006 financing had been determined, and the Tax Relief and Health Care Act (TRA) increased the costs for 2007 after the 2007 financing had been determined. Because of higher-than-anticipated 2004 and 2005 costs, the DRA, and the TRA, the increase in the Part B account assets was less than desired in 2005 and 2006, and the asset increase is now expected to be restricted again in 2007. The result is that the Part B assets will likely remain below the desired level. Under current law, correcting this situation would require a 3-percent increase in the 2008 premium, along with the corresponding general revenue transfers. However, should legislative changes block the negative physician updates that will otherwise occur for 2008 and later under current law, this increase would need to be larger. After 2007, assets held in the Part B account are projected to maintain an adequate contingency reserve for the Part B account of the trust fund, under current law.

The Part D account of the SMI trust fund was established in 2004 for Medicare prescription drug coverage, which began in 2006. For 2004 and 2005, the Transitional Assistance Account handled the transactions for transitional assistance under the prescription drug card program, with any remaining assets transferred to the Part D account in 2006.[9] Income and expenditures for the Part D account are projected to grow at an average annual rate of 12.6 percent for the 10-year period 2006 to 2016, in part due to expected further increases in enrollment. As with Part B, income and outgo are projected to

[9]For simplicity, the Transitional Assistance Account is treated in this report as if it were included in the Part D account.

remain in balance through the annual adjustment of premium and general revenue income to match costs. As a result of the appropriations process for Part D general revenues, it is not necessary to maintain a contingency reserve in the account (see section III.C3 for further details).

The projected Part D costs shown in this report are significantly lower than those in the 2006 report. The reduction is primarily attributable to the 2007 prescription drug plan bid submissions. The average 2007 plan bid was about 10 percent lower than in 2006. This extraordinary change reflected a number of factors, including a significant drop in plans' expectations for preferred brand name drug use and an associated increase in generic utilization. The decrease is also believed to reflect the substantial competition among Part D plans, together with much slower growth in prescription drug costs, generally, in 2004 through 2006 compared with prior years.

The primary test of financial adequacy for Parts B and D pertains to the level of the financing that has been formally established for a given period (normally, through the end of the current calendar year). As noted, the financial adequacy must be determined for Part B and Part D separately. The financing for each part of SMI is considered satisfactory if it is sufficient to fund all services, including benefits and administrative expenses, provided through a given period. Further, to protect against the possibility that cost increases under either part of SMI will be higher than expected, the accounts of the trust fund need assets adequate to cover a reasonable degree of variation between actual and projected costs. For Part B, the financing established through December 2007 is estimated to be sufficient to cover benefits and administrative costs incurred through that time period. As a result of the current higher-than-anticipated Part B expenditure level and the TRA, however, limited progress is expected in 2007 toward restoring the account balance to a more adequate contingency reserve level. The financing established for Part D is estimated to be sufficient to cover benefits and administrative costs incurred through 2007.

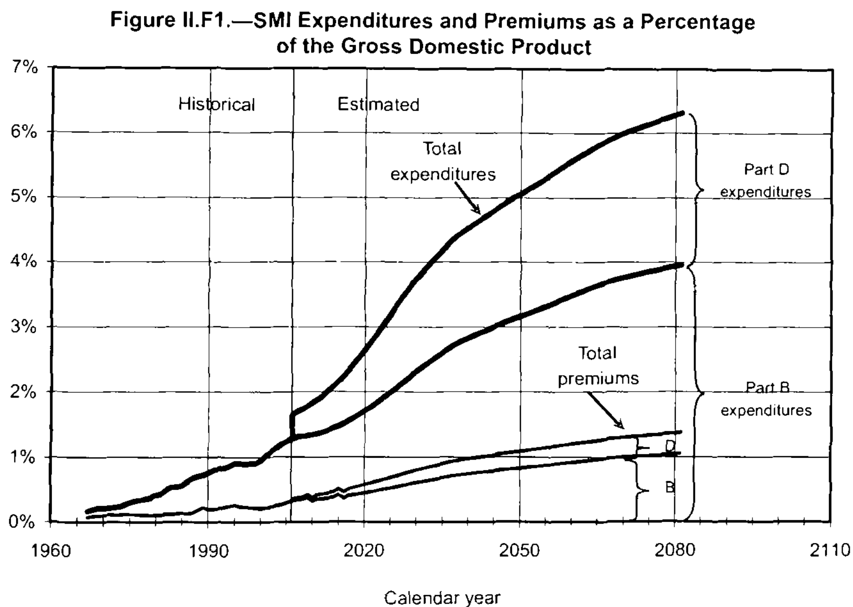
The amount of the contingency reserve needed in Part B is much smaller (both in absolute dollars and as a fraction of annual costs) than in HI or OASDI. This is so because the premium rate and corresponding general revenue transfers for Part B are determined annually based on estimated future costs, while the HI and OASDI payroll tax rates are set in law and are therefore much more difficult to adjust should circumstances change. Part D revenues are also

established annually to match estimated costs. Moreover, general revenue transfers for Part D will be made as funds are needed, thereby eliminating the need for a contingency reserve to cover unexpectedly higher costs.

2. 75-Year Actuarial Estimates (2007-2081)

Figure II.F1 shows past and projected total SMI expenditures and premium income as a percentage of the Gross Domestic Product (GDP). As noted, SMI expenditures are significantly understated as a result of unrealistic physician payment reductions required under the current-law sustainable growth rate system. As a result, the SMI estimates after 2007 should be interpreted cautiously. Annual SMI expenditures grew from about 1.2 percent of GDP in 2005 to 1.6 percent of GDP in 2006 with the commencement of the general prescription drug coverage. Under the intermediate assumptions, SMI expenditures would grow to almost 4 percent of GDP within 25 years and to more than 6 percent by the end of the projection period.

Figure II.F1.—SMI Expenditures and Premiums as a Percentage of the Gross Domestic Product



The projected SMI cost under current law would place steadily increasing demands on beneficiaries and society at large. Average per-beneficiary costs for Part B and Part D benefits are projected to increase after 2007 by at least 5 percent annually, despite the significant reductions in Part B physician payments under current

law. The associated beneficiary premiums would increase by approximately the same rate, as would the average levels of beneficiary coinsurance for covered services. In contrast, from one generation to the next, scheduled Social Security benefit levels increase at about the rate of growth in average earnings (estimated at roughly 3.8 percent).[10] Over time, the Part B and Part D premiums and coinsurance amounts paid by beneficiaries would typically represent a growing share of their total Social Security and other income. (Beneficiaries who qualify for Medicaid and the Part D low-income subsidy are an important exception to this trend, since they generally pay little or no premiums and cost-sharing amounts.)

Similarly, aggregate SMI general revenue financing for Parts B and D is expected to increase by roughly 6.5 percent annually, well in excess of the projected 4.4-percent growth in GDP. As a result, if personal and corporate Federal income taxes are maintained at their long-term historical level, relative to the national economy in the future, then SMI general revenue financing would represent a growing share of the total income tax revenue of the Federal Government.

[10]For each generation, after beneficiaries are initially eligible, their benefit level is adjusted to keep up with inflation (estimated at 2.8 percent).

G. CONCLUSION

Total Medicare expenditures were $408 billion in 2006 and are expected to increase in future years at a faster pace than either workers' earnings or the economy overall. As a percentage of GDP, expenditures are projected to increase from 3.1 percent currently to 11.3 percent by 2081 (based on our intermediate set of assumptions). The level of Medicare expenditures is expected to exceed that for Social Security in 2028 and, by 2081, to be 80 percent more than the cost of Social Security. Growth of this magnitude, if realized, would place a substantially greater strain on the nation's workers, Medicare beneficiaries, and the Federal Budget.

Total Medicare outlays, less dedicated revenues, are projected to first exceed 45 percent of outlays in 2013. Since this is within the first 7 fiscal years of the projection period, the Board determines that a condition of projected "excess general revenue Medicare funding" exists for the second consecutive year. This determination triggers a "Medicare funding warning," as required by the Medicare Modernization Act.

The HI trust fund ratio is expected to decline steadily after 2006. The trust fund is projected to be exhausted in 2019—1 year later than estimated in last year's report, primarily as a result of slightly higher projected payroll tax income and slightly lower expenditures than previously estimated. The HI trust fund fails to meet our short-range test of financial adequacy.

The long-range financial projections for HI continue to show a substantial financial imbalance. The long-range HI actuarial deficit in this year's report is 3.55 percent of taxable payroll, up slightly from 3.51 percent in last year's report. Tax income is expected to be less than expenditures in all future years, and trust fund assets would begin to decline in 2011. Without legislation to address these deficits, HI would increasingly rely on interest income and the redemption of fund assets, thereby adding to the draw on the Federal Budget. Scheduled HI tax income would cover only 79 percent of estimated expenditures in 2019 and only 38 percent in 2050. By the end of the 75-year period, less than one-third of HI costs could be paid from HI tax revenues. Accordingly, bringing the HI program into long-range financial balance would require very substantial increases in revenues and/or reductions in expenditures. As in past reports, the HI trust fund fails to meet our long-range test of close actuarial balance.

Overview

The financial outlook for SMI is fundamentally different than for HI, as a result of the statutory differences in how these two components of Medicare are financed. However, rapid expenditure growth is a serious issue for both. The Medicare Modernization Act established a separate account within the SMI trust fund to handle transactions for the new Medicare drug benefit. Because there is no authority to transfer assets between the new Part D account and the existing Part B account, it is necessary to evaluate each account's financial adequacy separately. Part B assets minus liabilities at the end of 2004 were at their lowest level, relative to annual outlays, in nearly 30 years. Moreover, while the financing established for the Part B account for calendar year 2007 is adequate to cover 2007 expected expenditures, the financial status of the Part B account in 2007 remains below the optimal level. Thus, the Part B financing rates for 2008 will have to be increased—for the fifth year in a row—in an effort to return to an adequate contingency reserve.

No financial imbalance is anticipated for the Part D account, since the general revenue subsidy for this benefit is drawn on a daily, as-needed basis. The projected Part D costs shown in this report are significantly lower than in previous reports, reflecting the latest data on drug cost trends generally and Part D bid levels.

For both the Part B and Part D accounts, income is projected to equal expenditures for all future years—but only because beneficiary premiums and general revenue transfers will be set to meet expected costs each year.

The projections shown in this report continue to demonstrate the need for timely and effective action to address Medicare's financial challenges—both the long-range financial imbalance facing the HI trust fund and the heightened problem of rapid growth in expenditures. We believe that solutions can and must be found to ensure the financial integrity of HI in the long term and to reduce the rate of growth in Medicare costs. Consideration of such reforms should occur in the relatively near future. The sooner the solutions are enacted, the more flexible and gradual they can be. Moreover, the early introduction of reforms increases the time available for affected individuals and organizations—including health care providers, beneficiaries, and taxpayers—to adjust their expectations. We believe that prompt, effective, and decisive action is necessary to address these challenges.

III. ACTUARIAL ANALYSIS

A. MEDICARE FINANCIAL PROJECTIONS

Medicare is the nation's second largest social insurance program, exceeded only by Social Security (OASDI). Although Medicare's two components—Hospital Insurance and Supplementary Medical Insurance—are very different from each other in many key respects, it is important to consider the overall cost of Medicare and the manner in which that cost is financed. By reviewing Medicare's total expenditures, the financial obligation posed by the program can be assessed. Similarly, the sources and relative magnitudes of HI and SMI revenues are an important policy matter. It should be noted that the Part B expenditures, and therefore the SMI and total Medicare expenditures, are substantially understated because projected current-law physician payment updates are unrealistically reduced under the sustainable growth rate system. Consequently, the estimates after 2007 should be used cautiously in evaluating the financial obligation posed by Medicare.

The issues of Medicare's total cost to society and how that cost is met are different from the question of the financial status of the Medicare trust funds. The latter focuses on whether a specific trust fund's income and expenditures are in balance. As discussed later in this section, such an analysis must be performed for each trust fund individually. The separate HI and SMI financial projections prepared for this purpose, however, can be usefully combined for the broader purposes outlined above. To that end, this section presents information on combined HI and SMI costs and revenues. Sections III.B and III.C of this report present detailed assessments of the financial status of the HI trust fund and the SMI trust fund, respectively.

1. 10-year Actuarial Estimates (2007-2016)

Table III.A1 shows past and projected Medicare income, expenditures, and trust fund assets in dollar amounts for calendar years.[11] Projections are shown under the intermediate set of assumptions for the short-range projection period 2007 through 2016 based on current law (including the unrealistic reductions in physician payment rates). A more detailed breakdown of

[11]Amounts are shown on a "cash" basis, reflecting actual expenditures made during the year, even if the payments were for services performed in an earlier year. Similarly, income figures represent amounts actually received during the year, even if incurred in an earlier year.

expenditures and income for HI and SMI is provided in tables III.B4 and III.C1, respectively.

Table III.A1.—Total Medicare Income, Expenditures, and Trust Fund Assets during Calendar Years 1970-2016
[In billions]

Calendar year	Total income	Total expenditures	Net change in assets	Assets at end of year
Historical data:				
1970	$8.2	$7.5	$0.7	$3.4
1975	17.7	16.3	1.3	12.0
1980	37.0	36.8	0.1	18.3
1985	76.5	72.3	4.2	31.4
1990	126.3	111.0	15.3	114.4
1995	175.3	184.2	−8.9	143.4
2000	257.1	221.8	35.3	221.5
2001	273.3	244.8	28.5	250.0
2002	284.8	265.7	19.1	269.1
2003	291.6	280.8	10.8	280.0
2004	317.7	308.9	8.8	288.8
2005	357.5	336.4	21.0	309.8
2006	437.0	408.3	28.7	338.5
Intermediate estimates:				
2007	461.7	437.9	23.8	362.2
2008	494.4	476.8	17.7	379.9
2009	540.9[1]	513.1	27.8	407.7
2010	540.5[1]	552.5	−12.0	395.6
2011	595.9	593.4	2.6	398.2
2012	637.7	639.6	−1.8	396.4
2013	679.1	688.0	−8.9	387.4
2014	723.4	741.1	−17.7	369.7
2015	798.1[1]	798.5	−0.4	369.3
2016	796.5[1]	862.5	−66.0	303.3

[1]Section 708 of the Social Security Act modifies the provisions for the delivery of Social Security benefit checks when the regularly designated day falls on a Saturday, Sunday, or legal public holiday. Delivery of benefit checks normally due January 3, 2010 will occur on December 31, 2009, and delivery of benefit checks normally due January 3, 2016 will occur on December 31, 2015.

Note: Totals do not necessarily equal the sums of rounded components.

As indicated in table III.A1, Medicare expenditures have increased rapidly during most of the program's history and are expected to continue doing so in the future. Health care cost increases, including those for Medicare, Medicaid, and private health insurance, are affected by the following factors:

- Growth in the number of beneficiaries;
- Increases in the prices paid per service, which reflect both higher wages for health care workers and inflation in the goods and services purchased by health care providers;
- Increases in the average number of services per beneficiary ("utilization"); and
- Increases in the average complexity of services ("intensity").

Medicare expenditures are projected to increase at an average annual rate of 7.8 percent during 2007-2016. The average growth rate reflects the continuing impact of each of the factors listed above, together with the effects of the provisions of the Medicare Modernization Act, the Deficit Reduction Act, and the Tax Relief Act, and the unrealistic physician payment reductions.

Through most of Medicare's history, trust fund income has kept pace with increases in expenditures.[12] In the future, however, Medicare income is projected to increase less rapidly than expenditures, primarily because HI payroll tax revenues would not keep pace with HI benefits under current law. In contrast to the growth factors listed above for health care costs, HI payroll taxes increase only as a function of the number of workers and increases in their average earnings. Moreover, with past declines in birth rates, continuing improvements in life expectancy, and prevailing rates of disability incidence, the number of workers is expected to grow slowly while the number of beneficiaries increases much more rapidly.

Past excesses of income over expenditures have been invested in U.S. Treasury securities, with total fund assets accumulating to $339 billion at the end of calendar year 2006. Combined assets are projected to continue increasing until reaching about $398 billion in 2011 and to begin declining thereafter.[13]

2. 75-year Actuarial Estimates (2007-2081)

Expressing Medicare expenditures as a percentage of GDP gives a relative measure of the size of the Medicare program compared to the general economy. The projection of this measure affords the public an idea of the relative financial resources that will be necessary to pay for Medicare services. However, after 2007, the projected SMI Part B and total Medicare expenditures are unrealistically low because of the current-law physician payment reductions. Should these payment rates, by new legislation, be prevented from declining, the overall Medicare costs shown in this section would be increased—possibly by 10 to 15 percent for 2030 and later (and by lower percentages prior to 2030), depending on the specific changes enacted.

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[12]This balance resulted from periodic increases in HI payroll tax rates and other HI financing, from annual increases in SMI premium and general revenue financing rates (to match the following year's estimated expenditures), and from frequent legislation designed to slow the rate of growth in expenditures.

[13]See sections III.B and III.C regarding the asset projections for HI and SMI, separately.

Table III.A2 shows past and projected Medicare expenditures expressed as a percentage of GDP.[14] Medicare expenditures represented 0.7 percent of GDP in 1970 and had grown to 2.7 percent of GDP by 2005, reflecting rapid increases in the factors affecting health care cost growth, as mentioned previously. Starting in 2006, Medicare provided subsidized access to prescription drug coverage through Part D, increasing projected Medicare expenditures to 3.1 percent of GDP.

Continuing rapid growth is expected thereafter, with total Medicare expenditures projected to reach about 11.3 percent of GDP by 2080. For comparison, projected Medicare costs would exceed those for Social Security in 2028 and would continue to grow more rapidly until, in 2081, the expenditure level for Medicare would be 80 percent more than that for Social Security. Another comparison would be that over the last 50 years, total Federal income tax receipts have averaged 11 percent of GDP.

As indicated, part of the projected substantial increase is attributable to the new prescription drug benefit in Medicare. In its first (partial) year of operation, this benefit increased aggregate Medicare costs by over one-eighth.[15] With continuing faster growth in drug costs, relative to the traditional HI and SMI Part B expenditures, this new benefit is projected to increase costs by roughly one-fourth for 2020 and later.[16]

The cost projections shown in table III.A2 for total Medicare, as well as for Parts A, B, and D, are somewhat different than those in the 2006 annual report. These differences arise for a number of reasons, which are described in sections III.B and III.C.

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[14]In contrast to the expenditure amounts shown in table III.A1, historical and projected expenditures are shown on an incurred basis. Incurred amounts relate to the expenditures for services performed in a given year, even if those expenditures are paid in a later year.

[15]Although the Part D drug benefit became available on January 1, 2006, beneficiaries had until May 15th to enroll. About 62 percent of the ultimate number of enrollees had enrolled as of January 1st.

[16]Costs beyond the first 25 years for HI, SMI Part B, and SMI Part D are each based on the assumption that age-sex-adjusted per beneficiary expenditures will increase at the rate determined by the economic model mentioned earlier. This rate is about 1.4 percent faster than the per capita GDP in 2031, decelerating to about the same rate as per capita GDP by 2081.

Table III.A2.—HI and SMI Incurred Expenditures as a Percentage of the Gross Domestic Product

Calendar year	HI Part A	SMI Part B	SMI Part D	Total
Historical data:				
1970	0.52%	0.22%	—	0.74%
1975	0.73	0.30	—	1.03
1980	0.91	0.41	—	1.32
1985	1.12	0.56	—	1.68
1990	1.14	0.76	—	1.90
1995	1.58	0.90	—	2.48
2000	1.33	0.95	—	2.28
2001	1.40	1.03	—	2.43
2002	1.44	1.08	—	2.52
2003	1.42	1.14	—	2.56
2004	1.43	1.19	0.00%	2.63
2005	1.46	1.23	0.01	2.70
2006	1.43	1.28	0.37	3.07
Intermediate estimates:				
2007	1.49	1.31	0.39	3.18
2008	1.52	1.32	0.42	3.25
2009	1.55	1.33	0.45	3.33
2010	1.58	1.35	0.49	3.41
2011	1.60	1.36	0.52	3.49
2012	1.63	1.39	0.57	3.59
2013	1.67	1.42	0.60	3.69
2014	1.71	1.45	0.64	3.81
2015	1.75	1.48	0.69	3.92
2020	2.00	1.71	0.93	4.64
2025	2.35	2.00	1.20	5.55
2030	2.75	2.32	1.43	6.51
2035	3.15	2.61	1.58	7.34
2040	3.48	2.83	1.70	8.01
2045	3.74	3.00	1.80	8.54
2050	3.95	3.16	1.90	9.00
2055	4.13	3.31	2.00	9.44
2060	4.33	3.48	2.10	9.91
2065	4.53	3.64	2.18	10.35
2070	4.71	3.76	2.24	10.72
2075	4.87	3.85	2.30	11.02
2080	5.00	3.94	2.35	11.29

The 75-year projection period fully allows for the presentation of future developments that are expected to occur, such as the impact of a large increase in enrollees that will begin within the next 10 years. This increase in the number of beneficiaries will occur because the relatively large number of persons born during the period between the end of World War II and the mid-1960s (known as the baby boom generation) will reach eligibility age and begin to receive benefits. Moreover, as the average age of Medicare beneficiaries increases, these individuals will experience greater health care utilization and costs, thereby adding further to growth in program expenditures. Table III.A3 shows past and projected enrollment in the Medicare program.

Table III.A3.—Medicare Enrollment
[In thousands]

Calendar year	HI	SMI			
	Part A	Part B	Part D	Part C[1]	Total[2]
Historical data:					
1970	20,104	19,496	—	—	20,398
1975	24,481	23,744	—	—	24,864
1980	28,002	27,278	—	—	28,433
1985	30,621	29,869	—	842	31,081
1990	33,747	32,567	—	1,181	34,251
1995	37,175	35,641	—	2,714	37,594
2000	39,257	37,335	—	6,233	39,688
2001	39,669	37,667	—	5,608	40,103
2002	40,065	37,982	—	5,005	40,508
2003	40,738	38,584	—	4,655	41,188
2004	41,485	39,123	1,217	4,683	41,902
2005	42,181	39,698	1,841	5,084	42,588
2006	42,852	40,271	27,854	6,550	43,249
Intermediate estimates:					
2007	43,772	40,726	30,957	7,644	44,160
2008	44,679	41,480	32,299	8,571	45,057
2009	45,655	42,294	33,679	9,414	46,022
2010	46,581	43,055	35,036	10,122	46,936
2011	47,647	43,901	36,511	10,717	47,992
2012	49,054	45,082	38,266	11,323	49,390
2013	50,587	46,404	39,448	11,891	50,915
2014	52,067	47,693	40,589	12,462	52,388
2015	53,571	48,999	41,748	13,002	53,884
2016	55,118	50,349	42,942	13,565	55,426
2020	61,927	56,342	48,203	15,924	62,216
2025	71,001	64,449	55,228	19,193	71,283
2030	78,813	71,528	61,283	22,308	79,098
2035	83,640	75,937	65,026	[3]	83,930
2040	86,578	78,675	67,306	[3]	86,872
2045	88,702	80,578	68,955	[3]	89,000
2050	91,140	82,802	70,846	[3]	91,441
2055	93,927	85,305	73,006	[3]	94,229
2060	97,283	88,386	75,607	[3]	97,587
2065	100,285	91,110	77,929	[3]	100,583
2070	103,056	93,651	80,069	[3]	103,345
2075	105,651	96,009	82,068	[3]	105,926
2080	108,366	98,477	84,158	[3]	108,623

[1]Number of beneficiaries enrolled in a Medicare Advantage plan. Figures from the early 1980s to 1997 represent those enrolled in a risk HMO, and figures from 1998 to 2003 represent those enrolled in a Medicare+Choice plan. In order to enroll in a Medicare Advantage plan, a beneficiary must be enrolled in both Part A and Part B. Therefore, Part C enrollment is a subset of both Part A and Part B enrollment.
[2]Number of beneficiaries with HI and/or SMI coverage.
[3]Enrollment in Medicare Advantage plans is not explicitly projected beyond 2030.

The past and projected amounts of Medicare revenues as a percentage of total non-interest Medicare income are shown in Table III.A4, based on the intermediate assumptions. Interest income is excluded, since, under current law, it would not be a significant part of program financing in the long range.

Table III.A4.—Medicare Sources of Income as a Percentage of Total Income

Calendar year	Payroll taxes	Tax on benefits	Premiums[1]	State transfers	General revenue
Historical data:					
1970	61.8%	0.0%	13.7%	0.0%	24.6%
1980	68.0	0.0	8.6	0.0	23.4
1990	62.2	0.0	9.8	0.0	27.9
2000	59.8	3.6	9.1	0.0	27.6
2006	43.3	2.5	11.7	1.3	41.2
Intermediate estimates:					
2010	43.1	2.9	12.3	1.5	40.2
2020	32.7	3.7	14.2	1.9	47.4
2030	25.3	3.7	15.7	2.4	53.0
2040	21.7	3.4	16.7	2.4	55.8
2050	19.7	3.1	17.4	2.5	57.3
2060	17.9	2.9	18.2	2.6	58.5
2070	16.5	2.8	18.9	2.6	59.2
2080	15.6	2.7	19.7	2.6	59.4

[1]Includes premium revenue from HI and both accounts in the SMI trust fund.

Note: Due to rounding, the sum of these percentages may not exactly equal 100 percent.

In 2006, HI payroll taxes represented 43 percent of total non-interest income to the Medicare program. General revenues (primarily those for SMI) were the next largest source of overall financing, at 41 percent. Beneficiary premiums (again, primarily for SMI) were third, at 12 percent. Under current law, HI tax revenues are projected to fall increasingly short of HI expenditures after 2006. In contrast, SMI premium and general revenues will keep pace with SMI expenditure growth, and, once fully phased down[17], state payments (on behalf of Medicare beneficiaries who also qualify for full Medicaid benefits) will grow with Part D expenditures. Consequently, in the absence of legislation, HI tax income would represent a declining portion of total Medicare revenues. In 2018, for example, just prior to the projected exhaustion of the HI trust fund, currently scheduled HI payroll taxes would represent about 34 percent of total non-interest Medicare income. General revenues and beneficiary premiums would equal about 46 and 14 percent, respectively.[18]

The Medicare Modernization Act (MMA) requires an expanded analysis of the combined expenditures and dedicated revenues of the HI and SMI trust funds. In particular, a determination must be made as to whether projected annual "general revenue funding" exceeds 45 percent of total Medicare outlays within the next 7 fiscal years

[17]State payments amounted to 90 percent of their projected foregone prescription drug costs in 2006, with this percentage phasing down over a 10-year period to 75 percent in 2015.

[18]The general revenue share of total Medicare *revenues* cannot be directly compared to the difference between outlays and dedicated revenues as a share of outlays (described previously). Although somewhat similar in magnitude, the former measure does not reflect the HI deficit, whereas the latter measure does.

(2007-2013). For this purpose, general revenue funding is defined in the law as total Medicare outlays minus dedicated Medicare financing sources. Dedicated Medicare financing sources include HI payroll taxes; income from taxation of Social Security benefits; State transfers for the prescription drug benefit; premiums paid under Parts A, B, and D; and any gifts received by the Medicare trust funds. The test is applied using incurred expenditures and revenues to avoid temporary distortions arising from the payment of Medicare Advantage capitation amounts in September when the normal October payment date is a Saturday or Sunday. Figure III.A1 shows the projected difference between total Medicare outlays and dedicated funding sources as a percentage of total outlays over the long-range projection period.

In the 2006 report, it was estimated that "general revenue funding" would exceed 45 percent in 2012, which was within the first 7 fiscal years. Therefore, a determination of "excess general revenue funding" was made. As indicated in figure III.A1, the difference between annual outlays and dedicated financing is now expected to first exceed 45 percent of total expenditures in 2013 under the intermediate assumptions. Since this estimate is within the 7-year test period prescribed in the law, a determination of projected "excess general revenue Medicare funding" is made for the second consecutive year in this report. Since it has been determined in two consecutive reports that the difference between Medicare outlays and dedicated financing sources is projected to reach 45 percent within the first 7 years, a "Medicare funding warning" is triggered, indicating that a trust fund's financing is inadequate or that the general revenues provided under current law are becoming unduly large. This finding requires the President to submit to Congress, within 15 days after the date of the next budget submission, proposed legislation to respond to the warning.[19] Congress is then required to consider this legislation on an expedited basis. This new requirement will help call attention to Medicare's impact on the Federal Budget.

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[19]The next such budget submission will be the President's Fiscal Year 2009 Budget, which will be released in early February 2008.

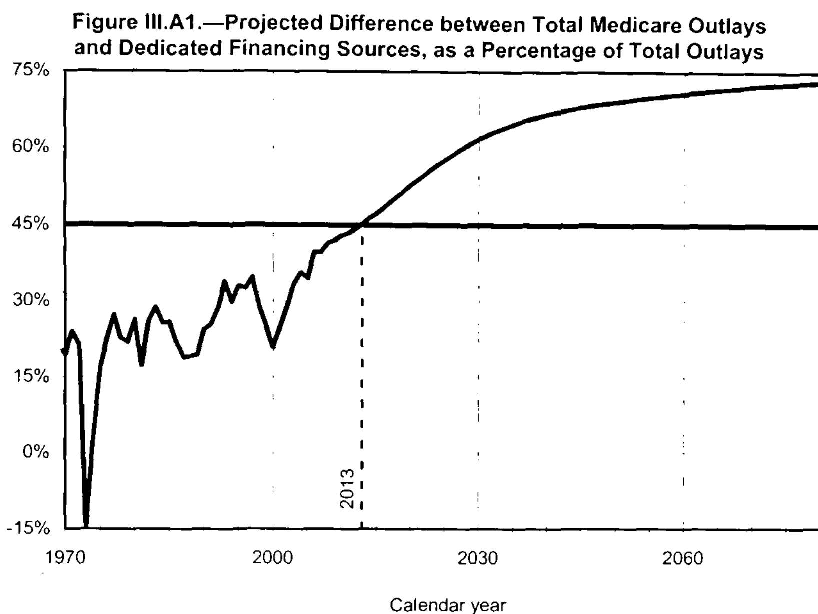

Figure III.A1.—Projected Difference between Total Medicare Outlays and Dedicated Financing Sources, as a Percentage of Total Outlays

As is also indicated in figure III.A1, the difference between outlays and dedicated funding sources is projected to continue growing throughout the 75-year period, reaching 63 percent of total outlays in 2031 and 73 percent in 2081. Although the law characterizes this difference as "general revenue funding," it is important to recognize that current law provides for general revenue transfers only for certain purposes related to Parts A, B, and D, as follows:

- Financing specified portions of SMI Part B and SMI Part D expenditures;
- Reimbursing the HI trust fund for the costs of certain uninsured beneficiaries;
- Paying interest on invested assets of the trust funds; and
- Redeeming the special Treasury securities held as assets by the trust funds.

The difference between outlays and dedicated funding sources, as shown in figure III.A1, will reflect all of these general revenue transfers, plus the imbalance between HI expenditures and dedicated revenues after HI asset exhaustion in 2019, for which there is no provision under current law to cover the shortfall. In particular,

transfers from the general fund of the Treasury could not be made for this purpose without new legislation.

The MMA also requires that projected growth in the difference between outlays and dedicated revenues be compared with other health spending growth rates. Table III.A5 contains this comparison.

Table III.A5.—Comparative Growth Rates of Medicare, Private Health Insurance, and National Health Expenditures

	Average annual growth in:				
Calendar year	Incurred outlays minus dedicated revenues	Incurred Medicare outlays	GDP	National health expenditures[1]	Private health insurance[1]
2001	29.7%	10.2%	3.2%	8.6%	9.6%
2002	22.0	7.2	3.4	9.1	10.5
2003	23.1	6.2	4.7	8.1	9.6
2004	16.6	9.8	6.9	7.2	7.9
2005	6.1	9.2	6.3	6.9	6.6
2006	38.5	21.0	6.3	6.8	4.8
2007	10.7	8.5	4.6	6.6	6.7
2008	9.5	7.3	5.0	7.0	7.0
2009	9.4	7.7	5.2	7.3	7.3
2010	9.8	7.6	5.1	6.9	6.7
2011	8.8	7.4	5.1	6.8	6.5
2012	10.1	7.8	4.9	7.0	6.5
2013	10.3	7.8	4.7	7.0	6.7
2014	10.2	7.7	4.6	6.9	6.3
2015	10.0	7.8	4.7	6.8	6.0
2016	10.7	8.0	4.7	6.8	5.8
2017-2031	8.0	9.9	4.5	—	—
2032-2056	5.5	5.9	4.4	—	—
2057-2081	5.0	5.1	4.4	—	—

[1]According to the national health expenditure (NHE) projections article, which was published on February 21, 2007. This article, along with the paper outlining the methodology, is available at http://www.cms.hhs.gov/NationalHealthExpendData/03_NationalHealthAccountsProjected.asp.

As shown in table III.A5, the gap between outlays and dedicated revenues, and Medicare outlays, both increased substantially when the prescription drug benefit was fully implemented in 2006. In addition, the outlay gap will increase faster than outlays throughout the 75-year period, since the dedicated sources of income to the HI trust fund will cover a decreasing percentage of HI outlays.

In addition to projected Medicare outlay growth, table III.A5 shows projected growth in GDP, total expenditures on health care in the U.S., and private health insurance expenditures. Each of the health expenditure categories is expected to increase more rapidly than GDP, continuing a longstanding trend. Private health insurance expenditures equal the total premiums earned by private health insurers, including benefits incurred and the net cost of insurance. The net cost of insurance includes administrative costs, additions to reserves, rate credits and dividends, premium taxes, and profits or

losses. Comparisons between aggregate Medicare and private health insurance cost growth are affected by several factors:

- The number of Medicare beneficiaries is currently increasing by about 1.5 percent per year, and this growth rate will approximately double after 2010 when the post-World War II baby boom generation reaches eligibility age. In recent years, the number of individuals with private health insurance has declined and is projected to increase only slowly in the future.

- The benefits covered by Medicare and private health insurance plans can vary. In particular, though most prescription drugs are currently covered by Medicare, this was not the case prior to 2006. Moreover, many Medicare beneficiaries who had private drug insurance coverage (such as Medigap policies) switched to the subsidized Part D coverage in 2006, thereby accelerating Medicare outlay growth while slowing private health insurance growth.

- The use of health care services differs significantly between Medicare beneficiaries (who are generally over 65) and individuals with private health insurance (who are predominantly below age 65). The former group, for example, has a higher incidence of hospitalization, skilled nursing care, and home health care. For the latter group, physician services represent a greater proportion of their total health care needs. Different cost growth trends by type of service will affect overall growth rates, reflecting the distribution of services for each category of people.

A number of research studies have attempted to control for some or all of these differences in comparing growth trends. Over long historical periods, average, demographically adjusted, per capita growth rates have been similar for Medicare and private health insurance. For shorter periods, however, the rates of growth have often diverged substantially. More information on past and projected national and private health expenditures, and comparisons to Medicare growth rates, is available in the sources cited in table III.A5.

Under current law, the HI and SMI trust funds are separate and distinct, each with its own sources of financing. There are no provisions for using HI revenues to finance SMI expenditures, or vice versa, or for lending assets between the two trust funds. Moreover, the benefit provisions, financing methods, and, to a lesser degree, eligibility rules are very different between these Medicare components. In particular, both accounts of the SMI trust fund are

automatically in financial balance under current law, whereas the HI fund is not.

For these reasons, the financial status of the Medicare trust funds can be evaluated only by separately assessing the status of each fund. The following two sections of this report present such assessments for HI and SMI, respectively.

B. HI FINANCIAL STATUS

1. Financial Operations in Calendar Year 2006

The Federal Hospital Insurance Trust Fund was established on July 30, 1965 as a separate account in the U.S. Treasury. All the HI financial operations are handled through this fund.

A statement of the revenue and expenditures of the fund in calendar year 2006, and of its assets at the beginning and end of the calendar year, is presented in table III.B1.

The total assets of the trust fund amounted to $285.8 billion on January 1, 2006. During calendar year 2006, total revenue amounted to $211.5 billion, and total expenditures were $191.9 billion. Total assets thus increased by $19.6 billion during the year, to $305.4 billion on December 31, 2006.

Table III.B1.—Statement of Operations of the HI Trust Fund during Calendar Year 2006
[In thousands]

Total assets of the trust fund, beginning of period	$285,769,529
Revenue:	
Payroll taxes	$181,274,266
Income from taxation of OASDI benefits	10,319,000
Interest on investments	15,736,764
Premiums collected from voluntary participants	2,644,550
Premiums collected from Medicare Advantage participants	30,262
Transfer from Railroad Retirement account	439,900
Reimbursement, transitional uninsured coverage	408,000
Reimbursement, program management general fund	130,797
Interest on reimbursements, SSA[1]	1,334
Interest on reimbursements, CMS[1]	0
Interest on reimbursements, Railroad Retirement	31,597
Other	2,622
Reimbursement, Union Activity	720
Fraud and abuse control receipts:	
Criminal fines	143,760
Civil monetary penalties	19,086
Civil penalties and damages, CMS	-6,736
Civil penalties and damages, Department of Justice	216,376
3% administrative expense reimbursement, Department of Justice	8,873
Fraud and abuse appropriation for FBI	114,000
Total revenue	$211,515,171
Expenditures:	
Net benefit payments	$188,989,159
Administrative expenses:	
Treasury administrative expenses	125,577
Salaries and expenses, SSA[2]	676,084
Salaries and expenses, CMS[3]	1,025,898
Salaries and expenses, Office of the Secretary, HHS	35,273
Medicare Payment Advisory Commission	6,040
Fraud and abuse control expenses:	
HHS Medicare integrity program	732,757
HHS Office of Inspector General	184,189
Department of Justice	43,814
FBI	114,000
Total expenditures	$191,932,792
Net addition to the trust fund	19,582,379
Total assets of the trust fund, end of period	$305,351,908

[1]A positive figure represents a transfer to the HI trust fund from the other trust funds. A negative figure represents a transfer from the HI trust fund to the other funds.
[2]For facilities, goods, and services provided by SSA.
[3]Includes administrative expenses of the intermediaries.

Note: Totals do not necessarily equal the sums of rounded components.

a. Revenues

The trust fund's primary source of income consists of amounts appropriated to it, under permanent authority, on the basis of taxes paid by workers, their employers, and individuals with self-employment income, in work covered by HI. Included in HI are

workers covered under the OASDI program, those covered under the Railroad Retirement program, and certain Federal, State, and local employees not otherwise covered under the OASDI program.

HI taxes are payable on a covered individual's total wages and self-employment income, without limit. For calendar years prior to 1994, taxes were computed on a person's annual earnings up to a specified maximum annual amount, called the maximum tax base. The maximum tax bases for 1966-1993 are presented in table III.B2. (Legislation enacted in 1993 removed the limit on taxable income beginning in calendar year 1994.)

The HI tax rates applicable in each of the calendar years 1966 and later are also shown in table III.B2. For 2008 and thereafter, the tax rates shown are the rates scheduled in current law.

Table III.B2.—Tax Rates and Maximum Tax Bases

		Tax rate (Percentage of taxable earnings)	
Calendar years	Maximum tax base	Employees and employers, each	Self-employed
Past experience:			
1966	$6,600	0.35%	0.35%
1967	6,600	0.50	0.50
1968-71	7,800	0.60	0.60
1972	9,000	0.60	0.60
1973	10,800	1.00	1.00
1974	13,200	0.90	0.90
1975	14,100	0.90	0.90
1976	15,300	0.90	0.90
1977	16,500	0.90	0.90
1978	17,700	1.00	1.00
1979	22,900	1.05	1.05
1980	25,900	1.05	1.05
1981	29,700	1.30	1.30
1982	32,400	1.30	1.30
1983	35,700	1.30	1.30
1984	37,800	1.30	2.60
1985	39,600	1.35	2.70
1986	42,000	1.45	2.90
1987	43,800	1.45	2.90
1988	45,000	1.45	2.90
1989	48,000	1.45	2.90
1990	51,300	1.45	2.90
1991	125,000	1.45	2.90
1992	130,200	1.45	2.90
1993	135,000	1.45	2.90
1994-2007	no limit	1.45	2.90
Scheduled in current law:			
2008 & later	no limit	1.45	2.90

Total HI payroll tax income in calendar year 2006 amounted to $181.3 billion—an increase of 5.8 percent over the amount of $171.4 billion for the preceding 12-month period. This increase in tax

income resulted from an increase in the number of workers and their earnings.

Up to 85 percent of an individual's or couple's OASDI benefits may be subject to Federal income taxation if their income exceeds certain thresholds. The income tax revenue attributable to the first 50 percent of OASDI benefits is allocated to the OASI and DI trust funds. The revenue associated with the amount between 50 and 85 percent of benefits is allocated to the HI trust fund. Income from the taxation of OASDI benefits amounted to $10.3 billion in calendar year 2006.

Another substantial source of trust fund income is interest credited from investments in government securities held by the fund. In calendar year 2006, $15.7 billion in interest was credited to the fund. The trust fund's investment procedures are described later in this section.

Section 1818 of the Social Security Act provides that certain persons not otherwise eligible for HI protection may obtain coverage by enrolling in HI and paying a monthly premium. Premiums collected from such voluntary participants in fiscal year 2006 amounted to about $2.6 billion.

The Railroad Retirement Act provides for a system of coordination and financial interchange between the Railroad Retirement program and the HI trust fund. This financial interchange requires a transfer that would place the HI trust fund in the same position in which it would have been if railroad employment had always been covered under the Social Security Act. In accordance with these provisions, a transfer of $440 million in principal and about $17 million in interest from the Railroad Retirement program's Social Security Equivalent Benefit Account to the HI trust fund balanced the two systems as of September 30, 2005. This amount, together with interest to the date of transfer totaling about $14 million, was transferred to the trust fund in June 2006.

Two sections of the statute authorize HI benefits for certain uninsured persons aged 65 and over. Entitlement to HI benefits was provided to almost all persons aged 65 and over, or near that age, when the HI trust fund first began operations. Legislation in 1982 added similar transitional entitlement for those Federal employees who would retire before having had a chance to earn sufficient quarters of Medicare-qualified Federal employment. The costs of this coverage, including administrative expenses, are reimbursed from the

general fund of the Treasury. In calendar year 2006, such reimbursement amounted to $408 million: $407 million for estimated benefit payments and $1 million for administrative expenses. The $407 million for benefit payments consisted of $201 million for non-Federal uninsured and $206 million for Federal uninsured beneficiaries.

The Health Insurance Portability and Accountability Act of 1996 established a health care fraud and abuse control account within the HI trust fund. Monies derived from the fraud and abuse control program are transferred from the general fund of the Treasury to the HI trust fund. During calendar year 2006, the trust fund was credited with about $495 million in receipts from this program.

b. Expenditures

Expenditures for HI benefit payments and administrative expenses are paid out of the trust fund. All expenses incurred by the Department of Health and Human Services, the Social Security Administration, the Department of the Treasury (including the Internal Revenue Service), and the Department of Justice in administering HI are charged to the trust fund. Such administrative duties include payment of benefits, the collection of taxes, fraud and abuse control activities, and experiments and demonstration projects designed to determine various methods of increasing efficiency and economy in providing health care services, while maintaining the quality of such services, under HI and SMI.

In addition, Congress has authorized expenditures from the trust funds for construction, rental and lease, or purchase contracts of office buildings and related facilities for use in connection with the administration of HI. These costs are included in trust fund expenditures. The net worth of facilities and other fixed capital assets, however, is not carried in the statement of trust fund assets presented in this report, since the value of fixed capital assets does not represent funds available for benefit or administrative expenditures and is not, therefore, considered in assessing the actuarial status of the funds.

Of the $191.9 billion in total HI expenditures, $189.0 billion represented net benefits paid from the trust fund for health services.[20]

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[20]Net benefits equal the total gross amounts initially paid from the trust fund during the year, less recoveries of overpayments identified through fraud and abuse control activities.

THE 2007 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS

COMMUNICATION

FROM

THE BOARD OF TRUSTEES, FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS

TRANSMITTING

THE 2007 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS

LETTER OF TRANSMITTAL

BOARD OF TRUSTEES OF THE
FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND
FEDERAL DISABILITY INSURANCE TRUST FUNDS,
Washington, D.C., April 23, 2007

The Honorable Nancy Pelosi
Speaker of the House of Representatives
Washington, D.C.

The Honorable Richard B. Cheney
President of the Senate
Washington, D.C.

Dear Madam Speaker and Mr. Cheney:

We have the honor of transmitting to you the 2007 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund, the 67th such report.

Respectfully,

/S/
Henry M. Paulson, Jr., *Secretary of the Treasury, and Managing Trustee of the Trust Funds.*

/S/
Elaine L. Chao, *Secretary of Labor, and Trustee.*

/S/
Michael O. Leavitt, *Secretary of Health and Human Services, and Trustee.*

/S/
Michael J. Astrue, *Commissioner of Social Security, and Trustee.*

/S/
John L. Palmer, *Trustee.*

/S/
Thomas R. Saving, *Trustee.*

/S/
Andrew G. Biggs, *Deputy Commissioner of Social Security, and Secretary, Board of Trustees.*

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THE 2007 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS

I. INTRODUCTION

The Old-Age, Survivors, and Disability Insurance (OASDI) program in the United States makes available a basic level of monthly income upon the attainment of retirement eligibility age, death, or disability by insured workers. The OASDI program consists of two separate parts which pay benefits to workers and their families—Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). Under OASI, monthly benefits are paid to retired workers and their families and to survivors of deceased workers. Under DI, monthly benefits are paid to disabled workers and their families.

The Board of Trustees was established under the Social Security Act to oversee the financial operations of the OASI and DI Trust Funds. The Board is composed of six members. Four members serve by virtue of their positions in the Federal Government: the Secretary of the Treasury, who is the Managing Trustee; the Secretary of Labor; the Secretary of Health and Human Services; and the Commissioner of Social Security. The other two members, John L. Palmer and Thomas R. Saving, are public representatives initially appointed by President William J. Clinton on October 28, 2000, and reappointed by President George W. Bush on April 18, 2006. The Deputy Commissioner of the Social Security Administration (SSA) is designated as Secretary of the Board.

The Social Security Act requires that the Board, among other duties, report annually to the Congress on the financial and actuarial status of the OASI and DI Trust Funds. This annual report, for 2007, is the 67th such report.

II. OVERVIEW

A. HIGHLIGHTS

The report's major findings are summarized below.

In 2006

At the end of 2006, 49 million people were receiving benefits: 34 million retired workers and their dependents, 7 million survivors of deceased workers, and 9 million disabled workers and their dependents. During the year an estimated 162 million people had earnings covered by Social Security and paid payroll taxes. Total benefits paid in 2006 were $546 billion. Income was $745 billion, and assets held in special issue U.S. Treasury securities grew to $2.0 trillion.

Short-Range Results

The OASI and DI Trust Funds, individually and combined, are adequately financed over the next 10 years under the intermediate assumptions. The combined assets of the OASI and DI Trust Funds are projected to increase from $2,048 billion at the beginning of 2007, or 345 percent of annual expenditures, to $4,210 billion at the beginning of 2016, or 407 percent of annual expenditures in that year. Combined assets were projected in last year's report to rise to 344 percent of annual expenditures at the beginning of 2007, and 407 percent at the beginning of 2016.

Long-Range Results

Under the intermediate assumptions, OASDI cost will increase more rapidly than tax income between about 2010 and 2030, due to the retirement of the large baby-boom generation. After 2030, increases in life expectancy and relatively low fertility rates will continue to increase Social Security system costs relative to tax income, but more slowly. Annual cost will exceed tax income starting in 2017 at which time the annual gap will be covered with cash from redemptions of special obligations of the Treasury that make up the trust fund assets, until these assets are exhausted in 2041. Separately, the DI fund is projected to be exhausted in 2026 and the OASI fund in 2042. For the 75-year projection period, the actuarial deficit is 1.95 percent of taxable payroll, 0.06 percentage point smaller than in last year's report. The open group unfunded obligation for OASDI over the 75-year period is $4.7 trillion in present value, and is $0.1 trillion above the measured level of a year ago. In the absence of any changes in assumptions, methods, and starting values,

the unfunded obligation would have risen to $4.8 trillion due to the change in the valuation date.

The OASDI annual cost rate is projected to increase from 11.21 percent of taxable payroll in 2007, to 16.59 percent in 2030, and to 18.55 percent in 2081, or to a level that is 5.20 percent of taxable payroll more than the projected income rate for 2081. In last year's report the OASDI cost for 2080 was estimated at 18.74 percent, or 5.38 percent of payroll more than the annual income rate for that year. Expressed in relation to the projected gross domestic product (GDP), OASDI cost is estimated to rise from the current level of 4.3 percent of GDP, to 6.2 percent in 2030, and to 6.3 percent in 2081.

Conclusion

Annual cost will begin to exceed tax income in 2017 for the combined OASDI Trust Funds, which are projected to become exhausted and thus unable to pay scheduled benefits in full on a timely basis in 2041 under the long-range intermediate assumptions. For the trust funds to remain solvent throughout the 75-year projection period, the combined payroll tax rate could be increased during the period in a manner equivalent to an immediate and permanent increase of 1.95 percentage points, benefits could be reduced during the period in a manner equivalent to an immediate and permanent reduction of 13.0 percent, general revenue transfers equivalent to $4.7 trillion in present value could be made during the period, or some combination of approaches could be adopted. Significantly larger changes would be required to maintain solvency beyond 75 years.

The projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers. Making adjustments sooner will allow them to be spread over more generations. Social Security plays a critical role in the lives of this year's (2007) 50 million beneficiaries and 163 million covered workers and their families. With informed discussion, creative thinking, and timely legislative action, we will work with Congress and others to ensure that Social Security continues to protect future generations.

B. TRUST FUND FINANCIAL OPERATIONS IN 2006

The table below shows the income, expenditures, and assets for the OASI, the DI and the combined OASDI Trust Funds in calendar year 2006.

Table II.B1.—Summary of 2006 Trust Fund Financial Operations

	Amounts (in billions)		
	OASI	DI	OASDI
Assets at the end of 2005	$1,663.0	$195.6	$1,858.7
Total income in 2006	642.2	102.6	744.9
Net contributions	534.8	90.8	625.6
Taxation of benefits	15.6	1.2	16.9
Interest	91.8	10.6	102.4
Total expenditures in 2006	461.0	94.5	555.4
Benefit payments	454.5	91.7	546.2
Railroad Retirement financial interchange	3.5	.4	3.8
Administrative expenses	3.0	2.3	5.3
Net increase in assets in 2006	181.3	8.2	189.5
Assets at the end of 2006	1,844.3	203.8	2,048.1

Note: Totals do not necessarily equal the sums of rounded components.

In 2006, net contributions accounted for 84 percent of total trust fund income. Net contributions consist of taxes paid by employees, employers and the self-employed on earnings covered by Social Security. These taxes were paid on covered earnings up to a specified maximum annual amount, which was $94,200 in 2006 and is increased each year automatically (to $97,500 in 2007) as the average wage increases. The tax rates scheduled under current law for 2006 and later are shown in table II.B2.

Table II.B2.—Tax Rates for 2006 and Later

	OASI	DI	OASDI
Tax rate for employees and employers, each (in percent)	5.30	0.90	6.20
Tax rate for self-employed persons (in percent)	10.60	1.80	12.40

Two percent of OASDI Trust Fund income came from subjecting up to 50 percent of Social Security benefits above specified levels to Federal personal income taxation, and 14 percent of OASDI income came from interest earned on investment of OASDI Trust Fund reserves. Social Security's assets are invested in interest-bearing securities of the U.S. Government. In 2006 the combined trust fund assets earned interest at an effective annual rate of

5.3 percent. More than 98 percent of expenditures from the combined OASDI Trust Funds in 2006 went to pay retirement, survivor, and disability benefits totaling $546.2 billion. The financial interchange with the Railroad Retirement program resulted in a payment of $3.8 billion from the combined OASDI Trust Funds, or about 0.7 percent of total expenditures. The administrative expenses of the Social Security program were $5.3 billion, less than 1.0 percent of total expenditures.

Assets of the trust funds provide a reserve to pay benefits whenever total program cost exceeds income. Trust fund assets increased by $189.5 billion in 2006 because income to each fund exceeded expenditures. At the end of 2006, the combined assets of the OASI and the DI Trust Funds were 345 percent of estimated expenditures for 2007, up from an actual level of 335 percent at the end of 2005.

C. ASSUMPTIONS ABOUT THE FUTURE

The actual future income and expenditures of the OASI and DI Trust Funds depend on many factors, including the size and characteristics of the population receiving benefits, the level of monthly benefit amounts, the size of the workforce, and the level of workers' earnings. These factors will depend in turn upon future birth rates, death rates, immigration, marriage and divorce rates, retirement-age patterns, disability incidence and termination rates, employment rates, productivity gains, wage increases, inflation, and many other demographic, economic, and program-specific factors.

The intermediate demographic and economic assumptions shown in table II.C1, designated as alternative II, reflect the Trustees' best estimates of future experience, and therefore most of the figures in this overview depict only the outcomes under the intermediate assumptions. Any projection of the future is, of course, uncertain. For this reason, alternatives I (low cost) and III (high cost) are included to provide a range of possible future experience. The assumptions for these two alternatives are also shown in table II.C1, and their implications are highlighted in a separate section on the uncertainty of the projections.

Assumptions are reexamined each year in light of recent experience and new information. This careful review and updating of the assumptions on an annual basis helps ensure that they provide the Trustees' best estimate of future possibilities.

Table II.C1.—Ultimate[1] Values of Key Demographic and Economic Assumptions for the Long-Range (75-year) Projection Period

Ultimate assumptions	Intermediate	Low Cost	High Cost
Total fertility rate (children per woman)	2.0	2.3	1.7
Average annual percentage reduction in total age-sex-adjusted death rates from 2031 to 2081	.70	.33	1.21
Annual net immigration (in thousands)	900	1,300	673
Annual percentage change in:			
Productivity (total U.S. economy)	1.7	2.0	1.4
Average wage in covered employment	3.9	3.4	4.4
Consumer Price Index (CPI)	2.8	1.8	3.8
Real-wage differential (percent)	1.1	1.6	.6
Unemployment rate (percent)	5.5	4.5	6.5
Annual trust fund real interest rate (percent)	2.9	3.6	2.1

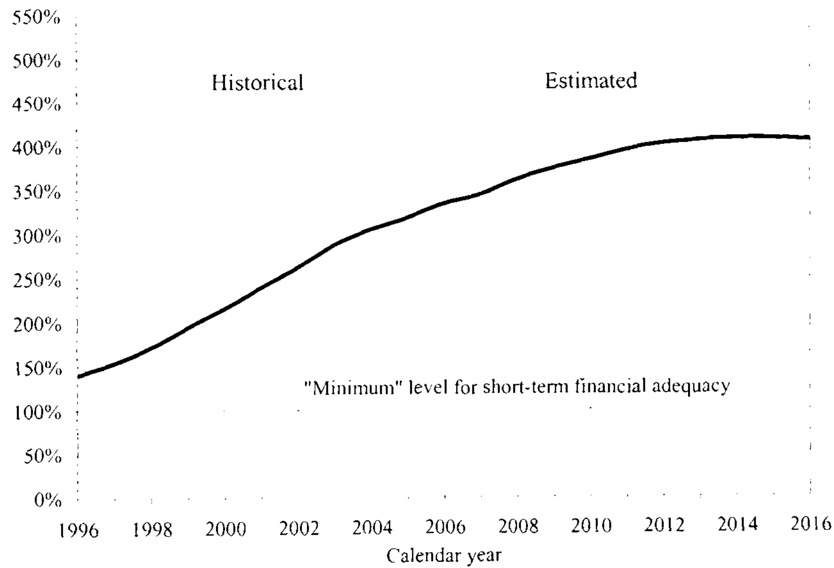
[1] Ultimate values are assumed to be reached within 2 to 25 years. See chapter V for details, including historical values and projected values prior to reaching the ultimate.

D. PROJECTIONS OF FUTURE FINANCIAL STATUS

Short-Range Actuarial Estimates

For the short range (2007-2016), the Trustees measure financial adequacy by comparing assets at the beginning of each year to projected program cost for that year under the intermediate set of assumptions. Having a trust fund ratio of 100 percent or more—that is, assets at the beginning of each year at least equal to projected cost for the year—is considered a good indication of a trust fund's ability to cover most short-term contingencies. Both the OASI and the DI trust fund ratios under the intermediate assumptions exceed 100 percent throughout the short-range period and therefore satisfy the Trustees' short-term test of financial adequacy. Figure II.D1 below shows that the trust fund ratios for the combined OASI and DI Trust Funds reach a peak level in 2014 and begin declining thereafter.

Figure II.D1.—Short-Range OASDI Trust Fund Ratios
[Assets as a percentage of annual expenditures]



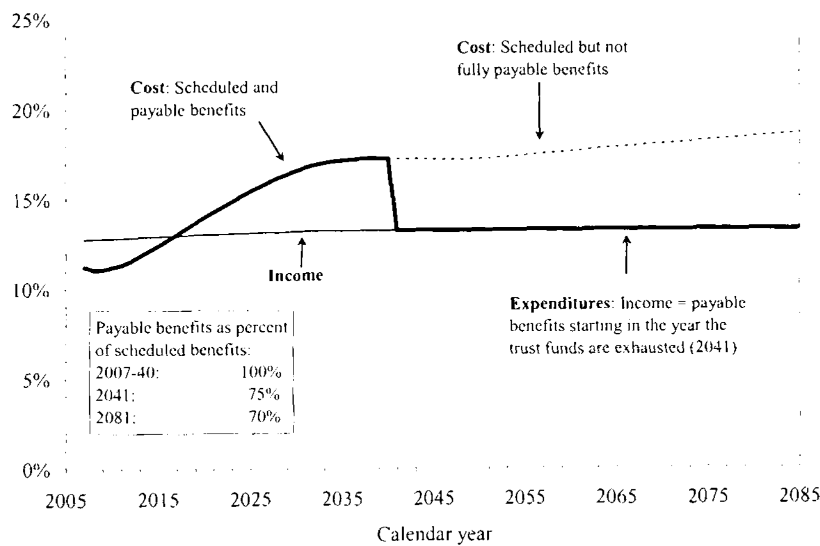
Long-Range Actuarial Estimates

The financial status of the program over the next 75 years is measured in terms of annual cost and income as a percentage of taxable payroll, trust fund ratios, the actuarial balance (also as a percentage of taxable payroll), and the open group unfunded obligation (expressed in present-value dollars). Con-

sidering Social Security's cost as a percentage of the total U.S. economic output (gross domestic product or GDP) provides an additional perspective.

The year-by-year relationship between income and cost rates shown in figure II.D2 illustrates the expected pattern of cash flows for the OASDI program over the full 75-year period. Under the intermediate assumptions, the OASDI cost rate is projected to decline slightly in 2008 and then increase up to the 2007 level within the next 2 years. It then begins to increase rapidly and first exceeds the income rate in 2017, producing cash-flow deficits thereafter. Cash-flow deficits are less than trust fund interest earnings until 2027. Redemption of trust fund assets will allow continuation of full benefit payments on a timely basis until 2041, when the trust funds will become exhausted. This redemption process will require a flow of cash from the General Fund of the Treasury. Pressures on the Federal Budget will thus emerge well before 2041. Even if a trust fund's assets are exhausted, however, tax income will continue to flow into the fund. Present tax rates would be sufficient to pay 75 percent of scheduled benefits after trust fund exhaustion in 2041 and 70 percent of scheduled benefits in 2081.

Figure II.D2.—OASDI Income and Cost Rates Under Intermediate Assumptions
[As a percentage of taxable payroll]

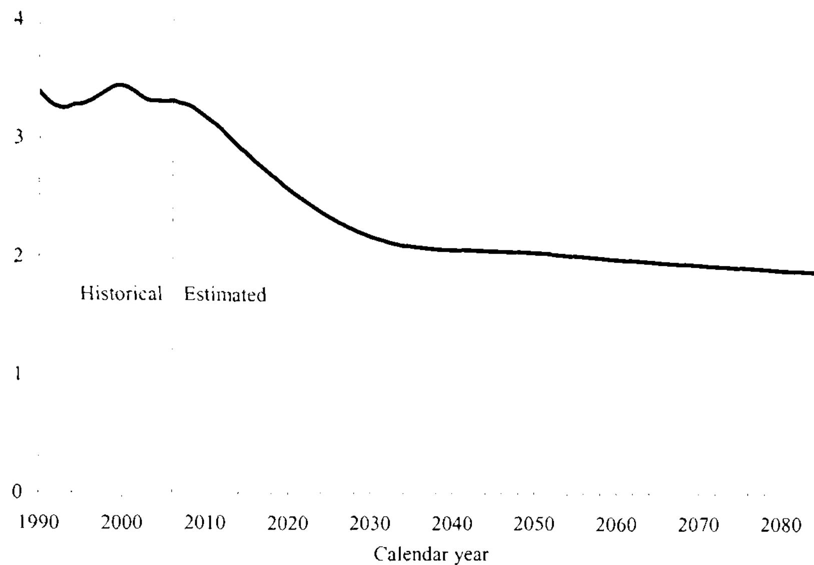


Social Security's cost rate generally will continue rising rapidly through about 2030 as the baby-boom generation reaches retirement eligibility age. Thereafter, the cost rate is estimated to rise at a slower rate for about 5 years

and then stabilize for the next 15 years as the baby-boom ages and decreases in size. Continued reductions in death rates and maintaining birth rates at levels well below those from the baby-boom era and before will cause a significant upward shift in the average age of the population and will push the cost rate from 17.3 percent of taxable payroll in 2050 to 18.5 percent by 2081 under the intermediate assumptions. In a pay-as-you-go system (with no trust fund assets or borrowing authority), this 18.5-percent cost rate means the combination of the payroll tax (scheduled to total 12.4 percent) and proceeds from income taxes on benefits (expected to be 0.9 percent of taxable payroll in 2081) would have to equal 18.5 percent of taxable payroll to pay all currently scheduled benefits. After 2081, the upward shift in the average age of the population is likely to continue and to increase the gap between OASDI costs and income.

The primary reason that the OASDI cost rate will increase rapidly between 2010 and 2030 is that, as the large baby-boom generation born in the years 1946 through 1965 retires, the number of beneficiaries will increase much more rapidly than the number of workers. The estimated number of workers per beneficiary is shown in figure II.D3. In 2006, there were about 3.3 workers for every OASDI beneficiary. The baby-boom generation will have largely retired by 2030, and the projected ratio of workers to beneficiaries will be only 2.2 at that time. Thereafter, the number of workers per beneficiary will slowly decline, and the OASDI cost rate will continue to increase largely due to projected reductions in mortality.

Figure II.D3.—Number of Covered Workers Per OASDI Beneficiary



The maximum projected trust fund ratios for the OASI, DI, and combined funds appear in table II.D1. The year in which the maximum projected trust fund ratio is attained and the year in which the assets are projected to be exhausted are shown as well.

Table II.D1.—Projected Maximum Trust Fund Ratios Attained and Trust Fund Exhaustion Dates Under the Intermediate Assumptions

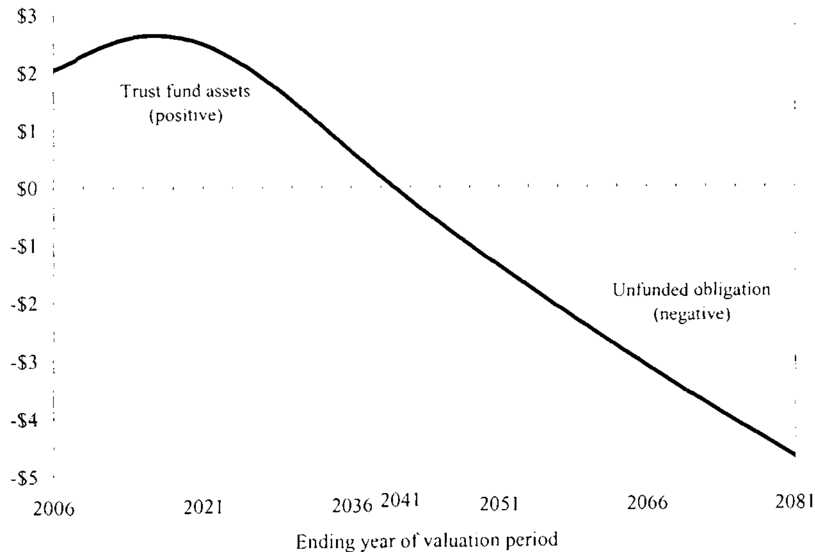
	OASI	DI	OASDI
Maximum trust fund ratio (percent)	463	200	409
Year attained	2015	2007	2014
Year of trust fund exhaustion	2042	2026	2041

The actuarial balance is a measure of the program's financial status for the 75-year valuation period as a whole. It is essentially the difference between income and cost of the program expressed as a percentage of taxable payroll over the valuation period. This single number summarizes the adequacy of program financing for the period. When the actuarial balance is negative, the actuarial deficit can be interpreted as the percentage that could be added to the current law income rate for each of the next 75 years, or subtracted from the cost rate for each year, to bring the funds into actuarial balance. Because the timing of any future changes is unlikely to follow this pattern, this measure should be viewed only as providing a rough indication of the average

change that is needed over the 75-year period as a whole. In this report, the actuarial balance under the intermediate assumptions is a deficit of 1.95 percent of taxable payroll for the combined OASI and DI Trust Funds. The actuarial deficit was 2.02 percent in the 2006 report and has been in the range of 1.86 percent to 2.23 percent for the last ten reports.

Another way to illustrate the financial shortfall of the OASDI system is to examine the cumulative value of taxes less costs, in present value. Figure II.D4 shows the present value of cumulative OASDI taxes less costs over the next 75 years. The balance of the combined trust funds peaks at $2.6 trillion in 2017 (in present value) and then turns downward. This cumulative amount continues to be positive, indicating trust fund assets, or reserves, through 2040. However, after 2040 this cumulative amount becomes negative, indicating a net unfunded obligation. Through the end of 2081, the combined funds have a present-value unfunded obligation of $4.7 trillion. This unfunded obligation represents 1.8 percent of future taxable payroll and 0.7 percent of future GDP, through the end of the 75-year projection period.

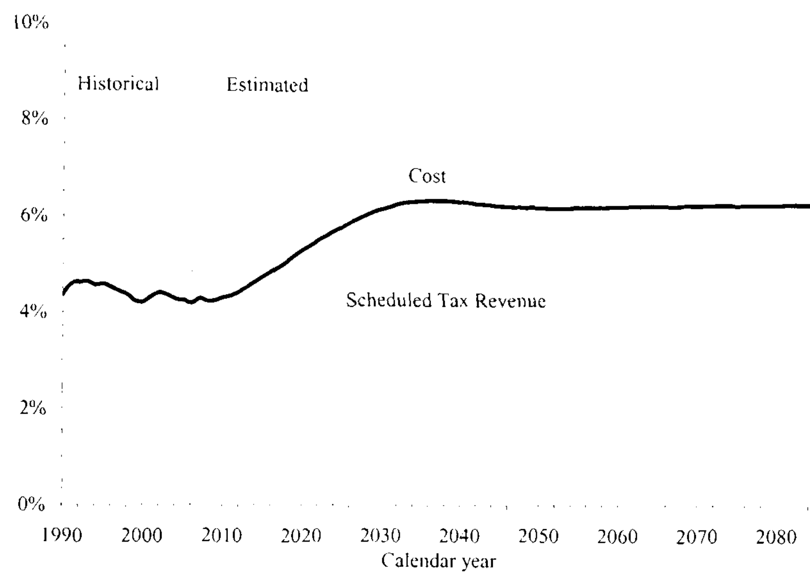
Figure II.D4.—Cumulative OASDI Income Less Cost, Based on Present Law Tax Rates and Scheduled Benefits
[Present value as of January 1, 2007, in trillions]



Still another important way to look at Social Security's future is to view its cost as a share of U.S. economic output. Figure II.D5 shows that Social Security's cost as a percentage of GDP will grow from 4.3 percent in 2007 to

6.2 percent in 2030, and then slightly increase to 6.3 percent in 2081. However, Social Security's scheduled tax income is projected to be about 4.9 percent of GDP in both 2007 and 2030, and then to decrease to 4.5 percent in 2081. Income from payroll taxes declines generally in relation to GDP in the future because an increasing share of employee compensation is assumed to be provided in fringe benefits, making wages a shrinking share of GDP. Between 2010 and 2030, however, the total non-interest income does not decline as a percent of GDP because benefits, and thus income to the trust funds from taxation of these benefits, are rising rapidly as a percent of GDP during the period.

Figure II.D5.—OASDI Cost and Scheduled Tax Revenue as a Percentage of GDP



Consideration of a 75-year period is not enough to provide a complete picture of Social Security's financial condition. Figures II.D2, II.D4, and II.D5 show that the program's financial condition is worsening at the end of the period. Overemphasis on summary measures for a 75-year period can lead to incorrect perceptions and to policy prescriptions that do not achieve sustainable solvency. Thus, careful consideration of the trends in annual deficits and unfunded obligations toward the end of the 75-year period is important. In addition, summary measures for a time period that extends to the infinite horizon are included in this report. These measures provide an additional indication of Social Security's very long-run financial condition, but are subject to much greater uncertainty. These calculations show that extending the

horizon beyond 75 years increases the unfunded obligation. Over the infinite horizon, the shortfall (unfunded obligation) is $13.6 trillion in present value, or 3.5 percent of future taxable payroll and 1.2 percent of future GDP. These calculations of the shortfall indicate that much larger changes may be required to achieve solvency beyond the 75-year period as compared to changes needed to balance 75-year period summary measures. The measured unfunded obligation over the infinite horizon increases from $13.4 trillion in last year's report to $13.6 trillion in this report. In the absence of any changes in assumptions, methods, and starting values, the unfunded obligation over the infinite horizon would have risen to $14.1 trillion due to the change in the valuation date.

Changes From Last Year's Report

The long-range OASDI actuarial deficit of 1.95 percent of taxable payroll for this year's report is smaller than the deficit of 2.02 percent of taxable payroll shown in last year's report under intermediate assumptions. Changes in methodology and assumed rates of disability incidence are the main reasons for the decrease in the deficit. For a detailed description of the specific changes identified in table II.D2 below, see section IV.B.7 on page 65.

Table II.D2.—Reasons for Change in the 75-Year Actuarial Balance Under Intermediate Assumptions
[As a percentage of taxable payroll]

Item	OASI	DI	OASDI
Shown in last year's report:			
Income rate	11.95	1.93	13.88
Cost rate	13.63	2.27	15.90
Actuarial balance	**-1.68**	**-.33**	**-2.02**
Changes in actuarial balance due to changes in:			
Legislation / Regulation	.00	.00	.00
Valuation period[1]	-.05	-.01	-.06
Demographic data and assumptions	-.03	.00	-.03
Economic data and assumptions	+.01	+.01	+.02
Disability data and assumptions	-.02	+.08	+.06
Programmatic data and methods	+.09	-.01	+.08
Total change in actuarial balance	-.01	+.07	+.06
Shown in this report:			
Actuarial balance	**-1.69**	**-.27**	**-1.95**
Income rate	11.99	1.93	13.92
Cost rate	13.68	2.19	15.87

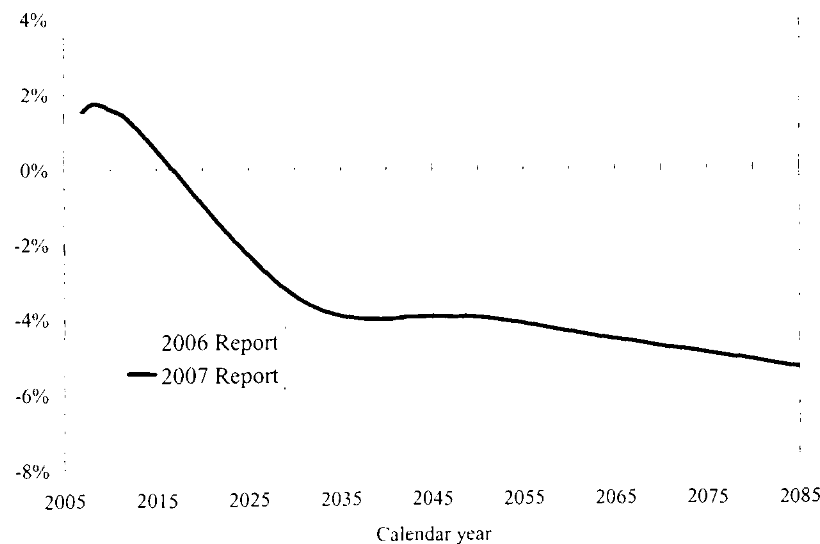
[1] In changing from the valuation period of last year's report, which was 2006-80, to the valuation period of this report, 2007-81, the relatively large negative annual balance for 2081 is included. This results in a larger long-range actuarial deficit. The fund balance at the end of 2006, i.e., at the beginning of the projection period, is included in the 75-year actuarial balance.

Note: Totals do not necessarily equal the sums of rounded components.

The open group unfunded obligation over the 75-year projection period has increased from $4.6 trillion (present discounted value as of January 1, 2006) to $4.7 trillion (present discounted value as of January 1, 2007). The measured increase in the unfunded obligation would be expected to be about $0.3 trillion due to advancing the valuation date by 1 year and including the additional year 2081. Changes in methods and assumptions offset most of this expected increase.

Figure II.D6 shows that this year's projections of annual balances are generally higher than those in last year's report principally because of the changes in methods and assumptions. Annual balances are similar between the two reports through about 2030. Thereafter, annual balances are somewhat higher for the rest of the long-range projection period. Section IV.B.7 on page 65 provides a detailed presentation of these changes.

Figure II.D6.—OASDI Annual Balances: 2006 and 2007 Trustees Reports
[As a percentage of taxable payroll under the intermediate assumptions]

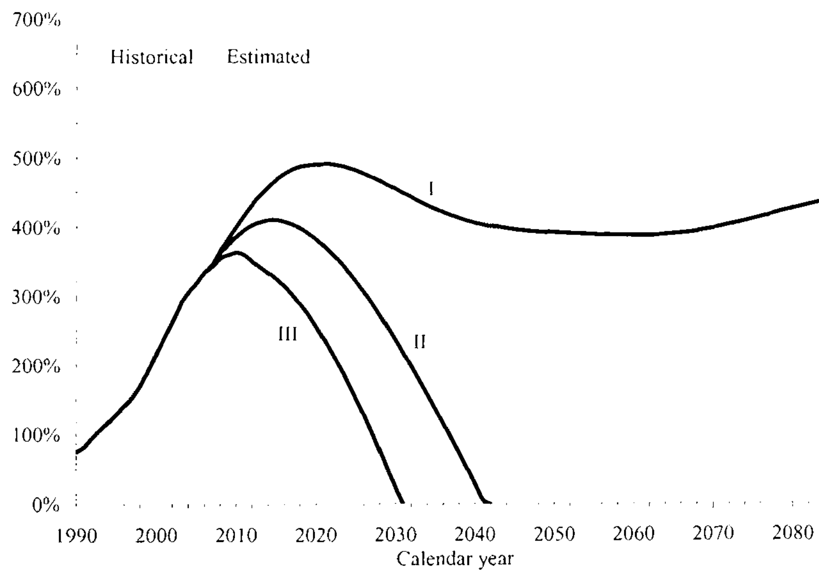


Uncertainty of the Projections

Significant uncertainty surrounds the intermediate assumptions. The Trustees have traditionally used low cost (alternative I) and high cost (alternative III) assumptions as an indication of this uncertainty. Figure II.D7 shows the projected trust fund ratios for the combined OASI and DI Trust Funds under the intermediate, low cost, and high cost assumptions. The low cost alternative is characterized by assumptions that improve the financial condition of the trust funds, including a higher fertility rate, slower improvement in mortality, a

higher real-wage differential, and lower unemployment. The high cost alternative, in contrast, features a lower fertility rate, more rapid declines in mortality, a lower real-wage differential, and higher unemployment. While it is extremely unlikely that all of these parameters would move in the same direction over the 75-year period relative to the intermediate projections, there is a not-insignificant—though quite low—probability that the actual outcome for future costs could be as extreme as either of the outcomes portrayed by the low and high cost projections. The method for constructing these high and low cost projections does not allow for the assignment of a specific probability to the likelihood that actual experience will lie within or outside the range they entail. However, an alternative approach to illustrating the uncertainty inherent in such long-term projections discussed in Appendix E suggests that the low and high cost projections bound a range that encompasses something on the order of 95 percent of possible future financial outcomes. Given there is an equal probability that the actual outcome will be either more or less favorable than that portrayed by the intermediate cost projection, this implies that there is something on the order of only a 2.5 percent probability that it will be as favorable as that portrayed by the low cost projection or as unfavorable as that portrayed by the high cost projection.

Figure II.D7.—Long-Range OASDI Trust Fund Ratios Under Alternative Assumptions
[Assets as a percentage of annual cost]



E. CONCLUSION

Under current law the cost of Social Security will soon begin to increase faster than the program's income, because of the aging of the baby-boom generation, expected continuing low fertility, and increasing life expectancy. Based on the Trustees' best estimate, program cost will exceed tax revenues starting in 2017 and throughout the remainder of the 75-year projection period. Social Security's combined trust funds are projected to allow full payment of scheduled benefits until they become exhausted in 2041. At that time annual tax income to the trust funds is projected to equal about 75 percent of program costs. Separately, the OASI and DI funds are projected to have sufficient funds to pay full benefits on time until 2042 and 2026, respectively. By 2081, annual tax income is projected to be about 70 percent as large as the annual cost of the OASDI program.

Over the full 75-year projection period the actuarial deficit estimated for the combined trust funds is 1.95 percent of taxable payroll—somewhat smaller than the 2.02 percent deficit projected in last year's report. This deficit indicates that financial adequacy of the program for the next 75 years could be restored if increases were made equivalent to increasing the Social Security payroll tax immediately and permanently from its current level of 12.4 percent (for employees and employers combined) to 14.35 percent. Alternatively, changes could be made equivalent to reducing all current and future benefits by about 13 percent. Other ways of reducing the deficit include making transfers from general revenues or adopting some combination of approaches.

If no action were taken until the combined trust funds become exhausted in 2041, then the effects of changes would be more concentrated on fewer years:

- For example, payroll taxes could be raised to finance scheduled benefits fully in every year starting in 2041. In this case, the payroll tax would be increased to 16.41 percent at the point of trust fund exhaustion in 2041 and continue rising to 17.60 percent in 2081.
- Similarly, benefits could be reduced to the level that is payable with scheduled tax rates in each year beginning in 2041. Under this scenario, benefits would be reduced 25 percent at the point of trust fund exhaustion in 2041, with reductions reaching 30 percent in 2081.

Either of these examples would eliminate the shortfall for the 75-year period as a whole by specifically eliminating annual deficits after trust fund exhaustion. Because of the increasing average age of the population (due to

expected improvement in life expectancy and continued low birth rates), Social Security's annual cost will very likely continue to grow faster than scheduled tax revenues after 2081. As a result, ensuring solvency of the system beyond 2081 would likely require further changes beyond those expected to be needed for 2081.

The projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers. Making adjustments sooner will allow them to be spread over more generations. Social Security plays a critical role in the lives of this year's 50 million beneficiaries, and 163 million covered workers and their families. With informed discussion, creative thinking, and timely legislative action, we will work with Congress and others to ensure that Social Security continues to protect future generations.

For further information related to the contents of this report, see the following websites.

- www.socialsecurity.gov/OACT/TR/TR07/index.html
- www.cms.hhs.gov/ReportsTrustFunds/
- www.treas.gov/offices/economic-policy/social_security.html

III. FINANCIAL OPERATIONS OF THE TRUST FUNDS AND LEGISLATIVE CHANGES IN THE LAST YEAR

A. OPERATIONS OF THE OLD-AGE AND SURVIVORS INSURANCE (OASI) AND DISABILITY INSURANCE (DI) TRUST FUNDS, IN CALENDAR YEAR 2006

Detailed information on the operations of the OASI and DI Trust Funds[1] during calendar year 2006 is presented in this section. Chapter IV provides projections for calendar years 2007 through 2085.

1. OASI Trust Fund

A statement of the income and disbursements of the Federal Old-Age and Survivors Insurance Trust Fund in calendar year 2006, and of the assets of the fund at the beginning and end of the calendar year, is presented in table III.A1. As shown in the table, total trust fund receipts in 2006 amounted to $642.2 billion, while disbursements totaled $461.0 billion, resulting in an increase in trust fund assets during 2006 of $181.3 billion.

The reported income and disbursements for 2006 were both affected by special transfers from the General Fund of the Treasury to the trust funds to correct the effects of a clerical error which resulted in overpayments to the Internal Revenue Service (IRS) related to a provision in the law which permits beneficiaries to have income tax payments withheld from their Social Security benefits.[2] The overpayments to IRS began with the inception of voluntary income tax withholding in 1999, and SSA detected and corrected the ongoing problem in early 2006. The reimbursements to the trust funds for the overpayments during the period 1999-2005 occurred, with interest, in two stages; the first reimbursement was in August 2006 for overpayments in 2002-05, while the final reimbursement was in December 2006 for overpayments in 1999-2001.[3] In table III.A1, the reimbursement of the nominal amount overpaid to IRS over the period 1999-2005 (approximately $5.9 billion) is shown as a reimbursement of benefit payments, while the $0.8 billion in interest reimbursed to the trust fund to compensate the OASI Trust Fund for the investment income lost over that period is shown as part of interest on reimbursements. Further details of the various components of trust fund income and disbursements are discussed in the following paragraphs.

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[1] Trust fund data are available by month, quarter, or year on the Social Security website at www.socialsecurity.gov/OACT/ProgData/fundsQuery.html.

[2] The overpayments to the IRS had no effect on beneficiaries. The correct amounts of net benefits were paid to these beneficiaries, with the appropriate withholding amounts reported to them on their annual Forms 1099.

[3] Because the first reimbursement was limited by statute to the last 4 calendar years (2002-05), legislation (P.L. 109-465) was required to authorize the final reimbursement.

Included in total receipts during calendar year 2006 were $536.7 billion in employment tax contributions. These contributions were partially offset by transfers totaling $1.9 billion to the general fund for the estimated amount of refunds to employees who worked for more than one employer during a year and paid contributions on total earnings in excess of the contribution and benefit base.

Net contributions thus amounted to $534.8 billion, an increase of 5.5 percent over the amount in the preceding year. The increase in OASI tax contributions from calendar year 2005 to calendar year 2006 is due to increased earnings and the increase in the contribution and benefit base. (Table VI.A1 shows the tax rates and contribution and benefit bases in effect for past years.)

Income based on taxation of benefits amounted to $15.6 billion in 2006. About 99 percent of this income represents amounts credited to the trust funds, on an estimated basis, generally in advance of the actual receipt of taxes by the Treasury. The remaining 1 percent of the total income from taxation of benefits represents amounts withheld from the benefits paid to nonresident aliens.

Table III.A1.—Operations of the OASI Trust Fund, Calendar Year 2006
[In millions]

Total assets, December 31, 2005		$1,663,037
Receipts:		
Contributions:		
Employment taxes	$536,679	
Payments from the General Fund of the Treasury for contributions subject to refund	-1,892	
Net contributions		534,787
Income based on taxation of benefit payments:		
Withheld from benefit payments to nonresident aliens	143	
All other, not subject to withholding	15,485	
Total income from taxation of benefits		15,628
Reimbursement from the General Fund of the Treasury for costs of payments to uninsured persons who attained age 72 before 1968		1/
Investment income and interest adjustments:		
Interest on investments	90,978	
Interest adjustments[2]	839	
Total investment income and interest adjustments		91,817
Gifts		1/
Total receipts		642,231
Disbursements:		
Benefit payments:		
Gross benefit payments	461,658	
Offset for collected overpayments	-1,201	
Reimbursement from the general fund for excess amounts of voluntary income tax withholding	-5,912	
Reimbursement from the general fund for unnegotiated checks	-52	
Net benefit payments		454,493
Transfer to the Railroad Retirement "Social Security Equivalent Benefit Account"		3,458
Payment for costs of vocational rehabilitation services for disabled beneficiaries		4
Administrative expenses:		
Costs incurred by:		
Social Security Administration	2,458	
Department of the Treasury	557	
Offsetting receipts from sales of supplies, materials, etc.	1/	
Miscellaneous reimbursements from the general fund [3]	-4	
Net administrative expenses		3,010
Total disbursements		460,965
Net increase in assets		181,266
Total assets, December 31, 2006		1,844,304

[1] Between -$500,000 and $500,000.
[2] Includes (1) interest on transfers between the trust fund and the general fund account for the Supplemental Security Income program due to adjustments in the allocation of administrative expenses, (2) interest arising from the revised allocation of administrative expenses among the trust funds, and (3) interest on certain reimbursements to the trust fund.
[3] Reimbursements for costs incurred in performing certain legislatively mandated activities not directly related to administering the OASI program.
Note: Totals do not necessarily equal the sums of rounded components.

Special payments are made to uninsured persons who meet certain requirements. The costs associated with providing such payments are largely reimbursed from the General Fund of the Treasury. Accordingly, transfers totaling $15,922 were made in 2006, reflecting costs incurred in fiscal year 2005.

The OASI Trust Fund was credited with interest netting $91.8 billion, which consisted of (1) interest earned on the investments of the trust fund, (2) inter-

est on transfers between the trust fund and the general fund account for the Supplemental Security Income program due to adjustments in the allocation of administrative expenses, (3) interest arising from the revised allocation of administrative expenses among the trust funds, and (4) interest on certain reimbursements to the trust fund, including the interest on special reimbursements related to voluntary income tax withholding described earlier. The remaining $49,668 of receipts consisted of gifts received under the provisions authorizing the deposit of money gifts or bequests in the trust funds.

Of the $461.0 billion in total OASI disbursements, $454.5 billion was for net benefit payments. Excluding the effect of special reimbursements totaling $5.9 billion in principal related to voluntary income tax withholding, net benefit payments would have been $460.4 billion. This higher amount of net benefit payments in calendar year 2006 represents an increase of 5.8 percent over the corresponding amount in calendar year 2005. This increase is due primarily to (1) an increase in the total number of beneficiaries and (2) an increase in the average benefit amount. The increase in the average benefit amount in 2006 was due in large part to the automatic cost-of-living benefit increase of 4.1 percent which became effective for December 2005 under the automatic-adjustment provisions in section 215(i) of the Social Security Act.

Provisions of the Railroad Retirement Act require an annual financial interchange between the Railroad Retirement and OASDI programs. The purpose of such provisions is to put the OASI and DI Trust Funds in the same financial position they would have been had railroad employment always been covered by Social Security. Under those provisions, the Railroad Retirement Board and the Commissioner of Social Security determined that a transfer of $3.5 billion to the Social Security Equivalent Benefit Account from the OASI Trust Fund was required in June 2006.

A disbursement of $4 million was made in 2006 to cover the costs of vocational rehabilitation services furnished to disabled widow(er) beneficiaries and to those children of retired or deceased workers who were receiving benefits on the basis of disabilities that began before age 22. Reimbursement from the trust funds for the costs of vocational rehabilitation services is made only in those cases where the services contributed to the successful rehabilitation of the beneficiary.

The remaining $3.0 billion of disbursements from the OASI Trust Fund represented net administrative expenses. The expenses of administering the OASDI and Medicare programs are allocated and charged directly to each of the various trust funds through which those programs are financed, on the basis of provisional estimates. Similarly, the expenses allocated for administering the Supplemental Security Income program are charged directly to the General Fund of the Treasury on a provisional basis. Periodically, as actual experience develops and is analyzed, adjustments to the allocations of

administrative expenses for prior periods are effected by interfund transfers and transfers between the OASI Trust Fund and the general fund account for the Supplemental Security Income program, with appropriate interest adjustments. As described earlier, the interest adjustments arising from the reallocation of administrative expenses are recorded in the trust fund accounting under investment income.

Over 80 percent of OASI net administrative expenses represent the cost of administering the program and are charged to the trust fund by the Social Security Administration ($2.5 billion in 2006). In addition, the Department of the Treasury charges directly to the trust fund certain expenses ($0.6 billion in 2006) that it incurs in helping to administer the OASI program. In addition a relatively small adjustment to administrative expenses is an offset ($372,967 in 2006) representing income from the sale of excess supplies and equipment.

Finally, certain net reimbursements are made from the General Fund of the Treasury for administrative costs incurred by the Social Security Administration in performing certain legislatively mandated activities that are not directly related to the OASI program. These reimbursements include the costs associated with union activities related to administering the OASI program and providing information to participants in certain pension plans. Such reimbursements totaled $4 million in 2006.

The assets of the OASI Trust Fund at the end of calendar year 2006 totaled $1,844.3 billion, consisting of $1,845.3 billion in U.S. Government obligations and, as an offset, an extension of credit amounting to $1.0 billion against securities to be redeemed within the following few days. The effective annual rate of interest earned by the assets of the OASI Trust Fund during calendar year 2006 was 5.3 percent, as compared to 5.4 percent earned during calendar year 2005. Table VI.A5, presented in appendix A, shows a detailed listing of OASI Trust Fund holdings by type of security, interest rate, and year of maturity at the end of each year 2005 and 2006.

All securities held by the trust funds are backed by the full faith and credit of the United States Government, as required by law. Those currently held by the OASI Trust Fund are special issues (i.e., securities sold only to the trust funds). These are of two types: short-term certificates of indebtedness and long-term bonds. The certificates of indebtedness are issued on a daily basis for the investment of receipts not required to meet current expenditures, and they mature on the next June 30 following the date of issue. Special-issue bonds, on the other hand, are normally acquired only when special issues of either type mature on June 30. The amount of bonds acquired on June 30 is equal to the amount of special issues maturing, less amounts required to meet expenditures on that day.

Section 201(d) of the Social Security Act provides that the obligations issued for purchase by the OASI and DI Trust Funds shall have maturities fixed with due regard for the needs of the funds. The usual practice has been to spread the holdings of special issues, as of each June 30, so that the amounts maturing in each of the next 15 years are approximately equal. Accordingly, the amounts and maturity dates of the OASI special-issue bonds purchased on June 30, 2006, with an interest rate of 5.125 percent, were selected so that the maturity dates of the total portfolio of special issues were spread evenly over the 15-year period 2007-21. The amount of bonds purchased on June 30, 2006 is shown in table III.A7.

2. DI Trust Fund

A statement of the income and disbursements of the Federal Disability Insurance Trust Fund in calendar year 2006, and of the assets of the fund at the beginning and end of the calendar year, is presented in table III.A2.

Line entries in the DI statement are similar to those in the OASI statement and the explanations of the OASI entries generally apply to DI as well.

Net contributions amounted to $90.8 billion, an increase of 5.5 percent from the amount in the preceding calendar year. This increase is attributable to the same factors, insofar as they apply to the DI program, which accounted for the change in contributions to the OASI Trust Fund.

Of the $94.5 billion in total disbursements, $91.7 billion was for net benefit payments. Excluding the effect of special reimbursements totaling $0.7 billion in principal related to voluntary income tax withholding, net benefit payments would have been $92.4 billion. This higher amount of net benefit payments in calendar year 2006 represents an increase of 8.2 percent over the corresponding amount of benefit payments in calendar year 2005. This increase in DI benefit payments was due to the same factors that resulted in the net increase in benefit payments from the OASI Trust Fund. However, the number of persons receiving benefits from the DI Trust Fund increased more rapidly in 2006 than the number receiving benefits from the OASI Trust Fund largely due to a) the current ages of the baby-boom generation, b) the scheduled increase in the normal retirement age (NRA), and c) the special administrative action, undertaken by SSA beginning in 2001, to identify and award benefits from the DI Trust Fund to a substantial number of current and former recipients of SSI benefits whose disability-insured status under the DI program was not previously recognized. Total DI disbursements, which started to exceed non-interest income in 2005, continue to exceed such income in 2006. However, as in 2005, total DI income (including interest) in 2006 exceeds total disbursements.

Table III.A2.—Operations of the DI Trust Fund, Calendar Year 2006
[In millions]

Total assets, December 31, 2005		$195,623
Receipts:		
Contributions:		
Employment taxes	$91,129	
Payments from the General Fund of the Treasury for contributions subject to refund	-321	
Net contributions		90,808
Income based on taxation of benefit payments:		
Withheld from benefit payments to nonresident aliens	4	
All other, not subject to withholding	1,226	
Total income from taxation of benefits		1,230
Investment income and interest adjustments:		
Interest on investments	10,518	
Interest adjustments[1]	85	
Total investment income and interest adjustments		10,603
Total receipts		102,641
Disbursements:		
Benefit payments:		
Gross benefit payments	93,113	
Offset for collected overpayments	-729	
Reimbursement from the general fund for excess amounts of voluntary income tax withholding	-678	
Reimbursement from the general fund for unnegotiated checks	-26	
Net benefit payments		91,680
Transfer to the Railroad Retirement "Social Security Equivalent Benefit Account"		388
Payment for costs of vocational rehabilitation services for disabled beneficiaries		61
Administrative expenses:		
Costs incurred by:		
Social Security Administration	2,220	
Department of the Treasury	98	
Miscellaneous reimbursements from the general fund[2]	8	
Total administrative expenses		2,326
Total disbursements		94,456
Net increase in assets		8,185
Total assets, December 31, 2006		203,808

[1] Includes (1) interest on transfers between the trust fund and the general fund account for the Supplemental Security Income program due to adjustments in the allocation of administrative expenses, (2) interest arising from the revised allocation of administrative expenses among the trust funds, and (3) interest on certain reimbursements to the trust fund.

[2] Reimbursements for costs incurred in performing certain legislatively mandated activities not directly related to administering the DI program.

Note: Totals do not necessarily equal the sums of rounded components.

The assets of the DI Trust Fund at the end of calendar year 2006 totaled $203.8 billion, consisting of $203.9 billion in U.S. Government obligations and, as an offset, an extension of credit amounting to $0.1 billion against securities to be redeemed within the following few days. The effective annual rate of interest earned by the assets of the DI Trust Fund during calendar year 2006 was 5.4 percent, compared to 5.5 percent earned during calendar year 2005. Table VI.A6, presented in appendix A, shows a detailed listing of DI Trust Fund holdings by type of security, interest rate, and year of maturity at the end of each year 2005 and 2006.

3. OASI and DI Trust Funds, Combined

A statement of the operations of the income and disbursements of the OASI and DI Trust Funds, on a combined basis, is presented in table III.A3. The entries in this table represent the sums of the corresponding values from tables III.A1 and III.A2. For a discussion of the nature of these income and expenditure transactions, reference should be made to the two preceding subsections covering OASI and DI separately.

Table III.A3.—Operations of the Combined OASI and DI Trust Funds, Calendar Year 2006
[In millions]

Total assets, December 31, 2005		$1,858,660
Receipts:		
Contributions:		
Employment taxes	$627,808	
Payments from the General Fund of the Treasury for contributions subject to refund	-2,213	
Net contributions		625,594
Income based on taxation of benefit payments:		
Withheld from benefit payments to nonresident aliens	147	
All other, not subject to withholding	16,711	
Total income from taxation of benefits		16,858
Reimbursement from the General Fund of the Treasury for costs of payments to uninsured persons who attained age 72 before 1968		1/
Investment income and interest adjustments:		
Interest on investments	101,496	
Interest adjustments[2]	924	
Total investment income and interest adjustments		102,420
Gifts		1/
Total receipts		744,873
Disbursements:		
Benefit payments:		
Gross benefit payments	554,771	
Offset for collected overpayments	-1,930	
Reimbursement from the general fund for excess amounts of voluntary income tax withholding	-6,590	
Reimbursement from the general fund for unnegotiated checks	-78	
Net benefit payments		546,173
Transfer to the Railroad Retirement "Social Security Equivalent Benefit Account"		3,846
Payment for costs of vocational rehabilitation services for disabled beneficiaries		65
Administrative expenses:		
Costs incurred by:		
Social Security Administration	4,677	
Department of the Treasury	656	
Offsetting receipts from sales of supplies, materials, etc.	1/	
Miscellaneous reimbursements from the general fund[3]	4	
Net administrative expenses		5,337
Total disbursements		555,421
Net increase in assets		189,452
Total assets, December 31, 2006		2,048,112

[1] Between -$500,000 and $500,000.
[2] Includes (1) interest on transfers between the trust funds and the general fund account for the Supplemental Security Income program due to adjustments in the allocation of administrative expenses, (2) interest arising from the revised allocation of administrative expenses among the trust funds, and (3) interest on certain reimbursements to the trust funds.
[3] Reimbursements for costs incurred in performing certain legislatively mandated activities not directly related to administering the OASI and DI programs.

Note: Totals do not necessarily equal the sums of rounded components.

To provide a context for estimates of future trust fund income and expenditures provided later in this report, table III.A4 compares past estimates of contributions and benefit payments for calendar year 2006, as shown in the 2002-06 Annual Reports, with the corresponding actual amounts in 2006.[1]

Table III.A4.—Comparison of Actual Calendar Year 2006 Trust Fund Operations With Estimates Made in Prior Reports[1]
[Amounts in billions]

	Net contributions[2]		Benefit payments[3]	
	Amount	Difference from actual (percent)	Amount	Difference from actual (percent)
OASI Trust Fund:				
Estimate in 2002 report	$558.3	4.4	$459.2	-0.3
Estimate in 2003 report	542.9	1.5	450.4	-2.2
Estimate in 2004 report	528.1	-1.2	443.2	-3.7
Estimate in 2005 report	528.8	-1.1	450.0	-2.3
Estimate in 2006 report	532.6	-.4	461.7	.3
Actual amount	534.8	—	[4] 460.4	—
DI Trust Fund:				
Estimate in 2002 report	94.8	4.4	87.6	-5.2
Estimate in 2003 report	92.2	1.5	88.8	-4.0
Estimate in 2004 report	89.7	-1.2	86.4	-6.5
Estimate in 2005 report	89.8	-1.1	89.0	-3.7
Estimate in 2006 report	90.4	-.4	93.5	1.2
Actual amount	90.8	—	[4] 92.4	—
OASI and DI Trust Funds, combined:				
Estimate in 2002 report	653.2	4.4	546.7	-1.1
Estimate in 2003 report	635.1	1.5	539.2	-2.5
Estimate in 2004 report	617.8	-1.2	529.6	-4.2
Estimate in 2005 report	618.6	-1.1	539.0	-2.5
Estimate in 2006 report	623.1	-.4	555.2	.4
Actual amount	625.6	—	[4] 552.8	—

[1] The estimates shown are based on the intermediate assumptions.
[2] "Actual" contributions for 2006 reflect adjustments for prior calendar years (see appendix A on page 126 for description of these adjustments). "Estimated" contributions also include such adjustments, but on an estimated basis.
[3] Includes payments, if any, for vocational rehabilitation services furnished to disabled persons receiving benefits because of their disabilities.
[4] Excludes reimbursements in 2006 for excess amounts of voluntary income tax withholding in 1999-2005. Reimbursements are $5.9 billion and $0.7 billion for OASI and DI, respectively.

A number of factors can contribute to differences between estimates and subsequent actual amounts, including actual values for key demographic, economic, and other variables that differ from assumed levels. In addition, new legislation or other administrative initiatives that were unanticipated at the time the earlier estimates were completed can contribute to such differences.

[1] Estimated amounts used to calculate percentage errors are before rounding to amounts shown in the annual reports.

At the end of calendar year 2006, about 49.1 million persons were receiving monthly benefits under the OASDI program. Of these persons, about 40.5 million and 8.6 million were receiving monthly benefits from the OASI Trust Fund and the DI Trust Fund, respectively. The number of persons receiving benefits from the OASI and DI Trust Funds grew by 1.0 percent and 3.7 percent, respectively, during the calendar year. The estimated distributions of benefit payments in calendar years 2005 and 2006, by type of beneficiary, are shown in table III.A5 for each trust fund separately.

Table III.A5.—Distribution of Benefit Payments by Type of Beneficiary or Payment, Calendar Years 2005 and 2006
[Amounts in millions]

	Calendar year 2005		Calendar year 2006[1]	
	Amount	Percentage of total	Amount	Percentage of total
Total OASDI benefit payments	$520,699	100.0	$522,763	100.0
OASI benefit payments	435,325	83.6	460,405	83.3
DI benefit payments	85,373	16.4	92,358	16.7
OASI benefit payments, total	435,325	100.0	460,405	100.0
Monthly benefits:				
Retired workers and auxiliaries	345,056	79.3	366,911	79.7
Retired workers	321,670	73.9	342,826	74.5
Spouses	20,497	4.7	21,003	4.6
Children	2,888	.7	3,082	.7
Survivors of deceased workers	90,064	20.7	93,290	20.3
Aged widows and widowers	71,745	16.5	74,134	16.1
Disabled widows and widowers	1,659	.4	1,758	.4
Parents	24	2/	24	2/
Children	15,101	3.5	15,812	3.4
Widowed mothers and fathers caring for child beneficiaries	1,535	.4	1,562	.3
Uninsured persons generally aged 72 before 1968	3/	2/	3/	2/
Lump-sum death payments	206	2/	204	2/
DI benefit payments, total	85,373	100.0	92,358	100.0
Disabled workers	78,361	91.8	84,928	92.0
Spouses	483	.6	509	.6
Children	6,529	7.6	6,921	7.5

[1] Excludes reimbursements in 2006 for excess amounts of voluntary income tax withholding in 1999-2005. Reimbursements are $5.9 billion and $0.7 billion for OASI and DI, respectively.
[2] Less than 0.05 percent.
[3] Less than $500,000.

Note: Totals do not necessarily equal the sums of rounded components.

Net administrative expenses charged to the OASI and DI Trust Funds in calendar year 2006 totaled $5.3 billion. This amount represented 0.9 percent of contribution income and 1.0 percent of expenditures. Corresponding percentages for each trust fund separately and for the OASDI program as a whole are shown in table III.A6 for each of the last 5 years.

Table III.A6.—Administrative Expenses as a Percentage of Contribution Income and of Total Expenditures, Calendar Years 2002-06

Calendar year	OASI Trust Fund		DI Trust Fund		OASI and DI Trust Funds, combined	
	Contribution income	Total expenditures	Contribution income	Total expenditures	Contribution income	Total expenditures
2002	0.5	0.5	2.7	3.0	0.8	0.9
2003	.6	.6	2.6	2.7	.9	1.0
2004	.5	.6	2.7	2.7	.8	.9
2005	.6	.7	2.7	2.6	.9	1.0
2006	.6	.7	2.6	2.5	.9	1.0

Changes in the invested assets of the OASI and DI funds between the end of 2005 and the end of 2006 are a result of the acquisition and disposition of securities during calendar year 2006. Table III.A7 presents these investment transactions for each trust fund separately and combined.

Table III.A7.—Trust Fund Investment Transactions, Calendar Year 2006
[In millions]

	OASI Trust Fund	DI Trust Fund	OASI and DI Trust Funds, combined
Invested assets, December 31, 2005	$1,663,726	$195,715	$1,859,441
Acquisitions:			
Special issues:			
Certificates of indebtedness	605,932	98,532	704,464
Bonds[1]	280,103	22,888	302,992
Total acquisitions	886,036	121,420	1,007,456
Dispositions:			
Special issues:			
Certificates of indebtedness	577,034	98,618	675,652
Bonds	127,389	14,595	141,984
Total dispositions	704,423	113,213	817,636
Net increase in invested assets	181,613	8,207	189,820
Invested assets, December 31, 2006	1,845,339	203,922	2,049,260

[1] Amounts shown were purchased on June 30, 2006. The interest rate on such purchases was 5.125 percent.

Note: All investments are shown at par value.

B. SOCIAL SECURITY AMENDMENTS SINCE THE 2006 REPORT

Since the 2006 Annual Report was transmitted to Congress on May 1, 2006, one law was enacted that had a direct financial effect on the OASDI program.

The Social Security Trust Funds Restoration Act of 2006, Public Law 109-465, required the General Fund of the Treasury to reimburse the combined OASI and DI Trust Funds to fully correct the effects of a clerical error that resulted in excess transfers to the Internal Revenue Service for years 1999 through 2005 for voluntary income tax withholding by Social Security beneficiaries. This reimbursement occurred in December 2006, and is reflected in the reported OASI and DI Trust Fund balances as of December 31, 2006. See section III.A.1. for more details.

IV. ACTUARIAL ESTIMATES

This chapter presents actuarial estimates of the future financial condition of the Social Security program. These estimates include projected income and cost of the OASI and DI Trust Funds, in dollars over the next 10 years and as a percentage of taxable payroll or in present-value dollars over the full 75-year period, along with a discussion of a variety of measures of the adequacy of current program financing. In this report we carefully distinguish between (1) the cost (or obligations) of the program, which includes, for the future, all benefits scheduled under current law, and (2) expenditures (disbursements or outgo), which include actual payments for the past and only the portion of the cost of the program that is projected to be payable with the financing provisions in current law.

As described in the Overview section of this report, these estimates depend upon a broad set of demographic, economic, and programmatic factors. Since assumptions related to these factors are subject to uncertainty, the estimates presented in this section are prepared under three sets of assumptions, to show a range of possible outcomes. The intermediate set of assumptions, designated as alternative II, reflects the Trustees' best estimate of future experience; the low cost alternative I is more optimistic and the high cost alternative III more pessimistic for the trust funds' future financial outlook. The intermediate estimates are shown first in the tables in this report, followed by the low cost and high cost estimates. These sets of assumptions, along with actuarial methods used to produce the estimates, are described in chapter V. In this chapter, the estimates and measures of trust fund financial adequacy for the short range (2007-16) are presented first, followed by estimates and measures of actuarial status for the long range (2007-81) and for the infinite future. As an additional illustration of uncertainty, estimated probability distributions of certain measures are presented in appendix E.

A. SHORT-RANGE ESTIMATES

Financial adequacy, or solvency, of the trust funds is generally measured on a year-by-year basis using the "trust fund ratio," which is defined to be the assets at the beginning of the year expressed as a percentage of the projected cost for the year. Thus, the trust fund ratio represents the proportion of a year's cost which can be paid with the funds available at the beginning of the year. During periods when trust fund income exceeds disbursements, the excess is held in the trust funds which serve to advance fund a portion of the Social Security program's future financial obligations. During periods when trust fund disbursements exceed income, as might happen during an economic recession, trust fund assets are used to meet the shortfall. In the event of recurring shortfalls for an extended period, the trust funds can allow time for the development, enactment, and implementation of legislation to restore financial stability to the program.

The test of financial adequacy over the short-range projection period is applicable to the OASI and DI Trust Funds individually and on a combined basis. The requirements of this test are as follows: If the estimated trust fund ratio is at least 100 percent at the beginning of the projection period, then it must be projected to remain at or above 100 percent throughout the 10-year projection period. Alternatively, if the ratio is initially less than 100 percent, then it must be projected to reach a level of at least 100 percent within 5 years and to remain at or above 100 percent throughout the remainder of the 10-year period. In addition, the fund's estimated assets at the beginning of each month of the 10-year period must be sufficient to cover that month's disbursements. This test is applied on the basis of the intermediate estimates. Failure to meet this test by either trust fund is an indication that solvency of the program over the next 10 years is in question and that legislative action is needed to improve the short-range financial adequacy of the program.

1. Operations of the OASI Trust Fund

This subsection presents estimates of the operations and financial status of the OASI Trust Fund for the period 2007-16, based on the assumptions described in chapter V. No changes are assumed to occur in the present statutory provisions and regulations under which the OASDI program operates.[1]

These estimates are shown in table IV.A1 and indicate that the assets of the OASI Trust Fund would continue to increase rapidly throughout the next 10 years under all three sets of assumptions. Also, based on the intermediate assumptions, the assets of the OASI Trust Fund would continue to exceed 100 percent of annual expenditures by a steadily increasing amount through the end of 2016. Consequently, the OASI Trust Fund satisfies the test of short-range financial adequacy by a wide margin. The estimates in table IV.A1 also indicate that the short-range test would be satisfied even under the high cost assumptions (see figure IV.A1 for graphical illustration of these results).

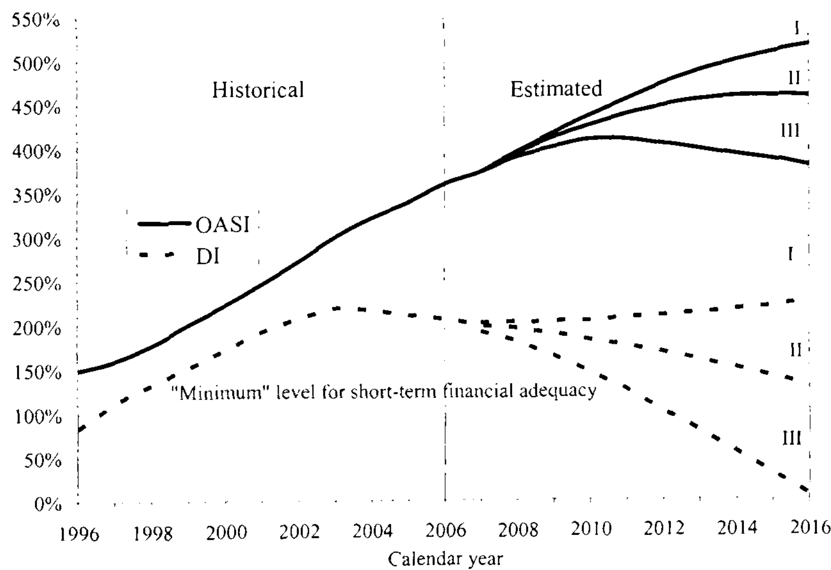
The increases in estimated income shown in table IV.A1 under each set of assumptions reflect increases in estimated OASDI taxable earnings and growth in interest earnings on the invested assets of the trust fund. For each alternative, employment and earnings are assumed to increase in every year through 2016. The number of persons with taxable earnings would increase on the basis of alternatives I, II, and III from 162 million during calendar year 2006 to about 177 million, 173 million, and 170 million, respectively, in 2016. The total annual amount of taxable earnings is projected to increase from $5,057 billion in 2006 to $8,112 billion, $8,145 billion, and

[1] The estimates shown in this subsection reflect 12 months of benefit payments in each year of the short-range projection period. In practice, the actual payment dates have at times been shifted over calendar year boundaries as a result of the statutory requirement that benefit checks be delivered early when the normal check delivery date is a Saturday, Sunday, or legal public holiday. The annual benefit figures are shown as if those benefit checks were delivered on the usual date.

$8,463 billion, in 2016, on the basis of alternatives I, II, and III, respectively.[1] These increases in taxable earnings are due primarily to (1) projected increases in employment levels as the working age (20-64) population increases, (2) increases in average earnings in covered employment (reflecting both real growth and price inflation), and (3) increases in the contribution and benefit base in 2007-16 under the automatic-adjustment provisions.

Growth in interest earnings represents a significant component of the overall increase in trust fund income during this period. Although interest rates payable on trust fund investments are not assumed to change substantially from current levels, the continuing rapid increase in OASI assets will result in a corresponding increase in interest income. By 2016, interest income to the OASI Trust Fund is projected to be about 20 percent of total trust fund income on the basis of the intermediate assumptions, as compared to 14 percent in 2006.

Figure IV.A1.—Short-Range OASI and DI Trust Fund Ratios
[Assets as a percentage of annual cost]



[1] Note that the pattern, by alternative, of these nominal amounts of total taxable earnings is not what might be expected, but the reverse, because of the varying inflation assumptions embedded in the respective estimates.

Table IV.A1.—Operations of the OASI Trust Fund, Calendar Years 2002-16[1]
[Amounts in billions]

	Income				Cost				Assets		
Calendar year	Total[2]	Net contri-butions	Taxa-tion of benefits	Net inter-est	Total	Benefit pay-ments	Admin-istra-tive costs	RRB inter-change	Net increase during year	Amount at end of year	Trust fund ratio[3]
Historical data:											
2002 . .	$539.7	$455.2	$12.9	$71.2	$393.7	$388.1	$2.1	$3.5	$146.0	$1,217.5	272
2003 . .	543.8	456.1	12.5	75.2	406.0	399.8	2.6	3.6	137.8	1,355.3	300
2004 . .	566.3	472.8	14.6	79.0	421.0	415.0	2.4	3.6	145.3	1,500.6	322
2005 . .	604.3	506.9	13.8	84.0	441.9	435.4	3.0	3.6	162.4	1,663.0	340
2006 . .	642.2	534.8	15.6	91.8	461.0	454.5	3.0	3.5	181.3	1,844.3	361
Intermediate:											
2007 . .	675.7	559.9	17.3	98.5	492.2	485.8	2.9	3.5	183.4	2,027.7	375
2008 . .	715.0	589.1	18.8	107.1	511.1	504.5	3.1	3.4	204.0	2,231.7	397
2009 . .	762.8	623.2	20.8	118.9	539.5	532.9	3.1	3.5	223.3	2,455.1	414
2010 . .	810.3	655.1	22.8	132.3	573.5	566.9	3.1	3.5	236.8	2,691.8	428
2011 . .	860.8	688.2	25.8	146.8	610.6	604.0	3.1	3.6	250.1	2,941.9	441
2012 . .	911.4	721.2	28.5	161.7	652.0	645.1	3.2	3.8	259.4	3,201.4	451
2013 . .	962.1	753.1	31.8	177.2	699.1	692.0	3.2	3.9	262.9	3,464.3	458
2014 . .	1,013.7	786.4	34.4	192.9	750.5	743.2	3.3	4.0	263.2	3,727.5	462
2015 . .	1,067.4	821.5	37.6	208.3	805.4	797.9	3.3	4.2	262.0	3,989.5	463
2016 . .	1,122.8	858.1	41.0	223.7	864.4	856.8	3.4	4.3	258.3	4,247.8	462
Low Cost:											
2007 . .	678.2	562.2	17.2	98.7	492.0	485.5	2.9	3.5	186.2	2,030.5	375
2008 . .	721.7	595.5	18.7	107.5	509.5	503.0	3.1	3.4	212.2	2,242.7	398
2009 . .	766.1	627.7	20.6	117.8	535.0	528.5	3.1	3.4	231.1	2,473.8	419
2010 . .	810.7	658.9	22.4	129.3	563.4	556.8	3.1	3.5	247.3	2,721.1	439
2011 . .	858.2	690.7	25.0	142.5	593.6	587.0	3.1	3.5	264.6	2,985.7	458
2012 . .	906.9	722.6	27.4	156.8	627.1	620.4	3.1	3.6	279.7	3,265.5	476
2013 . .	956.7	754.1	30.3	172.3	665.6	658.8	3.1	3.7	291.0	3,556.5	491
2014 . .	1,008.4	787.2	32.4	188.9	707.4	700.5	3.2	3.8	301.0	3,857.5	503
2015 . .	1,060.8	820.4	35.1	205.3	751.9	744.8	3.2	3.9	308.9	4,166.3	513
2016 . .	1,114.8	854.7	37.9	222.1	799.4	792.3	3.2	3.9	315.4	4,481.7	521
High Cost:											
2007 . .	667.6	553.0	17.3	97.3	492.5	486.0	2.9	3.5	175.2	2,019.5	375
2008 . .	696.3	571.9	18.9	105.4	515.5	508.9	3.1	3.4	180.8	2,200.2	392
2009 . .	746.9	608.6	21.0	117.3	546.6	540.0	3.1	3.5	200.3	2,400.6	403
2010 . .	788.9	635.5	23.2	130.2	583.1	576.4	3.1	3.6	205.8	2,606.3	412
2011 . .	849.3	674.4	26.7	148.2	632.1	625.2	3.2	3.7	217.2	2,823.5	412
2012 . .	931.1	724.9	30.4	175.8	694.5	687.3	3.3	4.0	236.6	3,060.1	407
2013 . .	1,000.0	768.7	34.7	196.5	763.8	756.1	3.4	4.2	236.2	3,296.3	401
2014 . .	1,058.9	809.7	38.2	211.0	833.5	825.5	3.5	4.6	225.3	3,521.7	395
2015 . .	1,115.5	850.4	42.1	223.0	902.4	893.9	3.6	4.9	213.1	3,734.7	390
2016 . .	1,172.5	891.3	46.3	234.9	976.6	967.9	3.6	5.1	195.9	3,930.6	382

[1] A detailed description of the components of income and cost, along with complete historical values, is presented in appendix A.

[2] "Total Income" column includes transfers made between the OASI Trust Fund and the General Fund of the Treasury that are not included in the separate components of income shown. These transfers consist of payments for (1) the cost of noncontributory wage credits for military service before 1957, and (2) the cost of benefits to certain uninsured persons who attained age 72 before 1968. Transfers for the cost of pre-1957 military service noncontributory wage credits were: (1) $414 million from the General Fund of the Treasury to the OASI Trust Fund in February 2002, and (2) $350 million from the trust fund to the general fund in December 2005. After 2006 such transfers are estimated to be less than $500,000 in each year.

[3] The "Trust fund ratio" column represents assets at the beginning of a year (which are identical to assets at the end of the prior year shown in the "Amount at end of year" column) as a percentage of cost for the year.

Note: Totals do not necessarily equal the sums of rounded components.

Rising expenditures during 2007-16 reflect automatic benefit increases as well as the upward trend in the number of beneficiaries and in the average monthly earnings underlying benefits payable by the program. The growth in the number of beneficiaries in the past and the expected growth in the future result both from the increase in the aged population and from the increase in the proportion of the population which is eligible for benefits.

The estimates under all three sets of assumptions shown in table IV.A1 indicate that income to the OASI Trust Fund would substantially exceed expenditures in every year of the short-range projection period, and assets are therefore estimated to increase substantially.

The portion of the OASI Trust Fund that is not needed to meet day-to-day expenditures is used to purchase financial securities, generally special public-debt obligations of the U.S. Government. The cash used to make these purchases flows to the General Fund of the Treasury and is used to meet various Federal outlays or to reduce the amount of publicly-held Federal debt. Interest on these securities is credited to the trust fund and, when the securities mature they are reinvested in new securities if not immediately needed to pay program costs. When securities are redeemed prior to maturity in order to pay program costs, general fund revenues flow to the trust fund. Thus, the investment operations of the trust fund result in various credits and cash flows between the trust fund and the General Fund of the Treasury.

2. Operations of the DI Trust Fund

The estimated operations and financial status of the DI Trust Fund during calendar years 2007-16 under the three sets of assumptions are shown in table IV.A2, together with values for actual experience in 2002-06. Income is generally projected to increase steadily under each alternative, reflecting most of the same factors described previously in connection with the OASI Trust Fund. The estimates indicate that the assets of the DI Trust Fund would also continue to increase throughout the next 10 years under the low cost assumptions, but would peak in 2012 and then begin to decline under the intermediate assumptions. Under the high cost assumptions, DI assets would increase through 2007 and decline steadily thereafter until exhaustion in 2016.

Cost is estimated to increase in part due to increases in average benefit levels resulting from (1) automatic benefit increases and (2) projected increases in the amounts of average monthly earnings on which benefits are based. In addition, under all three sets of assumptions, the number of DI beneficiaries in current-payment status is projected to continue increasing throughout the short-range projection period. Over the period 2006-16, the projected annual average growth rate in the number of DI worker beneficiaries is roughly 1.7, 2.5, and 3.9 percent under alternatives I, II, and III, respectively. Growth is

largely attributable to the gradual progression of the baby-boom generation through ages 50 to normal retirement age, at which higher rates of disability incidence are experienced.

Annual increases in incidence rates over the period 2001-03 represented a notable departure from the experience of the preceding decade, which generally showed modest annual declines in the age-sex-adjusted disability incidence rate.[1] During 2004 and 2005 however, this growth in the incidence rate subsided, and the incidence rate even declined in 2006. Nevertheless, incidence rates are still at a level somewhat higher than experienced during the late 1990s. The increases in 2001-03 were likely due in large part to the slowdown in economic growth experienced during that period. However, a special administrative activity undertaken by SSA beginning in 2001 has also contributed slightly to the upsurge in disabled worker awards. This special workload was the result of discovering a substantial number of current or former recipients of Supplemental Security Income (SSI) benefits whose disability-insured status under the DI program was not previously recognized. As this special disability workload continues to be processed over the next several years, the resulting disability awards will contribute to temporarily higher incidence rates than would have been expected as part of longer term underlying trends.

Estimates of the total size of this special workload, and the schedule for processing these cases, remain roughly the same as assumed for the 2006 report. After the last of these special workload cases is processed in about 2010, the incidence of disability is projected in this report to drop back somewhat from then current levels, and to remain roughly level over the remainder of the short-range period under the three alternative sets of assumptions.

[1] Historical and projected patterns of disability incidence rates are described in greater detail in section V.C.6.

Table IV.A2.—Operations of the DI Trust Fund, Calendar Years 2002-16[1]
[Amounts in billions]

Calendar year	Income: Total[2]	Income: Net contributions	Income: Taxation of benefits	Income: Net interest	Cost: Total	Cost: Benefit payments	Cost: Administrative costs	Cost: RRB interchange	Assets: Net increase during year	Assets: Amount at end of year	Assets: Trust fund ratio[3]
Historical data:											
2002 . .	$87.4	$77.3	$0.9	$9.2	$67.9	$65.7	$2.0	$0.2	$19.5	$160.5	208
2003 . .	88.1	77.4	.9	9.7	73.1	70.9	2.0	.2	15.0	175.4	219
2004 . .	91.4	80.3	1.1	10.0	80.6	78.2	2.2	.2	10.8	186.2	218
2005 . .	97.4	86.1	1.1	10.3	88.0	85.4	2.3	.3	9.4	195.6	212
2006 . .	102.6	90.8	1.2	10.6	94.5	91.7	2.3	.4	8.2	203.8	207
Intermediate:											
2007 . .	107.2	95.1	1.4	10.7	102.1	99.3	2.5	.4	5.1	208.9	200
2008 . .	112.4	100.0	1.6	10.8	106.3	103.4	2.5	.4	6.2	215.1	197
2009 . .	118.8	105.8	1.8	11.1	113.0	110.0	2.6	.4	5.8	220.8	190
2010 . .	124.7	111.2	2.0	11.4	120.7	117.4	2.8	.5	4.0	224.8	183
2011 . .	130.9	116.9	2.3	11.7	126.8	123.3	3.0	.5	4.1	228.9	177
2012 . .	137.0	122.5	2.6	11.8	135.7	132.0	3.2	.5	1.3	230.2	169
2013 . .	142.8	127.9	3.0	11.9	143.7	139.8	3.4	.5	-.9	229.3	160
2014 . .	148.6	133.5	3.2	11.8	151.8	147.7	3.5	.5	-3.2	226.1	151
2015 . .	154.6	139.5	3.5	11.6	160.5	156.2	3.7	.5	-5.9	220.2	141
2016 . .	160.8	145.7	3.8	11.3	169.4	165.0	3.9	.5	-8.7	211.5	130
Low Cost:											
2007 . .	107.6	95.5	1.4	10.7	100.6	97.8	2.5	.4	7.0	210.8	203
2008 . .	113.7	101.1	1.5	11.0	103.4	100.5	2.5	.4	10.3	221.1	204
2009 . .	119.8	106.6	1.7	11.5	108.3	105.2	2.6	.4	11.5	232.6	204
2010 . .	125.8	111.9	1.9	12.0	113.6	110.3	2.8	.5	12.3	244.9	205
2011 . .	132.1	117.3	2.1	12.7	117.2	113.8	2.9	.5	14.9	259.7	209
2012 . .	138.5	122.7	2.4	13.4	123.2	119.6	3.1	.5	15.3	275.0	211
2013 . .	145.0	128.1	2.7	14.3	128.4	124.7	3.3	.5	16.6	291.6	214
2014 . .	151.7	133.7	2.8	15.2	133.6	129.7	3.4	.5	18.1	309.7	218
2015 . .	158.5	139.3	3.0	16.2	139.3	135.2	3.6	.5	19.3	328.9	222
2016 . .	165.6	145.1	3.2	17.3	145.1	140.9	3.8	.4	20.5	349.5	227
High Cost:											
2007 . .	105.9	93.9	1.5	10.5	105.4	102.5	2.5	.4	.5	204.3	193
2008 . .	109.0	97.1	1.7	10.3	112.3	109.5	2.5	.4	-3.3	201.1	182
2009 . .	115.3	103.3	1.9	10.0	121.9	118.9	2.6	.4	-6.6	194.4	165
2010 . .	119.6	107.9	2.3	9.5	132.9	129.6	2.8	.5	-13.2	181.2	146
2011 . .	125.9	114.5	2.6	8.7	143.6	140.0	3.1	.6	-17.8	163.4	126
2012 . .	133.9	123.1	3.1	7.7	159.6	155.8	3.3	.5	-25.7	137.7	102
2013 . .	140.4	130.5	3.7	6.2	174.3	170.2	3.6	.6	-33.9	103.8	79
2014 . .	146.0	137.5	4.0	4.5	188.2	183.8	3.8	.6	-42.2	61.6	55
2015 . .	151.1	144.4	4.4	2.3	202.0	197.4	4.0	.6	-50.9	10.7	30
2016 . .	[4]	151.4	4.9	[4]	216.7	211.9	4.2	.6	[4]	[4]	5

[1] A detailed description of the components of income and cost, along with complete historical values, is presented in appendix A.
[2] "Total Income" column includes transfers made between the DI Trust Fund and the General Fund of the Treasury that are not included in the separate components of income shown. These transfers consist of payments for the cost of noncontributory wage credits for military service before 1957. In particular, a transfer is expected to be made in December 2007 in the amount of $7.7 million from the General Fund of the Treasury to the DI Trust Fund. Thereafter such transfers are estimated to be less than $500,000 in each year.
[3] The "Trust fund ratio" column represents assets at the beginning of a year (which are identical to assets at the end of the prior year shown in the "Amount at end of year" column) as a percentage of cost for the year.
[4] Under the high cost assumptions, the DI Trust Fund is projected to be exhausted in early 2016. Therefore, certain trust fund operation values for that year are not meaningful under present law and are not shown in this table.

Note: Totals do not necessarily equal the sums of rounded components.

The proportion of DI beneficiaries whose benefits terminate in a given year has also fluctuated in the past. Over the last 20 years, the rates of benefit termination due to death or conversion to retirement benefits (at attainment of normal retirement age) have declined very gradually. This trend is attributable, in part, to the lower average age of new beneficiaries. Declines in mortality for the general population have also led to improved mortality experience among the DI disabled worker beneficiaries. In addition, conversions to old-age benefits are at a temporarily reduced level for years 2003 through 2008 due to the gradual increase in the normal retirement age. The termination rate due to recovery has been much more volatile. Currently, the proportion of disabled beneficiaries whose benefits cease because of their recovery from disability is very low in comparison to levels experienced throughout the 1970s and early 1980s. Projected rates of recovery terminations in this year's report are somewhat lower initially due to resource constraints which temporarily limit the number of continuing disability reviews conducted by SSA. Following this temporary resource constraint, recovery termination rates are projected to return to levels consistent with last year's report. The overall termination rate (reflecting all causes) is projected in 2007-08 to remain near levels experienced since 2003, before returning to higher levels in 2009 when the gradual increase in the normal retirement age temporarily ceases.

At the beginning of calendar year 2006, the assets of the DI Trust Fund represented 207 percent of annual expenditures. During 2006, DI expenditures continued to exceed non-interest income. While total DI income exceeded DI expenditures by $8.2 billion, the trust fund ratio for the beginning of 2007 still decreased, to about 200 percent. Under the intermediate set of assumptions, total income is estimated to exceed expenditures through 2012. The projected expenditures in excess of income beginning in 2013 result in a decline in the projected trust fund ratio to 130 percent by the beginning of 2016.

Under the low cost assumptions, the trust fund ratio would increase to 227 percent at the beginning of 2016. Under the high cost assumptions, the assets of the DI Trust Fund would decline steadily, dipping below the level of 1 year's expenditures near the beginning of 2012, and becoming completely depleted early in 2016.

Because DI assets were greater than 1 year's expenditures at the beginning of 2007 and would remain above that level through 2016, the DI Trust Fund satisfies the Trustees' short-range test of financial adequacy under both the intermediate and low cost assumptions. However, under the high cost assumptions the DI Trust Fund fails to meet the short-range test of financial adequacy, because assets fall below 1 year's expenditures by the end of the short-range period, as described above (see also figure IV.A1).

3. Operations of the Combined OASI and DI Trust Funds

The estimated operations and status of the OASI and DI Trust Funds, combined, during calendar years 2007-16 on the basis of the three alternatives, are shown in table IV.A3, together with figures on actual experience in 2002-06. Because income and cost for the OASI Trust Fund represent over 80 percent of the corresponding amounts for the combined OASI and DI Trust Funds, the operations of the OASI Trust Fund tend to dominate the combined operations of the two funds. Consequently, based on the strength of the OASI Trust Fund over the next 10 years, the combined OASI and DI Trust Funds meet the requirements of the short-range test of financial adequacy under all three alternative sets of assumptions.

While combining the operations of the OASI and DI Trust Funds permits an assessment of the short-range test for the two programs on a combined basis, in practice assets from one trust fund cannot be shared with another trust fund without legislative changes to the Social Security Act. For example, under the high cost scenario, table IV.A2 shows that the DI Trust Fund becomes exhausted in 2016. The value of the combined OASI and DI Trust Funds in that year shown in table IV.A3 shows that OASI assets could be made available to pay DI benefits through 2016, but only with legislation to permit this action.

Table IV.A3.—Operations of the Combined OASI and DI Trust Funds, Calendar Years 2002-16[1]
[Amounts in billions]

Calendar year	Income				Cost				Assets		
	Total[2]	Net contributions	Taxation of benefits	Net interest	Total	Benefit payments	Administrative costs	RRB interchange	Net increase during year	Amount at end of year	Trust fund ratio[3]
Historical data:											
2002..	$627.1	$532.5	$13.8	$80.4	$461.7	$453.8	$4.2	$3.6	$165.4	$1,378.0	263
2003..	631.9	533.5	13.4	84.9	479.1	470.8	4.6	3.7	152.8	1,530.8	288
2004..	657.7	553.0	15.7	89.0	501.6	493.3	4.5	3.8	156.1	1,686.8	305
2005..	701.8	592.9	14.9	94.3	529.9	520.7	5.3	3.9	171.8	1,858.7	318
2006..	744.9	625.6	16.9	102.4	555.4	546.2	5.3	3.8	189.5	2,048.1	335
Intermediate:											
2007..	782.8	655.0	18.7	109.2	594.3	585.0	5.4	3.9	188.5	2,236.6	345
2008..	827.5	689.2	20.4	117.9	617.3	607.9	5.6	3.8	210.2	2,446.8	362
2009..	881.6	729.0	22.6	130.0	652.5	642.9	5.7	3.9	229.1	2,675.9	375
2010..	935.0	766.3	24.9	143.7	694.2	684.3	5.9	4.0	240.7	2,916.6	385
2011..	991.6	805.1	28.1	158.5	737.4	727.2	6.1	4.1	254.2	3,170.8	396
2012..	1,048.4	843.6	31.2	173.6	787.6	777.0	6.3	4.3	260.7	3,431.5	403
2013..	1,104.9	881.0	34.8	189.1	842.8	831.8	6.6	4.4	262.1	3,693.6	407
2014..	1,162.3	920.0	37.6	204.7	902.3	890.9	6.8	4.6	260.0	3,953.6	409
2015..	1,221.9	961.0	41.1	219.9	965.9	954.1	7.0	4.7	256.1	4,209.7	409
2016..	1,283.5	1,003.8	44.8	235.0	1,033.8	1,021.8	7.3	4.8	249.7	4,459.3	407

Table IV.A3.—Operations of the Combined OASI and DI Trust Funds, Calendar Years 2002-16[1] (Cont.)
[Amounts in billions]

	Income				Cost				Assets		
Calendar year	Total[2]	Net contri-butions	Taxa-tion of benefits	Net inter-est	Total	Benefit pay-ments	Admin-istra-tive costs	RRB inter-change	Net increase during year	Amount at end of year	Trust fund ratio[3]
Low Cost:											
2007. .	$785.8	$657.7	$18.6	$109.5	$592.6	$583.3	$5.4	$3.9	$193.2	$2,241.3	346
2008. .	835.4	696.6	20.3	118.5	613.0	603.6	5.6	3.8	222.5	2,463.8	366
2009. .	885.9	734.3	22.3	129.3	643.3	633.7	5.7	3.9	242.6	2,706.4	383
2010. .	936.5	770.8	24.3	141.3	676.9	667.1	5.9	4.0	259.6	2,966.0	400
2011. .	990.2	807.9	27.2	155.1	710.8	700.8	6.0	4.0	279.4	3,245.4	417
2012. .	1,045.4	845.3	29.8	170.2	750.4	740.1	6.2	4.1	295.0	3,540.5	433
2013. .	1,101.7	882.2	33.0	186.5	794.1	783.5	6.4	4.2	307.6	3,848.1	446
2014. .	1,160.2	920.8	35.3	204.1	841.1	830.2	6.6	4.2	319.1	4,167.2	458
2015. .	1,219.3	959.7	38.1	221.5	891.2	880.0	6.8	4.3	328.1	4,495.3	468
2016. .	1,280.4	999.9	41.1	239.4	944.5	933.1	7.0	4.3	335.9	4,831.2	476
High Cost:											
2007. .	773.5	646.9	18.7	107.8	597.8	588.5	5.4	3.9	175.7	2,223.8	343
2008. .	805.3	669.0	20.6	115.7	627.8	618.4	5.6	3.8	177.5	2,401.3	354
2009. .	862.2	711.9	23.0	127.3	668.5	658.9	5.7	3.9	193.7	2,595.0	359
2010. .	908.5	743.4	25.5	139.7	716.0	706.0	5.9	4.1	192.6	2,787.5	362
2011. .	975.1	788.9	29.3	156.9	775.7	765.2	6.3	4.2	199.4	2,986.9	359
2012. .	1,065.0	848.0	33.5	183.5	854.2	843.0	6.7	4.5	210.9	3,197.8	350
2013. .	1,140.4	899.3	38.4	202.7	938.1	926.3	7.0	4.8	202.3	3,400.1	341
2014. .	1,204.9	947.2	42.2	215.5	1,021.7	1,009.3	7.3	5.2	183.2	3,583.3	333
2015. .	1,266.6	994.8	46.5	225.3	1,104.4	1,091.4	7.6	5.5	162.2	3,745.4	324
2016. .	1,327.7	1,042.7	51.2	233.9	1,193.3	1,179.8	7.9	5.7	134.4	3,879.9	314

[1] A detailed description of the components of income and cost, along with complete historical values, is presented in appendix A.
[2] "Total Income" column includes transfers made between the OASI and DI Trust Funds and the General Fund of the Treasury that are not included in the separate components of income shown. These transfers consist of payments for (1) the cost of noncontributory wage credits for military service before 1957, and (2) the cost of benefits to certain uninsured persons who attained age 72 before 1968.
[3] The "Trust fund ratio" column represents assets at the beginning of a year (which are identical to assets at the end of the prior year shown in the "Amount at end of year" column) as a percentage of cost for the year.

Note: Totals do not necessarily equal the sums of rounded components.

4. Factors Underlying Changes in 10-Year Trust Fund Ratio Estimates From the 2006 Report

The factors underlying the changes in the intermediate estimates for the OASI, DI and the combined funds from last year's annual report to this report are analyzed in table IV.A4. In the 2006 Annual Report, the trust fund ratio for OASI was estimated to reach 462 percent at the beginning of 2015—the tenth projection year from that report. If there had been no changes to the projections, the estimated ratio at the beginning of 2016 would be 1 percentage point lower than at the beginning of 2015, or 461 percent. There were changes, however, to reflect the latest actual data, as well as adjustments to the assumptions for future years. The resulting ratio shown in this report for the tenth projection year (2016) is 462 percent. The net effect of changes in demographic assumptions over the short-range period resulted in a reduction in the tenth-year trust fund ratio of 3 percent-

age points. The cumulative net effects of changes in economic data and assumptions resulted in essentially no change in the trust fund ratio by the beginning of 2016. There were several relatively minor changes in the short-range projection methodology since the 2006 report. The changes included improvements in our methods for estimating the numbers of persons satisfying the program's insured status requirements, and the seasonal pattern of benefit receipt. The combined effects of these methodological improvements was to decrease the ending trust fund ratio by about 4 percentage points. Finally, an increase in the 2016 trust fund ratio of 8 percentage points resulted from the correction of the clerical error related to voluntary income tax withholding described in section III.A. A relatively small portion of that increase is attributable to a reimbursement authorized by Public Law 109-465 (its effect is shown in table IV.A4 attributed to "Legislation"). The majority of the effect due to this correction, including the effect on projected benefit levels, is shown under "Programmatic data and assumptions."

Corresponding estimates of the factors underlying the changes in the financial projections for the DI Trust Fund, and for the OASI and DI Trust Funds combined, are also shown in table IV.A4. The largest effect on the DI trust fund ratio at the beginning of 2016 was due to the change in the valuation period, making up essentially all of the total 9 percentage point reduction. Revised economic assumptions, updates for a variety of programmatic assumptions, and the voluntary income tax withholding correction contributed minor and offsetting changes.

Table IV.A4.—Reasons for Change in Trust Fund Ratios at the Beginning of the Tenth Year of Projection
[In percent]

Item	OASI Trust Fund	DI Trust Fund	OASI and DI Trust Funds, combined
Trust fund ratio shown in last year's report for calendar year 2015	462	139	409
Change in trust fund ratio due to changes in:			
Legislation	1/	1/	1/
Valuation period	-1	-9	-2
Demographic data and assumptions	-3	1/	-2
Economic data and assumptions	1/	1	1/
Programmatic data and assumptions	8	1	6
Projection methods and data	-4	-1	-4
Total change in trust fund ratio	1/	-9	-2
Trust fund ratio shown in this report for calendar year 2016	462	130	407

[1] Change in trust fund ratio of less than 0.5 percentage point.

Note: Totals do not necessarily equal the sums of rounded components.

B. LONG-RANGE ESTIMATES

Three types of financial measures are useful in assessing the actuarial status of the Social Security trust funds under the financing approach specified in current law: (1) annual cash-flow measures, including income and cost rates, and balances, (2) trust fund ratios, and (3) summary measures like actuarial balances and unfunded obligations. The first long-range estimates presented are the series of projected annual balances (or net cash flow), which are the differences between the projected annual income rates and annual cost rates (expressed as percentages of the taxable payroll). In assessing the financial condition of the program, particular attention should be paid to the level of the annual balances at the end of the long-range period and the time at which the annual balances may change from positive to negative values.

The next measure discussed is the pattern of projected trust fund ratios. The trust fund ratio represents the proportion of a year's projected cost that could be paid with the funds available at the beginning of the year. Particular attention should be paid to the level and year of maximum trust fund ratio, to the year of exhaustion of the funds, and to the stability of the trust fund ratio in cases where the ratio remains positive at the end of the long-range period. When a program has positive trust fund ratios throughout the 75-year projection period and these ratios are stable or rising at the end of the period, the program financing is said to achieve sustainable solvency.

The final measures discussed in this section summarize the total income and cost over valuation periods that extend through 75 years, and to the infinite horizon. These measures indicate whether projected income will be adequate for the period as a whole. The first such measure, actuarial balance, indicates the size of any surplus or shortfall as a percentage of the taxable payroll over the period. The second, open group unfunded obligation, indicates the size of any shortfall in present-value dollars. This section also includes a comparison of covered workers to beneficiaries, a generational decomposition of the infinite future unfunded obligation, the test of long-range close actuarial balance, and the reasons for change in the actuarial balance from the last report.

If the 75-year actuarial balance is zero (or positive), then the trust fund ratio at the end of the period will be at 100 percent (or greater), and financing for the program is considered to be adequate for the 75-year period as a whole. (Financial adequacy, or solvency, for each year is determined by whether the trust fund asset level is positive throughout the year.) Whether or not financial adequacy is stable in the sense that it is likely to continue for subsequent 75-year periods in succeeding reports is also important when considering the actuarial status of the program. One indication of this stability, or sustainable solvency, is the behavior of the trust fund ratio at the end of the projection

period. If trust fund ratios for the last several years of the long-range period are positive and constant or rising, then it is likely that subsequent Trustees Reports will also show projections of financial adequacy (assuming no changes in demographic and economic assumptions, or the law). The actuarial balance and the open group unfunded obligation for the infinite future provide additional measures of the financial status of the program for the very long range.

1. Annual Income Rates, Cost Rates, and Balances

Basic to the consideration of the long-range actuarial status of the trust funds are the concepts of income rate and cost rate, each of which is expressed as a percentage of taxable payroll. Other measures of the cash flow of the program are shown in appendix F. The annual income rate is the sum of the tax contribution rate and the ratio of income from taxation of benefits to the OASDI taxable payroll for the year. The OASDI taxable payroll consists of the total earnings which are subject to OASDI taxes, with some relatively small adjustments.[1] As such, it excludes net investment income and reimbursements from the General Fund of the Treasury for the costs associated with special monthly payments to certain uninsured persons who attained age 72 before 1968 and who have fewer than 3 quarters of coverage.

The annual cost rate is the ratio of the cost of the program to the taxable payroll for the year. The cost is defined to include scheduled benefit payments, special monthly payments to certain uninsured persons who have 3 or more quarters of coverage (and whose payments are therefore not reimbursable from the General Fund of the Treasury), administrative expenses, net transfers from the trust funds to the Railroad Retirement program under the financial-interchange provisions, and payments for vocational rehabilitation services for disabled beneficiaries. For any year, the income rate minus the cost rate is referred to as the balance for the year. (In this context, the term balance does not represent the assets of the trust funds, which are sometimes referred to as the balance in the trust funds.)

Table IV.B1 presents a comparison of the estimated annual income rates and cost rates by trust fund and alternative. Detailed long-range projections of trust fund operations, in current dollar amounts, are shown in table VI.F8.

The projections for OASI under the intermediate assumptions show the income rate rising due to the gradually increasing effect of the taxation of

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[1] Adjustments are made to include deemed wage credits based on military service for 1983-2001, and to reflect the lower effective tax rates (as compared to the combined employee-employer rate) which apply to multiple-employer "excess wages," and which did apply, before 1984, to net earnings from self-employment and, before 1988, to income from tips.

A MESSAGE TO THE PUBLIC:

Each year the Trustees of the Social Security and Medicare trust funds report on the current and projected financial status of the two programs. This message summarizes our 2007 Annual Reports.

The financial condition of the Social Security and Medicare programs remains problematic; we believe their currently projected long run growth rates are not sustainable under current financing arrangements. Social Security's current annual surpluses of tax income over expenditures will soon begin to decline and then turn into rapidly growing deficits as the baby boom generation retires. Medicare's financial status is even worse. Medicare's Hospital Insurance (HI) Trust Fund is already expected to pay out more in hospital benefits this year than it receives in taxes and other dedicated revenues. The growing annual deficits in both programs are projected to exhaust HI reserves in 2019 and Social Security reserves in 2041. In addition, the Medicare Supplementary Medical Insurance (SMI) Trust Fund that pays for physician services and the new prescription drug benefit will continue to require general revenue financing and charges on beneficiaries that grow faster than the economy and beneficiary incomes over time.

The drawdown of Social Security and HI Trust Fund reserves and the general revenue transfers into SMI will place mounting pressure on the Federal budget. In fact, this pressure is already evident. For the first time, a "Medicare funding warning" is being triggered, signaling that non-dedicated sources of revenues—primarily general revenues— will soon account for more than 45 percent of Medicare's outlays. By law, this warning requires that the President propose, and the Congress consider, remedial action.

We are increasingly concerned about inaction on the financial challenges facing the Social Security and Medicare programs. The longer we wait to address these challenges, the more limited will be the options available, the greater will be the required adjustments, and the more severe the potential detrimental economic impact on our nation.

Social Security

The annual cost of Social Security benefits represented 4.2 percent of Gross Domestic Product (GDP) in 2006, is projected to increase to 6.2 percent of GDP in 2030, and then rise slowly to 6.3 percent of GDP in 2081. The projected 75-year actuarial deficit in the combined Old-Age

and Survivors and Disability Insurance (OASDI) Trust Fund is 1.95 percent of taxable payroll, down from 2.02 percent in last year's report. This decrease is due primarily to revisions in key assumptions and to changes in methods. Although the program passes our short-range test of financial adequacy, it continues to fail our long-range test of close actuarial balance by a wide margin. Projected OASDI tax income will begin to fall short of outlays in 2017, and will be sufficient to finance only 75 percent of scheduled annual benefits in 2041, when the combined OASDI Trust Fund is projected to be exhausted.

Social Security could be brought into actuarial balance over the next 75 years in various ways, including an immediate increase of 16 percent in payroll tax revenues or an immediate reduction in benefits of 13 percent or some combination of the two. Ensuring that the system is solvent on a sustainable basis beyond the next 75 years would require larger changes. To the extent that changes are delayed or phased in gradually, larger adjustments in scheduled benefits and revenues would be required that would be spread over fewer generations.

Medicare

As we reported last year, Medicare's financial difficulties come sooner—and are much more severe—than those confronting Social Security. While both programs face demographic challenges, the impact is greater for Medicare because health care costs increase at older ages. Moreover, underlying health care costs per enrollee are projected to rise faster than the wages per worker on which payroll taxes and Social Security benefits are based. As a result, while Medicare's annual costs were 3.1 percent of GDP in 2006, or about 72 percent of Social Security's, they are projected to surpass Social Security expenditures in 2028 and exceed 11 percent of GDP in 2081.

The projected 75-year actuarial deficit in the Hospital Insurance (HI) Trust Fund is now 3.55 percent of taxable payroll, up slightly from 3.51 percent in last year's report. The fund again fails our test of short-range financial adequacy, as projected annual assets drop below projected annual expenditures within 10 years—in 2013. The fund also continues to fail our long-range test of close actuarial balance by a wide margin. The projected date of HI Trust Fund exhaustion is 2019, one year later than in last year's report, when tax income will be sufficient to pay only 79 percent of HI costs. HI tax income falls short of outlays in this and all future years. The program could be brought into actuarial balance over the next

75 years by an immediate 122 percent increase in the payroll tax, or an immediate 51 percent reduction in program outlays or some combination of the two. As with Social Security, adjustments of greater magnitude would be necessary to the extent changes are delayed or phased in gradually, or to make the program solvent on a sustainable basis beyond the 75-year horizon.

Part B of the Supplementary Medical Insurance (SMI) Trust Fund, which pays doctors' bills and other outpatient expenses, and Part D, which pays for access to prescription drug coverage, are both projected to remain adequately financed into the indefinite future because current law automatically provides financing each year to meet next year's expected costs. However, expected steep cost increases will result in rapidly growing general revenue financing needs—projected to rise from 1.3 percent of GDP in 2006 to 4.7 percent in 2081—as well as substantial increases over time in beneficiary premium charges.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 requires that the Medicare Report include a determination of whether the difference between total Medicare outlays and dedicated financing (such as premiums and payroll taxes) exceeds 45 percent of total outlays within the first 7 years of the projection period (2007-2013 for the 2007 Report). The Act requires that an affirmative determination in two consecutive reports be treated as a "funding warning" for Medicare that would, in turn, require a Presidential proposal to respond to the warning and expedited Congressional consideration of such proposal. The 2007 Report projects that the difference will surpass 45 percent in 2013 and therefore makes a determination of excess general revenue funding. Because the 2006 report also made such a determination, a "Medicare funding warning" is hereby triggered that requires the President to propose legislation that responds to this warning within 15 days of the submission of the Fiscal Year 2009 budget and for Congress to consider the proposal on an expedited basis. This requirement will help call additional attention to Medicare's impact on the Federal budget.

Conclusion

The financial difficulties facing Social Security and Medicare pose enormous, but not insurmountable, challenges. The sooner these challenges are addressed, the more varied and less disruptive their solutions can be. We urge the public to engage in informed discussion and policymakers to think creatively about the changing needs and preferences of working and

retired Americans. Such a national conversation and timely political action are essential to ensure that Social Security and Medicare continue to play a critical role in the lives of all Americans.

By the Trustees:

Henry M. Paulson, Jr.,
Secretary of the Treasury,
and Managing Trustee

Elaine L. Chao,
Secretary of Labor,
and Trustee

Michael O. Leavitt,
Secretary of Health
and Human Services,
and Trustee

Michael J. Astrue,
Commissioner of
Social Security,
and Trustee

John L. Palmer,
Trustee

Thomas R. Saving,
Trustee

A SUMMARY OF THE 2007 ANNUAL SOCIAL SECURITY AND MEDICARE TRUST FUND REPORTS

Who Are the Trustees? There are six Trustees, four of whom serve by virtue of their positions in the Federal Government: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two Trustees are public representatives appointed by the President: John L. Palmer, University Professor and Dean Emeritus of the Maxwell School of Citizenship and Public Affairs at Syracuse University, and Thomas R. Saving, Director of the Private Enterprise Research Center and Professor of Economics at Texas A&M University.

What Are the Trust Funds? Congress established the trust funds in the U.S. Treasury to account for all program income and disbursements. Social Security and Medicare taxes, premiums, and other income are credited to the funds. Disbursements from the funds can be made only to pay benefits and program administrative costs.

The Department of the Treasury invests program revenues not needed in the current year to pay benefits and administrative costs in special non-marketable securities of the U.S. Government on which a market rate of interest is credited. Thus, the trust funds represent the accumulated value, including interest, of all prior program annual surpluses and deficits, and provide automatic authority to pay benefits.

There are four separate trust funds. For Social Security, the Old-Age and Survivors Insurance (OASI) Trust Fund pays retirement and survivors benefits, and the Disability Insurance (DI) Trust Fund pays disability benefits. (The two trust funds are jointly designated as OASDI.) For Medicare, the Hospital Insurance (HI) Trust Fund pays for inpatient hospital and related care. The Supplementary Medical Insurance (SMI) Trust Fund comprises two separate accounts: Part B, which pays for physician and outpatient services, and Part D, which covers the prescription drug benefit that began in 2006. Medicare benefits are provided to most people age 65 and over and to most individuals who receive Social Security disability benefits.

What Were the Trust Fund Results in 2006? In December 2006, 40.5 million people received OASI benefits, 8.6 million received DI benefits, and 43.2 million were covered under Medicare. Trust fund operations, in billions of dollars, are shown below (totals may not add due to rounding). All four trust funds showed net increases in assets in 2006.

	OASI	DI	HI	SMI
Assets (end of 2005)	$1,663.0	$195.6	$285.8	$24.0
Income during 2006	642.2	102.6	211.5	225.5
Outgo during 2006	461.0	94.5	191.9	216.4
Net increase in assets	181.3	8.2	19.6	9.1
Assets (end of 2006)	1,844.3	203.8	305.4	33.1

How Has the Financial Outlook for Social Security and Medicare Changed Since Last Year? Under the intermediate assumptions, the combined OASDI Trust Funds show a 75-year actuarial deficit equal to 1.95 percent of taxable payroll, slightly smaller than last year's estimate of 2.02 percent. That change is largely due to improved methodology and lower assumed rates of disability incidence. The OASDI Trust Funds, separately and combined, are adequately financed over the next 10 years.

Medicare's HI Trust Fund now has a projected 75-year actuarial deficit equal to 3.55 percent of payroll compared with last year's estimate of 3.51 percent under the intermediate assumptions. That change is primarily caused by moving the valuation period forward by one year from 2006-80 to 2007-81, which adds a year (2081) with a high projected deficit into the estimate. The HI Trust Fund is also inadequately funded over the next 10 years, with trust fund assets projected to fall short of 100 percent of annual expenditures in 2013.

The SMI Trust Fund is adequately financed in both the short and long term because of the automatic financing established for Medicare Parts B and D. Nonetheless, projected SMI cost growth over the long term will require increased general revenue funding that will average 6.5 percent annually, placing an ever-increasing burden on Federal revenues.

Although there have been no substantial changes in the overall Medicare outlook, this year's Trustees Report is the second consecutive report in which the annual general revenue funding contribution to total Medicare expenditures is projected to exceed 45 percent within the first 7 years of the 75-year projection period. Therefore, by law, a "Medicare funding warning" is triggered by the report's findings. This warning requires the President to respond by submitting proposed legislation within 15 days of the next budget submission (early February, 2008) to address the problem, and for Congress to consider the proposal on an expedited basis.

How Are Social Security and Medicare Financed? For OASDI and HI, the major source of financing is payroll taxes on earnings that are paid by employees and their employers. The self-employed are charged the equivalent of the combined employer and employee tax rates. During 2006, an estimated 162 million people had earnings covered by Social Security and paid payroll taxes; for Medicare, the corresponding figure was 166 million people. The payroll tax rates are set by law and for OASDI apply to earnings up to an annual maximum ($97,500 in 2007) that increases with the growth in nationwide average wages. HI taxes are paid on total earnings. The tax rates (in percent) for 2007 and later are:

	OASI	DI	OASDI	HI	Total
Employees	5.30	0.90	6.20	1.45	7.65
Employers	5.30	0.90	6.20	1.45	7.65
Combined total. . .	10.60	1.80	12.40	2.90	15.30

About 75 percent of SMI Part B and Part D expenditures are paid from Federal general fund revenues, with most of the remaining costs covered by monthly premiums charged to beneficiaries. Part B and Part D premium amounts are based on methods defined in law and increase as the estimated costs of those programs rise.

In 2007, the Part B standard monthly premium paid by most enrollees is $93.50. During 2007-09, an income-related premium surcharge is being phased in for Part B beneficiaries whose modified adjusted gross income exceeds inflation-indexed thresholds (in 2007, $80,000 for individual tax returns, $160,000 for joint returns).

In 2007, the national average Part D base monthly premium is estimated to be $27.35. (Actual premium amounts charged to Part D beneficiaries depend on the specific plan in which they are enrolled.) Part D also receives payments from States for the Federal assumption of Medicaid responsibilities for prescription drug costs for individuals eligible for both Medicare and Medicaid. In 2007, State payments are estimated to cover 13 percent of Part D costs, but that percentage is projected to decline to 9 percent by 2012 as Part D outlays increase.

Income to each trust fund, by source, in 2006 is shown in the table below (totals may not add due to rounding).

Source *(in billions)*	OASI	DI	HI	SMI
Payroll taxes	$534.8	$90.8	$181.3	—
General fund revenue	—	—	0.5	$171.9
Interest earnings	91.8	10.6	15.7	1.8
Beneficiary premiums	—	—	2.6	46.3
Taxes on benefits	15.6	1.2	10.3	—
Other	*	—	1.0	5.5
Total	642.2	102.6	211.5	225.5

* Less than $50 million.

What Were the Administrative Expenses in 2006? Administrative expenses, as a percentage of total expenditures, were:

	OASI	DI	HI	SMI
Administrative expenses 2006	0.7	2.5	1.5	1.6

How Are Estimates of the Trust Funds' Future Status Made? Short-range (10-year) and long-range (75-year) projections are reported for all funds. Estimates are based on current law and assumptions about factors that affect the income and outgo of each trust fund. Assumptions include economic growth, wage growth, inflation, unemployment, fertil-

ity, immigration, and mortality, as well as factors relating to disability incidence and the cost of hospital, medical, and prescription drug services.

Because the future is inherently uncertain, three alternative sets of economic and demographic assumptions are used to show a range of possibilities. The intermediate assumptions (alternative II) reflect the Trustees' best estimate of future experience. The low-cost alternative I is more optimistic for trust fund financing, and the high-cost alternative III is more pessimistic; they show trust fund projections for more and less favorable economic and demographic conditions for trust fund financing than the best estimate. The assumptions are reexamined each year in light of recent experience and new information about future trends, and are revised as warranted. In general, greater confidence can be placed in the assumptions and estimates for earlier projection years than for later years. The statistics and analysis presented in this Summary are based on the intermediate assumptions.

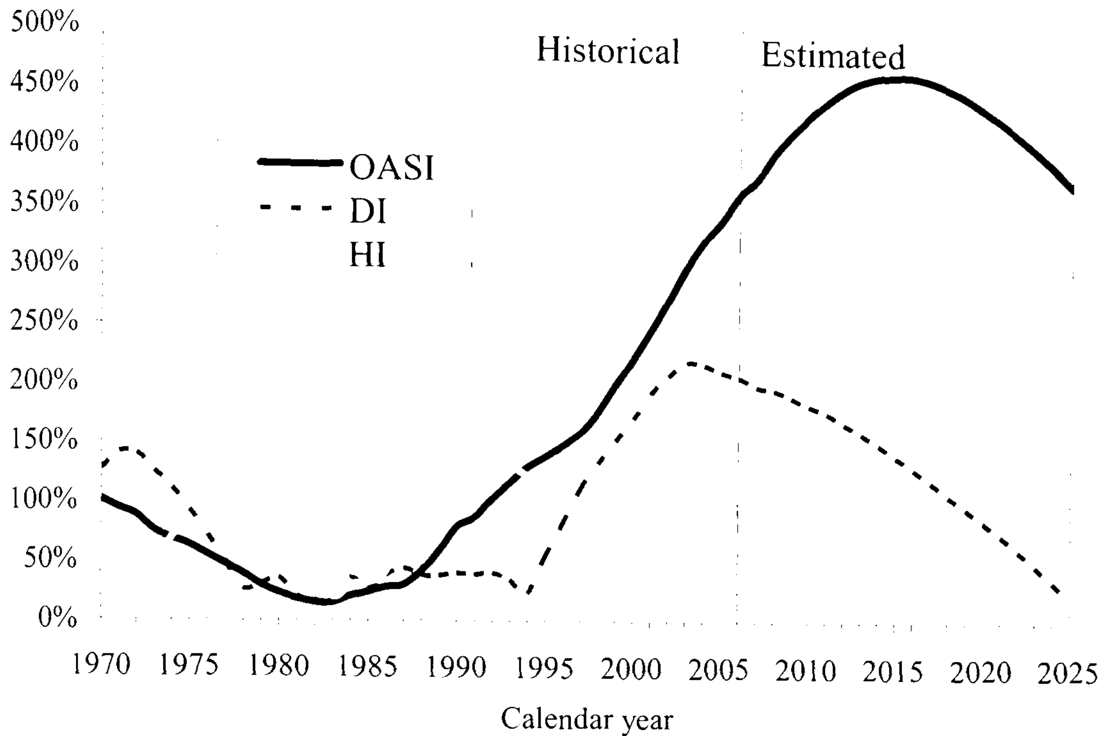
What is the Short-Range Outlook (2007-2016) for the Trust Funds? For the short range, the adequacy of the OASI, DI, and HI Trust Funds is measured by comparing their assets at the beginning of a year to projected costs for that year (the "trust fund ratio"). A trust fund ratio of 100 percent or more—that is, assets at least equal to projected benefit payments for a year—is considered a good indicator of a fund's short-term adequacy. This level of projected assets for any year means that even if expenditures exceed income, the trust fund reserves, combined with annual tax revenues, would be sufficient to pay full benefits for several years, allowing time for legislative action to restore financial adequacy.

By this measure, the OASI and DI funds are considered financially adequate throughout the short range because the assets of each fund exceed the 100 percent level through the year 2016. The HI fund does not meet the short-range test of financial adequacy because its assets fall below the 100 percent level of one year's outgo during 2013. Chart A shows these trust fund ratios under the intermediate assumptions through 2025.

For SMI Part B, a less stringent annual "contingency reserve" asset test applies because the bulk of the financing for that account is provided by beneficiary premiums and Federal general fund revenue payments automatically adjusted each year to meet expected costs. Part D is similarly financed on an annual basis. Moreover, the operation of Part D through private insurance plans, together with a flexible appropriation for Federal costs, eliminates the need for a contingency reserve in that account. Note, however, that the cost estimates for Part B are likely to be too low (perhaps by 25 to 40 percent in the long range) because they assume that current law governing the structure of physician payment updates will persist. That would lead to substantial reductions in physician payments per service during 2008-16 and slow the growth of projected Part B costs.

Chart A–OASI, DI, and HI Trust Fund Ratios

[Assets as a percentage of annual expenditures]



In each year since 2001, Congress has passed legislation to increase physician payments rather than allow the current law reductions. Thus, experience indicates that the apparent reductions are unlikely to occur before legislative changes intervene. The underestimated physician payments affect projected costs for Part B, total SMI, and total Medicare.

The following table shows the projected income and outgo, and the change in the balance of each trust fund, excepting SMI, over the next 10 years. SMI income and expenditures are shown in separate columns for Parts B and D. Changes in the SMI Trust Funds are not shown because of the automatic annual adjustments in program income to meet the following year's projected expenditures.

ESTIMATED OPERATIONS OF TRUST FUNDS

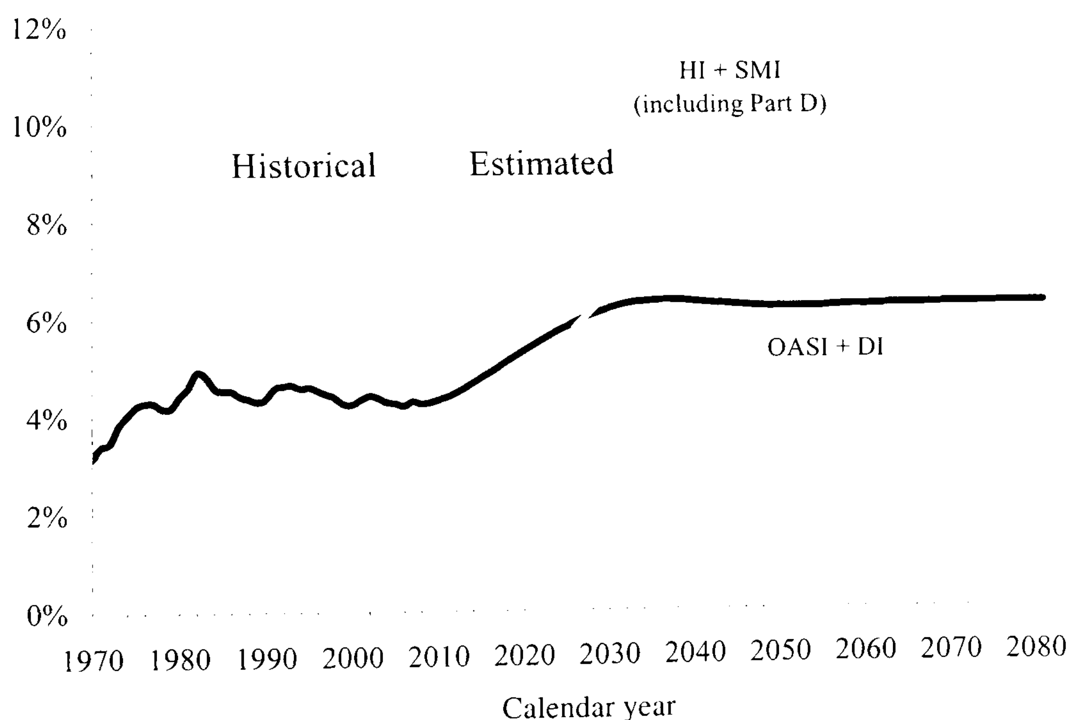
(In billions—totals may not add due to rounding)

	Income					Expenditures					Change in fund		
				SMI					SMI				
Year	OASI	DI	HI	B	D	OASI	DI	HI	B	D	OASI	DI	HI
2007	$676	$107	$224	$188	$50	$492	$102	$208	$180	$50	$183	$5	$15
2008	715	112	234	198	62	511	106	224	191	62	204	6	10
2009	763	119	248	224	70	539	113	241	203	70	223	6	7
2010	810	125	261	201	79	574	121	258	216	79	237	4	3
2011	861	131	274	232	89	611	127	275	229	89	250	4	-1
2012	911	137	288	249	101	652	136	294	244	101	259	1	-6
2013	962	143	301	266	112	699	144	314	262	112	263	-1	-14
2014	1,014	149	314	285	125	750	152	336	280	125	263	-3	-23
2015	1,067	155	327	332	139	805	160	360	300	139	262	-6	-33
2016	1,123	161	340	300	156	864	169	385	322	156	258	-9	-45

What is the Long-Range (2007-2081) Outlook for Social Security and Medicare Costs? An instructive way to view the projected cost of Social Security and Medicare is to compare the financing required to pay all scheduled benefits for the two programs with gross domestic product (GDP), the most frequently used measure of the total U.S. economy (Chart B). Costs for both programs rise steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. During those years Medicare costs increase at an even faster rate than Social Security because of the rising cost of health services, increasing utilization rates, and anticipated increases in the complexity of services. Beyond 2030, Social Security costs grow slowly but continue to increase primarily because of projected increases in life expectancy. Medicare costs, however, continue to grow rapidly after 2030 due to expected increases in the cost of health care.

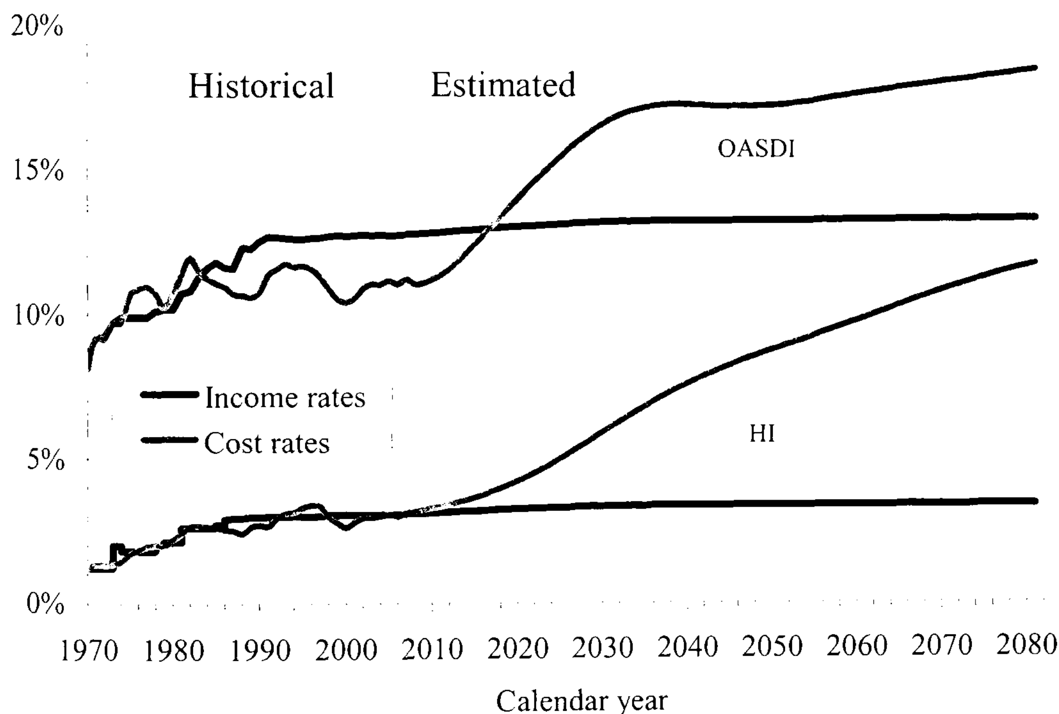
The 75-year projected cost outlook for Social Security and Medicare is similar to that described in last year's report. In 2006, the combined cost of the Social Security and Medicare programs represented roughly 7.3 percent of GDP. Social Security outgo amounted to 4.2 percent of GDP in 2006 and is projected to increase to 6.3 percent of GDP in 2081. Medicare's cost was smaller in 2006—3.1 percent of GDP— but is projected to surpass the cost of Social Security in 2028, growing to 11.3 percent of GDP in 2081 when it will be 80 percent larger than Social Security's cost. In 2081, the combined cost of the programs will represent 17.6 percent of GDP. As a point of comparison, in 2006 all Federal receipts amounted to 18.5 percent of GDP.

Chart B–Social Security and Medicare Cost as a Percentage of GDP



What is the Outlook for OASDI and HI Costs Relative to Tax Income? Both Medicare and Social Security costs are projected to grow substantially faster than the economy over the next several decades, but unless current law is changed, tax income to the HI and OASDI Trust Funds will not. Because the primary source of income for HI and OASDI is the payroll tax, it is customary to compare the programs' income and costs expressed as percentages of taxable payroll. These income and cost rates are shown in Chart C. Although both the Medicare and Social Security annual cost rates increase markedly from their 2006 levels (3.01 and 11.02 percent), income rates increase very little over the long run. The reason is that payroll tax rates are not scheduled to change and income from the other tax source to these programs, taxation of OASDI benefits, will increase only gradually as a greater proportion of beneficiaries is subject to taxation in future years.

Chart C–Income and Cost Rates
[Percentage of taxable payroll]



What is the Long-Range Actuarial Balance of the OASI, DI, and HI Trust Funds? The traditional way to view the outlook of the payroll tax financed trust funds is in terms of their actuarial balances for the 75-year valuation period. The actuarial balance of a fund is essentially the difference between annual income and costs, expressed as a percentage of taxable payroll, summarized over the 75-year projection period. Because SMI is brought into balance annually through premium increases and general revenue transfers, actuarial balance is not an appropriate concept for that program.

The OASI, DI, and HI Trust Funds each have an actuarial deficit under the intermediate assumptions, as shown in the following table. Each actu-

arial deficit can be interpreted as the percentage points that could be either added to the current law income rate or subtracted from the cost rate for each of the next 75 years to bring the funds into actuarial balance, defined as a terminal trust fund balance equal to the following year's expenditures. Because large and growing annual deficits are projected at the end of the long-range period, adequate financing beyond 2081 would likely require even larger changes than are needed for solvency in 2007-81.

LONG-RANGE ACTUARIAL DEFICIT OF THE OASI, DI, AND HI TRUST FUNDS

(As a percentage of taxable payroll; total may not add due to rounding)

	OASI	DI	OASDI	HI
Actuarial Deficit	1.69	0.27	1.95	3.55

What Are Key Dates in Long-Range OASI, DI, and HI Financing? When costs exceed income excluding interest (Chart C), use of trust fund assets occurs in stages. For HI, the process is expected to start in 2007, when interest earnings on trust fund assets will be used to help pay benefits. Beginning in 2011, costs are projected to exceed income including interest, and assets must be redeemed each year until the trust fund is exhausted in 2019. Those dates are one year later than reported last year due to slightly higher projected payroll tax income and slightly lower projected benefits than previously estimated. In 2019, tax income is estimated to be sufficient to pay 79 percent of HI costs—and by 2081 only 29 percent.

For OASDI, interest income will first be needed to pay a portion of benefits in 2017, although the trust funds will continue to accumulate assets. In 2027, trust fund assets will begin to be depleted and are projected to be exhausted in 2041—a year later than indicated in last year's report—when tax income would cover 75 percent of costs. By 2081, tax income would cover 70 percent of scheduled benefits. The key dates regarding cash flows are shown below.

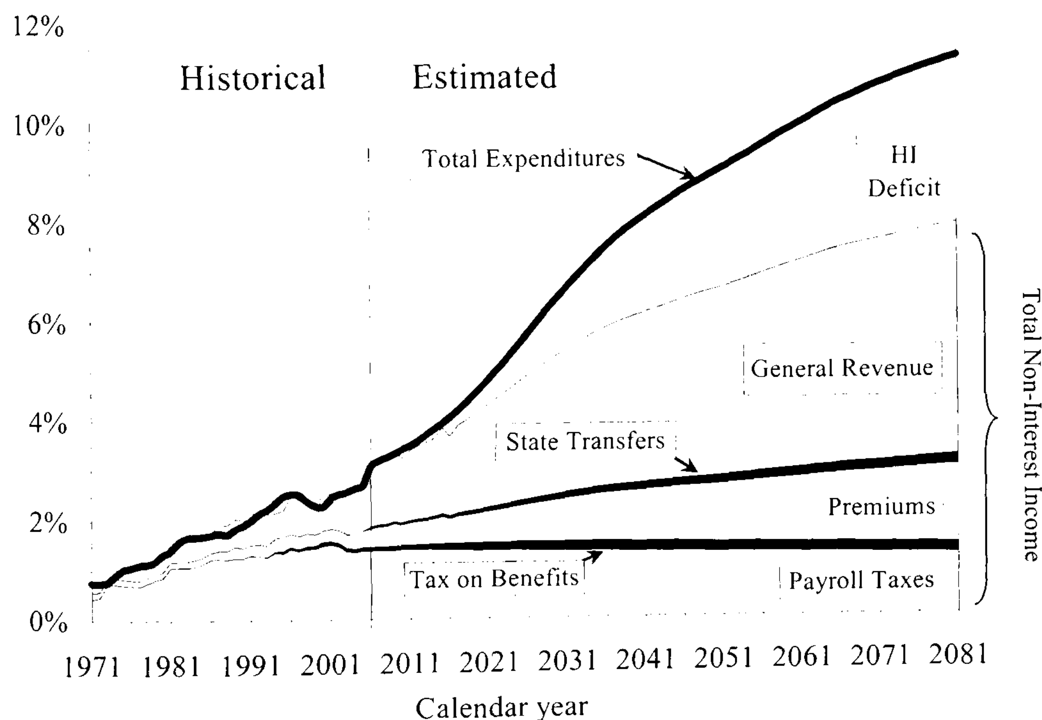
KEY DATES FOR THE TRUST FUNDS

	OASI	DI	OASDI	HI
First year outgo exceeds income excluding interest	2018	2005	2017	2007
First year outgo exceeds income including interest	2028	2013	2027	2011
Year trust fund assets are exhausted	2042	2026	2041	2019

How Do the Sources of Medicare Financing Change? As Medicare costs grow over time, general revenues and beneficiary premiums will play a larger role in financing the program. Chart D shows expenditures and current law non-interest revenue sources for HI and SMI combined as

a percentage of GDP. The total expenditure line is the same as displayed in Chart B and shows Medicare costs rising to 11.3 percent of GDP by 2081. Revenues from taxes are expected to remain at about 1.5 percent of GDP, while general fund revenue contributions are projected to increase from 1.3 percent in 2007 to 4.7 percent in 2081, and beneficiary premiums from 0.4 to 1.6 percent of GDP. Thus, revenues from taxes will fall substantially as a share of total non-interest Medicare income (from 46 percent to 18 percent) while general fund revenues will rise (from 41 to 59 percent), as will premiums (from 12 percent to 20 percent). The gap between total non-interest income and expenditures steadily widens due to growing annual HI deficits, which reach 3.4 percent of GDP by 2081. All told, by 2081 the Medicare program is projected to require SMI general revenue transfers equal to 4.7 percent of GDP. Moreover, the HI deficit would equal another 3.6 percent of GDP, and there is no provision to address this deficit under current law through general fund transfers or any other means.

Chart D–Medicare Expenditures and Non-Interest Income by Source as a Percent of GDP



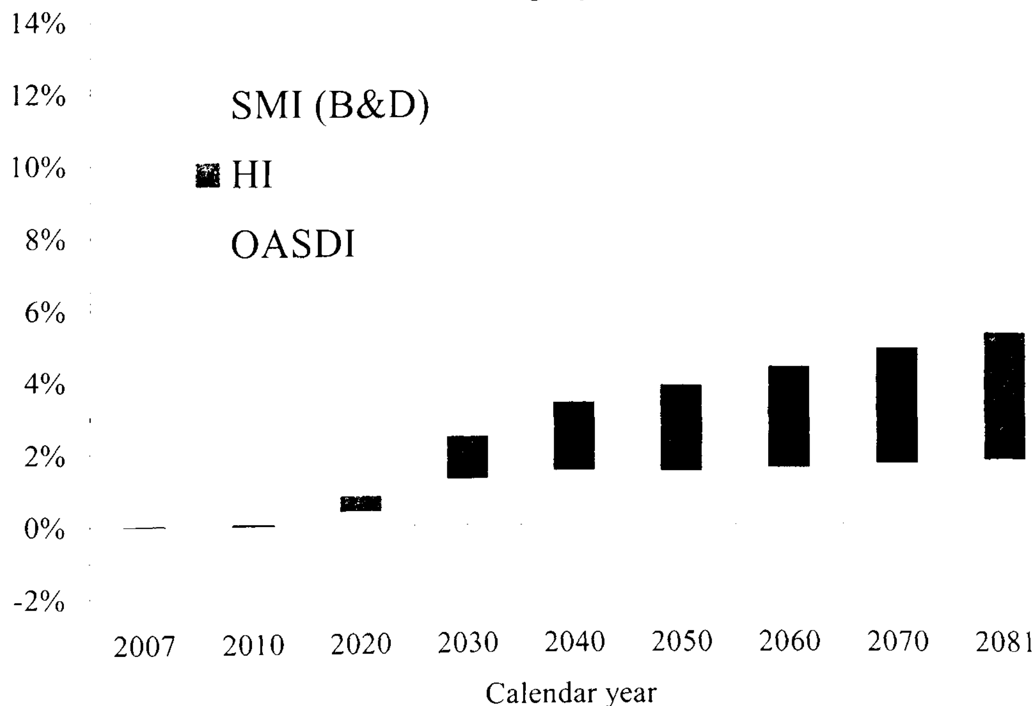
The Medicare Modernization Act (2003) requires that the Board of Trustees determine each year whether the annual difference between program outlays and dedicated revenues (the bottom four layers of Chart D) exceeds 45 percent of total Medicare outlays within the first 7 years of the 75-year projection period. The law effectively establishes a threshold condition that signals that a trust fund's dedicated financing is inadequate or that general revenue financing of Medicare is becoming excessive. A first "excess general revenue Medicare funding" determination was issued by

the Trustees in their 2006 Report. This year's Report estimates that the difference between projected outlays and dedicated financing revenues will exceed 45 percent in 2013 (compared with 41 percent in 2006), again leading to an "excess general revenue Medicare funding" determination. Because the Trustees have made this determination in two consecutive reports, a "Medicare funding warning" is triggered.

Why is Reform to Improve the Social Security and Medicare Financial Imbalances Needed? Concern about the long-range financial outlook for Medicare and Social Security often focuses on the exhaustion dates for the HI and OASDI Trust Funds—the time when projected finances under current law would be insufficient to pay the full amount of scheduled benefits. A more immediate issue is the growing burden that the programs will place on the Federal budget well before the trust funds are exhausted.

The Federal general fund revenues that would be needed to finance currently scheduled benefits for Social Security and Medicare are shown in Chart E for selected years during the 2007-81 projection period. The total draw on general fund revenues (as a percentage of GDP) has three components: the gaps between tax income and the cost of scheduled benefits for the OASDI and HI programs, as well as the general fund revenue requirements to finance SMI's Parts B and D (75 percent of expenditures).

Chart E– Projected OASDI and HI Tax Income Shortfall *plus* the 75-Percent General Fund Revenue Contribution to SMI
(Percentage of GDP)



The initial negative amounts shown for OASDI indicate that tax income exceeds outgo (which occurs during 2007-16) and represent net revenues

to the Treasury that result in the issuance of Treasury bonds to the trust funds. Those OASDI net revenues are more than offset by the Medicare general revenue requirements under current law. For instance, in 2007 the Social Security tax income surplus ($85 billion) is estimated to be significantly smaller than the statutory Medicare Part B and Part D general revenue transfers, resulting in an overall cash requirement of $100 billion (0.7 percent of GDP) from the general fund of the Treasury.

The combined difference grows each year, so that by 2018, net revenue flows from the general fund will total $545 billion (2.3 percent of GDP). The positive amounts that begin in 2017 for OASDI, and in 2007 for HI, initially represent payments the Treasury must make to the trust funds when assets are redeemed to help pay benefits in years prior to exhaustion of the funds. Note that neither the redemption of trust fund bonds, nor interest paid on those bonds, provides any new net income to the Treasury, which must finance redemptions and interest payments through some combination of increased taxation, reductions in other government spending, or additional borrowing from the public.

Chart E shows that the difference between outgo and dedicated payroll tax and premium income will grow rapidly in the 2010-30 period as the baby-boom generation reaches retirement age. Beyond 2030, the difference continues to increase nearly as rapidly due primarily to health care costs that grow faster than GDP. After the trust fund exhaustion dates (2041 for OASDI, 2019 for HI), the increasing positive amounts for OASDI and HI depict the excess of scheduled benefits over projected program income. When the statutory SMI general fund revenue requirements are added in, the projected combined Social Security and Medicare general fund revenues needed in 2081 equal 10.1 percent of GDP. A similar burden today would require nearly all Federal income tax revenues, which amounted to 10.8 percent of GDP in 2006.

To put these magnitudes into historical perspective, in 2006 the combined annual cost of HI, SMI, and OASDI amounted to 40 percent of total Federal revenues, or about 7 percent of GDP. That cost (as a percentage of GDP) is projected to double by 2042, and then to increase further to nearly 18 percent of GDP in 2081. It is noteworthy that over the past four decades, the average amount of total Federal revenues as a percentage of GDP has also been 18 percent, and has never exceeded 21 percent in a given year. Assuming the continued need to fund a wide range of other government functions, the projected growth in Social Security and Medicare costs would require that the total Federal revenue share of GDP increase to wholly unprecedented levels.

This year's Trustees Reports describe large long-term financial imbalances for Social Security and Medicare, and demonstrate the need for timely and effective action. The sooner that solutions are adopted, the more varied and gradual they can be.

A MESSAGE FROM THE PUBLIC TRUSTEES

These are the seventh annual Trustees Reports issued since our initial appointments as Public Trustees by President Clinton and subsequent reappointments by President Bush. They are also the last to be issued on our watch, since our second terms will end later this year. Our goal as Public Trustees has been to work in a nonpartisan way to ensure the integrity of the process by which the reports are prepared and the objectivity and credibility of the information they contain. We believe the role of the Public Trustees is important and urge the President to nominate, and the Senate to confirm, our successors as soon as possible, so that they can participate fully in the process leading up to next year's reports.

The projections in the reports are based on a number of underlying assumptions. While any projections are inherently uncertain, we believe the Trustees' intermediate ones, which are the basis for our following discussion, provide the most reliable available picture of the financial outlook under current law for Social Security and Medicare. This outlook continues to be highly problematic.

Social Security

This year's OASDI report shows little deviation from last year's in the intermediate projections for Social Security. There has been a slight improvement in the outlook for the combined trust funds throughout the 75-year projection period, due to the positive effects of updates in program data and minor changes in methods and assumptions that more than offset the negative consequences of extending the valuation period by one year. As a result, the date of trust fund exhaustion has moved from 2040 back to 2041, the actuarial deficit for the 75-year projection period has declined from 2.02 to 1.95 percent of taxable payroll, and the end-year (now 2081) annual deficit is lower (5.20 percent of taxable payroll for 2081, compared with last year's 5.38 percent for 2080). Despite the improvement, the projected costs of scheduled benefits as a percentage of GDP remain the same as described in last year's report, rising from a 2007 level of 4.3 to 6.2 in 2030 and to 6.3 in 2080. Again, the projected cost of scheduled future benefits is far greater than projected revenues. In consequence, Social Security poses a significant challenge to Federal government finances.

The difference between the costs of currently scheduled benefits and tax revenues for the Social Security program over the 75-year projection period provides a summary measure of the magnitude of this challenge.

This difference is projected to total $6.8 trillion in present value, or about 1 percent of the present value of GDP over the same period. While current trust fund reserves provide the authority to cover the first $2.0 trillion of this funding shortfall before being depleted, Treasury must still come up with this amount in future cash as the special issue Treasury securities that make up trust fund reserves are redeemed. Because the deficits for Social Security continue to increase beyond the 75-year horizon, the magnitude of the fiscal problem over the very long run is much greater than the 75-year picture conveys.

Thus, the fundamentals remain the same this year as for all the years of our tenure as Public Trustees. Current annual surpluses of tax income over expenditures for the combined OASDI trust funds will soon begin to decline with the retirement of the baby-boom generation and, in 10 years, become rapidly growing deficits that must be covered with cash from the General Fund of the Treasury until trust fund reserves are exhausted a few decades later. At that time (2041), current law would no longer require Treasury to cover the annual trust fund deficits, and annual trust fund tax revenues would be sufficient to pay only 75 percent of currently scheduled Social Security benefits. Additional revenues initially equivalent to 13 percent of Federal income tax revenues (projected at their historical average share of GDP over the past four decades) and growing over time—would be necessary to fill this gap.

As we have noted in our past two years' Messages, demographic change is the major force shaping the financial outlook for Social Security, and only highly unlikely deviations in actual experience from the Trustee's intermediate assumptions for expected rates of fertility, mortality, and immigration could dramatically alter this outlook. The same is true of the long-term growth rate of the economy. Were the economy to expand as rapidly in future decades as in past ones, the financial outlook for Social Security would improve somewhat, though not nearly enough to eliminate its long-term deficit. But the marked slowdown in the growth of the labor force over the next several decades virtually precludes this.

Medicare

The outlook for Social Security presents a fiscal challenge that pales in comparison to that posed by Medicare. The big news in this year's report is the triggering of the "Medicare funding warning." While the warning is new, it simply reflects the same dire financial outlook for the program

we have been reporting for years and which was exacerbated by the recent addition of the Part D prescription drug benefit.

Projected Medicare costs are even more sensitive to population aging than Social Security's. But they are also projected to grow faster than those of Social Security over the entire projection period for a far more important second reason: the expectation that per capita health care costs will continue to grow faster than per capita GDP in the future, as they have in the past. As a result, this year's report—as did last year's—projects overall Medicare expenditures to increase from their 2007 level of 3.2 percent of GDP to 6.5 percent by 2030, and to 11.3 percent by the end of the 75-year period. In the absence of reform that greatly restrains these cost increases, taxes on the working age population and out-of-pocket payments by beneficiaries will both have to rise far faster than incomes in the decades ahead.

The Medicare program's Hospital Insurance (HI) component is inadequately financed over the next 10 years, is already running an annual deficit in tax income relative to expenditures, and is expected to exhaust its Trust Fund reserves in 2019. By then, annual revenues to the Trust Fund (generated primarily by Medicare's 2.9 percent payroll tax) would cover less than 80 percent of projected costs. The gap between projected costs and revenues grows so rapidly thereafter that projected revenues are less than 40 percent of projected costs by 2050, and less than 30 percent by the end of the 75-year projection period. The present value difference between projected expenditures and dedicated revenues for the 75-year horizon for just the HI component of Medicare is $11.6 trillion, 70 percent higher than the analogous $6.8 trillion measure of the budgetary challenge represented by OASDI as noted above.

The Supplementary Medical Insurance (SMI) component of Medicare—which covers outpatient services (Part B) and prescription drugs (Part D)—never experiences a shortfall between projected costs and revenues, since under current law, beneficiary premium income and general revenue transfers to the SMI trust fund are assumed to increase each year to match expected costs. But per capita expenditures for this program component, as for HI, are projected to grow in line with per capita health care costs over the long run. Thus, SMI trust fund revenues from premiums and general revenue transfers are expected to account for a growing share of beneficiary incomes and Federal general revenues over time. The level of general revenue transfers in excess of their current share of total Federal revenues amounts to $13.2 trillion over the next 75 years, and is an appropriate measure of the additional burden projected SMI expenditures

will place on Federal finances during this period. Thus, if program costs grow as currently projected, the total additional burden that would be imposed on Federal finances by Medicare (HI plus SMI) over the 75-year projection period would be $24.8 trillion. This is more than five times the current outstanding Federal (publicly-held) debt and amounts to 3.4 percent of projected GDP over the same period.

On a cash-flow basis, last year's general revenue transfers to Medicare were equivalent to 12.3 percent of Federal income tax revenues. To fully fund currently projected Medicare costs would require—in addition to currently dedicated sources of income from payroll taxes, premiums and the like—the equivalent in such transfers of nearly double this percentage of Federal income tax revenues (again, projected at their historical average share of GDP over the past four decades) within 15 years and more than triple in 25 years. Such transfers would require that over the next 25 years either Federal spending on government programs other than Social Security and Medicare fall by almost 25 percent, or that income tax revenues increase by more than 25 percent from their historical shares of GDP.

We should note that long-term projections of Medicare costs are subject to more sources of unexpected variation than are those for Social Security. In addition to the uncertainty inherent in the economic and demographic assumptions used in common with the Social Security projections, factors specific to health care—such as the rate of scientific breakthroughs, the frequency of the development of new "blockbuster" drugs, the possibility of new diseases or wide reoccurrence of older ones, the development of new medical treatment techniques, and the preferences of the population for particular kinds of care—introduce further uncertainty into the future course of Medicare costs. The most important Medicare-specific assumption embodied in the Trustees' long-term projections is that health care cost inflation, which has historically exceeded the growth in GDP on a per capita basis by more than two percentage points annually, will gradually decline over the 75-year projection period until it simply equals GDP growth at the period's end. This assumption seems reasonable, since per capita expenditures on health care cannot grow faster than per capita GDP indefinitely without all other forms of consumption trending to zero. Our citizenry has demonstrated a strong propensity over the past half-century to increase the share of income spent on health care, and there is, as yet, no clear evidence of when, or even how, this trend might abate. But if it does not do so soon, then the bleak fiscal picture portrayed in these reports will be bleaker still. Thus, along with

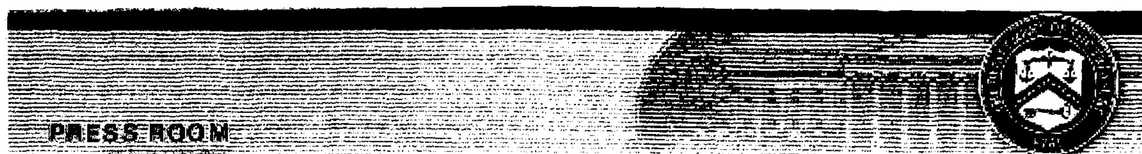
the overall imperative to reform Medicare funding comes an urgent need for better understanding of the factors contributing to the growth of health care spending and how these factors might be moderated in the future. We encourage further work on this important issue.

Conclusion

Social Security and Medicare both present daunting fiscal challenges, though Social Security's is far more manageable analytically and dollar-wise. Their fiscal problems are driven by inexorable demographic change and, in the case of Medicare, relentless increases in health care costs, and are not likely to be greatly ameliorated by economic growth or mere tinkering with program financing. Prudence dictates action sooner rather than later to address these fiscal challenges.

John L. Palmer,
Trustee

Thomas R. Saving,
Trustee



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April 23, 2007
HP-368

Treasury Statement on Release of President Bush's ID Theft Task Force Strategy

Washington, DC- President Bush's Identity Theft Task Force today released its strategic plan for combating identity theft, the top consumer fraud reported to the Federal Trade Commission.

Treasury Deputy Assistant Secretary for Critical Infrastructure Protection and Compliance Policy D. Scott Parsons, who led the Department's efforts with the taskforce, released the following statement today:

"President Bush recognized that identity theft is a crime with global reach and potentially serious consequences for our security and economic well-being. The criminals are sophisticated and the crimes can have a lasting impact on victims' lives.

"Many agencies, like the Treasury, have existing plans to combat identity theft, but this strategy promotes enhanced coordination among federal, state, and local authorities and recognizes the need for private sector participation. The report will serve as a blueprint for preventing and tracking down identity thieves and giving them due justice. More importantly, it charts a course to improve public awareness and data security, to prevent the opportunities for these crimes and to assist victims."

The Treasury Department is a member of the 17-agency task force, co-chaired by Attorney General Alberto Gonzales and FTC Chairman Deborah Majoras. The group, created by executive order in May 2006, developed 31 major recommendations for the plan. More information can be found at www.idtheft.gov.

REPORTS

- ID Theft Task Force Release

Department of Justice

Federal Trade Commission

FOR IMMEDIATE RELEASE
MONDAY, APRIL 23, 2007
WWW.USDOJ.GOV

AG
(202) 514-2007
TDD (202) 514-1888

THE PRESIDENT'S IDENTITY THEFT TASK FORCE RELEASES COMPREHENSIVE STRATEGIC PLAN TO COMBAT IDENTITY THEFT

WASHINGTON - Attorney General Alberto R. Gonzales and Federal Trade Commission Chairman Deborah Platt Majoras today announced the completion of the President's Identity Theft Task Force strategic plan to combat identity theft.

The strategic plan is the result of an unprecedented federal effort to formulate a comprehensive and fully coordinated plan to attack this widespread and destructive crime. The plan focuses on ways to improve the effectiveness of criminal prosecutions of identity theft; enhance data protection for sensitive consumer information maintained by the public sector, private sector, and consumers; provide more comprehensive and effective guidance for consumers and the business community; and improve recovery and assistance for consumers.

"Identity theft is a crime that goes far beyond the loss of money or property," said Attorney General Gonzales. "It is a personal invasion, done in secret, that can rob innocent men and women of their good names. The strategic plan we are releasing today is part of a comprehensive effort to fight this crime, protect consumers, and help victims put their lives back together."

"Identity theft is a blight on America's privacy and security landscape," said FTC Chairman Majoras. "Identity thieves steal consumers' time, money, and security, just as sure as they steal their identifying information, and they cost businesses enormous sums. The Strategic Plan submitted to the President provides a blueprint for increased federal prevention and protection."

Although much has been done to combat identity theft, the specific recommendations outlined in the Strategic Plan – from broad policy changes to small steps – are necessary to wage a more effective fight against identity theft and reduce its incidence and damage. Highlights of the recommendations include the following:

- Reduce the unnecessary use of Social Security numbers by federal agencies, the most

valuable commodity for an identity thief;

- Establish national standards that require private sector entities to safeguard the personal data they compile and maintain and to provide notice to consumers when a breach occurs that poses a significant risk of identity theft;

- Implement a broad, sustained awareness campaign by federal agencies to educate consumers, the private sector and the public sector on methods to deter, detect and defend against identity theft; and

- Create a National Identity Theft Law Enforcement Center to allow law enforcement agencies to coordinate their efforts and information more efficiently, and investigate and prosecute identity thieves more effectively.

The Task Force's recommendations also include several legislative proposals designed to fill the gaps in current laws criminalizing the acts of many identity thieves, and ensure that victims can recover the value of the time lost attempting to repair damage inflicted by identity theft. These proposals include the following actions:

- Amending the identity theft and aggravated identity theft statutes to ensure that identity thieves who misappropriate information belonging to corporations and organizations can be prosecuted;

- Adding new crimes to the list of offenses which, if committed by identity thieves in connection with the identity theft itself, will subject those criminals to a two-year mandatory sentence available under the "aggravated identity theft" statute;

- Broadening the statute that criminalizes the theft of electronic data by eliminating the current requirement that the information must have been stolen through interstate communications;

- Amending existing statutes to assure the ability of federal prosecutors to charge those who use malicious spyware and keyloggers; and

- Amending the cyber-extortion statute to cover additional, alternate types of cyber-extortion.

The plan was released at an authentication workshop which resulted from an earlier recommendation of the Task Force. In addition to the release of the Task Force's Strategic Plan, a Web site was launched today, http://www.idtheft.gov, which contains the full Strategic Plan, and will eventually serve as clearinghouse for educational resources for consumers, businesses, and law enforcement on ways to prevent and detect identity theft, and help victims recover.

The Identity Theft Task Force, co-chaired by the Attorney General and the FTC Chairman, was established by Executive Order of the President on May 10, 2006, and is now

comprised of 17 federal agencies and departments. The Task Force will continue its work over the coming months, and play a central role in the implementation of the Strategic Plan.

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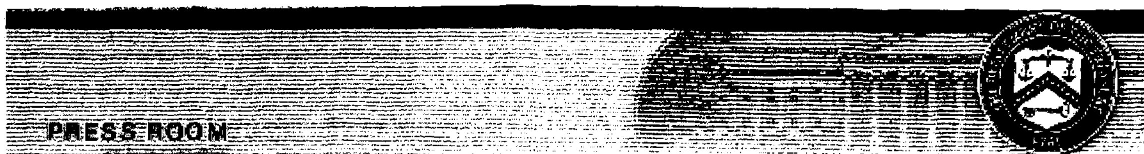
07-277

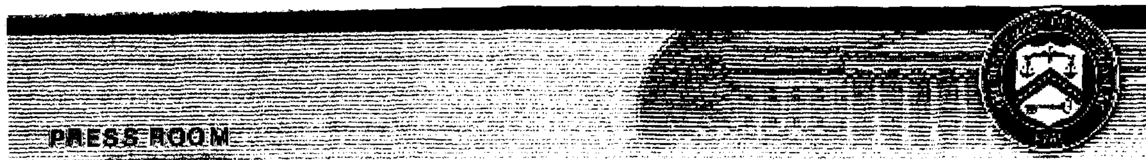


April 24, 2007
HP-369

Under Secretary Steel to Deliver Remarks in NYC on US Capital Markets

U.S. Treasury Under Secretary for Domestic Finance Robert K. Steel will deliver remarks before the Manhattan Institute's Conference on Capital Markets on Thursday, April 26 in New York City. The Under Secretary will discuss issues surrounding the competitiveness of U.S. capital markets. The following event is open to credentialed media:

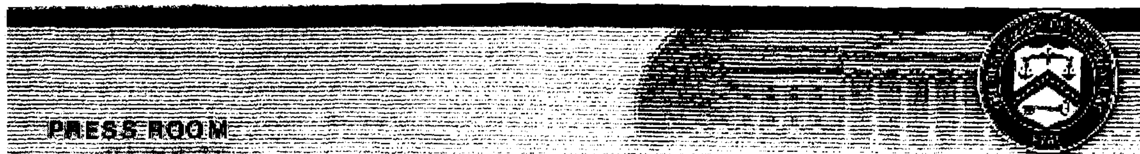
Who
U.S. Treasury Under Secretary for Domestic Finance Robert K. Steel
What
Keynote Address before the Manhattan Institute's Conference on Capital Markets
When
Thursday, April 26, 1:00 p.m. (EST)
Where
The Down Town Association
60 Pine Street
New York, NY



April 25, 2007
HP-370

Chin Sworn In as U.S. Executive Director at the Asian Development Bank

Washington, D.C.--Curtis S. Chin, appointed by President Bush to serve as U.S. Executive Director at the Asian Development Bank, was sworn in today by Secretary Henry M. Paulson, Jr. He was confirmed by the Senate on March 29, 2007. Previously, Chin served as a managing director with Burson-Marsteller where he worked in various capacities, focusing most recently on such issues as corporate responsibility, stakeholder engagement and public-private sector partnerships. He has lived and worked throughout the United States and Asia. He previously served on the Department of State's Advisory Committee on Cultural Diplomacy, and during the George H.W. Bush Administration served as a Special Assistant to the Secretary of Commerce. He holds degrees from Northwestern University and Yale University.



April 27, 2007
HP-371

Treasury Releases 'Choose to Save Television Commercial during National Financial Literacy Month

Washington, DC – The U.S. Treasury launched its first financial education television commercial this week to encourage Americans to save for important life events. The "Choose to Save" public service announcement, a product of a partnership with the American Savings Education Council (ASEC), arrives during national financial literacy month and promotes free government resources for financial planning available on the website www.MyMoney.gov and toll-free hotline 1-888-MyMoney.

The 30-second public service announcement, part of ASEC's broader Choose to Save series of radio and television spots, can be found at www.treas.gov/financialeducation. The National Association of Broadcasters is nationally distributing the commercial, which was created at WJLA-TV in Washington, D.C.

"The goal of this television spot is to make more Americans aware of the federal government's treasure of free, non-biased financial planning resources," said Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. "Before the MyMoney.gov website, this information was all a hidden treasure, spread across more than 20 government web sites. This commercial tells everyone that now they only need to know one place to visit."

The ad directs viewers to the federal government's one-stop shop website for personal finance information. The MyMoney.gov website, available in both English and Spanish, has links to materials that teach the importance of saving for retirement, managing credit cards, investing, avoiding scams and many other useful subjects. Users can also test their financial literacy knowledge with the Money 20 quiz.

The April release of the Choose to Save commercial coincides with Financial Literacy Month, a national observance to promote wise money management. The month has been recognized by resolutions by both houses of Congress and with events across the country.

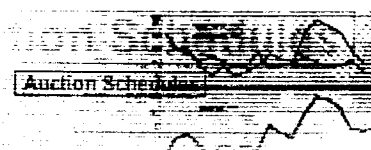
"Managing your money is a year-round job, but this month we join with our financial literacy partners in government, business and the non-profit world to encourage Americans to take the first steps to learning more about their money," Iannicola said. "With that knowledge Americans have the power to plan a secure financial future."

Treasury heads the Congressionally-mandated Financial Literacy and Education Commission. The 20-agency federal commission created the MyMoney.gov website and toll-free hotline in October 2004 and released a national strategy for financial literacy in April 2006.

ASEC and ChoosetoSave.org are educational programs of the nonpartisan Employee Benefit Research Institute.

LINKS

- Choose to Save Commercial



Office of Financial Education

MISSION

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States.

My Money PSA - The "Choose to Save" public service announcement, a product of a partnership with the American Saving Education Council (ASEC), promotes free government resources for financial planning available on the website MyMoney.gov and toll-free hotline 1-888-MyMoney.

Text Version for the hearing impaired

View in Real Player format

View in Windows Media

STATISTIC OF THE WEEK

Did you know that on average, adults get a grade of 70 (C) for their knowledge of economics and personal finance, based on a 24 question quiz and students' average score is 53 (F)?

National Council on Economic Education's (NCEE) What American Teens and Adults Know about Economics. Released in April 2005.

FINANCIAL EDUCATION NEWSLETTER

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FINANCIAL LITERACY AND EDUCATION COMMISSION - RESOURCES AND UPDATES

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The one stop shop for the Federal Government's financial education resources

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Last Updated: May 7, 2007

PRESS ROOM

April 30, 2007
2007-4-30-13-15-38-23036

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $66,734 million as of the end of that week, compared to $66, 889 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	April 20, 2007			April 27, 2007		
TOTAL	66,889			66,734		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	12,984	10,714	23,698	12,896	10,648	23,544
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,989	5,225	18,214	13,021	5,192	18,213
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			4,896			4,896
3. Special Drawing Rights (SDRs) [2]			9,040			9,040
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	April 20, 2007			April 27, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	April 20, 2007			April 27, 2007		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

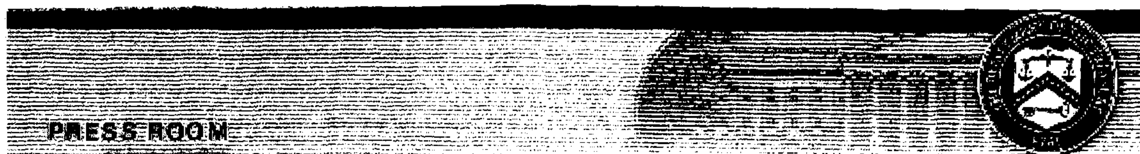
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



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April 30, 2007
HP-373

Treasury Announces Market Financing Estimates

Washington, DC- Treasury announced its current estimates of net marketable financing today for the April – June 2007 and July – September 2007 quarters:

- Over the April – June 2007 quarter, the Treasury expects to pay down $145 billion of net marketable debt, assuming an end-of-June cash balance of $30 billion. The current estimated paydown is $15 billion greater than announced in January 2007. The decrease in borrowing is primarily the result of higher net issuances of State and Local Government Series securities.
- Over the July – September 2007 quarter, the Treasury expects to borrow $43 billion of net marketable debt, assuming an end-of-September cash balance of $45 billion.

During the January – March 2007 quarter, Treasury borrowed $126 billion of net marketable debt, finishing with a cash balance of $6 billion at the end of March. In January 2007, Treasury announced net marketable borrowing of $141 billion, assuming an end-of-March cash balance of $10 billion. The decrease in borrowing was primarily the result of higher-than-expected net issuances of State and Local Government Series securities.

Since 1997, the average absolute forecast error in net borrowing of marketable debt for the current quarter is $11 billion and the average absolute forecast error for the end-of-quarter cash balance is $9 billion. Similarly, the average absolute forecast error for the following quarter is $33 billion and the average absolute forecast error for the end-of-quarter cash balance is $11 billion.

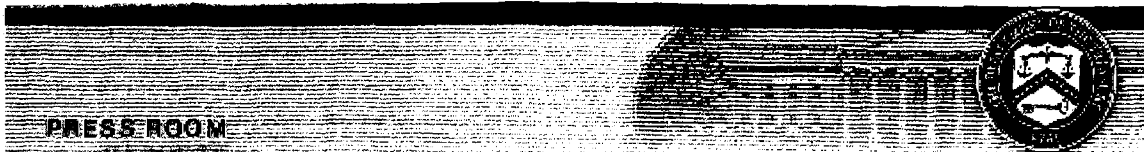
Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 a.m. on Wednesday, May 2.

REPORTS

- Sources and Uses Table

Sources and Uses Reconciliation Table							
			Financing				
Quarter	*Announcement Date*	Financing Need (1)	Marketable Borrowing (2)	All Other Sources (3)	Total (4) = (2) + (3)	Change in Cash Balance (5) = (4) - (1)	*Memo End-Of-Quarter Cash Balance* (6)
Oct - Dec 2005	**Actual**	**97**	**93**	**6**	**98**	**1**	**37**
Jan - Mar 2006	**Actual**	**173**	**158**	**(14)**	**144**	**(28)**	**8**
Apr - Jun 2006	**Actual**	**(137)**	**(92)**	**(7)**	**(99)**	**38**	**46**
Jul - Sep 2006	**Actual**	**19**	**45**	**(19)**	**26**	**6**	**52**
Oct - Dec 2006	**Actual**	**70**	**42**	**6**	**48**	**(21)**	**31**
Jan - Mar 2007	**January 29, 2007**	**162**	**141**	**1**	**141**	**(21)**	**10**
	Actual	**159**	**126**	**9**	**134**	**(25)**	**6**
	Memo: Forecast Revision	(3)	(15)	8	(7)	(4)	(4)
Apr - Jun 2007	**January 29, 2007**	**(156)**	**(130)**	**(7)**	**(136)**	**20**	**30**
	April 30, 2007	**(162)**	**(145)**	**6**	**(138)**	**24**	**30**
	Memo: Forecast Revision	(6)	(15)	13	(2)	4	0
Jul - Sep 2007	**January 29, 2007**	**23**	**47**	**(9)**	**38**	**15**	**45**
	April 30, 2007	**18**	**43**	**(10)**	**33**	**15**	**45**
	Memo: Forecast Revision	(5)	(4)	(1)	(5)	0	0

Notes: All data reported on a cash basis



April 30, 2007
HP-374

Treasury Assistant Secretary for Economic Policy
Phillip Swagel

Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

Washington, DC- Economic growth slowed at the start of 2007, but is expected to strengthen through the balance of the year to a sustainable pace. Core inflation appears to be contained and the labor market remains broadly healthy, with low unemployment, steady job creation, and ongoing wage gains supporting consumer spending. These developments provide a solid foundation for the economy and should support faster growth in the remainder of the year.

Real GDP grew by 1.3 percent at an annual rate in the first quarter of 2007. Consumer spending remained strong but, as expected, residential construction subtracted about a full percentage point from growth. Business investment turned up following a late-2006 pullback, but the increase in capital outlays was offset by a slowdown in inventory accumulation and downturn in net exports. A decline in federal government spending reflected lower defense outlays in the first quarter of 2007.

The decline in residential building activity has subtracted from GDP growth since late 2005. Although the residential sector remains weak, there are signs that the housing market is stabilizing. Housing starts have recovered modestly from the low levels recorded in the fall of 2006 and sales of existing single-family homes (over 80 percent of the one-family market) edged higher in the first quarter following little change in the fourth quarter. However, sales of new single-family homes continued to decline in the first quarter, and the overhang of both new and existing homes for sale remains substantial. Private analysts expect that declining housing activity will continue to act as a damper on growth at least through mid year.

Thus far, the slowdown in housing activity does not appear to have had an appreciable impact on consumer spending, which accounts for about 70 percent of economic activity. Real personal consumption expenditures rose by 3.8 percent at an annual rate in the first quarter. Robust income growth has buoyed consumer spending, with real disposable personal income rose by 4.5 percent at an annual rate in the first quarter. Household balance sheets appear healthy, with household net worth reaching a new high in the fourth quarter of 2006, boosted by strong equity gains and rising real estate wealth.

Steady job gains and a low unemployment rate have also lent support to consumption. Nonfarm payroll employment expanded by 180,000 in March and the job gains for January and February were revised up, bringing the net job gain for the first three months of 2007 to 455,000. Altogether, the economy has generated 7.8 million jobs, or 181,000 jobs per month on average, since the employment trough in August 2003. The unemployment rate dipped to 4.4 percent in March, matching the 5-1/2-year low recorded in October.

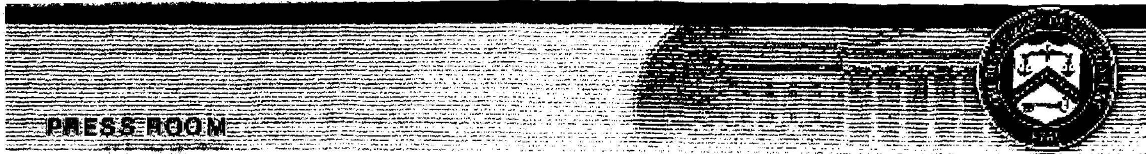
Business investment turned up in the first quarter of 2007, with nonresidential fixed investment gaining by 2.0 percent at an annual rate in the first quarter after a decline at the end of 2006. Spending on equipment and software rebounded slightly and outlays for structures accelerated somewhat. There are signs that capital

spending is poised to strengthen further in the coming quarters. New orders of core capital goods (non-defense capital goods excluding aircraft) rose in March, retracing about half of the two previous monthly declines. In addition, hiring and consumption are both solid, corporate profits as a share of GDP are near a 57-year high, and corporate balance sheets are healthy.

The Administration's most recent economic forecast, prepared in November, projects 2.9 percent real GDP growth over the four quarters of 2007 – similar to the U.S. historical average over the last 20 years. The pace of economic activity is expected to pick up as the year progresses. Recent private forecasts call for growth of 2-1/2 percent during 2007, with the pace expected to accelerate throughout the year.

Inflationary pressures remained broadly contained in the first quarter. Headline consumer price inflation rose by 2.8 percent over the twelve months ended in March, down from a 3.4 percent gain in the year-earlier period. Energy prices increased just 4.4 percent in the latest twelve-month period compared to year-over-year gains averaging 21 percent per month in the first half of 2006. Excluding both energy and food, core consumer prices advanced by 2.5 percent in the year ended in March, slower than the 2.9 percent gain posted over the year ending in September.

In sum, the economy remains in transition but growth is expected to accelerate, returning to its long-term trend by the end of the year. The labor market remains firm and inflation appears contained.



April 30, 2007
HP-379

Testimony of Dan Iannicola, Jr.
Deputy Assistant Secretary for Financial Education
Before the U.S. Senate Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia

Washington, DC- Good afternoon Chairman Akaka, Ranking Member Voinovich and distinguished members of the Subcommittee. Thank you for this opportunity to appear before you today to talk about the important issue of financial literacy in America. As Financial Literacy Month comes to a close, I would like to recognize the strong bi-partisan emphasis on this important topic. Thank you for sponsoring the Senate resolution supporting April as Financial Literacy Month. I would like to commend the House for their recognition of Financial Literacy Month as well. Additionally, President Bush issued a statement observing April as Financial Literacy Month.

Secretary Paulson, along with the rest of the Administration, believes in the importance of increasing financial literacy levels across our nation. In fact, just last week President Bush recommitted his Administration to the cause of financial literacy and charged Secretary Paulson with building on the Financial Literacy and Education Commission's efforts to bring financial education to all Americans. Mr. Chairman, I commend you for your continued leadership on the issue of financial education and for focusing a national spotlight on this critical topic.

I would like to briefly discuss the financial literacy issue we are faced with, then discuss the responses to that issue to date and conclude with a discussion of next steps.

The Issue

Today Americans are faced with a robust marketplace of financial products and services which give them many more options than ever before in structuring their finances. However this has not always been the case. For example, there used to be only a few ways to finance a home, now there are numerous mortgage options. Credit cards used to be hard to come by, now consumer credit is widely available. At one time your employer managed your retirement, now with the steady migration from defined benefit plans to defined contribution plans, the individual has much more to think about.

Times have changed on us. This generation doesn't know any less about money than our parents or grandparents. It is simply that we need to know more *now* than they did *then*. It is as if every American has awoken to find himself or herself promoted to the position of CFO of his or her own household. Are we ready for the job? And if not, how do we address the new reality that our economic choices have simply outpaced our financial knowledge?

The answer, of course, is financial education. Only when we learn more about our money will we be able to move forward confidently in the modern financial marketplace. As a nation we need to learn more about saving and investing, using credit wisely, avoiding fraud and a number of other financial topics.

The Response

Three players are responding to the financial literacy issue: non-profits, businesses and the government.

Non-profits

Non-profit organizations of many varieties are involved in financial education. Some are large national organizations, while others are community-based groups that operate on the grass roots level. They address a variety of financial education issues for adults like banking the unbanked, providing credit counseling or free tax preparation, or helping people build assets to prepare for financial emergencies or to achieve financial goals. Other non-profits, including schools, center their efforts on young people. Some of these groups focus on school based programs that train students and teachers on money matters while other groups focus on reaching youth outside of the classroom.

Businesses

Many companies have also wisely recognized financial education as a cause worthy of their attention. Some companies develop curricula or donate funds for use in support of youth and adult financial education programs. Other companies encourage their associates to volunteer their time on financial literacy programs of non-profit organizations. Still other private sector firms devote resources to financially educate their own employees on money matters.

Federal Government

While the efforts of state and local governments to spread financial education have been commendable, this testimony will focus on the efforts at the federal level.

The Department of the Treasury supports the expansion of financial education both through its own work and through its leadership of a multi-agency commission. I will describe both roles.

Department of the Treasury

Several bureaus and offices within the Treasury Department work in the field of financial education. These include the Bureau of Public Debt (BPD), Internal Revenue Service (IRS), Mint, Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and the Office of the Treasurer. While all of these offices perform important tasks in financial education, Treasury's main effort in the field is conducted by its Office of Financial Education.

In 2002 Treasury established the Office of Financial Education. Since that time, the office has developed rapidly and now stands as a policy leader in the field of financial education in the U.S. and around the world. The office has five key functions.

1) Outreach

First, the office promotes and delivers financial education across the country through its ambitious outreach efforts. The Office has traveled to 42 states and held 304 financial education sessions reaching over 24,000 people and generating 470 media stories. Many of the people reached are educators, counselors, journalists, community leaders, or service providers who themselves engage in financial literacy outreach to many more Americans. This creates a multiplier effect which only increases the office's total impact.

The office has performed its work wherever needed, ranging from classrooms to corporate boardrooms to military bases, and even to the Gulf Coast region to counsel Katrina victims. The office has reached out to students of all ages, teachers, lenders, credit counselors, accountants, attorneys, community activists, the media and the public at large. The message to each group varied according to

its specific needs but the theme has been the same, that financial knowledge is an empowering force that helps people improve their lives and realize their dreams.

2) Setting Standards for Quality Programs

The office's second function is to set standards for quality financial education. It does this through the development and dissemination of the "Eight Elements for Successful Financial Education" programs. Financial educators across the country have been using these qualitative standards to evaluate and enhance financial education programs.

3) Technical Assistance

Third, the office operates a Technical Assistance Center in English and Spanish for those seeking advice on establishing or improving financial education programs in their communities.

4) Brokering Partnerships

Fourth, the office uses its unique position within the financial education community to broker partnerships between the supply side and demand side of financial education. Some organizations have financial education resources to offer, while other organizations are in need of such resources. The office works with groups nationwide to help the right people get connected with the right resources to advance financial education.

5) Federal Government Coordination

The fifth and final role of the office is to coordinate financial education efforts across the federal government. Treasury's office of Financial Education performs this task by coordinating the activities of the Financial Literacy and Education Commission. The details of this function are described below

The Financial Literacy and Education Commission

The Fair and Accurate Credit Transactions (FACT) Act of 2003 established a twenty agency group called the Financial Literacy and Education Commission. The FACT Act named the Secretary of the Treasury as chair of the Commission and gave the Commission and Treasury four mandates: a Web site, a hotline, a multimedia campaign and a national strategy.

I will describe progress on each of these projects.

1) Web Site

In October 2004, the Commission launched MyMoney.gov, a Web site designed to be a one-stop shop for federal financial education information which is available in English and Spanish. Operated by the General Services Administration (GSA), the Web site is organized intuitively, the way Americans live their lives instead of the way their government is structured--organized by topic rather than agency. Topics include Paying for Education, Saving and Investing, Home Ownership and Privacy, and Frauds and Scams. MyMoney.gov also provides links to financial education grants offered by different Commission agencies. The site has 399 links and has had 1,717,247 visitors, 1,053,004 in 2006 alone. On the site, visitors can also access an interactive, instructional quiz on financial literacy, view a public service announcement promoting MyMoney.gov and get information on the activities of the Commission.

2) Toll Free Hotline

In October 2004, the Commission also launched a toll free hotline called 1-888-

MyMoney. Operated by the GSA, the hotline is available in English and Spanish and permits callers to order a free MyMoney toolkit. The English language toolkit contains eight federal publications covering topics from savings to investing to understanding the Social Security system. The Spanish language toolkit has six publications. To date, the MyMoney Hotline has received 18,781 calls, 15,508 calls in 2006 alone.

3) Multimedia Campaign

The Treasury is working with the Ad Council on the production of a campaign that will address the topic of credit literacy, emphasizing the impact of one's credit score. The project has progressed through the research and focus group stages and is now in the creative stage where advertising professionals are working to develop creative concepts to communicate the campaign message. The campaign is scheduled to launch in the fall of 2007.

4) National Strategy

The FACT Act also required the Commission to develop a national strategy for financial literacy. In April of 2006, the Commission released *Taking Ownership of the Future - the National Strategy for Financial Literacy.* The *Strategy* is a comprehensive blueprint for improving financial literacy in America, covering 13 areas of financial education in 13 chapters. At the end of each chapter are specific, numbered calls to action. Most of the actions are assigned to the federal government, but some of the activities are recommendations to the private sector or to individuals.

Since the launch of the Strategy just over a year ago, the Commission has been busy executing these "calls to action." These calls to action are milestones for the Commission which allows us to measure its performance and could not have been accomplished without the cooperation of all 20 member agencies. Below is a summary of progress on the Strategy's calls to action.

Chapter 1: General Saving

1-1 In April of 2007, Treasury and the American Savings Education Council launched a public service announcement on the importance of saving. The PSA promotes the website, MyMoney.gov and toll-free hotline, 1-888-MyMoney.

Chapter 2: Homeownership

2-1 In July of 2006, the Department of Housing and Urban Development (HUD) and Treasury co-hosted a roundtable which highlighted successful partnerships that have advanced homeownership. During the meeting, the complexity of identifying partners to advance homeownership was discussed at length. Participants cited best practices which have helped with foreclosure prevention, non-traditional mortgage products, and the identification of a variety of hidden costs.

Chapter 3: Retirement Saving

3-2 In April of 2006, the Small Business Administration (SBA) linked its online retirement training tools for small businesses to MyMoney.gov. In addition, the Department of Labor (DOL) and IRS developed and released a new publication, *Payroll Deduction IRAs*, to complement a series on retirement plan options for small employers. DOL conducted six fiduciary education seminars in coordination with IRS, the American Institute of Certified Public Accountants and the Society of Human Resources Management.

Chapter 4: Credit

4-1 In 2005, Treasury entered into an agreement with the Ad Council to

develop and execute a multimedia public service announcement campaign on credit literacy for young adults. The campaign is scheduled to launch in the fall of 2007. It will also be available in Spanish.

Chapter 5: Consumer Protection

5-2 In April of 2006, Treasury released the DVD "Identity Theft: Outsmarting the Crooks," and made it available to the public through MyMoney.gov and 1-888-My Money. To date, 60,750 copies have been distributed.

Chapter 6: Taxpayer Rights

6-2 In the first full year of the "Go Direct" campaign, which ended in June of 2006, Treasury and the Federal Reserve Banks converted 600,000 paper check recipients to direct deposit enrollees. An additional 160,000 people were enrolled as of December of 2006. The success of the program would not be possible without the cooperation and support of financial institutions across the country. The program will continue through 2007.

6-3 As a result of the Department of Health and Human Services' (HHS) public awareness campaign on the new Medicare drug benefit that encourages seniors and people with disabilities to take a look at their prescription drug coverage options, over 90 percent of those with Medicare have some form of drug coverage. Of those, almost 24 million have prescription drug coverage through the new Medicare Part D benefit. HHS worked with 40,000 partners and conducted more than 12,000 events to educate taxpayers and beneficiaries on enrolling in the Part D program. As of late January 2007, more than 1.4 million beneficiaries have enrolled in Medicare's Part D program since June of 2006, bringing the total number of people with Medicare receiving comprehensive prescription drug coverage to more than 39 million.

Chapter 8: The Unbanked

8-1 To date, three regional conferences have been held on how to reach the unbanked. The conferences were held in Chicago, IL in May 2006; Edinburg, TX in December 2006; and Seattle, WA in March 2007. The conferences have touched on topics such as building partnerships and identifying solutions, serving immigrant communities, reaching young customers, and providing financial education to help new and potential bank customers. The conferences were accomplished by the Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), OCC, OTS, Treasury, the Federal Reserve Banks of Chicago, Dallas, and San Francisco, along with assistance from HUD, partnering to bring a wide range of attendees together on the topic of the unbanked population. After the final regional conference is completed in the fall of 2007, a white paper will be released which will summarize the conferences findings and make recommendations based on them.

Chapter 9: Multilingual / Multicultural Populations

9-1 In March of 2007, the first roundtable took place at Treasury and was focused on the Native populations. The roundtable touched on the needs and wants of Native populations and how financial education can help. Other topics included public and private partnerships, access to financial institutions and services, and public awareness events on reservations.

Chapter 10: Kindergarten – Postsecondary Financial Education

10-1 In February of 2007, the Department of Education (ED) and Treasury co-hosted a two-day summit on kindergarten through postsecondary financial education. The summit brought together teachers, students, program providers and researchers from across the country to discuss the role of financial education at school, non-school venues and college level programs to assist others who are starting or enhancing programs. The summit findings will be made available to the

public in the summer of 2007.

Chapter 12: Coordination

12-1 The Commission continues to enhance MyMoney.gov. In 2006, the "Money 20" interactive quiz was added to the Web site, where visitors can test their knowledge with a 20-question online quiz which covers a variety of personal finance issues. Currently, all Commission members have links to MyMoney.gov from their agencies' Web sites.

12-2 In August of 2006, GSA and Treasury completed the first survey of Federal financial education programs and resources. Findings have shown very little overlap or duplication among Federal financial education efforts. The overlap noted was found to be minor and necessary to the completeness of a particular resource or topic.

12-5 In April of 2007, Treasury and Office of Personnel Management (OPM) hosted the inaugural meeting of the "National Financial Education Network" of federal, state and local governments. The network will meet regularly by phone to discuss topics related to financial education.

Efficiency

Since part of the focus of this Subcommittee is government management, I wanted to comment briefly on the manner in which this Commission has been managed. During its work, the Commission has sought to carry out the purpose of the FACT Act by coordinating the federal effort and helping the 20 agencies to work together more efficiently on the issue of financial education. Many of the mandates of the FACT Act can be met through such cooperation. The consequence of this is that, in many cases, the Commission has been able to add value without needing to add resources. As good stewards of federal funds, the Commission is obligated to seek the least costly way to meet its obligations under the law. With a number of accomplishments and few expenditures, the Commission has been successful thus far in achieving good value for Congress, the Administration and the American taxpayer.

Government Accountability Office Review of the Commission

In December of 2006, the Government Accountability Office (GAO) issued a report on the Commission. We on the Commission welcomed the insights of GAO on how we could better accomplish our important mission on behalf of the American people. The Commission chose to consider the GAO recommendations as part of the Commission's annual review of the Strategy which is required by the FACT Act. During that review the Commission incorporated many of the GAO recommendations into its 2007 revisions to the *Strategy*. For instance, GAO recommended that definitions to "financial education" and "financial literacy" be added to the *Strategy*; in response the Commission defined and incorporated both terms. Also consistent with GAO's recommendations, the Commission plans to conduct usability testing of and measure customer satisfaction with MyMoney.gov by 2009.

Additionally, GAO suggested an independent review of the federal financial education programs and resources. Although the FACT Act does not require an independent review of such programs and resources, the Commission decided to pursue such a review, with the first series of assessments to be completed in 2009. Lastly, GAO recommended that the Commission work closely with private entities and state and local governments to improve financial literacy. In response, on April 17, 2007 Treasury and OPM co-hosted the Commission's inaugural meeting of the "National Financial Education Network" of federal, state and local governments at Treasury. This network will facilitate precisely the type of cooperation called for in the GAO report.

Next Steps

The *Strategy* outlines clear steps for the Commission to implement in the next few years.

In the remainder of 2007, the Commission will continue working on issues pertaining to credit literacy, general savings, retirement planning, homeownership preservation and youth financial education while performing special outreach to minority communities. To succeed, we will convene those leading efforts in the private and public sectors through regional conferences, national roundtables and an international summit. The Commission will issue policy papers and meeting findings to further national efforts on financial education. In addition, Treasury plans to launch a multimedia campaign. Lastly, the Commission will continue performing regular enhancements to MyMoney.gov and 1-888-MyMoney.

In 2008, the Commission will host a roundtable discussion on insurance issues as well as an academic research symposium on financial education.

Later in 2009, the Commission intends to conduct a usability testing and customer satisfaction survey of MyMoney.gov as well as complete the first series of independent assessments of federal financial education programs and resources.

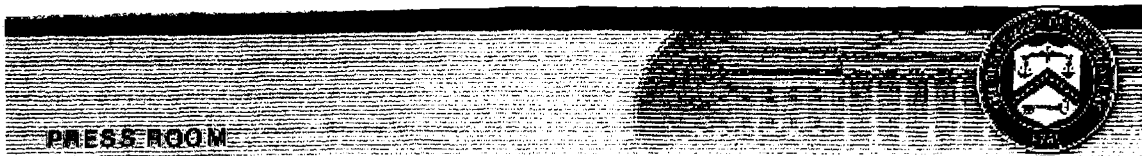
Conclusion

I hope this discussion has given an insightful overview of Treasury's and the Commission's work on financial literacy.

While it is valuable to look at this issue from a high level as a policy matter, it is also helpful to view it in terms of the individual and the difference it can make to his or her future. Put simply, there are two paths before each person we are all trying to help. The first is a rocky path that leads to a place where the complexity of the marketplace appears overwhelming, where people are easy prey for fraud and where bad choices lead to bad outcomes that can last a lifetime.

The other path travels through financial literacy and it takes people to a place where understanding replaces apprehension, where people make the most of their abundant options and where they have a tangible, enduring stake in their futures – it is a place some of us refer to as the Ownership Society. It comes from the idea that a true community is based more on shared aspirations than shared geography. Each of us wants to provide for our families, have a comfortable retirement and achieve financial security. These goals become more obtainable when we are financially literate, and that is why financial education is a priority for Secretary Paulson and for this Administration. We hope that through our emphasis on increased financial literacy people gain the skills to make better decisions and live better lives.

Now, I will be happy to answer any questions from the Subcommittee concerning financial literacy.



April 30, 2007
HP-380

Prepared Remarks of Ahmed Saeed
Deputy Assistant Secretary for Africa and the Middle East
On the Signing of the International Compact with Iraq

Nine months ago – on July 27, 2006 – the Government of Iraq and the United Nations announced the launch of the International Compact with Iraq. Under this initiative, the Government of Iraq reached out to key partners in the international community to establish a collaborative process for developing policy commitments to put its economy on a path to self-sufficiency and sustainable growth, while also creating safeguards to protect the most vulnerable groups in its society.

The Government of Iraq and the UN established a preparatory group to help develop the Compact, based on best practices and lessons derived from the experiences of other transition economies. Between July and December, Iraq consulted regularly with members of this group, including the World Bank, the IMF, and the Arab Fund for Economic and Social Development, as well as knowledgeable government officials from the Gulf, Europe, and Asia. The U.S. Government also played a strong supporting role.

The UAE and Kuwait each hosted preparatory group meetings, and the UN briefed its members on progress under the Compact on September 18, November 13, and March 16. The World Bank and IMF also hosted a Compact briefing during their annual meetings in Singapore in September 2006.

The final Compact document was presented at a meeting attended by over seventy countries and institutions and hosted by Secretary General Ban Ki Moon in New York on March 16. It is significant in many respects:

The Compact is comprehensive in scope, ranging from commitments to strengthen public expenditure management, to policies designed to improve health, education, and the environment. It is also underpinned by clear, measurable benchmarks.

The Compact commits to a number of significant unifying principles, including the adoption of policies to ensure that all Iraqis benefit from the country's vast hydrocarbons resource base, important anti-corruption practices, and the accelerated development of Iraq's private sector.
The Compact document was unanimously endorsed by the Cabinet of Ministers last December, establishing a clear consensus on the direction and strategy for realizing Iraq's economic potential.

The Compact has been a critical vehicle for Iraq's engagement with its neighbors – preparatory group meetings were hosted in the UAE and Kuwait, and the final signing is in Egypt.

The Compact has provided the Iraqi government an opportunity to draw attention to its own very significant economic accomplishments: a sound macroeconomic framework and management of inflation, adherence to the strict criteria of an IMF Stand-By Arrangement and reduction of fuel subsidies, bank restructuring, pension reform, passage of an investment law, and forward movement on hyrdrocarbons legislation and a revenue management law.

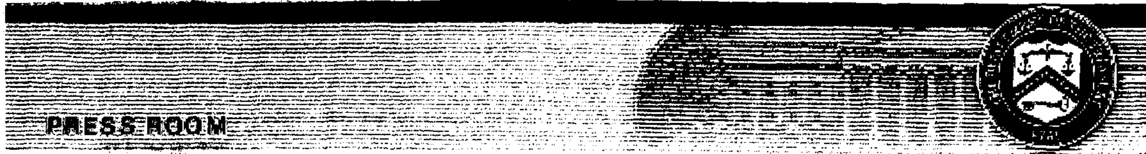
The next step is for Iraq and the international community to formally endorse this Compact at a Ministerial-level meeting in Sharm el Sheikh on May 3. At this event,

participants have been invited to offer their support for the Compact. To be clear, this is not a gap-filling exercise: the international community has not been asked to meet a specific fundraising target. However, they have been asked to provide other forms of support.

Chief among them is debt relief. With Iraq's focus on financial sustainability, ridding the balance sheet of Saddam era debts is one of the most important, and prudent steps it can take. It is expected that Saudi Arabia will announce at Sharm el Sheikh a commitment to provide debt relief and that others, including, the UAE, will follow suit.

Other countries are expected to offer support in the form of loans, grants, and technical assistance. The United States will also offer a generous bilateral pledge.

Secretary Rice will attend the signing, supported by Treasury Deputy Secretary Kimmitt, who is also the President's Special Envoy on the Compact. The UN and Iraq expect the meeting to be attended by over 35 countries and organizations. Ministers will be attending from the UK, Germany, Italy, Denmark, Bulgaria, Poland, China, Korea, Saudi Arabia, the UAE, Bahrain, Kuwait, Egypt, Turkey, and Greece, among others. Other countries, including Russia and Japan, are expected to be represented at senior levels. UNSYG Ban Ki Moon will co-chair the event with Prime Minister Maliki.



April 30, 2007
HP-381

Secretary Paulson to Speak This Week on U.S. - China Economic Relationship

Secretary Henry M. Paulson, Jr. will speak at a conference hosted by the Peterson Institute for International Economics on Wednesday and to students at Harvard's Business School, Law School, and Kennedy School of Government in Boston on Thursday. Secretary Paulson's remarks will focus on the importance of the U.S.-China economic relationship and both countries' efforts to strengthen that relationship through the U.S.-China Strategic Economic Dialogue. The second meeting of the SED will occur in Washington in May. The following events are opened to credentialed media:

Who
Treasury Secretary Henry M. Paulson, Jr.
What
Remarks at the Peterson Institute for International Economics
When
Wednesday, May 2, 11 a.m. EDT
Where
Peterson Institute of International Economics
1750 Massachusetts Avenue, NW
C. Fred Bergsten Auditorium, 1st Floor
Washington, DC
Note:
Media must pre-set by 10:45 a.m. and RSVP to Katharine Keenan at kkeenan@petersoninstitute.org or 202-454-1334.

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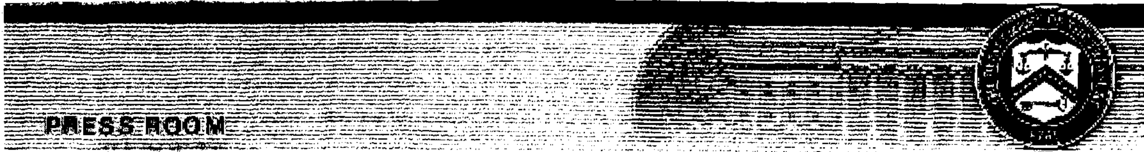
Who
Treasury Secretary Henry M. Paulson, Jr.
What
Remarks at Harvard Business School
When
Thursday, May 3, 1 p.m. EDT
Where
Harvard Business School
Burden Auditorium
Boston, MA
Note:
Media must RSVP to Jim Aisner (617-495-6157 or jaisner@hbs.cedu) or Kerry Parke (617-495-6931 or kparke@hbs.edu) at Harvard Business School.



April 26, 2007
HP-382

Secretary Henry M. Paulson, Jr.
Remarks at Screening of Alexander Hamilton
The Cash Room
Thursday, April 26, 2007

Thank you very much and welcome to the Treasury Department. We're pleased to host the premiere screening of *Alexander Hamilton*. Thank you to Bruce Cole and the National Endowment for the Humanities for supporting this project; to PBS for sponsoring and airing the movie as part of the "American Experience" series; to Twin Cities Public Television and Middlemarch Films for bringing the movie to life; and to the scholars and actors who put so much energy into the production. I'd also like to extend a special welcome to former Treasury Secretary Nick Brady and his wife, Kitty. Wendy and I have very much appreciated their hospitality and friendship as they have welcomed us to Washington. Welcome back to Treasury, Mr. Secretary.

Alexander Hamilton is very important to this Department – he was its founding Secretary. As you all know he was one of our truly great Founding Fathers. Though Hamilton never served here in Washington, Treasury employees are frequently reminded of his role in our history – as they walk down Alexander Hamilton Place, pass the statue of Alexander Hamilton on the south side of the building, or see the portrait of Hamilton outside the Secretary's suite. A select few Treasury employees are recognized for their service to the Department and to our country with the Alexander Hamilton Award, which is the highest honor bestowed by Treasury. And when visitors come to see me, I like to show off the Alexander Hamilton silver, which is on display in the conference room next to my office.

For most Americans, their most frequent interaction with Hamilton is when they use a ten-dollar bill. Many of us remember from school days that Hamilton was killed in a duel with Vice President Aaron Burr on the cliffs of Weehawken, New Jersey.

As an author of the Federalist Papers, Hamilton rallied support for the federal Constitution. As the first Treasury Secretary, he built confidence in our nation's ability to repay its obligations by assuming state war debts. He also promoted commerce and manufacturing as the route to prosperity, and helped establish a national bank to support a growing financial system. In many ways he was the father of our nation's financial system. Alexander Hamilton saw the vast economic potential of the United States and he set us on the path to achieving it. The fact that I have always been a great admirer of Hamilton makes the opportunity to serve as Treasury Secretary particularly meaningful to me.

The movie we're about to see will offer Americans a detailed view of this very important yet often overlooked Founding Father. I am really looking forward to the show. But first, I'd like to introduce the Chairman of the National Endowment for the Humanities, Bruce Cole, to say a few words.

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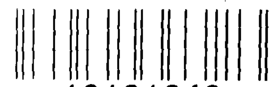
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