S. HRG. 109–649

CONCURRENT RESOLUTION ON THE BUDGET FISCAL YEAR 2007

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

February 2, 2006—THE CBO BUDGET AND ECONOMIC OUTLOOK

February 7, 2006—THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL

February 15, 2006—UNDERSTANDING THE CAUSES OF AND SOLUTIONS TO ADDRESSING THE FEDERAL TAX GAP

February 16, 2006—THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL (STATE DEPARTMENT)

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Printed for the use of the Committee on the Budget

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THE CBO BUDGET AND ECONOMIC OUTLOOK

THURSDAY, FEBRUARY 2, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Allard, Crapo, Alexander, Conrad, Stabenow, and Menendez.

Staff present: Scott B. Gudes, Majority Staff Director and Jim Hearn, director for federal programs and budget process.

Mary Ann Naylor, Staff Director and John Righter, deputy staff director & commerce and housing credit.

OPENING STATEMENT CHAIRMAN JUDD GREGG

Chairman GREGG. Let me begin the hearing.

We appreciate today having the opportunity to hear from Don Marron, who is the acting head of CBO. This is an opportunity to get CBO's estimate relative to the baseline, which is important. It is a technical concept, the baseline, but it substantively drives everything that we do around here. So this hearing is important on where we are going as a Government and how we are going to be able to approach the budgeting process in this coming year, because what CBO says, it is the memo that controls the meeting, as Henry Kissinger was fond of saying.

So we look forward to hearing from Mr. Marron, who is doing an exemplary job, an excellent job. We appreciate his being thrown into the breach here and taking over so well.

On other topics or the general topic of what is happening relative to the budget, I want to congratulate the House of Representatives for passing the reconciliation bill last night. It was a close vote, as it was here in the Senate, a tie vote in the Senate with the Vice President casting the vote that caused it to go over the top.

This bill is the first time in 8 years that we have begun undertaking the process of addressing entitlement spending. Anybody who looks at the Federal budget these days, if they are honest, has to admit that the issue is entitlement spending. As Willie Sutton said, when they asked him why he robbed banks, he said, "That is where the money is." Well, the money in the Federal Government is in the entitlement accounts. They have grown to about 60 percent of our spending, and the failure of the Congress to discipline those accounts and to put in place responsible policies in those areas has caused those accounts to continue to grow at a rapid pace. But, more importantly, with the looming issues of the baby-boom generation retiring, the demand on the Federal Government and, therefore, on the taxpayers of this country, who will be the baby boomers children and grandchildren, will be extraordinary.

We have talked about this a lot, but approximately in the year 2035, three accounts—Social Security, Medicaid, and Medicare—will essentially absorb all the revenues of the Federal Government, assuming that the Federal Government stays at the historical level of revenues. And the practical implications of that are that there isn't going to be any money for anything else—national defense, education, environmental protection, or just general entitlement activity.

So we have an obligation as a Government and as policymakers, but more importantly as baby boomers, to address this issue. We have no right as one generation to pass on to the next generation the problems which are going to confront it if we do not address the issue of entitlement reform, specifically in the areas of health care and pensions.

And so I was also appreciative of the President raising the visibility on this issue by talking about it in terms of the baby-boomer responsibility in the State of the Union, and hopefully we can proceed from that point and actually get something constructive going here. It cannot be done unless it is done in a bipartisan manner. I know that the Senator from North Dakota is very interested in this issue, very concerned about this issue. We have different approaches, obviously, but that doesn't mean we shouldn't be able to sit down and try to work something out. And that is what I hope we can do, or at least begin the process of doing, and at least the reconciliation bill did show that we can put our toe in this water—and it was just our toe in the area of Medicaid—and try to do something constructive.

So we look forward to hearing from you and getting your thoughts on what the baseline looks like. I have many questions about how we structure this baseline, but I do not want to absorb all the discussion here. And I will yield to the Senator from North Dakota for his thoughts, and then we would like to hear from you, Mr. Marron.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you, Mr. Chairman. Thank you again for your courtesy in discussing the agenda of the committee for the year and the many courtesies extended by you and your staff to me and my staff. We continue to appreciate the extraordinary professionalism that you bring to this task and that your staff does as well.

Chairman GREGG. Thank you, and the feeling is mutual obviously.

Senator CONRAD. And welcome to Mr. Marron. I think this is the first time you have had an opportunity to present before the committee, and we welcome you and look forward to a good working relationship with you as well. We had a very good meeting the other day in my office talking about some of these same concerns that the chairman has raised.

Obviously, we do have a different perspective. My great concern is the explosion of deficits and debt. That is a combination of spending and revenue, and I believe we are going to have to work on both sides of the equation in order to achieve a result. And hopefully somewhere there is a principled compromise on which both sides could agree to avert this explosion of debt.

Let me just go through——

Chairman GREGG. Would you just yield for a second?

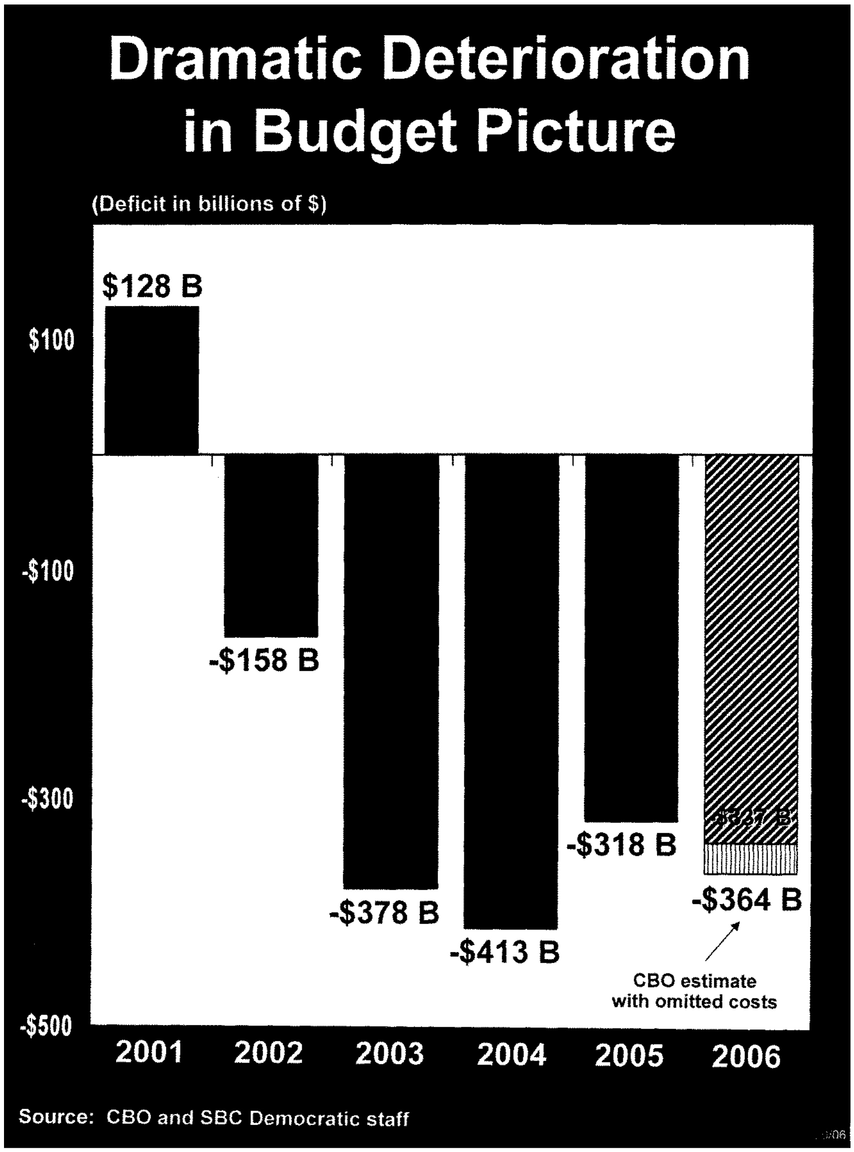
Senator CONRAD. Yes, I would be happy to.

Chairman GREGG. I failed to recognize Senator Menendez, who has joined us and is part of the committee now, and we very much appreciate his choosing the Budget Committee to serve on. It is a place where you get a lot of arrows and very few kudos, and we thank you for being willing to take some arrows.

[Laughter.]

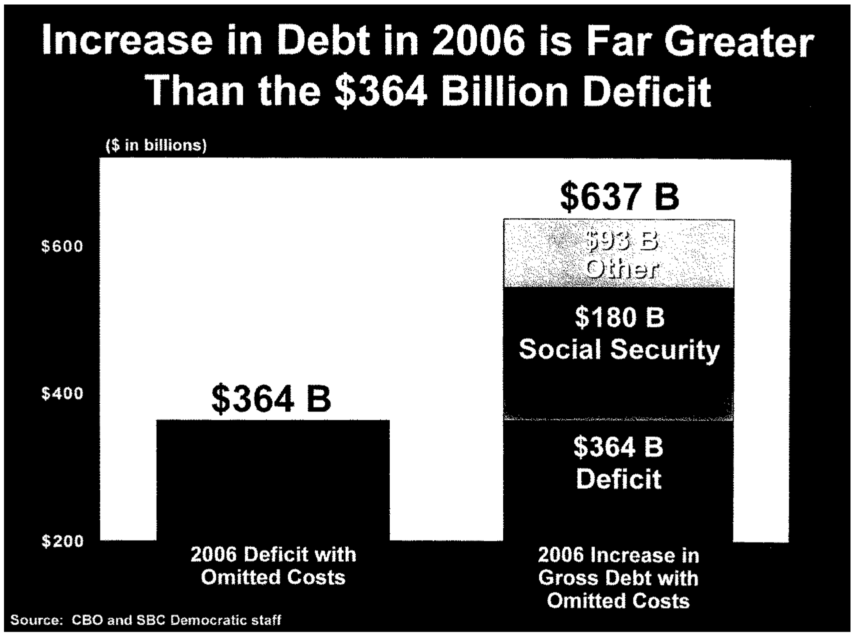
Senator CONRAD. If I could, Mr. Chairman, extend my welcome as well. I was going to wait until we introduced Mr. Menendez to the committee, but this is an appropriate time to welcome him to the Senate Budget Committee. He comes from a distinguished career in the House of Representatives. This is a challenging post, and Senator Menendez and I have already talked about the work that we will have this year and on into the future.

Let me just try to outline what I see as the significant concerns we face. This is the history over the last 5 years of what has happened to the budget deficit, and these are the largest budget deficits in dollar terms we have ever experienced. Last year, there was a bit of improvement, but then the outlook for this year, especially when you add back omitted costs, looks like we are headed back in the wrong direction.


Dramatic Deterioration in Budget Picture
(Deficit in billions of $)
$128 B
-$158 B
-$378 B
-$413 B
-$318 B
-$364 B
CBO estimate with omitted costs
$100
-$100
-$300
-$500
2001
2002
2003
2004
2005
2006
Source: CBO and SBC Democratic staff

Let's go to the next slide, if we could.

My greatest concern is that the growth of the debt is far greater than the deficits, and I find people are confused by this. I go around my State, and people assume—many people assume that the amount of the deficit is the amount by which the debt increases. And, of course, Mr. Marron, you know that is not the case. We are projecting now a deficit for 2006 of $364 billion, but we now estimate the debt will increase by $637 billion. Of course, the biggest difference between the two is Social Security money that is in surplus at the moment, but which will be all needed for the future, which is being used to pay for other things.


Increase in Debt in 2006 is Far Greater Than the $364 Billion Deficit
($ in billions)
$600
$400
$200
$364 B
$637 B
$93 B Other
$180 B Social Security
$364 B Deficit
2006 Deficit with Omitted Costs
2006 Increase in Gross Debt with Omitted Costs
Source: CBO and SBC Democratic staff

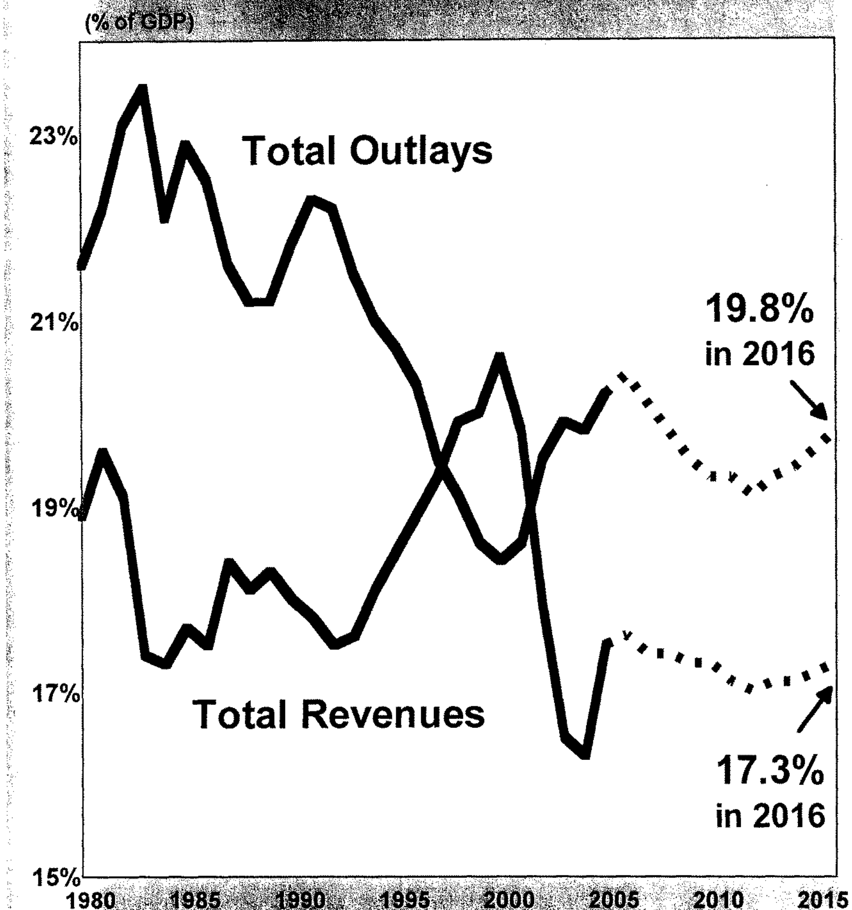
Let's go to the next slide.

This is a slide that I wish we could just imprint on members of the committee and our colleagues in the Congress, because this goes back to 1980 and it shows the relationship between spending and revenue. The red line is the spending line. The green line is the revenue line. And you can see back in the 1980's we were spending about 22 percent, some years even more than that, of gross domestic product in the Federal Government. During the 1990's, each and every year the spending came down as a share of gross domestic product. Now since the Bush administration came in, we have had a substantial move up. But I think it is important for people to know that roughly 90 percent of the increase in discretionary spending is defense, homeland security, and rebuilding New York—spending priorities we all agreed were necessary.

But look what happened to the revenue side of the equation. Revenue, when the President came in, was at a record high. He was quite correct in pointing out at the time that revenue was at a record high in terms of a share of our national income. But look at what has happened since. The revenue side of the equation fell dramatically.

Some of our friends will say, well, when you cut taxes, you get more revenue. We cut taxes in a major way three times, and revenue kept falling. Now we have had an uptick, but we are still well short of where we were in the 1980's and 1990's, and the difference between what CBO and OMB are projecting in terms of spending and what they are projecting in terms of spending and revenue is this gap. And it is a big gap. And it is a gap that is occurring in many ways at the worst possible time—before the baby boomers retire.

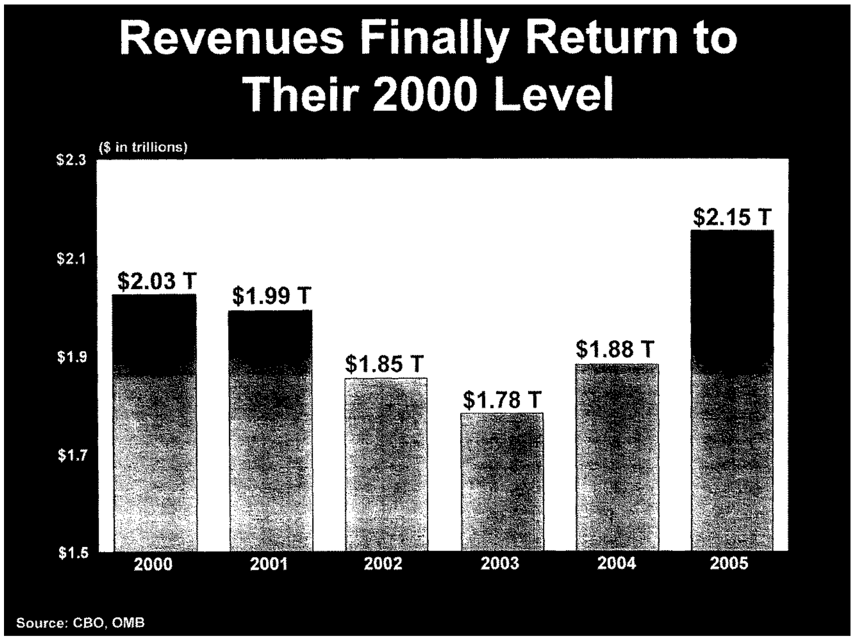
Spending and Revenues



Source: CBO
Note: CBO January 2006 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, spending reconciliation conference report, and without extension of 2006 supplementals.

Let's go to the next slide.

There have been so many assertions that if you cut taxes you get more revenue. Let's just have a historical review here. The Federal Government in 2000 received $2 trillion in revenue, just a little over $2 trillion; 2001, right at $2 trillion. At that point we enacted substantial tax reductions. The next year, revenue fell to $1.85 trillion. We enacted more tax cuts. The next year revenue fell to $1.78 trillion. In 2004, we had a bit of an uptick but still well short of where we were back in 2001. In 2005, a healthy increase, only now getting back to where we were in revenue way back in 2000.


Revenues Finally Return to Their 2000 Level
($ in trillions)
$2.3
$2.1
$1.9
$1.7
$1.5
$2.03 T
$1.99 T
$1.85 T
$1.78 T
$1.88 T
$2.15 T
2000
2001
2002
2003
2004
2005
Source: CBO, OMB

Let's go to the next slide.

As we look at the CBO numbers, it is very important for people listening to understand the Congressional Budget Office is only able to tell us what they project deficits to be absent policy changes. But we know that policy changes are being recommended. For example, the President is saying make the tax cuts permanent. That costs $2 trillion. Alternative minimum tax reform, the old millionaires' tax—it is now becoming a middle-class tax trap—costs $864 billion to fix. These are all over 10 years. The President's defense buildup costs about $300 billion; the funding for ongoing war costs, almost $400 billion.

Then we adjust for things that are one-time that should be removed. For example, we have taken out the effect of supplementals because we hope—we hope—those are one-time events. That takes out $827 billion, and the reconciliation conference report just passed in the House and previously passed in the Senate, that should save over 10 years $105 billion. If you add the debt service that occurs as a result of these additions, you have $3 trillion of added debt.

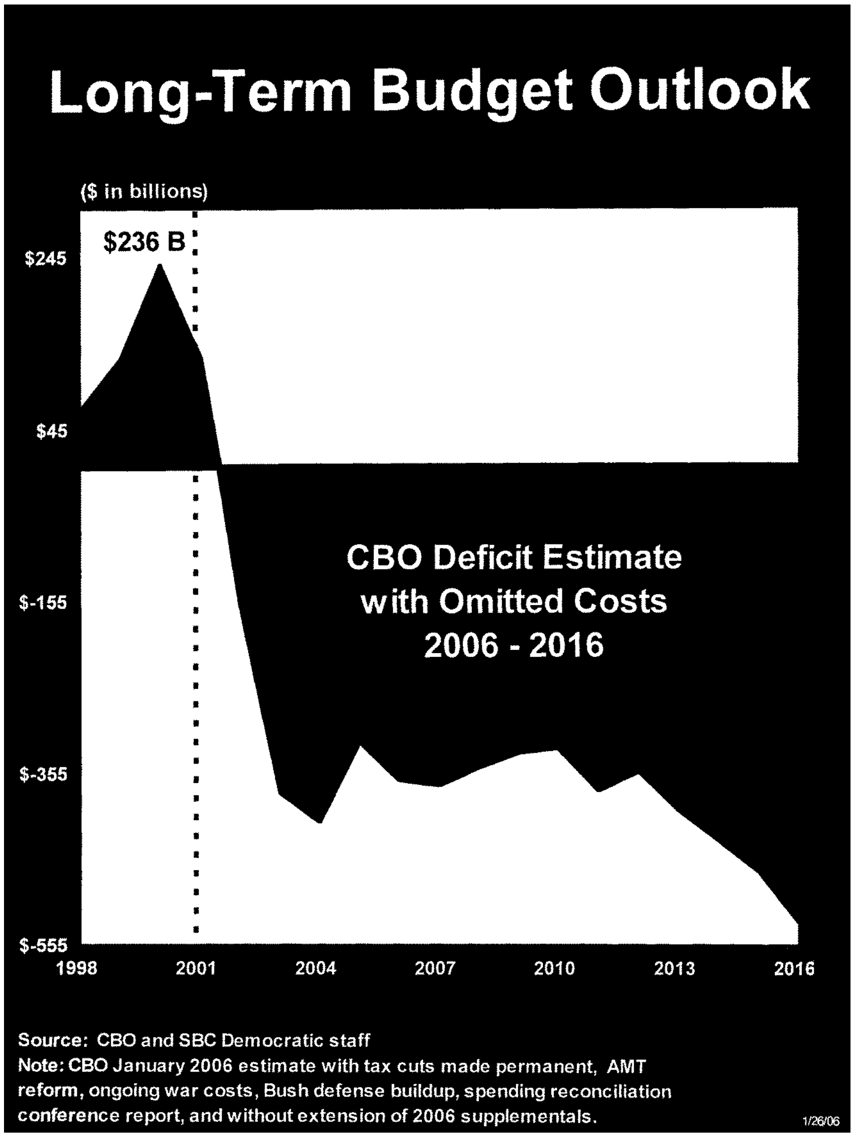
CBO's Ten-Year Baseline Estimate Understates Deficit

Adjustments:

• Cost of Making Tax Cuts Permanent	$2.0 T
• AMT Reform	$864 B
• Bush Defense Buildup	$296 B
• Funding for Ongoing War Costs	$387 B
• Remove Extension of 2006 Supplementals	-$827 B
• Spending Reconciliation Conference Report	-$105 B
• Debt Service	$481 B
Total	$3.1 T

Note: Unified deficit
Source: CBO and SBC Democratic staff

That is where we are headed with the policy changes that have been proposed. That gives us a very different long-term budget outlook than what the President is talking about. The President is talking about cutting the deficit in half, but he only gets there by leaving out things. When we add them back, here is what we see as the deficit outlook. And, of course, the President only has a 5-year budget horizon. The cost of his tax cuts absolutely explodes right beyond the 5-year budget horizon.


Long-Term Budget Outlook
($ in billions)
$236 B
$245
$45
$-155
$-355
$-555
1998
2001
2004
2007
2010
2013
2016
CBO Deficit Estimate
with Omitted Costs
2006 - 2016
Source: CBO and SBC Democratic staff
Note: CBO January 2006 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, spending reconciliation conference report, and without extension of 2006 supplementals.
1/26/06

Let's go to the next one.

The President has said, back in 2001, "My budget pays down a record amount of debt. We will pay off $2 trillion. That will be the largest debt reduction of any country ever."

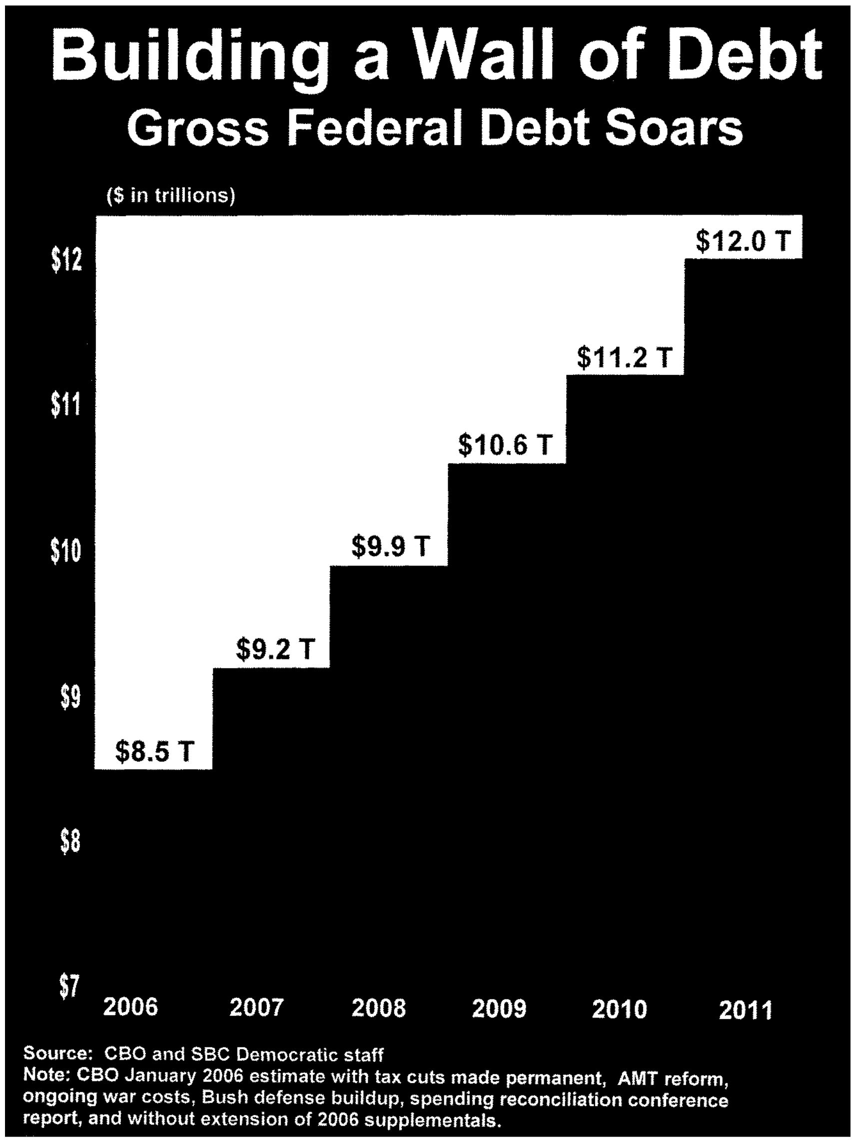
Then he made a statement that I strongly agree with: "Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren." That is what the President said.

Bush Administration on Importance of Paying Down Debt

"...(M)y budget pays down a record amount of national debt. We will pay off $2 trillion of debt over the next decade. That will be the largest debt reduction of any country, ever. Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren."

–President George W. Bush
Radio Address
March 3, 2001

Here is what is happening. When he made that statement, the debt of the country was $3 trillion less than it is now. It was below the bottom of this chart. Just in these 5 years, the debt has gone up by $3 trillion to $8.5 trillion, and every year of this budget proposal that has just been heralded here by my colleague, the debt is going to increase by $600 or $700 billion each and every year. This is before the baby boomers retire.


Building a Wall of Debt
Gross Federal Debt Soars
($ in trillions)
$12
$11
$10
$9
$8
$7
$8.5 T
$9.2 T
$9.9 T
$10.6 T
$11.2 T
$12.0 T
2006
2007
2008
2009
2010
2011
Source: CBO and SBC Democratic staff
Note: CBO January 2006 estimate with tax cuts made permanent, AMT reform, ongoing war costs, Bush defense buildup, spending reconciliation conference report, and without extension of 2006 supplementals.

This to me is utterly unsustainable, and it does require our prompt action. I agree absolutely with the Senator: Entitlements on the spending side are the big enchilada. That is where the money is. But I think, in fairness and in truth, we are also going to have to deal with the revenue side of this equation. And lest somebody conclude that my first reaction is to increase taxes, let me assure my colleagues that is not my first reaction. My first reaction is to attack aggressively the tax gap, the difference between what is owed and what is being paid. That difference, the Revenue Service tells us, is over $300 billion a year. We have to do better than that.

I thank the chairman for his patience, and I thank the witness for his presence.

Chairman GREGG. Thank you, Senator.

We would now like to hear from Mr. Marron.

STATEMENT OF DONALD B. MARRON, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. MARRON. Outstanding. Thank you. Is this on?

Chairman GREGG. If the red light is on, it is.

Mr. MARRON. Excellent. Thank you, Chairman Gregg, Senator Conrad, members of the committee. It is a pleasure and exciting to be here today for my first appearance.

Let me just say in my first month or so of being Acting Director, I haveten to work closely with your staffs and gotten to meet both of you and felt it has been very productive and look forward to continuing that.

Both of you obviously are already familiar with our outlook, which we released last week, so I will try to keep my remarks short here.

The key points that we have are:

The deficit projection for 2006 increased a little bit from where we were last August. Most of that is due to Katrina, not a surprise.

Some small improvements in the later years of our projection period, revenues slightly higher than we predicted previously, spending slightly lower. But I would characterize those changes as relatively small, and I would characterize the budget outlook as being roughly the same as what we reported last August.

On the economic front, basically a solid economy for a variety of reasons. The economy has momentum and we expect solid growth this year, expect that to continue.

And then a point that I want to emphasize and that reinforces some of the opening remarks of the members is that you can see in our projection the beginning of the challenges that are going to be posed by Social Security, Medicare, and Medicaid. And so it is in there. It is within the 10-year budget window that we are looking at.

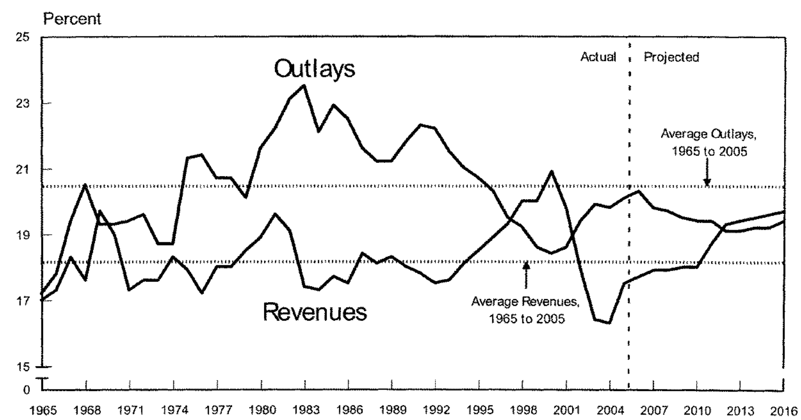
Turning to some details, as mentioned, our official budget projection of the deficit for 2006 in the Outlook is $337 billion. We are not in the business of projecting what legislation might pass, and so as a result, we did not include the reconciliation bill in that number. If you include the reconciliation bill, that projection would become something in the neighborhood of $332 billion. That is up slightly from last year, but basically in the same ballpark relative to the overall size of the economy, 2.5 percent of GDP this year versus 2.6 percent last year.

Again, we are in the business of projecting assuming current law, current policies. We cannot make predictions about what happens in the future. There are a few spending pressures that we see that are already sort of built in to what is going to happen: some additional spending on operations in Iraq and Afghanistan, and some spending that is likely to be necessary very soon on flood insurance. If you take those and add them in, for 2006 we would be looking for a deficit that is somewhere in the $355 billion range.

If you could put up the first chart, please?

Looking out over the rest of our projection—and the members have these charts in front of them as well—it is basically a race between the red line and the blue line as you look at the right side of this chart. Let me start with the red line, which is spending. It has a variety of components—mandatory and discretionary primarily, along with interest—and the key thing to know is that, as CBO constructs its baseline, we are required to do so under certain rules.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1965 to 2016



For mandatory programs, we basically take the mandatory programs as they are structured and assume that they continue regardless of whether or not they are scheduled to expire over this period. Over this period, the drivers of spending on mandatory include growth in the caseloads for those programs, particularly driven by the baby-boom generation, and for the health care-related ones, there is the increasing expectation that health care will continue to cost—the costs of health care will continue to rise more rapidly than the economy. Those two factors together cause mandatory spending to grow relative to GDP over our projection period.

Now, you don't see that in our red line because of the way that we are required to structure our projection of discretionary spending. For discretionary spending, in essence what we do is take the budget authority that has been approved for fiscal year 2006, and we project it out into the future using our economic forecast of inflation rates. As you all know, in recent years discretionary spending has tended to grow much more rapidly than inflation alone, but for purposes of constructing this baseline, those are the rules that we have to follow. And what you see with the red line, where spending relative to GDP appears to go down over the projection period, that is in essence the story of the construction that we are doing for discretionary spending more than offsetting the underlying growth in the mandatory spending that we see going on in parallel.

On the revenue side, the key thing I would point out is that given our current tax system, the natural state of affairs is for revenues to grow slightly faster than the economy. That is because of the structure of the regular tax system, because of the structure of the AMT, and also because increasingly with the baby-boom generation coming upon us, we are going to see some withdrawals from 401(k)'s and tax-deferred accounts that are going to provide some boost to revenues.

So the natural tendency of revenues is to grow faster than the economy, but the big enchilada, which you can see in our forecast when we get out to 2011, is that under the rules under which we construct our baseline, we assume that the various tax provisions expire, and as a result, revenues increase dramatically in 2011 and 2012. And that essentially explains why the blue line of revenues rises up and gets slightly above the red line of outlays.

Let me turn just to the economic outlook quickly. Again, we see a solid economy with momentum. There are reasons to believe that business investment needs to continue to be strong and will be strong this year and next year. Basically that is a story where the demand for products, the growth of demand for products in recent years has grown faster than the investment that businesses have been doing and that, therefore, in essence businesses have to do some additional extra investment to catch up.

Rising wealth and rising incomes are helping to support spending by consumers, and there are some reasons to believe also that our situation on the trade front should improve somewhat. The dollar declined substantially from 2002 through 2004, went up a little bit last year, but there is still basically some pent-up decline in the dollar that needs to flow through and is expected to flow through into somewhat better performance on the international side. You take all those together and our expectation is for solid growth, 3.6 percent real GDP growth this year, 3.4 percent next year.

People worry a lot about housing. In our projection, we expect that the housing sector will indeed cool somewhat this year and next year. So we see housing investment lower this year than last, and we see it lower in 2007 than in 2006. So that degree of cooling is built into our projection.

Then, again, in thinking about the longer-run challenges that we face on the budget front, it is important to recognize that another effect of the baby-boom generation aging is that the expected growth of the labor force, the pool of workers who produce things in our economy, that is expected to slow over time. And so that even as we see growth above 3 percent this year, next year, and for a few years after, in the later years of our forecasts we actually see economic growth slowing to about 2.6 percent. And so we are in a situation in which spending on mandatory programs is going to be rising faster and faster, and yet the size of the economy to support it is actually going to be growing slower and slower.

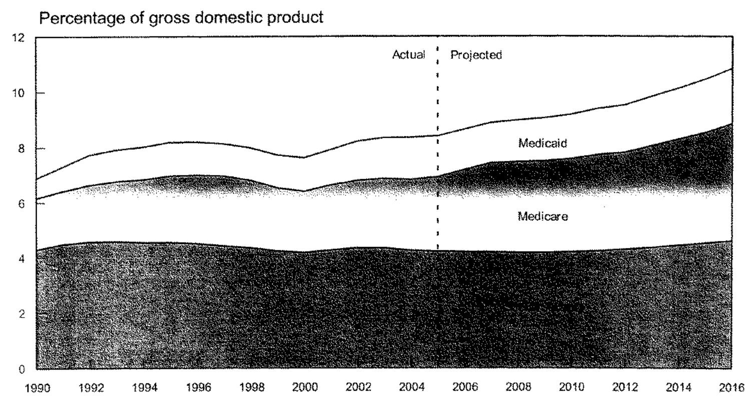
Let me just emphasize quickly, as you all know, there are great uncertainties in the projections that we put together. It is extremely difficult to forecast all of the effects that will drive budget outcomes. If you take our projection in the spirit in which it is intended, which is as a projection, the key uncertainties are economic and technical factors. In the report, we have a very nice fan chart which tries to illustrate what the range of uncertainties are, and the basic story there is if you go out 5 years, say, to 2011, in that year we project a small deficit under the rules under which we construct our projection, but realistically it could be several percentage points of GDP either way. So there is a significant amount of uncertainty. We do our best to resolve that and eliminate it. But the reality is we live in an uncertain world.

Then, second of all, our projection is not intended in any shape, way, manner, or form as a forecast, but it is sometimes interpreted that way. The key uncertainty for anyone who wishes to take our projection as a forecast, as was already pointed out, is policy uncertainty. Depending on what policies are adopted by the Congress and the administration, the outcomes could turn out quite different from what we project.

Finally, if we could just go to the second of the two charts I had? There it is.

I just want to emphasize a point I made earlier, which is you can now see within the window—the 10-year window that we are using for projecting the increasing pressures that are coming from the big three entitlement programs. So you can see that Social Security, Medicare, and Medicaid combined are going to place increasing pressures on the budget. Over this time period, these three rise by about 2 percentage points of GDP, from about 8.7 percent of GDP this year to about 10.8 percent in 2016, the final year of our projection. Most of this at the moment is being driven by the expectation that health care costs are going to continue to rise much more rapidly than the economy. You can only begin to see the transition in demographics. As you get beyond this window, the pressures from those programs become increasingly larger, and as you go out several decades, again, under the projections we make both in this report and in our long-term budget report, these three programs look to grow to be, say, 15 percent of GDP, which seems relative to where we have been historically something that would be unsustainable.

Spending on Social Security, Medicare, and Medicaid, 1990 to 2016



With that, I am happy to take your questions.

Chairman GREGG. Thank you. We appreciate that. And we especially appreciate your explaining that your baseline really is—it takes into account things that probably are not going to happen.

Mr. MARRON. Yes.

Chairman GREGG. And you are forced to do that by law. For example, you have to continue Katrina spending as if we are going to do it forever. And you have to continue the war, the Iraq supplementals as if they were going to go on forever. And clearly those two events are not. They are both going to come down rather drastically here, as the chart that Senator Conrad held up made that point.

But that is one of the things that bothers me, I guess, and the big area that we have this problem is in the area of how you are required to account for entitlements and revenues. You know, you have two different major rules on entitlements. If they sunset, you still have to consider them as going on. You have a different rule for discretionary, which you described. And then you have a different rule for revenues.

Shouldn't we have homogenization here so that we have one rule that basically applies to all four categories so that there is consistency? In other words, if we are going to sunset revenues and we are going to presumably go back to the old law, then shouldn't we do the same for entitlements and actually have mechanisms to create that and make it happen so that we have a baseline that is consistent and treats these different accounts consistently?

Mr. MARRON. Well, that is a challenging question. I think it is important to keep in mind that whatever rules we choose, the goal—I think the goal cannot be to create baseline projections that look like forecasts because there will be, obviously, policy changes in the future.

Chairman GREGG. We want to create as much accuracy as we can.

Mr. MARRON. We want to create—well, accuracy and, I guess, usefulness to you. I mean, in part I am afraid my answer is going to be to put the question back on you and your colleagues about what is the most constructive and useful way to present these data. And then I would distinguish the discretionary side where it is not entirely obvious to me what the rules are and what the alternative rules are one might use to project that out into the future. We went through various scenarios in our book of, you know, keeping it flat in nominal terms or growing it at the growth rate of GDP. At the moment, the rules are grow at inflation. I am not exactly sure of the best—if there is some specific way that would guide us to choose which of those makes the most sense.

As for mandatory spending versus tax revenues, that raises a key issue, which you raised, which is if there is any symmetry. So we assume that tax things that expire truly expire; whereas, mandatory things that expire do not expire. That is clearly an asymmetry. It is clearly something to think about. I guess I would put back on you is that constructive for the process or is that not constructive.

Chairman GREGG. Well, I appreciate that. I do not think it is constructive, and we will try to address it.

But on another issue, today on the floor we have the reconciliation tax bill. The big battle, to the extent there is a big battle, has been waged around the issue of extending capital gains and dividend rates for 2 years. There appears to be support—I am not necessarily one of them—for doing an AMT patch, for doing State and local sales tax deductibility across the board, or across the aisle.

I guess my question to you is, if you look at State and local deductibility, which essentially gives States which have a high tax burden a benefit, in other words, you are saying to a State that has a sales tax, you go ahead and raise it because your people are going to be able to deduct a percentage of it, so you can raise it to the extent the Federal income tax basically subsidizes it; whereas, States that do not have a sales tax, like mine—we do not have an income tax—end up, therefore, paying an unfair—getting treated unfairly in that exercise because they have nothing to deduct because their States are fiscally responsible and do not have those taxes. So you create an atmosphere where you are actually encouraging tax increases in States, and most of those are large States. Connecticut, Massachusetts, New Jersey, New York, Illinois, California all have major sales taxes.

If you compare that tax from an effect on the economy to capital gains, where basically you are saying to people you go out and you invest and you reinvest and you realize your gains and then you reinvest and you create jobs, which one generates more economic activity, which in turn probably generates more revenue for the Federal Government: cap gains or sales tax deductibility—extending the cap gains rates or making sales tax deductible? Recognizing that both are essentially costing the same.

Mr. MARRON. So purely from an economic efficiency point of view in terms of economic activity, leaving aside any distributional considerations, reducing taxes on investment returns and on the returns to saving generally tend to be among the most pro-growth tax reductions that you can have. They encourage capital formation. Capital formation leads to a larger economy, higher wages, and economic growth as we go over time; whereas, the deduction for State and local taxes has exactly the two effects that you emphasized. The first is that, in essence, it reduces the cost to individual States to raising their taxes and, therefore, on balance encourages higher taxes at the State level. And then, second, given the different approaches that States take in this country to how they structure taxation, it provides that incentive in a way that sort of is not equal across the States and, therefore, it creates some—I guess you would say economic activity as a result faces different taxes at the margin across different States, which is not something that encourages efficiency.

Chairman GREGG. I appreciate that answer, and I appreciate the forthrightness of it, and I agree with it. Basically we should not extend the deductibility of State and local sales taxes, in my opinion, because it does have an adverse and disproportionate benefit to States that have high—an adverse impact on States with low tax burdens, or at least that don't have sales tax burdens, and a disproportionately positive impact on States that have high tax burdens and have a sales tax.

Another issue, and I am running out of time, but the Part D premium, the Part D drug benefit, the estimate is that it is now $45 billion over the original estimate. Is that correct? Or do you have a number on that? That is the estimate we have. And shouldn't we bring it back or have you assume that it is going to be brought back in line with the original estimate in order to properly budget for it?

Mr. MARRON. In our outlook we have a box that discusses Medicare Part D and tries to put some of the numbers in context. I believe the number we have at the moment is $42 billion so that our current estimate—and I should emphasize what that is. Our current estimate of the spending from Medicare on prescription drugs is about $42 billion higher than we estimated in our original cost estimate. That increase reflects essentially three things:

Some economic changes, basically inflation was higher over recent periods than we previously thought, and that flows through into some of the prices;

Second of all, we have learned some more about how the program is going to operate. We learned something about how the rules are going to be implemented. A variety of those factors lead to the change;

And that is what is built into our baseline, so we have no expectation of any possible future legislative change to the program. We have the program that is currently written.

Chairman GREGG. But if we were to bring it back to its original proposals, we would reduce the rate of growth in that program by about $42 billion.

Mr. MARRON. If we brought it back to the original estimates, yes.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Let me just go to a couple of questions to you because I know it is confusing to people out there listening, and I think it is confusing, frankly, to our own colleagues when they see CBO issue these estimates, because I don't think they have it firmly in mind what the chairman has said. That is, you are required by law to use existing policy, not what the policy proposals are that we are facing and that are likely to be adopted, but instead, existing policy. Isn't that correct?

Mr. MARRON. Absolutely.

Senator CONRAD. And you are required by law to do it that way, aren't you?

Mr. MARRON. Yes.

Senator CONRAD. So this is not any criticism—I want to make it clear—of the Congressional Budget Office. You are required to do it this way, and there is a good reason for that. But the problem is it is unlikely to match reality.

Now, let's talk a minute about the policy proposals that are out there. Let me just ask you, the President said in his State of the Union, "Make the tax cuts permanent." We see the 10-year estimate of the cost of that proposal is $2 trillion of lost revenue. Do you agree with that? Is that roughly your understanding—

CBO's Ten-Year Baseline Estimate Understates Deficit

Adjustments:

• Cost of Making Tax Cuts Permanent	$2.0 T
• AMT Reform	$864 B
• Bush Defense Buildup	$296 B
• Funding for Ongoing War Costs	$387 B
• Remove Extension of 2006 Supplementals	-$827 B
• Spending Reconciliation Conference Report	-$105 B
• Debt Service	$481 B
Total	$3.1 T

Note: Unified deficit
Source: CBO and SBC Democratic staff

Mr. MARRON. Yes.

Senator CONRAD. An alternative minimum tax reform—and I know you say alternative minimum tax and right away people tune you out. But basically it is the old millionaires' tax that, unfortunately, is rapidly becoming a middle-class tax trap. There are going to be 20 million people affected this year if we do not do something.

The 10-year cost of fixing that is $864 billion. Do you agree with that rough estimate?

Mr. MARRON. With the caveat that I think people may disagree on what constitutes a fix.

Senator CONRAD. A fix.

Mr. MARRON. And so we have a specific possibility, as we illustrated in our report, but obviously the actual fix, if one happens, may look different.

Senator CONRAD. And this estimate of what has been widely regarded as a fix, that is, to freeze this so more people are not swept into it, rough cost $860 billion over 10 years?

Mr. MARRON. Let me check my numbers.

That sounds about right.

Senator CONRAD. The third issue is the President's ongoing defense buildup, and we have been given an estimated 10-year cost of roughly $300 billion. Do you believe that is roughly——

Mr. MARRON. I must admit that is not actually a calculation I have seen. I expect other people at CBO have.

Senator CONRAD. Let me just say that we face a tremendous stress on the military budget. I have just been advised by my Guard leaders and other Army leaders that the equipment in Iraq, much of it will just have to be left there because it is junk, and it is becoming junk because of the extreme heat, the adverse conditions, and, of course, the stress of combat. And this is going to pose substantial additional costs.

Funding for ongoing war costs, I believe this is actually a CBO estimate, 10-year cost $380 billion. Do you agree that that is in the ballpark?

Mr. MARRON. Under a particular set of assumptions, yes.

Senator CONRAD. Now, we have backed out the 2006 supplementals for the reason that Senator Gregg gave, and I think he is exactly right. Many of these supplementals for Katrina, for the war in Iraq, you are required to include those in future year estimates, but we have backed them out because we assume they are one-time costs. And when we back those out, that is a savings of $827 billion. Would you agree that that is roughly correct?

Mr. MARRON. Yes.

Senator CONRAD. And then the reconciliation conference report passed in the House—I know it is referred to as $39 billion, but that is the 5-year effect; the 10-year effect, $105 billion. Do you agree with that?

Mr. MARRON. That looks about right.

Chairman GREGG. It passed the Senate, too.

Senator CONRAD. And it passed the Senate.

Chairman GREGG. I just want to make that point.

Senator CONRAD. Yes, it passed the Senate. The debt service related to all this, $481 billion. So we see the debt going up by $3 trillion over this next 10 years. Do you agree that that is roughly in the ballpark?

Mr. MARRON. Ballpark, if all these things come to pass.

Senator CONRAD. All of these elements. Well, that, I would say to my colleagues, is alarming to me because this is before the baby boomers fully retire. And if there is one place the chairman and I absolutely agree, it is this demographic change that is occurring is going to create a tsunami of debt, because the number of people eligible for Medicare and Social Security are going to double in very short order.

Would you agree that the number of people eligible for Social Security and Medicare will double as the baby boomers retire?

Mr. MARRON. Yes.

Senator CONRAD. So if we are looking at the spending side of this equation, we have to focus there. Would you agree?

Mr. MARRON. Yes.

Senator CONRAD. And on the revenue side of the equation, the notion that tax cuts pay for themselves, my understanding is that CBO has found, using a wide variety of economic models, the tax cuts do not pay for themselves. Some of the models show positive effects on growth, but they are not large enough to offset the revenue loss. Is that an accurate characterization of what CBO has found?

Mr. MARRON. Yes. Pro-growth tax cuts, reducing marginal rates, things that are focused on savings and investment do help the economy grow. And, therefore, you get back something from macroeconomic behavior that a purely static estimate would not account for. But the scenarios we have considered do not come close to actually paying for themselves.

Senator CONRAD. Let me just say this by way of conclusion. I believe that we together have to take on this growth of the debt. I believe it is going to take a focus on the spending side, especially entitlements, and on the revenue side, and that the first place we ought to look for revenue is this massive tax gap.

One final question, if I could on that. The tax gap—have you had a chance to look at the Internal Revenue Service estimates of the difference between what is owed and what is being paid per year?

Mr. MARRON. I know they exist. They are somewhere between $300 and $400 billion a year.

Senator CONRAD. The difference is $300 to $400 billion. That, my colleagues, I suggest, on the revenue side ought to be the first place we look.

I thank the Chair.

Chairman GREGG. I hope we can pursue that later, whether you have language which could accomplish that.

Senator Crapo I guess was here first.

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Marron, I wanted to pursue a little further the line of questioning that both the chairman and the ranking member have pursued with you, namely, the dynamic impact of tax cuts.

As you have already indicated, certain types of tax cuts are pro-growth, stimulate the economy, stimulate the development of capital and wealth and development of jobs, and have the ability, therefore, to create a stronger and more dynamic environment in which greater revenue can be accomplished.

Now, you indicated on the models that you have looked at that they did not return as much as they cost. Do you build any of those models into your projections, or have you just looked at them?

Mr. MARRON. For purposes of the baseline that we construct and that we have talked about here today, we do indeed account for dynamic effects. And so, for example, in our projections in 2011 and 2012—in 2011, in particular, you see taxes rise significantly. And so as a result, in our projections we see that labor force participation goes down after that. And so there are some dynamic effects in the baseline.

In the evaluation of legislation, which on the tax side I should emphasize is primarily done by the Joint Committee on Taxation, those effects are typically not accounted for.

Senator CRAPO. Do you get specifically into—say that again, what you just said? What is not accounted for?

Mr. MARRON. In evaluating legislative proposals on the tax side, which, again, is primarily done by our colleagues at JCT, they take into account some behavioral responses, so they are not purely static estimates, but they do not take into account possible macroeconomic effects of tax cuts.

Senator CRAPO. As you are evaluating the impact of tax relief, do you focus on the specific taxes that are being—let's take, for example—and I think you are aware of the recent information that has come out on the capital gains tax cuts over the last 2 or 3 years and the impact of those cuts on revenue. Do you take that into account specifically as to the specific taxes that have been cut?

Mr. MARRON. There are really two related things there. In constructing our baseline, we definitely take account of the fact that if you change capital gains taxes, you change people's realization behavior roughly as you would expect. If the capital gains tax is lower, people are more willing to realize gains, and they also affect their timing. So we build that into the baseline. And then we also build into the baseline some macroeconomic effects from that, although, they are not that large given all the other taxes that we have.

Senator CRAPO. Well, what I am trying to get at—and I am using the capital gains tax information as the example here. I am trying to get at an understanding of just what it is that you are projecting and are not, because it appears that the projections of CBO, and others, when we passed the capital gains tax cut all were that there would be a net negative impact on the Treasury, on the budget in terms of revenue, and yet that the actual occurrence was dramatically different than that and that the net result was that there was a significant increase in revenue as a result of—and then the question is: Was it as a result of the tax relief, or was it as a result of something else?

Mr. MARRON. Specifically with capital gains, my understanding is the estimates that are prepared by the Joint Committee on Taxation do take account of the fact that people change their realization behavior. And so, for example, we saw capital gains tax rates come down significantly, and that essentially unlocks some gains that people had not wanted to realize, and that may—depending on the relative size of the change in taxes can give you either a plus or a minus on revenues.

Senator CRAPO. But our actual experience was that it was a dramatic increase in revenues, wasn't it?

Mr. MARRON. Yes, we have seen capital gains revenues on both the individual side and corporate side go up significantly. There is a confounding factor. There is something that happened at the same time which we are not able to fully yet measure, which is this dramatic increase in real estate prices. And so some of the recent increase in capital gains is clearly coming from that sector.

Senator CRAPO. And wouldn't some of that even have been a result of the increase in capital transactions generated by——

Mr. MARRON. Yes, and some of that may be the realization of capital gains on real estate that had been there for some time.

Senator CRAPO. The bottom line, though, is that the charts we were all using 3 years ago were saying that it was a net loss, and the reality that we are seeing now is that it was a very significant net gain. Is that not correct?

Mr. MARRON. It is true that the capital gains realizations have been very strong. Connecting that strength specifically to the tax reduction is a challenge because of the other things that have happened in the economy. And for that I would have to plead the need for more research.

Senator CRAPO. Are you saying that we do not have the ability to make those kinds of estimates in terms of the dynamic impacts?

Mr. MARRON. I think our colleagues at JCT, do their professional best to understand, given what happened in the past, to forecast capital gains realizations. We have a brief discussion in our outlook here about how forecasting capital gains is a particularly challenging part about constructing revenue projections. Just in the normal course of affairs, the actual realizations that occur could deviate wildly from what the best economic models predict.

Senator CRAPO. But you do not at CBO try to conduct that type of dynamic analysis?

Mr. MARRON. We do for purposes of constructing our baseline. This is one of the confusing nuances about how we do things. So in our baseline, which is our responsibility, we try to take into account exactly those effects. When it comes to score legislative changes, that is done by JCT. They take into account behavioral response, but they do not take into account macroeconomic effects.

Senator CRAPO. All right. I just have about a minute left, and I want to shift topics entirely here for a minute and talk about the growth in Medicare. I noticed that growth is projected to be in this—I don't know if these are your figures are not, but $339 billion in 2006 to $500 billion in 2011, and then over the next 10 years it grows to $744 billion.

Do you know what percent of the growth in Medicare is attributable to the enactment of the prescription drug benefit?

Mr. MARRON. For 2006 alone, the addition of the drug benefit is responsible for about 50 percent of the growth in Medicare. That obviously gets smaller as you go out over time. This is the first year.

Senator CRAPO. And do you know what percent is attributable in these projections to the increased in the number of seniors retiring?

Mr. MARRON. I don't have particular numbers at hand for you, but I would say that the predominant driver is increased health care spending, so increased services and increased prices for those services. But there is also a portion of—because of the transition to the baby boom, significant growth in the population in the program. I could get you specific numbers, but qualitatively it is primarily the rise in health care costs and then also some significant change from the caseloads.

Senator CRAPO. All right. One last question, and you may give the exact same answer to this, but do you have any idea what percent is attributable to the more intensive care that is being provided to seniors?

Mr. MARRON. I would include that in with the rise in health care costs, which is being driven, as I said, in part by prices and in part by increased utilization of various services.

Senator CRAPO. All right. Thank you.

Chairman GREGG. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. I want to thank you and the ranking Democrat for the welcome to the committee and for reassuring me I made such a great choice in seeking the committee. But it is a privilege to be here, and I look forward to working with our colleagues in crafting a sensible, responsible budget, and I look at that as a very serious exercise since I believe that budgets are a reflection of values. We do that every day in our lives in terms of our personal budgets. What we earn and what we spend in terms of providing a home, educating our children, providing for health care, the money that we tithe to our faith, the charitable contributions we may make—those are all expressions of values within a budget. And I think the national budget collectively on behalf of the Nation is also an expression of values, and so how we choose to use the collective resources of the Nation is an expression of our collective values. And in some respects I haven't agreed with the values that we have had over the last several years.

I hope one of the values that we will be able to deal with today as we work on the Senate floor is rewarding work, those individuals who work very hard every day but find themselves in a set of circumstances where they are going to be subject to a tax even though their income may not have grown on the alternative minimum tax. That was never meant for 17 million middle-class families in our country, many from my home State of New Jersey. So I am looking forward to seeing that the Senate hopefully will act in a way that speaks to a value that rewards work.

And I certainly share the concerns of Senator Conrad in this presentation. To me, one of the things that I thought we achieved several years ago is balancing budgets for the first time in a generation, creating record surpluses, low unemployment, low inflation, and moving to a Nation that was debt-free within 4 years. And now this mountain of debt that is being generated is just in my mind beyond the realm and comprehension of most Americans.

When we talk about the type of figures that are being projected in the out-years, it certainly baffles them, as I think it might baffle any one of us. And that does not even deal with some of the concerns that I have that we have learned over the last year, that in addition to the rate of debt that we are accumulating, one of the things we learned, especially last year, is that sometimes the unexpected and the unthinkable will happen, and it certainly did last year. And that adds to our challenges and our readiness. So it is in that context that I look forward to the work of the committee.

I would like to ask you, Director, about a couple of issues. One is the CBO acknowledges that the war costs may be understated in the next few years given that the baseline includes the $50 billion appropriated for 2006, a figure that is likely to be surpassed this year. Given the probability that we will be near the $90 billion range in 2006, and the possibility that we may be near these same funding levels at least for the next couple of years, could you provide a revised baseline and demonstrate the impact on the deficit if we were spending between $80 and $90 billion on the war effort through 2008?

Mr. MARRON. Sir, we can clearly run scenarios based on different assumptions about what funding would be for Iraq and Afghanistan operations, absolutely. I wouldn't be able to characterize them as a baseline. The baseline is what the baseline is, but as an alternative set of projections, that is certainly possible to do.

Senator MENENDEZ. So if we asked you to do that, you could do that for us.

Mr. MARRON. Certainly.

Senator MENENDEZ. OK. We will ask you to do that, because I just find it very difficult to be including in supplementals, which in my understanding was supposed to be emergencies, that which you know that you are spending. We are obviously still engaged in Afghanistan and Iraq, and yet we continue to offer supplementals versus deal with the funding expectations that we need to provide for the engagement of our troops, their safety, and ultimately our mission.

Let me ask you about the CBO projects that the budget reconciliation bill passed by the House yesterday results in about $5 billion in savings in 2006, $39 billion between 2006 and 2010 and $99 billion from 2006 through 2015.

It also projects the costs of extending the 2001 and 2003 tax cuts would be about $346 billion if we extended it through 2011, and a whopping $2 trillion if we extended it through 2016.

Given the arguments that the spending cuts will help reduce the deficit, can you compare the impact of each of these approaches that it has on the deficit? Isn't $99 billion in savings over 9 years a drop in the bucket compared to $2 trillion in additional revenue loss?

Mr. MARRON. That is an easy one, so yes, roughly $100 billion is about 1/20th of roughly $2 trillion.

Senator MENENDEZ. Let me ask you, with reference to the President's—I have been listening to the President's State of the Union speeches now for 5 years. We have heard numerous times from the President his intention to cut the deficit in half by 2009. If I am correct, he first made that pledge in 2004. At that time the projected deficit for 2004 was $521 billion, and the projected deficit for 2009 was $237 billion. So cutting the deficit in half was more of a projection than a promise.

Is the President talking about actual dollar terms or is he talking about the deficit as a percentage of GDP? Which one is he talking about?

Mr. MARRON. Sir, I have seen news coverage and discussions that characterize it both ways, either in dollar terms or as a share of GDP.

Senator MENENDEZ. Well, it is hard to have it both ways, isn't it?

Mr. MARRON. They are both meaningful measures. You know, I have the luxury of being sort of a pointy-headed economist, and we like to divide through by GDP, so that tends to be the type—obviously, as you saw in my chart earlier, that tends to be the kind of numbers we focus on. But I would hesitate to characterize, you know, what the President's specific target was.

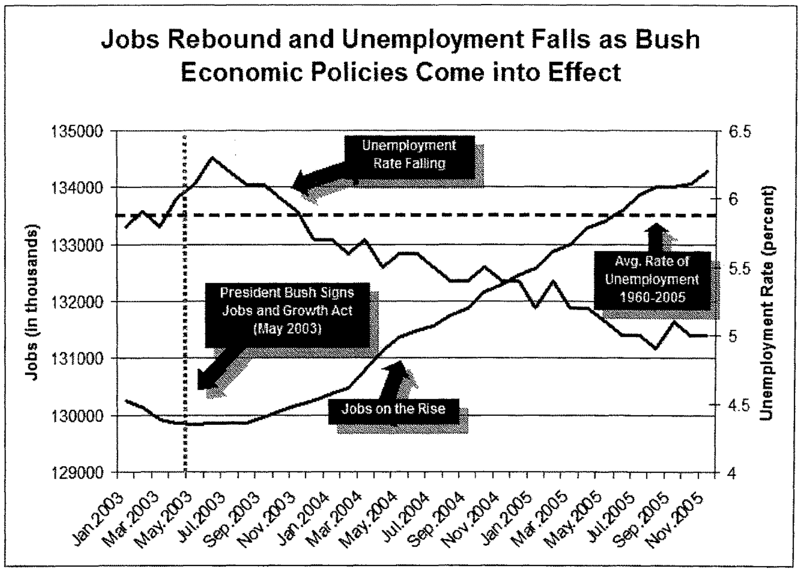
Senator MENENDEZ. I think most Americans would expect, when they hear that we are going to cut the deficit and the debt, they are talking about listening to actual dollar amounts. That is the reality in their lives. They don't get to do it as a percentage of GDP.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you very much, Senator.

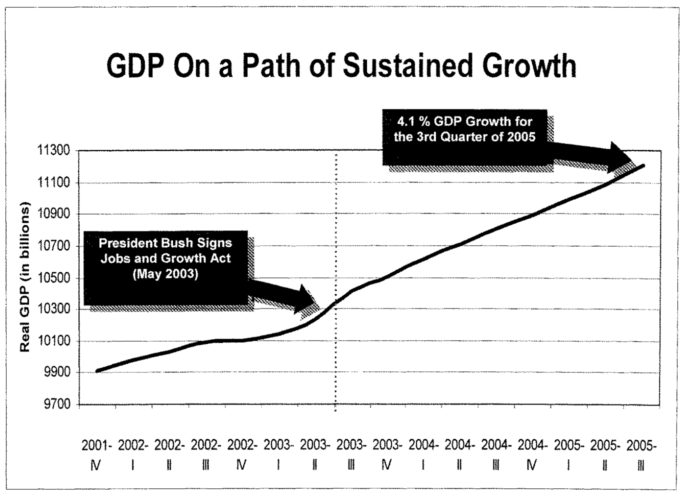
Senator ALLARD. Mr. Chairman, thank you. And at the risk of starting a war of charts, which I hope we can avoid, I just want to make a very brief point here because my good friend from North Dakota has tried to say that the growth package that was put forward by the President and passed by the Congress in 2003 was not good public policy. The fact is that the facts point out differently, and so I have just four charts I want to briefly run through here that point that out.

The first chart that we see here reflects basically that jobs have rebounded and that unemployment is falling.



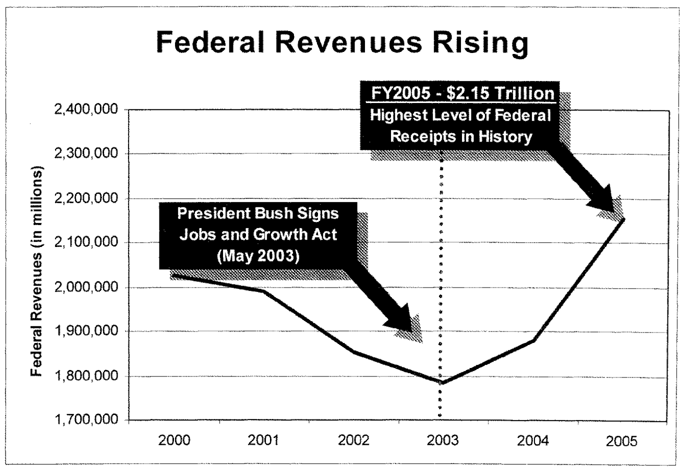
Source: U.S. Department of the Treasury

On the second chart that we have here, we have a chart that just quickly reflects the fact that gross domestic product is on a path of sustained growth and continuing in that direction. And the green line that we see on the chart is actually the point where the jobs growth package, a main portion of which was capital gains and growth stimulus, where we reduced taxes to stimulate the economy.



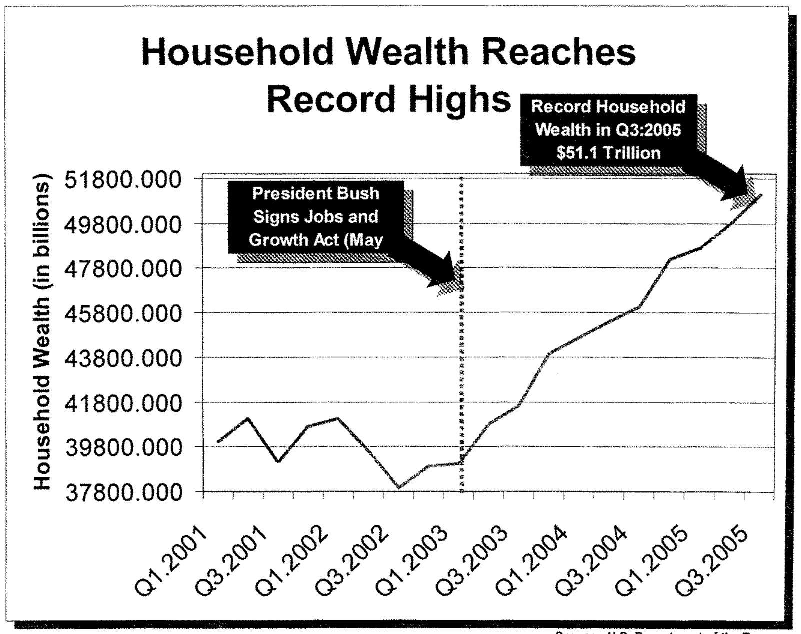
Source: U.S. Department of the Treasury

Then on the third chart we have, look what has happened to Federal revenues rising. Despite projections that they would go down when the President's growth package was implemented, we see that the chart shows a pretty dramatic growth upwards.



Source: U.S. Department of the Treasury

Then the fourth chart shows what is happening to household wealth, and it has reached record highs.



Source: U.S. Department of the Treasury

Now, while those in opposition to those tax cuts have tried to make the point that it is bad public policy, in reality what we have seen happen is that that policy has been good for the economy.It has been good for the Federal Government because revenues have increased to the Federal Government, and it has actually helped American families. And so I for one think it was very good public policy, and I hope we can sustain that effort with policy toward a permanent tax cut. And I would agree with the chairman that capital gains was a vital part of that.

One of the problems with estimating capital gains taxes is they have always been dramatically off, and in general, when we talk about cutting taxes to benefit the economy, it seems like the estimates that we get from the CBO have been off considerably.

Let me take a couple of examples just to make that point. In 1992, President Clinton was elected into office, and around 1993, we had what was characterized by many of us as the largest tax increase in the history of America at that particular point in time. The CBO projection in 1992 for the year 1993 up to 1996 had estimated a certain level of revenue. And when we applied these tax—when they applied the tax increases—and they were increases of up to 16 percent to 28 percent, depending upon—that was just on the top tax rates. And the revenue that was generated from that was less than 1 percent higher than the 1992 estimate.

Now, when we get into the 2000 President's tax growth package earlier, the CBO had estimated that it was going to cost revenues to the Federal Government $27 billion. In reality, what it did, it increased revenues by $26 billion. There was a miscalculation of somewhere around $53 billion there.

And when we look at—before I ask my question, and my question is going to be how can we improve the accuracy of revenues when we are talking about cutting tax policy, policy we retain of cutting taxes, particular economic growth taxes.

By the way, on the chart of my good friend from North Dakota where he showed the economy coming down dramatically, revenues are up, we hadn't even applied the President's tax growth yet. We were still working under the policy of the previous administration, the Clinton administration. And so then when we see the Bush administration policy comes, we see the growth and what all of these charts here reflected.

So, again, my question is: What is it that we can do to improve the accuracy of a tax cut's impact on the economy and revenues to the Federal Government?

Mr. MARRON. Again, I want to emphasize what I understand to be—as the new guy I may get this slightly wrong, but I want to emphasize my understanding of the roles and responsibilities. CBO is responsible for the baseline projection of revenues and spending. Among those would be capital gains. Our colleagues and friends at the Joint Committee on Taxation are responsible for the scoring of bills.

And so to the extent that any of these issues arise with their scoring of the bills, I cannot speak to it directly.

Senator ALLARD. I am not trying to—but you understand how they score bills, don't you?

Mr. MARRON. Yes, I understand why they do it.

Senator ALLARD. What can we do to improve that, so we get a more accurate reflection of what is going to happen when you do things like cut capital gains?

Mr. MARRON. I have the standard economist answer, which is that one of the great challenges we face, particularly on capital gains, is how long is takes us to have data about what is happened recently. So if you think about it, capital gains often go to people with complicated tax returns. People with complicated tax returns often do not file until October of the year during which their taxes are due. It takes a while for the IRS to get the data together. And as a result, for people who are trying to study capital gains realizations and project them on behalf of the Congress we are actually operating—I forget the exact period. but we are operating with roughly a 2-year lag in which we are kind of guessing, to be honest. So it is hard to know exactly what is going on.

I think unfortunately there is some irreducible uncertainty about capital gains realizations. They bounce around, for reasons that professional economists have not yet been able to fully ascertain.

And then, perhaps to be more responsive to your question, I think it is always helpful and fruitful to revisit the techniques we use to forecast these things. And to the extent that there is room for improvement there—I cannot speak to it because I am not exactly sure how JCT does it, but to the extent that there is room for improvement——

Senator ALLARD. I appreciate the last part of your response. I do think we need to look at it, and hopefully we can do something to make this more accurate.

That is the whole point of my question. I think that, as policymakers, it serves us all if we can improve the accuracy so it truly reflects. It is a chronic problem with capital gains. Every time it is come through this Congress, it is been—revenues from reduction of capital gains has been badly underestimated. And I do think we need to look seriously at that.

With your indulgence, and perhaps maybe the minority members' indulgence, I have another question on flood insurance. We are going to be increasing the debt limit on how much the National Flood Insurance Program can incur. I guess we do not know exactly where that number is going to be, but we are going to be increasing that up to $23 billion. In other words, they can incur these obligations on flood insurance up to that because of what is happened with Katrina.

So you have this that is increasing. And then we have this other obligation of how we are going to pay for the current program, there is actually two aspects to it. And we have people that are exempted from having to pay flood insurance because they were there before the program was initiated.

Do you have any ideas on how we can make this program more actuarially sound? And perhaps maybe you do not have any ideas but I think it would be helpful for those of us who happen to be on the Banking Committee to get some kind of written—me personally, I would be particularly interested in getting some kind of written response to that, what we can do to actuarially make our flood insurance program sustain itself without having to have a future obligation we are placing on it by increasing this debt limit, that we are looking at putting around probably somewhere around $23 billion.

Mr. MARRON. Sir, as you know, I had the opportunity to appear before the Banking Committee last week and talk a little bit about these issues. I would be happy to provide more detail on anything you have in mind.

The key issue which you identify is there is a certain group of properties that are subsidized under the program. They pay premiums that are significantly less from what people believe would be actuarially fair, and particularly what FEMA estimates would be actuarially fair.

To eliminate that by itself, the natural economist response would be to raise premiums, but that clearly raises issues about some of those people dropping their coverage and whether that is a desirable public policy outcome. Other ideas were brooded about at the hearing and we would be happy to followup with you.

Senator ALLARD. I would appreciate taking a little time to discuss that with you.

I thank the indulgence of the chairman and minority party.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. Thank you and welcome, Mr. Marron. It is good to see you, as a member of the Banking Committee as well, seeing you in front of both committees.

Mr. Chairman, I feel like Yogi Berra when he said it is deja vu all over again. It seems that every year that I have been on the committee since 2001 we have heard about growing deficits. We have heard about what is happening in terms of the budget.

When we look at the fact that now the projection from CBO, understanding that you have to project out with current policies, is going to be $1 trillion over the next 10 years for our children and our grandchildren. It is astounding.

And when we figure in what Senator Conrad was talking about, with the costs of the war and Katrina and all of the other issues, we are talking more like $4 trillion, which is stunning when we look at these numbers.

Mr. Chairman, we have a lot of work to do on this, as I know you know.

I wanted to speak to the question of wages. We are always, I think, in a classic debate about supply and demand and where that balance is. I think some of my colleagues feel it should all be about supply side tax cuts, focusing on that. Others of us believing that it is about wages, money in people's pockets as well as being able to support investments and so on.

And I certainly have to say that with my friend, Senator Allard, who just showed the charts on wealth, I assume that the only way we could get those kind of numbers would be to include equity in people's homes. Because certainly people are not feeling that somehow they are wealthier, certainly in my State, and in many other States across the country. They may have a home with more equity in it but they cannot sell the house. They have to live in the house. It does not pay the heating bill. It does not pay the gas bill. It does not send the kids to college.

So where the rubber meets the road in Michigan it is a very different picture.

But I wanted to just raise an interesting section on 121 of your report, just an interesting comment that I think is important to this debate. You talk about two of the most important types of income for projecting Federal revenue are wages and salaries and corporate profits. And you say wages and salaries are the most highly taxed component of income—wages and salaries—being subject to income tax and Social Security and Medicare and so on.

And then you say consequently, CBO estimates that an additional dollar of corporate profits produces less revenue than an additional dollar of wages and salaries. Thus, higher projections for wages and salaries and correspondingly lower projections for profits result in higher projected budget received.

And you go on to talk about that relationship to lowering the debt.

I say that to followup on Senator Menendez's comment about valuing work. Valuing work. I mean, here we are talking about how the way that people are taxed the most in our country are through wages and salaries. Is the person working every day getting a paycheck? But then we go to this debate about capital gains possibly at the expense of the Alternative Minimum Tax hitting middle income people. And this seems to go certainly contrary to the picture of what is really happening if, in fact, the wages and salaries of Americans are the most highly taxed part of the revenue that is received for the Federal Government.

And we are debating with the House of Representatives about whether 19 million people ought to get a tax increase right now because they bump up against the AMT ceiling versus giving another tax cut for people who earn their money off of investments.

So I wonder if you might just speak for a moment about the importance of jobs or wages and salaries. I would argue that it is not only about revenue for the Federal Government, but that in my State, where we are losing jobs, we have lost one-third of our manufacturing jobs in the last 5 years, we are really fighting for our way of life in our country and it is about jobs.

And we cannot just say this is about top down economics. It has to also be about somebody working, having wages, having money in their pocket to purchase things, to drive the economy as consumers.

So I wonder if you might just speak—I guess I would not have a specific question for you other than to say that wages and salaries and people working are an important part of this equation; isn't that correct?

Mr. MARRON. Absolutely. Wages and salaries, clearly they are important for tax revenues. They are important for providing people with the money to live on and accomplish the things that they want to accomplish.

I guess as an economist, the point I would emphasize is that the wages and salaries come from employers. And so you have to think about the balance of setting up an environment which makes employers as enthusiastic about hiring people as possible.

From an individuals' point of view, a key determinant of how much you get paid obviously are your skill levels and your education. From the employer's point of view, the key determinant of how much they are willing to pay you is essentially how productive you can be for them. And over very long periods—not even very—over long periods what economists have found is that a key determinant of that is productivity growth. And then a key driver of productivity growth is capital accumulation.

So that one channel actually for raising wages and salaries in the long run is to make sure that our companies invest, buildup capital, and therefore in the future are willing to pay high wages and salaries to their workers.

I just want to emphasize lowering taxes for capital does not necessarily mean you are not helping workers.

Senator STABENOW. I understand that. But doing that at the expense, as a tradeoff to lowering taxes on wages or salaries or doing other things such as lowering health care costs, protecting somebody's pension, lowering the cost to go to college, it all is a package. And we do not often enough, in my opinion, focus enough on that whole package.

Let me just say, in conclusion, that in a global economy I think that debate changes from what you are saying. We have seen productivity go up and jobs go down and investments go overseas. The reality is in a global economy that our workers can and are more productive than they have ever been. But because of what is happening in the global economy, because we fund health care differently than any other country, because we do not enforce our trade laws on currency manipulation or counterfeit parts—and I will give you one example of $12 billion counterfeit auto parts coming into this country. Illegal. Illegal. We have beefed up our laws, and yet we are doing nothing about it. And it is cost 200,000 jobs. People stealing our patents.

I would just suggest that if we only say that this is about on the supply side, we have no guarantee that that capital is going to be in the United States unless we address the other pieces that unfortunately, because of the deficit right now and the tradeoffs that are being made, we are not addressing. We are not addressing. We would be a lot better off for jobs, that wages and salaries component that you are talking about for revenue for us, if we were to invest those dollars on the high-end tax cuts back into paying for health care and helping manufacturers build to compete in the global economy to keep high wages here and invest in our people here at home.

I would just say, Mr. Chairman, that I think part of all of this, as well, is when you talk about investing for the future and what employers want in a skilled work force, the $12 billion we just cut in student loans goes contrary to anything that we ought to be doing, in my mind, to compete in the global economy.

Thank you.

Chairman GREGG. Thank you, Senator.

I would point out that there was no reduction in student loans. In fact, what we did was reduce the rate of return, which was a windfall of significant proportions to the lenders. And then we took some of that money and we actually put it into expanding the benefits to students, through expanding the Pell grants. We took some of that money and moved it toward deficit reduction.

Senator STABENOW. Mr. Chairman, if I might just insert one thing, and that is over $12 billion was shifted onto people who get student loans. We are already seeing a change in Michigan.

Chairman GREGG. No, that is not true, Senator. As a practical matter, that is a representation that has been made that is totally inaccurate.

The HELP Committee produced a bill which reduced the subsidy to the lender community, which if we had not done, quite honesty, would have dramatically—would have created a dramatic windfall to the lender community.

We did keep a fixed loan rate, which was a mistake. We did not go to a variable loan rate, which would have benefited students.

But I would point out that that was at the request of the Democratic side of the aisle. That those of us who wanted a variable rate, which would have allowed students to get a better deal even, were not able to get that through the Committee because of the opposition of Senator Kennedy.

This representation that student loans have been cut is a canard.

Senator STABENOW. I look forward to debating the results of the policy we passed, as it becomes apparent. Thank you.

Chairman GREGG. So do I, because I think the numbers are pretty clear—

Mr. Marron, the asbestos bill that is going to be coming to the floor, we have a reserve fund that this Committee put in place that is has some—that basically wants to keep this bill—is structured for the purpose of keeping the bill from costing the American taxpayer money. What is CBO's view of whether or not this bill is going to cost us money?

Mr. MARRON. The structure of the program, as I understand it, is to raise revenues in various ways and then to spin them out to beneficiaries who are stipulated under the bill language. The way that is going to be accounted for is that the money that comes into the fund are indeed treated as revenues to the Federal Government. And that, as a result, the money that goes out to pay claimants is treated as spending.

So in an accounting sense, it is clearly going to be a spending and revenue program.

If your question is how does—is your question how it operates over the long run and what its long-run prospects are?

Chairman GREGG. My question is that if I am asked, as Chairman of the Budget Committee, whether or not the conditions of the reserve fund are met, which is that this will not be an obligation which falls onto the American taxpayer but will be paid for by the community which has agreed to absorb the responsibility, am I going to be able, as Chairman of this Committee, to say in good faith no, the American taxpayer will not have to pay the bill here.

Mr. MARRON. I think that—as written—the bill is intended to have a structure in which the administrator of the fund is supposed to stop paying claims if they believe that the claims will exceed the revenues that come into the program. And so, in principle, it is supposed to stop and not spend more money than it is going to receive.

Whether that actually executes as written, I think will depend on kind of the discussions that happen at that point. That would be a projection of what policy changes might be in the future, but clearly we would understand that there is the possibility that there would be pressure to have the Federal Government step in.

I am giving you an on the one hand/on the other hand answer.

Chairman GREGG. It appears that way, yes. Unfortunately, whether I make a point of order is not an on the one hand/on the other hand issue.

Senator CONRAD. Can I make a point on this?

Chairman GREGG. Yes, of course, jump in.

Senator CONRAD. If I could say, Mr. Chairman, my people have done a report that is now on my desk that I will be sharing with you hopefully later today. I have not had a chance to read it.

I have asked for the conclusion—and this is with respect to the issue that you are raising. And my people have no ax to grind here. And they have reported to me that they believe, in nominal terms over the life of the program that this proposal is $150 billion underwater.

Chairman GREGG. On top of the $150 billion that is——

Senator CONRAD. Yes. That the shortfall over the 50 year life is $150 billion. That is the nominal shortfall.

Chairman GREGG. Let me see if I understand that. CBO has estimated—the general estimate is that this program is going to cost $140 billion?

Senator CONRAD. Correct.

Chairman GREGG. So you are saying there is another $150 billion on top of it?

Senator CONRAD. Correct. Over the life of the program, the net present value—net present value—shortfall is $50 billion.

Mr. Marron, I think you have said on many occasions that the risks to this program all run toward the taxpayers—that they are heavily weighted in that direction. Is that not correct? CBO found that your estimates of the risks here run in the direction of taxpayers?

Mr. MARRON. We have our official numbers, official estimate. And then there were a variety of things that we were not able to price out and cost. Most of those seem to point toward higher costs than the range we have. There is at least one study that would be done that could point the other way. So there is some possibility of being lower.

But again, we are in the business of scoring legislation as it is written. And as we understand as it is written, it is supposed to stop at $140 billion. But I am sympathetic to where you gentlemen are coming from, which is it is not entirely obvious that that would actually be what reality looks like.

But from where we sit, I cannot say too much on that.

Senator CONRAD. I understand the strictures that you are under.

I would just say to my colleague I asked this question of my staff, professional staff. They spent a lot of time analyzing this. They came back to me and they said they think this is way underwater.

As I have looked at their work, and I have not read the whole analysis that they have just put on my desk I think yesterday or the day before, it really is striking. It really is striking.

The assumption that the fund is ever going to stop, I think we have to do a reality check here. Is there any prospect, once this thing gets going, that it is going to be stopped? I think that is just—I know that you have to assume that it does stop. But the reality, all of us who are here, I think we all know what is going to happen. They are not going to stop.

Chairman GREGG. Senator Stabenow, do you want to—I know this is an issue for your state.

Senator STABENOW. It is. In an ideal world—yes, thank you.

I am very concerned about the numbers, Mr. Chairman, as I mentioned to you. In an ideal world, this is an issue for us and our manufactures and I would like to see a trust fund that works. But there are a lot of issues that have been raised and the budget numbers are of concern to me. And so I am anxious to look at what Senator Conrad has been talking about before making a final decision myself.

Chairman GREGG. We look forward to getting this information from you and your staff.

On another question, to what extent are you factoring in oil costs? It appears we are in a world where $60 a barrel is, for the foreseeable future, the number, maybe even higher depending on demand coming out of Asia and what happens in places that are fairly unstable like Nigeria and Venezuela and, of course, the Arab nations such as Iraq and Iran.

Mr. MARRON. Our economic projection is built off of substantially higher oil prices than we have ever had before in one of our projections. It starts off in the neighborhood of the high 50's. I remember we locked down our economic forecast a bit over a month ago. Essentially it has prices at that level and then rising with inflation in the later years of the forecast. So we definitely have what traditionally has been viewed as high oil prices.

In the intervening month, oil prices have gone up even further, and it is something clearly that we are keeping an eye on to see to what extent that may have some dampening effect on the economy.

Chairman GREGG. As you know, one of the amazing things about the American economy and the American people are that we react and we are flexible. How do you factor this in to out-year productivity, which is clearly going to have an impact? Do you presume we will innovate out of this? Or do you presume that you just pick a static number and go forward?

Mr. MARRON. This is not something that we factor in, in an incredibly detailed level, into the projections that we make. As you say, the economy has been very resilient and flexible in the past. It is absorbed various shocks in various areas. In terms of projecting longer run productivity growth, we essentially look at a snapshot of recent history and use that as our projection of what will happen in the future.

Chairman GREGG. I do think this is a huge issue for us, because I do not think we have had this type of shock to our economy in a long time. I think we are just beginning to have the impact of it felt. Hopefully, we can innovate our way out, or at least through policy drive other sources of production.

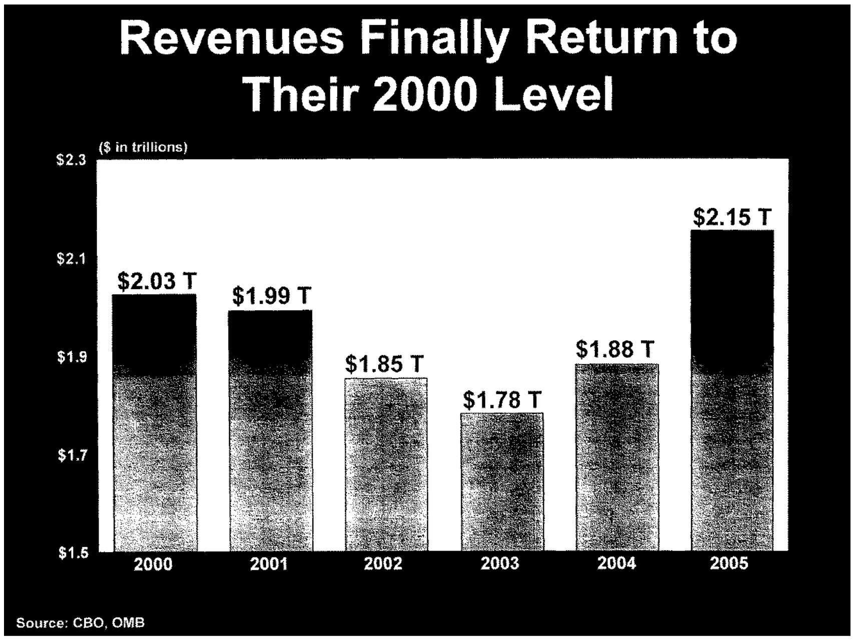
But in any event, it looks like this price for production, whether it comes from ethanol or whether it comes from some other nuclear—it still looks like the price is going to—we are going to have a new base on an economy that was built on $11 to $15 per barrel of oil, and it is got a base of $60 a barrel, and that changes a lot of things in an economy. And the changes will not be immediate maybe, but they will certainly have an impact over the long run, I would think, on productivity and on the development of wealth, the development of capital.

I would be interested if you could have some of your thinkers take a look at that beyond the static approach and give us your reaction. If we are going to go out—and even if it is not oil—whatever it is. If we are going to pay for that unit of energy $60, what $60 translates into, whether it comes from some other source or not, as versus what has historically been probably $15. What is that sort of a quadrupling of the cost of that unit of energy do to our economy over the long run? And how—well, you do not answer this, this is our job. But when we have that number, how should we try to address it?

Mr. MARRON. I would be happy to.

Chairman GREGG. Thank you. Senator Conrad.

Senator CONRAD. Mr. Chairman, let me just go back. My colleague from Colorado made a number of characterizations of charts that I put up. He said that with respect to revenue and the drop in revenue compared to where we were, that that happened before President Bush's policies took hold. That is just not the case. That is just factually not the case.


Revenues Finally Return to Their 2000 Level
($ in trillions)
$2.3
$2.1
$1.9
$1.7
$1.5
$2.03 T
$1.99 T
$1.85 T
$1.78 T
$1.88 T
$2.15 T
2000
2001
2002
2003
2004
2005
Source: CBO, OMB

In 2000 we had over $2 trillion of revenue. In 2001, the first year of the President's administration, we had almost $2 trillion. In 2002, after the big tax cuts of 2001, revenue was down.

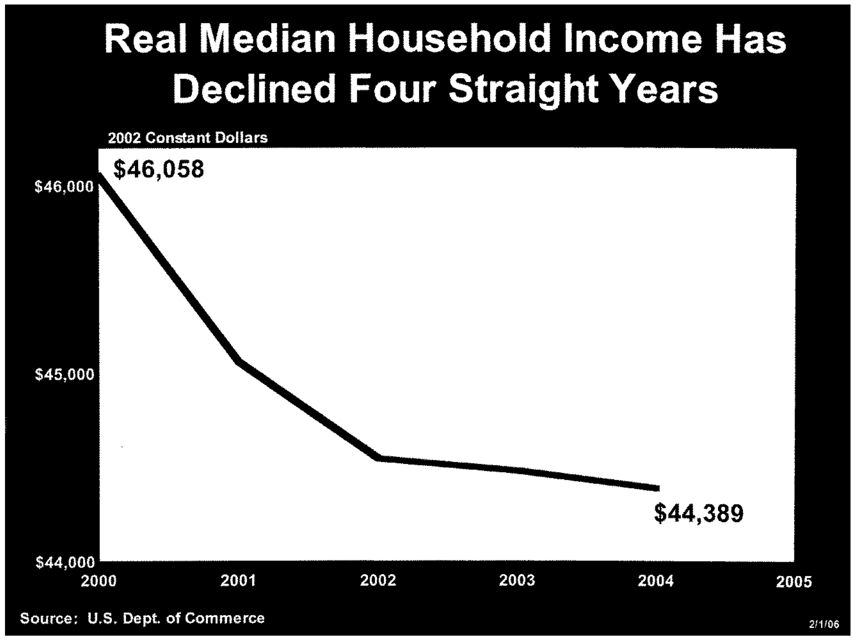
More tax cuts in 2002. In 2003 revenues are down more.

Then we had an uptick in 2004 but still way below where we were back in 2000. Much less revenue.

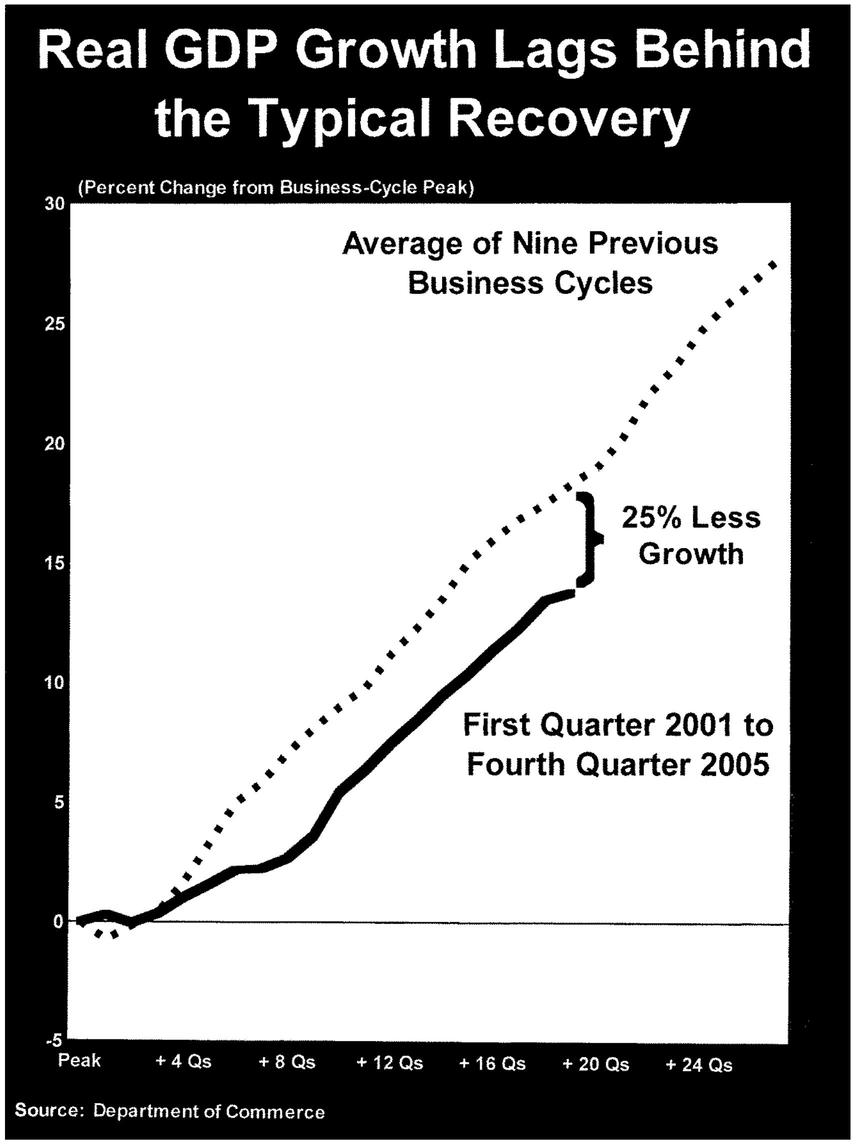
Only now, 5 years later, are we back—and this is in dollar terms. If you look at this with inflation taken out, we have still not recovered.

Now we are in the fifth year of the presidency. To say that his policies have not taken hold, I do not think it is factually correct.

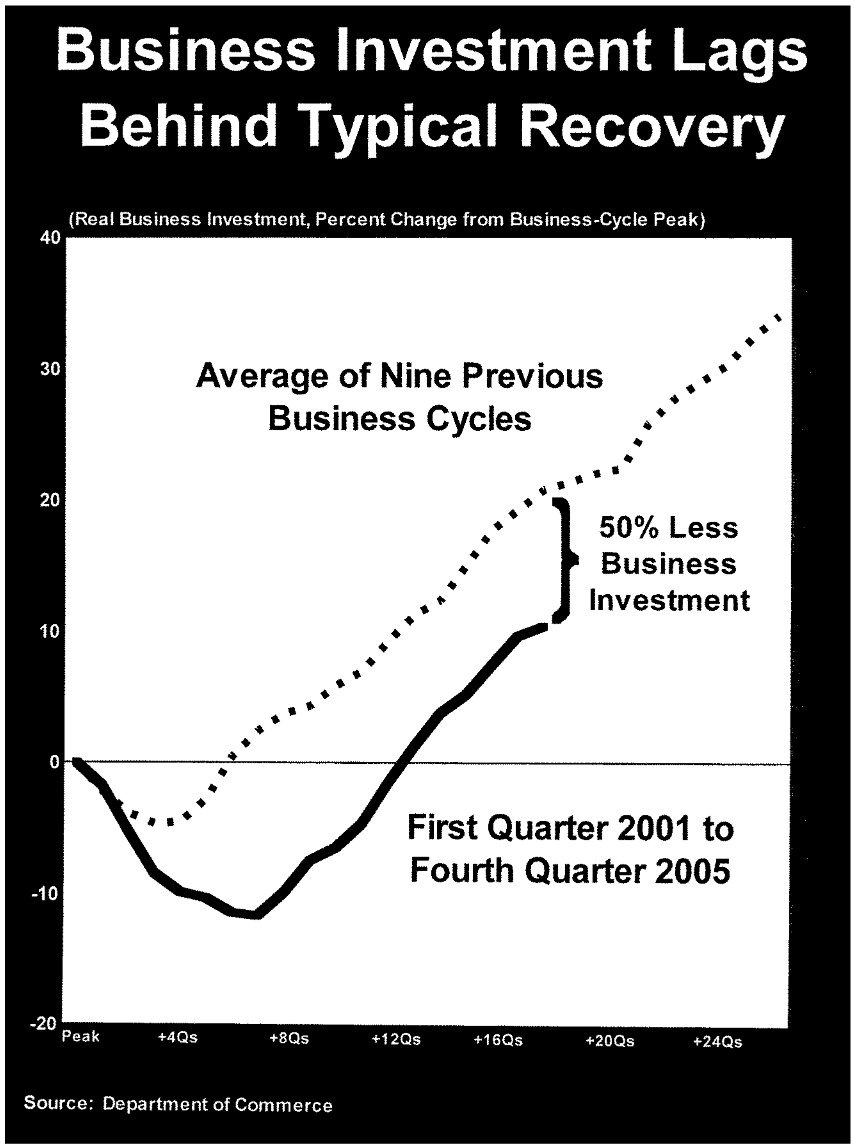
The Senator from Colorado talked about how good the economy has been. Let us look at a number of measures here. This is what has happened to real median household income. It has declined for four straight years. We believe the 2005 numbers will show a further decline. This is inflation adjusted household income. It has gone down every year. That is not the sign of a good economy.


Real Median Household Income Has Declined Four Straight Years
2002 Constant Dollars
$46,058
$46,000
$45,000
$44,000
$44,389
2000
2001
2002
2003
2004
2005
Source: U.S. Dept. of Commerce
2/1/06

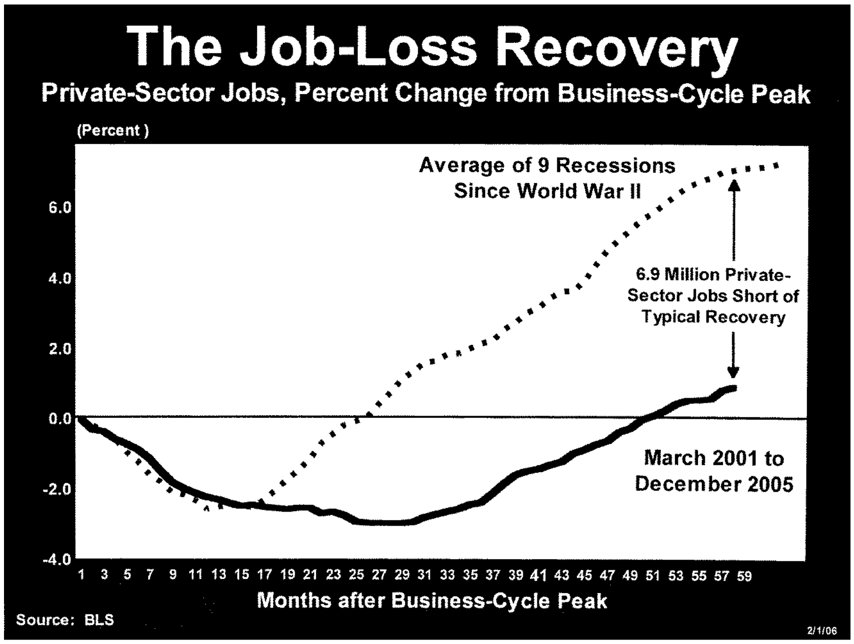
Let us compare what has happened in this economic recovery to the other major recoveries that have occurred since World War II. There have been nine business cycles, major recessions, since World War II. The red dotted line is what has happened to GDP growth coming out of those recessions. The black line is what has happened in this recovery. It is 25 percent weaker than the average of all of the other recovery since World War II. That is GDP growth.


Real GDP Growth Lags Behind the Typical Recovery
(Percent Change from Business-Cycle Peak)
30
25
20
15
10
5
0
-5
Peak
+ 4 Qs
+ 8 Qs
+ 12 Qs
+ 16 Qs
+ 20 Qs
+ 24 Qs
Average of Nine Previous Business Cycles
25% Less Growth
First Quarter 2001 to Fourth Quarter 2005
Source: Department of Commerce

Let us look at business investment. Business investment is even worse. Again, the dotted red line is what we have seen in each of the other recoveries since World War II, the average. The black line is what we are seeing in business investment in this recovery. It is 50 percent lower than the average of all other recoveries since World War II.

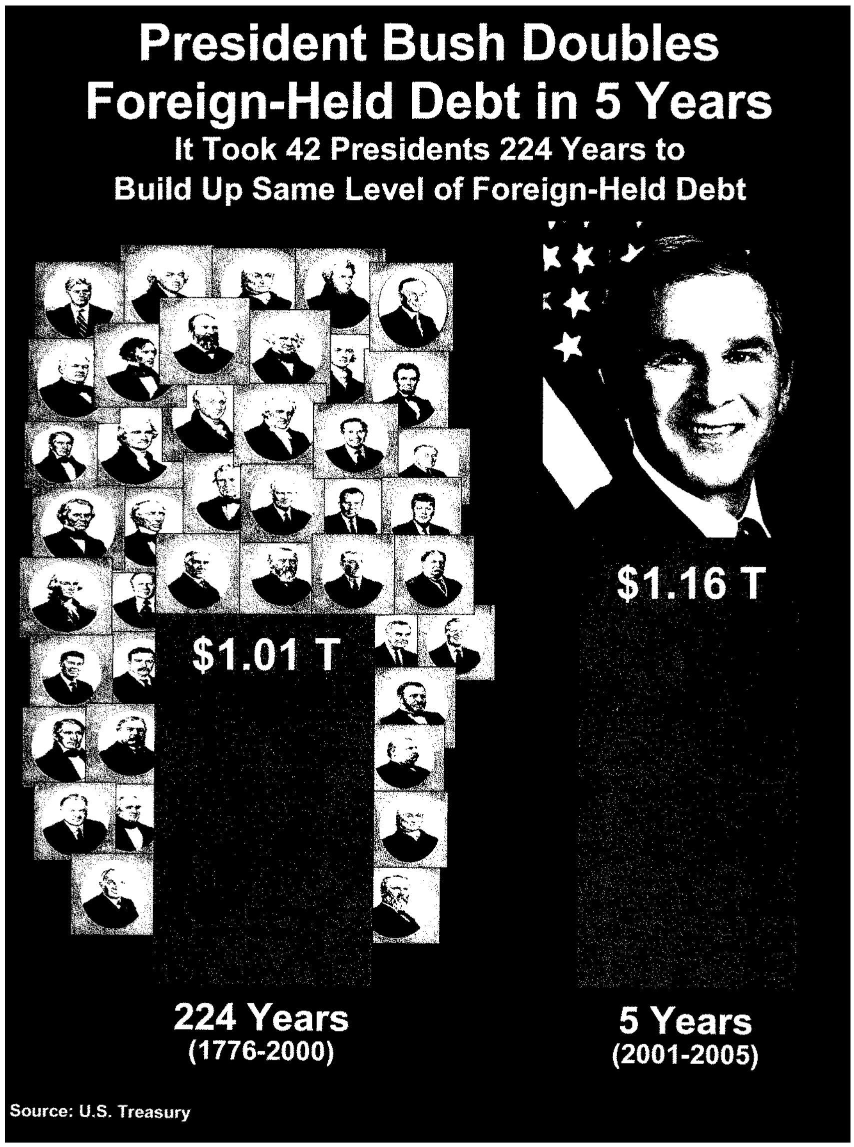

Business Investment Lags
Behind Typical Recovery
(Real Business Investment, Percent Change from Business-Cycle Peak)
40
30
20
10
0
-10
-20
Average of Nine Previous
Business Cycles
50% Less
Business
Investment
First Quarter 2001 to
Fourth Quarter 2005
Peak
+4Qs
+8Qs
+12Qs
+16Qs
+20Qs
+24Qs
Source: Department of Commerce

Job loss recovery. Again, the red dotted line is the average of all the recoveries, the major recoveries, since World War II. The black line is what we are getting in this recovery. We are 6.9 million private sector jobs short of the typical recovery.

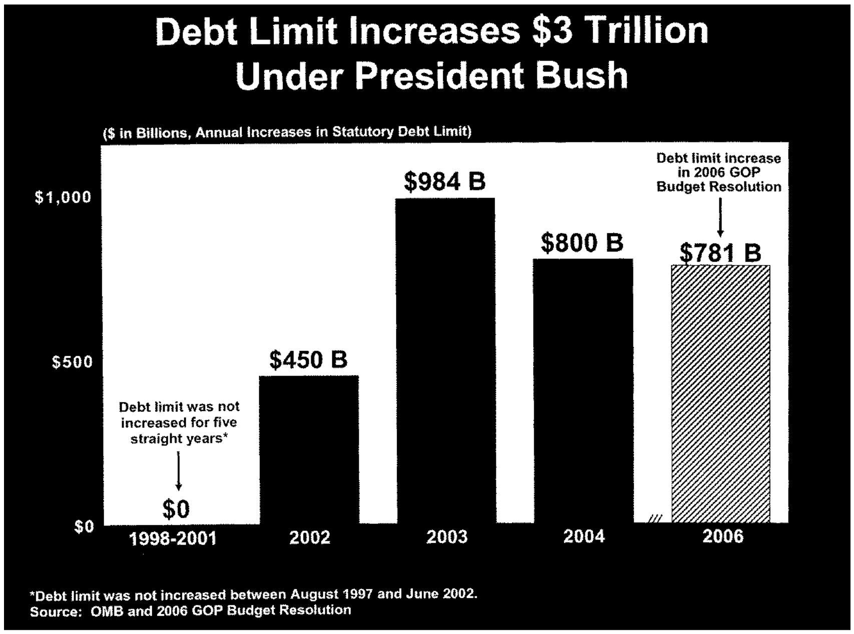

The Job-Loss Recovery
Private-Sector Jobs, Percent Change from Business-Cycle Peak
(Percent)
Average of 9 Recessions Since World War II
6.9 Million Private-Sector Jobs Short of Typical Recovery
March 2001 to December 2005
6.0
4.0
2.0
0.0
-2.0
-4.0
1 3 5 7 9 11 13 15 17 19 21 23 25 27 29 31 33 35 37 39 41 43 45 47 49 51 53 55 57 59
Months after Business-Cycle Peak
Source: BLS
2/1/06

Something is wrong here. Something is wrong here. Something has fundamentally changed. I would argue it is what is happening with international competition.

The result is, what the Senator did not want to talk about, is what has happened to the debt. The debt has skyrocketed. And the external debt of the United States has more than doubled. It took 224 years and 42 presidents to run up a trillion dollars of external debt. This president has doubled it in 5 years, more than doubled it.


President Bush Doubles
Foreign-Held Debt in 5 Years
It Took 42 Presidents 224 Years to
Build Up Same Level of Foreign-Held Debt
$1.01 T
$1.16 T
224 Years
(1776-2000)
5 Years
(2001-2005)
Source: U.S. Treasury

Let me just show, finally, the other thing he did not want to talk about is what has happened to the debt. In 1998 to 2001, we did not add any publicy-held debt in this country. Nor did we increase the debt limit. In fact, we were paying down debt.


Debt Limit Increases $3 Trillion
Under President Bush
($ in Billions, Annual Increases in Statutory Debt Limit)
$1,000
$500
$0
Debt limit was not
increased for five
straight years*
$0
$450 B
$984 B
$800 B
Debt limit increase
in 2006 GOP
Budget Resolution
$781 B
1998-2001
2002
2003
2004
2006
*Debt limit was not increased between August 1997 and June 2002.
Source: OMB and 2006 GOP Budget Resolution

In 2002, we had to add $450 billion to the debt limit. In 2003, $984 billion was added to the debt limit. In 2004, $800 billion. Now in 2006 they want to add another almost $800 billion.

So, unfortunately, an awful lot of what is going on here is being put on the charge card and increasingly it is a charge card that is owed to foreigners.

I would just ask, Mr. Marron, do you believe it is sustainable—sustainable to have this growth of debt held by foreign entities? We had 100 percent increase, more than 100 percent, in 5 years.

Mr. MARRON. If I think about it in terms of the current account deficit and what would be sustainable on that front, which essentially translates into the debt as it builds, our analysis suggests that if the current account deficit were to hold at its current level in nominal dollar terms, and therefore decline over time as a share of the economy, that would probably return back to a sustainable level. But if it stays the same, relative to the size of the economy, over time that would be extremely difficult to sustain.

Senator CONRAD. I deeply believe that the combination of our trade deficit and our budget deficits, especially in light of the demographic time bomb that is coming at us, this is utterly unsustainable.

I would just ask you, on the question of budget policy, do you believe, Mr. Director, that there is an imperative for us to act on these long-term imbalances in our budget accounts?

Mr. MARRON. Sir, the long-term situation would seem to be unsustainable, and I think I am well within the range of what CBO Directors and Acting Directors are allowed to do if I were to say that addressing those earlier rather than later is probably helpful for everyone involved.

Senator CONRAD. I know the Chairman believes that. I certainly believe it. The quicker we get at this, the better. And I hope that is the conclusion that comes from this hearing.

Chairman GREGG. Thank you.

I also think that is the conclusion that comes from this hearing, so that is a good place to stop.

We appreciate your testimony and we thank you for your time and for your professionalism and the professionalism of your organization. It is very important to us as a Congress to have a fair arbiter out there, and you are it.

Thank you.

Mr. MARRON. Thank you.

[The prepared statement of Mr. Marron follows:]

CBO TESTIMONY

Statement of
Donald B. Marron
Acting Director

The Budget and Economic Outlook: Fiscal Years 2007 to 2016

before the
Committee on the Budget
United States Senate

February 2, 2006

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, February 2, 2006. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Gregg, Senator Conrad, and Members of the Committee, thank you for giving me this opportunity to present the Congressional Budget Office's (CBO's) budget and economic outlook for fiscal years 2007 to 2016.[1]

CBO projects that under current laws and policies, the federal budget will report a deficit of $337 billion in 2006 (see Table 1). That estimate is somewhat higher than the $318 billion shortfall recorded in 2005 but about the same in comparison to the size of the nation's economy. At 2.6 percent of gross domestic product (GDP), this year's deficit would be slightly larger than the 2.3 percent average recorded since 1965.

Because of the statutory rules that govern baseline projections, CBO's current estimates omit a significant amount of spending that is likely to occur later this year. In particular, additional funding will probably be necessary in 2006 to pay for military activities in Iraq and Afghanistan and for flood insurance claims. If that funding is provided, CBO expects that outlays will grow by another $20 billion to $25 billion this year, resulting in a deficit in the vicinity of $360 billion, or about 2.8 percent of GDP.

CBO's baseline includes spending from the $50 billion that the Congress has appropriated this year for military activities in Iraq and Afghanistan, but more resources are likely to be necessary within a few months. The baseline also includes the effect of legislation dealing with disaster relief, flood insurance, and other programs that were funded in the aftermath of Hurricane Katrina and other storms. Such legislation will add an estimated $47 billion in outlays during 2006; hurricane-related tax relief will reduce revenues by an estimated $7 billion this year. But paying all claims expected under the federal flood insurance program could require a few billion dollars of additional funding for that program. Furthermore, the pending spending reconciliation act, if signed into law, would reduce the deficit by about $5 billion in 2006.

Under the assumptions incorporated in CBO's baseline—in particular, that various tax increases occur as scheduled and that discretionary spending grows at the rate of inflation—the budget deficit totals $270 billion (2.0 percent of GDP) in 2007 and continues to fall thereafter, essentially reaching balance in 2012. After that, the budget remains close to balance in the baseline, showing small surpluses ranging from $40 billion to $73 billion through 2016 (the end of the current projection period).

By statute, CBO's baseline must project the future paths of federal spending and revenues under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Underlying CBO's baseline projections is a forecast that the U.S. economy will continue growing at a healthy pace throughout calendar years 2006 and 2007. CBO forecasts that GDP will grow by 3.6 percent (in real, inflation-adjusted, terms) this year and by 3.4 percent next year. That rate of growth is projected to slow to an average of 3.1 percent from 2008 through 2011 and 2.6 percent from 2012 through 2016.

Over the longer term, the aging of the U.S. population combined with rapidly rising health care costs will put significant strains on the federal budget, which begin to be evident within the projection period. When the first members of the baby-boom generation reach age 62 in 2008, they will become eligible for Social Security benefits. As a result, the annual rate of growth of Social Security spending is expected to increase from about 4.8 percent in 2008 to 6.5 percent in 2016.

1. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006).

Table 1.

CBO's Baseline Budget Outlook

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							In Billions of Dollars							
Total Revenues	2,154	2,312	2,461	2,598	2,743	2,883	3,138	3,378	3,546	3,724	3,912	4,113	13,823	32,496
Total Outlays	2,472	2,649	2,732	2,857	2,984	3,105	3,252	3,340	3,506	3,666	3,839	4,046	14,930	33,328
Total Deficit (-) or Surplus	**-318**	**-337**	**-270**	**-259**	**-241**	**-222**	**-114**	**38**	**40**	**57**	**73**	**67**	**-1,107**	**-832**
On-budget	-494	-518	-466	-476	-474	-473	-380	-238	-243	-230	-218	-226	-2,269	-3,424
Off-budget[a]	175	181	196	217	233	250	266	276	283	288	291	293	1,162	2,592
Debt Held by the Public at the End of the Year	4,592	4,925	5,204	5,477	5,732	5,967	6,092	6,064	6,032	5,981	5,912	5,848	n.a.	n.a.
							As a Percentage of GDP							
Total Revenues	17.5	17.7	17.9	17.9	18.0	18.0	18.7	19.3	19.4	19.5	19.6	19.7	18.1	18.9
Total Outlays	20.1	20.3	19.8	19.7	19.5	19.4	19.4	19.1	19.1	19.2	19.2	19.4	19.6	19.4
Total Deficit (-) or Surplus	**-2.6**	**-2.6**	**-2.0**	**-1.8**	**-1.6**	**-1.4**	**-0.7**	**0.2**	**0.2**	**0.3**	**0.4**	**0.3**	**-1.4**	**-0.5**
Debt Held by the Public at the End of the Year	37.4	37.6	37.8	37.7	37.5	37.2	36.3	34.6	32.9	31.3	29.6	28.1	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	12,293	13,082	13,781	14,508	15,264	16,021	16,768	17,524	18,311	19,121	19,963	20,839	76,343	172,101

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

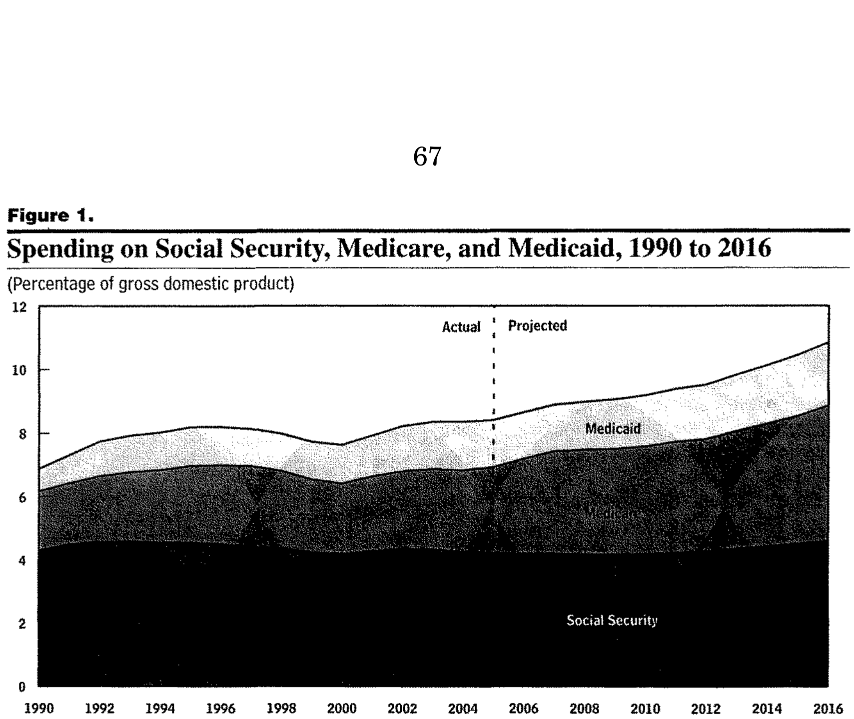
In addition, because the cost of health care is likely to continue rising rapidly, the annual rate of growth of Medicare spending is projected to increase from 7.4 percent in 2008 to about 8.9 percent in 2016. (Medicare spending is anticipated to rise by 17 percent this year and 14 percent in 2007 as the new prescription drug program gets under way.) Rapid growth is also projected for Medicaid spending—an average of 8.3 percent annually from 2008 to 2016. Under the assumptions in CBO's baseline, Social Security, Medicare, and Medicaid together will account for 56 percent of all federal spending by the end of the projection period (up from 43 percent in 2006). Measured as a share of the economy, spending for the three programs will equal 10.8 percent of GDP in 2016, up from 8.7 percent this year (see Figure 1).

Beyond 2016, those trends are projected to continue. The percentage of the population age 65 or older will continue to increase (from 14 percent in 2016 to more than 19 percent in 2030). In addition, no evidence suggests that the growth of health care costs, which have risen faster than GDP over the past four decades, is likely to slow significantly in the future. As a result, spending for Social Security, Medicare, and Medicaid will exert pressures on the budget that economic growth alone is unlikely to alleviate. A substantial reduction in the growth of spending and perhaps a sizable increase in taxes as a share of the economy will be neces-

Figure 1.

Spending on Social Security, Medicare, and Medicaid, 1990 to 2016

(Percentage of gross domestic product)



Source: Congressional Budget Office.

sary for fiscal stability to be at all likely in the coming decades.[2]

The Budget Outlook

In CBO's current baseline, deficits decline gradually through 2010, as outlays increase at an average annual rate of 4.0 percent and revenues rise by 5.7 percent a year. Beyond 2010, spending related to the aging of the baby-boom generation raises projections of the average annual growth of total outlays to 4.5 percent. However, revenues increase sharply in 2011 and 2012, growing by 8.9 percent and 7.6 percent, respectively—under the assumption that various tax increases occur as scheduled—and thereby bring the baseline projection of the budget near balance. Beyond 2012, revenues grow at about the same pace as outlays (roughly 5 percent a year), which keeps the bottom line showing small surpluses through 2016.

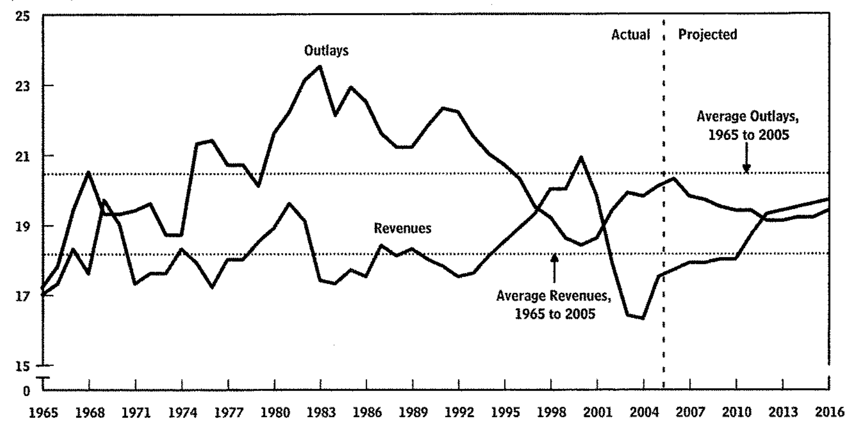
From 2007 through 2016, outlays are projected to remain between 19 percent and 20 percent of GDP under the assumptions in CBO's baseline (see Figure 2). Mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by 5.8 percent a year—faster than the economy as a whole. Discretionary appropriations, by contrast, are assumed simply to keep pace with inflation and, to a lesser extent, with wage growth. Thus, discretionary outlays are projected to increase by about 2.0 percent per year, on average—a pace less than half as fast as the projected rate of growth of nominal GDP and

2. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005), *Updated Long-Term Projections for Social Security* (March 2005), and *The Outlook for Social Security* (June 2004).

Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1965 to 2016

(Percent)



Source: Congressional Budget Office.

significantly slower than the average annual rate of 4.3 percent over the past 20 years.

According to CBO's projections, the structure of the tax code and rapid growth in retirement income will cause revenues to increase faster than the overall economy in each year of the projection period. In addition, CBO assumes—as rules for the baseline require—that the various tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and modified by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and by the Working Families Tax Relief Act of 2004 (WFTRA) will expire as scheduled. Many of those provisions are set to expire at the end of December 2010, but some have an earlier expiration date. As a result, revenues as a percentage of GDP are projected to rise slightly through 2010, from 17.7 percent to 18.0 percent, and to increase more rapidly over the following two years, to 19.3 percent of GDP in 2012. By 2016, revenues are projected to reach 19.7 percent of GDP.

In CBO's baseline, accumulated federal debt held by the public (mainly in the form of Treasury securities sold in the capital markets) equals about 38 percent of GDP through 2009. Thereafter, projections of shrinking annual deficits and small surpluses diminish the government's anticipated borrowing needs, causing debt held by the public to decline to about 28 percent of GDP by 2016.

Relative to its previous baseline projections, which were published last August, CBO's estimate of the deficit for 2006 has increased by $22 billion and its projections of deficits in 2007 through 2015 have declined by an average of about $100 billion per year.[3] Those revisions reflect no fundamental change in the budgetary and economic environment. Indeed, when viewed as a percentage of the economy, they represent a difference of just 0.5 percent of GDP over the 2006-2015 period.

Most of the changes in CBO's new baseline stem from changes in economic factors that affect revenues and net interest, which cause the projection of the deficit for the 2006-2015 period to decline by a cumulative $736 billion. CBO's projected rates of economic growth are about the same as those underlying its previous baseline. However, higher inflation in the second half of calendar year 2005, combined with an upward revision to past measures of GDP, causes CBO to project higher levels of GDP and revenues throughout the projection period. In addition, CBO anticipates slightly lower interest rates from 2008 through 2015, reducing projected net interest outlays during that time.

Differences attributed to legislation also have reduced CBO's projection of the cumulative deficit, by $157 billion. The irregular timing and varying amounts of supplemental appropriations together with the treatment of such appropriations under the rules for the baseline explain most of that adjustment. Other, technical adjustments to the baseline have had a minimal effect—upward changes to both revenues ($151 billion) and outlays ($170 billion) nearly offset each other and increase the projected deficit by $19 billion over the 2006-2015 period.

The Economic Outlook

Economic activity had considerable momentum last year, some of which will carry into calendar year 2006. CBO forecasts that real GDP will grow by 3.6 percent this year and by 3.4 percent in 2007 (see Table 2).

Despite an anticipated weakening in the housing market, economic growth will be driven by forces already set in motion—firms' continued need to expand productive capacity, solid increases in household income and wealth, and the lagged effects of declines in the value of the dollar since 2002. The housing market is expected to cool because potential buyers are likely to be deterred by concerns about the future growth of home prices and by higher interest rates. Business investment, however, will continue its recent strength because it has not yet fully caught up with the acceleration in the growth of demand in 2004 and 2005. The increases in employment and wages seen last year are also expected to continue, with the unemployment rate remaining near 5 percent, underpinning consumer spending. In addition, the lower value of the dollar combined with somewhat stronger economic growth abroad will cause exports to increase faster than imports (in real terms), CBO forecasts, bolstering the economy and keeping the U.S. trade deficit near its current level.

Along with healthy growth in demand and output, the growth of labor productivity (which usually slows in the later stages of economic expansions) will remain strong, CBO expects, though not as rapid as the extraordinary pace of the past five years. Overall inflation (as measured by the consumer price index) is likely to be lower this year than in 2005, when rising energy prices boosted it. According to CBO's forecast, the growth of the consumer price index will decline from the 3.4 percent recorded last year to 2.8 percent in 2006 and 2.2 percent in 2007. But the core rate of inflation—which excludes food and energy prices—will increase slightly in the near term, from 2.2 percent in 2005 and 2006 to 2.3 percent in 2007. Short-term interest rates are expected to rise in the first half of 2006, reaching 4.5 percent. Long-term interest rates are also anticipated to rise—to more than 5 percent, widening the spread between the rates on three-month Treasury bills and 10-year Treasury notes that existed in mid-January (when that spread was very small).

3. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2005).

Table 2.

CBO's Economic Projections for Calendar Years 2006 to 2016

	Estimated	Forecast		Projected Annual Average	
	2005	2006	2007	2008-2011	2012-2016
Nominal GDP (Billions of dollars)	12,494	13,262	13,959	16,954 [a]	21,064 [b]
Nominal GDP (Percentage change)	6.5	6.1	5.3	5.0	4.4
Real GDP (Percentage change)	3.6	3.6	3.4	3.1	2.6
GDP Price Index (Percentage change)	2.7	2.4	1.8	1.8	1.8
Consumer Price Index[c] (Percentage change)	3.4	2.8	2.2	2.2	2.2
Core Consumer Price Index[d] (Percentage change)	2.2	2.2	2.3	2.2	2.2
Unemployment Rate (Percent)	5.1	5.0	5.0	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	3.2	4.5	4.5	4.4	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.2	5.2	5.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: Percentage changes are year over year.

Year-by-year economic projections for calendar years 2006 to 2016 appear in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, Appendix E.

a. Level in 2011.

b. Level in 2016.

c. The consumer price index for all urban consumers.

d. The consumer price index for all urban consumers excluding prices for food and energy.

Hurricanes Katrina and Rita interrupted the economy's momentum temporarily. They reduced economic growth in the second half of 2005 by about 0.5 percentage points, in part by pushing up energy prices, which had already risen sharply since 2003. The impact of those natural disasters on the overall economy is expected to be relatively brief, however. This year, the recovery of energy production, rebuilding, and related activities are likely to boost growth by an amount similar to the reduction in 2005.

Beyond 2007, the pace of economic growth will probably slow somewhat. The main reason is that the labor force is projected to grow less quickly as members of the baby-boom generation begin to retire and as the scheduled expiration of various tax provisions in 2011 discourages work by raising marginal tax rates. Real GDP is projected to grow at an average annual rate of 3.1 percent between 2008 and 2011 and at 2.6 percent between 2012 and 2016. The rate of inflation is assumed to average 2.2 percent after 2007; and the unemployment rate, 5.2 percent. Interest rates on three-month and 10-year Treasury securities are projected to average 4.4 percent and 5.2 percent, respectively.

Senator CONRAD. You have done a very good job.
Chairman GREGG. The hearing is adjourned.
[Whereupon, at 11:33 a.m., the committee was adjourned.]

PREPARED STATEMENTS SUBMITTED

Michael B. Enzi

Statement of Michael B. Enzi

Senate Budget Committee Hearing:
CBO's Budget and Economic Outlook
FY2007-2016
February 2, 2006

I would like to thank Acting Director Marron for joining us today. I am looking forward to an active year in the Budget Committee as we work toward drafting the fiscal year 2007 Budget Resolution. I am pleased to hear that the Chairman will continue his work in support of fiscal discipline.

The Senate took an important step in limiting the growth of mandatory spending in December by passing the Deficit Reduction Act of 2005, *which produced nearly $40 billion in savings over 5 years*. The HELP Committee's contributions to the Deficit Reduction package account for approximately 40% of the entire savings.

However, I believe this was just a down payment. Congress needs to do more to contain mandatory spending. CBO is projecting a sharp increase in the amount of federal spending needed for Medicare, Medicaid and Social Security. Health care costs continue to rise, and our baby boomers are nearing retirement. These hearings over the next two months provide essential background for the Committee as we prepare to draft the FY2007 Budget Resolution this spring. I look forward to your input and thank you again for coming before the Committee to testify today.

THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL

TUESDAY, FEBRUARY 7, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 3:03 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Bunning, Cornyn, Alexander, Conrad, Murray, Wyden, Johnson, Byrd, Nelson, Stabenow, and Menendez.

Staff present: Scott B. Gudes, Majority Staff Director and Dave Pappone, professional staff member.

Mary Ann Naylor, Staff Director and John Righter, deputy staff director & commerce and housing credit.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will begin the hearing, and we certainly appreciate the Director of the Office of Management and Budget, Josh Bolten, being here today, someone whom I have great simpatico for because I think he is the only person in the city who upsets more people than I do just by showing up. Well, actually, Senator Bunning actually beats us both.

[Laughter.]

Chairman GREGG. Director Bolten has a very difficult job in a very complex and challenging time, which is putting together the budget of the United States. It is always hard to believe that a budget that spends $2.7 trillion is attacked for not spending enough. And yet that happens. And it is a complex budget in that it addresses today's problems, but it also has to address next year's problems and the year's after that.

I want to thank the Director, speaking on behalf of the President—not me, but the Director representing the President, for having put in play what I consider to be the biggest public policy issue which we have as a Nation beyond the question of fighting terrorism, and that is the issue of how we deal with the retirement of the baby-boom generation, which we know is going to cost us an extraordinary amount of money as a Nation because the size of the generation is so huge, and the effects of that generation's demand on their children and their children's children relative to services for their retirement in the area of pensions and health care is going to overwhelm us.

The estimates from the Comptroller's office, which is a fair arbiter on this issue, is that the unfunded liability of Medicare, Medicaid, and Social Security exceeds $47 trillion. That is over the actuarial life of those programs, 75 years. That is a hard number to comprehend, $47 trillion, but to try to put it in context, all the taxes raised in the United States since the beginning of our Government represent less than $47 trillion. The entire net worth of this country—everybody's car, house, stock, assets—is only $43 trillion, I believe. So we actually have on the books a debt that exceeds our net worth as a Nation. And it is not going down.

Last year, we put our toe in the water on this issue with a reconciliation bill which for the first time started to address mandated costs, which are health care and pensions. That passed, after a long, tortuous route, just a week or so ago, $40 billion over the next 5 years, a reduction in the rate of growth of the Government.

It had in it good policy, especially on the issue of Medicaid. This committee does not have any jurisdiction over Social Security by law. But we do have jurisdiction over the issues of health care, and so I respect and thank the administration for being willing to step forward on the issue of Medicare this year. Last year, there was some reticence to do that. This year, the budget addresses it, using what I think are fairly reasonable proposals, especially in the context of the overall Medicare spending. You are asking for, I think, $35 billion in a slowing of the rate of growth of Medicare. That means Medicare, instead of growing at 8.1 percent every year for the next 5 years, will grow at about 7.7 percent. And those reductions in the rate of growth are, as I understand it, a function of proposals that came forward from a bipartisan health care policy group, MedPAC, which is a highly respected organization and which should be listened to.

So I respect the administration's proposals there. I also respect the fact the administration understands that we are fighting a war and we have to do whatever is necessary to give our troops the support to accomplish that effort.

So we have a budget before us that obviously none of us really like in concept, but, in fact, it is something that we have to go forward with. We would rather not have a deficit projection of over $400 billion, but we understand, in light of what happened in Katrina and in light of the war we are fighting for our own survival as a Nation, that there are expenses we have to incur.

But we also have a budget that at least sets us on a policy road to try and address what I consider to be our biggest public policy issue, which is the question of how we deal with the responsibility of paying for the next generation that is about to retire, the baby-boom generation.

So I congratulate you for that, and I thank you for being willing to take the time to appear before this committee, and I will turn to the Senator from North Dakota for his thoughts, and an occasional chart, I am sure.

[Laughter.]

Chairman GREGG. Then we will hear from the Director.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. First of all, thank you, Mr. Chairman. Thank you for calling this hearing. Thank you, Mr. Director, for being here. It is always good to see you, and I enjoyed our visit the other day as well.

I think you know pretty much my criticism of the budget is that it is really not coping or facing up to the fiscal imbalances that we face as a Nation. In fact, I think the President is doing an enormous disservice to the country by not putting before the American people how serious these long-term challenges really are.

Let me just point out that these are the things left out of the President's budget. He does not have full 10-year numbers. He does not have Iraq war costs beyond 2007. He does not have the cost of fixing the alternative minimum tax. And he does not have spending policy details beyond fiscal year 2007, something that has typically been provided.

What's Left Out of Bush Budget

Full 10-Year Numbers

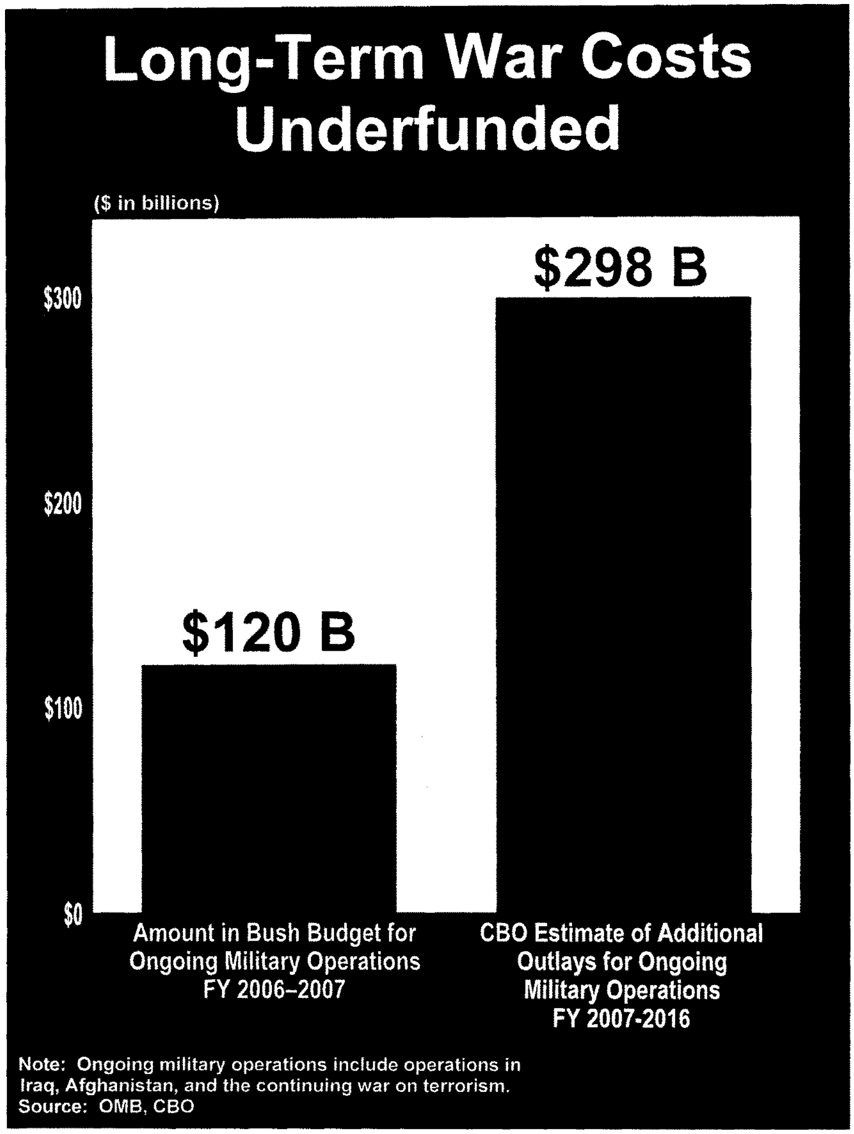
Ongoing Iraq Costs Beyond FY 2007

AMT Reform Beyond FY 2006

Spending Policy Details Beyond FY 2007
(Discretionary)

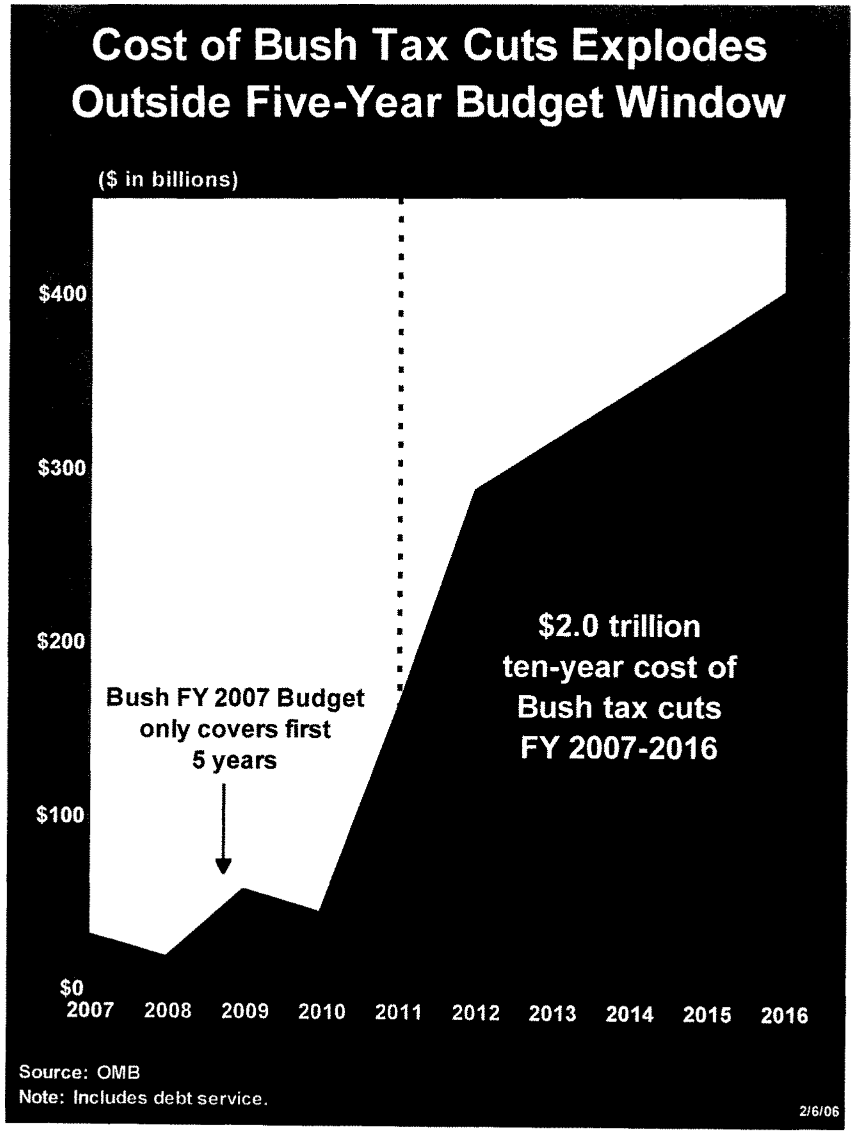
Let's go to the next slide, if we could.

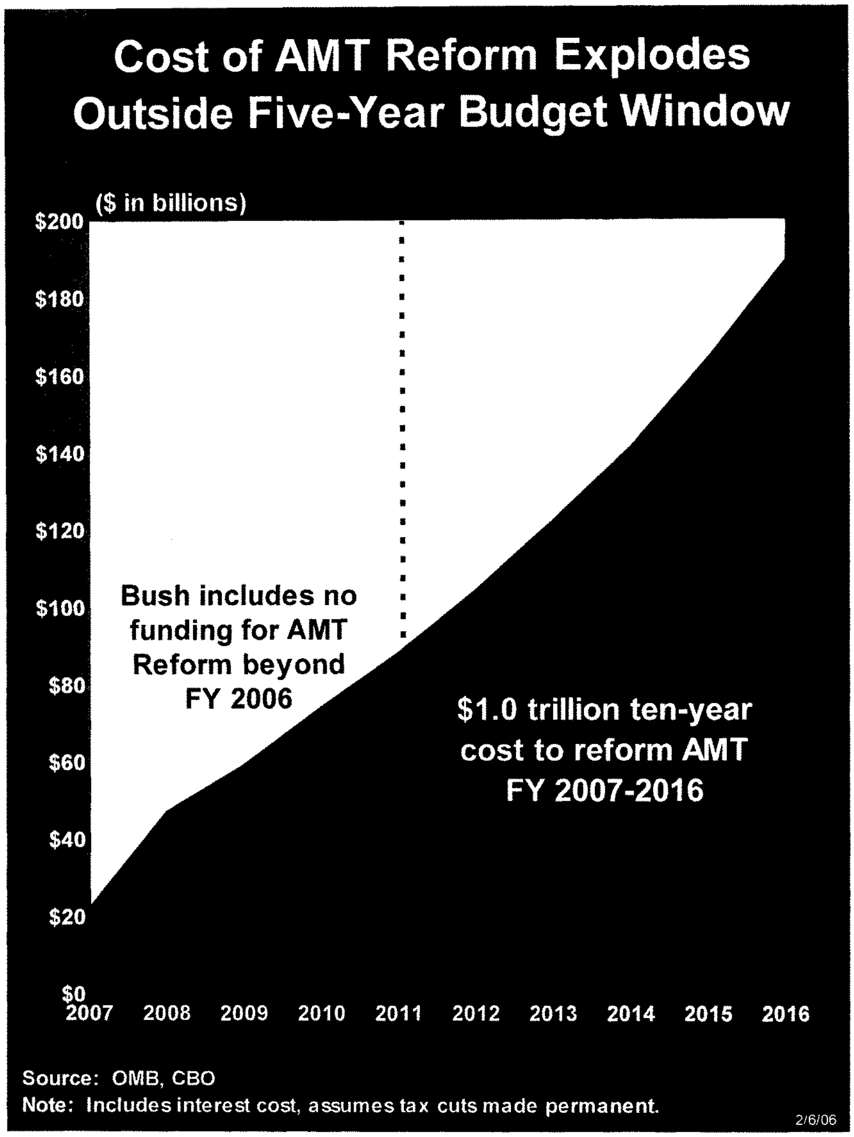
The long-term war costs are substantially underfunded. The President has $120 billion in 2006 and 2007. The Congressional Budget Office says the additional outlays that are necessary are almost $300 billion.


Long-Term War Costs Underfunded
($ in billions)
$300
$200
$100
$0
$298 B
$120 B
Amount in Bush Budget for Ongoing Military Operations FY 2006–2007
CBO Estimate of Additional Outlays for Ongoing Military Operations FY 2007-2016
Note: Ongoing military operations include operations in Iraq, Afghanistan, and the continuing war on terrorism.
Source: OMB, CBO

Let's go to the next.

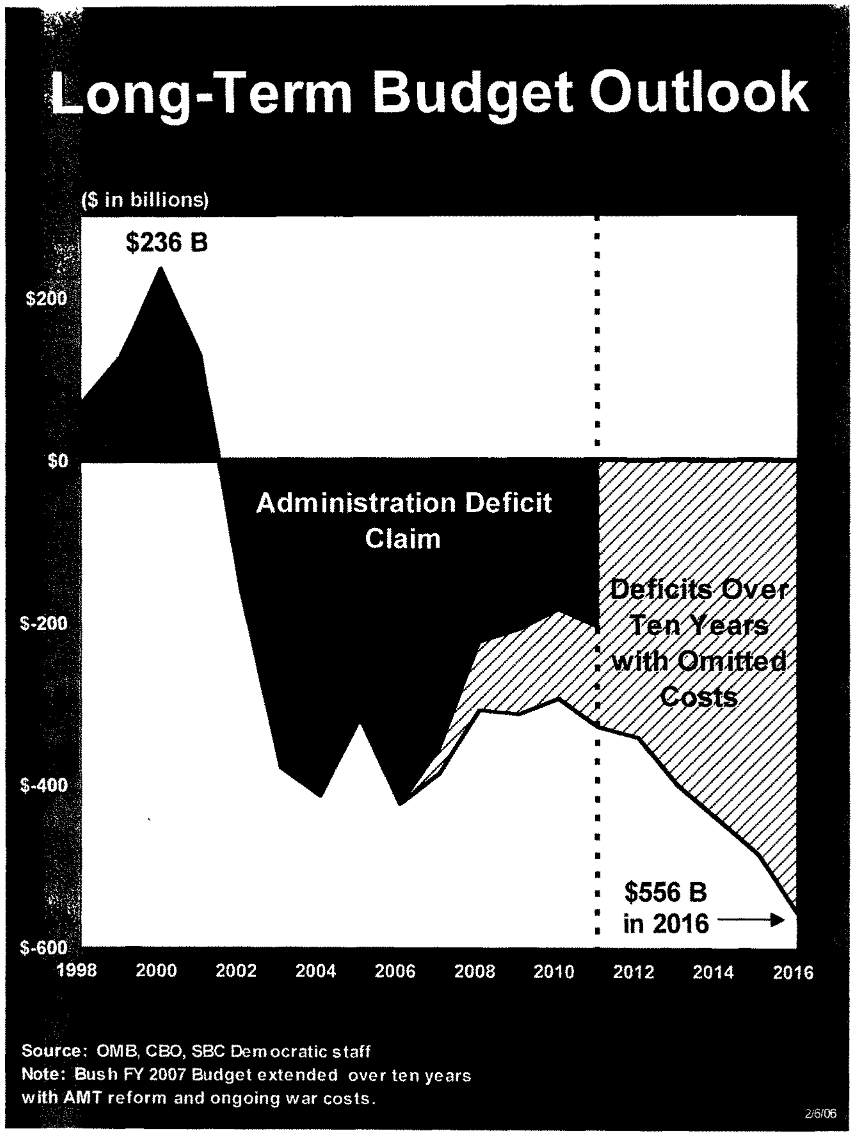
Probably the area that the President is, I think, doing the poorest job in alerting the American people as to the full costs of his proposal is in the area of extending his tax cuts and the other tax cut proposals that he has made. This dotted line is the 5 years of the budget. You can see the President's tax cut proposals explode beyond the 5-year budget window, and this pattern is very consistent, whether it is war costs or the tax cut or—let's go to the next slide—the alternative minimum—the cost of reforming the alternative minimum tax, the old millionaires' tax, it is now rapidly becoming a middle-class tax trap. The President has no funding for AMT reform beyond fiscal year 2006. So he is not facing up to any of this cost. It is $1 trillion with debt service, 10-year cost. It is not in the President's budget. That is not a real budget.


Cost of Bush Tax Cuts Explodes
Outside Five-Year Budget Window
($ in billions)
$400
$300
$200
$100
$0
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Bush FY 2007 Budget
only covers first
5 years
$2.0 trillion
ten-year cost of
Bush tax cuts
FY 2007-2016
Source: OMB
Note: Includes debt service.
2/6/06


Cost of AMT Reform Explodes Outside Five-Year Budget Window
($ in billions)
$200
$180
$160
$140
$120
$100
$80
$60
$40
$20
$0
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Bush includes no funding for AMT Reform beyond FY 2006
$1.0 trillion ten-year cost to reform AMT FY 2007-2016
Source: OMB, CBO
Note: Includes interest cost, assumes tax cuts made permanent.
2/6/06

Let's go to the next.

The President says, well, don't worry, we are going to cut the deficit in half over the next 5 years. That is this projection. But when you add back the things he has left out—the full costs of the war, the need to fix the alternative minimum tax, the full cost of his tax cuts—this is the pattern that we see. And the deficit gets a little bit better between now and 5 years from now, but then it falls off the cliff.


Long-Term Budget Outlook
($ in billions)
$236 B
$200
$0
$-200
$-400
$-600
Administration Deficit Claim
Deficits Over Ten Years with Omitted Costs
$556 B in 2016
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
Source: OMB, CBO, SBC Democratic staff
Note: Bush FY 2007 Budget extended over ten years with AMT reform and ongoing war costs.
2/6/06

Let's go to the next.

This is what the President said in 2001: "My budget pays down a record amount of national debt. We will pay off $2 trillion over the next decade. That will be the largest debt reduction of any country ever."

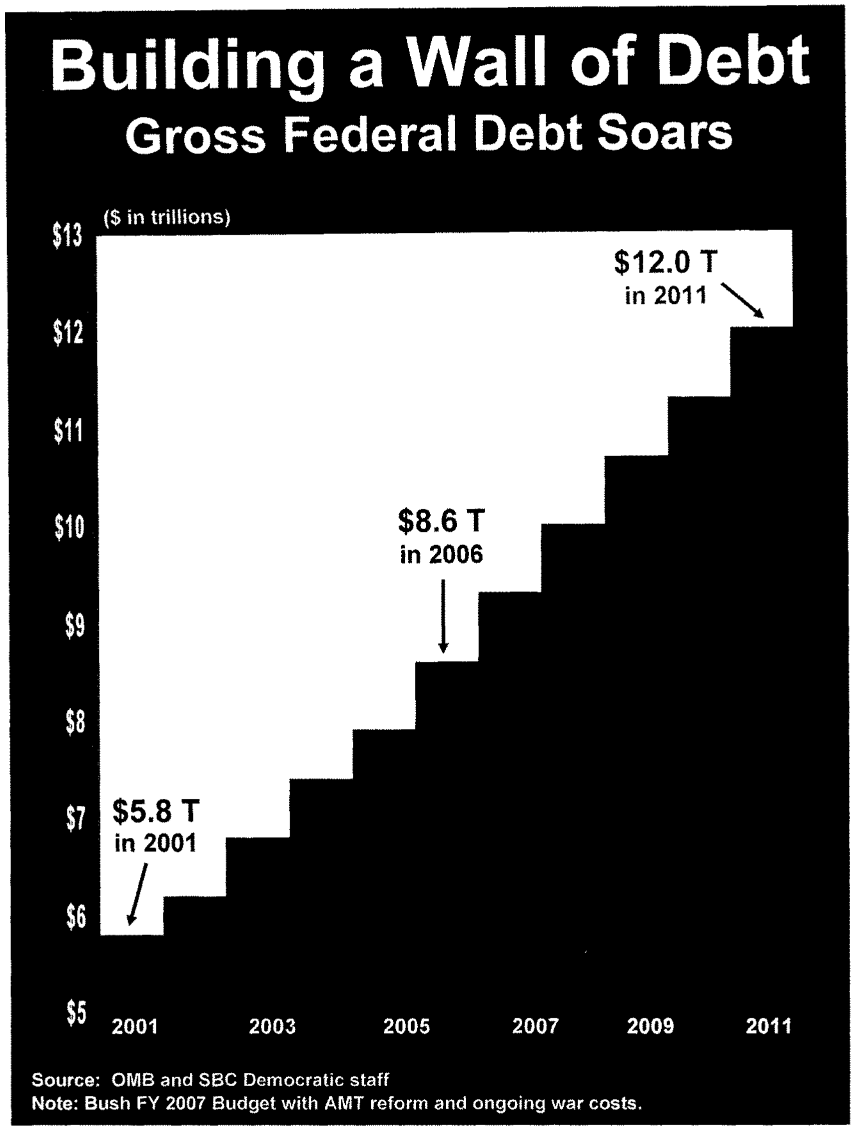
Then he said something I agree with very strongly: "Future generations should not be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren." The words were good. The performance has not been good.

Bush Administration on Importance of Paying Down Debt

"...(M)y budget pays down a record amount of national debt. We will pay off $2 trillion of debt over the next decade. That will be the largest debt reduction of any country, ever. Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren."

–President George W. Bush
Radio Address
March 3, 2001

This is my final point. This is what has happened since the President took office on the debt. There is no paydown of debt going on here. The debt is exploding. At the end of his first year in office, the debt was $5.8 trillion. That has gone up. At the end of this year it will be $8.6 trillion, and our projections now say in the next 5 years, if the President's policies are followed, the debt will reach $12 trillion—a doubling of the national debt—a doubling—before the baby boomers retire. That to me is a course that just is not sustainable, and it should not be supported.


Building a Wall of Debt
Gross Federal Debt Soars
($ in trillions)
$13
$12
$11
$10
$9
$8
$7
$6
$5
$12.0 T
in 2011
$8.6 T
in 2006
$5.8 T
in 2001
2001
2003
2005
2007
2009
2011
Source: OMB and SBC Democratic staff
Note: Bush FY 2007 Budget with AMT reform and ongoing war costs.

I thank the Chair.

Chairman GREGG. Thank you, Senator Conrad.

We would like to hear from the Director now. Give us your thoughts, and then we will ask you some questions.

STATEMENT OF HON. JOSHUA BOLTEN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. BOLTEN. Mr. Chairman, Mr. Conrad, other distinguished members of the committee, the President's 2007 budget, which I transmitted to the Congress on the President's behalf on Monday, meets the priorities of the Nation and builds on the progress of the last 5 years.

Before getting to the 2007 budget, I would like to take a moment to review the substantial accomplishments in spending restraint we were able to achieve together over the past year. We have put up on the screens for you, Mr. Chairman—and I thank you for the technology.

Chairman GREGG. This is a very high-tech committee.

Mr. BOLTEN. It is indeed, sir.

Progress on Spending Restraint

2006 Budget		2007 Budget
President's Request	**Congress Delivered**	**President's Request**
Discretionary spending below inflation	✓	Discretionary spending below inflation
Non-security cut	✓	Non-security cut
Cut or terminate 154 programs	89 programs	Cut or terminate 141 programs
$54 billion in mandatory savings	$39 billion	$65 billion in mandatory savings

Last year's budget, the 2006 budget of the President's, had four major objectives:

First, the President proposed to hold growth in overall discretionary spending below the rate of inflation.

Second, he proposed an actual cut in the non-security portion of discretionary spending, the first such proposal since the Reagan administration.

Third, he proposed major reductions or eliminations in 154 Government programs that were not getting results or not fulfilling essential priorities.

And, fourth, he proposed reforms in mandatory programs to produce $54 billion in savings over 5 years.

The Congress substantially delivered on all four of these objectives, as the chart on your screen shows in the second column. I would like to thank you, Mr. Chairman, in particular, and the members of this committee for your leadership and dedication in helping achieve those goals that are reflected in the second column on the chart on the screen.

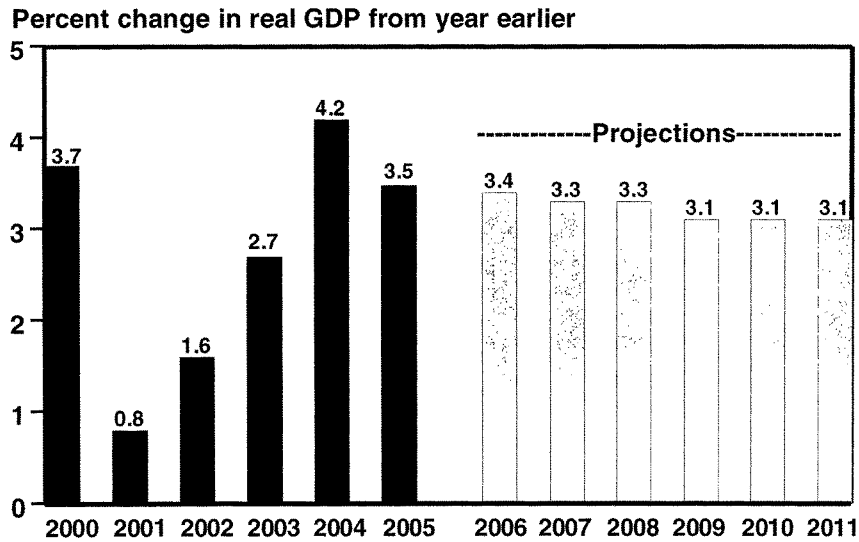
When President Bush gave me guidance on what the 2007 budget should look like, he directed me to build on last year's progress by focusing on national priorities and tightening our belt elsewhere. He told me to give our troops and those who defend our security what they need to fight and win the global war on terror. And he emphasized that the 2007 budget must support our pro-growth economic agenda.

In particular, he said we should maintain our economic strength by extending the tax relief that has fueled our economic expansion and by aggressively restraining spending. Yesterday, I presented on the President's behalf a budget that does just that.

In the past 5 years, our economy suffered a historic series of shocks, starting with the recession and the terror attacks of 2001 and continuing through the hurricanes of last summer. Those events had profound impacts on job creation and on the fiscal outlook.

Despite these challenges, thanks to the productivity and hard work of the American people, our economy, as the chart on the screen now shows, is expanding at a healthy pace. In 2005, the economy grew by an estimated 3.5 percent—the third consecutive year of healthy growth. And as you can see on the chart, we project ongoing economic strength for the next several years. Economic expansion has produced more than 4.7 million new jobs since May 2003, reduced the unemployment rate to 4.7 percent, and raised homeownership to all-time highs.

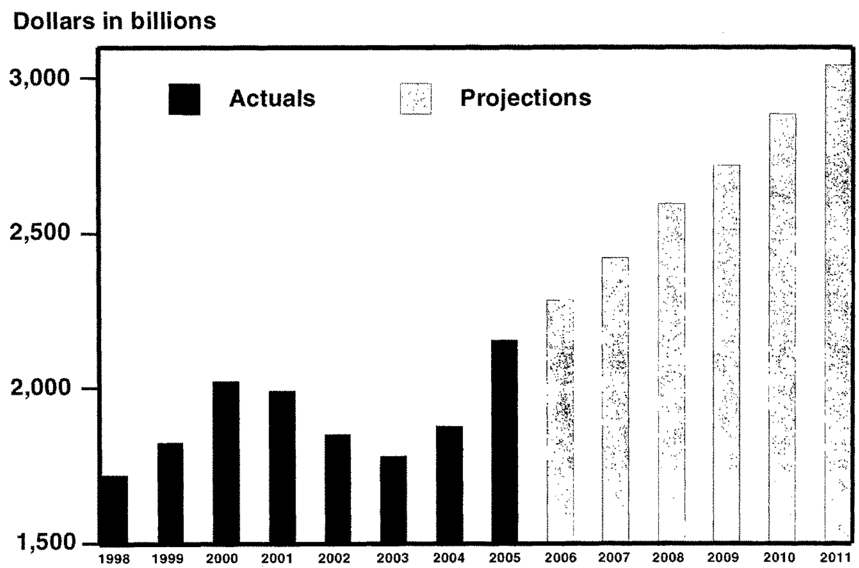
Strong Economic Growth Continues



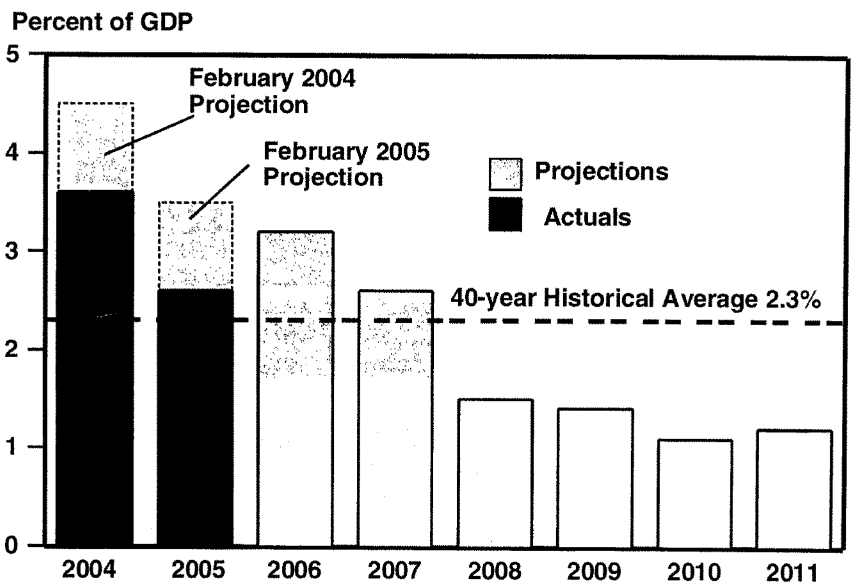
This economic growth would not have been possible without the tax relief that you in the Congress passed and the President signed. The tax cuts—which were fully implemented in May 2003—have been critical to helping the economy recover from the recession and terrorist attacks of 2001—and then helping the economy to continue expanding despite the hurricanes and high energy prices of the past year.

With the tax cuts fully implemented in 2003, the economy responded strongly and tax receipts rebounded. As you can see on this chart, receipts grew substantially in 2004. What that reflects is 5.5 percent growth between 2003 and 2004. In 2005, receipts jumped by a remarkable $274 billion, or 14.5 percent, the largest increase in 24 years. These recent gains in receipts confirm that a strong economy is the most important factor in reducing the deficit.

Actual & Projected Receipts



Cutting the Deficit in Half



The chart on the screen now shows our progress in bringing down the deficit. Since the President set a goal of cutting the deficit in half from its projected peak in 2004 of 4.5 percent of GDP, the deficit has come down markedly. The final 2004 deficit was 3.6 percent of GDP, and fueled by the surge in receipts I just mentioned, the 2005 deficit fell further to 2.6 percent of GDP.

Although revenues are projected to continue to rise in 2006, the deficit for the current fiscal year is now projected to come in at 3.2 percent of GDP, or in nominal terms, $423 billion, which is more than previously expected. This is in significant part due to the unanticipated spending associated with the relief and recovery efforts from Hurricanes Katrina and Rita. While this increase in the deficit is unwelcome, at 3.2 percent of GDP that projected deficit would be well within the historical range and smaller than the deficit in 11 of the last 25 years.

More importantly, we project that if the policies in the President's budget are adopted, the deficit will return to its downward trajectory. We forecast a decline in the 2007 deficit to 2.6 percent of GDP. By 2009, the deficit is projected to be cut by more than half from its projected peak to just 1.4 percent of GDP, well below the 40-year historical average of 2.3 percent of GDP.

In order to keep the deficit on this declining path, we must continue to do two things: first, keep the economy growing; and, second, restrain spending.

First, the 2007 budget supports continued economic growth by proposing to make permanent the tax relief signed into law by the President in 2001 and 2003. Some have argued that we should let the tax relief expire. A tax increase is the wrong prescription, not only for the Nation's economic health, but for the Treasury's fiscal health as well.

We are not an undertaxed society. By rejecting tax increases on families and small businesses, this budget will help keep the economy on a continuing course of job creation and strengthen the foundations for long-term growth.

The second critical component of deficit reduction is a vigorous policy of spending restraint. Similar to last year, the 2007 budget again holds overall discretionary spending growth below the rate of inflation. That is reflected in the last column on the chart on the screen now. It again proposes a cut in non-security discretionary spending. It calls for major reductions in or total eliminations of 141 Federal programs, saving nearly $15 billion. And it continues our efforts to slow the growth in spending on mandatory programs, by proposing $65 billion in savings over 5 years.

Progress on Spending Restraint

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Cut or terminate 154 programs	89 programs	Cut or terminate 141 programs
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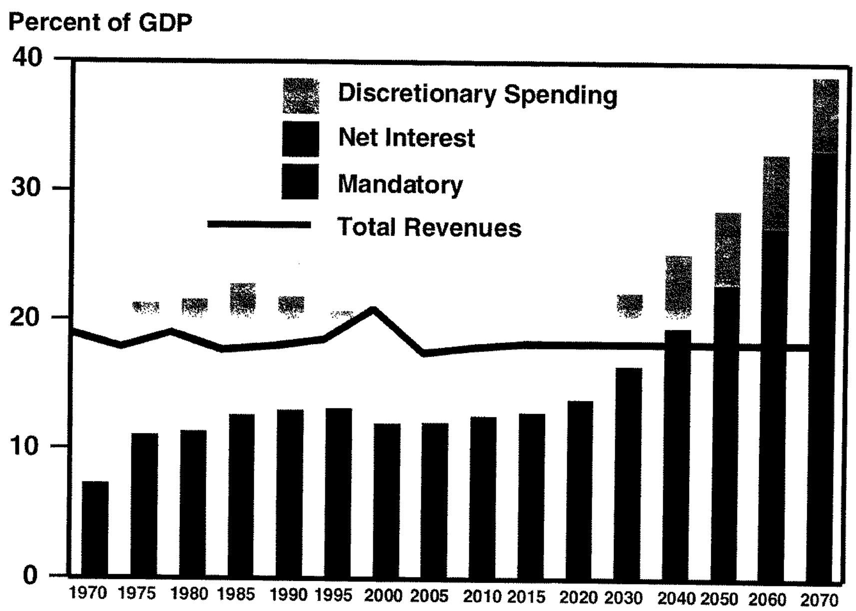
These efforts to restrain the growth in mandatory spending are vital—not just for our near-term deficit reduction efforts, but especially for the long term. The chart on the screen now displays our long-term situation. Toward the end of the next decade, deficits stemming largely from entitlement programs such as Social Security and Medicare will begin to rise indefinitely. No plausible amount of spending cuts in discretionary programs or tax increases could possibly solve this problem.

Current Trends Are Not Sustainable



The President has shown a willingness to take on these future unfunded obligations and to propose long-term reforms. This year's budget proposes $36 billion in savings from Medicare and includes proposals that pave the way for additional reforms in the future. As with Social Security and Medicaid, we do not need to cut Medicare, but we do need to slow its growth. And this budget beings to do just that.

In addition, the 2007 budget contains proposals to significantly improve the budgetary process. The budget proposes discretionary spending caps as well as restraints on new mandatory spending. The administration is also pleased that the congressional leadership is focused on the need for reform of earmarks in the budget process. One way we can address the excessive use of earmarks together is by Congress giving the President the line-item veto.

The 2007 budget, Mr. Chairman, also continues our efforts to improve performance and make sure the taxpayers get the most for their money. Using the President's Management Agenda, OMB measures success not by good intentions or by dollars spent but, rather, by results achieved.

As part of these efforts, OMB introduced just yesterday a new website called ExpectMore.gov. ExpectMore.gov allows taxpayers to review the OMB assessments of nearly 800 Federal programs. You can search the programs by rating, topic, or by a simple keyword. I urge you and your staffs to make use of this new resource.

This management agenda, coupled with the restraint reflected in the President's 2007 budget, will help ensure that taxpayer dollars continue to be spent wisely, or not at all.

Mr. Chairman, I would be happy to take your questions.

Chairman GREGG. Thank you. Could you leave that chart up, that last chart you had, present trends are not sustainable?

Picking up on that point, if you look at this chart—and your black line is historic revenues, obviously.

Mr. BOLTEN. Yes. Historic revenues are about 18.2 percent of GDP.

Chairman GREGG. It is fairly obvious that at some point in the not too distant future—within all of our lifetimes in this room, theoretically—we are going to have a cost of Government as a result of mandatory spending that exceeds the historic revenues of tax revenues, correct?

Mr. BOLTEN. Correct. At some point, and on this chart——

Chairman GREGG. About 2035.

Mr. BOLTEN. About 2035, we would need to spend all of our revenues just to pay for the mandatory programs with money left for nothing else.

Chairman GREGG. And that would mean we would have no money left for national defense, for building roads, for environmental protection, for education.

Mr. BOLTEN. Correct.

Chairman GREGG. Because those are mandatory programs. And so the way out of that is either, one, to raise the historic revenue obligation of people, which would mean dramatically increasing taxes on our children and grandchildren, right?

Mr. BOLTEN. I suppose, although I don't think there is any precedent in history for tax rates at the level that would be necessary to actually close the gap.

Chairman GREGG. So you essentially cannot tax your way out of this.

Mr. BOLTEN. I do not believe so, and the damage to the economy would be enormous and would probably affect revenues in the long run.

Chairman GREGG. So the way you need to address this is by reforming the programs that are going to basically drive this issue, which is the major entitlement programs of Social Security, Medicare, and Medicaid.

Mr. BOLTEN. Absolutely, Mr. Chairman.

Chairman GREGG. And your budget really does not do a whole lot in this area, but it does more than anybody else has attempted to do, so I congratulate you for that, which is $35 billion in the Medicare accounts.

Can you explain to us what the policy is behind that proposal, where it came from and why you think it is reasonable to make that type of change and what the base is? In other words, that $35 billion over 5 years compares to total Medicare spending of how much over 5 years?

Mr. BOLTEN. I don't recall the total Medicare spending. One of my colleagues may be able to give that to us. But on the 10-year window that we looked at, if the President's Medicare proposals were adopted, the rate of annual growth in Medicare spending would decline over the next 10 years from about 7.8 percent per year to about 7.5 percent per year. So it is a relatively modest decrease in a very rapidly growing program.

Most of the savings in the $36 billion that the administration has proposed—and that is a 5-year number, the $36 billion savings is.

Chairman GREGG. So it works out to about $7 billion a year.

Mr. BOLTEN. Roughly, over the 5 years, although it expands in the later years.

Chairman GREGG. Right.

Mr. BOLTEN. Most of the 5 year savings, that we would achieve in our proposals would come from a very modest reduction in the market basket by which the Medicare providers are given their annual update. The proposals that we carry in the reduction in the market basket were recommended by or build upon the themes of the independent MedPAC Commission, which, as you know, Mr. Chairman, is an independent Commission that is appointed by the Comptroller General of the United States and makes its own recommendations. The kinds of savings we are proposing——

Chairman GREGG. On MedPAC, I think it is important to understand who the MedPAC group is, because this is where the essence of your proposal comes from. They are health care professionals and policy professionals. They are not in any way partisan. Is that correct?

Mr. BOLTEN. No, and they have no connection to the executive branch that I am aware of.

There are several other proposals within the Medicare $36 billion that we have on the table. For example, we are proposing that clinical laboratory services be handed out on a competitive basis, which is not required to happen now. Most of those are relatively small in comparison to the market basket changes we are talking about.

I should emphasize, in closing my response on this point, Mr. Chairman, that your initial point is just right. This is just a down-payment on the broader reform that needs to be undertaken in Medicare. This is a modest first step that I hope we can all agree on and then come together on more fundamental reform that is needed to really change the trajectory of that first chart you asked me to put back up.

Chairman GREGG. Well, I think that is important to understand, and I think that chart there—for anybody who is involved in public policy and has an obligation to the next generation—and it is really our generation that has created the problem, the baby-boom generation. That chart there is a stunning statement of what we need to confront. And if we leave this job of public policy without having confronted that, we won't have done our job but, more importantly, we will have given our kids a very difficult hand to deal with in their future.

At this point I yield to the Senator from North Dakota.

Senator CONRAD. Let me just that this is the point on which we agree. I agree with the chairman completely in terms of we are on a course that is not sustainable, and my deep regret is I think the President's budget does nothing to get us on a more sustainable course. In fact, as I examine the President's budget, I think he makes the situation a whole lot worse when you put in the things he has left out.

Let me ask you this: What was the gross debt of the United States when the administration came into office?

Mr. BOLTEN. I believe you had the figure on your chart, Mr. Conrad.

Senator CONRAD. Would you agree with that figure?

Mr. BOLTEN. I don't have any basis to disagree with it. I always enjoy your charts.

Senator CONRAD. The debt was $5.8 trillion at the end of his first year. I do not hold him responsible, obviously, for the first year because other policies were in place. But since that time, he said we were going to have maximum paydown of the debt, but here is what has actually happened. Year over year, the debt just goes up, up, and up. And at the end of this year, can you tell us what you think the debt will be at the end of this year?

Mr. BOLTEN. I don't have any reason to disagree with what is on your chart, Mr. Conrad.

Senator CONRAD. $8.6 trillion. We are just under $8.2 trillion today and headed for $8.6 trillion at the end of this year. That is the projection. Maybe actually somewhat more than that.

What is your projection for 2011?

Mr. BOLTEN. $11.5 trillion is the projection we hold.

Senator CONRAD. We actually see the debt somewhat more than you are projecting by 2011. We think it is going to be $12 trillion.

But let's take your projection. The debt of the country will more than have doubled during this administration. In other words, it took 224 years to run up over $5 trillion of debt, and in the next 10 years—the 8 years of this administration included in that 10 years—the debt will more than double. Isn't that right?

Mr. BOLTEN. When you combine the debt held by Government accounts and publicly held debt, yes.

Senator CONRAD. Well, to me that is——

Chairman GREGG. Are you giving us a couple extra years in this administration, to 2011?

[Laughter.]

Senator CONRAD. No, but, you know, this is their 5-year budget. It is not anybody else's. It is theirs. They are putting us on a course to run up the debt in this way.

To me, it is just a failing grade. It is a failing grade. This administration proposes more spending and more tax cuts when we cannot pay our bills already. And the result is the debt is jumping very dramatically. This is what the debt is doing. Let's show that other chart.

Increasingly, this debt is being bought by foreigners. When we hold a bond auction, increasingly the debt is being bought by these countries: Japan, now over $680 billion; China, over $250 billion. Have we got that other chart that shows how the debt is—yes, that one right there.

This is debt held abroad. It took 224 years and 42 Presidents to run up $1 trillion of debt held by foreigners. This President has more than doubled it in 5 years.

Mr. Director, in your judgment, is this a sustainable pattern?

Mr. BOLTEN. No, absolutely not, Mr. Conrad, and I am glad you are focusing on debt, on the long-term debt situation, because that is where our problem is. But the problem is not one of discretionary spending accounts. It is not one of being undertaxed. The problem and the reason why we have this exploding debt situation going out indefinitely into the future is a problem of the entitlement programs that I have been just been addressing with the chairman.

Now, the President has put on the table measures to address the fundamental problems in our entitlements. He put on the table last year fundamental Social Security reform. We didn't get very far with it, but as the President said in his State of the Union, this problem is not going away, and the President is——

Senator CONRAD. Well, let me just ask you, on that proposal, did that increase the debt or reduce the debt?

Mr. BOLTEN. Over the long term, that proposal would have put Social Security on an entirely sustainable basis.

Senator CONRAD. Well, you are talking a long term in which everybody is dead. In the foreseeable future, what that proposal did was add another $800 or $900 billion to the debt because it doesn't—you know, the President, he has a bad habit here. This administration has a bad habit. Every question, the answer is to borrow money. We are going to have tax cuts? We are borrowing the money from China and Japan to give tax cuts here. You need more money for defense? We borrow money from China and Japan.

I tell you, that to me is not a way to strengthen the country. And when we talk about it is all on the spending side of the equation, that is not what the evidence reveals. This is going back to 1980. The red line is the spending line. The green line is the revenue line. The red line was coming down each and every year until this administration. Under this administration's watch, spending has jumped.

On the revenue side of the equation, the revenue was going up until this administration, and the revenue side of the equation has collapsed. The result is massive deficits. This gap represents the difference between what we are spending and what we are raising. And under this administration, you keep spending more, but you are not raising the money to pay for the spending.

Let me just conclude on this thought: instead of raising taxes as the first notion of how to get additional revenue, I wish we were more aggressively going after this tax gap, the difference between what is owed and what is being paid.

Could you tell us, how big is that tax gap now a year in your estimate?

Mr. BOLTEN. Mr. Conrad, you will be more familiar with the estimates than I because you follow them very closely. I know Commissioner Everson has presented some estimates that run into the hundreds of billions of dollars of money that we should be collecting in revenues and are not. We are making strenuous efforts to try to close that gap. We have put proposals into our budgets in the last several years to improve enforcement. A lot of it means, though, going after a fairly heavy dose of fraud that is going on in the Medicare and the Medicaid programs, in the earned income tax credit. We do need to dig in on all of those measures, and I am very encouraged by your interest in closing that gap because the administration shares that interest completely.

Senator CONRAD. Let me just say that the proposal from the administration is to collect about one in every 1,000 of those dollars. We have to do better than that.

I thank the chairman.

Chairman GREGG. Thank you.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. First of all, I would like to put a statement into the record.

Chairman GREGG. Of course.

[The prepared statement of Senator Bunning follows:]

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL
7 FEBRUARY 2006

Jim Bunning
2/7/06

Thank you, Mr. Chairman.

Last week was historic. Thanks to the leadership of Chairman Gregg and others, the U.S. Congress sent to the President the first reductions in mandatory spending in almost 10 years.

Reviewing the budget projections presented to us by OMB and by CBO presents us with some sombering information about the future of entitlements in this country. C.B.O. tells us that spending for just Social Security, Medicare and Medicaid will equal 8.7% of G.D.P. this year. That number is expected to grow to almost 11% by 2016. These three programs currently account for 43% of the federal budget and that number will rise to 56% in 10 years.

We spend most of our time on this committee talking about discretionary spending. But we must never lose sight of the fact that discretionary spending accounts for less than half of the total federal budget. The entire budget is the responsibility of this committee and we must keep the entire budget in mind this year, as we did last year.

Therefore, once again we must examine mandatory spending. We took a hard look at this area last year, resulting in the Reconciliation bill that was sent to the President last week. Our Chairman has made clear that he is willing to continue to look at this often-ignored part of the budget and I support his plan to put these entitlement items on the table and examine them.

Congress must also take a hard look at our Social Security system and make some reforms. In just over a decade, Social Security will begin paying out more in benefits than it collects in revenue. By the year 2041, the program will be insolvent. Without any reforms, the current system has an unfunded liability of over ten trillion dollars. We owe it to our children and grandchildren to have an honest debate on this issue and put this program on a financially sound path.

I thank Director Bolton for the hard work and dedication of his office and for his willingness to appear before us today to explain the most recent analysis in detail.

Thank you.

Senator BUNNING. Josh, as released yesterday, in the budget for international affairs, the West Bank and Gaza are slated to receive $150 million. Is this funding going to be reviewed by the administration in light of the Hamas win in the recent Palestinian legislative council elections?

Mr. BOLTEN. Yes, Senator. The budget was put to print before the elections were held. We are going to put a pause on that money, review it. Bear in mind that what is in the budget is 2007 money, so it would not——

Senator BUNNING. I understand.

Mr. BOLTEN. So it would not be money that would be available for some time. So we do have time to make an assessment of the situation——

Senator BUNNING. We do, too, and that is why——

Mr. BOLTEN. By "we," I meant the administration and the Congress, and I imagine that that will be a subject of intense review. Under present circumstances, I would expect that Secretary Rice would want that to be reconsidered.

Senator BUNNING. Just reading and listening to what she has to say.

Mr. BOLTEN. Yes.

Senator BUNNING. Also, the National Flood Insurance Program was created to generate enough revenue through premium dollars to prevent taxpayers from paying for disaster-related assistance due to flooding during an average flood loss year. Claim payments for flood damage from Hurricane Katrina will surpass any previous payments from the program at an estimated $23 billion. Under the current structure, assuming no major floods, it would take the program decades to repay the United States Treasury the necessary funds to pay off these claims.

What changes would you suggest to improve the soundness of this program?

Mr. BOLTEN. Senator, you are raising a very important issue that I think has been underappreciated in the context of the Katrina debate. It is an unsound system as it now stands. The Congress adopted last year $18 billion in borrowing authority for that program to meet its immediate needs. We need to go forward now in the next couple of weeks, I understand, to provide additional funds so that the Flood Insurance Program can pay off the legitimate claims that are now being made on it.

The administration has sent forward proposals for fundamental reform in that program, which I anticipate will have to involve a reassessment of how we are calculating the premiums that people need to pay——

Senator BUNNING. We had a hearing today in——

Mr. BOLTEN [continuing]. And what the Federal liabilities need to do.

Senator BUNNING. —Banking, so I know it is very important, but we have to have a pay-as-you-go program, and we are not getting it done.

In 2004, CBO estimated that capital gains liabilities for 2004–05 would be $98 billion, a $27 billion decrease from earlier projections made for those 2 years. When we look at CBO's most recent report, it shows payments from capital gains taxes for $151 billion for

2004 and 2005, significantly higher than CBO estimated this time last year. I understand that when Congress cut capital gains in 1997, actual 1997–98 capital gains revenue were about 11 percent higher than the original CBO estimates. Can you make a comment about this, please?

Mr. BOLTEN. I can, Senator. What those data points reflect is that lowering the capital gains rate has had a very strong stimulative effect, not just on economic activity but also, it turns out, in our Federal revenues. One of the reasons why we had that spectacular increase in revenues in 2005, almost at 15-percent increase in revenues, was because we had much stronger than expected capital gains receipts. That is good news for the economy and one way that the tax cuts that you and the President have put in place have done a good job not only in restoring economic health but fiscal health to our economy.

Senator BUNNING. Thank you very much. I yield 5 seconds.

Chairman GREGG. Thank you. That is extremely generous.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Bolten, welcome. Given the administration's interest in holding down the costs of entitlement programs, are you all willing to reconsider your opposition to lifting the restriction in Medicare so that Medicare can bargain to hold down the costs of medicine? It seems to me a particularly appropriate time for you all to re-examine this. We got 51 votes in the Senate as of the last vote for this. As you know, there have been huge problems in rolling out this benefit in the first few months. Are you willing to work with us on a bipartisan basis to re-examine the administration's position with respect to bargaining power in Medicare?

Mr. BOLTEN. I am going to let Secretary Leavitt engage in the detailed discussions with you, but when last I spoke to him, my understanding was that our assessment was that it would not, in fact, save the Medicare system money to allow the Medicare program itself to come in and buy the drugs.

We are finding that the——

Senator WYDEN. That is just factually wrong. There is a CBO letter that says on single-source drugs alone, there would be savings.

Mr. BOLTEN. I do not believe the administration agrees with that, but I will let Secretary Leavitt take it up with you directly. But something we are finding is that the Medicare Part D program is costing less than originally anticipated, and part of it is because of the competition that is occurring in the private sector, with the private sectors providers now engaged in delivering those services to our seniors. So that aspect of the program seems to be working pretty well.

Senator WYDEN. I am going to move on. Let's see what the costs are when people who are not automatically signed up start making these——

Mr. BOLTEN. I should say the jury is still out on how well the costs are going to come down, but the initial signs are hopeful.

Senator WYDEN. The Bush budget proposal requires Bonneville Power to make additional payments to the Treasury if the agency's revenues from power sales exceed $500 million per year. Now, out in our region, folks really say this is sort of like Government loansharking. It would be requiring somebody to pay more in loan fees just because they are making more money.

Now, my question is: Because the President says if you do not extend his expiring tax cuts, that is a tax increase. Wouldn't it be correct under that reasoning that the administration's budget proposal for Bonneville is a rate increase because you are not extending a current policy that keeps Bonneville's rates from going up in the future?

Mr. BOLTEN. No, I don't think so. What the policy does is say that if—and I am sure, Senator—you and I have had a chance to talk about this in the past some, but what the policy does is say that the Bonneville rates within the customer area are substantially below those in the neighboring districts, that when Bonneville sells power into those other districts at prices that are well above its costs—I think into California it is about twice its costs right now—the additional revenue that comes in to Bonneville from that can be used, as it has been, to lower the rates even further for Bonneville customers, which is a good thing. We like to see low energy rates for everybody in the country. But what we are asking is, that when those revenues exceed $500 million a year, that the extra money be used to pay down Bonneville's Treasury debt, which we believe in the long run will enhance the soundness and stability of BPA and make it possible, with some ancillary proposals for BPA, to make investments in an infrastructure that in the long run will actually reduce the rates for Bonneville customers.

I think this is a sound Government proposal that will not have any significant detrimental effects on Bonneville's customers even in the short run.

Senator WYDEN. You will find unanimous opposition in our region, Democrats and Republicans, to your views on that.

One last question, if I might. Why are you all upending the most successful forestry law in decades? The Forest Service itself says that our county payments law, which is the law, of course, that replaces the money we used to get through Federal timber receipts, has brought together people who have never talked before—the timber industry, the environmentalists, local government.

Your proposal would cut the revenue by more than 50 percent. We are very concerned about the prospect of an ideological fight through these land sales. I would just like you to set out for the record, Why do you all want to, as the kids say, "mess with success"?

Mr. BOLTEN. Senator, the original program was designed to be a transitional program to assist those communities that were hard hit by the sudden drop-off in timber receipts. It has been successful in that regard.

The administration believes that we can carry through that success with our proposal, which is to reauthorize the law, which does expire. Going back to our conversation about expiring and not expiring, this program was intended to expire. It does expire. The administration is proposing that it be continued at a phasing out rate of subsidy to these communities. We believe that this can be done responsibly and that it can be done on a revenue neutral basis if we make available Forest Service lands that are unwanted, isolated, unused, and so on. We think that this can all be done responsibly within a responsible budget, because all of the difficulties I have talked about with the chairman and Mr. Conrad and the other members suggests that we are in a constrained budget situation. We need to achieve savings where we can, and this is an area where we believe we can responsibly go forward with the program but do it on a revenue-neutral basis.

Chairman GREGG. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Director Bolten, thank you for coming. Senator Conrad was talking about bad habits. I wanted to congratulate you for encouraging us toward some good habits last year with the suggestion that we slightly restrain the growth of Medicaid and the suggestion this year that we slightly restrain the growth of Medicare. And I would urge for your consideration as a part of the management part of your job S. 489, which is a bill sponsored by Democrats and Republicans that would give States and local governments more ability to terminate outdated Federal court consent decrees so that as we change our policy and our rules, they are able to respond and set their own priorities.

But it was after these hearings last year that I sat down with Senator Domenici and Senator Bingaman, and we said to ourselves if all we do over the next 10 years is spend our money on war, welfare, Medicare, Medicaid, disasters, and debt, we are not going to have an economy strong enough to pay for all those urgent needs. And we asked the National Academy of Sciences exactly what should we do to keep our edge in science and technology so we can keep our jobs from going overseas and so we can have the kind of weaponry we need to win the war against terrorism and the technology to deal with health care. And I am very pleased that the President is off to a good start, and in the Senate we now have 60 Senators—30 Democrats, 30 Republicans—in support of the recommendations of the National Academies.

I wondered if you would want to comment on the rationale for the good financial start for that initiative in this tight budget and the level of the President's ongoing commitment to this competitiveness issue.

Mr. BOLTEN. Yes, Senator Alexander, thank you. And thank you for your and Senator Domenici's commitment to the competitiveness of this country and to the initiative that the President included in his State of the Union address and that is prominent in our budget. The conversations that the two of you have had directly with the President I know were substantial contributors to the final result.

The President's proposal is recognizing that a critical part of maintaining our competitive edge in an increasingly competitive world is that we continue to lead in basic science, which is the underpinning of all of the major technological advances that have made this economy the envy of the world.

To that end, the President's proposal is that over the next 10 years we double funding to those successful agencies that are at the core of Government's basic science research—the National Science Foundation, the Department of Energy's Science Program, and NIST at the Commerce Department. So the President's budget proposal reflects progressively over time, over the next 10 years, a doubling of spending in those areas. We believe that that is money very well spent, particularly because these science programs, if they can avoid earmarks, are done on a competitive basis. And they do a very good job, when they are left with a free hand, of handing out money to the most promising scientific projects.

Second, the initiative involves a permanent extension of the research and experimentation tax credit, which has been so important to private industry. And, third, the initiative involves an education element that you and Senator Domenici and others, including Norm Augustine, the Chairman of the National Academy of Sciences panel that you helped get underway and bring prominence to. This country is falling behind in math—has fallen behind in math and science education for our children. The President's budget includes a $380 million investment in improving math and science education in the United States and ensuring that those who have an interest in math and science have an opportunity to pursue those interests in higher education.

Senator ALEXANDER. Thank you very much. I have one other short question. I believe I see in the budget that there is no funding to help States pay for the REAL ID legislation that we passed last year. This is a law to deal with border security that imposes a lot of responsibilities on States and State budgets. I think it tries to turn driver's license examiners into CIA agents. And it is going to be very expensive. The National Conference of State Legislatures suggests it will cost $100 million a year.

Now, I believe that if we impose a mandate on the States, we ought to pay the bill. And I am wondering why in a $30-billion-plus homeland security budget we do not include a sufficient amount of money, which is estimated at $100 million a year, to help the States pay to implement the REAL ID legislation. Senator Gregg got passed last year a 60-vote point of order for unfunded Federal mandates, and this violates the spirit of that.

Mr. BOLTEN. Senator, I am not familiar with the details of the mandate on REAL ID that the legislation imposes or how we are proposing to fund that. I would like to come back to you for the record on it.

Insert for the Record

The Administration is currently developing a draft proposed rule to implement the REAL ID Act. After this rule has been published, DHS will submit the spend plan that will guide the allocation of $40 million in state grants provided by Congress in FY 2006. The spend plan, based in part on the requirements in the proposed rule, will identify key actions for Federal and state agencies to take to fulfill the requirements of the Act. The Administration intends to strongly encourage the use of existing Federal agency data sets and tools, enabling states to meet the Act's requirements with minimal additional costs.

Additionally, the Administration is making it easier for states to verify the immigration status of non-U.S. citizens prior to issuing a driver's license or identification card, as required by the REAL ID Act. The President's FY 2007 Budget requests $4 million for DHS to improve its existing immigration status verification program. This program allows states to electronically verify the legal status of non-U.S. citizens in a timely manner.

The one thing I would say is that while the administration very much supports the notion that unfunded mandates ought not be imposed on the States when the Federal Government is not willing to put money behind them. There are already a lot of unfunded mandates in the law, and there is already in the law a lot of spending in the Federal budget that is a essential form of revenue sharing that goes out to the States. One of the things that the President directed me to look at, as we looked at the 2007 budget, is are we being sensible with all the dollars that are being sent out to the States, especially when State treasuries are in most cases in much better health now than they were a few years ago, largely a product of the improving economy the tax cuts you enacted helped trigger. The State treasuries are in the kind of situation where they ought to pick up more responsibility from the Federal Government. I don't know whether this is a good case for that particular situation on the REAL ID or not, but I think it is fair to say that overall in the budget, when the Federal Government is dealing with Federal responsibilities like fighting the global war on terror and responding to Hurricane Katrina and so on, that it is fair to expect the States to pick up a larger share of the burden.

Chairman GREGG. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman. I appreciate the opportunity to hear from Director Bolten on the President's 2007 budget request.

I do have a number of concerns. I actually sent you a letter, January 31st, and I hope that I get a response on that, and a number of my questions. Let me just start by saying I would really have to concur with the remarks of our ranking member regarding this budget. This plan assumes the largest deficit in the history of the country, and yet it assumes over $1 trillion in new tax cuts. It does not show us the true costs of our commitments in Iraq, and really, from my point of view, really fails America's children in the cutbacks in education, and our poor, the citizens who are most vulnerable who count on Medicaid funding, and really our seniors, with the proposed cuts in Medicare, I really see it as a budget that kind of forces a huge burden on those who can least afford it.

And there is one thing I can say about this budget, it is not a shared sacrifice budget, so I have a lot of real concerns. I know this year, here we are back. It is February already. We are still dealing with last year's budget and appropriations through the Budget Revenue Reconciliation and Debt Ceiling, we are being asked to still work on. I think we need to remember on this Budget Committee, that it starts with the budget process, and when we have an unrealistic budget, we end up 2 days before Christmas here unable to pass our appropriations bills.

As ranking member on the Transportation, Treasury, Housing, Urban Development, Judiciary Branch—I think it is the one that oversees OMB as well, you know it well—we are going to be facing a very, very tough situation, and I will be working with Senator Bond, but I think it we do not invest in our transportation infrastructure, we are hurting our economy in the future, so I have more about that.

But I did specifically want to ask you, Director Bolten, today about the VA budget, and wondered if you had talked with Secretary Nicholson, so we can prevent some of the budget shortfalls that we saw in 2005 and 2006. You may know that the GAO is doing an analysis on the VA's medical services budget modeling, and one of the initial major findings has been—and I want to read it to you—"VA's internal process for formulating the medical program's funding request was informed by but not driven by projected demand." How do you justify a VA budget request that is not based on demand of services? How do we send that message to our men and women in uniform?

Mr. BOLTEN. Well, the budget, I believe, is based on projections of what we expect the demand to be. There was an error made last year, that you, among many members——

Senator MURRAY. Has the budget modeling been revised then to reflect the——

Mr. BOLTEN. Yes. I believe that that is an ongoing process of improving the budget modeling, but I believe that the errors that were in the modeling process last year that caused those errors have been corrected.

Senator MURRAY. I would like to specifically see that, because that is one of the things we were deeply concerned about is that the VA budget has to be based on real numbers and not just guessing. We know that the model was not correct, so I would appreciate——

Mr. BOLTEN. Sure. And my folks have worked hard with the folks at the VA to try to make sure that the modeling is better. You were among the many members that helped us put through a correction to an underestimate to how much demand there would be in the VA system.

I should point out that this year's budget for the VA in health care is about a 9 percent increase.

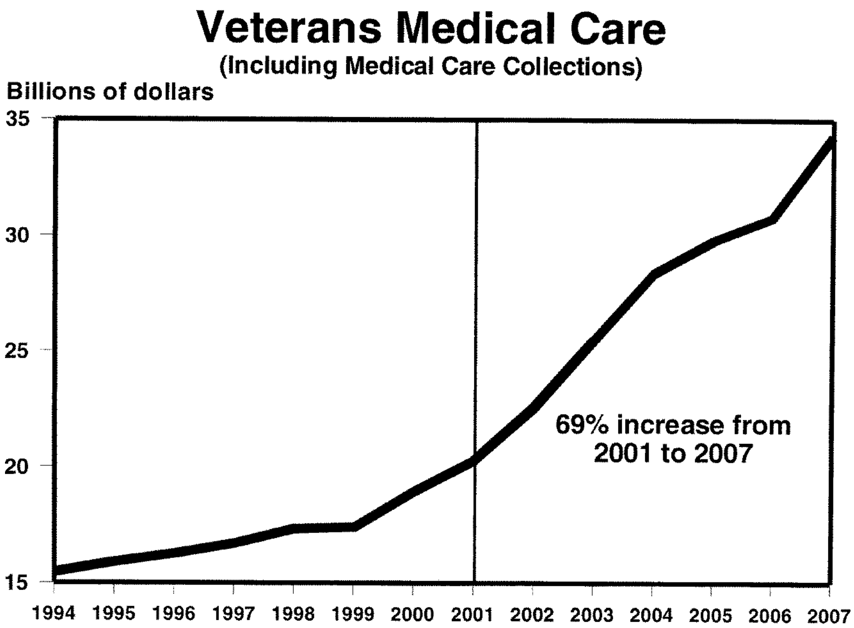
Senator MURRAY. Right. I saw that and I appreciate that, and I have had a chance to talk to many of the VSOs out there who appreciate that, but one of their biggest concerns is that a lot of that increase is based on fees and copays that are again proposed by the administration. In fact, Secretary Nicholson and his staff have made it really clear that part of the purpose of that is to keep 1.1 million vets from enrolling in the VA and prevent 200,000 vets from accessing care. That is part of their goal with those fees. Well, for one thing, none of our men and women who signed up to service were told that, "You will get health care services based on your income later in life." It was, "You will serve our country and we will be there for you."

But there is another challenge here, and that is, having been around my State and holding a number of forums on the Medicare Prescription Drug, a lot of people who are calling about the Medicare program to Department of Health and Services are being asked, "Are you a veteran?" And if their answer is yes, they are saying, "Well, do not do this prescription drug thing. Go to the VA." So it seems to me we kind of have two contradicting efforts here. We have Secretary Nicholson and his staff who are trying to lower the number of vets who are accessing VA through these copays and fees, and meanwhile over on the other side we have HHS who is telling everybody to go to the VA. How do you deal with that contradictory message?

Mr. BOLTEN. I am not sure about the contradiction. The purpose of the fees is not to drive people out of the system, but rather to——

Senator MURRAY. Actually, that has been made pretty clear from the VA, that one of the reasons that they are proposing these fees is to lower the access.

Mr. BOLTEN. Well, if I can just back up for a second and say a word about the levels of VA medical care funding over the course of this administration. As the chart that has just been put up on the board shows, VA medical care funding has increased over the course of this administration.



Note: Data prior to 2001 is estimated due to account restructuring.

Senator MURRAY. Right.

Mr. BOLTEN. In our current budget, what that will lead to is an almost 70 percent increase overall in the——

Senator MURRAY. No surprise. The cost of health care has gone up. The number of veterans who are returning home from Iraq and Afghanistan has increased. The number of men and women who do not have health care at their employer any more, vets who are turning to—the aging population of veterans from Vietnam who are accessing the system. That does not surprise me the all. What does surprise me is based on what happened last year and the fact that the VA said, "We looked at the wrong formula. We need to revise our formula."

I remain concerned that that formula has not been revised based on real demands, so that we are not faced with a situation 3 months from now, 6 months from now, a year from now, with the same underestimates, and we are turning back to our VA centers across this country, and they are saying to me today that there are still long lines, that vets are not getting their access. They are coming home from Iraq and Afghanistan and are not getting access to PTSD care, and numerous other issues that I can describe for the committee here, but I think it is critical that we go back and make sure we have real numbers based on real facts, and I am yet to be convinced that that is occurring. so I appreciate the increased cost, but if we do not get a handle on what the reality is out there, it still is not going to work.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Thank you, Mr. Bolten, for your presentation. I would just say that I do not have any constituents who have come to me and ever complained because their taxes were too low. In fact, the response I have seen from the President's growth package is that the economy has grown, jobs have been created, revenues have gone up, and it is not unique just to this administration. The Kennedy administration put in place tax cuts so they could have more money for their programs, and the Reagan administration, and now we have seen it work in the Bush administration. These are all facts. You can go ahead and look at them, even reflected on Senator Conrad's chart if he had gone past the first 2 years there when we were still living under the Clinton policy.

So I hope that we can do something to make these taxes permanent. My question to you is, I think the response to the economy would have even been greater if we had made those permanent. Have you done a study as to how much revenue we would have lost to the Federal Government by failing to make them permanent, just putting them out for just 5 years, in some cases even shorter? What amount of revenue would we have lost in the Federal Government from the stimulation of the package when we compared it to permanent versus temporary?

Mr. BOLTEN. We have not, Senator Allard. One of the problems we face in this area is that economists and actuaries have difficulty agreeing on how to calculate the feedback stimulative effect of a tax cut on the economy. But we—and the budget numbers, as they now exist, and that often get cited, do not take account of that feedback effect at all.

One thing we do know is that the feedback effect exists, that when taxes are cut, the economy grows, and revenues into the treasury grow. It is has just been so far impossible to get agreement among the economists and actuaries as to how big that effect is. I believe the effect is large, and I believe the effect is magnified, when on top of a tax increase, we threaten uncertainty in the system because that is the one thing that really throws businesses off. On top of losing the opportunity to keep some of their well-earned gains, what really throws them off is not knowing what the tax rates are going to be. So, certainty, as well as a low-tax environment, are two key elements that I believe are critical to economic growth.

Senator ALLARD. I would like to move on. I did not realize you just put "Expectmore.gov" up. I have already been on it.

Mr. BOLTEN. Really?

Senator ALLARD. Yes. You have 189 programs that you have listed there have either been "Ineffective" or "Results were not demonstrated." The ineffective is pretty clear to me. I think many have set-ups and goals and objectives, and for one reason or another, they are not able to reach those goals and objectives. But the group that went into "results not demonstrated," is this a group that just absolutely refused to put in the right management policies to get us so we can evaluate that program? You have described it here as "A rating of results not demonstrated indicates that a program has not been able to develop acceptable performance goals or collect data to determine whether it is performing." Most of them fall into that category. Only 27 are ineffective.

I wondered if you could clarify a little bit about how you come up with these two different types of ratings?

I think it is important to us, by the way, when we look at where we can get more efficiency in our programs, get more performance out of them. I think it is a great approach. Go ahead.

Mr. BOLTEN. Thank you, Senator, and thank you for logging on to "Expectmore.gov." The "results not demonstrated" category can mean a variety of things. In most cases it is not resistance from the program, but it is an unfamiliarity with having to set a goal of what the program is intended to achieve. Under the President's direction, my Deputy for Management, Clay Johnson, has been very aggressive in pushing all programs in Government to try to set some measure of accountability for what the money is being spent on, and then be able to make an assessment of, are you meeting that measure?

And in a lot of cases it is understandably difficult to move to a system that actually measures accountability. That is what the "Results not demonstrated" usually shows. In some cases I expect that when we are able to establish measures of accountability, those programs may score pretty well. My guess is a lot of them will score pretty badly, and one of the reasons why there has been resistance to establishing measures of accountability is that they cannot be met.

Senator ALLARD. I think from a policy standpoint it gives us some guidance, and kind of begins to focus us on those programs that perhaps maybe can justify why they do it, and during times when we are struggling to balance our budget, I think this is a helpful tool. So I want to commend your staff and you for working to put these out, because from a policy standpoint I think they are helpful.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman.

Welcome, Mr. Bolten. We appreciate your being with us.

Just to start, for the record, as we look at historically the decisions that are made in the last 5 years, I think it is important to note that 2001, when I came in as the President did, and I came in on the Budget Committee, we had the largest surpluses in the history of the country recorded. At that time we had two proposals in front of us, one by our ranking member, Senator Conrad, who suggested we divide that into thirds, take a third of it for tax cuts to stimulate the economy, a third to invest in education, health care and science, research, all of the things that Senator Alexander has talked about eloquently, and a third to prefund the liability to Social Security.

When you look back at that now and what you have talked about in terms of Social Security, I think that proposal looks pretty doggone good. Instead, unfortunately, it was top-down tax cut and massive debt, turning the largest surplus in the country into the largest deficit. I hate to think what is coming for our kids and our grandkids.

Let me talk specifically about this budget. The budget really is a values document, I believe. It is a lot of numbers, but it translates into things that affect real people, and it really reflects, just like our own checkbooks do, what our values and priorities are.

When I look at what is happening in Michigan right now and the job loss, what is happening to manufacturing, which has built the middle class in this country, it is deeply disturbing to see what is not in this budget, in fact, the cuts that are made in things like the Manufacturing Extension Partnership, and the Advanced Technology Program, things that are important for us in terms of jobs, and the other areas that are very important for us to grow in.

And, again, Senator Alexander talked about math and science and education, all of which I support. I supported the words of the President in terms of talking about education and competitiveness. But when we look at the budget, it does not match the words, and that is deeply concerning. In fact, the budget cuts education funding by $2.1 billion. It would cut it below the current year, below 2005, below 2004. In fact, it appears that it would be the biggest cut in the 26 years of the Department of Education since it was set up by President Carter.

So you have small things, which I would support in focusing on math and science, but the big picture, when we talk about funding Leave No Child Behind, special education, the desire to eliminate vocational education, cut technology in schools and so on, I would just suggest the big picture on education does not reflect what you are talking about.

Is it not true that in this budget you would cut $2.1 billion out of education?

Mr. BOLTEN. Senator, I am checking my book here. I believe that you are right, that there is a reduction in the spending in education from 2006 to 2007 of $2.1 billion. I would like to make a couple of points.

First of all, the overall increase in education spending during the tenure of this President is about 30 percent, which I think over the course of any 6-year term is about as large as we have seen in the history of this country. So I do not think the President—if you want to judge the commitment to education by dollars spent, I do not think the President can actually be doubted on that count.

Second, you mentioned that we need to put priority on those with the least economic means, the Title I kids, and the President has increased Title I funding as part of his No Child Left Behind proposals every year that he has been in office, very substantially over the first several years of NCLB. In this budget Title I funding increases by $200 million. You mentioned——

Senator STABENOW. Mr. Bolten, if I might just say that Michigan, if we were fully funding education, Leave No Child Behind at the level that we voted for, that I voted for in this bipartisan bill, Michigan would this year, counting the last 5 years, have $12.3 billion more. So the idea that there are small increases when there is a huge amount in standards and paperwork, and all that has been added to it, and the fact is, we passed something very different.

I see my time is running out. Let me just raise one other issue, and that relates to health care, when you talk about health care cuts. Would you not agree that when hospital reimbursements are cut, they simply shift that over onto business? I mean we see right now that the biggest issue with our manufacturers, the biggest issue for our families, relates to health care. And when we see big cuts, or even small cuts as it relates to hospitals or doctors or home health and so on, would you not agree that this just means that we are going to see a shift over, and we are going to see private insurance rates go up? I mean that is how it works. The private sector picks it up when we are not funding the obligations from the public sector.

Mr. BOLTEN. Are you referring to——

Chairman GREGG. Senator——

Mr. BOLTEN. I am sorry.

Chairman GREGG. Why don't you answer this question, and then we are going to have to move on.

Senator STABENOW. Sure.

Mr. BOLTEN. I am going to assume, Senator, you are referring to the President's proposals on Medicare?

Senator STABENOW. I am.

Mr. BOLTEN. As I discussed with the Chairman at the outset, these are very moderate changes in projected growth in Medicare spending. If all of the President's proposals are adopted, the rate of increase in Medicare spending will decline from 7.8 percent over the next 5 years to 7.5 percent.

Second, will those costs—if there are higher than they were hoping for—or if there are lower than they were hoping for reimbursements going to hospitals and other providers, do those costs necessarily get passed on to the patient or to business? I do not think that is necessarily the case. One of the great accomplishments of this economy is the efficiencies that we have achieved in this economy in all sorts of areas. The one glaring exception that has been left behind is medical care, and in medical care we need to put in place the mechanisms that will ensure that we have an efficient medical system that can provide better service for the same amount of dollars as almost every business is required to do, and I think we can expect the same from providers in the Medicare system.

Senator STABENOW. I agree, and I hope you are supporting Senator Snowe's and my Health IT bill. But let me just say that does not address the big issue in term of jobs in this country and manufacturers, which is to move health care off of the back of our employers and families and change the way we fund health care. This does not do that.

Chairman GREGG. Thank you, Senator.

Senator DOMENICI.

Senator DOMENICI. Thank you, Mr. Chairman.

Director Bolten, Thank you very much for testifying. I want to ask two questions for the record, and then I will get on to some observations.

Would you furnish the committee, in detail, two things, one, the list of the programs that you contemplate eliminating or dramatically reducing, just a list of them?

Mr. BOLTEN. Yes, we will.

Senator DOMENICI. The reason I need to know, I need to know how many of them we have tried again and tried again. Second, there is a list of receipts like the Bonneville Power and the like, where you expect revenues by changes in formulas or the like. I would like a list of all of those kinds of things, and an indication whether they have been tried before, or how many times have they been submitted up here and not done. Even if it is only once, we would like to see them. Can you do that?

Mr. BOLTEN. Right. We can do that, Senator. There is a chart at the back of the main budget volume that lists all of our revenue proposals, and what we will do, we will check off the ones that are repeats.

Senator DOMENICI. Would you do that?

Mr. BOLTEN. Which I gather is your interest.

Senator DOMENICI. Yes. My interest is just to see, as we put the budget together, what can we expect. I think that is a rather relevant thing. You would too if you were in my shoes.

Mr. BOLTEN. Yes, that is a fair question.

Senator DOMENICI. Now I want to make a point. Hidden in this budget, in the State of the Union speech, is a little paragraph that I would like to share with those who are listening, and with you, to be something passed over quickly that I think may be the salvation of this country. That is a little statement that the President is going to appoint a bipartisan commission. I hope he does it quick. What is it going to be about? It is going to be about the health care costs that the United States has now promised its citizens under Medicare and Medicaid, the expectations versus what we can afford, versus what is going to happen to our fiscal policy.

I do not think there is any question we need not waste any more time. We cannot pay for what we promised unless we decided to impose taxes so high that the country economy cannot work. So we either wait around till everything falls apart—that is an option. I had begun to think about it, and for a while I figured that is when it will happen, when health care falls apart, we will do something about it. When the pension system breaks, we will do something about it. I hoped that there could be another answer, that we might do it in a bipartisan way because there is no other way. Democrats cannot do it. Republicans cannot do it. We can stand up here and preach and blame the other guy, as is happening today. You did too much on Medicare. If you do more, you are hurting people. If you do nothing, you were irresponsible. It just depends who is in office. But nothing happens.

So that might be your one—whoever put that in there—nice idea. I hope they are good people, and then I hope he follows them. We have had one before. The President kept the string on too tight and we did not get the results. I have had a chance to talk to him about this, the President. He is not going to do that. When he appoints the commission, he is going to take their recommendations. I hope it happens. No other chance, in my opinion, to save Medicare and Medicaid for the American people. Sounds bad.

Second, I am not so sure we are going to know when it falls apart. I mentioned that a little bit ago. I am not sure. It may be falling apart around the seams right now, health care. I am not sure, but maybe.

Now, having said that, your budget does a terrific job of prioritizing. The problem is when we put it together, all the things you did not prioritize by cutting or reducing are going to run into your priorities, and that is the tough part, because the President has done a terrific job with competitiveness. The Alexander-Bingaman-Domenici-Mikulski PACE Act or the President's so-called competitive initiative. You have funded it about 75 percent. That is terrific. Science, physics, R&D, research and development, all of those things we should have been doing, we are doing. Some terrific education programs to stimulate our ability to let our children develop their brains to the maximum.

Then we will have American real brain power and free enterprise versus China, instead of America brain power depleted by our inability to teach our kids physics and math and science, competing with the Chinese. We will not make it that way. So those are great.

But I am worried that when we are finished, because those are fit in your budget by reducing a lot of things that we will not have the courage to reduce, and we will not get the good things.

So might I ask, will the President, in your opinion, stand firm on us getting these new initiatives in this appropriation process?

Mr. BOLTEN. I believe he will, Senator, and I think the encouragement that you and Senator Alexander have given him on this issue has been critical. He shares your passion for achieving the requests that he has put into this budget.

Senator DOMENICI. I am going to close by saying he mentioned some energy initiatives. I find them in the budget. I am very impressed.

There is one area I am not so impressed with, and maybe Senator Byrd is going to speak of it, but in any event, I will just mention there is significant reductions in the fossil fuel research. Some of it is coal research. I think that I would like you, for the record, to explain in some detail what the justification was for the fossil fuel reductions, because you have some new initiatives in coal, but you got rid of some of the old ones, and I do not understand. You may be right, but I do not have an understanding. And I have to appropriate them now. Senator Byrd knows that. So I would like an explanation of that if you would, please.

Mr. BOLTEN. I will provide that for the record.

Senator DOMENICI. Thank you very much.

Chairman GREGG. Thank you, Senator Domenici.

Senator BYRD.

Senator BYRD. Thank you, Director Bolten. Thank you for being our witness here today.

The President's budget includes a nominal 2.8 percent increase in coal health and safety enforcement. This barely covers inflation.

Since 2001 there are 217 fewer mine safety inspectors and support staff. That President's budget does not propose adding a single position to the Mine Safety and Health Administration. We have had this brought to our attention vividly in the last few weeks. In the wake of 19 coal miner deaths in just 37 days, where is the new money to hire additional mine safety inspectors and personnel?

Mr. BOLTEN. Senator, the President's budget does have a modest increase, as you referenced, for the Mine Safety Organization. There have been increases throughout the course of this presidency, so that we are funding that organization at levels that are equal to or above what it has always been funded at, I think even accounting for inflation.

But you are right, the recent events have highlighted the need for a reexamination. That need for reexamination has been highlighted at a time after our budget went to press, and it is an issue that I know Secretary Chao and others will be glad to work with you and other relevant Members of the Congress on as we prepare the 2007 appropriations. I know that it will be a substantial discussion in her Appropriations Subcommittee.

Senator BYRD. I hope so. According to the President's budget request your proposed increase for MSHA is to cover the mandatory cost of living adjustment for current employees and increase in rent, but no new funding for new mine safety personnel. Will the President submit a supplemental request for additional personnel, core enforcement personnel?

Mr. BOLTEN. I do not expect that, Senator. The request, I see in my notes here, is for $288 million, a 3.6 percent increase over the previous year. I do not expect a supplemental request to be submitted, but it is an issue that I think we can address in the overall budget situation without having to resort to a supplemental if the administration and the Congress agree that additional resources in the mine safety area are likely to be warranted, which I understand they well may.

Senator BYRD. I think they are warranted. I think so. Don't you?

Mr. BOLTEN. Senator, I do not know enough to know whether the funding levels at the Mine Safety and Health Administration were related to the problems we have experienced so far. My understanding had been that the safety record during the course of this administration has been pretty good under this Mine Safety Administration. The recent events suggest that there is a problem there. Whether the problem is with the Mine Safety and Health Administration though, I do not know, and before I made any indication that we would want to substantially plus up funding there, I would want to see a good case made as to how that funding might improve the situation.

Senator BYRD. I think it probably does in considerable detail affect the Mine Safety and Health Administration. 19 deaths in 37 days. That is not a very good record.

According to the General Accounting Office, the Defense Department's accounting system is in disarray, costing taxpayers billions of dollars each year. The Pentagon's budget, including supplementals, exceeds one-half trillion dollars annually, and yet the Defense Department cannot pass a simple audit. I have been talking about this for years. Secretary Rumsfeld, I think we first talked about it a half dozen years ago, and he said he was going to see if he could not do something about it. I think he has tried. It is so big, I do not know how we will ever get our arms around it.

The Pentagon's budget, as I say, is such that the Defense Department cannot pass a simple audit. When do you think the administration will make this a top priority issue? What is OMB doing to accelerate audit reforms at the Pentagon?

Mr. BOLTEN. It is a priority, Senator. And I know that a number of our management experts have been working intensively over the last several years even, as you say, to try to improve the situation at DOD that does not create a sudden change in the way the Defense Department does business. The problem in their accounting structures has been present, I think, for probably almost as long as there has been a Defense Department. So it is an enormously complicated structure, an enormously complicated undertaking to try to bring them around to a situation in which they can pass an audit. It does remain a priority of this administration to move the Defense Department toward that goal.

I mentioned earlier my Deputy Director for Management, Clay Johnson, is keenly focused on that, and is working with the folks at the Pentagon to try to make progress on that. We would welcome your assistance in making that come about, because it is certainly a goal that OMB would like to see achieved.

Senator BYRD. Do you think w are making progress toward that end?

Mr. BOLTEN. Yes, in certain sectors I believe we are making progress toward that end. There are much better measures of accountability that are now in place than were three or 4 years ago, but there is a long way to go. There is no sugar-coating the situation there, but I believe we are making progress, and I think everybody involved is committed to making progress more rapidly.

Senator BYRD. How did we get so far behind? What happened?

Mr. BOLTEN. Senator, I do not know.

Chairman GREGG. Senator?

Senator BYRD. Yes?

Chairman GREGG. Can we come back to you for a second round?

Senator BYRD. Yes.

Chairman GREGG. Thank you.

Senator BYRD. Thank you.

Chairman GREGG. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

Welcome. Mr. Bolten, I know you cannot know about everything in the budget, but I need to bring out one inconsistency with the administration here. The Department of Defense had approved the Navy request for $100 million for repairs from Hurricane Wilma relief funds for the critical infrastructure recovery at Key West Naval Air Station. The reason they had approved that is that it is now critical for the training of our pilots, because they will send a squadron down to Key West Naval Air Station, and then they have all that area out there over the Gulf of Mexico that is restricted space where they train.

That request was refused by the OMB, so we have this conflict on the essential readiness of the carrier battle groups as they prepare to deploy. Key West was significantly damaged in Hurricane Wilma. These funds—and I can give you the breakdown. I have been down there, I have checked it out. Congress appropriated these recovery funds to ensure the readiness of our fleet, and we are going to have this insisting that that be allowed to be spent. So tell me about you want to deny it in the budget, and yet the funds are there in the relief bill. So how do we go about, in your opinion, getting this thing squared away?

Mr. BOLTEN. Senator, I am not familiar with the details of it. I will commit to looking into it and come back to you.

Senator NELSON. Well, the Navy is going to insist on this. OMB has thrown up the roadblock, in that it is not in the budget, and yet the funds were already appropriated in the Wilma hurricane relief funds. Let me just put it to you here, that I want to be notified as soon as the requested funds have been released to DOD. Is that a process that you would do?

Mr. BOLTEN. That I personally would get involved in? No, not typically, Senator.

Senator NELSON. But OMB?

Mr. BOLTEN. Yes. OMB is the final stage before funds are released before anybody spends it, but my guess is that there is a story there that we will want to look into that may involve some details that I would want to inform you of before we reached any definite conclusions about whether what has happened so far is the right thing or not.

Senator NELSON. OK. I will continue to converse with you on that.

Mr. BOLTEN. Thank you, Senator.

Senator NELSON. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator. I am shocked to learn that OMB stood in the way of an agency doing something.

Let me just check and see if Senator Conrad had any additional questions. Otherwise, we appreciate your attentiveness to this hearing.

We thank you very much. We appreciate your answering all of the questions in such a forthright way, and we appreciate the work you do. It is a very hard job you have, and we are fortunate to have public servants of your ability and talent in this Nation. I am sure all my colleagues feel that way, whether they agree with you or not. I happen to agree with you.

Thank you.

Mr. BOLTEN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Bolten follows:]

Testimony of OMB Director Joshua B. Bolten
President's FY 2007 Budget
Committee on the Budget
United States Senate

February 7, 2006

Chairman Gregg, Ranking Member Conrad, and distinguished members of the Committee, the President's 2007 Budget, which I transmitted to the Congress on the President's behalf on Monday, meets the priorities of the Nation and builds on the progress of the last five years.

Before getting to the 2007 Budget, I would like to take a moment to review the substantial accomplishments in spending restraint we were able to achieve together over the past year.

Last year's 2006 Budget set four major objectives:

First, the President proposed to hold growth in overall discretionary spending below the rate of inflation.

Second, he proposed an actual cut in the non-security portion of discretionary spending – the first such proposal since the Reagan Administration.

Third, he proposed major reductions or eliminations in 154 Government programs that were not getting results or not fulfilling essential priorities.

And fourth, he proposed reforms in mandatory programs to produce $54 billion in savings over five years.

The Congress substantially delivered on all four of these objectives. I would like to thank Chairman Gregg and the members of this committee for your leadership and dedication in helping achieve these goals.

When President Bush gave me guidance on what the 2007 Budget should look like, he directed me to build on last year's progress by focusing on national priorities and tightening our belt elsewhere. He told me to give our troops and those who defend our security what they need to fight and win the Global War on Terror. And he emphasized that the 2007 Budget must support our pro-growth economic agenda.

In particular, he said we should maintain our economic strength by extending the tax relief that has fueled our economic expansion and by aggressively restraining spending. Yesterday, I presented on the President's behalf a budget that does just that.

In the past 5 years, our economy suffered an historic series of shocks, starting with the recession and the terror attacks of 2001 and continuing through the hurricanes last summer. Those events had profound impacts on job creation and on the fiscal outlook.

Despite these challenges, thanks to the productivity and hard work of the American people, our economy is expanding at a healthy pace. In 2005, the economy grew by an estimated 3.5 percent – the third consecutive year of healthy growth. Economic expansion has produced more than 4.7 million new jobs since May 2003, reduced unemployment to 4.7 percent, and raised homeownership to all-time highs.

This economic growth would not have been possible without the tax relief that you passed and the President signed. The tax cuts – which were fully implemented in May 2003 – have been critical to helping the economy recover from the recession and terrorist attacks of 2001 – and then helping the economy to continue expanding despite the hurricanes and high energy prices in 2005.

With the tax cuts fully implemented in 2003, the economy responded strongly and tax receipts rebounded. Receipts grew substantially in 2004 – by 5.5 percent. In 2005, receipts jumped by a remarkable $274 billion, or 14.5 percent, the largest increase in 24 years. These recent gains in receipts confirm that a strong economy is the most important factor in reducing the deficit.

Since the President set a goal of cutting the deficit in half from its projected peak in 2004 of 4.5 percent of GDP, the deficit has come down markedly. The final 2004 deficit was 3.6 percent of GDP, and fueled by the surge in receipts, the 2005 deficit fell further to 2.6 percent of GDP.

Although revenues are projected to continue to rise in 2006, the deficit for the current fiscal year is now projected to come in at 3.2 percent of GDP, or in nominal terms, $423 billion, which is more than previously expected and is in significant part due to the unanticipated spending associated with relief and recovery efforts from Hurricanes Katrina and Rita. While this increase in the deficit is unwelcome, at 3.2 percent of GDP the projected deficit would be well within the historical range and smaller than the deficit in 11 of the last 25 years.

More importantly, we project that if the policies in the President's Budget are adopted, the deficit will return to its downward trajectory. We forecast a decline in the 2007 deficit to 2.6 percent of GDP, or $354 billion. By 2009, the deficit is projected to be cut by more than half from its projected peak to just 1.4 percent of GDP, well below the 40-year historical average.

In order to keep the deficit on this declining path, we must continue to do two things: First, keep the economy growing; and second, restrain spending.

First, the 2007 Budget will support continued economic growth by proposing to make permanent the tax relief signed into law by the President in 2001 and 2003. Some have argued that we should let the tax relief expire. A tax increase is the wrong prescription, not only for the nation's economic health, but for the Government's fiscal health as well.

We are not an under-taxed society. By rejecting tax increases on families and small businesses, this budget will help keep the economy on a continuing course of job creation and strengthen the foundations for long-term growth.

The second critical component of deficit reduction is a vigorous policy of spending restraint. Similar to last year, the Budget again holds overall discretionary spending growth below the rate of inflation. It again proposes a cut in non-security discretionary spending. It calls for major reductions in or total eliminations of 141 Federal programs, saving nearly $15 billion. And it continues our efforts to slow the growth in spending on mandatory programs, by proposing $65 billion in savings over five years.

These efforts to restrain the growth in mandatory spending are vital – not just for our near-term deficit reduction efforts – but especially for the long-term. Toward the end of the next decade, deficits stemming largely from entitlement programs such as Social Security and Medicare will begin to rise indefinitely. No plausible amount of spending cuts in discretionary accounts or tax increases could possibly solve this problem.

The President has shown a willingness to take on these future unfunded obligations and to propose long-term reforms. This year's Budget proposes $36 billion in savings from Medicare, and includes proposals that pave the way for additional reforms in the future. As with Social Security and Medicaid, we do not need to cut Medicare, but we do need to slow its growth – and this budget begins to do just that.

In addition, the 2007 Budget contains proposals to significantly improve the budgetary process. The Budget proposes discretionary spending caps as well as restraints on new mandatory spending. The Administration is pleased that the Congressional leadership is focused on the need for reform of earmarks in the budget process. One way we can address the excessive use of earmarks together is by Congress giving the President the line-item veto.

The 2007 Budget also continues our efforts to improve performance and make sure the taxpayers get the most for their money. Using the President's Management Agenda, OMB measures success not by good intentions or by dollars spent, but rather by results achieved.

As part of these efforts, OMB has introduced a new website called Expectmore.gov. ExpectMore.gov allows taxpayers to review the OMB assessments of nearly 800 Federal programs. You can search the programs by rating, topic, or by a simple keyword search. I urge you and your staffs to use this new resource.

The management agenda – coupled with the restraint reflected in the President's 2007 budget – will help ensure that taxpayer dollars continue to be spent wisely, or not at all.

[Whereupon, at 4:33 p.m., the committee was adjourned.]

PREPARED STATEMENTS SUBMITTED

Statement of Michael B. Enzi

Senate Budget Committee Hearing:
The President's Fiscal Year 2007 Budget Proposal
February 7, 2006

I would like to thank Director Bolten for testifying today. As you know, I look forward to reading the President's budget every single year. This year is no exception. I would also like to recognize the hard work you and your staff put in on this document each year. You do not have an easy job today – discussing a budget that is over 2,000 pages long and covers everything from our national parks to our homeland security. I look forward to reading the President's blueprint for our nation.

As we begin the discussion over FY 2007 spending, I urge everyone involved to take a step back and remember that the President's proposal is the first step in a lengthy budgetary process. We must also not lose sight of the fact that this proposal is just that – a guide for Congress to use as we move forward in crafting our budget resolution. However, this is a very important document to use when looking at the overall fiscal picture of our federal government.

I commend the President for taking bold steps in his FY 2007 Budget Request. I believe that Congress needs to contain spending and further reduce the national deficit. The budget is stretched, and right now, Congress is being presented with a lot of tough choices. However, it is important for the budget to accommodate and Congress to fund essential government programs. As HELP Committee Chairman, I am committed to reviewing programs under the Committee's jurisdiction to make sure that we eliminate any waste or fraud, and maintain fiscal discipline. Additional resources can be found by eliminating duplicity in federal programs. When dollars are stretched, it is important to review programs through aggressive oversight to ensure they are cost effective.

In addition, I am very interested in Mr. Bolton's testimony regarding entitlement spending. In particular, I am interested in the President's proposal to contain Medicare spending. On a related topic, I also look forward to reviewing the President's proposal to cut the national deficit in half by 2009. I am a strong supporter of fiscal restraint by the federal government and look forward to working with the Administration as well as my Budget Committee colleagues in an effort to control spending.

Finally, I am pleased that President Bush reiterated his support for biennial budgeting. This is an issue I have been working on and believe that a two-year budget cycle, similar to the one we use in Wyoming, will lead to enhanced fiscal management and give Congress additional time for increased oversight.

Statement of Senator Tim Johnson

Tim Johnson

Senate Budget Committee

Hearing on the President's Fiscal Year 2007 Budget Proposal

February 7, 2006

First, thank you Chairman Gregg and Ranking Member Conrad for calling today's hearing on the President's proposed Fiscal Year 2007 budget. I appreciate Director Bolten taking the time to explain the President's budget and look forward to his answers to the Committee's questions.

As every American family knows, budgets are about priorities, and unfortunately, the President's Fiscal Year 2007 budget is a replay of last year's budget. I'm disappointed this budget shortchanges so many programs that are vitally important to so many Americans. As we move through the budget process, I will continue to highlight these deficiencies and work to ensure our budget meets these needs in a fiscally responsible manner that more properly reflects the priorities and the values of American families.

I do want to take a moment to express my appreciation to Director Bolten for listening to the South Dakota delegation earlier this winter as we explained to you why the Administration must increase the budget for the Bureau of Reclamation's rural water construction account. In South Dakota, we are constructing two of the largest drinking water projects in the country and each year the project sponsors, surrounding communities, and Indian Tribes served by these projects play a guessing game waiting for release of the President's budget. I appreciate that the President's budget has increased funds for the Lewis and Clark Rural Water System, as well as the Mni Wiconi Rural Water System. My concern remains that the increases in federal resources are failing to keep pace with the increased construction costs and capabilities of each project. In the end, as long as the Administration balks at significantly ramping-up resources in the Bureau of Reclamation's rural water construction account, projects, such as the Lewis and Clark Rural Water System, could face construction delays that only serve to drive up the final cost to the federal government.

While there are many areas of concern for me in this budget, I will highlight a handful of those concerns this afternoon. Just like last year, the Administration is again proposing a 5 percent across-the-board cut to crop and dairy payments for producers in its Fiscal Year 2007 Budget proposal. Commodity program payments, including marketing loan gains, direct and counter-cyclical payments, would take a significant hit under this proposal. I simply believe that you can't, and shouldn't, balance such a tremendous deficit on the backs of our nation's producers. Producers have saved roughly $15 billion since the Farm Bill was enacted, and these across the board cuts are simply outrageous. Reductions to agriculture spending are unfair to rural America.

However, the budget would reduce the payment limit cap for individuals to $250,000 for crop payments. Additionally, it removes the three-entity rule. I have long supported common-sense payment limitations that would save serious money and reduce program abuse. I am pleased to see that the Administration has recommended reasonable payment limits.

There are several funding proposals in the agriculture arena which are cause for significant concern. The Resource, Conservation and Development program, for example, is once again slated for substantial reductions. Under the Bush Administration's proposal, RC&D funding would be scaled back to $25.9 million for Fiscal Year 2007. I worked with my colleagues on the Agriculture Appropriations Subcommittee to fund this vital rural economic development program at $51.3 million in the Fiscal Year 2006 Appropriations bill.

The President has also proposed scrapping the Commodity Supplemental Food Program (CSFP) entirely. I helped secure $108.3 million in the most recent agriculture spending bill for this program. I am incredibly concerned for impacts of this proposal on the nation's elderly, many of whom rely on the CSFP and have already been subjected to funding reductions in other areas. I find it unconscionable to eliminate funding for a program that provides crucial nutrition and outreach to an already underserved population.

In regard to the President's budget request for Indian Country, it is apparent that this budget doesn't fully reflect the treaty and trust responsibilities the federal government has with the tribes. The President has requested the elimination of 141 programs. Unfortunately, some of those programs directly affect Indians and Indian tribes.

For instance, the Urban Indian Health Program within the Indian Health Service budget was completely slashed. This program provides care to American Indians that live off reservations in urban areas where approximately 60 percent of all Indians reside. In my home state of South Dakota this funding deficiency will affect Indian populations in three urban communities. Another program that faces elimination is the Johnson O'Malley program with in the Bureau of Indian Affairs budget. This is a program that provides assistance to native students in public schools. While this program was modestly funded at $16 million dollars in FY06, it provides assistance to many native students throughout the country.

Essential programs, such as health care and education, are being slashed - hurting the people that need it most. Budgets are about priorities, and it is obvious to me that the president's budget priorities for Indian Country are backwards.

In addition to the cuts to programs that serve native students, the President's budget request again shortchanges educational opportunities for all school children. It's unfortunate that this budget builds upon the education cuts enacted last year. The No Child Left Behind Act would be underfunded by $15.4 billion for FY07, brining the cumulative shortfall for NCLB programs since enactment to $55.7 billion. Additionally, the President's budget would leave behind 3.7 million students, including an estimated 12,252 in my state of South Dakota, who could be served by Title I if it were fully funded.

The Administration's funding request for special education is no better. The federal government has never lived up to the promise to provide 40 percent of the cost of special education. We all know how tight state and local education budgets are, and if we fully funded IDEA, school districts could use local revenue for a host of community priorities like smaller class sizes, increased teacher pay, technology upgrades, or school construction. Under this request, the federal government would provide only 17 percent of the average per-pupil cost of special education. We were making limited progress in IDEA funding when we provided 19 percent in

FY05, but we've moved backwards and provided 18 percent last year. It's time for the federal government to live up to its education promises made when NCLB and IDEA were enacted.

Even with the modest funding increases in NCLB and IDEA, the President's request eliminates 42 programs within the Department of Education for a total of about $3.5 billion. These programs range from career and technical education programs to Safe and Drug Free Schools programs to the Even Start program.

Once again, President Bush has proposed shifting the burden of providing VA health care on to our nation's veterans. Increasing co-payments and mandating enrollment fees is not the solution. Instead, the Bush Administration should submit a budget with adequate funding to address the needs of our veterans. The Bush Administration has proposed once again a $250 annual enrollment fee for Category 7 and 8 veterans. Further, the budget also would increase pharmacy copayments for Category 7 and 8 Veterans from $8 for a 30-day supply of drugs to $15. Providing for the health care of our nation's veterans is a moral issue, and the brave men and women who fought for our country should not be told their health care needs come last.

This budget proposal cuts Medicare by about $35 billion over five years. Savings would be achieved by reducing payments to hospitals and other providers including nursing home and home health, which will be particularly detrimental to rural providers who are already struggling to meet community needs with current reimbursement. The budget request also would add additional cost sharing for some higher income beneficiaries through higher premiums for doctor visits. Currently, Medicare charges $88.50 a month for this coverage.

Rural Health programs are allocated a total of $27 million, which represents a cut of $94 million or 73 percent. Title VIII Nursing programs are flat funded at $150 million, and the Title VII Health Professions Training programs are proposed for elimination. At least 15 other programs are completely eliminated, including Emergency Medical Services for Children, Newborn Hearing Screening, and Trauma Care. Other programs cut or eliminated include the Rural Health Outreach grant program, the Rural Health Flexibility grant program, and the Rural and Community Access to Emergency Devices program.

Community development funding is another area of disappointment. Last year, the President offered us an Orwellian proposal called the "Strengthening America's Communities Initiative." Its basic strategy is to eliminate effective government tools for investing in disadvantaged communities, abandoning them to sink or swim on their own. In response to a huge outpouring of public criticism, Democrats and Republicans in Congress worked together to reject nearly all of the initiative.

Unfortunately, the President disregarded public sentiment and the Congress, which is led by members of his own party, and offered a recycled version of the same bad proposal. For example, he proposes to cut three quarters of a billion dollars from the popular and effective Community Development Block Grants (CDBG) program, which facilitates infrastructure and housing investments in disadvantaged communities.

I fully recognize the need to get our record-breaking budget deficits under control, and I support efforts to eliminate wasteful government spending. But these cuts are proposed for a different purpose – to partially offset additional tax cuts that benefit a tiny slice of society. Our rejection of last year's Strengthening America's Communities Initiative showed the members of Congress from both sides of the aisle felt it was wrong to take money from low- and middle-income people to give to upper-income people. It was wrong then, and it's still wrong today.

Thank you again, Mr. Bolten, for appearing before the Committee. Mr. Chairman, I look forward to working with you and Senator Conrad in the coming weeks as we consider the President's budget request.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

May 4, 2006

The Honorable Judd Gregg
Chairman
Committee on Budget
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are answers to questions we have received for the record following the testimony of Joshua Bolten before your committee on February 8, 2006. Since Mr. Bolten has resigned as Director of the Office of Management and Budget (OMB) and has now assumed new responsibilities as White House Chief of Staff, these answers provide responses from OMB, rather than from Director Bolten personally.

Sincerely,

Clay Johnson III
Acting Director

Enclosure

Question for the record from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Question: **Would OMB submit, in detail, a list of the programs that you contemplate eliminating or reducing?**

As in the 2006 Budget, the 2007 Budget proposes to eliminate or reduce Government programs that are not producing results or fulfilling essential priorities. In 2006, the Congress achieved $6.5 billion in savings by acting on 89 of the 154 discretionary proposals for terminations or reductions.

Building on last year's success, the 2007 Budget proposes major savings in or eliminations of 141 programs, totaling nearly $15 billion. On February 9th, OMB released the document, *Major Savings and reforms in the President's 2007 Budget,* which provides additional information on these terminations and reductions. And, a detailed list of discretionary programs proposed for termination or reduction is attached.

The Administration looks forward to working with the Congress to continue to eliminate or reduce funding for programs that are not producing results or fulfilling essential priorities.

Discretionary Program Terminations in the FY 2007 Budget
(Budget authority in millions)

Terminations	Has the reduction been proposed before? 2004	2005	2006	2006 Request	2006 Enacted	2007 Request	2007 Request less 2006 Enacted
Department of Agriculture							
Microbiological Data Program	N	N	N	6	6	---	-6
Community Connect (Broadband) Grants	N	Y	Y	---	9	---	-9
Commodity Supplemental Food Program	N	N	N	107	107	---	-107
Research & Extension Grant Earmarks/Low Priority Programs	Y	Y	Y	---	196	---	-196
P.L. 480 Title I, Direct Credit and Ocean Freight Differential Grants	N	N	N	65	80	3	-77
Forest Service Economic Action Program	Y	Y	Y	---	10	---	-10
High Cost Energy Grants	Y	Y	Y	---	26	---	-26
Public Broadcast Grants	N/A	Y	Y	---	5	---	-5
Watershed Protection and Flood Prevention Operations	N	N	Y	---	75	---	-75
Total, Agriculture Terminations				**178**	**514**	**3**	**-511**
Department of Commerce							
Advanced Technology Program (ATP)	Y	Y	Y	---	79	---	-79
Emergency Steel Guarantee Loan Program	Y	Y	Y	-50	---	-49	-49
Public Telecom. Facilities, Planning and Construction Grants	Y	Y	Y	2	22	---	-22
Total, Commerce Terminations				**-48**	**101**	**-49**	**-150**
Department of Education							
Educational Technology State Grants	N	N	Y	---	272	---	-272
Even Start	Y	Y	Y	---	99	---	-99
High School Programs Terminations:							
Vocational Education State Grants	N	N	Y	---	1,182	---	-1,182
Vocational Education National Programs	Y	Y	Y	---	9	---	-9
Upward Bound	N	N	Y	---	311	---	-311
GEAR UP	N	N	Y	---	303	---	-303
Talent Search	N	N	Y	---	145	---	-145
Tech Prep State Grants	Y	Y	Y	---	105	---	-105
Smaller Learning Communities	Y	Y	Y	---	94	---	-94
Safe and Drug-Free Schools State Grants	N	N	Y	---	347	---	-347
Small Elementary and Secondary Education Programs:							
Parental Information and Resource Centers	Y	Y	Y	---	40	---	-40
Arts in Education	Y	Y	Y	---	35	---	-35
Elementary and Secondary School Counseling	Y	Y	Y	---	35	---	-35
Alcohol Abuse Reduction	Y	Y	Y	---	32	---	-32
Civic Education	N	N	Y	---	29	---	-29
National Writing Project	Y	Y	Y	---	22	---	-22
Star Schools	Y	Y	Y	---	15	---	-15
School Leadership	Y	Y	Y	---	15	---	-15
Ready to Teach	Y	Y	Y	---	11	---	-11
Javits Gifted and Talented Education	Y	Y	Y	---	10	---	-10
Exchanges with Historic Whaling and Trading Partners	Y	Y	Y	---	9	---	-9
Comprehensive School Reform	Y	Y	Y	---	8	---	-8
School Dropout Prevention	Y	Y	Y	---	5	---	-5
Mental Health Integration in Schools	N	N	Y	---	5	---	-5
Women's Educational Equity	Y	Y	Y	---	3	---	-3
Academies for American History and Civics	N/A	N/A	N/A	---	2	---	-2
Close-Up Fellowships	Y	Y	Y	---	1	---	-1
Foundations for Learning	N	Y	Y	---	1	---	-1
Excellence in Economic Education	N	Y	Y	---	1	---	-1
Small Higher Education Programs:							
Higher Education Demos for Students with Disabilities	Y	Y	Y	---	7	---	-7
Underground Railroad Program	Y	Y	Y	---	2	---	-2
State Grants for Incarcerated Youth Offenders	Y	Y	Y	---	23	---	-23
Small Postsecondary Student Financial Assistance Programs							
Perkins Loan Cancellations	N	N	Y	---	65	---	-65
Leveraging Educational Assistance Programs	Y	Y	Y	---	65	---	-65
Byrd Scholarships	N	N	Y	---	41	---	-41
Thurgood Marshall Legal Educational Opportunity	Y	Y	Y	---	3	---	-3
B.J. Stupak Olympic Scholarships	Y	Y	Y	---	1	---	-1
Small Vocational Rehabilitation (VR) Programs:							
Supported Employment	Y	Y	Y	---	30	---	-30
Projects with Industry	Y	Y	Y	---	20	---	-20
VR Recreational Programs	Y	Y	Y	---	3	---	-3
VR Migrant and Seasonal Farmworkers	Y	Y	Y	---	2	---	-2
cher Quality Enhancement	N	N	Y	---	60	---	-60
otal, Education Terminations				---	**3,468**	---	**-3,468**

Discretionary Program Terminations in the FY 2007 Budget
(Budget authority in millions)

Terminations	Has the reduction been proposed before? 2004	2005	2006	2006 Request	2006 Enacted	2007 Request	2007 Request less 2006 Enacted
Department of Energy							
University Nuclear Energy Program	N	N	N	24	27	---	-27
Oil and Gas Research and Development	N	N	Y	20	64	---	-64
Geothermal Technology Program	N	N	N	23	23	---	-23
Total, Energy Terminations				**67**	**114**	**---**	**-114**
Department of Health and Human Services (HHS)							
CDC Preventive Health and Health Services Block Grant	N	N	Y	---	99	---	-99
Real Choice Systems Change Grants	N	N	Y	---	25	---	-25
Community Services Block Grant	N	N	Y	---	630	---	-630
Community Services Programs:							
Community Economic Development	N	N	Y	---	27	---	-27
Rural Community Facilities	Y	Y	Y	---	7	---	-7
Job Opportunities for Low-Income Individuals	N	N	Y	---	6	---	-6
Maternal and Child Health Small Categorical Grants	N	Y	Y	---	39	---	-39
Urban Indian Health Program	N	N	N	33	33	---	-33
Total, HHS Terminations				**33**	**866**	**---**	**-866**
Department of Homeland Security (DHS)							
Office of Grants and Training	N	N	N	1,854	229	---	-229
Total, DHS Major Terminations				**1,854**	**229**	**---**	**-229**
Department of Housing and Urban Development (HUD)							
HOPE VI	Y	Y	Y	-143	99	-99	-198
Total, HUD Terminations				**-143**	**99**	**-99**	**-198**
Department of the Interior							
BIA Johnson-O'Malley Assistance Grants	N	N	N	8	16	---	-16
LWCF State Recreation Grants	N	N	Y	---	28	---	-28
National Park Service Statutory Aid	N	N	Y	---	7	---	-7
Rural Fire Assistance	N	N	Y	---	10	---	-10
Total, Interior Terminations				**8**	**61**	**---**	**-61**
Department of Justice							
Byrne Discretionary Grants	Y	Y	Y	---	189	---	-189
Byrne Justice Assistance Grants	N	N	Y	---	327	---	-327
COPS Law Enforcement Technology Grants	N	Y	Y	---	128	---	-128
Juvenile Accountability Block Grants	Y	Y	Y	---	49	---	-49
National Drug Intelligence Center	N	N	Y	17	39	16	-23
State Criminal Alien Assistance Program	Y	Y	Y	---	400	---	-400
Total, Justice Terminations				**17**	**1,132**	**16**	**-1,116**
Department of Labor							---
America's Job Bank	N	N	N	20	15	---	-15
Denali Commission Job Training Earmark	N	Y	Y	---	7	---	-7
Migrant and Seasonal Farmworkers Training Program	Y	Y	Y	---	79	---	-79
Reintegration of Youthful Offenders	Y	N	Y	---	49	---	-49
Susan Harwood Training Grants (OSHA)	Y	Y	Y	---	10	---	-10
Work Incentive Grants	N	N	N	20	20	---	-20
Total, Labor Terminations				**40**	**180**	**0**	**-180**
Department of Transportation							
National Defense Tank Vessel Construction Program	N	N	Y	-75	---	-74	-74
Railroad Rehab. and Improvement Financing Loan Program	N	N	Y	---	---	---	---
Total, Transportation Terminations				**-75**	**---**	**-74**	**-74**
Environmental Protection Agency (EPA)							
Unrequested Projects	Y	Y	Y	---	277	---	-277
Total, EPA Terminations				**---**	**277**	**---**	**-277**
Other Agencies							
CNCS National Civilian Community Corps	N	N	N	26	27	5	-22
CNCS President's Freedom Scholarships	N	N	N	4	4	---	-4
National Veterans Business Development Corporation	N	N	Y	---	1	---	-1
Small Business Administration Microloan Program	N	Y	Y	---	14	---	-14
Postal Service Forgone Revenue Appropriation	N	Y	Y	---	29	---	-29
Total, Other Agencies Terminations				**30**	**75**	**5**	**-70**
Total, Discretionary Program Terminations				**1,961**	**7,116**	**-198**	**-7,314**

Major Discretionary Reductions in the FY 2007 Budget
(Budget authority in millions)

Major Reductions	Has the reduction been proposed before? 2004	2005	2006	2006 Request	2006 Enacted	2007 Request	2007 Request less 2006 Enacted
Department of Agriculture							
Conservation Operations	Y	Y	Y	768	822	745	-77
Resource Conservation and Development Program	N	N	Y	26	51	26	-25
State and Private Forestry	N	N	N	99	217	117	-100
In-House Research	Y	Y	Y	996	1,124	1,001	-123
Mandatory Reductions Providing Discretionary Offsets:							
Environmental Quality Incentives Program	Y	Y	Y	-200	-NA-	-270	-270
Market Access Program	Y	Y	Y	-75	-NA-	-100	-100
Rural Economic Development Grants	Y	Y	Y	-5	-NA-	-89	-89
Watershed Rehabilitation Program	Y	Y	Y	-210	-NA-	-65	-65
Farmland Protection Program	Y	Y	Y	-16	-NA-	-47	-47
Value-added Marketing Grants	Y	Y	Y	-120	-NA-	-40	-40
Wildlife Habitat Incentives Program	Y	Y	Y	-25	-NA-	-30	-30
Agricultural Management Assistance	N	N	Y	-14	-NA-	-14	-14
Broadband	Y	Y	Y	-50	-NA-	-10	-10
Ground and Surface Water Conservation	N	N	Y	---	-NA-	-9	-9
Renewable Energy Program	Y	Y	Y	-23	-NA-	-3	-3
Biomass Research and Development	N	N	Y	-2	-NA-	-2	-2
Total, Agriculture Major Reductions				**1,149**	**2,214**	**1,210**	**-1,004**
Department of Commerce							
Manufacturing Extension Partnership	Y	Y	Y	47	105	46	-59
Technology Administration	N	N	Y	4	6	1	-5
Total, Commerce Major Reductions				**51**	**111**	**47**	**-64**
Department of Education							
Perkins Loans Institutional Fund Recall	N	N	N	---	---	-664	-664
Teaching American History	N	N	N	119	120	50	-70
Physical Education	Y	N	Y	55	73	26	-47
Mentoring Program	N	N	Y	49	49	19	-30
Total, Education Major Reductions				**223**	**242**	**-569**	**-811**
artment of Energy							
vironmental Management	N	N	Y	6,505	6,590	5,828	-762
Weatherization Assistance Program	N	N	N	230	243	164	-79
Clean Coal Power Initiative	N	N	N	50	50	5	-45
Total, Energy Major Reductions				**6,785**	**6,883**	**5,997**	**-886**
Department of Health and Human Services (HHS)							
HRSA- Children's GME	Y	Y	Y	200	297	99	-198
HRSA- Health Professions	Y	Y	Y	161	295	159	-136
HRSA- Poison Control Centers	Y	N	N	23	23	13	-10
HRSA- Rural Health	Y	Y	Y	29	160	27	-133
Social Services Block Grant	N	N	N	1,700	1,700	1,200	-500
Substance Abuse and Mental Health Administration- Programs of Regional and National Significance	N	N	Y	837	851	780	-71
Total, HHS Major Reductions				**2,950**	**3,326**	**2,278**	**-1,048**
Department of Homeland Security (DHS)							---
Office of Grants and Training	N	N	N	1,854	1,789	1,095	-694
Total, DHS Major Reductions				**1,854**	**1,789**	**1,095**	**-694**
Department of Housing and Urban Development (HUD)							
Public Housing Capital Fund	N	N	Y	2,327	2,439	2,178	-261
Total, HUD Major Reductions				**2,327**	**2,439**	**2,178**	**-261**
Department of the Interior							
BIA School Construction	N	Y	Y	174	207	157	-50
Bureau of Reclamation Reductions (excl. Central Utah Project)	Y	Y	Y	873	977	850	-127
USGS Mineral Resources Program	N	Y	Y	25	53	31	-22
Total, Interior Major Reductions				**1,072**	**1,237**	**1,038**	**-199**
Department of Labor							
State Job Training Grants Consolidation	Y	Y	Y	3,933	3,927	3,413	-514
International Labor Affairs Bureau	Y	Y	Y	12	73	12	-61
Office of Disability Employment Policy	N	N	Y	28	28	20	-8
Total, Labor Major Reductions				**3,973**	**4,028**	**3,445**	**-583**
partment of Transportation							
rak	Y	Y	Y	360	1,294	900	-394
- Airport Improvement Program (oblim)	N	N	Y	3,000	3,515	2,750	-765
Total, Transportation Major Reductions				**3,360**	**4,809**	**3,650**	**-1,159**

Major Discretionary Reductions in the FY 2007 Budget
(Budget authority in millions)

	Has the reduction been proposed before? 2004	2005	2006	2006 Request	2006 Enacted	2007 Request	2007 Request less 2006 Enacted
Department of the Treasury							
IRS Business Systems Modernization	N	N	N	197	197	167	-30
Total, Treasury Major Reductions				**197**	**197**	**167**	**-30**
Environmental Protection Agency							
Alaska Native Villages	N	N	Y	15	34	15	-19
Clean Water State Revolving Fund	Y	Y	Y	730	887	688	-199
Total, EPA Major Reductions				**745**	**921**	**703**	**-218**
International Assistance Programs (IAP)							
Assistance for Eastern European Democracy	N	N	N	382	357	274	-83
Assistance for the Independent States of the Former Soviet Union	N	N	Y	482	509	441	-68
Total, IAP Major Reductions				**864**	**866**	**715**	**-151**
National Aeronautics and Space Administration (NASA)							
Aeronautics Mission Research Directorate	N	N	Y	851	884	724	-160
Total, NASA Major Reductions				**851**	**884**	**724**	**-160**
Other Agencies							
Corporation for Public Broadcasting	N	N	Y	390	460	346	-114
Denali Commission	N	Y	Y	140	53	6	-47
NARA National Historical Publications and Records Commission	N	N	Y	---	8	---	-8
Total, Other Agencies Major Reductions				**530**	**521**	**352**	**-169**
Total, Major Discretionary Reductions				**26,931**	**30,467**	**23,030**	**-7,437**

Question for the record from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Question: There is a list of receipts, the Bonneville Power and the like, where OMB expect revenues by changes in formulas or the like. I would like a list of all of those kind of things, and an indication whether they have been tried before, or how many times they have been submitted up here and not done. Can you provide that?

Answer: User fee proposals in the budget appear in the *Analytical Perspectives* volume in Table 18-3. "User Fee and Other User Charge Proposals", pages 276-77.

Attached is a copy of that table with a new column indicating whether the user fee proposals in the budget have been proposed before as the same or similar proposal in the FY 2002-2006 budgets.

Regarding the Bonneville Power item identified in the question, this does not appear in the table because it is not a discretionary or mandatory proposed change in fees. Under the President's FY 2007 Budget, Bonneville Power will use its authority under current law to use any surplus power sales (not secondary) revenues it earns above its historical high level of $500 million in a year to make early payments on its Federal bond debt to the U. S. Treasury. This program assumption has not been made in the recent past.

February 22, 2006

FROM THE *ANALYTICAL PERSPECTIVES* VOLUME OF THE FY 2007 BUDGET (page 276-77)
Table 18-3. USER FEE AND OTHER USER CHARGE PROPOSALS IN THE FY 2007 BUDGET 1/
(estimated collections in millions of dollars)

	Proposed before? 2/	2007	2008	2009	2010	2011	2007-2011
DISCRETIONARY:							
1. Offsetting collections							
Department of Agriculture							
Farm Service Agency user fees	No	35	34	34	33	34	170
Department of Defense							
Medical care fees	No	249	635	907	1,106	1,353	4,250
Department of Health and Human Services							
Medicare program management: Survey and certification user fee	No	35	34	34	33	34	170
Department of Homeland Security							
Transportation Security Administration: Aviation security fees	Yes	1,631	1,778	1,938	2,105	2,283	9,735
Department of Housing and Urban Development							
Office of Federal Housing Enterprise Oversight: Government-sponsored enterprise (GSE) regulation	Yes	-62	-60	-60	-59	-59	-300
Department of Justice							
Bureau of Alcohol, Tobacco, Firearms, and Explosives: Explosives regulation user fees	Yes	120	116	115	114	115	580
Department of Transportation							
St. Lawrence Seaway Development Corporation commercial tolls	Yes	9	9	9	9	9	45
Department of Veterans Affairs							
Medical care fees:							
Prescription copayments for PL7s and 8s	Yes	288	255	255	255	254	1,307
Annual enrollment user fee for PL 7s and 8s	Yes	226	229	221	212	204	1,092
Eliminating offset of copayments with insurance collections for PL 7s and 8s	Yes	30	34	38	42	47	191
Commodity Futures Trading Commission							
Transaction fees	Yes	127	123	122	120	122	614
2. Offsetting receipts							
Department of the Interior							
Abandoned mine reclamation fees (extension of existing fee, not a new fee)	Yes	312	79	---	---	---	391
Repeal Energy Bill fee prohibition	Yes	---	20	20	20	20	80
Subtotal, discretionary user charge proposals		3,000	3,286	3,633	3,990	4,416	18,325
MANDATORY:							
1. Offsetting collections							
Depatment of Housing and Urban Development	Yes						
Government-sponsored enterprise (GSE) regulation		6	6	6	6	6	30
Federal Housing Enterprise Regulator							
Government-sponsored enterprise (GSE) regulation	Yes	98	98	98	98	98	490
Federal Housing Finance Board							
Government-sponsored enterprise (GSE) regulation	Yes	-36	-38	-39	-40	-41	-194
2. Offsetting receipts							
Department of Agriculture							
Food Safety and Inspection Service user fees*	Yes	105	155	148	151	154	713
Grain, Inspection, Packers, and Stockyards Administration (GIPSA) user fees*	Yes	20	20	21	21	22	104
Agricultural Marketing Service standardization user fees*	Yes	14	14	15	15	15	73
Animal and Plant Health Inspection Service user fees*	Yes	8	11	11	12	12	54
Federal crop insurance fees*	No	---	15	15	15	15	60
Department of Defense							
National defense stockpile asset sales: Authorization for additional sales	3/	1	50	72	80	96	299
Department of Health and Human Services: Food and Drug Administration							
Re-inspection fees*	No	22	23	23	24	24	116
Food and animal feed export certification fees*	No	4	4	4	4	4	20
Department of Homeland Security							
Immigration examination fees	Yes	31	31	31	31	31	155
Department of the Interior							
Bureau of Land Management land sale authority	Yes	---	5	9	14	52	80
Arctic National Wildlife Refuge, lease bonuses:							
Collections for payments to Alaska	Yes	---	3,502	2	503	3	4,010
Federal receipts	Yes	---	3,502	2	503	3	4,010
Department of Labor							
Foreign labor certification fees	Yes	35	35	35	35	35	175

February 22, 2006

FROM THE *ANALYTICAL PERSPECTIVES* VOLUME OF THE FY 2007 BUDGET (page 276-77)
Table 18-3. USER FEE AND OTHER USER CHARGE PROPOSALS IN THE FY 2007 BUDGET 1/
(estimated collections in millions of dollars)

	Proposed before? 2/	2007	2008	2009	2010	2011	2007-2011
Pension Benefit Guaranty Corporation premiums	Yes	—	4,202	4,209	4,223	4,237	16,871
Department of the Treasury							
Alcohol and Tobacco Tax and Trade Bureau regulatory activity user fees*	Yes	29	29	29	29	29	145
Corps of Engineers – Civil Works							
Additional recreation fees	Yes	9	17	17	17	17	77
Environmental Protection Agency							
Pesticide user fees*	Yes	56	66	53	53	53	281
Pre-manufacturing notice user fees*	Yes	4	8	8	8	8	36
Federal Communications Commission							
Authorize spectrum license fees	Yes	50	150	300	300	400	1,200
Subtotal, mandatory user charge proposals		456	11,905	5,069	6,102	5,273	28,805
GOVERNMENTAL RECEIPTS:							
Department of the Interior							
National Indian Gaming Commission activity fees	Yes	—	5	5	5	5	20
Total, user charge proposals		**3,456**	**15,196**	**8,707**	**10,097**	**9,694**	**47,150**

1/ A negative sign indicates a decrease in collections.
2/ The same or similar proposal was in at least one of the FY 2002-2006 budgets.
3/ National Defense stockpile sales have been proposed and enacted several times in the past decade.
* Once the fees are enacted, the Administration will work to reclassify them to offset discretionary spending beginning in 2008.

Question from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

In his State of the Union address, the President announced the American Competitiveness Initiative to encourage American innovation. A major part of the initiative is to double funding for three key agencies that support research in the physical sciences – the Department of Energy Office of Science, the National Science Foundation, and the National Institute of Standards and Technology. The FY07 budget requests increases to these three agencies, on average, of over 9 percent, putting them on track to double in ten years.

Question: Will OMB remain committed, over the next three years, to doubling funding by 2017 to these key supporters of physical science research?

Answer: Through the American Competitiveness Initiative, the Administration has committed to a path that would by 2016 double funding collectively for the Department of Energy's Office of Science, the National Science Foundation, and the labs of the National Institute of Standards and Technology. The Administration looks forward to working with Congress to accomplish this.

Question from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

<u>Question:</u> Can OMB explain, for the record in some detail, what the justification is for the fossil fuel reductions, because OMB have some new initiatives in coal, but OMB got rid of some of the old ones, and I do not understand why?

Answer: The 2007 Budget for Fossil Energy Research and Development focuses funding on the President's priorities, while reducing funding for programs that need to improve performance or are not achieving results.

The 2007 Budget provides $281 million for the Coal Research Initiative within the Department of Energy, nearly completing (total of $1.9 billion requested from 2002-2007) the President's $2 billion, ten-year commitment for clean coal R&D four years ahead of schedule. The Budget requests $54 million for FutureGen, DOE's flagship demonstration of next-generation clean coal technology, and an advance appropriation of $203 million for 2008. Funding for FutureGen and its supporting R&D is consistent with the Administration's R&D Investment Criteria and is a priority because these technologies are a significant leap beyond the technology of conventional "pulverized coal" power plants. They focus on long-term, potentially large public benefits, and as a result there are insufficient market incentives to expeditiously drive innovation through the private sector alone.

The Budget restricts the addition of new funds to DOE's other clean coal demonstration program, the Clean Coal Power Initiative (CCPI), so that the program can take steps to improve the use of funds already provided for projects. As identified in its Program Assessment Rating Tool (PART) review, CCPI and its predecessor demonstration programs have a backlog of over $500 million in unused balances, including money for projects that were awarded several years ago and have not even started. The program is working to improve project selection to ensure consistency with the R&D Investment Criteria, withdraw funds when projects stall, and improve contract and project management controls so that desired results are achieved on schedule and on budget. Ongoing CCPI projects, FutureGen, and various tax incentives continue to provide incentives for demonstration of clean coal technologies.

The Budget also provides for orderly termination of the Oil and Gas research and development (R&D) programs. In explaining the proposed termination of the natural gas technologies program in the 2007 Budget, the President said, "The private sector has got better incentives to provide natural gas for you -- it's called price, not the Federal government's program." The 2007 Budget proposes to terminate DOE's oil and gas R&D programs, as in the 2006 Budget, because these R&D activities are more appropriate for the private sector to perform and the programs have not demonstrated results, as identified in the PART review. The 2007 Budget also recommends repealing provisions in the Energy Policy Act of 2005 for a new mandatory $50 million per year (2007–2017) oil and gas R&D program funded with Federal revenues from oil and gas leases, which would be similar to the discretionary programs proposed for termination. The oil and gas technology programs focus on incremental and evolutionary technology advances that oil and gas companies have the incentive to conduct, which is not in accord with the Administration's R&D Investment Criteria.

Question from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Question: I note that OMB has requested almost $68 million between the Forest Service and BLM to fully fund implementation of President Clinton's Pacific Northwest Forest Plan. Can OMB explain to me why the Administration is so willing to expend Forest Service funds in California, Oregon, and Washington, while we have seen no similar increase for timber or forest restoration funding in the Intermountain States?

Answer: President Bush has made a commitment to fully implement the Northwest Forest Plan and achieve the increased level of timber harvest promised under that plan. The Forest Service budget meets that commitment.

The Budget increases funding for hazardous fuels treatments in the Intermountain states to over $110 million. That is a $6 million increase (+5.5%) over FY 2006. Also, $2.4 million of this increase goes to the Southwest Region, which includes New Mexico and Arizona. The Southwest Region is to receive over $45 million for hazardous fuels projects. These investments, coupled with the tools under the President's Healthy Forests Initiative, have enabled us to thin more than 215,000 acres in this region in FY 2005, a level that is more than triple the FY 2002 amount of 69,000 acres. The Budget provides $76 million for the Forest Service timber budget in the Intermountain States, a -$10 million (-11%) reduction below 2006. The Southwestern Region, which includes Arizona and New Mexico, will receive $13 million for timber, a reduction of -$2 million (-16%) below 2006. However, despite this reduction, the Budget provides $57 million for timber and hazardous fuels for the Southwestern Region, a level equal to that for 2006.

Equally important, the Budget reflects a continuing emphasis on Forest Service performance. To achieve that end, the Budget reflects greater use of streamlined forest planning and authorities included in the President's Healthy Forests Initiative and the Healthy Forests Restoration Act. In addition, the Budget continues administrative efficiencies and organizational reforms for the Forest Service. Collectively, these efforts will lead to higher restoration levels throughout the National Forest System, including in the Intermountain States.

Question for the record from Senator Pete Domenici
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Last year, for the first time in nearly a decade, Congress passed critical reforms to our nation's most expensive programs. However, in the end, the changes that were made were only a fraction of what the Administration recommended. We saved just over $10 billion when the Administration made recommendations for changes that would have saved nearly $100 Billion. In the President's FY07 budget, the president recommends changes to Medicare that would save almost $36 billion dollars over the next five years as well as other changes to the Medicaid and Social Security program.

Question: **What will be the impact on our economy if mandatory spending continues to grow at current rates and consumes a larger and larger portion of our gross domestic product?**

Answer: The fact is that mandatory spending cannot continue to grow at current rates indefinitely, absorbing an ever-larger portion of our economy. Financing this rising spending with higher tax rates would cripple the economy. The slow growth rates that have plagued our trading partners for more than a decade are traceable in part to the much higher tax burdens in Europe and Japan. Alternatively, borrowing to finance the rising spending would also bring risks to future growth. If the resulting deficit comes at the expense of domestic investment, the long-term effect would be to slow down capital formation and impede growth. It is not necessary to cut the absolute level of mandatory spending, but there is no escape from the need to make fundamental changes in these programs to bring future benefits in line with available resources.

Question: **What would our financial situation look like both domestically and internationally if changes are not made?**

Answer: As indicated in the previous answer, the effects depend on how future mandatory spending is paid for in the absence of reforms. Higher taxes would slow growth and limit the rise in future living standards. Higher domestic borrowing would have similar effects by reducing investment in the private sector.

<u>Question:</u> Although most members of Congress acknowledge the problems, few seem willing to address it. What does the Administration intend to do to make sure the necessary changes are made?

Answer: The Administration is committed to making fundamental reforms in the Nation's major entitlement programs. In his State of the Union address, the President called for a bipartisan commission to examine the impact of the retirement of the baby boom generation on Social Security, Medicare, and Medicaid. The Administration has also made specific proposals for Social Security reform, an enhanced Medicare fiscal control mechanism, and $65 billion in savings over five years in mandatory programs. There is ample time to act in a responsible way to limit entitlement spending, but the sooner serious action is taken, the better. Through the bipartisan commission and through its specific budget proposals, the Administration stands ready to work with Congress to make progress on this vital issue.

Question for the record from Senator Jim Bunning
Senate Budget Committee Hearing
OMB Response
February 7, 2006

It appears that Corps of Engineer funding for hydropower continues to decrease, especially in the FY07 budget.

Question: Why has the funding continued to decrease and are there sufficient funds to continue on-going hydropower repairs and provide the level of service needed to maintain recreational opportunities currently afforded to the public?

Answer: The Budget continues to invest substantial resources in the Army Corps of Engineers (Corps) hydropower program. The Budget level for this program is about the same as the one enacted for FY 2005, and is about four percent ($11 million) below the FY 2006 enacted level.

While the total for the Corps hydropower program declined compared to last year, the Budget provides more funding than last year to operate and maintain the existing facilities. The Budget also funds three significant projects to replace existing hydropower units. However, the total funding for replacements has declined. Some projects did not qualify for funding because their economic return is lower than other potential civil works investments. Two others – the Buford Powerhouse, GA, and Hartwell Lake Powerhouse, SC and GA – are scheduled to be completed in FY 2006 with the enacted funding and therefore did not require additional funding. Funding also may vary from year to year based on factors such as the specific on-the-ground work schedule at each project and the ability of contractors to do the work.

Hydropower continues to be a valuable source of energy supply for the nation and the Administration will be actively looking at new ways to maintain and improve our nation's hydropower infrastructure.
The funding provided for the Corps recreation program in the FY 2007 budget is about equal to the enacted level for FY 2006.

<u>Question:</u> What are the impacts to the Wolf Creek – Lake Cumberland project?

The President's FY 2007 budget includes $31 million for dam safety construction at Wolf Creek and $7 million for operations and maintenance. Of that amount, $5 million is for essential hydropower operations and maintenance, including a generator re-wind at Wolf Creek Dam.

Kentucky Lock Addition was in the budget from FY02 to FY05 and was not included in FY06 because of remaining benefit – remaining to cost ratio (2.5). A significant contract for road and bridges relocation was awarded in FY05 for $89 million with a 54 month duration. Congress added $23 million in FY06 to continue this project.

<u>Question:</u> Why is it not included in the FY07 President's budget?

Answer: The FY 2007 Budget again proposes seven performance guidelines for allocating funds among construction projects within the Corps main mission areas. Under these guidelines, the Budget will build the best projects faster, complete more projects sooner, and ensure that taxpayer dollars are spent on projects with the greatest return on the investment, based on objective performance criteria. The Kentucky Lock & Dam project on the Tennessee River, KY, did not meet the required performance threshold for funding under the performance guidelines, based upon its ratio of remaining benefits to remaining costs (RBRC). Specifically, commercial navigation-related construction projects must have at least a three-to-one RBRC in order to compete successfully for funding in the Corps Budget. As you stated, the Kentucky Lock & Dam project has an estimated RBRC below that performance threshold.

Questions for the record from Senator Lindsey Graham
Senate Budget Committee Hearing
OMB Response
February 7, 2006

When the Savannah River Site was selected as the site where the Mixed Oxide Fuel (MOX) program was to be carried out, the Department of Energy and National Nuclear Security Administration made important commitments to the state of South Carolina. If the MOX plant was not constructed and fully operational according to a schedule codified in the FY2003 Defense Authorization Act, the federal government would be required to pay the state of South Carolina up to $100 million dollars per year beginning in 2011. The MOX program is currently three years behind schedule. In the FY06 Energy and Water Appropriations Act, the penalty payment time table was adjusted by three years in order to reflect these delays. However, we must accelerate the program in order to bring it closer to the original construction and operations schedule.

Question: Should the new schedule for the MOX plant not be met, is it the intention of the Federal Government to honor its commitments to South Carolina and make the penalty payments?

Answer: The Administration will work with Congress and the State of South Carolina to fully meet its legal commitments.

Question: Can I get OMB's assurance that the administration will work to prevent any attempts to further weaken the penalty language?

Answer: The Administration strongly supports the MOX program and is not proposing legislation to alter the penalty language.

The President has requested $383 million for the MOX program for FY 2007. On a cost basis, the MOX program represents our nation's largest single non-proliferation program. After the MOX plants in South Carolina and Russia are constructed and operational, they will lead to the ultimate elimination of 34 metric tons of defense plutonium. This represents approximately 4,000 nuclear warheads.

<u>Question:</u> Does the FY 2007 funding level aim to accelerate construction to make up for time lost in negotiating with the Russians?

<u>Answer:</u> No. The FY 2007 request supports a revised schedule that incorporates both the two-year delay resulting from negotiations and the $118 million reduction in FY 2006 enacted funding. The new schedule has major construction beginning in 2006 and full operations in 2015. Although we expect both the Russian and the U.S. programs to move forward, they will be on the new schedule reflected above.

<u>Question:</u> While the funding is increased over last year's appropriated amount, it does not appear to be enough money to bring the project back on time. How much money would be required to bring the project back on schedule?

<u>Answer:</u> The President's FY 2007 budget supports beginning major construction in 2006 and beginning operations in 2015. This schedule reflects the negotiation delays with the Russians and funding reductions. However, until the Department can validate the re-baselined cost and schedule of the new program through an independent review, it is unknown whether these activities can be accelerated and what funding would be required.

The Department of Energy Inspector General just released a report that detailed poor management and significant cost over-runs in the program. While NNSA disputes the costs associated with the over-runs, any over-run is troublesome. Recognizing that we are operating within significant fiscal restraints, any cost over-runs in this project are problematic.

<u>Question:</u> What is OMB doing to ensure that cost-over runs associated with this project are minimized?

Answer: OMB understands that the Inspector General report cited difficulties faced by the program well over a year ago. In the intervening time DOE has taken actions to address many of the issues raised by the report. We will follow the independent review DOE will conduct on the re-baselined cost and schedule estimates for construction of the MOX facility, and the implementation of new contract provisions that should minimize future cost overruns. OMB will assess these changes and actions once completed, and take further action if they appear insufficient to reduce the future risk of additional over-runs.

Questions for the record from Senator Lindsey Graham
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Question: Why are all unobligated funds for Project Seahawk cancelled? In the event that Project SeaHawk's work is terminated, what is the President's plan to immediately address the security shortfall that will occur?

The 2007 Budget proposes to rescind $27 million in unobligated balances associated with Project Seahawk. Congress first funded the creation of Project SeaHawk, an intermodal transportation and port security pilot project, at the Port of Charleston, South Carolina in the 2003 consolidated appropriations. At that time, the Department of Homeland Security (DHS) had only just been established, and the United States Attorneys (USAs) were directed in the appropriations language to coordinate the project. However, the USAs do not have expertise in managing port security projects. Today, DHS, through the U.S. Coast Guard, is responsible for overseeing port security nationwide.

The Coast Guard has been a full partner in leading and funding SeaHawk operations since its inception. The Coast Guard owns and maintains the SeaHawk building and funds maintenance for the majority of the sensors and information systems, and has a draft plan to transition SeaHawk to sole DHS/Coast Guard leadership and management. A full time USCG liaison officer is assigned to SeaHawk to coordinate current operations with DOJ and manage any transition that may be necessary.

Independent port security initiatives administered by agencies other than the Department of Homeland Security, such as Project SeaHawk, are not necessary and are redundant of DHS's efforts to improve port security.

Question: What is the Administration doing to ensure that all agencies responsible for protecting our nation's commercial seaports are working in a coordinated manner?

The Coast Guard, through the Department of Homeland Security, has the lead responsibility for coordinating port security for the Federal government and since 9/11 has implemented a wide range of new programs to protect the country's maritime infrastructure from terrorist attack. Coast Guard's activities include heightened port security patrols and a regulatory framework designed to improve the safety and security of all U.S. port facilities and vessels operated in U.S. waters under its "Ports, Waterways and Coastal Security" mission. In addition, the Department and Coast Guard have instituted new intelligence programs focused on preventing terrorist incidents in the maritime realm, which are conducted in coordination with other DHS and Federal agencies.

In 2007 the Administration has proposed a 15 percent increase in support of port security activities over the 2006 enacted level. This significant growth represents the high priority the administration has placed on port security, including such targeted programs as the Customs and Border Protection's Customs-Trade Partnership Against Terrorism (C-TPAT) program and the Container Security Initiative (CSI) and the Department of Energy's Megaports and Seaport monitoring initiatives. Specific initiatives have included:

- **C-TPAT.** C-TPAT has become the largest government/private partnership to arise from 9/11, with more than 10,000 private-sector applicants since it began in November 2001. Under C-TPAT, companies sign an agreement to work with CBP to protect the supply chain, identify security gaps, and implement specific security measures. Applicants must address a broad range of security topics including: personnel, physical, and procedural security; access controls; education, training, and awareness; manifest procedures; conveyance security; threat awareness; document processing; business partners and relationships; and suppliers.
- **CSI.** Initiated in January 2002, CSI addresses the threat to border security and global trade posed by the potential for terrorist use of a maritime container. CSI established a security regime to ensure that all containers posing a potential risk for terrorism are identified and inspected at foreign ports before they are placed on vessels destined for the United States. With 44 operational CSI ports in Europe, Asia, Africa, the Middle East, and North and South America, approximately 75 percent of cargo containers headed to the U.S. originate in or are transshipped through CSI ports.
- **Port Security Grants.** Since 9/11, the Administration has awarded over $700 million in grants to enhance physical security in the Nation's seaports, and for FY2006, Congress provided an additional $173 million in Port Security Grant funding. DHS is currently developing program guidance that will target the FY2006 funds to our highest risk ports for their most critical terrorism prevention and preparedness needs, especially against explosives and non-conventional threats that would cause major disruption to commerce and significant loss of life.

The FY2007 Budget would continue to support port security efforts through the Targeted Infrastructure Protection Grant program, a $600 million program targeted to those infrastructure assets at greatest risk. While there is not a specific allocation for ports, up to 40% of the funding could be allocated to ports based on historical awards, and the total program represents a significant increase over similar programs in FY2006.

The following chart highlights port security funding from 2004 enacted to the 2007 Administration request:

Port Security Funding

(Dollars in Millions)

	2004 Enacted	2005 Enacted	2006 Enacted	2007 Request
United States Coast Guard				
Port Security	$1,695	$1,608	$1,731	$2,035
U.S. Customs and Border Protection				
CSI	$61	$126	$137	$139
C-TPAT	$14	$38	$54	$55
Other Port Security[1]	$173	$225	$232	$249
Preparedness				
TIP Grants[2]	$0	[$365]	[$386]	*$248*
Port Security Grants	$141	$150	$173	-
Science and Technology Directorate				
Port Security	$12	$15	$18	$16
Transportation Security Administration				
Cargo and Credentialing	$68	$22	$0	$0
Domestic Nuclear Detection Office[3]				
RPMs/Advanced Spectroscopic Portals	-	-	$110	$78
Total DHS Funding	**$2,164**	**$2,184**	**$2,455**	**$2,820**
Department of Energy NNSA Funding				
DOE Megaports Initiative	$13	$49	$73	$40
DOE Core (partially seaport monitoring)	$33	$26	$24	$84
Total DOE Funding	**$46**	**$75**	**$97**	**$124**
Total Port Security Appropriation	**$2,210**	**$2,259**	**$2,552**	**$2,944**

[1] CBP's "Other Port Security" funding includes inspections of individuals and cargo at seaports, including technology costs. Funding for these years represents **expenditures** as estimates of budget authority for these years is unavailable.

[2] FY07 TIP estimate reflects ports' share of infrastructure grants over FY05-06, but FY07 funds will be distributed at the Secretary's discretion using risk and threat information regarding ports, transit, and other critical infrastructure.

[3] DNDO will be purchasing both current generation systems referred to as Radiation Portal Monitors (RPM) and next-generation systems which are known as Advanced Spectroscopic Portals (ASP). The decrease in funding reflects total costs for completion of seaport RPM deployment (98 percent).

Question for the record from Senator Bill Nelson
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Last year, the commander of U.S. Pacific Command told Congress that China's military buildup is "unprecedented and proceeding quite rapidly." More recently, the Quadrennial Defense Review directs the Navy to assume a "greater presence" in the western Pacific by adding at least one aircraft carrier and five nuclear submarines over the next decade.

Given the current and potential growth of tension in the Pacific, and our continuing commitments in Central Asia, the geo-strategic risk associated with a reduction in the size of our carrier fleet is unjustified and unacceptable. DoD and Navy leadership argue that new operating practices in the Fleet Response Plan mitigate the risks. However, a recent RAND study for the Navy, notes that, "FRP was conceived and formulated on the core premise that the service would retain its long-standing post-cold-war force structure of 12 deployable carriers and ten active air wings."

Consistent with this assessment of current and future threats and requirements, the Congress enacted legislation, signed by the President that requires a minimum 12-carrier naval force structure in law. The Defense Department's budget request for fiscal year 2007 does not include funding necessary to meet this requirement. We appreciate that the law may have been enacted so late in your budget estimate process that the fiscal year 2007 budget request does not fully fund this requirement.

Question: What is the funding shortfall in the President's fiscal year 2007 budget request that will be necessary to ensure that the nation has the 12 operational carriers required in law?

Answer: The Department of Defense has not determined what funding would be needed to maintain and operate the USS John F. Kennedy beyond FY 2006. The Navy is conducting a materiel assessment of the USS John F. Kennedy to determine the budgetary impact of needed repairs.

Question: What is OMB's plan to find or request the funds necessary to meet this requirement? Will OMB include the necessary funding to sustain a 12-carrier fleet in either a budget amendment and/or a supplemental appropriations request?

Answer: The President's FY 2007 Budget reflects the leading edge priorities that the Department of Defense identified in its 2006 Quadrennial Defense Review (QDR). The QDR calls for a Naval Fleet consisting of 11 Carrier Strike Groups. This reflects the judgment of senior Navy leadership that 11 operational carriers are sufficient to respond to current and future threats. The operation of a carrier in excess of military requirements would thus divert valuable resources away from other priorities of greater military value. As a result of this QDR recommendation, the Navy will propose legislation that would eliminate the requirement for 12 carriers.

Question for the record from Senator Bill Nelson
Senate Budget Committee Hearing
OMB Response
February 7, 2006

The DOD had recently approved the Navy request for $100 million for repairs from Hurricane Wilma relief funds for the critical infrastructure recovery at Key West Naval Air Station. The reason they had approved that it is because it is now critical for the training of our pilots. That request was refused by the OMB, so we have this conflict on the essential readiness of the carrier battle groups as they prepare to deploy. Key West was significantly damaged in Hurricane Wilma. Congress appropriated these recovery funds to ensure the readiness of our fleet and we are going to have this insisting that be allowed to be spent.

Question: How do we go about, in OMB's opinion, getting this squared away?

Answer: The Administration determined that DOD received sufficient funding from prior hurricane supplementals to address damage to Federal facilities caused by Hurricanes Dennis and Wilma. The Administration requested a general provision in the February 16th Katrina Supplemental that would allow DOD to transfer Katrina-related funds from other DOD accounts to military construction. DOD would be able to fund the Key West Naval Station projects if Congress approves the transfer and authorizes the Key West projects to proceed.

Question for the record from Senator Mike Enzi
Senate Budget Committee Hearing
OMB Response
February 7, 2006

Question: **Please elaborate on the pension proposal highlighted in your budget, which OMB estimates will raise $16.7 billion over 5 years.**

The Administration is re-proposing pension reform that would strengthen the defined benefit pension system. Our proposal includes funding reform, improvements to plan disclosure, and premium adjustments. The $16.7 billion increase over 5 years reflects the amount of increase in premiums that if continued would restore the pension insurance system to solvency over 10 years. Though our proposal has not changed from last year, this 5 year figure has been adjusted to reflect our best current estimate of PBGC's shortfall.

UNDERSTANDING THE CAUSES OF AND SOLUTIONS TO ADDRESSING THE FEDERAL TAX GAP

WEDNESDAY, FEBRUARY 15, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:59 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Grassley, Sessions, Conrad, and Wyden.

Staff present: Scott B. Gudes, Majority Staff Director; and Cheri Reidy, director for revenues and budget review.

Mary Ann Naylor, Staff Director and Steve Bailey, sr. analyst for revenues.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. Let's get started a little early, which hopefully will set a precedent here, because our witnesses are here, and Senator Conrad is here. I know we will be joined by other people as we proceed forward.

This hearing is to deal with the issue of what we call the Federal tax gap, the fact that there is a lot of taxes owed to the Federal Government which are not being collected. The IRS estimates a gap of $345 billion a year. That is a huge number, and the practical effect of not collecting those taxes is that other taxes end up being burdensome. The ability and flexibility of the Federal Government to do things that are necessary to improve the quality of life for Americans and to defend our Nation is limited. And we as a Nation need to make sure we are collecting what people owe simply to maintain the integrity of the Tax Code.

We have always had a Tax Code which has been built on the concept of basically voluntary compliance. People recognize they owe a certain amount and they should pay it. Its success is unique to Western democracies. We have not had a history of avoidance, or fraud that has been systemic. It has occurred but has not been systemic.

To the extent fraud occurrs, we should try to address it, improve on our collection capability, and make the Code more comprehensible so that we can effectively collect taxes which are owed so people can feel that the distribution of the tax burgen is just.

But there is a lot we need to address to accomplish this goal. So we have an excellent panel today.

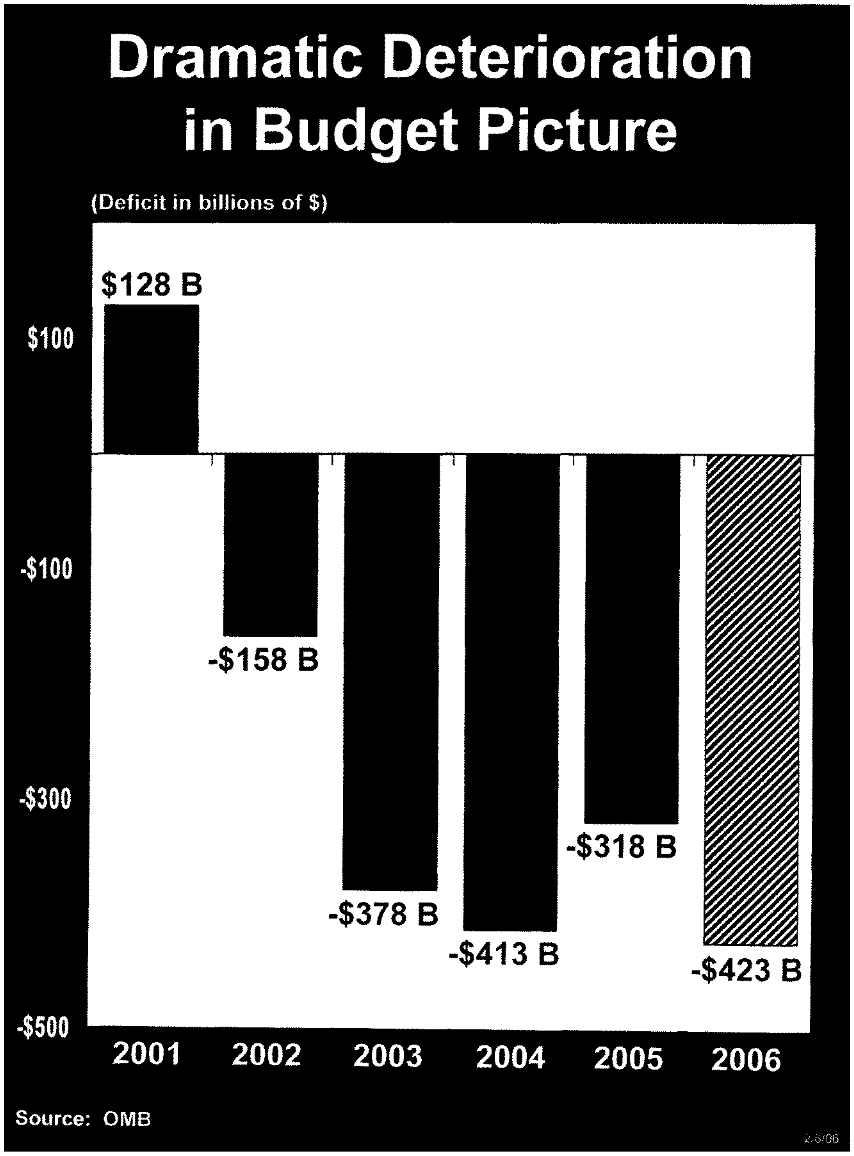
The person who has been the greatest force here in the Congress in trying to address this issue has been my colleague, the Ranking Member on the Committee, Senator Conrad. This has been an issue that he has raised innumerable times, and I thank him for his vigilance on this and for raising the level of rhetoric. When someone becomes a champion for getting something done around here, that is the key of getting it done around here. And so, following his leadership, maybe we can get something done.

So I yield to Senator Conrad on this issue that he has been so active and effective on.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

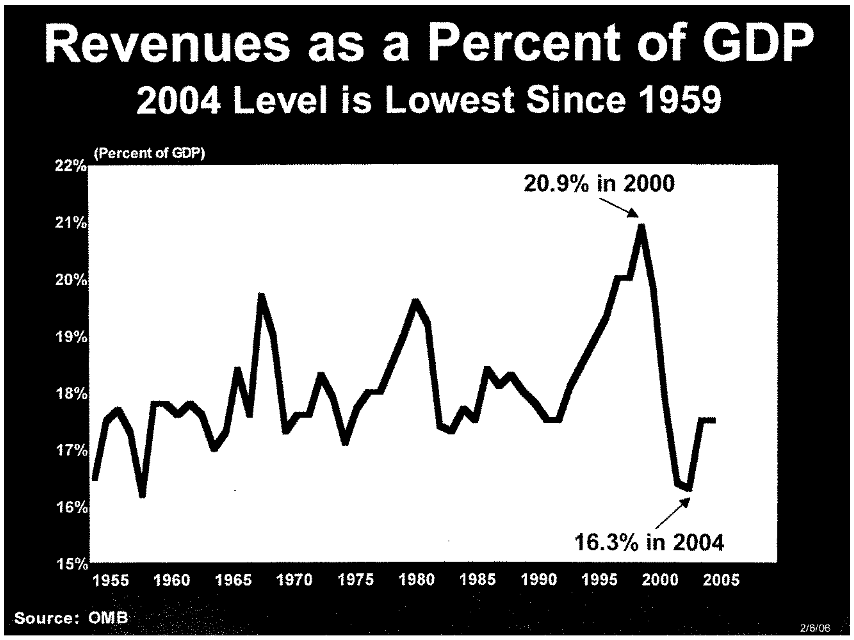
Senator CONRAD. First of all, I want to thank the chairman, especially thank him for his kind, generous remarks this morning, but thank him as well for holding this hearing. I very much appreciate it.

I really do believe this is one of the big ideas that we have to pursue in order to make progress on the deficit.


Dramatic Deterioration in Budget Picture
(Deficit in billions of $)
$128 B
-$158 B
-$378 B
-$413 B
-$318 B
-$423 B
$100
-$100
-$300
-$500
2001
2002
2003
2004
2005
2006
Source: OMB

Let me just run through a couple of things quickly which put it in perspective. We have the President now suggesting the deficit this year will be $423 billion. My own calculations are that that is somewhat high. I see a deficit this year of about $360 billion. But, still, that would give us four of the largest deficits we have had in history in dollar terms the last 4 years.

Let's go to the next.

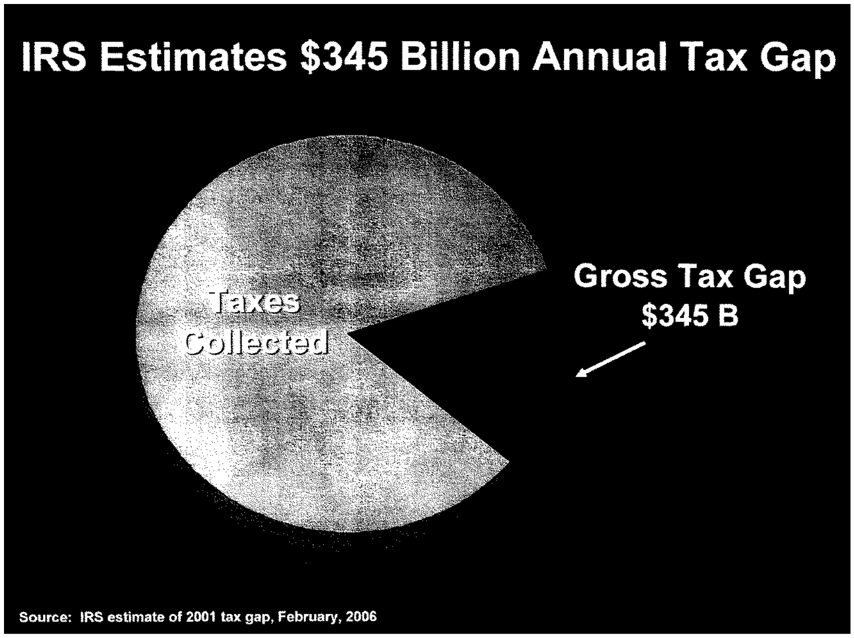

Revenues as a Percent of GDP
2004 Level is Lowest Since 1959
(Percent of GDP)
22%
21%
20%
19%
18%
17%
16%
15%
20.9% in 2000
16.3% in 2004
1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005
Source: OMB
2/6/06

When we look at revenue as a share of GDP, here is what we have seen going back to 1955. There have been a lot of jigs and jags, but really the revenue side of the equation fell out from 2001 to 2004. We have had some recovery here. But here is the point I want to make.

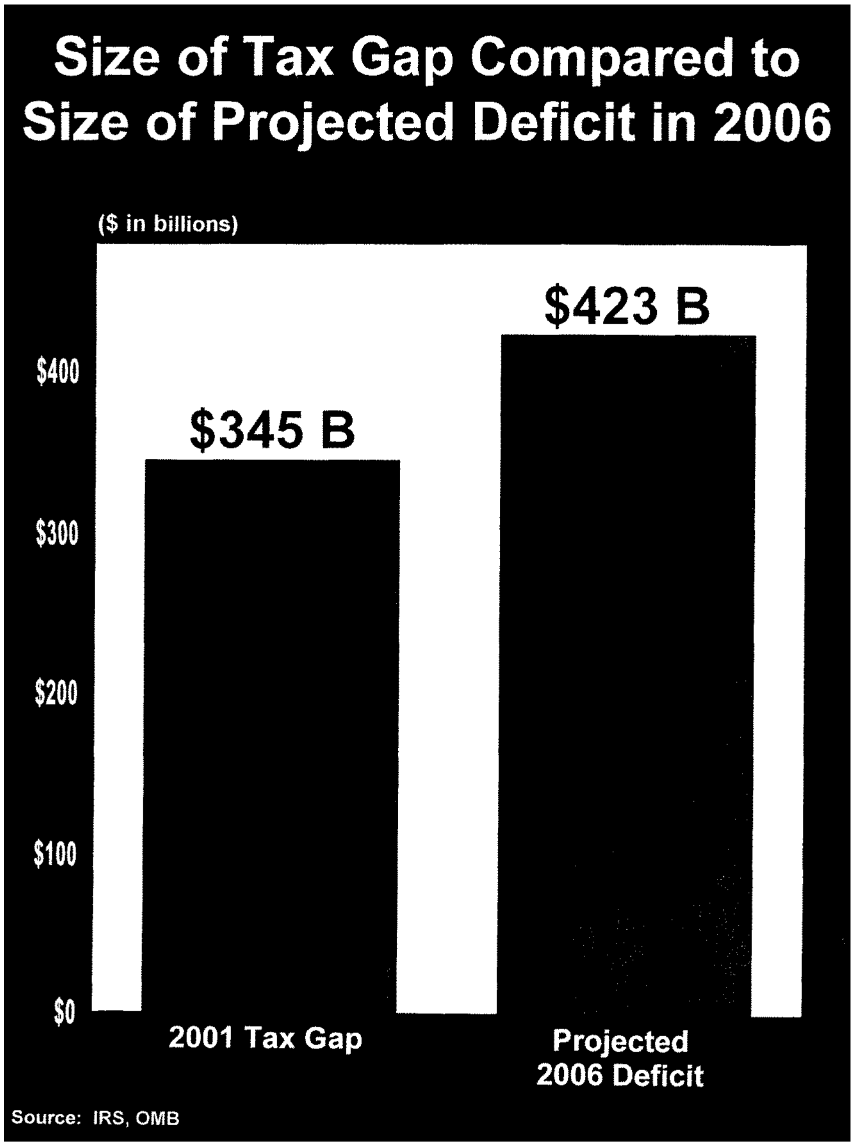
If the tax gap, the difference between what is owed and what is being paid, is $350 billion a year or thereabouts, that represents about 2.5 percent of GDP. If we were collecting that, we would have collections as a share of GDP about right here, with no tax increase. No tax increase.

The point I am trying to make to my colleagues is we clearly need more revenue to float this boat. We also have to be tough on spending, without question. We also have to reform long-term entitlements. But we also need more revenue. And the first place to look, rather than any tax increase, is to collect the taxes that are actually now owed. If we were doing that, we would have a very different budget situation.

Let's go to the next chart.


IRS Estimates $345 Billion Annual Tax Gap
Taxes Collected
Gross Tax Gap
$345 B
Source: IRS estimate of 2001 tax gap, February, 2006

This is the rough estimate that we have received from IRS that the gross tax gap is approaching $350 billion a year. Hopefully we can get to a newer estimate because I think that is pretty conservative, based on my own judgment.


Size of Tax Gap Compared to
Size of Projected Deficit in 2006
($ in billions)
$423 B
$345 B
$400
$300
$200
$100
$0
2001 Tax Gap
Projected
2006 Deficit
Source: IRS, OMB

Let me just put it in perspective. This is the projected deficit for the year, $423 billion. Here is the amount of the gross tax gap, $345 billion. Again, I think this deficit number is somewhat overstated. My own judgment is the deficit will be about $360 billion this year. If we are actually able to collect all this revenue that is owed, we would come close to eliminating the deficit. And I understand the difficulties with collecting it all. The question is: How can we make serious progress, not just through enforcement but through tax reform? Because I think we have to now seriously consider fundamental tax reform as part of the mission.

The point I really want to make is that this is critically important to solving our budget problems. This is a component of what we could do to really close the gap, and we could do it without increasing taxes, but increasing the collection of taxes that are now due and owed.

And with that I want to again thank the chairman very much for holding this hearing.

Chairman GREGG. Thank you, and I appreciate your suggesting that we have this hearing. I think it is a critical issue.

Of course, the Budget Committee only has the capacity to set a budget out which projects where we are going to and how we are going to get there. But it doesn't have the authority to actually institute action in these areas. That lies with a different authorizing committee. In the area of tax policy, that is clearly the Finance Committee, and I notice we are joined by the chairman. Does Chairman Grassley have anything he wishes to add?

Senator GRASSLEY. Not at this point, Mr. Chairman. I am just around to see what the Budget Committee thinks I ought to do a better job of doing.

[Laughter.]

Chairman GREGG. Well, the Budget Committee is always interested in having the chairman here.

Mr. Everson, we would love to hear from you. We are joined today by two witnesses in the first panel: of course, the Commissioner of the Internal Revenue Service, Mr. Everson; and the Comptroller General, David Walker.

Mr. Everson.

STATEMENT OF HON. MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you, Mr. Chairman, Senator Conrad, and I will say Chairman Grassley, because if I leave that out, it would probably be at my peril, given the frequency with which I am before Finance.

I am pleased to be here today to discuss the tax gap. I understand it has been at least some years since an IRS Commissioner has come before the Budget Committee. Given the fact that the IRS is responsible for collecting substantially all of the over $2 trillion that comes into Government coffers each year, I commend you for putting tax compliance on your agenda. If we can improve tax compliance and reduce the tax gap, it will make all of our jobs easier and reduce the burden of debt being shifted to future generations.

I also want to thank the committee for the important role you played last year in ensuring that the IRS received adequate resources for our enforcement activities. I am hopeful that you will do the same as pertains to the President's 2007 budget request.

Simply stated, the tax gap is the difference between the tax that taxpayers should pay and what is actually paid on a timely basis. Overall, our Nation enjoys a very high compliance rate, certainly among the best in the world. The vast majority of Americans pay their taxes honestly and accurately, and they have every right to expect that their neighbors and competitors do the same. Not only are the dollars at stake important, but so is the sense of fairness. As President Kennedy stated in 1961, "Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others."

Unfortunately, our research indicates that in tax year 2001, there was a gross tax gap of $345 billion and a noncompliance rate of about 16.5 percent. Noncompliance takes three forms: nonfiling, underreporting, and underpayment. As this chart indicates, the bulk of the tax gap, over 80 percent, relates to underreporting of income, not nonfiling or underpayment. The research which we have just completed for tax year 2001 further indicates that the largest piece of the underreporting component of the gap relates to individual income tax, almost $200 billion a year. And of this, over half is underreported business income.

In attacking the tax gap, I would like to make four points.

First, we are doing a great deal to restore the enforcement functions of the IRS. This chart shows the growth of enforcement revenues achieved over the last several years. Enforcement revenues are the direct moneys we bring in from our collection activities, audits, and document matching program. Enforcement revenues do not include the indirect behavioral impact of our enforcement activities. But enforcement revenues alone have increased from $33.8 billion in fiscal year 2001 to over $47 billion last year. I believe the credibility of our enforcement activities has been restored. Still, we need to do more, and we will.

As I indicated moments ago, I very much appreciate the support this committee has given for securing adequate funding for the IRS. Appropriate funding is essential to reducing the tax gap.

Two, we are using the conclusions from our research to update our audit models. The tax gap research will help us do a better job of selecting cases for review. Our enforcement operations will be more efficient and more productive.

Three, the President's budget proposal contains several legislative proposals which will help close the tax gap. These are generally in the area of increased third-party reporting. This chart depicts the fact that noncompliance is greatest where there is little or no third-party reporting.

Four, we continue to work to improve taxpayer service. Helping taxpayers understand their obligation and facilitating their participation in the system no doubt supports compliance. But I would emphasize that the most important thing we could do to better serve taxpayers would be to simplify the Tax Code. Complexity obscures understanding.

The last point I would like to make is that while we are moving aggressively to reduce the tax gap and can close a significant portion of the gap over a period of years, I say here, "no one should think...”—maybe I should revise that for Senator Conrad—that we can totally eliminate the gap. That would take draconian measures and make the Government too intrusive. We need to strike the right balance.

Thank you.

[The prepared statement of Mr. Everson follows:]

WRITTEN TESTIMONY OF COMMISSIONER OF INTERNAL REVENUE MARK EVERSON BEFORE THE SENATE COMMITTEE ON THE BUDGET ON THE TAX GAP AND HOW TO SOLVE IT FEBRUARY 15, 2006

Introduction

Chairman Gregg, Senator Conrad, and Members of the committee, I am pleased to be here today to discuss the latest information we have on the tax gap. I also want to discuss steps we are taking to reduce the gap as well as some specific changes in the law that will enable us to do an even better job in the future.

Background:

The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time. Moreover, because the complexity of our current tax system is a significant reason for the tax gap, fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions in the tax gap.

Last March, the IRS released preliminary results of our analysis of the compliance data recently compiled by the National Research Program (NRP). These preliminary results were for Tax Year 2001 and were the first such comprehensive numbers available since 1988. We have done several much narrower studies since 1988, but nothing that would allow us to comprehensively update our estimates of the overall tax gap.

Prior to the early 1990s, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line by line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas. The NRP was born out of our effort to find a less intrusive way to measure compliance with the tax laws.

The NRP introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study. These innovations included the compilation of a comprehensive set of data to supplement what was being reported on select returns; the introduction of a classification process that helps identify how best to handle each return in the sample; and the streamlining of the collection of data which, among other things, provided auditors with new tools to detect noncompliance.

A focused statistical selection process resulted in the NRP sample including approximately 46,000 returns, somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which required the taxpayer to support the entry made on every line on the return. At the same time, we expect that the data collected through the NRP sample will be about the same quality as the data collected under the TCMP.

One of the other advantages derived from the NRP study is the opportunity to update our discriminant function (DIF) formulas. The DIF system is a well known statistical technique that the IRS has been using since the early 1970's. It is designed to help us choose which returns merit further examination and to avoid examining compliant taxpayers.

Using the recent NRP study data, we have developed new DIF formulas for several examination classes. IRS implemented these new formulas in January 2006 to evaluate Tax Year 2005 returns. We will begin examining returns selected using these new formulas in October 2006. We believe using the new formulas will allow us to improve productivity and reduce taxpayer burden by reducing significantly the number of examinations resulting in little or no change to the taxpayer's tax liability.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the study is on individual income tax returns. It does not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. The numbers we use for those estimates of compliance with taxes other than the individual income tax are still based on rough projections that assume no change in compliance behavior among the major tax gap components since the most recent compliance data were compiled. (i.e.,1988 or earlier).

I would note, however, that we have just announced the latest NRP study which will assist us in better analyzing both the individual and corporation income tax gaps. Specifically, the newest NRP study will focus on S Corporations, the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year.

With this new study we will gauge the extent to which the income, deductions, and credits of S corporations are properly reported on the returns filed by them and their shareholders. This study will serve as a complement to the individual reporting compliance study.

Distinguishing the Tax Gap From Related Concepts

The tax gap is not the same as the so called "underground economy", although there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap does not include the illegal sector of the economy and the underground economy does not include certain types of tax noncompliance such as overstated deductions or claiming improper filing status.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding.

Latest Numbers

Historically, there are three types of income that are not well represented in compliance audits: informal supplier income, tip income, and unreported income that is not detected by auditors. We have taken the preliminary analysis done last March and supplemented it with other data and special analyses to account more accurately for these three income types. In the past, these supplemental analyses have taken several years to complete after the audit data became available. Utilizing new technologies, we have been able to refine the data over the past several months.

These numbers showed that there is an overall gross tax gap of approximately $345 billion, leading to a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates provided last spring.

The net tax gap or what is remaining after enforcement and other late payments is $290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 8.6 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, as shown on the chart on the next page, *individual* income tax underreporting is approximately $197 billion. This constitutes about 56 percent of the overall tax gap. While a comparison with 1988 data would suggest a slight worsening of individual income tax reporting compliance, it is important to remember that the data tell us nothing about the years just before or just after Tax Year 2001 and, as such, cannot tell us whether compliance trends today are improving or getting worse.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**56%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
All other components of the tax gap	**109**	**33%**
Total Tax Gap	**345**	
Note: Detail does not add due to rounding		

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting contributes nearly 70 percent of the overall tax gap.

It appears that compliance rates for sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study in 1988. The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage (NMP) for wages and salaries is only 1 percent.

Amounts subject to third-party information reporting, but not to withholding (interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4% percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage (e.g., 12 percent for capital gains). As expected, amounts not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The misreporting estimate for "other income" is 64 percent or $23 billion of tax.

With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may be swamped by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reason, it is easy to see that we have a serious problem with underreporting for those items not subject to withholding or third party information reporting.

What We Are Doing Today to Address the Tax Gap

We recognize that the best way to address the tax gap is to maintain a balance between service and enforcement. Our mantra is that Service + Enforcement = Compliance.

The Tax Code is extremely complex and it is easy even for sophisticated taxpayers to make honest mistakes. The IRS has an obligation to assist taxpayers in both understanding the tax law and remitting the proper amount of tax. In 2006, we will maintain a strong service focus. We have updated our website to allow taxpayers to find out if they qualify for the earned income tax credit or whether they will be subject to the alternative minimum tax. Through our FreeFile program, 70 percent of all individual taxpayers can now file their federal taxes electronically at no cost. Returns filed electronically have a significantly lower risk of error, saving time and resources for both taxpayers and the IRS.

The level of electronic filing continues to grow and as a result, refunds are processed faster than ever. The accuracy of answers that taxpayers get when they reach our call centers continues to rise and the level of expertise at our volunteer income tax assistance centers (VITA) has never been better.

Most Americans pay their taxes honestly and accurately, and have every right to be confident that when they do, their neighbors and competitors are doing the same. When their neighbors and competitors let them down and fail to file properly, the IRS has an obligation to respond.

I have talked about some of our service initiatives. Let me provide you an overview of the steps we are taking from an enforcement perspective to bolster the confidence of the American people that all are paying their fair share.

We have several enforcement priorities, one of which is to discourage and deter non-compliance, with an emphasis on corrosive activity by corporations, high income individuals, and other contributors to the tax gap.

- In 2005, we audited nearly 220,000 high income taxpayers, more than double the number audited in 2000.

- Overall, audits for individuals reached 1.2 million, 20 percent more than 2004 and almost double the level five years earlier.
- In 2005, we audited nearly 5000 businesses with assets over $250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets of $10 million. Finally, audits of businesses with less than $10 million in assets rose 145 percent from 2004.

Enforcement revenue from audits of corporations and individuals hit $17.7 billion in 2005 compared to $10.7 billion in 2003. In all, collections from heightened enforcement efforts rose 10% in 2005 moving from $43.1 billion in 2004 to $47.3 billion in 2005

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high income individuals. About 22 months ago we made a settlement offer regarding the Son of Boss tax shelter. For the first time, the IRS required a total concession by the taxpayer of artificial losses claimed and, for most taxpayers, required a payment of penalties. Nearly 1200 taxpayers have participated in that initiative and we have collected $3.8 billion in taxes, interest, and penalties.

In addition to Son of Boss, last October we announced a global settlement initiative that covered 21 listed and non-listed transactions. They include a wide cluster of transactions involving funds used for employee benefits, charitable remainder trusts, offsetting foreign currency contracts, debt straddles, lease strips, and certain abusive conservation easements.

Taxpayers had until January 23, 2006 to file an election to take part in the global settlement program. Under the terms of the settlement, taxpayers will be required to pay 100 percent of taxes owed, interest and, depending on the transaction, either a quarter or half the accuracy-related penalty the IRS will otherwise seek

We have been pleased by the response to this initiative and we believe the response was buoyed by the provisions of the Gulf Qpportunity Zone Act of 2005 that modified the rules for calculating interest on tax deficiencies of individual taxpayers who participated in certain abusive tax shelters and increased incentives for individuals to come forward as part of this program.

In addition, our Large and Mid-Sized Business Division has issued more than 500 administrative summonses as part of our attack on shelter promoters, and we have approximately 200 active promoter examinations under way. Entities being looked at include banks, accounting firms, law firms and brokerage houses. We want to make it clear that taxpayers who take aggressive return positions relying on the "audit lottery" and the chance they will not be examined have made a really bad decision.

Combating abusive tax shelters will remain a top priority in 2006. We will not let our guard down. Our plan is to focus on improper uses of tax exempt bonds and trusts, questionable transfer-pricing practices, offshore accounts, and charitable donations of intangible assets.

We are also getting help in our efforts from other Federal entities. The Financial Accounting Standards Board recently issued Proposal 109, which stipulates that in order to show the net financial benefits of a tax position, the treatment must have a "probable" recognition threshold, which is commonly interpreted as at least a 70 percent likelihood of being upheld. Previously, the wording was "more likely than not", that is, more than 50 percent.

The Securities and Exchange Commission is also increasing the information it shares with us. As a result, the new transparency on financial statements, as required under the Sarbanes-Oxley Act, will have growing significance for tax compliance.

Another enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.

In some cases, this erosion reaches criminal levels. In 2005, we initiated 248 criminal investigations of tax preparer fraud. This is in addition to cases in which, we either have indictments or pending convictions involving criminal behavior. In 2005, 118 tax preparers received sentences from a judge. Nearly 86 percent were incarcerated and the average sentence was 18 months.

We have done quite a bit to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. Treasury regulations set forth rules governing what does and does not qualify as an independent opinion about a tax shelter. Specifically, new Treasury Department regulations took effect last June which revise Circular 230 governing tax practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners.

Further, additional revisions to Circular 230 were recently proposed to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior IRS is likely to challenge under the Circular.

The IRS has made noncompliance by tax exempt and governmental entities and misuse of the tax exempt status of such entities by third parties for tax avoidance purposes, another major enforcement priority.

For example, earlier this year, we concluded that more than 30 credit counseling firms, accounting for more than half of the industry's revenues, are not entitled to tax exempt status. The revocations of the tax exempt status of these entities are the culmination of more than two years of work covering more than 60 credit counseling organizations.

These organizations were granted tax exempt status originally because they were supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations, instead, operate for the benefit of insiders or are improperly in league with profit making companies.

Another example of our recent enforcement efforts is the high profile case of Richard Hatch, the winner of $1 million on the first season of *Survivor*. He was recently convicted for tax evasion for failure to report that and other income to the IRS. However, he was also using a charity to shelter some of that income. In addition, he was accepting money on behalf of the charity and channeling it for his own personal use.

We want to make sure that when people donate money to charities that it is going for the purpose intended and not into the pockets of some individuals associated with the charitable organization.

In 2006, the tax exempt sector will continue to focus on key areas where organizations are abusing their exempt status or where others are using them for unintended purposes. Three of the areas in which we anticipate renewed enforcement include political intervention, compensation and abusive transactions.

Relative to political intervention, we will be finishing up in 2006 contacts with 130 organizations suspected of political intervention in the 2004 election. Almost half of these are churches. Most of the problems we are finding in this area are one-time events that can be easily resolved. However, we continue to get reports of tax exempt entities possibly crossing the line in this area.

Excessive compensation of executives will also be a main focus of our enforcement efforts. There are indications that organizations have allowed key executives too great a voice in determining their own compensation or otherwise have not done due diligence in setting compensation levels. We have contacted almost 2000 Section 501(c)(3) organizations including about 400 private foundations. In addition, we are exploring hospitals and their compensation to executives.

As far as potentially abusive transactions go, I have already spoken about our global settlement initiative. At least ten of the transactions included in this initiative involve our Tax Exempt/Government Entities division (TE/GE).

FY 07 Budget Proposal

Secretary Snow will soon appear before this committee to discuss the FY 07 budget proposed by the President. Included in that budget is a recommendation for the IRS.

As with other federal agencies, the budget recommendation for IRS demands increased efficiencies in our overall operation and will require that we all do more with less. The proposed budget for FY 2007 is $10,591,837,000 in direct appropriations supplemented by $135 million in increased user fees for a total operating budget of $10,726,837,000. This represents a 1.4 percent increase from the FY 06 enacted level and we believe it will allow us to continue the balance between service and enforcement that is so critical in tax administration.

Of the total request, $6.961 billion in direct appropriations is requested for enforcement, an increase of $137 million or two percent more than FY 2006. However, this enforcement increase is requested as a program integrity cap adjustment similar to the adjustment enacted in FY 2006. And, as with FY 06, the $137 million increase and the $6.824 base will be "fenced" so as to specify that the funding can only be used for enforcement.

It was this committee that last year recognized the importance of IRS's enforcement initiatives and included the program integrity cap adjustment in the Budget resolution. That adjustment is now being used to support many of the enforcement activities I enumerated earlier.

I wish to express my deep appreciation to this committee for taking that action last year.

The cap adjustment requested this year is somewhat different than the one in the FY 06 budget. Last year the $446 million increase actually helped supplement enforcement program initiatives. The $137 million requested for FY 07 is what is needed to pay the cost increases associated with the FY 2006 enforcement base.

In other words, approval of the $137 million in the FY 07 request is necessary in order to reap the full benefits of the investment made in enforcement last year, an investment I would remind the committee has paid off handsomely for American taxpayers.

Although not directly connected, the IRS yields approximately four dollars in direct revenue for every additional dollar spent in its enforcement efforts. In FY 2005 we brought in a record of $47.3 billion in enforcement revenue, an increase of $4.2 billion from the previous years.

Beyond the direct revenues generated by increasing audits, collection and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

It is important that we not allow the tax cheats and those who seek to game the system a chance to get back on the offensive. The investments we made in enforcement last year have them on the run. Let's not undermine that progress by failing to fund the $137 million it takes to pay cost increases out of the FY 2006 base.

Legislative Proposals to Reduce the Tax Gap

Please imagine if you will that each of our enforcement initiatives is a tool. Collectively, as I have enumerated above, these tools make a pretty impressive tool belt. However, with more tools in our belt, we should be able to accomplish even more. As part of his FY 2007 Budget proposal, the President proposed several legislative changes that would add additional tools to our belt and help to reduce the tax gap.

The five changes proposed by the President would generate $259 million in increased collections in FY 07 and, over the course of the next ten years, a total of $3.6 billion. Allow me to address each of the proposals individually.

The first proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment tax. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable if they met certain specified standards.

The second proposal would increase reporting on payment card transactions. Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some retail businesses to accurately report their gross income, including income derived from payment card transactions, represents a significant portion of the tax gap.

Specifically, the Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding for card issuers in the event that a merchant payee fails to provide a valid taxpayer identification number.

It is clear that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. Because reimbursement information is provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on card issuers. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden.

Our third proposal would require increased information reporting for certain government payments for property and services. In March, I will be testifying before the Senate Permanent Subcommittee on Investigations. The subject of that hearing will be to follow- up on an earlier hearing that looked at the number of Federal contractors who themselves are delinquent in their Federal taxes. GAO identified 97 such cases and we have, or will be soon looking at each of these.

As strange as it may seem, government at all levels does business with vendors who are delinquent on their taxes. Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, state and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of wages and interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The fourth proposal would amend collection due process procedures for employment tax liabilities. Employment taxes constitute one-fifth of the IRS total inventory of unpaid taxes. Currently, we are authorized to take various collection actions including issuing Federal tax levies. Before a tax levy can be issued, however, the IRS must provide the taxpayer with a notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for hearing and judicial review for each period.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to levies issued to collect a federal tax liability from a state tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax preparers. Under current law, paid tax return preparers are required to sign and include their taxpayer identification number (TIN) on income tax return and related documents that they prepare for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns or related documents such as employment tax returns, excise tax returns, and estate and gift tax returns. The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns. Further, it would impose penalties for preparing non-income tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

Conclusion

On the whole, our system of self-assessment of tax liabilities works well. Most countries would be thrilled to have a voluntary compliance rate of almost 84 percent.

We owe it, however, to compliant taxpayers to do everything we can to make sure we collect the other 16 percent. Otherwise, the legitimate taxpayers are asked to carry an unfair and unnecessary burden.

It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the excellent service that the taxpaying public deserves, and to maintain a strong and well targeted enforcement presence are necessary to improve compliance rates.

We will continue our efforts to maintain the balance between service and enforcement, but it is a balance. In addition to providing excellent service and maintaining a strong respect for taxpayer rights, we must have the resources and the tools to enforce the laws. Adoption of the President's budget request for our agency along with the five legislative proposals will make sure we have those tools for another year.

Thank you for the opportunity to discuss the tax gap and our efforts to combat it. I am happy to take your questions.

Chairman GREGG. Thank you, Mr. Everson.

Mr. Walker.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Mr. Chairman, Senator Conrad, Chairman Grassley, thank you for being here to talk about the tax gap. I would respectfully request that my entire statement be included in the record.

Chairman GREGG. Of course.

Mr. WALKER. I will move to summarize the highlights.

Let me note at the outset that I, too, would like to commend this committee for being concerned with this issue. I would also like to note for the record that the Senate Finance Committee held a hearing on this exact subject last year, at which both the Commissioner and I had the opportunity to testify. I hope and expect that the Senate Finance Committee will be taking action in a number of related areas in the future.

With regard to the tax gap, let me make five major points, and I have some slides that have been made available to you that I will show so the audience can see.

GAO's long-term budget simulations show that over the long term we face large and growing structural deficits due primarily to known demographic trends, rising health care costs, and lower Federal revenues as a percentage of the economy. Figure 1 and Figure 2, the first two slides that are on pages 4 and 5 of my testimony, exhibit this large and growing structural imbalance. I am happy to answer questions about the differences between 1 and 2 in the Q&A section if you so desire.

Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Reducing the current tax gap would contribute to our fiscal sustainability while simultaneously improving fairness for those citizens who fully and timely meet their tax obligations.

Second, underreporting of income by businesses and individuals accounted for most of the $345 billion tax gap for 2001, with individual income tax underreporting alone accounting for $197 billion. Corporate income tax and employment tax underreporting accounted for $84 billion, and that is noted on Table 1 on page 7, or the third slide that you have.

Third, given the persistence and size of the tax gap, we need not only to consider options that have previously been proposed, but also explore new administrative and legislative approaches to reducing the tax gap. Even modest progress would yield significant revenue. Each 1-percent reduction would likely yield nearly $3 billion per year. Reducing the tax gap will be a challenging effort. Long-term progress will require attacking the gap on multiple fronts and involving multiple strategies over a sustained period of time. These strategies could include and in some cases should include such efforts as to regularly obtain data on the extent of and reasons for noncompliance; simplifying the Tax Code—I would agree that is No. 1; providing quality services to taxpayers, which

I know the IRS has been focused on in recent years; enhancing enforcement of tax laws by utilizing such enforcement tools as tax withholding, additional information reporting, enhanced penalties where they have been eroded over time due to inflation, better leveraging technology, and maximizing resource allocation based upon the areas that are likely to generate the best value and, therefore, close most of the tax gap.

With regard to tax expenditures, which are noted on Figures 3 and 4 on pages 13 and 14 of my testimony, this notes the significant increase in the number of tax expenditures over the past two decades. We lose $700 to $800 billion a year in tax revenues due to tax expenditures. They represent in many cases back-door spending.

It is important that we have appropriate visibility on these tax expenditures in order to make them part of the overall equation on assuring that we can ultimately pay our current bills and deliver on our future promises over time.

And, last, Figure 5, which is on page 17 of my testimony, summarizes selected information with regard to individual tax underreporting as it relates to areas where information returns are not provided and withholding is not required. In this regard, some examples of additional information reporting or withholding actions which might make sense going forward would be: requiring tax withholding and more and better information return reporting on payments that are made to independent contractors; requiring information return reporting on certain payments made to corporations; and requiring more data on information returns dealing with capital gain income.

In summary, our Nation's fiscal imbalance and related challenges have created a situation where we are on an imprudent and unsustainable path that needs to be addressed. While our long-term imbalance cannot be corrected solely by addressing the tax gap, and while we should have zero tolerance for people who don't pay their fair share, the tax gap will never be zero. Nonetheless, it could help tremendously in closing the gap over the longer term. We will, however, need to take other steps, and we stand ready to work with the Congress in trying to address this and other issues of mutual interest and concern.

Thank you very much.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony
Before the Committee on Budget,
U.S. Senate

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TAX GAP

Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions

Statement of David M. Walker
Comptroller General of the United States

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Highlights

Highlights of GAO-06-453T, a testimony before the Committee on the Budget, U.S. Senate

February 15, 2006

TAX GAP

Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions

Why GAO Did This Study

The Internal Revenue Service's (IRS) most recent estimate of the difference between what taxpayers timely and accurately paid in taxes and what they owed was $345 billion. IRS estimates it will eventually recover some of this tax gap, resulting in an estimated net tax gap of $290 billion. The tax gap arises when taxpayers fail to comply with the tax laws by underreporting tax liabilities on tax returns; underpaying taxes due from filed returns; or nonfiling, which refers to the failure to file a required tax return altogether or in a timely manner.

The Chairman and Ranking Minority Member of the Senate Committee on the Budget asked GAO to present information on the causes of and possible solutions to the tax gap. This testimony addresses the nature and extent of the tax gap and the significance of reducing the tax gap, including some steps that may assist with this challenging task. For context, this testimony also addressed GAO's most recent simulations of the long-term fiscal outlook and the need for a fundamental reexamination of major spending and tax policies and priorities.

What GAO Recommends

GAO is not making any new recommendations but discusses some past recommendations and highlights some new areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-06-453T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Our nation's fiscal policy is on an imprudent and unsustainable course. As long-term budget simulations by GAO show, over the long term we face a large and growing structural deficit due primarily to known demographic trends, rising health care costs, and lower federal revenues as a percentage of the economy. GAO's simulations indicate that the long-term fiscal challenge is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major policies and priorities will be important to recapture our future fiscal flexibility.

Underreporting of income by businesses and individuals accounted for most of the estimated $345 billion tax gap for 2001, with individual income tax underreporting alone accounting for $197 billion, or over half of the total gap. Corporate income tax and employment tax underreporting accounted for an additional $84 billion of the gap.

Reducing the tax gap would help improve fiscal sustainability. Given the tax gap's persistence and size, it will require considering not only options that have been previously proposed but also new administrative and legislative actions. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion annually. Reducing the tax gap will be a challenging long-term task, and progress will require attacking the gap with multiple strategies over a sustained period. These strategies could include efforts to regularly obtain data on the extent of, and reasons for, noncompliance; simplify the tax code; provide quality service to taxpayers; enhance enforcement of tax laws by utilizing enforcement tools such as tax withholding, information reporting, and penalties; leverage technology; and optimize resource allocation.

IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

Type of noncompliance	Type of tax: Individual income	Corporate income	Employment	Estate	Excise	Total
Underreporting	$197	$30	$54	$4	No estimate	$285
Underpayment	23	2	5	2	$1	$34
Nonfiling	25	No estimate	No estimate	2	No estimate	$27
Total	$244	$32	$59	$8	$1	$345

Source: IRS.

Note: Figures may not sum to totals due to rounding.

Chairman Gregg, Senator Conrad, and Members of the Committee:

I appreciate this opportunity to discuss the annual tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—and how reducing that gap can help the nation cope with its large and growing long-term fiscal challenges. The Internal Revenue Service (IRS) most recently estimated a gross tax gap that reached $345 billion for tax year 2001. IRS estimated that it would recover around $55 billion through late payments and IRS enforcement actions, resulting in a net tax gap of around $290 billion.[1] The tax gap arises when taxpayers intentionally or unintentionally fail to comply with the tax laws. Their failure to pay taxes increases the burden of funding the nation's commitments for those taxpayers who voluntarily pay their taxes.

For context in considering the tax gap, I will first provide the committee with an overview of the federal government's fiscal condition and the challenges we will face in funding our nation's commitments. Next, I will discuss the size and components of the tax gap. Finally, I will discuss the significance of reducing the tax gap and various means to achieve that goal, including measuring the extent of, and reasons for, noncompliance; simplifying the tax code; improving taxpayer service; enhancing IRS enforcement through the use of tools such as withholding, information reporting, and penalties; leveraging technology; and optimizing resource allocation.

My remarks are based on our previous work on a variety of issues, in particular, recent testimonies and a report on reducing the tax gap.[2] These efforts were conducted in accordance with generally accepted government auditing standards.

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]GAO, *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); and *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005).

Let me begin by highlighting three major points:

- GAO's long-term budget simulations show that over the long term we face large and growing structural deficits due primarily to known demographic trends, rising health care costs, and lower federal revenues as a percentage of the economy. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations. Reducing the current tax gap would contribute to our fiscal sustainability while simultaneously improving fairness for those citizens who fully and timely meet their tax obligations.

- Underreporting of income by businesses and individuals accounted for most of the estimated $345 billion tax gap for 2001, with individual income tax underreporting alone accounting for $197 billion, or over half of the total gap. Corporate income tax and employment tax underreporting accounted for an additional $84 billion.

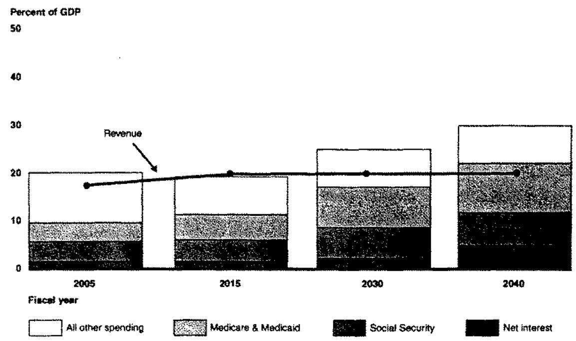
- Given the persistence and size of the tax gap, we need not only to consider options that have been previously proposed but also explore new administrative and legislative approaches to reducing the tax gap. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion annually. Reducing the tax gap will be a challenging, long-term task and progress will require attacking the gap on multiple fronts and with multiple strategies over a sustained period. These strategies could include efforts to regularly obtain data on the extent of, and reasons for, noncompliance; simplify the tax code; provide quality services to taxpayers; enhance enforcement of the tax laws by utilizing enforcement tools such as tax withholding, information reporting, and penalties; leverage technology; and maximize resource allocation.

Long-term Fiscal Challenge Provides Impetus to Reexamine Tax Policies and Compliance

The federal government's financial condition and long-term fiscal outlook present enormous challenges to the nation's ability to respond to emerging forces reshaping American society, the United States' place in the world, and the future role of the federal government. Over the next few decades as the baby boom generation retires and health care costs continue to rise, federal spending on retirement and health programs—Social Security, Medicare, Medicaid, and other federal pension, health, and disability programs—will grow dramatically. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between expected federal spending and tax revenues will mean escalating and eventually unsustainable federal deficits and debt that will threaten our future economy, standard of living, and, ultimately, our national security. Ultimately, the nation will have to decide what level of federal benefits and spending it wants and how it will pay for these benefits.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Indeed, the nation's long-term fiscal outlook is daunting under many different policy scenarios and assumptions. For instance, under a fiscally restrained scenario, if discretionary spending grew only with inflation over the next 10 years and all existing tax cuts expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over 80 percent of federal revenue by 2040. (See fig. 1.) On the other hand, if discretionary spending grew at the same rate as the economy in the near term and if all tax cuts were extended, by 2040 federal revenues may just be adequate to pay only some Social Security benefits and interest on the growing federal debt. (See fig. 2.)

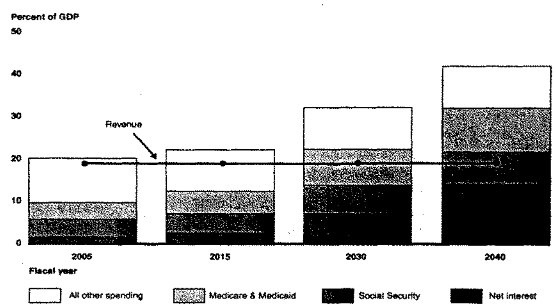
Figure 1: Composition of Spending as a Share of GDP Under Baseline Extended



Source: GAO's January 2006 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions are Extended



Source: GAO's January 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

Addressing the projected fiscal gaps shown here will require policymakers to examine the advisability, affordability, and sustainability of existing programs, policies, functions, and activities throughout the entire federal budget—spanning discretionary spending, mandatory spending, including entitlements, and tax policies and programs. Neither slowing the growth of discretionary spending nor allowing tax cuts to expire—nor both options combined—would by themselves eliminate our long-term fiscal imbalance. Additional economic growth is critical and will help to ease the burden, but the projected fiscal gap is so great that it is wholly unrealistic to expect that we will grow our way out of the problem. The President's 2007 budget released last week included some proposals to reduce the growth in Medicare spending. Whether or not these proposals are adopted, they should serve to raise public awareness of the importance of health care costs to both today's budget and tomorrow's. This could also serve to jump start discussion about appropriate ways to control a major driver of our long-term fiscal outlook—health care spending. Clearly, tough choices will be required. Changes in existing budget processes and financial, fiscal, and performance metrics will be necessary to facilitate these choices.

Early action to change existing programs and policies would yield the highest fiscal dividends and provide a longer period for prospective beneficiaries to make adjustments in their own planning. The longer we wait, the more painful and difficult the choices will become and the less transition time we will have. By waiting, an important window is lost during which today's relatively large workforce can increase saving and begin preparing for the necessary changes in fiscal policy, Social Security, and health care as well as other reforms that may be necessary parts of the solution to this coming fiscal crunch. However, the long-term challenge is fast becoming a short-term one as the retirement of the baby boomers' generation will begin as early as 2008 and since overall workforce growth has already begun to slow. While our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenges facing the nation.

Underreporting Accounted for Most of the Tax Gap Estimate

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been timely and accurately paid and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or timely.[3] Estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers.

IRS develops its tax gap estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely complied with their tax obligations. That rate is then used, along with other data and assumptions, to estimate the dollar amount of taxes not timely and accurately paid. For instance, IRS most recently estimated that for tax year 2001, 83.7 percent of owed taxes were paid voluntarily and timely, which translated into an estimated gross tax gap of $345 billion. IRS

[3] Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed timely.

developed these estimates using compliance data collected through the National Research Program (NRP).[4]

Using its recently collected compliance data, IRS has estimated that underreporting of income represented over 80 percent of the tax gap for 2001 (an estimated $285 billion out of a gross tax gap estimate of $345 billion), as indicated in table 1.

Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	**Individual income tax**	**Corporate income tax**	**Employment tax**	**Estate tax**	**Excise tax**	**Total**
Underreporting	$197	$30	$54	$4	No estimate	**$285**
Underpayment	23	2	5	2	1	**$34**
Nonfiling	25	No estimate	No estimate	2	No estimate	**$27**
Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

Note: Figures may not sum to totals due to rounding.

Within the underreporting estimate, IRS attributed about $197 billion, or about 57 percent of the total tax gap, to individual income tax underreporting, including underreporting of business income, such as sole proprietor,[5] informal supplier,[6] and farm income (about $109 billion); nonbusiness income, such as wages, interest, and capital gains (about $56

[4]NRP replaced the Taxpayer Compliance Measurement Program, which last measured compliance for individuals for 1988 but then was canceled because of concerns about costs and burdens on taxpayers. GAO, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, GAO-02-769 (Washington, D.C.: June 27, 2002); and GAO, *Tax Administration: Status of IRS' Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C.: June 18, 2001) discuss the development of the NRP study.

[5] Sole proprietors are self-employed individuals who should file a Schedule C with their individual tax return to report profits and losses from their business. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers.

[6] Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an "informal" manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on a Schedule C.

billion); overstated credits (about $17 billion); and overstated income adjustments, deductions, and exemptions (about $15 billion). Underreporting of corporate income tax contributed an estimated $30 billion, or about 10 percent, to the 2001 tax gap, which included both small corporations (those reporting assets of $10 million or less) and large corporations (those reporting assets of over $10 million).

Employment tax underreporting accounted for an estimated $54 billion, or about 16 percent, of the 2001 tax gap and included several taxes that must be paid by self-employed individuals and employers. Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. Employers are required to withhold these taxes from their employees' wages, match these amounts, and remit withholdings to Treasury at least quarterly. Underreported self-employment[7] and employer-withheld employment taxes, respectively, contributed an estimated $39 billion and $14 billion to IRS's tax gap estimate. The employment tax underreporting estimate also includes underreporting of federal unemployment taxes (about $1 billion).

Taxpayers who do not file their tax returns on time or at all and otherwise do not pay their tax liabilities accounted for the remainder of the 2001 tax gap—around $61 billion. For example, nonfiling and underpayment noncompliance by individual taxpayers alone contributed an estimated $48 billion to this portion of the tax gap.

IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes. For large corporate income tax underreporting, IRS based its estimate on the amount of tax recommended from operational examinations rather than the tax ultimately assessed as part of the total tax liability.[8] According to IRS officials, IRS relies on the amount of tax recommended because it is difficult to determine the true

[7]As employment taxes and income taxes for self-employed taxpayers are largely assessed on the same income, self-employed individuals who underreport their income consequently underreport the employment tax due on that income.

[8]IRS continually examines tax returns from about 1,100 of the nation's largest corporations, all of which have assets of more than $250 million. For fiscal year 2002, IRS examined around 7 percent of all large corporations.

tax liability of large corporations due to complex and ambiguous tax laws that create opportunities for differing interpretations and that complicate the determination. These officials further stated that because these examinations are not randomly selected and are not focused on identifying all tax noncompliance, the estimate produced from the examination data is not representative of the tax gap for all large corporations. They also explained that due to these complexities and the costs and burdens of collecting complete and accurate data, IRS has not systematically measured large corporation tax compliance through statistically valid studies, even though the officials acknowledged that such studies would be useful in estimating the related tax gap.[9]

IRS has no estimates for corporate income, employment, and excise tax nonfiling or for excise tax underreporting. For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable. In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[10]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. Recently, IRS has taken a number of steps that may improve its ability to reduce the tax gap. Favorable trends in staffing of IRS enforcement personnel; examinations performed through correspondence, as opposed to more complex face-to-face examinations; and the use of some enforcement sanctions such as liens and levies are encouraging. Also, IRS has made progress with respect to abusive tax shelters through a number of initiatives and recent settlement offers that have resulted in billions of dollars in collected taxes, interest, and penalties. In addition, IRS has successfully prosecuted a number of taxpayers who have committed criminal violations of the tax laws.

[9]GAO, *Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement*, GAO/GGD-94-70 (Washington, D.C.: Sept. 1, 1994); *Tax Administration: Factors Affecting Results from Audits of Large Corporations*, GAO/GGD-97-62 (Washington, D.C.: Apr. 17, 1997); and *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

[10]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

Reducing the Tax Gap Will Require Expanding Existing Approaches and Considering New Legislative Actions

Given its persistence and size, we need not only to consider expanding current approaches but also explore new legislation to help IRS in reducing the tax gap.[11] Although IRS has made a number of changes in its methodologies for measuring the tax gap over the past three decades, which makes comparisons difficult, regardless of methodology the voluntary compliance rate that underpins the gap has tended to range from around 81 percent to around 84 percent. Thus, although the dollar amounts of the tax gap have changed, IRS has consistently reported a persistent, relatively stable portion of the taxes that should have been timely and accurately paid were not paid.

As we have reported in the past,[12] closing the entire tax gap may not be feasible nor desirable, as it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit. However, given its size, even small or moderate reductions in the net tax gap could yield substantial returns, which could improve the government's fiscal position. For example, based on IRS's most recent estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. Thus, a 10 percent to 20 percent reduction of the net tax gap would translate into from roughly $30 billion to $60 billion in additional revenue annually.[13]

[11] We have suggested similar steps for the entire tax system as well as all major spending programs in order to confront the nation's fiscal challenge through a fundamental review, reexamination, and reprioritization of government's capacity to align itself with the needs and demands of the 21st century. See GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

[12] GAO, *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*, GAO/T-GGD-97-35 (Washington, D.C.: Jan. 9, 1997).

[13] Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance. In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap simply because the amount of tax that should be paid has been reduced, even if the level of compliance remains unchanged.

However, reducing the tax gap will be challenging[14] and it must be attacked on multiple fronts and with multiple strategies, some of which follow.

Regularly Measure Compliance and Set Compliance Goals

A critical step toward reducing the tax gap is to understand the sources and nature of taxpayer noncompliance. Regularly measuring compliance, including the reasons why taxpayers are not compliant, can offer many benefits, including helping IRS identify new or growing types of noncompliance, identify changes in tax laws and regulations that may improve compliance, understand the effectiveness of its programs to promote and enforce compliance, more effectively target examinations of tax returns, and determine its resource needs and allocations. Likewise, regularly measuring compliance can provide IRS with information against which to set goals for improving compliance and measure progress in achieving such goals.

In our July 2005 report on reducing the tax gap, we made recommendations to IRS to develop plans to periodically measure tax compliance; take steps to improve its data on the reasons why taxpayers do not comply; and establish long-term, quantitative goals for voluntary compliance levels with an initial focus on individual income tax underreporting and total tax underpayment. Taken together, these steps can help IRS build a foundation to understand how its taxpayer service and enforcement efforts affect compliance and make progress on reducing the tax gap. The Commissioner of Internal Revenue agreed with our recommendations, highlighted challenges associated with them, and commented on various steps IRS would take to implement each recommendation. We are encouraged that according to IRS's Fiscal Year 2007 Congressional Budget Justification, IRS has recently established a voluntary compliance goal, with a target of 85 percent voluntary compliance by 2009, and plans to periodically measure progress against this goal.

[14]Recognizing these challenges, we have long been concerned about tax noncompliance and IRS's efforts to address it. Since 1990, we have had various aspects of tax noncompliance on our high-risk list, and last year we have affirmed our broad concern by consolidating two prior high-risk areas into one—Enforcement of Tax Laws. See GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

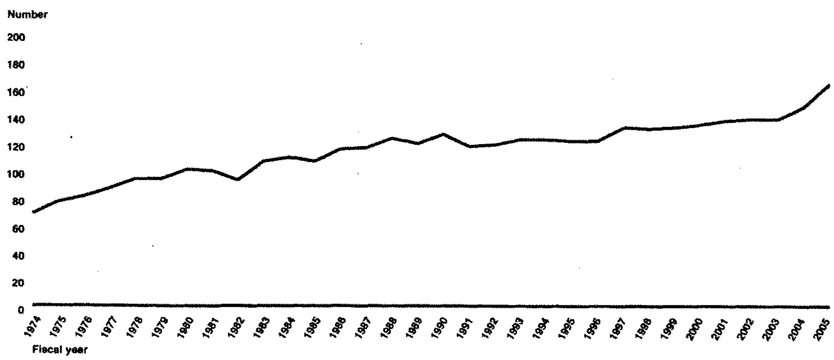
Simplify the Tax Code

Efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations. Among the many causes of tax code complexity is the growing number of preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates.[15] Tax expenditures—as they are known by statute[16]—can be a tool to further some federal goals and objectives, such as financing higher education or funding research and development. However, their aggregate number contributes to the complexity that taxpayers face in doing their taxes and planning their financial decisions. As figure 3 shows, the number of tax expenditures reported by the Department of the Treasury has more than doubled since 1974. Figure 4 shows the Revenue Loss Estimates for the Five Largest Tax Expenditures Reported for Fiscal Year 2005.

[15]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

[16]The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, Sec. 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. sec. 622(3)).

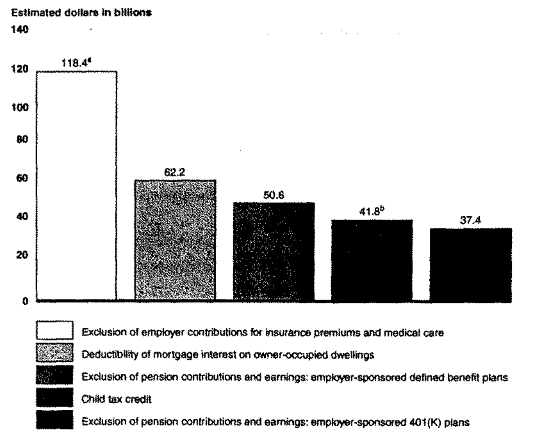
Figure 3: Number of Tax Expenditures Reported by Treasury, 1974-2005



Source: GAO analysis of OMB budget reports on tax expenditures, Fiscal Years 1976-2007.

Note: The number of tax expenditures reflects all provisions reported by Treasury, including those enacted but effective for future fiscal years. For example, Treasury's last list included tax expenditures enacted in 2005 that will be effective in fiscal years 2006 and later. The trend also reflects changes in Treasury's income tax baseline that defines a tax expenditure.

Figure 4: Revenue Loss Estimates for the Five Largest Tax Expenditures Reported for Fiscal Year 2005



Source: Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007.*

Note: "Tax expenditures" refers to the special tax provisions that are contained in the federal income taxes on individuals and corporations. OMB does not include forgone revenue from other federal taxes such as Social Security and Medicare payroll taxes.

[a]If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.

[b]This is the revenue loss and does not include associated outlays of $14.6 billion.

The multiple tax preferences for education assistance illustrate the consequences of the proliferation of tax expenditures. In our July 2005 report[17] on postsecondary tax preferences, we found that hundreds of thousands of taxpayers do not appear to make optimal decisions when

[17]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

selecting education-related tax preferences. One explanation of these taxpayers' choices may be the complexity of postsecondary tax preferences, which experts have commonly identified as difficult for tax filers to use. Also, many argue that complexity creates opportunities for tax evasion, through vehicles such as tax shelters. Simplification may reduce opportunities for taxpayers to avoid taxes through the creation of complex and abusive tax shelters.

Another area of the tax system that may deserve additional exploration, although not directly related to the tax gap, is whether the federal income-based tax system is sustainable and administrable in a global economy and how we should tax the income of U.S. multinational corporations that is earned outside of the United States.[18] Every year, U.S.-based multinational corporations transfer hundreds of billions of dollars of goods and services between their affiliates in the United States and their foreign subsidiaries.[19] Such transactions may be a part of normal business operations for corporations with foreign subsidiaries. However, it is generally recognized that given the variation in corporate tax rates across countries, an incentive exists for corporations with foreign subsidiaries to reduce their overall tax burden by maximizing the income they report in countries with low income tax rates, and minimizing the income they report in or repatriate to countries with high income tax rates. Various studies have suggested that U.S.-based multinational corporations appear to engage in transactions such as these that shift income from their affiliates in high-tax countries to subsidiaries in low-tax countries to take advantage of the differences in tax rates in foreign countries.[20]

The growth in multinational corporate transactions and structures has also introduced increasing complexity in administering the tax code. The loss of highly skilled technical employees at IRS who can examine compliance

[18]Although not necessarily a solution to the tax gap, given the challenges facing our income-based tax system, some have suggested moving more towards a consumption-based tax system. Our recent report on understanding the tax reform debate discusses a number of topics that tax experts have identified as those that should be considered when evaluating tax policy. See GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

[19]GAO, *International Taxation: Information on Federal Contractors with Foreign Subsidiaries*, GAO-04-293 (Washington, D.C.: Feb. 2, 2004).

[20]A survey of studies that examine income shifting by multinational corporations appears in Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (Washington, D.C.: December 2000), 197-213.

issues arising from globalization, such as transfer pricing, underscores the challenge that IRS faces in ensuring it has sufficient staff with adequate skills to address these complex issues.

Enhance Services to Taxpayers

Providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap. One method of improving compliance through service is to educate taxpayers about confusing or commonly misunderstood tax requirements.[21] For example, if the forms and instructions taxpayers use to prepare their taxes are not clear, taxpayers may be confused and make unintentional errors. One method to ensure that forms and instructions are sufficiently clear is to test them before use. However, we reported in 2003 that IRS had tested revisions to only five individual forms and instructions from July 1997 through June 2002, although hundreds of forms and instructions had been revised in 2001 alone.[22]

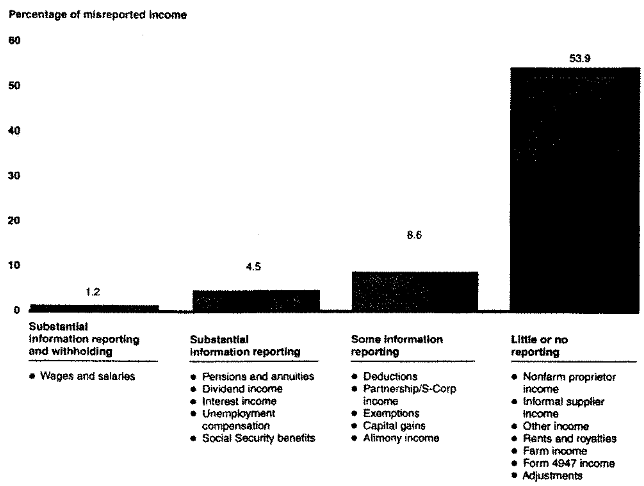
Enhance Enforcement Tools Available to IRS

In terms of enforcement, IRS will need to use multiple strategies and techniques to identify and deter noncompliance. As figure 5 shows, one pair of tools have been shown to lower levels of noncompliance—withholding tax from payments to taxpayers and having third parties report information to IRS and the taxpayers on income paid to taxpayers. For example, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Similarly, most wages, salaries, and tip compensation are reported by employers to employees and IRS through Form W-2. Findings from NRP indicate that around 98.8 percent of these types of income are accurately reported on individual returns.

[21]GAO/T-GGD-97-35.

[22]GAO, *Tax Administration: IRS Should Reassess the Level of Resources for Testing Forms and Instructions*, GAO-03-486 (Washington, D.C.: Apr. 11, 2003).

Figure 5: Individual Income Tax Underreporting Categorized by Amount Subject to Withholding and Information Reporting, 2001



Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:[23]

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for

[23]GAO, *Tax Gap: Many Actions Taken, but a Cohesive Strategy Needed*, GAO/GGD-94-123 (Washington, D.C.: May 11, 1994).

independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to separately report on their tax returns the total amount of payments to independent contractors.[24] IRS's Taxpayer Advocate Service recently recommended allowing independent contractors to enter into voluntary withholding agreements.[25]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[26] payments made by others to corporations are generally not covered by information returns. The Taxpayer Advocate Service has recommended requiring information reporting on payments made to corporations,[27] and the Administration, in its fiscal year 2007 budget, has proposed requiring additional information reporting on certain goods and service payments by federal, state, and local governments.[28]

- **Requiring more data on information returns dealing with capital gain income.** Past IRS studies have indicated that much of the noncompliance associated with capital gains is a result of taxpayers overstating an asset's "basis," the amount of money originally paid for the asset. Currently, financial institutions are required to report the sales prices, but not the purchase prices, of stocks and bonds on information returns. Without information on purchase prices, IRS cannot use efficient and effective computer-matching programs to check for compliance and must use much more costly means to examine taxpayer returns in order to verify capital gain income. The Taxpayer Advocate Service has

[24]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance,* GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

[25]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2005 Annual Report to Congress* (Washington, D.C. Dec. 31, 2005).

[26]Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

[27]*National Taxpayer Advocate 2005 Annual Report to Congress.*

[28]Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007.*

recommended requiring financial institutions to track cost basis information and report it to IRS and taxpayers.[29]
Although withholding and information reporting are highly effective in encouraging compliance, such additional requirements generally impose costs and burdens on the businesses that must implement them. However, continued reexamination of opportunities to expand information reporting and tax withholding could increase the transparency of the tax system. Opportunities to expand information reporting and tax withholding could be especially relevant toward improving compliance in areas that are particularly complex or challenging to administer, such as with net income and losses passed through from "flow-through" entities such as S corporations and partnerships to their shareholders and partners.[30]

Another enforcement tool that can potentially deter noncompliance is the use of penalties for filing inaccurate or late tax and information returns. Congress has placed a number of civil penalty provisions in the tax code. However, as with civil penalties related to other federal agencies, inflation may have weakened the deterrent effect of IRS penalties. For example, the Treasury Inspector General for Tax Administration has noted that the $50 per partner per month penalty for a late-filed partnership tax return, established by Congress in 1978, would equate to $17.22 in 2004 dollars. In its fiscal year 2007 budget, the administration has proposed expanding penalty provisions applicable to paid tax return preparers to include non-income tax returns and related documents. In addition, Congress recently increased certain penalties related to tax shelters and other tax evasion techniques.[31] Given Congress's recent judgment that some tax penalties were too low and concerns that inflation may have weakened the effectiveness of the civil penalty provisions in the tax code, additional increases may need to be considered to ensure that all penalties are of sufficient magnitude to deter tax noncompliance.

Leverage Technology

Leveraging technology to improve IRS's capacity to receive, process, and utilize taxpayer returns could help IRS better determine how to allocate its

[29] *National Taxpayer Advocate 2005 Annual Report to Congress.*

[30] Partnerships and S corporations are businesses commonly referred to as flow-through entities, as they do not generally pay taxes on income. Instead, they distribute net income and losses to partners, shareholders, and beneficiaries, who are subsequently required to report net income or losses on their individual tax returns and pay any applicable taxes.

[31] American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

resources to reduce the tax gap and would seem to be a prudent investment. IRS has invested heavily in modernizing its technology and those investments have paid off. Telephone service has improved and taxpayers are much more likely to get through to IRS and obtain assistance from IRS than before IRS upgraded its technology. Further, electronic filing has grown substantially. Tax information submitted to IRS electronically enables faster, more accurate processing and quicker interactions between IRS and taxpayers. Electronically filed returns are processed as they are received, therefore giving IRS access to more timely and accurate tax information, which can be used for better data analysis capability and quicker focus on issues that need resolution. IRS estimates it saves $2.15 on every individual tax return that is processed electronically. According to IRS data, electronic filing has allowed IRS to use more than a 1,000 fewer staff years to process paper returns, resources that can then be dedicated to other service or enforcement work.[32]

However, IRS's Business Systems Modernization project, through which the agency is modernizing its outdated technology, is far from complete. IRS needs to continue to strengthen management of this effort and make prudent technology investments to maximize the efficiencies that can be gained in IRS operations and services to taxpayers.

Optimize Resource Allocation

Sound resource allocation is another tool for addressing the tax gap. The more effectively IRS can allocate its resources, the more progress should result. The new NRP data, for example, are to be used to better identify which tax returns to examine so that fewer compliant taxpayers are burdened by unnecessary audits and IRS can increase the amount of noncompliance that is addressed through its enforcement activities. As part of its attempt to make the best use of its enforcement resources, given budget constraints, IRS has developed rough measures of return on investment in terms of tax revenue that is directly assessed from uncovering noncompliance. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts, as well as on the indirect tax revenues generated when current enforcement actions prompt voluntary compliance improvements in the future. Continuing to develop

[32]Some state and federal tax experts have recognized that mandatory electronic filing for certain categories of tax practitioners is one remaining option with the potential to significantly increase electronic filing. However, mandatory electronic filing would likely impose some costs and burdens on tax practitioners.

the return on investment measures could help officials make more informed decisions about allocating resources, particularly during periods of budget constraints. Even with better data, however, officials will need to make judgments that take into account intangibles, such as how to achieve an equitable enforcement presence across the various taxpayer groups.

Concluding Observations

Our nation's fiscal imbalance and challenges have created an imprudent and unsustainable path that needs to be addressed. While our long-term fiscal imbalance is too large to be corrected by one strategy, reducing the tax gap can help address the looming fiscal challenges. Collecting the billions of dollars that already should be paid, for example, would help ease the many difficult decisions that need to be made about our spending programs as well as the rest of the tax system. However, the tax gap itself has been large and pervasive over the years and therefore, reducing the gap will not only require expansions of current efforts, but also new and innovative solutions. While IRS takes the lead in continuing to find ways to significantly reduce the tax gap, support from Congress will be essential since legislation will likely be needed to implement many of the tax gap reduction ideas offered today. We look forward to continuing to work with Congress and IRS on these issues.

Chairman Gregg, Senator Conrad and members of the committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. For further information on this testimony, please contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov. Individuals making key contributions to this testimony include Tom Short, Assistant Director; Jeff Arkin; Elizabeth Fan; and Cheryl Peterson.

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Chairman GREGG. Thank you, Mr. Walker, and thank you for the really excellent information and data that you have given the Congress, especially in the area of the out-year unsustainability of our present programmatic activity and the entitlement accounts. Anybody who looks at your numbers on entitlement accounts recognizes we have to do something, and it is our obligation as policymakers to do it sooner rather than later. So we thank you for that because you are viewed as a fair arbiter of those numbers.

Commissioner Everson, last year the budget had in it basically what amounted to a reserve fund which was available to the Appropriations Committee to assist in funding further increases in enforcement for the IRS. I think it worked out to about $446 million when it was all done.

The administration has asked for another $137 million for that type of a plussing up of your enforcement activity, again, as a special budgetary item within the budget. So it is a unique vehicle to use, quite honestly, to get to this enforcement.

To what extent do those dollars assist you? And if we would put in more than $137 million, would we get a return of—you know, what is the return on those dollars? Is it 1:1 or 2:1 or 10:1? Hopefully 10,000:1.

Mr. EVERSON. Let me first state, as I indicated a moment ago, I very much appreciate what you did last year. It was essential to our continued rebuilding of our enforcement activities. And I hope that you support every dollar requested in the budget, as well as the program integrity cap.

I am taking the same approach I took last year. I am asking for every penny of the President's budget request but not for a penny more. I don't——

Chairman GREGG. Let's stop there. What I want to know is: How much did we get for the money we put in last year? And if we exceeded the President's request, would we get more back? I mean, I don't mind putting more in——

Mr. EVERSON. I am going to answer that. I am going to answer that. So I am not asking for more than the President has requested.

Chairman GREGG. I understand that.

Mr. EVERSON. That is the first thing I am going to say and I am going to get that out of the way.

Obviously, when we invest in enforcement moneys for the IRS, we get a return. If you take a look at our budget, our total budget is about $10.6 billion. So, roughly speaking—let's go back to the enforcement revenues—the enforcement revenues alone last year were $47 billion. So use that as an order-of-magnitude comparison. That is the direct moneys you got back against the whole budget. The enforcement piece we are talking about is approaching $7 billion in terms of how we allocate within our budget what is enforcement. But the other moneys play an important role, too—modernizing our systems—the whole thing is important.

Now, when you make a marginal investment, the return on that marginal investment depends. If you are doing document matching, it is very cheap. You might get a very high return—10:1, 15:1. If you are doing high-end complex audits, the return is lower, but it is still a multiple of one after you have trained the people. So it is a good investment.

Again, though, the big point here is that this is only the direct return that I am speaking about. I am not talking about some concept that I would consider dynamic—or you might consider dynamic scoring—which is to say when we audit Senator Conrad and whether or not we find more money——

Senator CONRAD. You wouldn't get a dime.

[Laughter.]

Mr. EVERSON. You may think twice about something that you might do on your return. That is not in these concepts. And, clearly, there is an important behavioral impact.

So, yes, you get a positive return. If you give us more money, yes, you will get a multiple of that.

Chairman GREGG. Well, let's say we were to take this number, 137, the President has asked for and double it. Could we presume that our return on that would be 5 times, 10 times? I mean, how would we—in other words, if we were going to offset that with receipts that we would score in our baseline, what would be the number that we should be considering putting in as a result? And when do we get to a diminishing return event?

Mr. EVERSON. I don't think you will get to a diminishing return for some time. This gets to the basic question of how much can you reduce that tax gap. The way I view it is you can clearly reduce it by $50 or $100 billion without changing the way the Government interacts with its citizenry. And I don't know precisely where that point is. But at some point, you will be more intrusive. You will get more allegations of strong-arm tactics and excess. But I believe you can make progress with investment and with the statutory reforms. I have seen in the press that some have pooh-poohed these, but I think that they are the most significant reforms that we have asked for in two decades, since the 1986 act when Congress said, "Going forward, if you are going to get an exemption for somebody, you have to put down the Social Security number, not just the name." Well, the next year, 5 million dependents vanished.

What we are trying to do here is attack this also with statutory proposals, so I wouldn't want you to lose sight of those.

Chairman GREGG. Well, of course, this committee does not have jurisdiction over statutory proposals. That is Senator Grassley's. But we do have the ability to set up this fund.

Mr. EVERSON. Yes.

Chairman GREGG. And give the money to the Appropriations Committee, which we did last year, which in turn generates additional revenues, which in turn allows us to score higher revenues, which in turn gives us a different budget scenario. So it is critical to us to know how those dynamics all work together, and I think you have answered that question for us.

Mr. EVERSON. I would say one thing. My understanding is that part of the problem here is the revenue side does not score. That is my understanding.

Chairman GREGG. Well, we understand that, too, but at some point we have to start being logical about this. If we put an extra $500 million into your enforcement mechanisms, we have to talk to

CBO about giving us some score for that, because, clearly, there is a return for that money.

Senator Conrad.

Senator CONRAD. Let me just pursue, if I could, with you, Mr. Everson and General Walker—first of all, I want to thank you both. I think your testimony has been excellent, I think it has been honest, and I think we begin to get a sense of how big this is, this $350 billion revenue gap here.

I hear you saying, Commissioner Everson, in your judgment we could close that by $50 to $100 billion without affecting the interaction between the agency and taxpayers in some negative way.

Let me first say I believe—and I have gone over in some detail how the estimates were made. I believe that it is likely the estimates are understated. And I understand how the estimates were made. I don't fault you for how the estimates were made. You are in some sense locked into building off a base that is quite old because, as I understand it, this update to 2001 is based off a file that is substantially earlier than that. And so with what I have seen happen in the accounting community in terms of aggressive approaches to tax avoidance, I believe that there is a strong likelihood that the estimates are understated.

Could you share, Commissioner Everson, your sense on that issue?

Mr. EVERSON. Sure. Can we go to the tax gap map?

If you look at the way we have color-coded this map, we have three colors. Now, this is not some sort of national security warning system, but maybe it is a fiscal warning system.

Green represents actual amounts—that is to say the underpayment piece, which when I file my return and I indicate that I owe $7,000 but I don't send the check in. That is a good, hard number.

The blue numbers are the estimates that have been updated from this national research program that we did using the 46,000 2001 audits so we think those numbers are very good. Also, the nonfiling piece is a very good estimate because we used census data and our own records to try and get our arms around what we think has not come in.

Now, what is less reliable and gets to the issue that you just mentioned, are the pieces in yellow, and the biggest piece in yellow relates to corporate returns.

The reason we didn't update this piece is because we still have significant research to do here. We started with the individuals because that is where historically the biggest piece of the problem is. In terms of corporate audits, especially the larger corporate entities, we have a very high audit coverage. For businesses with assets of over $250 million, our audit rate is over 40 percent. So we are doing a lot in that area, anyway.

I take your point, though, and I agree with it, but what I would say is, even if the tax gap for corporations is understated by half—that is to say, it is $60 billion instead of $30 billion—it still doesn't change the picture that dramatically. And I would not allocate our resources any differently because we already give, as Senator Grassley knows, a great deal of focus to corporations and high-income individuals.

Senator CONRAD. Let me just say that I have had the opportunity to talk to a number of big firms on Wall Street who have taken a look at this issue, and they have told me they have reviewed the analysis, had people with great expertise, and they think we may be understating this by $50, perhaps even $100 billion a year. Do you think that is out of the question?

Mr. EVERSON. I would not venture a guess as to the amount. I would say, however, that one of my principal concerns is the issue of corporate compliance, particularly with increasing globalization. And what we have done is we have enhanced our contacts with other taxing jurisdictions.

I was at a meeting—it took almost 2 years to set this up, believe it or not—where for the first time we have included the Chinese and the Indians in some of our discussions in anticipation of the reversal of capital flows.

We are doing more here. We set up something called the Joint International Tax Shelter Information Center about a year and a half ago. It is a joint center involving the Brits, the Australians, and the Canadians, where we share information along with our exchange agreements, totally in accordance with treaties. We have found numerous instances of tax arbitragers who set up deals so that there is a tear line between our system and the U.K. system, and they don't end up paying taxes either place. And that is not——

Senator CONRAD. May I just say——

Mr. EVERSON [continuing]. What was intended.

Senator CONRAD. When I was a State tax commissioner, in one case alone I found a major company doing business in my State had an operation in the Cayman Islands. They showed no profits on very extensive operations in the United States. They showed hundreds of millions of dollars of profits in the Cayman Islands with one employee. And I always said that was the most efficient person in the world. That person was really productive. And that person didn't even work full-time for the company. That individual was an agent for many companies.

I showed on the floor of the Senate last week a five-story building in the Cayman Islands that is the home to 12,500 companies. It is amazing how much you can get done in a situation like that on avoiding taxes legitimately due here, and what they were doing is through the use of transfer pricing, showing their profits in the Cayman Islands where there are no taxes, avoiding their legitimate taxes here, and I collected a lot of money from companies playing this game when I was the State tax commissioner.

Mr. EVERSON. I know David wants to say something, but let me just make one final point on this subject. The root cause of the problem here is the divergence between the incentives to increase book earnings on the one hand and to drive share prices and to minimize taxable earnings on the other.

I would recommend to you a very interesting article in the Sunday Business Section of the New York Times from about 10 days ago that talks about this problem and the fact that all of this is obscured to the investor and public community.

Mr. WALKER. As you know, among other things I am a certified public accountant, and I practiced in the private sector for a number of years. I believe that the world has changed dramatically, especially in the corporate sector, since the baseline for these estimates were created.

We need to understand that corporations do not have duties of loyalty to countries. They have duties of loyalty to their shareholders. They will do everything that they can legally do to avoid and minimize taxes. In today's world, through transfer pricing, through basing of corporate headquarters, there are lots of things that can be done in order to minimize tax burdens. Some of this deals with being able to make sure the IRS has enough people with the right kind of skills and knowledge to be able to effectively address these issues, because they are very sophisticated transactions.

Part of it is the Congress looking at a substance over form doctrine to determine what does it take in order for somebody to legitimately say that they are headquartered in for example, the Cayman Islands, when, in fact, a vast majority of their operations and revenues occur in the United States. Their executives are based in the United States and many spend most of their time in the United States.

And so, it will take both administrative actions as well as a potential legislative actions that the Senate Finance Committee will have to take a look at.

Chairman GREGG. And we will turn to the Senate Finance Committee chairman.

Senator GRASSLEY. To what extent are the numbers on here money that is going to come into the Federal Treasury once, if you have found that these people were cheating, or to what extent is that going to repeat from year to year? Like, for instance, if you close the gap on self-employment tax at $39 billion, would that $39 billion come in this year, next year, and next year?

Mr. EVERSON. The first point I would make about that, is that there is a reason there is an arrow in between those two. That amount is largely derivative of the underreported business income. In other words, you have obscured the income; therefore, that has just sort of an automatic effect on the self-employment tax that the Schedule C filer is not putting in there.

These are annual figures. This is what is not coming in every year. If we go to the enforcement——

Senator GRASSLEY. Well, if you found a taxpayer cheating and they started paying their taxes, then these numbers would say this would come in year after year?

Mr. EVERSON. That is right. What we have to do here is two things: we need to reduce that gross gap, which is to get better behavior up front, and we need to continue to make the IRS more efficient and effective in terms of what we actually bring in. That is how you get to the $290 billion number that is in there. It is the 345 less an estimate back in 2001 of about 55 that we would bring in through enforcement revenue and late payments.

Obviously that 55 number is now better because we have increased the enforcement revenue. So you want to attack it from both sides: bring down the overall gross gap and increase our recoveries.

Senator GRASSLEY. Now, questions that even if we did in these areas would be probably a small amount of revenue compared to the tax gap, but I want to ask your views on a couple things that my committee has been working on. One would be what I call the battle of appraisers, legitimate valuation disputes. We took some steps to deal with this a couple of years ago by giving more straightforward rules on car donations and intellectual property. In a bill that just passed the Senate, we have some additional steps regarding reforms of appraisal and who can appraise as well as trying to deal with other problems, such as clothing donations and facade easements, and valuation is part of this determination.

Give me your view on this matter in general as to how big of a problem that is, and your thoughts are important. You might want to give some detail in writing. I recognize that, just as we have found, it may be many targeted reforms that are needed to deal with this overall problem. In other words, I wish there was one magic bullet about everything you have on here. But I think we are going to have to do like how do you eat 10,000 marshmallows one at a time.

[Laughter.]

Mr. EVERSON. First, let me say I think that you and I are in lockstep agreement that the tax-exempt sector is extremely important, not just for reasons of protecting the integrity of the sector itself, but beyond that, for protecting the revenue base of the country. If we allow individuals and businesses to masquerade as charities or tax-exempt entities, over time we will erode the revenue base.

You are correct, though, Mr. Chairman, in saying that the costs of those abuses as indicated here our study are relatively small. But just as your committee has been aggressively looking at this issue, I think what we have to do is stop abuses in charities before they really get going and get larger.

So I think you are on the right track here to make sure we address this.

Senator GRASSLEY. OK. Then on another issue that may be small, but may be very big, too, because I don't know that we know for sure, the Taxpayer Advocate recently came out with this proposal on reporting for stocks about what the basis is. How big of a problem do you see the issue of basis in the tax gap? In other words, how much would it help if we had a better basis reporting? And what are your thoughts on the Taxpayer Advocate's proposal that has been put forth in this area?

Mr. EVERSON. Certainly. If you look at this chart it sort of spreads those numbers in a different way in terms of what is in the underreporting piece. The capital gains understatement that we determined in the study was only about $11 billion. And I say "only" because that was a surprise compared to what some academics and others had thought it might be. And so, as you can see here, the noncompliance rate to be about 12 percent. So I would caution to say that this, at least on the basis of our research, does not appear to be as big a problem as some had thought it to be.

Now, of course, different years you would bring different results. In year 2001, stock prices were going down. You might haveten a different answer in earlier years in which the valuations were different.

But we have not included a proposal focusing on the tax basis issue in the President's budget. We have included five proposals largely touching on increased reporting to get after these, but we have not targeted this particular issue at this time.

Senator GRASSLEY. Before you go, General—but does what you just told me deal with the issue of how do you determine basis?

Mr. EVERSON. Sure, because what they are doing, we are doing the audits here. We get good third-party reporting on the transaction in the sense that the sale is reported and the proceeds are reported to us. So it is only the basis that is at issue here.

Senator GRASSLEY. OK. General Walker.

Mr. WALKER. As you know, Mr. Chairman, this is something that we recommended at the hearing that you conducted on the tax gap last year. There were several specific areas where we felt that additional information reporting and potential additional withholding would be appropriate, and this was one. I would also respectfully suggest that $11 billion is a lot of money.

Furthermore, if we look at what is happening with regard to investment patterns, it is not just stocks and bonds. There is a tremendous amount of investment going on in real estate. The capital gains aspects of real estate for investment properties has exploded within the last few years. And so I think if we are doing these estimates based upon conditions that existed in the 1980's, I think it is a different ball game today than the 1980's.

Mr. EVERSON. The estimates are not based on the conditions of the 1980's. The 1980's issue really gets to Senator Conrad's point about the corporations. That is where you get the $30 billion on the corporation side. The individual side is fresh research. Just to clarify this.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman GREGG. Mr. Everson, just to clarify, these numbers don't really include things like dishonest transactions, such as the drug industry and things like that?

Mr. EVERSON. By "drug industry," do you mean illegal drugs?

Chairman GREGG. I am talking about illegal drugs, yes.

[Laughter.]

Mr. EVERSON. I think I know what you are saying, and that is correct.

Chairman GREGG. And illegal gambling.

Mr. EVERSON. Illegal sources.

Chairman GREGG. This number, 340 or 420, whatever it is, does not even take into account that. This is just underreported or——

Mr. EVERSON. Legal source.

Chairman GREGG [continuing]. Those taxable events that we should be able to find.

Mr. EVERSON. That is right.

Chairman GREGG. Senator Sessions.

Senator SESSIONS. This is an excellent hearing. I am delighted to be with you, and I am one who believes that people should pay their taxes. They should be as low as we can possibly make them, but they ought to pay them. I try to pay mine. Most Americans try to pay theirs. And when somebody doesn't pay their taxes, they are cheating all of us. If you are competing against a business who doesn't pay their taxes, it is hard for you to compete when you are doing the right thing every day. So I think it is very, very important, and as a Federal prosecutor who worked with IRS agents a lot, Mr. Everson, I found that they were far more reasonable than most of the people they were investigating.

[Laughter.]

Senator SESSIONS. A lot of them were crooks. A lot of them used political pressure to get around paying taxes they owed and should have paid. But I do think we had this spasm before Senator Grassley took over to control the IRS, whatever they thought they were doing, and I am concerned we might have gone too far. We want this system to be a voluntary compliance system. People ought to pay their taxes, and if they are not, they ought to expect to be investigated at some point and possibly disciplined, if that is the appropriate thing.

I saw the deal in Italy a number of years ago on "60 Minutes," and they were raising the taxes to, I think, 95 percent because nobody was paying them. And so they just kept raising them up, and it becomes absurd, of course. Nobody is going to pay 95 percent of what they make. So everybody cheats. If we can keep it simple and low, I think that is the better approach.

Perhaps you stated it, but I would ask both of you, out of this $345 billion estimate over a period of, say, 2 or 3 years, if we can commence a series of good reforms, how much of it could we recapture?

Mr. EVERSON. What I indicated earlier, Senator, was that I think that over a period of time you can collect somewhere between $50 and $100 billion without changing the dynamic between the IRS and the people.

What we have said is that between now and 2009 we want to get the compliance rate from 83.5 percent to 85 percent, which gets you about $30 billion in improved compliance. That is a combination of things. It is increasing up those enforcement revenues further and driving down the noncompliance overall.

Now, that is relatively modest, but I think what we need to do here is gain the experience of reinvigorating the IRS. We need to get that tax reform done; that will really help. And we need to build off of the legislative proposals for some increased reporting, because, again, where there is a third-party reporting there is greater compliance, and the idea here is not to be too burdensome. That is why we have asked credit card issuers to report to us gross receipts for a business and government entities to report to us the payments for goods and services. If we do things like that, I think we can make some real headway here.

Senator SESSIONS. Mr. Walker, do you have any thoughts on how much we could reasonably expect if we took a series of appropriate steps, whatever they may be?

Mr. WALKER. First, you should do what can you achieve through additional enforcement activities and additional communication activities to enhance voluntary compliance and you try to provide reasonable assurance that individuals are complying with the law and paying their fair share.

When the Commissioner says $50 to $100 billion, I don't know if that is incremental to the $55 billion.

Mr. EVERSON. That is a net improvement from——

Mr. WALKER. OK.

Mr. EVERSON. From the 345, we figured we brought in 55. I am saying you can get another 50 to 100 on top of that 55.

Mr. WALKER. That is helpful.

Mr. EVERSON. Some of this is the result of increased collection and some is the result of behavioral change.

Mr. WALKER. Right. I understand. He is in a better position to give you an estimate on that. I will tell you this, Senator: I do not believe that you are going to make dramatic progress on the 345 billion unless you get tax simplification and unless you end up getting additional information returns in selected areas and additional withholding in selected areas. I am happy to be more specific if you want.

Mr. SESSIONS. Well, my time is up. But, Mr. Chairman, as we do tax reform and, Senator Grassley, as we do tax reform, perhaps we need to ask the people who are collecting the taxes while we are doing it, if we wrote it in a simple, clear way, it would be easier to audit, it would be easier for people to—there wouldn't be the gray areas they might justify not paying because it would be more clear, and we may get a better compliance rate.

Chairman GREGG. Thank you, Senator. Obviously that is a bigger issue than this committee has a role in, although we can clearly be interested in it, as we are. But the things that we can impact are the issue of enforcement, because we can fund that through the appropriations process with specific language in the budget.

Are there other things, Mr. Commissioner, that the budget could do in the way it was written which would assist you in collecting and addressing this tax gap?

Mr. EVERSON. In terms of the jurisdiction of this committee, I think you have put your finger on the issues. There is a short-term issue of the President's request, and then there is the overall issue of scoring, which goes back and forth and has taken different tacks at different times. So I think those are two.

And I echo General Walker's views here, that these are significant proposals on the reporting, and I hope that you as individual Senators will champion these proposals. They will be quite controversial in some communities, principally in small business, and some in the banking community will say that the credit card issuers may be reluctant to take these steps. So you can say this is important from an overall budgetary point of view.

Chairman GREGG. Your one chart—and I appreciate your outlining where we can be most helpful, but that one chart on individual income tax underreporting gap, which shows the vast majority of the money is lack of transparency, is a startling chart.

Mr. EVERSON. Yes.

Chairman GREGG. Especially since we are not talking about illegal activity here. I mean, if we were talking about illegal activity, that would be an understandable number. But since it is not illegal activity, one presumes we ought to be able to get transparency on it some way.

Mr. EVERSON. And if I could make just one point on this, because it is important. Most Americans are subject to this reporting already. There are about 235 million W–2s that are issued each year for about 150 million employees. There is not only reporting but, of course, as everybody is aware, withholding.

What we are proposing here is relatively modest but I would say quite significant to get some information reporting, say, on gross receipts for businesses.

Chairman GREGG. Mr. Walker, you made a comment that we also need to address tax expenditures. Can you define the type of tax expenditure you are talking about? Are these like targeted tax expenditures? Would these be the same things as an earmark? Is that what you are talking about? Or are you talking about something that is more broadly determined to be a tax expenditure such as the deductibility of mortgage interest?

Mr. WALKER. Mr. Chairman, I will talk to you about this on an informational basis because all Senators would be interested, but it is not necessarily within the jurisdiction of this committee.

What I am talking about is that ultimately what we have to do in order to get our fiscal house in order is that we need to do something about the tax gap to make sure that people are paying their fair share. We need to do something to constrain spending, including reforming entitlement programs. Ultimately we will also need to make sure that we have enough revenues to be able to pay our current bills and deliver on our future promises.

In doing that, one of the things that is largely off the radar screen is the revenue side. We spend $700 to $800 billion in deductions, exclusions, exemptions, credits and other types of tax preference activities. Some have an economic policy impact. Some are for social policy reasons. But they are not part of the budget process. They are not part of the appropriations process. They are not adequately disclosed in the financial statements of the U.S. Government. And yet they are $700 to $800 billion a year and growing rapidly. The No. 1 item is the fact that no individuals in America—pay income tax or payroll tax on the value of employer-provided and -paid health care, no matter how much money they make, no matter how wealthy they are, and no matter how generous their health care package might be.

And so just as you talked before about if you end up investing more money in enforcement, that is likely to generate revenues, I think we need to think about how we can make sure that what is happening on the revenue side, whether it is a plus or a minus, comes on the radar screen. Right now it is largely off.

Chairman GREGG. I appreciate that. You are getting into the broader concept of tax expenditure when you talk about that. I thought you might be talking about a more targeted event, which this committee might actually be drawn into that fight, because this committee is going to be drawn into the fight of earmarks by it being set up as a point of order, it appears. Although it won't be going through this committee, it appears it is being done by a separate working group somewhere in some back room. But it is clearly going to be a point of order, which means this committee is going to be involved in that.

What we are going to do here, since Senator Wyden just arrived, we are going to go to Senator Conrad for his second 5 minutes, then Senator Grassley, then to Senator Wyden.

Senator CONRAD. First of all, let me say my own belief is that the tax gap is larger, perhaps significantly so, than the estimates. I say that not just based on some feeling, but based on our analysis of how this determination was made, and also what I have been told by very sophisticated financial firms on Wall Street who tell me they see the other side of these transactions. They think there is big leakage. They think there is significant underreporting on basis by both corporations and individuals that is very hard to detect.

So, first of all, I believe that the tax gap is larger. A lot of this is behavioral change. Nobody knows this better than General Walker, who used to be in the accounting profession, and a very distinguished career there, I might add, with an outstanding company which at the time was the gold standard, I found in my transactions, absolutely superb people. And there has been a change, it is undeniable, in the corporate culture, because some of these firms, accounting firms, established very aggressive accounting practices after these base estimates were made, after the base periods. And so you have had—and I have people who I worked with very closely over many years telling me, Kent, there has just been a dramatic change in the ethic—in the ethic—and that because of competition, firms became much more aggressive, accounting firms, in helping people and companies avoid what they legitimately owe. I believe that is the case.

Could I get a reaction from the two of you on that basic proposition?

Mr. EVERSON. I think I have covered the point on the estimates, and we are going to use the estimates as well as we can. And I don't think that changes really how I would do my job. There is real money on the table here. We know where the larger issues are. And so we are going to do the best we can, and we are going to continue to get better estimates, as the GAO and others have suggested, as best we can.

Your point is exactly correct. Our system depends upon not being overly intrusive compared to other countries. It depends on the integrity of tax practitioners, and there is no doubt, I would suggest to you, that over the course of decades, the role of professionals has changed.

I was also at that fine firm that you referenced for 6 years starting in 1976. And the role of the accountant in that era was to make sure that your client adhered to professional standards and followed the law. That role migrated to value creation and risk management, and this migration has compromised the image of both accountants and attorneys, whose roles have changed. And that is why in our 5-year strategic plan we made one of our four enforcement priorities to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. And we have done a lot in this respect. We have increased the size of our Office of Professional Responsibility and have a former prosecutor doing that work. As Chairman Grassley knows, there have been important criminal proceedings that have taken place in this area. And I think that the message that this hasten out of hand, hasten through.

Senator CONRAD. General Walker.

Mr. WALKER. Senator, I practiced public accounting from 1973 to 1979 and from 1989 to 1998 with some of the largest and best-known firms in the world. It was a fundamental change in business and in the accounting profession between those two time periods.

As I said before, corporations do not have duties of loyalty to countries. They have duties of loyalty to shareholders, and they will do everything that they can in order to maximize revenue and minimize expense legally. In addition to that, when attorneys and CPAs are representing clients in tax planning, they are not independent. They are there to try to help their client minimize their tax burden—legally, of course.

There has been an explosion of products and techniques to try to legally avoid and minimize tax burdens. In today's world, where more and more economic activity is crossing borders, part of that is the use of sophisticated transfer pricing techniques where specialized practices have been created, headed by Ph.D. economists and a variety of other individuals.

You have the example that you gave where people will in form set up their headquarters in certain tax-advantaged locations, but in substance they are not really there. That didn't really occur to a great extent in the 1970's, but it occurs quite frequently today.

Senator CONRAD. It has changed. It has changed dramatically. I have people that I dealt with in the accounting profession over many years. Your former firm is the absolute gold standard. I found deeply honorable people very, very troubled by what occurred.

Let me go quickly to two other things. Obviously, more reporting, more withholding would make a significant difference. Let me go, because my time has really expired, to the question of tax reform, because my own conviction is, yes, we can make progress probably on the order of what, Mr. Commissioner, you are suggesting. But for us really to make dramatic progress would probably require tax reform that would involve simplification and also a system that is just more transparent by its nature.

A final comment on that question?

Mr. WALKER. I think Senator Sessions said it well. Ultimately if you want to minimize the tax gap, you are going to have to reform the overall tax system to make it as simple as possible and, therefore, broadening the base, having much fewer exemptions, deductions, and exclusions. You need to keep it as simple as possible, enhance the transparency associated with income of all different types from all different parties, and thereby try to minimize the tax rate that would apply to a much broader base and a much simplified tax structure.

Over the long term, the Congress, in addition to streamlining and simplifying the income tax system, may also have to consider whether and to what extent it wants to have our tax structure more consumption based, because we are the only major industrialized country in the world that doesn't derive a significant percentage of its revenue through a consumption type approach. After all the distribution of wealth and income in the United States is fundamentally different today than it was in the early 1900's when we created the income tax.

Mr. EVERSON. I would simply add that I think tax simplification is absolutely essential. As I indicated in the oral statement, complexity obscures understanding. And so it hurts the taxpayer who desires to be compliant, and it also is a tool of taxpayers who seek to obscure their true activities from us as tax administrators.

Mr. WALKER. And if I can quickly say, Senator, I have for a number of years prepared my tax return by hand, and I am a CPA. It is mind-numbingly complex. Even for an individual who wants to pay every dime that they owe, it is tough to be sure that you have done it right. It is unbelievably——

Senator CONRAD. Can I just say, as a former tax commissioner, I would be happy to review your return and make sure you are paying——

[Laughter.]

Mr. EVERSON. I will say this. If he has a problem and in any way we have mishandled it, David, just call me personally.

Senator CONRAD. Can I just conclude by saying I would ask for both of you, if you could provide to us in writing your recommendations on what we could do to really make progress, whether they are on the tax reform side or the administrative side, your recommendations to us.

Mr. EVERSON. The Administration proposed, in its Fiscal Year 2007 Budget Request, five new legislative changes to reduce the tax gap and re-proposed four legislative changes to improve tax administration efficiency. In addition, the Administration noted that it would strudy the standards used to distinguish between employees and independent contractors for purposes of withholding and paying federal employment taxes. The nine legislative proposals are:

Closing the Tax Gap

1. Clarify the circumstances in which employee leasing companies and their clients can be held jointly liable for federal employment taxes. This proposal would facilitate the effective use of third party employee leasing companies by small businesses to pay employment taxes. In addition to clarifying joint liability, it would also provide standards for holding employee leasing companies solely liable for such taxes, if they meet specified requirements.

2. Increase information reporting on paypment card transactions. In order to improve compliance, annual reporting to the IRS would be required for aggregate payment card reimbursements made to certain businesses in a calendar year.

3. Expand information reporting to certain payments made by Federal, State, and local governments to procure property and services. This proposal would improve tax compliance of those taxpayers who do business with government agencies.

4. Amend Collection Due Process procedures for employment tax liabilities. For Collection Due Process purposes, this proposal would align the treatment of levies to collect employment taxes with the treatment of levies to collect Federal taxes from State tax refunds. The proposal would curtail delinquent employers' ability to pyramid myltiple periods of unpaid employment tax liabilities. Tax-

payers would retain the ability to seek managerial appeal and to participate in the formal Collection Appeals Process.

5. Expand to non-income tax returns the requirement that paid return preparers identify themselves on such returns and expand the related penalty provision. This proposal would address the growing problem of return preparers who assist in the preparation and submission of improper excise, employment tax, and other non-income tax returns and related documents.

Improving Tax Administration

1. Implement administrative reforms to improve the efficiency of IRS operations such as (a) adopt measures to reduce frivolous submissions made solely to delay or impede tax administration; (b) allow the IRS to terminate installment agreement if the taxpayer is not paying as agreed; and (c) streamline jurisdictionover collection due process cases in the Tax Court.

2. Initiate cost savings measures such as: (a) Reduce transaction costs by changing the way the Treasury Department's Financial Management Services is reimbursed for offsetting collections, and (b) expand IRS' authority to require electronic filing.

3. Authorize the IRS to access employment date in HHS' National Directory of New Hires for tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers, and identification of levy sources.

4. Extend IRS' authority to fund undercover operations, which expires on December 31, 2006, to permit the IRS to fund certain necessary and reasonable expenses of undercover operations, including international and domestic money laundering and narcotics operations.

These legislative proposals strategically target areas where (1) research reveals the existence of significant compliance problems, (2) the compliance benefit is properly balanced against the burden placed on taxpayers, and (3) the changes support the Administrations's broader focus on identifying legislative and administrative changes to reduce the tax gap. The enactment of these proposals would position the IRS for improved service and enforcement effectiveness and productivity.

The FY 2006 appropriation for the IRS earmarked $6,382 million (post rescission) specifically for tax enforcement and included an increase of $442 million (post rescission) for enchanced enforcement programs, for a total of $6,842 million. The Appropriators were able to accommodate this increase as part of a program intergrity cap adjustment proposed by the Administration in the FY 2006 Budget, and adopted as part of the Budget Resolution. This enhancement is a critical component of our efforts to reduce the tax gap.

In the FY 2007 request, the Administration is again proposing a program intergrity cap adjustment for IRS enforcement. The amount for FY 2007, $137 million, is the amount needed to pay cost increases associated with the FY 2006 enforcement base (the FY 2006 cap adjustment of $442 million is now part of the "base" and would be included within the capped amounts when the Subcommittees receive their 302(b) allocations.) The $137 million is necessary to perserve the intergrity of the program increase provided in the FY 2006 budget.

Mr. EVERSON. I don't speak to tax policy, as Chairman Grassley knows, but we will certainly give you what we can in terms of pulling this all together.

Chairman GREGG. Senator Grassley.

Senator GRASSLEY. I have a statement I want to put in the record, an opening statement.

[The prepared statement of Senator Grassley follows:]

Statement of Senator Chuck Grassley
Budget Committee Hearing
Tax Gap
February 15, 2006

Chuck Grassley

I want to make it clear that the Finance Committee has the expertise to close the tax gap, and it is my intention, as Chairman, to close the tax gap. It is a big problem, costing our country $300 billion per year, but it is not an insurmountable problem. A little over a year ago, the Joint Committee on Taxation, at the Finance Committee's request, issued a report. That report provided suggestions that would close the gap by about $190 billion over five years.

Many of those items are very controversial.
Let me give you examples:

- Repeal the mortgage interest deduction for home equity loans.
- Subject state and local workers to the Medicare tax.
- Apply the payroll tax to most fringe benefits.
- Allow the offshore activities of U.S. companies to be exempt from U.S. tax.

These are controversial proposals, and I'm sure many on this committee don't endorse them now.

At the Finance Committee, we stuck our toe in this pond last spring when we examined the payroll tax gap. We heard testimony from the Joint Committee on Taxation and the Treasury Department on leakage in the payroll tax system. It seemed clear to me that many of the comprehensive payroll tax gap proposals, all which would have improved Social Security solvency, were too controversial to stand on their own. With the lack of bipartisan cooperation on Social Security, we did not have an environment to consider these important, but controversial proposals. Perhaps, if there had been bipartisan cooperation on addressing the Social Security problem, we could have made headway on the payroll tax gap.

My point is that the tax gap is a huge problem for the tax system, and it is easy to discuss it in the abstract. Taking concrete steps requires a lot of political will and bipartisan cooperation. We also may have to take opportunities to resolve tax gap problems as they present themselves. I praise the Treasury and IRS for taking some initial steps. I'd also alert my colleagues to the fact that we have measures in the tax relief reconciliation bill that aim at discrete, though minor, aspects of the tax gap.

Let me assure members of the Budget Committee that the Finance Committee will cull from the tax gap report, and other sources, offsets that can pass the Finance Committee. The other sources will be the national taxpayer advocate and the Administration's proposed budget for fiscal year 2007.

I look forward to hearing from the witnesses today.

Senator GRASSLEY. I want to bring up something that probably would amount to no more than a few hundred million dollars that you have on the tax gap there, but probably a few hundred million that you may not collect the way we are going now, and make a suggestion to you, Commissioner. And that is in regard to the interplay between the alternative minimum tax and the incentive stock options.

You know, the idea of our tax law is to encourage people to hold their stock to get preferential tax treatment in a very legal way, but then we had the dotcom bubble burst of 2001 so people received a lot of stock options. They drop in value. They don't have it. They have to pay the tax on, you know, what is not really income. So I believe that we have a lot of that in this tax gap.

And I have had people in my State come to me about this, and probably for every one in my State, there are 50 people in California having a problem, maybe Massachusetts, too. But I believe the right solution here for the IRS would be to exercise its expansive authority that it was given in the 1998 IRS restructuring bill to provide offers in compromise for the purpose of effective tax administration. I think that these cases fit well within the type of people Congress is trying to assist, people who have honestly paid their taxes for years but because the law is working at cross purposes, they are between a rock and a hard place. And, unfortunately, the IRS and Treasury, I believe, have been overly narrow in construing the authority given them in this provision passed in 1998.

So I have been pushing for quite some time to get the IRS and the Treasury to move more open-mindedly on this matter and would like to note that I particularly appreciate the Taxpayer Advocate's assistance in trying to help some of my constituents.

So I am only asking—I am not asking you to explain right now, but if you would make this a priority, because I believe it is a way of bringing in some income, that maybe because you cannot get blood out of a turnip, you may get nothing.

Mr. EVERSON. Certainly, Senator, we will take a look at it again. This is a complicated issue because if people exercise the options and then hold onto the stock and the stock value decreases, they may have a personal economic hardship, and then they can come in to us under the offer in compromise program if they don't have the money. But sometimes they are asking for a blanket exemption, which we tend to feel might require a statutory review.

So we will certainly take a look at it, of course.

Senator GRASSLEY. OK. And then just for the benefit of the Budget Committee, I would say that Senator Baucus and I have made the tax gap a very major effort of ours over the last couple years, working very closely with the Commissioner trying to take care of some of these industries that are promoting tax shelters, a lot of them that leave the poor taxpayer owing the Government a lot of money and thought they were getting honest advice that just was not very good advice.

But in addition, Senator Baucus and I asked the Joint Tax Committee to study, and they came out a year ago with a report. Some of it, as the General has suggested, just changing tax laws to bring in more revenue, not from people cheating on it necessarily, and some of these are very controversial: repeal of the mortgage interest deduction for home equity loans, subject State and local workers to Medicare tax, apply the payroll tax to most fringe benefits, allowing the offshore activities of U.S. companies to be exempt from U.S. taxes, examples of things that are very difficult to deal with and very popular with taxpayers.

Then they had another part of it that dealt with the tax gap, in other words, people cheating, and we are trying to zero in on those efforts, and efforts that are not there, some things that our respective staffs are coming up with.

And then, last, sometime last year we held a hearing on leakage of the payroll tax system, in other words, how it basically impacts upon solvency of Social Security. And, again, some of those are very controversial, probably would be real easy to handle in the context of overall Social Security reform because they deal with small business, maybe more difficult to deal with the case in isolation, although I am not saying that they shouldn't be dealt with in isolation, but, you know—well, I guess I have said what I wanted to say.

Thank you, Mr. Chairman.

Mr. WALKER. Can I comment real quick, Mr. Chairman, on this?

Senator Grassley, I realize that there are two dimensions, as you properly pointed out, with regard to this revenue issue, one of which is what can be done to try to reduce the tax gap—you will never eliminate it—and the other is what type of broader tax reforms might be necessary. And they are very different things.

Candidly, based upon any reasonable set of assumptions given where we are at and where we are headed fiscally, in addition to minimizing the tax gap—and I think things can and should be done through additional information returns and withholding and targeted enforcement activities—there is no question that you are going to have to make some tough choices in order to generate enough revenues to be able to pay our current bills and deliver on our future promises. And it is going to require real tough choices that are not going to be popular.

Frankly, one of the things that I am trying to do is to try to help pave the way for people to understand that, because realistically, elected officials cannot get too far ahead of their constituents, and their constituents need to understand where we are and where we are headed and what the consequences are for their kids and for our country if we don't start dealing with some of these things.

Senator GRASSLEY. The only think I would add to what you said is that the other side of the equation is the extent to which Congress over the last 4 years, maybe unrealistically, overpromised, and promises that cannot be kept as well, maybe not badly intentioned at the time, but how unrealistic they are right now, that you couldn't close the gap just on the revenue side.

Mr. WALKER. Absolutely. The current liabilities and unfunded commitments of the United States, which includes unfunded promises for Social Security and Medicare—just those two, not Medicaid—are $46 trillion in current dollar terms, up from $20 trillion 5 years ago, and growing every second of every day.

Chairman GREGG. A startling number.

Senator Wyden.

Senator WYDEN. Gentlemen, thank you, and thank you for your service, and both of you have been very helpful to me.

I have introduced the Fair Flat Tax Act, S. 1927, and in the legislation—I am going to hold it up—is a one-page 1040 form. I filled it out myself. It took about half an hour, and that in and of itself is kind of a revolution for a member of the Senate Finance Committee to actually be able to do their own taxes. And a reporter called yesterday and said he did his in 15 minutes using my form.

It is pretty straightforward. You take your income from all your sources, subtract your deductions, add your credits, and send it off to Mr. Everson and say to the IRS, "I'm done. Have a nice day." The end.

What I find so baffling is I have a one-page 1040 form, the President's Commission that reported this fall, their proposal, colleagues, is maybe six, seven lines longer, but for purposes of Government work, they are pretty darn close. What are the problems in terms of actually getting this done?

I pressed Secretary Snow on this a week ago. I just for the life of me can't understand why an effort can't be begun immediately to jump-start this tax reform. I have one approach. The President has another. A Democrat is saying that the Republicans have some good ideas.

What is the problem here? Why can't this be well underway?

Mr. EVERSON. I, again, as you can appreciate, do not speak for the administration on tax policy. I have said consistently, including before the tax panel last March, that I believe reform is essential. As I indicated actually before you came in, Senator, simplification is one of the most important answers in terms of reducing the tax gap, which is the subject of today's hearing. So I am a strong advocate of moving forward with reform.

Senator WYDEN. But specifically on the idea of taking what I have and what the administration's proposal has—and others, by the way, have good ideas as well—wouldn't that make sense doing that now?

Mr. EVERSON. I think that Treasury is looking at the reform panel ideas, and I am sure that as they do that, they are cognizant of what else is also out there, including your proposal.

Senator WYDEN. You are being very diplomatic. When I tried to get them to put this on deadline or anything resembling some sense of urgency, it just wasn't there.

Mr. EVERSON. It is in my self-interest to be diplomatic.

Senator WYDEN. Yes, it is.

[Laughter.]

Senator WYDEN. Mr. Walker, you are a good man. Any thoughts on this?

Mr. WALKER. From a policy standpoint, it absolutely makes sense. From the standpoint of trying to close the tax gap, it absolutely makes sense.

There are a lot of people, Senator, vested in the status quo. Not everybody is for transparency. Not everybody is for broadening the base because they have their special preferences and an interest in maintaining their special preferences. And my view is it is also a matter of what other priorities exist at any given point in time as to where decisionmakers are going to allocate their time and political capital.

The sooner, the better, from the standpoint of streamlining and simplifying the Tax Code, not only from the standpoint of the tax gap, but in order to minimize tax burdens and enhance economic growth and efficiency.

Senator WYDEN. There are plenty of interests that will oppose this, you are right. But unlike Social Security, there are not going to be any rallies outside a Member of Congress' office saying, "I love the Internal Revenue Code."

I am going to do everything I can with colleagues on a bipartisan basis to see what I can do to goad both political parties into getting into this.

Gentlemen, in your view, how much of the underreporting and underpayment of taxes is due to genuine confusion—genuine confusion—due to complexity, and how much is due to cheating? Give me just a ballpark figure because I know, Mr. Everson, there are a lot of issues with respect to how that is calculated. But give me a ballpark assessment of how much you think is confusion, how much you think is people trying to cut corners.

Because willful noncompliance has to do with the motivation of the taxpayer at the time he or she filed his or her tax return, it is virtually impossible to know for certain how much of the tax gap is due to genuine confusion as opposed to cheating. While our auditors may be able to identify what appear to be obvious cases of willfulness or simple mistakes, in the vast majority of cases, the motivation of the taxpayer is not at all clear. Moreover, it is not realistic to rely on taxpayers themeselves to indicate whether they deliberately tried to understate their tax liability. Finally, many taxpayer mistakes arise from not doing something that should have done, which could be caused by anything from innocent carelessness to willful evasion. It is not difficult for an auditor to note what was not done, but it is often virtually impossible to be certain about why.

That fact that reporting accuracy is much worse in the absence of third-party information reporting and withholding suggests that, with respect to income reporting, many taxpayers exploit their opportunities to be noncompliant. It also suggest that information reporting makes it easier for honest taxpayers to comply. More significantly, the growing complexity of the tax law is a primary driver of the tax gap, creating both genuine confusion and opportunities for those who wish to exploit the tax law.

Mr. EVERSON. I would decline to do that, Senator. While we directionally are trying to work on that issue through our research, we don't have precise conclusions at this point even to give a ballpark. What I would suggest to you, though, is that there is no doubt that confusion is a very real contributor here.

Look at something like the EITC or look at some of the other credits that are out there. Complexity is quite significant and a great challenge to individuals as they try to navigate educational credits, of which there are a number.

Senator WYDEN. I still think it is important for you all to give us a ballpark estimate of what this problem is all about. I understand it is difficult. But I would like to ask you, as one member of the Finance Committee and someone on this committee as well, to get back to us with even a ballpark figure, because to just say, well, we cannot give that.

Mr. EVERSON. Well, I will talk to our research people to see whether they can do that.

Senator WYDEN. Right.

Mr. EVERSON. I must tell you that, they are pretty reticent to say something that they don't feel is substantiated.

Senator WYDEN. I understand, but I think we owe it to our constituents to get a general sense so that we know what it is we are tackling.

One more question for you, Mr. Everson. What is it going to take to make those yellow boxes blue? My understanding is that the yellow boxes are the areas where we are not making the kind of progress we need in terms of the audits.

Mr. EVERSON. Yes.

Senator WYDEN. Can you give us a deadline when those yellow boxes will be blue so that people will see that there are modernized criteria with respect to how taxes are determined?

Mr. EVERSON. We are looking now at the continuation of our research programs. One thing we have done this year is work on S corporations. S corporations have exploded over the last two decades in terms of being used as pass-through entities. They don't even show up on that yellow piece there, if you will. But that is where we are looking now.

As I indicated, I think before you came in, if you look at what we do in terms of the corporation side, which is the biggest piece of the yellow, our coverages there are significantly higher by a factor of 10fold or more than what they are on the individual side. That is why we have not gone forward to do research per se on that issue.

I would say to you that as we look at this program, we will probably be more inclined to circle back and update the 2001 figures on the individual side and probably do more on the C corporations.

Senator WYDEN. Now, the administration's budget expands third-party reporting of income for additional transactions as part of its proposal to close the gap. They propose specifically expanding third-party reporting to include Government payments for goods and services as well as debit and credit card reimbursements paid to merchants. But the proposal for expanded third-party reporting does not include third-party reporting of investment income.

I find it very troubling. What I did with my tax reform proposal was build on what Ronald Reagan said in 1986, that, marginal rates are a big deal, they send a powerful message with respect to growth and opportunity, but we ought to treat all income the same, which is, of course, what was done in 1986.

And so I want to continue to try to build on the philosophy that Ronald Reagan laid out and would simply ask, Why aren't you applying the same rules to investment income that apply to wage, interest, and other income?

Mr. EVERSON. I guess my answer to that, Senator, is the five proposals we have made as well as the commitment we have made to look at the definition of employee versus independent contractor, which is really going to cause a firestorm. That definition has been locked in since 1978, and since then the employment model has really changed with many more independent contractors. I do consider them a very significant set of proposals. If we can work and get these done, then, of course, we ought to look at what other issues need to be included.

What we have not done in our proposals, by the way, is send specific language over to Finance or Ways and Means. We have said we want to do this and then will work with you on the details. So we are open to discussing what needs to be done here, but I do view it as very important that we are again tackling this issue substantially for the first time in 20 years.

Senator WYDEN. I share your view, and I think it is helpful that you are. I just am concerned that right out of the box again we are going to set up a double standard in this country. And colleagues have heard me talk about that we have two standards in America: one for people who work for wages and another for folks who make their money from investments. I am not interested in soaking anybody. I believe in markets. I believe in creating wealth. But when the cops on the street gets a raise, they pay 25 percent of their income to the Government in taxes, pay Social Security payroll taxes on top of it, and the person who makes their money on capital gains and investments pays 15 percent and no Social Security payroll tax, looks at this budget and says, Hah, down in Washington, D.C., they are talking about closing the tax gap, I hear all about that, but we got one set of rules that apply to me and we got another set of rules that apply to the investor.

Mr. EVERSON. I would point out, as you know, there is very good reporting in the dividends and interest areas already, and that is why the noncompliance rate is very low there.

Chairman GREGG. Senator Sessions.

Senator SESSIONS. Quickly, I would ask Mr. Everson, if we had tax simplification, would that not help your auditors and reduce the time that they spend and help them be able to focus more on the abuses?

Mr. EVERSON. Absolutely, sir.

Senator SESSIONS. Could you suspend CPAs and attorneys, short of some criminal or ethical prosecution, for irresponsible advice or lack of professionalism? And would that be something you could accomplish with far less litigation than might otherwise be the case?

Mr. EVERSON. We have strengthened professional accountability over the last several years through doubling the size of our Office of Professional Responsibility. There is something called Circular 230, which is standards that govern the conduct of attorneys and accountants who practice before us. We have included for the first time a provision that says said if you get an opinion from an attorney that you are doing the right thing, then you get out of paying penalties if the Service audits you and says that transaction does not work. We have said now how those opinions have to be developed for shelter transactions. That is a very important step.

We continue to monitor this area and look to do more, but, again, the leverage of making sure the practitioners are responsible is also essential and keeps us from having to, if you will, have more auditors. We have to have integrity in the attorneys and the accountants.

Senator SESSIONS. Well, most accountants I think really do try to do the right thing, and when they sign their name on there, they expect you to know that they have done professional diligence. Would you not both agree on that?

Mr. EVERSON. Yes, that is absolutely correct, and the steps we have taken, including the steps you have taken in the Congress—for example, the JOBS Act, which provides tougher standards and penalties for people who go awry of the standards—are important. And the other thing we are asking with one of the five proposals, gets to preparer standards on the non-income tax type reporting. So that is in the mix. We are trying to do more there, and we are asking for you to pass some new law on that issue.

Senator SESSIONS. Mr. Walker, would you like to comment as a CPA yourself?

Mr. WALKER. I would agree that simplification would do a lot to take enforcement pressure off of the IRS and help them target much more. I also agree that a vast majority of CPAs, and I am sure attorneys as well, try to do their job to the best of their ability and in compliance with the laws and regulations as they understand them, although I think we have to keep in mind we live in a gray world.

Mr. EVERSON. Let me make one final point. Practitioners come to me all the time and say, "We applaud what you are doing, going after the bad practitioners," because it is a competitive disadvantage when somebody in your State is saying, "I can get you a better deal with the IRS" when they really are just, you know, smoking something.

[Laughter.]

Mr. EVERSON. That is the drug business we were talking about.

Chairman GREGG. You are implying that to deal with the IRS you should be smoking something.

[Laughter.]

Senator SESSIONS. I dealt with a good lawyer when I was United States Attorney, and he came to me and he said, "Tell me what the law is. I am telling my client they have to pay taxes on this. The competitive businesses down the street are not paying taxes on it. They think I am costing them money. What is the law? What should we do?" It was a fair question, I thought. I am not sure that he ever got a clear answer.

With regard to your allocation, Mr. Everson, of the resources you get in total, are you satisfied that you have the resources in the right areas? I do notice that your customer service seems to be working. Complaints are down, and audits are beginning to go back up. Those are good things. Are you confident as Congress mandates money in certain ones of these accounts, whether it is audits or compliance or those things, are we requiring expenditures and organizations of your office that make you less efficient than you would like to be? And can we help?

Mr. EVERSON. Broadly speaking, let me say this. We have three strategic objectives for the IRS: one is to continue to improve service to taxpayers; the second is to significantly enhance enforcement of the law; and the third is to modernize the IRS.

This only works if we support all three in a balanced manner, and that includes the funding. So it would be a bad cocktail to give us more money for enforcement but to cut services or the IT infrastructure, because they all have to work together. And it is important to leave, I believe, the latitude to the Government managers—there are only two appointees in the whole agency—to take those funds and use them wisely.

So I do worry that we are in a bad space. We are in the TTHUD Subcommittee on Appropriations. And if you look at the President's request, HUD is down by 2 percent and Transportation by something like 9 percent. I looked at the Federal Page the day after the budget came out. If you look at the non-Homeland, non-DOD domestic discretionary budget, it is a tough corner of the budget to be in.

So, yes, I ask you to do what the President asks and provide us the funds that we have requested and let us be free to spend them as wisely as we can.

If I could make one final pitch: please do your job on time. We are a big operational agency, and when you give us moneys or write language into the appropriations process 2 or 3 months into the year saying don't do this or do that, then it is very hard for us, particularly with the curb we have on our spending, to implement some of those provisions.

Chairman GREGG. Thank you. Let me thank you very much for your time. You have given us a lot of time today.

Senator CONRAD. Might I have a minute?

Chairman GREGG. Yes.

Senator CONRAD. Two quick things, and I would say this to the Commissioner. My own brother called me. My brother prepares returns for people. He used to be the head of the Office of Management and Budget in our State. And he said in the office in Bismarck, the IRS office, it is on the second floor of a building, of a bank building. Forms are not available on the first floor by some agreement with the bank. And when you call to see if forms are available, he was unable to get through repeatedly in Bismarck, North Dakota. And if you could check on that and if we could do something to——

We appreciate that your brother pointed out this issue. There is an IRS office on the third floor of the same building in which the bank is located. We did some checking with the bank and determined that it does not appear that the bank ever distributed tax forms in its lobby. We recently placed a new sign on the first floor of the building. This sign indicates the location and hours of available tax assistance and also indicates that Tax Forms are available in the IRS office.

In addition, IRS forms and publications are available in downtown Bismarck at the Veteran Library on North 5th Street. Forms also can be downloaded for free from IRS.gov and they are available free by calling 1-800-TAX-Form.

Mr. EVERSON. Certainly.

Senator CONRAD. You know, when my brother calls—my brother in 19 years has never called me about any governmental matter. But he said, you know, "Kent, it just not good service to taxpayers in the capital city of our State."

Mr. EVERSON. Certainly.

Senator CONRAD. One final thing I would say. When I was tax commissioner, an accountant came to me one of the first days I was in office and brought me his list of clients with a recommendation that I audit them.

[Laughter.]

Senator CONRAD. I thought that was a rather curious thing.

Chairman GREGG. It would be helpful, if you can do this—and maybe you can't do this, but the administration asked for $137 million of additional funding, set up in this special mechanism that basically gets you additional funding on top of whatever TTHUD can do for you. If you can give us an estimate of what that would represent in broad terms, in additional receipts as a result of better enforcement, that would be very useful to us, to maybe even go beyond $137 million.

The $137 million you mention represents funds that provide for the pay raise and non-pay inflation associated with maintaining the enforcement base and building from Fiscal Year 2006 hiring. As these funds are intended to maintain the enforcement base, we measure that not in terms of additional receipts but rather the potential for lost revenue without the increase. As I reported last year, our FY 2006 initiative will yield a $4 to $1 enforcement revenue return per year once fully implemented. In addition, the increased enforcement presence will have a deterrent effect on those who are tempted to abuse the tax law. To clairify, if Congress does not provide the additional $137 million to maintain its FY 2006 enforcement build, the Federal Government would lose approximately $4 for every $1 reduced and the deterrent effect of the unfunded enforcement activities. If Congress provided additonal funding for enforcement activities in which the additonal funds were invested.

Mr. EVERSON. Yes, sir.

Chairman GREGG. Thank you, and I appreciate very much your time, and I appreciate your service. Both of you do extraordinary work for our Nation, and we thank you for using your talents on behalf of the American people.

Mr. EVERSON. Thank you.

Mr. WALKER. Thank you.

Chairman GREGG. Our next witness is going to be Nina Olson, who is the Tax Advocate.

Ms. Olson, we appreciate you taking time to come today. We appreciate your job as Tax Advocate and we look forward to your thoughts. You have obviously listened to the Commissioner and the General. Give us your thoughts.

STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, TAXPAYER ADVOCATE SERVICE

Ms. OLSON. Mr. Chairman, Senator Conrad, and members of the Committee, thank you for inviting me here today to testify about the tax gap.

The tax gap is a serious problem because it deprives our Government of much-needed revenue and imposes excessive burdens on compliant taxpayers. The average individual tax return is effectively assessed a surtax of more than $2,200 each year to subsidize noncompliance by others. That is simply unacceptable.

The starting point for addressing the tax gap is solid research about the causes of noncompliance. The IRS needs more information to determine the best allocation of its resources after taking into account both the direct and indirect effects of its activities on tax revenue. Not all forms of taxpayer service and not all enforcement measures have the same affect on compliance.

For example, if the IRS is given additional funds to combat noncompliance, will the IRS get the biggest bang for its buck by spending the funds on strengthening enforcement or on improving taxpayer service? If the answer is enforcement, should IRS continue to target corporate tax shelters or should it move more aggressively against the cash economy? If the answer is that funds are better spent on taxpayer service, should the IRS expand existing taxpayer services or should it develop new services that take advantage of the latest improvements in technology?

Unfortunately, the IRS has little reliable research to help guide its choices. Simply put, we need more extensive research to make optimal fully informed resource allocation decisions. We do not know the return on investment of taxpayer service moneys because the IRS does not measure it.

I want to stress that not all the tax gap is attributable to deliberate cheating. The sheer complexity of our 1.5 million word Internal Revenue Code leads to significant inadvertent error, particularly on the part of small-business owners and low and middle income taxpayers who have limited resources yet are expected to comply with particularly complex requirements.

As the IRS works to reduce the tax gap, its choices should reflect the central role that taxpayer service, particularly taxpayer assistance, outreach and education, plays in achieving long-term compliance.

Congress also has an important role to play here. If you adopt fundamental tax reform that puts a premium on simplification, inadvertent errors will decline. In my 2005 annual report to Congress I outlined six common sense principles for tax reform. And if you are able to construct a tax system that reduces what I call opportunities for noncompliance that will go even further to reducing the tax gap.

Data released yesterday show that the most significant source of the tax gap is economic transactions that go unreported to the IRS, what I call the cash economy. Consider this: where payments are subject to tax withholding, compliance is almost 100 percent. Where payments are subject to Form 1099 or other third-party information reporting to the IRS, compliance is about 96 percent. But where economic transactions are invisible to the IRS the compliance rate drops dramatically, perhaps to around 50 percent, although no one knows for sure.

These data tell us what most people would intuitively expect. When a taxpayer believes IRS knows he has received a payment, the taxpayer will surely comply. When a taxpayer thinks the IRS has no clue he has received a payment, the likelihood he will comply plummets.

If we are then to successfully address the tax gap I believe that Congress must examine ways to expand such reporting. In some cases the burden of requiring third-party information reporting will outweigh the benefits. But the tax gap is composed of many different types of taxes, types of noncompliance, and types of taxpayers. There is no one silver bullet that will eradicate all components of the tax gap once and for all. So we should begin by identifying various categories of transactions that currently are not subject to information reporting and consider on a case-by-case basis whether the benefits of requiring reporting outweigh the burdens such a requirement would impose.

In the meantime there are many steps Congress or the IRS can take right now that would chip away at the tax gap. In my 2005 annual report to Congress I made a number of administrative and legislative recommendations that are summarized at the end of my written statement. For example, some self-employed taxpayers who really do want to comply fall behind on their tax payments and simply cannot save enough money during the year to make quarterly payments. Thus, the IRS should encourage self-employed taxpayers to sign up for automatic monthly payments of estimated tax from their bank accounts like they pay their car payments or their mortgages. We already have a system capable of receiving regular payments. We need to do more to promote it.

Under current law an individual taxpayer can escape information reporting by incorporating. For Form 1099-Miscellaneous information reporting purposes there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer is incorporated and another has not. Therefore, we recommend that many corporate taxpayers be subject to 1099 Miscellaneous reporting requirements to the same extent that unincorporated businesses are today.

My report also contains recommendations to promote voluntary withholding agreements, to require backup withholding on payments to taxpayers with a demonstrated history of noncompliance, and to develop local compliance initiatives tailored to the unique economies of different regions of the country.

We also recommend that Congress require brokers on a going forward basis report to taxpayers and the IRS the cost basis of publicly traded stocks and mutual funds when these shares are sold.

In conclusion, I am pleased that the IRS is making the tax gap a priority. I am pleased to see strong Congressional interest in this issue, and I am hopeful that we will make strides to collect more of what is due, yet with minimal burden on the taxpayer.

Thank you.

[The prepared statement of Ms. Olson follows:]

Written Statement of Nina E. Olson
National Taxpayer Advocate

Before the

Committee on the Budget
United States Senate

On

The Causes of and Solutions to the Federal Tax Gap

February 15, 2006

Table of Contents

Mr. Chairman, Ranking Member Conrad, and distinguished Members of the Committee:

Thank you for inviting me to testify today about the causes of the Federal tax gap and proposals to try to reduce it.[1] In my testimony, I will provide an overview of the tax gap and discuss two of its principal causes: (1) the large percentage of taxable payments that are not reported to the IRS and with respect to which the IRS has great difficulty collecting tax (*i.e.*, the "cash economy") and (2) the difficulty many taxpayers not subject to tax withholding face in saving enough money to pay their tax bills when they come due. I will suggest several possible solutions that eliminate opportunities for noncompliance and thus should reduce the tax gap. These recommendations are outlined in the appendices to this testimony.

The tax gap is composed of many different types of taxes, types of noncompliance, and types of taxpayers. There is no one silver bullet that can eradicate all components of the tax gap, once and for all. This diversity requires the IRS to conduct serious and ongoing research to better understand the causes of the tax gap and to identify the most effective solutions. I commend Commissioner Everson for supporting and expanding the National Research Program (NRP) to help identify the areas where noncompliance is greatest. To help identify the most appropriate and effective solutions, I believe the IRS should also devote more effort to studying the *causes* of noncompliance.

I. The Significance of the Tax Gap

It is widely understood that the failure of some taxpayers to pay their fair share of taxes reduces much-needed Federal revenue. That consequence, by itself, would require the government to act. But the consequences of the tax gap run deeper than that. The tax gap raises an issue of fundamental fairness in the tax system. When honest taxpayers feel like chumps, some of them start fudging, too. And when that happens, voluntary payments drop even more, necessitating more examination and collection actions. This sense that the system is unfair can result in a vicious cycle of increased noncompliance and increased enforcement.

According to preliminary data the IRS released last year as part of the National Research Program (NRP) study of Tax Year 2001 individual income tax returns, the annual gross tax gap falls somewhere in the range of $312 billion to $353 billion. After

[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

accounting for receipt of late payments and IRS collection activity, the IRS estimates the annual net tax gap is in the range of $257 billion to $298 billion.[2] The IRS estimates tax noncompliance is in the range of 15.0 percent to 16.6 percent. Or, stated differently, the rate of taxpayer compliance with the tax laws in 2001 ranged from 83.4 percent to 85 percent.[3]

The IRS receives approximately 130 million individual income tax returns each year. Given the estimated $257 billion-$298 billion net tax gap, the average tax filer pays a "surtax" of some $2,000 per year to subsidize noncompliance.

II. The Cash Economy Is the Largest Source of the Tax Gap

Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due. Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously to a range from about 20 percent to about 68 percent, depending on the type of transaction.[4] For purposes of my testimony, I will use the term "cash economy" to mean all taxable payments that are not reported to the IRS by third parties.[5]

The cash economy may be responsible for more than a third of the tax gap. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy. However, according to IRS estimates:

- About 43 percent of the gross tax gap, $134 billion to $155 billion per year, is attributable to underreporting of income and self employment taxes by self-employed individuals.[6]

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[2] The IRS has developed estimates of both the "gross tax gap" and the "net tax gap." The gross tax gap is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely. The net tax gap is the portion of the gross tax gap that will not be collected after all IRS and taxpayer actions have been completed for a given tax year. Both figures probably understate the true level of noncompliance because they exclude illegal-source income and certain other categories of noncompliance.

[3] These preliminary results from the National Research Program study were released on March 29, 2005. The IRS plans to update the results shortly, possibly between the time this statement is submitted and the time this hearing takes place.

[4] IRS National Headquarters, Office of Research, July 2004 (unpublished).

[5] There is no universally agreed-upon definition of the term "cash economy." For a definition similar to mine, *see* Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong. 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting . . . your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.").

[6] Taxpayers who underreport business income on individual returns account for $83 billion to $99 billion of the gross tax gap and those who underreport self-employment taxes account for another $51 billion to $56 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.[7]

These estimates suggest that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the tax gap, accounting for more than a third of the gap and over $100 billion per year.[8]

III. To Address the Tax Gap, Congress and the IRS Should Explore Ways to Reduce Opportunities for Noncompliance and Supplement Traditional IRS Enforcement Initiatives in the Cash Economy

Ninety-nine percent (99%) of income subject to withholding is reported on taxpayers' income tax returns.[9] This fact does not mean that wage earners are "good" people and taxpayers who receive income that is not reported to the IRS by third parties are "bad" people. It means simply that wage earners do not have the opportunity to be noncompliant because their wages are reported by their employers and their taxes are withheld at the source of payment. Participants in the cash economy, on the other hand, have a significantly greater opportunity for noncompliance. An effective strategy for reducing the portion of the tax gap attributable to the cash economy must focus on reducing opportunities for noncompliance.

Moreover, because income from the cash economy is not subject to information reporting, many of the IRS's traditional means of enforcement -- Correspondence Examinations, Document Matching, and Automated Substitute for Returns -- are unlikely to be effective in addressing it. The IRS has a number of initiatives that could be effective if coordinated and pursued more aggressively. However, no single function coordinates research, outreach, and compliance initiatives aimed at improving reporting compliance among cash economy participants. Nor does the IRS give these initiatives the same level of attention as other initiatives, such as those addressing tax shelters or the Earned Income Tax Credit. This lack of coordination and Service-wide attention has historically impaired the IRS's response to the cash economy.

In the National Taxpayer Advocate's 2005 Annual Report to Congress, I recommended that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. I am pleased that the IRS Commissioner for the Small Business/Self-Employed Operating Division has agreed to establish a joint IRS-Taxpayer Advocate Service task force on the cash economy that will seek to determine the feasibility of this and other recommendations. I am hopeful that this task force will jump-start the development of a comprehensive strategy for addressing the cash economy that includes education, outreach, research, procedural, and enforcement initiatives.

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[7] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

[8] 80 percent of $134 billion (the lower end of the estimate of underreporting attributable to self-employed individuals) comes to $107 billion.

[9] IRS National Headquarters, Office of Research, July 2004 (unpublished).

IV. To Reduce Opportunities for Noncompliance in the Cash Economy, Third-Party Information Reporting Should Be Expanded in Appropriate Cases

If our sole objective were to maximize the amount of tax revenue, we could simply require that anyone making a taxable payment to another person report the payment to the IRS. Such a requirement would close much, if not most, of the tax gap. But requiring everyone making a taxable payment to file a report with the government would impose more burden than most of us would be willing to bear. No one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow their lawn, or calls a plumber to fix a broken faucet.

To address the tax gap, we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose. In many cases, we will ultimately decide that it is inappropriate to impose a reporting requirement. But in some cases, we may decide that requiring reporting is appropriate.

For example, under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity.

For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, we recommend that corporate taxpayers (including Subchapter S corporations) with 50 or fewer shareholders be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.

To cite another example, I recommended in the National Taxpayer Advocate's 2005 Annual Report to Congress that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, it provides an opportunity for noncompliance.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about $25 billion a year.[10] IRS officials studying the NRP data believe the revenue loss is substantially lower, but they agree that the level of underreporting reaches into the billions of dollars. We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.[11]

V. Many Taxpayers Not Subject to Tax Withholding Cannot Save Enough Money To Pay Their Tax Bills, So in Appropriate Cases, We Should Encourage Taxpayers to Schedule Monthly Payments as Automatic Debits from Their Checking Accounts

Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds. Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Most other creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge.[12] Similarly, the

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[10] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005).

[11] Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

[12] The Treasury Inspector General for Tax Administration (TIGTA) previously recommended that the IRS clearly communicate to taxpayers that EFTPS is free. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus

IRS could send letters to self-employed taxpayers each quarter to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use IRS's Electronic Funds Transfer Payment System (EFTPS), a free service, to make estimated tax payments electronically or by phone and to schedule payments in advance, just like automatic payments to a mortgage lender or utility.[13] The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.[14] Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding. As previously noted, taxpayers report 99 percent of their income subject to withholding. In the National Taxpayer Advocate's 2005 Annual Report to Congress, I make several administrative and legislative recommendations regarding the electronic payment of estimated taxes.

VI. Where Taxpayers in the Cash Economy are Substantially Noncompliant, the IRS Should Have Back-up Withholding Authority to Drive Compliance

Because we know that income-reporting compliance is nearly 100 percent when payments are subject to withholding, we are compelled to examine the feasibility of requiring withholding on certain cash-economy payments. We must acknowledge that withholding can impose significant burdens on the payor and in many instances is administratively unworkable. Thus, I am not advocating universal withholding. But we should at least consider the feasibility of the following:

- Entering into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms (*e.g.,* travel agencies and travel agents, or hair salons and stylists). The IRS, on a case-by-case basis, could agree to provide a safe-harbor worker classification where the payor enters into a voluntary withholding agreement.

- As proposed above, actively encouraging self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through EFTPS. Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene if the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, the IRS could impose a back-up withholding requirement, as described below.

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indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

[13] Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly property tax payments or spend the funds elsewhere.

[14] Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

- Amending IRC § 3406 to require a form of "backup withholding" by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

For over thirty years in the United Kingdom, contractors in the construction industry have been required to withhold on payments to independent contractors unless Her Majesty's Revenue and Customs (HMRC, formerly Inland Revenue) declares the independent contractor to be exempt from withholding. Independent contractors can obtain exemption certificates from HMRC by demonstrating compliance. This approach has the advantage of making it in the contractor's best interest to employ compliant subcontractors, since most contractors want to minimize their paperwork burden and avoid withholding requirements.

In the National Taxpayer Advocate's 2005 Annual Report to Congress, I recommended that Congress authorize the Secretary to exempt payors from back-up withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS "Compliance Certificate." A taxpayer would be eligible for a Compliance Certificate if he or she has been in compliance with prior filing and payment obligations. If the taxpayer has been noncompliant, the IRS would still issue a Compliance Certificate if, for example, the taxpayer makes arrangements to satisfy past obligations and schedules a year's worth of estimated tax payments through EFTPS.

The Compliance Certificate could serve as the mechanism for market-driven compliance. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the service-recipient would know there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service-recipient immediately would know that backup withholding on payments to this independent contractor is possible, if not likely. Moreover, if the service-recipient operates in an industry or industry segment where the IRS has determined that a significant number of substantially noncompliant independent contractors are operating, backup withholding could be mandatory on payments to independent contractors who do not present a valid Compliance Certificate.

Under this recommendation, market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a payor to avoid a backup withholding situation would be to hire only independent contractors that present a valid Compliance Certificate. It follows that independent contractors who want to work would obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor would have to be tax compliant. Thus, tax compliance would become a condition of conducting business.

VII. Regulation of Unenrolled Return Preparers Would Reduce Noncompliance in the Cash Economy

The majority of individual taxpayers today use the services of paid tax-return practitioners to prepare and file their individual tax returns, as do most business taxpayers. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and their right to practice before the IRS is subject to revocation in the event of wrongdoing.[15] Yet there is virtually no federal oversight over "unenrolled" return preparers, who constitute the majority of tax return preparers today.

The IRS does not know how many unenrolled return preparers are actively preparing returns for a fee in the United States. Nor does it know what qualifications and education these preparers possess to prepare returns. While the IRS has a number of initiatives that address the perpetration of criminal schemes by tax preparers, it only conducts a small number of preparer negligence investigations and it collects even fewer dollars in the rare instances that it assesses a preparer negligence penalty.[16]

Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled return preparers and to administer a basic examination that ensures that persons who prepare returns for a fee have a basic level of competency. The test should contain an ethics component, so that preparers understand the ethical (as well as legal) obligation to accurately report income and expenditures. Moreover, an ongoing education requirement would ensure that preparers are current on tax law changes and learn from the most common mistakes. For example, the most common type of underreporting by taxpayers filing Schedules C (Profit or Loss from Business (Sole Proprietorship)) relates to understated gross receipts or overstated cost of goods sold. With respect to the latter issue, inventory accounting rules are very complex. Unenrolled preparers may not be aware of these complex provisions and thus carry errors forward from one year to the next.

VIII. To Effectively Address the Cash Economy Tax Gap, the IRS Should Initiate a Local Compliance Strategy and Utilize Local and State Data

Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to develop successful initiatives without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information so that it can adjust its strategy to effectively address local compliance issues. The IRS previously recognized the importance of a local response when it created local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.[17]

If the IRS could focus its enforcement and educational efforts on a particular local market, it might be able to change norms of behavior within that market. A local planning organization could work to identify local compliance challenges, direct the

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[15] Circular 230, § 10.50(a).

[16] General Accounting Office, GAO-04-70, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Preparers, But Oversight for IRS Is A Challenge* 16 (October 2003).

[17] *See* General Accounting Office, GAO/GGD-96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* 30 (June 1996); Internal Revenue Service, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8.

IRS's local response, and measure its effectiveness. A national cash economy program office could replicate successful local strategies nationwide.

Moreover, the IRS should use more of the information available from state and local governments, Forms 8300 (Report of Cash Payments Over $10,000 Received In a Trade or Business), and its audit selection tools to audit taxpayers who are operating in the cash economy and underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions, and computer-based tools to identify underreporting, it used very few of these resources in FY 2005.[18]

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.[19] The IRS should consider seeking access to business license tax filings and comparing gross receipts, as reported on those filings, with gross income reported on the taxpayer's federal income tax return. This comparison could help the IRS identify businesses that may be underreporting their income.

IX. The IRS Needs to Conduct More and Better Research to Identify the Best Approaches to Reducing the Cash Economy Tax Gap and Understanding the Causes of Noncompliance

The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities on tax revenues.[20] In most cases, the indirect effects are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers all unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS researchers have estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.[21]

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[18] In FY 2005, the IRS considered 1,092 state information items for examination potential, reviewed 2,366 Forms 8300, and closed 15,873 examinations of non-EITC taxpayers filing Schedules C selected using its Unreported Income Discriminant Function (UI-DIF).

[19] *See, e.g.*, Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005) (imposing a Business, Professional and Occupational License (BPOL) tax based on gross receipts). *See also* 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), *available at* http://www.state.va.us/dpor/Contractors%20Web.pdf (requiring contractors to obtain different contractor license classes based on the value of the contractors' jobs).

[20] *See generally* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

[21] Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 396, 405 (1990).

However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance.[22] The IRS does not have current research to show where its next dollar is best spent. More generally, we do not even know whether the next dollar is better spent on enforcement or on taxpayer service.[23] Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.[24]

It is important to keep in mind that taxpayers are compliant or noncompliant for different reasons, and a comprehensive approach to reducing the tax gap must recognize these differences.[25] Because unreported income from the cash economy is so difficult and costly for the IRS to detect and deter through traditional enforcement methods, the indirect effect of the IRS's activities is even more important in fostering compliance among cash-economy participants than for the general population. Thus, research in this area is very important.

X. While Increasing Its Efforts to Reduce the Tax Gap, the IRS Must Not Decrease Those Services that Enable the Vast Majority of Taxpayers to Comply with the Tax Laws

As the IRS develops initiatives to narrow the tax gap, it should place priority emphasis on providing sufficient assistance, outreach, and education to those taxpayers who are currently compliant or who are trying to comply so that they do not become

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[22] In 1996, IRS researchers estimated that every dollar the IRS spent on return preparation generated $396 of additional tax revenue. *See* Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

[23] For a more detailed discussion, *see* National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: IRS Examination Strategy); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (Apr. 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing And Urban Development, and Related Agencies (Apr. 7, 2005); *see also* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005).

[24] The Government Accountability Office has also recommended that the IRS obtain more and better research regarding the reasons that taxpayers fail to comply with the law. *See, e.g.*, Government Accountability Office, GAO-06-208T, *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005).

[25] For a discussion of the categories of taxpayer noncompliance, *see* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

noncompliant. It should target its formidable enforcement powers at those few taxpayers who will not otherwise comply with the tax laws. If this integrated, two-pronged approach is to succeed, the IRS must fully recognize the central role taxpayer service plays in achieving compliance and do more to study the optimal ways to deliver taxpayer service and the magnitude of the impact.

In discussing the tax gap, we need to be careful that we don't ignore the needs of the vast majority of taxpayers. Taxpayer service plays an important role with respect to the self-employed taxpayer, who may not be able to afford professional tax advice and looks to the IRS for direction. Today, many tax law questions pertaining to self-employed individuals (*e.g.,* self-employed health insurance deduction, depreciation, depreciation recapture on the gain (loss) from the sale or other disposition of business property, net operating losses, and retirement plans) are deemed out-of-scope for IRS employees. If the questions are too complex for IRS employees to answer, then they are likely to be too complex for the small business person. This complexity engenders ill-will toward the IRS and a willingness to fudge. After all, the IRS wasn't there to answer the question.

Thus, in addition to asking ourselves, "How can we reduce the tax gap?," we should ask, "How can we increase voluntary compliance?" This latter question will lessen the tax gap and has the added benefit of focusing on the long-term behavior of taxpayers. Moreover, it makes the IRS analyze programs from the taxpayer's perspective rather than solely from the agency's point of view. Establishing goals for the IRS based on these two questions will ensure that the IRS focuses its activities on the full panoply of taxpayer needs. These goals will require the IRS to design its programs by looking at the underlying causes of noncompliance and applying the appropriate "touch" – education, assistance, procedural change, or enforcement – to bring about maximum compliance with the tax laws.

Exhibit A Cash Economy – Administrative Recommendations

Recommendation		Summary	Reason
1	Expand use of EFTPS	Send self-employed taxpayers a letter to remind them when estimated tax payments are due and offer the option of paying electronically, by phone or via automatic monthly (or biweekly) withdrawals from the taxpayer's bank account free of charge.	Self employed taxpayers who want to comply with their estimated tax payment obligations sometimes fail because they have difficulty estimating income, remembering oddly spaced payment dates (April 15, June 15, September 15 and January 15), and saving enough money each quarter. When they fail to pay enough estimated taxes, they are more likely to understate their liability.
2	Revise Form 1040, Schedule C	Include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099.	This revision would encourage taxpayers to report income even if it is not subject to information reporting. Taxpayers are more likely to report income that is reported to the IRS by third parties on information returns, such as Forms 1099. Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it. Separating out gross receipts on the income tax form as we propose would likely improve compliance by emphasizing to taxpayers that income not reported on information returns is still subject to tax. It may also suggest to them that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.
3	Revise business income tax return forms	Include two questions: (1) Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business? (2) If yes, did you file all required Forms 1099?	These two questions would encourage taxpayers to comply with information reporting requirements. They would also suggest to taxpayers that the IRS is looking at information reporting compliance and that there is additional risk to avoiding the information reporting requirements by paying contractors "under the table." Payments reported to the IRS on information returns are much more likely to be reported on the payee's income tax return. Thus, increased information reporting compliance would cause contractors (payees) to report more of their income.

Recommendation		Summary	Reason
4	Implement more voluntary withholding agreements	Encourage taxpayers to enter into voluntary withholding agreements by agreeing not to challenge the classification of workers who are a party to such an agreement. (Statutory authority exists under IRC § 3402(p)(3), but the IRS may need to work with the Treasury Department to issue regulations before it can use its authority and may prefer additional legislative authority.)	Research shows that taxpayers are most compliant in paying taxes on income subject to withholding. Unlike payments to employees, payments to independent contractors are generally not subject to withholding. Businesses sometimes have difficulty determining whether service providers should be classified as employees or independent contractors and the IRS often challenges such determinations. These agreements could reduce both underreporting by payees and the controversy associated with worker classification.
5	Institute backup withholding more quickly	Require mandatory backup withholding to begin more quickly when taxpayers provide an invalid TIN to the payor.	By the time a payor receives a backup withholding notice from the IRS, the payee (service provider) may no longer be receiving payments from the service recipient. Thus, the IRS has lost the opportunity for backup withholding. For additional information see National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (MSP: Limited Scope of Backup Withholding Program).
6	Use more available information	Use more of the information available from state and local governments as well as information from Forms 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business) when selecting returns for audit and when auditing them.	The IRS currently uses information from Forms 8300 to identify returns that may have unreported income. It also receives and uses state income tax audit reports as well as sales tax records, which a cross-functional team has concluded could be used more consistently and effectively. States and localities also impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts. Such information may be useful in detecting unreported income. Local property taxes are also based on the value of real and personal property. Taxpayers whose property holdings are disproportionately large in comparison to the income reported on their federal income tax returns may be underreporting their income. The IRS could combine all of this information, perhaps in conjunction with the UI-DIF (or to improve it), for selecting returns for audit and auditing them.

Recommendation		Summary	Reason
7	Establish local compliance planning organizations	A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness.	Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information and feedback so that it can adjust its strategy to effectively address local compliance issues. If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete. However, if the IRS could motivate a critical number of businesses in a given market to report their income, then the market price for their goods or services would increase so that businesses could both compete and pay their taxes. As the IRS's activity starts to affect market prices, research suggests it could produce a dramatic increase in voluntary compliance in the local cash economy as it changes local norms. A national cash economy program office could replicate successful local strategies nationwide.

Recommendation		Summary	Reason
8	Create a cash economy program office	The cash economy program office would coordinate research, outreach, and compliance efforts aimed at improving income reporting compliance among cash economy participants, as the EITC program office has done with respect to EITC compliance.	The EITC Program Office coordinates EITC related activities, measures the results of its initiatives and takes responsibility for ensuring that the program works as intended, even though it relies on many other parts of the IRS to achieve its goals. As with EITC initiatives, responsibility for initiatives that may improve income reporting by cash economy participants is dispersed throughout the IRS. Nobody at the IRS with the authority to coordinate research, outreach, and compliance efforts takes primary responsibility for reducing underreporting among cash-economy participants. As a result, the IRS is not as effective as it could be in improving compliance among cash-economy participants. For example, a cash-economy program office could work with IRS Research to measure the impact of initiatives to reduce underreporting by cash-economy participants. TIGTA and GAO generally agree that such measures would help the IRS to reduce the tax gap. A cash-economy program office could also be justified on the basis that the EITC has a program office and the amount of the tax gap attributable to cash-economy participants dwarfs the amount of the tax gap attributable to EITC claimants.
9	Educate cash economy participants	Educate cash economy participants about the benefits of reporting their income and study the effect of such efforts to determine whether they are cost effective.	In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in retirement benefits; disability benefits; survivors benefits; Medicare benefits; access to credit; earned income tax credits; and the ability to gain admission to the U.S. or a visa-status adjustment for family members or employees. The IRS could test this concept by educating taxpayers through outreach and various media targeting cash-economy participants in communities where compliance is low and such benefits are not well known. Researchers have suggested that publicity about such benefits, when combined with other enforcement initiatives, may significantly improve reporting compliance in a given community.

Recommendation		Summary	Reason
10	Obtain more and better research	Sponsor research to identify the most effective use of IRS resources after taking into account the direct and indirect effects of IRS activities on tax revenue.	IRS researchers have previously estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment. However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance. The IRS does not have current research to show where the next dollar is best spent. We do not even know whether the next dollar is better spent on enforcement or taxpayer service. Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.

Exhibit B Cash Economy – Legislative Recommendations

Recommendation		Summary	Reason
1	Amend IRC § 3406 to encourage compliance in certain cash-economy transactions	Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance by: ▪ Instituting backup withholding on payments to taxpayers who have demonstrated "substantial noncompliance"; ▪ Releasing backup withholding on payments to taxpayers who become "substantially compliant" and who agree to schedule and make future payments through the Electronic Funds Transfer Payment System (EFTPS); ▪ Providing that payors will not be required to institute backup withholding on taxpayers who present payors with a valid IRS "Compliance Certificate".	Current withholding and information-reporting provisions do not adequately capture income from transactions in the cash economy. Unreported payments include: ▪ Deliberate "under the table" cash payments. ▪ Payments that are reported with an invalid TIN or payee/TIN mismatch. ▪ Payments subject to information reporting that are not reported. Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. Payors wishing to comply with their information-reporting obligations may be reporting payments to independent contractors who have supplied invalid TINs. Under existing provisions, these payors may not know that a payee's TIN is invalid until several payments have been made. Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is $50.
2	Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS.	Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by FY 2012.	Current law requires IRS to use EFTPS to collect at least 94 percent of depository taxes. In contrast, the IRS received less than one percent of all estimated tax payments through EFTPS in tax year 2004. Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers. EFTPS has the potential to alleviate some estimated tax problems because it is convenient and relatively easy to use. Moreover, taxpayers can use EFTPS to schedule automatic estimated payments.

Recommendation		Summary	Reason
3	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contactors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreements, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).	Some independent contractors may wish to enter into withholding agreements with their payors. It is currently unclear, however, whether statutory authority exists to enter into such agreements. IRC § 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent contractor would be permitted.
4	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations.	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(2)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code), with 50 or fewer shareholders.	Taxpayers report 96 percent of income from transactions subject to information reporting. The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape Form 1099-MISC information-reporting by incorporating. A taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC § 6041A reporting requirements. For Form 1099-MISC information-reporting purposes, there should be no distinction between taxpayers who are incorporated and those who are not.

Exhibit C Requiring Brokers to Track and Report Cost Basis – Legislative Recommendation

Recommendation	Summary	Reason
Amend IRC § 6045(a) to authorize the Secretary of the Treasury to require brokers to track and report cost basis in connection with the sale of mutual funds and stocks.	Amend IRC § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks. To facilitate accurate basis reporting, financial institutions that hold mutual funds or stocks for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.	When transactions are subject to information reporting to the government, tax compliance is generally very high – well over 90 percent. The opportunity for noncompliance upon sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government. This proposal also helps taxpayers (and that was our primary reason for proposing it.) Today, more Americans own stocks or mutual funds than ever before. Most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not. With regard to stock investors, most brokers keep track of purchases their customers make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings. While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time.

Chairman GREGG. Thank you very much. I appreciate that statement.

A lot of what you talked about, of course, is not within the jurisdiction of this Committee but just pursuing some of it just for my own edification and because it is part of the process of resolving this, you are basically saying that we could do some minimal things in the area of reporting—well, not minimal but some things in the area of reporting which are doable—let us put it that way rather than minimal—such as requiring—I like this idea of basis being reported prospectively.

The Commissioner talked about having credit cards reported. Is that included?

Ms. OLSON. That is not in our report, although I do not particularly have any objections to that myself.

Chairman GREGG. Would that accomplish some of the goals?

Ms. OLSON. I think it would. I think that the $11 billion that shows up in this new tax gap estimate for capital gains is about double what the IRS originally estimated the last time they estimated it, and is more than the tax gap attributable to the Earned Income Tax Credit which we throw a lot of resources at.

So I think that $11 billion dollars is really interesting in terms of where you might want to pay attention.

I think the unreporting of—the not reporting payments to small corporations—our recommendation was corporations with 50 or fewer shareholders—goes to a trend I am seeing where Schedule C sole proprietor taxpayers are converting to the corporate format for legitimate non-tax reasons, limited liability, those sorts of concerns. And S Corporations and small corporations are the forum of choice. And they are really operating as independent contractors but in the corporate format.

So we are losing a lot of information there that we could just very simply and inexpensively document match to see whether those payments are showing up on the S Corporation's gross receipts.

I think that is where is some real money is. And again, when people think we are going to get that information they report it. It makes them nervous. And as I have often said, I like a society of nervous taxpayers because that changes their behavior.

Chairman GREGG. On that theme of making people nervous, if we were to take $137 million the Administration has asked for and doubled it as an available resource for the purposes of enforcement, do you think that would make enough people nervous so we would generate significantly more revenues?

Ms. OLSON. The one concern I have about that is that the IRS has done a lot of hiring in the last couple of years because of Congress's support for building the enforcement side. And when you have a lot of new trainees you have problems with the kind of audits that you are able to give them to work on.

And so although you might not max out on the IRS's ability if it had fully trained auditors, that many auditors or that many collection people, they will not be fully trained over a period of time. You might max out on what kind of work we can actually give them in a particular area.

Chairman GREGG. But you have to start training them some time. You are never going to get to the point of being able to do a complex tax shelter deal unless you put people in the pipeline so that four or 5 years from now can do it.

Ms. OLSON. I believe that what we need to have is over a period of years this hiring initiative so that each year we are bringing on more people and being adequately able to train them and having them at various levels.

Chairman GREGG. Does the IRS need some sort of differential in pay, such as we did with the FBI, in order to get talented people into the technology area?

Ms. OLSON. That is a very interesting comment. I think that is very true. I think that my biggest concern right now—it is not my biggest concern but a great concern I have is on the business systems modernization. I believe that we really do need to support that initiative.

So many times in the cases that my office gets, and our cases are increasing. They increased 17 percent last year on and year-to-date they are increasing 11 percent, taxpayers that are having significant hardships in their dealings with the IRS.

When we go out to the IRS and ask, can we fix this problem, so many times the answer is we cannot fix it systemically because of our systems. And so there is a real taxpayer service and problem-generating aspect to our systems, that they are just so far behind where they need to be. They create work and they create problems for the IRS. And our employees are spending time on those problems that are being generated just by our systems and not by enforcement actions.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. And thank you for being here as a witness. It is important to the work of the Committee and the work of the Congress.

Let me just say what we have heard there this morning is the gross tax gap is roughly $350 billion a year. I believe that that is probably a conservative estimate based on the analysis that we have done.

And we have heard from the Commissioner that he believes he could collect an additional $50 billion to $100 billion a year if we took the appropriate steps. And he focused on reporting and withholding.

You have indicated today that in your analysis of where there is under-reporting taxes to the Revenue Service that in those areas where there is withholding there is almost 100 percent compliance. In those areas where there is reporting there is almost 96 percent compliance. But where there is not reporting, where there is not transparency, compliance falls to perhaps 50 percent.

Interestingly enough, I was talking to a major Wall Street firm with significant research capabilities. They had almost the identical estimate that they gave to me some months ago in a conversation I had. That where there is not reporting they believe, from observing the other side of transactions, that compliance is way off.

So if we were to engage in more transparency—because after all the vast majority of people, as your testimony indicated, the vast majority of people do have those requirements. Is not that the case?

Ms. OLSON. Right. That is correct.

Senator CONRAD. What percentage of the people have reporting requirements now? What percentage of taxpayers? Has your work revealed what that would look like?

Ms. OLSON. Commissioner Everson said this morning that we get 235 million W–2s and there are 150 million employees. We get about 130 million individual returns a year. I do not have the answer to your questions exactly but we can go back and ask IRS to comment.

Senator CONRAD. Let me just say in business school we always talked about the 80/20 rule: 80 percent of your problem is with 20 percent of your clientele. If that rule applies here, and there are many variants on it, maybe it is 85/15. But the point is a fraction of your clientele—or in this case taxpayers—is the bulk of your problem.

Do you believe that is the case here?

Ms. OLSON. I think that is. And then I think that within that fraction there are many different reasons why they are noncompliant. We have spent a lot of time over the past 3 years focusing on the cash economy and the problems of self-employed individuals. I prepared returns for a living for 27 years and was a tax lawyer representing taxpayers in controversies. So I did not do the planning side. I got them when they had problems already and tried to get them out.

And so much of the time the non-reporting, the underreporting, was not because they did not want to be compliant. It was because they just could not save or because their neighbor was also cheating and they felt that they cannot compete, they have to get away with that kind of cheating.

And that has really led me to thinking about how do you change norms of behavior? And that goes to long-term compliance. This is the issue Senator Grassley was concerned about, that you get one fix 1 year. How do you convert people from noncompliant people to compliant taxpayers?

Senator CONRAD. Let me just tell you when I was Tax Commissioner I had a program that I declared a period in which people could come in who had been tax cheating and I would suspend penalties. I would charge them interest but I would suspend penalties. It was amazing what we got.

I remember one man had not paid any income taxes to our State since the Korean War. I had one man come in who was a priest. He had not paid taxes in 22 years. He came in and he cried. He said you know, this has bothered me every year around filing time. He said I have been so anxious about getting caught. I have been so upset. And he said I did not do it for a few years and then it kind of got to be a habit. And then I was afraid if I would report what the penalties would be and it would swamp me financially.

I know there is a real resistance to declaring that kind of thing.

But I must say I told him I made a deal with our legislature. You give me $1 million—in North Dakota that's a lot of money—and I will give you a 10-to-one return. We got substantially in excess of that.

And we started it by indicating OK, we are going into a new regime here. This deal of paying your taxes every other year, which some people had in their heads, that is over. We are going to get you—you can come and, come clean, just pay the interest on what you owe and we will start fresh. But from now on there is not going to be any of this.

And it was amazing the kind of response we had.

And it was behavior changing. We had people who after that filed every year. It makes quite a difference when you have people who are not paying at all all of a sudden start to pay into the system like the vast majority of people do.

Ms. OLSON. Congress has authorized a program called the Offer in Compromise Program. And how it is administered is that taxpayers can come in and say if they have a tax debt that they cannot afford to pay the full amount of the tax, the penalties, and the interest. And the penalties and interest are often more than the tax after a period of years. We have 10 years to collect.

And we look at what, on the basis of their financial condition, they can afford to pay. We say you have to pay that.

Part of the deal though, because it is a deal, is that they have to agree to be a complaint for 5 years with all tax laws. And if they violate that agreement then the debt in full is reinstated and we get to go forward with collection action.

I have always thought that that was a very important program for people who just have things that go wrong or they make bad business decisions. You want to be careful in administering this program. But that promise to be compliant for 5 years means that if somebody really is compliant for 5 years, his behavior is really changed for the long-term.

Now disturbingly, the number of offers that we haveten over the last few years has declined significently. I think that people are concerned about the way the IRS is administering this program. And I have tried to say to the IRS this is an important program. It turns people who are noncompliant into compliant. And it does not undermine your other enforcement initiatives. They are actually mutually strong messages.

Senator CONRAD. That is a good point.

I again want to very much thank the Chairman for holding this hearing. I want to thank the witnesses that we have had here today.

I think there is a growing level of information that supports the notion. This really is an area that needs to be addressed, that we could make meaningful progress at closing the budget deficit by aggressive approach on the tax gap, the difference between what is owed and what is being paid.

At $350 billion a year, that just cannot be left unattended.

Chairman GREGG. I thank the Senator for bringing this matter forward and being aggressive on it. And I know he is going to remain aggressive on it, as I hope I can. And to the extent this Committee can do something about it, we intend to.

We also appreciate your testimony, Ms. Olson. I think your approach is very common sense, which is good. I hope somebody at the IRS will listen to you and maybe you can track down Mr. Everson in the hallway here.

Ms. OLSON. He is my boss.

Chairman GREGG. Because I do think the ideas you are putting forward make a lot of sense, which is to make sure that we put in place the mechanisms for getting more reporting and, as a result, getting more compliance.

So thank you. We appreciate your testimony.

The Committee is adjourned.

[Whereupon, at 11:48 a.m., the Committee was adjourned.]

PREPARED STATEMENTS

Statement of Michael B. Enzi

Senate Budget Committee Hearing: Understanding the Causes and Solutions to Addressing the Federal Tax Gap
February 15, 2006

I would like to thank Commissioner Everson for testifying today before the Senate Budget Committee. I would also like to thank David Walker, Comptroller General of the Government Accountability Office as well as Nina Olson from the National Taxpayer Advocate. I am very familiar with the National Taxpayer Advocate program and am pleased to say that we have an IRS Taxpayer Assistance Center in Cheyenne. I am looking forward to hearing your views on how we can address the giant problem of the tax gap.

The Department of the Treasury believes that this gap between taxes voluntarily paid on time and total taxes owed is approximately $300 billion each year. This is equal to 15 percent of all taxes collected. In tax year 2001 this amount grew to $345 billion. Although the tax gap will probably never be zero, $345 billion is far too high. This is money that is legally owed to the government in order for Congress to properly fund important priorities such as giving our military the equipment they need and providing support to improve the education of our children. These uncollected taxes could also go towards paying down our deficit.

The tax gap is also an issue of fairness. While a majority of Americans are following the law and paying their taxes in a timely manner, there are those who break the law and do not pay their allotted share of taxes. It is simply not fair to allow people to get away with tax evasion while hardworking Americans pick up their tax burden.

One problem may be the difficulty many people have in filling out their tax forms. We have an incredibly and needlessly complicated tax code. Even the most honest and diligent taxpayer can make an innocent mistake. As a small businessman and an accountant, I am constantly amazed at just how complex our tax code is. We must start working on making our tax code far less complicated and much more rational.

While I will continue to support efforts to reduce the tax burden for all Americans, I also believe that Congress and the IRS must work together to decrease the tax gap.

To all our panelists, thank you again for taking the time to testify today.

Michael B. Enzi

Questions from Senator Domenici:

1. What effect, if any, will adopting a biennial budget and appropriations process have on our tax revenues?

Moving to a biennial budget and appropriations would not result in significant increases in tax revenues, but would lead to more effective planning and management of resources. The advantages are listed as follows:

Advantages

- Enables better planning for management of resources and performance. The IRS would be able to establish and implement two-year hiring plans, secure funding for annualization of hiring initiatives, and maximize recruitment processes and training plans for new hires. In effect, a consistent funding stream and stable hiring process for enforcement personnel could result in some increased revenues.
- Improves ability to review programs' base resources and performance in order to identify, plan, and implement efficiencies that would yield long-term savings that could be redirected into front-line enforcement.
- Enhances ability to manage resources and ultimately result in less lapsed funds.
- Potentially result in negotiation of lower priced contracts.
- Secures funding for multi-year, critical projects (i.e. Philadelphia Consolidation, case processing and insolvency, ramp down of submission processing).
- Reduces and/or eliminates impact on hiring and implementation of new initiatives that results from operating under a Continuing Resolution.

2. What tax-related benefits do you foresee if Congress adopts a biennial budget? If Congress moves to a biennial budget, are there any special provisions or considerations we need to take into account relating to the Tax Code?

We do not foresee any tax-related benefits or detriments if Congress were to adopt a biennial budget. We also do not believe there are any special provisions or considerations that would need to be taken into account relating to the tax code.

3. Do you agree that there would likely be an increase in art and collectible sales if the capital gains tax rate were lowered for such sales?

If the capital gains tax rate were lowered for gains from the sale of art and collectibles, it is likely that there would be some increase in reported sales of art and collectibles.

4. What similar economic incentives do you think Congress should consider to raise revenue while encouraging economic activity?

While the IRS does not offer policy recommendations, the Department of the Treasury believes that the most important action is to permanently extend the 15 percent rate on capital gains and dividends and the lower tax rates that were put in place by the 2001 and 2003 tax reductions.

Treasury believes that lowering the taxes on capital encourages increased long-term investment. With additional capital, labor productivity and output rises. And with rising labor productivity the demand for labor increases, raising wages and living standards. This process of economic growth will automatically lead to higher revenues.

5. Has this Administration ever considered correcting the tax code's disparate treatment of investors in art and collectibles?

The Administration has not proposed reducing the capital gains tax rate on gains from the sale of art and collectibles. The primary focus of the Administration's proposals with respect to taxes on capital gains has been reducing the economic distortions associated with the double tax on corporate income by reducing the tax rates on dividends and capital gains. While the Administration has not made any proposals in this area, it would be willing to work with members of Congress on the issue of capital gains tax rates on gains from the sale of art and collectibles.

Questions from Senator Mike Enzi:

To combat the tax gap problem, the Administration offered a few legislative proposals in the Fiscal Year 2007 budget. One of the proposals includes requiring debit and credit card issuers to report to the IRS gross reimbursements paid to certain businesses. I have a few questions relating to this idea:

1. **What was the genesis of the proposal? Was this idea vetted with Congress or any stakeholders prior to the budget rollout?**

   The genesis of the proposal was a combination of findings from the IRS' recent National Research Program (NRP) study and our experience that third-party reporting positively impacts reporting compliance. From our analysis of the NRP data for Tax Year 2001, we estimate that underreporting (as opposed to nonfiling and underpayment) constitutes nearly 82 percent of the $345 billion annual gross tax gap. About 57 percent of the total (or $197 billion) is attributed to individual income tax underreporting. The NRP data also suggest that well over half ($109 billion) of the individual underreporting gap comes from understated net business income (unreported receipts and overstated expenses).

   Our NRP data also confirm that the types of income least likely to be misreported on tax returns are those subject to both third party information reporting and withholding, e.g., wages and salaries, for which the net misreporting percentage (NMP) is only one percent. Income categories subject to third-party information reporting, but not to withholding, exhibit slightly higher misreporting percentages -- about four percent misreporting for interest and for dividends and 12 percent for capital gains, for example. In contrast, the NMP for nonfarm proprietor income, which is reported on a Schedule C and is subject to little third-party reporting or withholding, is 57 percent, contributing about $68 billion to the tax gap.

The concept of expanding third-party reporting to combat noncompliance is not a new one. Over the past year, we have discussed third-party reporting on credit card receipts with the Small Business/Self-Employed subgroups of the IRS Advisory Council (IRSAC) and the Information Returns Program Advisory Committee (IRPAC). Both of these subgroups represent a diverse cross-section of the tax professional community.

Upon release of the President's Budget, we had conversations about this and other tax gap related proposals with a variety of stakeholders including:

- Federation of Tax Administrators
- Government Finance Officers Association
- National Governors Association
- National League of Cities
- United States Department of Labor
- National Association of State Workforce Agencies
- United States Chamber of Commerce
- National Federation of Independent Business
- Small Business Legislative Council.
- American Bankers Association

2. Did the Department of Treasury or the IRS determine if this proposal would increase costs for any private sector groups?

No, neither the Department of the Treasury nor the IRS made such a determination. However, we did tailor the mechanics of the proposal to capitalize on the infrastructure already in place in the private sector in an effort to minimize the resulting costs. For example, the fact that many payment card companies already provide statements of expenditures by vendor to their card holders indicates that data necessary to support reporting aggregate reimbursements to merchants, as envisioned in the proposal, is already available.

3. How much extra money does the IRS hope/expect to recover from this proposal? How did you arrive at these figures?

The Office of Tax Policy in the Department of Treasury has responsibility for estimating the revenue impact of IRS' legislative proposals. Based on Treasury's "scoring" model, the proposal is expected to generate $9 million in additional revenue in the first year and $225 million over a ten-year period.

THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL

THURSDAY, FEBRUARY 16, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:57 a.m., in room SR–325, Russell Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Conrad, and Murray.

Staff present: Scott B. Gudes, Majority Staff Director; and Maureen O'Neill, professional staff member.

Mary Ann Naylor, Staff Director and Rock Cheung, jr. analyst for science and international affairs, webmaster.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will convene the hearing a little early, which is nice. We appreciate the Secretary being here early. We know she has a very busy schedule and we hope to accommodate that schedule.

It is a pleasure to have the Secretary of State here. She is an exceptional representative for our Nation around the world. She has done an incredibly strong job of making America's views known throughout the world and effectively advocating our policies, and we appreciate her taking the time to come address the Budget Committee.

It is ironic that we are meeting in this room. The last time that I was to have a hearing in this room was on September 11, 2001 and the First Lady, Mrs. Bush, was supposed to be here to talk about education with the HELP Committee, and of course we know what happened. That is a day which clearly no one will ever forget and we should not forget. Much of what the secretary and her team does is about that day and how we continue to respond to the threat, which remains regrettably very viable out there.

We have heard from our enemies that they intend to continue to try to attack us and kill Americans and destroy our culture. And part of our response to that is to have a strong State Department which can carry our message around the world of freedom, democracy and market-oriented approaches to the economies of the world.

So this Committee, which has the jurisdiction of setting the numbers, deems it a pleasure to have the Secretary here to talk about how the State Department—the type of resources the State Department needs and how we can be of assistance in making sure you get the resources you need.

With that I will yield to Senator Conrad.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you, Mr. Chairman, and again thank you for holding this important hearing. And welcome, Secretary Rice. It is good to see a fellow Stanford alum here. I had a much less distinguished career there than you did.

Chairman GREGG. That is true of most of the schools.

Senator CONRAD. That is true.

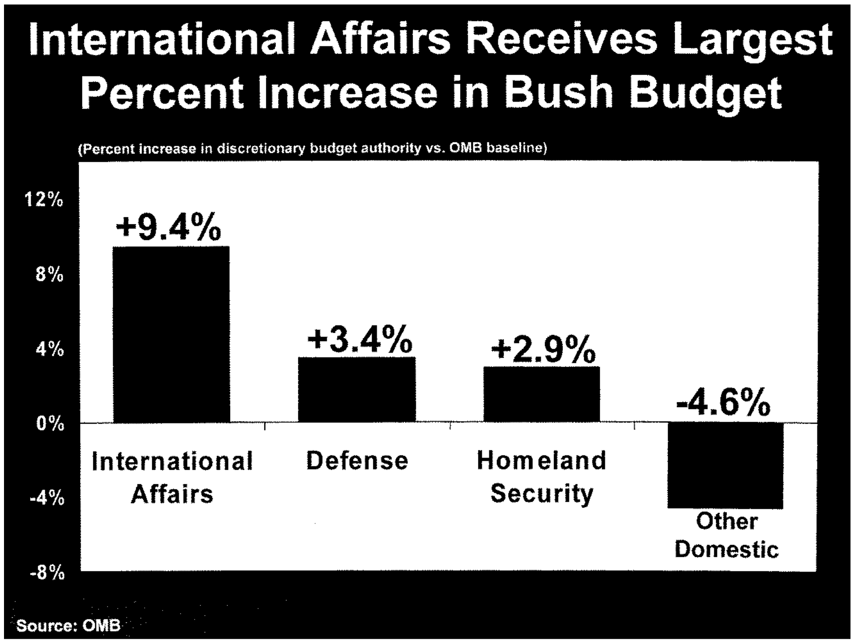
Chairman GREGG. He and I went to the same high school.

Senator CONRAD. So we very much appreciate your service to the country. We know this is an incredibly challenging time for our Nation and for many parts of the world.

With that said, this Committee is responsible for budget decisions and allocating resources. This is going to be a difficult and challenging year.

Let me just say, I have already heard more from my constituents about this budget than any budget in the 19 years I have been in the Senate and serving on this Committee.

I am going to go through in a moment what I am hearing about. But let me just first put up a slide that talks about the overall priorities of the budget. What we see here is in international affairs, which you have preeminent responsibility for, is getting the biggest increase—9.4 percent over the baseline. Defense, 3.4 percent, Homeland Security a little less than 3 percent. Other domestic spending down almost 5 percent. Let's go to the next slide, if we can, because these are the kinds of things I am hearing about and it is important for you to hear it as well. And I know you are not responsible for putting together budgets and you are not responsible for domestic priorities, but I think it is important for you to know the kinds of feedback that we are getting.


International Affairs Receives Largest Percent Increase in Bush Budget
(Percent increase in discretionary budget authority vs. OMB baseline)
12%
8%
4%
0%
-4%
-8%
+9.4%
+3.4%
+2.9%
-4.6%
International Affairs
Defense
Homeland Security
Other Domestic
Source: OMB

Wrong Priorities

Program	Cut
Byrne Justice Assistance Grants	Eliminated
Safe and Drug-Free School Grants	Eliminated
Vocational Education	Eliminated
Rural Health Care	83%
COPS	78%
Essential Air Service	54%
Amtrak	30%
RUS Electrification Loans	29%

Source: OMB
FY '07 request versus FY '06 enacted.

Let me just say in my State, Byrne Justice Grants are for local law enforcement. The President's budget eliminates those. He eliminates the money for Safe and Drug-Free Schools. These first two are especially sensitive in my State at this time because we are facing an epidemic of methamphetamines, is the worst illegal drug I have ever seen. It is absolutely destroying families in my State.

He eliminates funding in the budget for vocational education, also something very much valued in my State.

Rural health care is cut 83 percent in this budget.

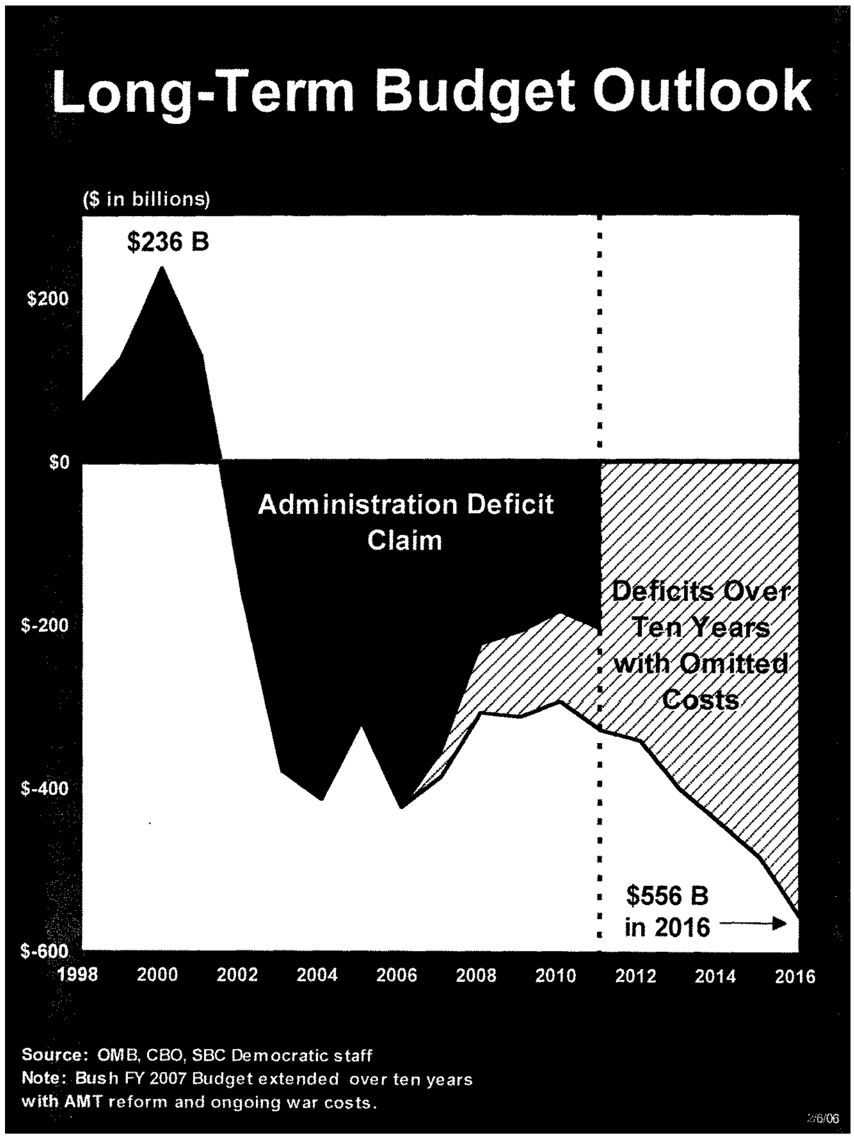
The COPS Program, which has put some 200 police officers on the street in my State, is cut 78 percent.

The Essential Air Service, which is critically important to the transportation needs of my State, cut more than 50 percent.

Amtrak cut 30 percent, which will endanger passenger rail service to my State.

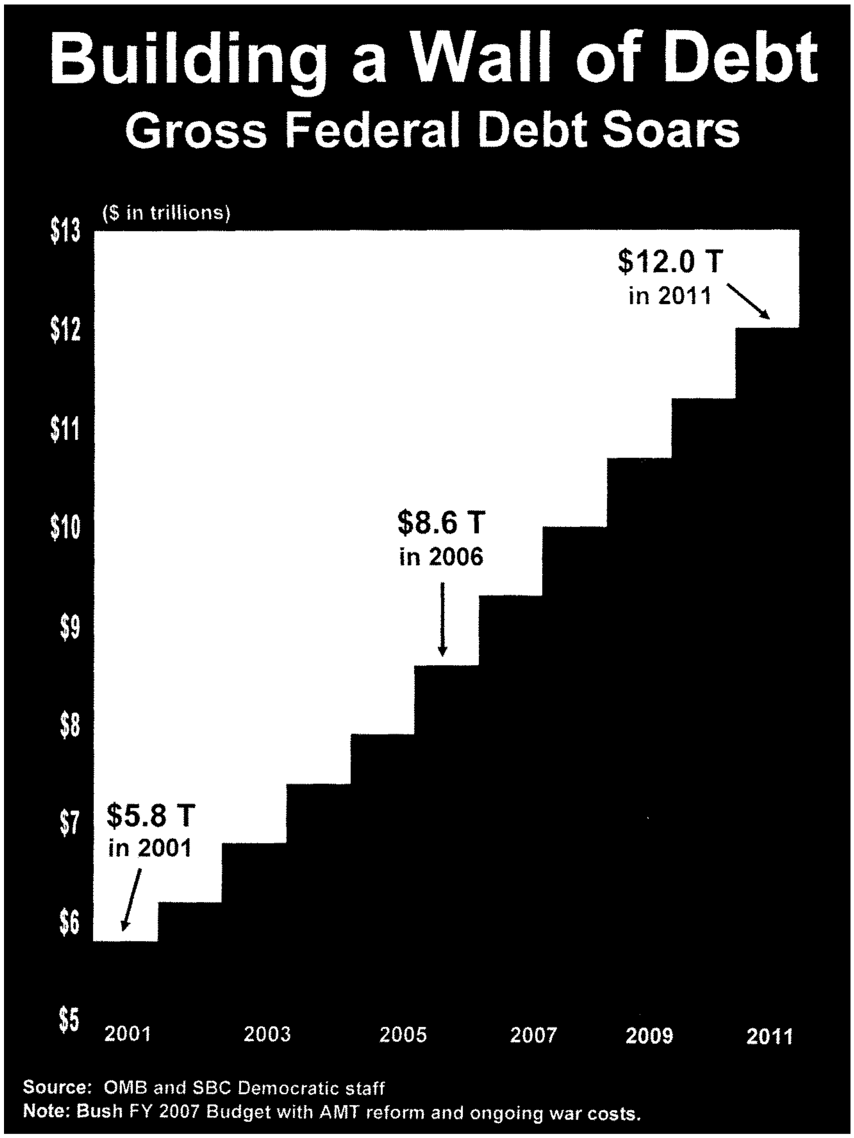
And the RUS electrification loans, which are almost religion in my State, cut 29 percent.

You can see that these priorities create real conflict. And I can tell you this budget submission is unpopular in the constituency that I serve.



Long-Term Budget Outlook
($ in billions)
$236 B
$200
$0
$-200
$-400
$-600
Administration Deficit Claim
Deficits Over Ten Years with Omitted Costs
$556 B in 2016
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
Source: OMB, CBO, SBC Democratic staff
Note: Bush FY 2007 Budget extended over ten years with AMT reform and ongoing war costs.

Let us go to the next one. I have shown this to my colleagues many times. As we look ahead we see the deficits with some small improvement over the next few years, but then getting much worse if the President's policies are adopted.


Building a Wall of Debt
Gross Federal Debt Soars
($ in trillions)
$13
$12
$11
$10
$9
$8
$7
$6
$5
$12.0 T
in 2011
$8.6 T
in 2006
$5.8 T
in 2001
2001
2003
2005
2007
2009
2011
Source: OMB and SBC Democratic staff
Note: Bush FY 2007 Budget with AMT reform and ongoing war costs.

And the debt of the country, and this is an area that I hope is of direct concern to you, the debt of the country growing very dramatically—$5.8 trillion at the end of the President's first year. Now at the end of this year, $8.6 trillion. Our projections are that, in the next 5 years, it will reach $12 trillion.

And more than that, increasingly, we are relying on foreigners to finance this debt. In 5 years we have doubled the amount of debt held by foreigners. Doubled.

Top Ten Countries Holding Our National Debt

Japan	$685 B
China	$257 B
United Kingdom	$234 B
"Caribbean Banking Centers"	$111 B
Taiwan	$71 B
Germany	$67 B
OPEC	$67 B
South Korea	$66 B
Canada	$53 B
Hong Kong	$44 B

Source: Department of Treasury
Note: As of December 2005

These are the countries that we now owe money. Japan we owe almost $700 billion. China, more than $250 billion, and on it goes.

This is of increasing concern in terms of our vulnerability to others making decisions about our financing. If these people pulled away from financing our debt, most economists tell us interest rates would rise significantly in this country, which would create economic slowdown.

GAO Comptroller General Walker Believes Current Fiscal Path Threatens Our National Security

"Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security."

–GAO Comptroller General David M. Walker
Testimony before Senate Budget Committee
February 15, 2006

The Comptroller General said this on February 15th in a hearing in this Committee “Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.”

That is really the final point I want to make because it goes right to the heart of what makes a strong country. If we are not financially strong, we cannot be militarily strong.

And so the question of how we arrange the priorities of the country in the work of this Committee is critically important and we welcome your insights.

Chairman GREGG. Thank you, Senator Conrad. Madam Secretary, we would be happy to hear whatever you wish to tell us.

STATEMENT OF HON. CONDOLEEZZA RICE, SECRETARY, U.S. DEPARTMENT OF STATE

Secretary RICE. Thank you very much. Thank you, Senator Gregg. Thank you, Senator Conrad and members of the Committee.

I have a longer statement which I would like to enter into the record but I will not subject us to a reading of that statement so that we can have full time for a discussion and for questions.

I would like, in lieu of reading the statement, to make just a few points and then, of course, to take your questions.

It has been a little over a year since I was confirmed as Secretary of State and it has been a very eventful year. It is a time of great and historic change. It is a time when the United States and its friends are meeting multiple challenges across the globe.

If I could start where you began, Senator Gregg, September 11th really was a crack in time. It changed our security priorities. It changed our thinking about what makes a secure America when we were attacked in that brutal way on that September day.

The challenge for the United States is, of course, to use all of our means of national power, our military power, our economic power, our diplomatic strength, our influence around the world, of course to defeat the terrorist threat that so brutally attacked us, but recognize that we are not going to be able to have a permanent peace to pass on to other generations. I think we recognize also that the degree to which we can leave a world that is more democratic, more free, more prosperous, where there are not failed states of the kind that Afghanistan became which led directly to terrorist training camps in which people trained to attack us from, the more that we recognize that the incapacity of states to govern, to control their borders, to fight terrorists themselves endangers us.

The President’s budget is a budget that is in support of those national security goals. And I have said to my colleagues, to your colleagues on Senate Foreign Relations Committee yesterday, that I think we should think of our assistance programs as national security spending because without a robust effort by the Department of State, on the diplomatic side, on the foreign assistance side, and on bringing well-governed democratic states alongside us, we will not be able to protect ourselves in the long term.

This budget therefore is a budget that is in support of the tremendous democratic transition that is going on in the world in places like Iraq, where clearly there is a struggle for the creation of a stable and democratic Iraq. But the struggle that they are embarked on is far preferable to the false stability of the dictatorship of Saddam Hussein who threatened us all, threatened his neighbors and caused two wars in the region.

Afghanistan, as I said before, was a failed state that directly produced Al Qaeda and its attacks. Of course, countries like Jordan and Pakistan that are in the front lines of the fight on terrorism are with us. And we have seen, in places like the Palestinian Territories, that democratic processes are always not very predictable.

At some point I can speak to the issue of the election that brought Hamas to power. Obviously, this will have an effect on American assistance. We have made very clear that we cannot fund a Palestinian government unless that government is devoted to Israel's right to exist, to denouncing terror and to indeed disarmament.

This budget also recognizes that we have other major challenges. In the areas of proliferation of weapons of mass distraction and prevention of that. I announced yesterday that we will be asking, in a supplemental request, for an additional $75 million for democracy programs in Iran. Perhaps one of the biggest problems that we face is the policy of the Iranian regime, which is a policy of destabilization of the world's most volatile and vulnerable region. It is not just Iran's nuclear program but also their support for terrorism around the world. They are, in effect, the central banker for terrorism around the world. They are also, of course, going 180 degrees away from the way that this region should be going in terms of human rights and democracy for their own people.

We have worked very hard to create a coalition of states that will confront Iran's aggressive policies, particularly its nuclear program. We have had some success and we are now in the U.N. Security Council to address that problem.

I think it is worth noting that we will not be able to address the Iranian nuclear program and problem in a vacuum. It is Iran's regional policies that really are concerning as we watch them with their sidekick Syria destabilizing places like Lebanon and the Palestinian Territories and indeed, even in southern Iraq.

So there is recognition of those matters in this budget.

There is also recognition of America's desire to continue to be a compassionate nation. We have led the world, of course, when there have been humanitarian disasters, when there has been a need to deal with the world's most vulnerable populations through refugee assistance or food assistance. And that is represented in this budget.

And finally, and this is to speak, in part, to Senator Conrad's concern. We are, Senator, very aware of the pressures on this budget. And we are very aware of the pressures on the American people and the American taxpayers' dollars to fund the significant program that we need to secure ourselves through diplomatic means.

As a result, we have launched a number of reform initiatives to try and make certain that we are better stewards of the American people's taxpayer dollars, that we are not engaging in duplicative activities, that we are engaging in activities that are effective.

I would just cite two of those reforms, which we have put under the title of transformational diplomacy. On the one hand, I have asked for and received a plan for global repositioning of our diplomatic presence. It seemed to me that almost 15 years after the end of the cold war are still rather heavy in parts of the world where we traditionally had large presences, in Europe for instance, and rather light in places that are really growing in influence: Brazil, China, India, other places in Latin America and indeed in Africa.

We have to put our people increasingly in very difficult hardship posts where they cannot take family with them, so I want to make sure that our people are well treated. To meet these changes, we are moving our diplomats around. So far we have repositioned 100 people and I have asked for further repositioning plans to do more of this.

I am asking in this budget that we create 285 new positions, for transformational posts, very important security measures that we must take, and also for work that we need to do to improve our capabilities in critical language skills. We are just simply very short of people who can use Arabic or Farsi effectively in the places that we really are meeting the threats.

The other aspect of transformational diplomacy is that we are working very hard for foreign assistance reform. We believe that we must realign better the somewhat 80 percent of the foreign assistance budget that resides in USAID and State so that we are certain that we are meeting the objectives, addressing the concerns and the needs of the world's most vulnerable people. But we are also building State capacity to address those concerns. We do not want our foreign assistance program to be a kind of permanent dependency for countries. We really want them to be able to take on their own problems. If you fund countries that are corrupt, if you fund countries that are unreformed, then there are going to be permanently dependent because they cannot govern wisely.

So through foreign assistance reform we hope to be able to use the precious dollars that we receive better, to make sure that we are not duplicating efforts, and to make sure that we are spending on the highest priority items.

I have proposed creating a Director of Foreign Assistance reporting directly to me who would also be the USAID Administrator so that we can get synergies between our various programs.

Finally we are requesting for the Millennium Challenge account $3 billion this year. I know that there have been questions about how rapidly the Millennium Challenge program hasten up and running. I can go through some of the numbers later. But let me say that I think this is really, in many ways, the President's flagship program, to change the way that recipient countries think about their responsibilities as they receive our foreign assistance dollars. These countries are states that are governing wisely, that are investing in their people, that are fighting and rooting out corruption and that we think are the lead edge of responsible sovereign states that can not only do better for their people but be contributing states to a safer and more secure world.

Thank you very much.

[The prepared statement of Secretary Rice follows:]

Written Budget Testimony of Secretary of State Condoleezza Rice
Submitted for the Record to the Senate Budget Committee
Thursday, February 16, 2006

Thank you, Mr. Chairman, Members of the Committee.

I appreciate this opportunity to address the Committee and to talk about America's role in meeting the unprecedented challenges of our world today. I look forward to working closely with Congress to ensure that America's diplomacy has the necessary resources to secure our interests, advance our ideals, and improve people's lives around the world. In all of these mutual efforts, of course, we must remain committed to our responsibility to be good stewards of the American taxpayers' hard-earned dollars.

The President's FY 2007 International Affairs Budget for the Department of State, USAID, and other foreign affairs agencies totals $35.1 billion. President Bush also plans to request supplemental funding to support emergency, one-time programs that are essential to the success of some of our highest foreign policy priorities.

This money will do more than support our diplomacy; it will strengthen our national security. America today is a nation at war. We are engaged in a long conflict against terrorists and violent extremists. Across the world, the members of our Foreign Service, Civil Service, and our Foreign Service Nationals are advancing America's diplomatic mission, often working in dangerous places far away from their friends and loved ones. Our nation's men and women in uniform are also shouldering great risks and responsibilities. They are performing with courage and heroism, and many have made the ultimate sacrifice to secure our way of life. Today, I want to recognize these courageous public servants and their families, who endure long periods of service abroad and painful separation with fortitude.

America's enemies remain eager to strike us again, but our actions in the past four years have weakened their capability. Our diplomacy plays a vital role in defeating this threat. We are building partnerships with traditional allies and with new partners that share our perception of the threat. Most importantly, we are working directly with foreign citizens who wish to build thriving free societies that replace hatred with hope.

Mr. Chairman, I would now like to offer an overview of the current mission of the men and women of the State Department—a mission that we have called *transformational diplomacy.*

A New Diplomacy for a Transformed World
In his Second Inaugural Address, President Bush laid out the vision that leads America into the world: "It is the policy of the United States to seek and support the growth of democratic movements and institutions in every nation and culture, with the ultimate goal of ending tyranny in our world."

The President's vision stems from the recognition that we are living in an extraordinary time, one in which centuries of international precedent are being overturned. The prospect of violent conflict among great powers is more remote than ever. States are increasingly competing and cooperating in peace, not preparing for war. Peoples in China, India, South Africa, Indonesia, and Brazil are lifting their countries and regions to new prominence. Democratic reform has begun in the Middle East. And the United States is working with our democratic partners in every region of the world, especially our hemispheric neighbors and our historic treaty allies in Europe and Asia, to build a true form of global stability: a balance of power that favors freedom.

At the same time, other challenges have assumed new urgency. The greatest threats today emerge more within states than between them, and the fundamental character of regimes matters more than the international distribution of power. It is impossible to draw neat, clear lines between our security interests, our development goals, and our democratic ideals in today's world. Our diplomacy must integrate and advance all of these goals together.

So I would define the objective of transformational diplomacy this way: To work with our many partners around the world to build and sustain democratic, well-governed states that will respond to the needs of their people and conduct themselves responsibly in the international system. This is a strategy rooted in partnership, not paternalism—in doing things with other people, not for them. We will use America's diplomatic power and our foreign assistance to help foreign citizens better their own lives, build their own nations, transform their own futures, and work with us to combat threats to our common security, including the spread of weapons of mass destruction.

Practicing Transformational Diplomacy

Faced with such extraordinary challenges, we must transform old diplomatic institutions to serve new diplomatic purposes, and we must empower our people to practice transformational diplomacy. With the generous support of the Congress, my good friend and predecessor, Colin Powell, brought American diplomacy into the 21^{st} century. Now, my leadership team and I are building on this strong foundation and beginning the generational work of transforming the State Department. This will not only strengthen national security, it will improve our fiscal stewardship. We are committed to using American taxpayers' dollars in the most effective and responsible way possible to strengthen America's mission abroad.

In the past year, we have begun making changes to our organization and our operations that will enable us to advance transformational diplomacy. We are forward-deploying our people to the cities, countries, and regions where they are needed most. We are starting to move hundreds of diplomats from Europe and Washington to strategic countries like China, India, South Africa, and Indonesia. We are giving more of our people new training and language skills to engage more effectively with foreign peoples. We are enabling our diplomats to work more jointly with America's servicemen and women. And I have announced that I am creating a new position of Director of Foreign Assistance. This reform will transform our capability to use foreign assistance more efficiently and more effectively to further our foreign policy goals, to bolster our national security, to reduce poverty, and to improve people's lives around the world.

We are making the initial changes using our existing authority, and the additional funding we are requesting in the FY 2007 budget will help us continue implementing our vision to transform the State Department to meet the challenges of the 21^{st} century. For this purpose, we are requesting $9.3 billion for State Department operations.

Transformational diplomacy begins with our people—ensuring that they are in the right places, with the necessary tools and training to carry our their mission. We are requesting $23 million for 100 new positions on the new frontlines of our diplomacy: key transitional countries and emerging regional leaders in Africa, Latin America, the Middle East, and Asia. These new positions will complement the 100 that we are already repositioning as part of our ongoing effort to change our global diplomatic posture. This repositioning effort will require a renewed commitment to secure and modernize our many posts overseas, and we are seeking $1.5 billion for security-related construction and rehabilitation of our diplomatic facilities.

In addition to requesting new positions, we will continue to invest in our people, our greatest resource. More and more, we are calling upon our diplomats to leave their families and serve at unaccompanied "hardship posts" that now make up 20 percent of our yearly overseas assignments. With your help, as part of our effort to modernize the Foreign Service, we will institute a new pay-for-performance system that fairly compensates our men and women working abroad. We will also further our efforts to train America's diplomats to speak critical languages like Chinese, Urdu, and Arabic, which they will increasingly need, in addition to more traditional languages, as they progress in their careers. New training will also make full use of dynamic new technologies, and we are asking for $276 million to integrate our workforce with the latest information technology and to support professional training needed for success.

These new tools and training will better enable our nation's diplomats to tell America's story to the people of the world, and in turn, to listen to the stories they have to tell. We have heard the legitimate criticisms that have been made of our public diplomacy, and we are rethinking how we do business. I have stressed that public diplomacy is the responsibility of every single member of our diplomatic corps, not just our public diplomacy specialists. One idea we are beginning to implement is the creation of forward-deployed, regional public diplomacy centers. These centers, or media hubs, will be small, lean operations that work out of our embassies or other existing facilities, enabling us to respond quickly to negative propaganda, to correct misinformation, and to explain America's policies and our principles. The $351 million that we seek will be essential for us to continue revitalizing our public diplomacy.

To complement our public diplomacy, we must ensure that America remains a welcoming place for all tourists, students, and businesspeople, while at the same time protecting our homeland from terrorists and criminals who would exploit our open society to do us harm. The State Department, in partnership with the Department of Homeland Security, has taken new steps in the past year to realize the President's vision of secure borders and open doors through information technology. Our request of $1.1 billion will fund the Border Security Program and enable us to hire 135 new consular officers and passport staff to meet the growing demand of foreign citizens seeking to travel to America, while maintaining our fundamental commitment to serve each and every American citizen when they go abroad. At the same time, we are seeking $474 million to support our educational and cultural exchanges, which increase mutual understanding between our citizens and the peoples of the world.

Finally, we must continue to enable our nation's diplomats to work effectively with their partners in the United Nations and other international organizations. We seek $1.6 billion to fund U.S. assessed and voluntary contributions to international organizations. The United States takes our international obligations seriously, and we remain committed to strengthening the financial stability, efficiency, and effectiveness of international organizations.

Defeating Terror and Advancing Liberty

The President's FY 2007 budget will help prepare the men and women of the State Department to meet the goals of transformational diplomacy. Our principal objectives are to stem the tide of terrorism and to help advance freedom and democratic rights.

We are requesting $6.2 billion to strengthen the coalition partners who are standing shoulder to shoulder with us on the front lines in the fight against terrorism. Our assistance empowers our partners to practice more effective law enforcement, police their borders, gather and share essential intelligence, and wage more successful countrerterrorism operations. In many states, our assistance will also help to bolster thriving democratic and economic institutions reducing the societal schisms that terrorists exploit for their own ideological purposes. Our FY 2007 request includes, among others, $739 million for Pakistan, $560 million for Colombia, $154 million for Indonesia, $457 million for Jordan, and $335 million for Kenya.

Essential to winning the war on terrorism is denying our enemies the weapons of mass destruction that they seek. Our diplomacy cannot focus on non-proliferation alone; we must also develop new tools and new policies of counter-proliferation: actively confronting and rolling up the global networks involving rogue states, outlaw scientists, and black market middlemen who make proliferation possible. We are building on the achievements of the Proliferation Security Initiative, the G-8 Global Partnership, and UN Security Council Resolution 1540. We are working to stop Iran and North Korea from succeeding in their quest for weapons of mass destruction, and we continue to do everything in our power to deny terrorists access to the world's most dangerous weapons, including threatening conventional weapons like MANPADS. The FY 2007 budget proposes to increase funding for our State Department's efforts to help countries fight the proliferation of dangerous weapons and materials.

These requirements are essential and immediate, but our vision must look beyond present horizons. To defeat the threat of terrorism, we must work to build a future of freedom and hope. As President Bush has said, in the long run, liberty and democracy are the only ideas powerful enough to defeat the ideology of hatred and violence. Freedom is on the march today all around the world, and the United States must continue to open a path for its expansion, especially in Iraq and Afghanistan.

In December, over 12 million Iraqi people voted in free elections for a democratic government based on a constitution that Iraqis themselves wrote and adopted. Through their actions, the overwhelming majority of Iraqis are demonstrating that they support freedom and oppose terrorism. The democratic government that is taking shape in Baghdad today should support human rights, foster new opportunities for prosperity, and give all Iraqis a stake in a free and peaceful future. It should separate stalwart Iraqis from the purveyors of terror and chaos. Iraq is on a track of transformation from brutal tyranny to a self-reliant emerging democracy that is working to better the lives of its people and defeat violent extremists.

Although Iraqis are undertaking this work themselves, international assistance remains essential to Iraq's success. U.S. assistance is helping Iraqis to build their security capabilities, empowering civil society and democratic institutions, increasing and improving the production and availability of electricity, distributing millions of new textbooks, providing access to clean water for millions of Iraqis, and helping protect millions of Iraqi children from disease.

The President's request of $771 million, along with the forthcoming supplemental request, is an essential part of our National Strategy for Victory in Iraq. The funding for the Department's operations and programs is a critical counterpart to the efforts of our troops in the field as we pursue our integrated security, economic, and political tracks to success in Iraq. The supplemental request will fund programs that are integral to our counter-insurgency campaign and to the operating and security costs of our diplomatic mission, while the FY 2007 request supports capacity development essential for Iraq's transition to self-reliance. The money requested by State will allow us to work effectively with our Iraqi partners to advance our strategy of "Clear, Hold, Build"—clearing areas of insurgent control, holding newly gained territory under the legitimate authority of the Iraqi government, and building economic infrastructure and capable national democratic institutions that are essential to Iraq's success.

Our work also continues in Afghanistan. After the United States, along with our allies and friends, removed the Taliban regime, the Afghan people set out to liberate themselves. They did so with the international community by their side. And today, the Afghan people have achieved the ambitious vision that we all set together four years ago in Bonn, Germany: a fully functioning, sovereign Afghan government. This government was established through successful presidential and parliamentary elections, in which millions of men and women voted freely for the first time. Today, Afghanistan has a democratic constitution; an emerging free economy; and a growing, multi-ethnic army that is the pride of the Afghan people.

Despite this dramatic progress, there is still much hard work to be done. President Bush's request of $1.1 billion for Afghan reconstruction, along with supplemental funding to be requested, will allow us to continue helping the people of Afghanistan meet the remaining political, economic, and security challenges they face. With your continued support, along with help from NATO, the United Nations, and all other contributors from the international community, we can help the Afghan people complete their long journey toward a future of hope and freedom.

The people of Iraq and Afghanistan are helping to lead the transformation of the Broader Middle East from despotism to democracy. This is a generational challenge, in which elections are an important and necessary beginning. The freedom to choose invests citizens in the future of their countries. But as President Bush has said, one election does not establish a country as a democracy. Successful democracies are characterized by transparent, accountable institutions of governance; a thriving civil society that respects and protects minority rights; a free media; opportunities for health and education for all citizens; and the official renunciation of terrorism and ideologies of hatred. On this last point especially, we will continue to insist that the leaders of Hamas must recognize Israel, disarm, reject terrorism, and work for lasting peace. Helping the nations of the Broader Middle East to make progress in building the foundations of democratic societies is the mission of the Middle East Partnership Initiative, for which we are seeking $120 million. We are also requesting $80 million for the National Endowment for Democracy to continue its good work in promoting lasting democratic change all around the world.

The progress of the Broader Middle East is hopeful, but it still faces determined enemies, especially the radical regime in Tehran. Iran is a strategic challenge to the United States, and we have a comprehensive view of the threat that Iran poses. The regime is seeking to develop nuclear weapons. It is a leading state sponsor of terrorism. It is working to destabilize its region and to advance its ideological ambitions. And the Iranian government oppresses its own people, denying them basic liberties and human rights. Through its aggressive and confrontational behavior, Iran is increasingly isolating itself from the international community.

In recent months, U.S. diplomacy has broadened the international coalition to address Iran's nuclear ambitions, and Iran's case will soon be heard in the U.N. Security Council. Our goal now is to broaden this coalition even further, to intensify the international spotlight and encourage our many international partners to respond to the full spectrum of threats that the Iranian regime poses.

For our part, the United States wishes to reach out to the Iranian people and support their desire to realize their own freedom and to secure their own democratic and human rights. The Iranian people should know that the United States fully supports their aspirations for a freer, better future. Over the past two years, the Department of State has invested over $4 million in projects that empower Iranian citizens in their call for political and economic liberty, freedom of speech, and respect for human rights. We are funding programs that train labor activists and help protect them from government persecution. We are working with international NGOs to develop a support network for Iranian reformers, political dissidents, and human rights activists. We will devote at least $10 million to support these and other programs during this year (FY 2006), and we are eager to work more closely with Congress to help Iranian reformers build nationwide networks to support democratic change in their country.

Meeting Global Challenges

Like terrorism and nuclear proliferation, many of the greatest challenges in today's world are global and transnational in nature. These threats breach even the most well-defended borders and affect all nations. Today's global threats require global partnerships, and America's diplomats are helping us transform our relationships with countries that have the capacity and the will to work on a global basis to achieve common purposes—countries like India, Japan, South Korea, Australia, El Salvador, and our allies in Europe.

One major global threat comes from disease, especially the scourge of HIV/AIDS. This pandemic affects key productive members of societies: the individuals who drive economies, raise children, and pass on the customs and traditions of their countries. The United States is committed to treating people worldwide who suffer from AIDS because conscience demands it, and also because a healthier world is a safer world. The hallmark of our approach is the President's Emergency Plan for AIDS Relief. This program is the largest international initiative ever by one nation to combat a single disease. The Emergency Plan combines our strong bilateral programs with complementary multilateral efforts to fight AIDS and other debilitating infectious diseases through contributions to the Global Fund to Fight AIDS, Tuberculosis, and Malaria, of which America is by far the largest contributor since the program's inception.

The Emergency Plan is rooted in partnership. Our approach is to empower each nation to take ownership of its own fight against HIV/AIDS through prevention, treatment, and care. The results to date have been remarkable. In the past two years, the Emergency Plan has expanded life-extending antiretroviral treatment to 471,000 people worldwide, 400,000 of whom are located in sub-Saharan Africa. And as of last year, the Emergency Plan has extended compassion and care to more than 1.2 million orphans and vulnerable children. The President's 2007 Budget requests $4 billion, $740 million more than this year, to continue America's leadership in the global fight against HIV/AIDS.

The 2007 budget also includes $225 million to fight malaria, which is a major killer of children in sub-Saharan Africa. This request is part of the President's pledge to increase U.S. funding of malaria prevention and treatment by more than $1.2 billion over five years. The United States is committed to working with the international community to increase preventive and curative programs in 15 African countries with particularly high rates of infection by 2010. We seek to reduce malaria deaths by 50 percent in these countries after three years of full implementation.

The United States is also playing a key global role in preparing for the threat of a possible avian influenza pandemic—providing political leadership, technical expertise, and significant resources to this effort. In September 2005, President Bush announced the International Partnership on Avian and Pandemic Influenza. The Partnership, which includes 89 countries and nine international organizations, generates political momentum and coordinating action among all partners. At the January 2006 International Pledging Conference on Avian and Pandemic Influenza held in Beijing, the United States pledged $334 million in current budget authority to protect health in the United States and around the world. The most effective way to protect the American population from an influenza outbreak is to contain it beyond our borders. The 2007 Budget provides resources to continue these activities in countries already experiencing outbreaks of influenza and in other countries on the cusp of infection.

Another key global challenge is to curtail the illicit drug trade and to dissolve the relationships between narco-traffickers, terrorists, and international criminal organizations. The 2007 Budget requests $722 million for the Andean Counterdrug Initiative, which advances the President's goal of strengthening democracy, regional stability, and economic development throughout the hemisphere. The Initiative provides funding for law enforcement, security programs, and alternative livelihood assistance for those at risk from the trade of illicit narcotics.

Finally, as we transform our diplomacy to meet the increasingly global challenges of the 21st century, the United States remains committed to putting the power of our compassion into action wherever and whenever it is needed. In 2005, the United States led the world with our generous emergency responses to people suffering from unprecedented natural disasters—from the Indian Ocean tsunami, to the earthquake in Pakistan, to the mudslides in Central America. Our swift action has helped to provide relief, to prevent the spread of disease, and to begin restoring livelihoods and rebuilding these devastated regions. The United States remains the world's most generous provider of food and other emergency humanitarian assistance. Throughout the world, we are also helping refugees to return to their countries of origin. When that is not a viable option, the United States leads the international community in resettling refugees here in our nation. The FY 2007 request of $1.2 billion for humanitarian relief, plus $1.3 billion in food aid, will ensure that we are prepared to extend the reach of American compassion anywhere in the world.

Three Goals of U.S. Foreign Assistance

The United States will continue to build strong partnerships to meet the global challenges that increasingly define international security in the 21st century. But we recognize that many states cannot meet the basic responsibilities of sovereignty, including just and effective control over their own territory. In response, the United States must assist the world's most vulnerable populations through our transformational diplomacy—using our foreign assistance and working with our partners to build state capacity where little exists, help weak and poorly governed states to develop and reform, and empower those states that are embracing political and economic freedom. These are three main goals of our country assistance programs, with the ultimate purpose being "graduation" from foreign economic and governance assistance altogether. Vibrant private sectors in free, well-governed states are the surest form of sustainable development.

Building State Capacity

We must do all we can to anticipate and prevent the emergence of failed states that lead to humanitarian crises, serious regional instability, and havens for terror and oppression that threaten our security. On September 11, we were attacked by terrorists who had plotted and trained in a failed state, Afghanistan. Since then, we have spent billions of dollars and sacrificed precious lives to eliminate the threat and liberate the brutally repressed people of Afghanistan. We must use all the tools and resources available not only to prevent future failed states, but to help nations emerging from conflict and war to become responsible, democratic states.

The Office of the Coordinator for Reconstruction and Stabilization was established to address complex and challenging situations around the globe. Partnering with the international community, we will help countries in crisis achieve a path to lasting peace, good governance, and economic development. Working in conjunction with our lead regional bureaus, our Reconstruction and Stabilization office is already beginning to advance this mission in the field. It deployed a team to Sudan to assess the effectiveness of our assistance programs in implementing the Comprehensive Peace Agreement, in negotiating a political settlement in

Darfur, in delivering humanitarian assistance, and in establishing security. As a result of these assessments and planning efforts, U.S. resources have been allocated more effectively to help people in need in Sudan. Our office has also helped the Haitian people take a decisive step toward a better future, pinpointing problems with voter registration and the electoral council in time for them to be remedied before last week's historic elections.

The 2007 Budget proposes to strengthen this office's ability to lead U.S. planning efforts for countries and regions of most concern, and to coordinate the deployment of U.S. resources when needed. The Budget proposes $75 million, including a Conflict Response Fund to build our civilian response capabilities, to prevent failing states, and to respond quickly and effectively to states emerging from conflict around the world. With an early and effective civilian response, we can reduce the need for a more robust and costly military commitment by more quickly shifting responsibility for key functions to civilian actors.

Our efforts to build state capacity continue in Sudan. The need for security is of the utmost importance to this effort, and the Comprehensive Peace Accord (CPA) points the way forward. The CPA, which ended 22 years of North-South civil war in Sudan, is the framework for resolution of conflict throughout Sudan. The CPA created a Government of National Unity that shares power and wealth, and establishes elections at every level by 2009.

Implementing the CPA is essential to ending the genocide in Darfur. The United States is appalled by the ongoing atrocities that have persisted in Darfur, and we continue to lead the ongoing international effort to aid the region's displaced people, assisting over 1.8 million internally-displaced persons and over 200,000 Sudanese refugees in Chad. I ask for your full support of the President's upcoming supplemental request, which will include support for the African Union and for transition to a UN Peacekeeping Mission to bring peace to this war-torn area. We are requesting $1.1 billion in the FY 2007 budget to transition to peace in Sudan, meet humanitarian needs, lay the foundations for economic development, and strengthen sustainable democratic institutions.

We are also continuing to partner with the people of Haiti to advance the cause of freedom and build lasting foundations of a democratic state. Just last week, the people of Haiti held fair and free elections. We now look forward to working with the citizens of Haiti, their newly elected government, and the international community to help Haiti chart a positive path of freedom and prosperity by strengthening good governance, improving security and the rule of law, fostering economic recovery, and addressing critical humanitarian needs.

As is evident by the hard work and sacrifice of the UN peacekeepers in Haiti, international peacekeeping missions carried out by the United Nations and partner organizations are essential to creating the secure conditions conducive for democratic elections and basic state capacity. The $1.3 billion request for these efforts worldwide is also crucial to facilitating the delivery of humanitarian relief and providing a stable political and economic environment that fosters democratic institutions and development. To continue to provide well-trained, effective peacekeepers that understand and respect human rights, I am requesting over $100 million for the third year of the Global Peace Operations Initiative to train and equip 75,000 troops by 2010. Current missions and capacity building efforts increase our security at home and provide relief to the heroic troops in our own armed forces.

Helping Developing States and the Most Vulnerable Populations

Where the basic foundations of security, governance, and economic institutions exist, the United States is advancing bold development goals. Under President Bush, the United States has embarked on the most ambitious development agenda since the Marshall Plan, including a new debt relief initiative, the doubling of Official Development Assistance since taking office, and funding for the international financial institutions that is linked to performance. Development is an integral pillar of our foreign policy. In 2002, for the first time, the President's National Security Strategy elevated development to the level of diplomacy and defense, citing it as the third key component of our national security. States that govern justly, invest in their people, and create the conditions for individual and collective prosperity are less likely to produce or harbor terrorists. American diplomacy must advance these development principles.

U.S. development assistance focuses on building the tools for democratic participation, promoting economic growth, providing for health and education, and addressing security concerns in developing nations, while at the same time responding to humanitarian disasters. Such investments are crucial to improving the lives of people around the world and enhancing our own national security. At the same time, we must invest in reform in countries so that these efforts will not go to waste, but provide both the necessary tools and the right incentives for host governments to secure the conditions necessary for their citizens to achieve their full potential.

Relieving the burden of heavily indebted countries is essential to ending a destabilizing lend-and-forgive approach to development assistance for poorer countries and allowing these countries to progress on the road to prosperity. At the Gleneagles summit last July, the G-8 agreed on a landmark initiative to provide 100 percent cancellation of qualifying Heavily Indebted Poor Countries' debt obligations to the World Bank, the African Development Bank, and the International Monetary Fund. U.S. leadership was instrumental in securing this agreement. We estimate that a total of 42 countries will receive up to $60 billion in debt relief as a result of this initiative. The Budget that I present to you today fully supports the U.S. share of the multilateral debt forgiveness provided by the G-8 proposal.

The United States and our G-8 partners went much further than relieving debt. I ask you to go much further as well and support our government's commitment for the most ambitious package for Africa ever supported by the G-8. This package will fight malaria, HIV/AIDS, and corruption and help create an environment where democracy and economic opportunity can flourish. Specifically, the 2007 Budget supports the President's commitment to double our assistance to Africa between 2004 and 2010. In addition, the request supports the U.S. Government's commitment to help African countries to build trade capacity; to educate their citizens through the four year, $400 million Africa Education Initiative; and to combat sexual violence and abuse against women through a new Women's Justice and Empowerment Initiative.

Although Africa is a focus of our efforts to reduce poverty and invest in people and reform, it is by no means the only continent on which our resources are directed. We seek a total of $2.7 billion for Development Assistance and Child Survival and Health funds. By investing in the citizens of developing countries, we are investing in the future of the American people.

Empowering Transformational States

The final goal of our country assistance programs is to empower those states that are governing justly and to help them address key constraints to their economic growth and poverty reduction. The flagship of our efforts is the Millennium Challenge Account, which is helping states that are making measurable progress to achieve sustainable development and integration into the global economy.

In 2002, in Monterrey, Mexico, the nations of the world adopted a new consensus on how to reduce international poverty. Developed nations agreed to dramatically increase their amount of assistance to developing countries, and developing countries committed to making progress toward good governance, economic freedom, and an investment in the health and education of their people. In response to this Monterrey Consensus, our Administration and the Congress created the revolutionary Millennium Challenge Account, which targets billions of dollars in new development assistance to countries that meet benchmarks of political, economic, and social development. This innovative approach partners with and invests in low and lower-middle income countries that take ownership for their own sustainable development and poverty reduction.

In the past year, we have accelerated our efforts to negotiate and sign development compacts between transformational countries and the Millennium Challenge Corporation. To date, the MCC has identified 23 countries eligible for development compacts, and we have approved compacts worth a total of $1.5 billion with eight countries: Armenia, Benin, Cape Verde, Georgia, Honduras, Madagascar, Nicaragua, and Vanuatu. Nine eligible countries have prepared proposals totaling $3.1 billion, and another six will soon submit proposals of their own. We are seeking $3 billion of new funding in the FY 2007 budget, with the goal of approving up to 10 new compacts.

As important as our foreign assistance is, free trade is ultimately the key to every country's sustained development and economic growth. As the President stressed in the State of the Union, promotion of free trade is essential to enhancing the prosperity of the American people and to supporting developing countries in their effort to participate fully in the global economy. The Bush Administration has signed or negotiated free trade agreements with Chile, Singapore, Jordan, Bahrain, Oman, Morocco, Australia, five Central American countries plus the Dominican Republic, and most recently, Peru. Fostering free trade is a vital part of our development policy. In the past five years, the United States has more than doubled our investment in helping developing countries to trade freely and competitively in the global economy. We pledged at the recent WTO ministerial in Hong Kong to increase this assistance to $2.7 billion by 2010, and our FY 2007 request for trade-related development assistance will be an important step toward that ambitious and hopeful goal.

Mr. Chairman: America's purpose in this young century is to marry our democratic principles with our dramatic power to build a more hopeful world. Our purposes are idealistic, that is true; but our policies are realistic, and we are succeeding. President Bush and I have called upon the men and women of the State Department to practice transformational diplomacy, and they are rising to this challenge with enthusiasm and courage. They are helping our many partners around the world to build a future of freedom, democracy, and hope for themselves and their families.

Realizing the goals of transformational diplomacy will require a sustained effort over the course of a generation. Most importantly, it will require a strong partnership with the Congress. We at the Department of State will do our part to use our existing authority to make our foreign assistance more effective and to enhance our ability to serve as responsible stewards of the American taxpayers' money. Our goal in establishing the new position of Director of Foreign Assistance is a first step. We welcome a dialogue with Congress about how we can work together to improve America's foreign assistance further, enabling us to respond more quickly and more effectively to the world's development challenges. By making America's foreign assistance more efficient and more effective, we will help people around the world to improve their lives, we will strengthen the hope that comes with freedom, and we will advance our national security.

Chairman GREGG. Thank you, Madame Secretary.

That was really an excellent summary for us of where the State Department is and what you are trying to do. And I especially congratulate you on this effort, this transformational effort, to try to move people to where the problems are, which is something when I was chairing the State Department appropriating committee I worked on. There was some progress. But obviously your commitment to this is great. And we want to be supportive of that.

You are in an ironic situation in that you are one of the few secretaries who comes before this Committee who has had significant increases in your budget. I guess our question to you is are there efficiencies which we could look at? Are there things that we should be thinking about that would allow us to get more additional dollars, more additional activity for the dollars we are putting in? There is concern about the Millennium Challenge and the way that has been started up.

Can you just sort of give us an overview of how you think the Department can most effectively use the dollars we are giving you and whether or not the dollars we are giving you are enough, considering the fact that you are getting a significant increase?

Secretary RICE. Thank you, Senator Gregg. I really do not take for granted or take lightly the sacrifice that is being made on behalf of the programs that we run. I know that there is a lot of pressure on this budget.

I would just first go back to one point before I address the question of what the Department can do.

We are now in a phase of our diplomacy in which we have gone through two wars in Iraq and Afghanistan. We have gone through the largest terrorist attack on American soil. And we are literally, I think, in the midst of a big historic transformation to a world that, if we do our work correctly, will be more democratic, more free, and have states that will be allies in the war on terrorism, not states that will be fueling the war on terrorism. We are in the midst of trying to beat back concerns about the proliferation of weapons of mass destruction because heaven help us if weapons of mass distraction ever fall into the hands of terrorists, let alone into the hands of rogue states.

We are trying to meet the challenges of helping front-line states that are taking enormous risk in the war on terrorism, like Jordan and like Pakistan. We are in the midst of trying to help the people of Iraq and Afghanistan rebuild on the ruins on these dictatorships that were supportive of terrorism.

And around the world we are trying to use our diplomacy to further the cause of freedom and liberty and responsible states and to engage our long-term allies as real partners in doing that.

I would note that we have been very fortunate, for instance, to have the whole world really united against Iran, not just the United States. That takes work and it takes diplomatic effort.

The Millennium Challenge, as I said, gives us a particular kind of tool to encourage responsible behavior by states. I can tell you that countries want to participate. They want to make the case for why they ought to be a Millennium Challenge country. They will tell you what they are doing to fight corruption and what they are doing to invest in their people. I think these are all dollars well spent so that we can leave a foundation for a more peaceful and secure world, much as our predecessors left the foundation for a Europe that became whole, free and at peace and a Europe where no one can any longer imagine a war between the great powers.

That is the challenge that we have in a volatile region like the Middle East.

We will do our part to make sure that the dollars are well spent. It is why I think that we have to continue with our global repositioning. It is not going to be enough to come to the Committee and ask for more positions, and heaven knows we need more positions around the world, in places like Baghdad, like Islamabad, in many of our Latin American posts and in our posts in China and India. If you just look at the importance of those countries and the growth in populations in some of those countries, we are not meeting the diplomatic needs that we need to meet. However, with some combination of new resources and reprogrammed resources, I think can help us meet those needs.

I have also asked Henrietta Fore, who is the Management Under Secretary, to work harder on our rightsizing initiative and to work on questions of what we might be able to do to merge functions between various parts of the foreign policy community, to see if we can do with more regionalization of some of our efforts. Maybe every embassy does not have to have every thing. Maybe we can do things on a more regional basis.

So I promise you, we are going to be looking to squeeze out every dollar that we can. But right now the demand outstrips the supply of even significant increases that we have had because I think we have recognized the challenges before us.

Chairman GREGG. Thank you.

Yesterday I listened to some of the questions you were asked at the Foreign Relations Committee yesterday. And I thought some of them may have more to do with campaigns for the presidency maybe than what your answers were.

But independent of that, the bottom-line question was, I thought, what is going to happen in Iraq? And when are we going to get out of there And so let me ask you that question.

Secretary RICE. Well, the Iraqis are now engaged in the final stages of their political journey to actually create a permanent government. It is very hard to realize that it has only been a year since they have had their national elections and they now are in the process of creating a permanent government and creating a constitution. It is very hard because this is a country that has always resolved its problems by repression of groups, even repressions of majorities like the Shia or by dictatorship of the kind that Saddam Hussein imposed.

However now they have to do this by politics and by compromise. I think they are doing really rather well at it and I think you will see the formation of a national unity government.

Our support for them has been twofold. The Congress was generous in reconstruction funding for Iraq, which has been subject to some problems due to security. But I think the reconstruction program has had a real effect. We have been able to modernize large portions of the Iraqi infrastructure. For instance, we are delivering water and sewage in much larger numbers to many more Iraqis than in the past. We are continuing to work on the oil and the electricity infrastructure.

The Iraqi security forces are about 227,000 strong now. And to be fair, we made a mistake earlier on. We relied on numbers, not quality. These are, according to those who train them, quality forces that are now the Iraqi security forces. They are taking their own territory, holding their own territory, and now beginning to create the circumstances under which these provinces can really be rebuilt.

That, Senator is the way that I think about the course ahead for Iraq. Now our part in that is to continue to support them and to continue to support them so that they can have a secure basis on which to become democratic and prosperous.

But I do not believe that we ought to think that this is only a job for American military forces. As Iraqi security forces stand up in their security task, there is no doubt in my mind that American security forces will be less and less needed and less and less relevant to the task.

Indeed, I think it is why General Casey recommended to the President that we go from 17 brigades to 15 brigades, one now in Kuwait as a rapid reaction force. I think you will see more of that because Iraqi forces are stepping up, because the political process is progressing, because Sunnis are now heavily engaged in the political process and insurgents have less reason to be in the insurgency and Sunnis have more reason to be in the political process.

So I know that it sometimes looks like a complicated place but it is a place that is making progress along the political front and ultimately that is how you defeat an insurgency. If we leave early, if we do not remain committed, then we risk leaving an Iraq that is going to be a force of instability and terrorism in the region. If we do this job well, imagine the impact of an Iraq that is fighting terrorism, that is democratically governed, that is a friend of the United States and that can anchor a different kind of Middle East, a Middle East which desperately is in need of change because any region that produces an ideology of hatred so great that people fly airplanes into our buildings is in desperate need of change.

I think that the future of a better Middle East is one where Iraq is an anchor. That is why the United States is so important to that cause.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Madam Secretary, did I hear you right when you said that water and sewer has improved in Iraq?

Secretary RICE. Yes, you did. We have increased the capacity for clean water for several million Iraqis and 4 million Iraqis have better sewage than before the war.

The New York Times
THURSDAY, FEBRUARY 9, 2006

Iraq Utilities Are Falling Short of Prewar Performance

$56 Billion Cost Estimate Is Seen as Low

By JAMES GLANZ

WASHINGTON, Feb. 8 — Virtually every measure of the performance of Iraq's oil, electricity, water and sewerage sectors has fallen below preinvasion levels even though $16 billion of American taxpayer money has already been disbursed in the Iraq reconstruction program, several government witnesses said at a Senate Foreign Relations Committee hearing on Wednesday.

Of seven measures of public services performance presented at the committee hearing by the inspector general's office, only one was above preinvasion levels.

Those that had slumped below prewar levels were electrical generation capacity, hours of power available in a day in Baghdad, oil and heating oil production and the numbers of Iraqis with drinkable water and sewage service.

Only the hours of power available to Iraqis outside Baghdad had increased over prewar values.

In addition, two of the witnesses said they believed that an earlier estimate by the World Bank that $56 billion would be needed for rebuilding over the next several years was too low.

At the same time, as Iraq's oil exports plummet and the country remains saddled with tens of billions of dollars of debt, it is unclear where that money will come from, said one of the witnesses, Joseph A. Christoff, director of international affairs and trade at the Government Accountability Office.

And those may not be the most serious problems facing Iraq's pipelines, storage tanks, power lines, electrical switching stations and other structures, said Stuart W. Bowen Jr., the special inspector general for Iraq reconstruction, an independent office.

In one sense, focusing on the plummeting performance numbers "misses the point," Mr. Bowen said. The real question, he said, is whether the Iraqi security forces will ever be able to protect the infrastructure from insurgent attack.

"What's happened is that an incessant, an insidious insurgency has repeatedly attacked the key infrastructure targets, reducing outputs," Mr. Bowen said. He added that some of the performance numbers had fluctuated above prewar levels in the past, only to fall again under the pressure of insurgent attacks and other factors.

The chairman of the committee, Senator Richard G. Lugar, Republican of Indiana, began by billing the session as a way of deciphering how much of America's original ambitions in the rebuilding program are likely to be fulfilled with the amount of money that Iraq, the United States Congress and international donors are still prepared to spend on the task.

This downsizing of expectations was striking given that $30 billion American taxpayer money has already been dedicated to the task, according to an analysis by Mr. Christoff of the accountability office. Of that money, $23 billion has already been obligated to specific rebuilding contracts, and $16 billion of that amount has been disbursed, Mr. Christoff said.

Slow Progress

Progress reports for nearly every major area of Iraq's infrastructure were below prewar levels at the end of last year.

INDICATOR	BEFORE WAR	AS OF DEC. 31, 2005
Electricity generation	4,500 megawatts	3,995
Hours of power per day in Iraq	4-8	10
Hours per day in Baghdad	16-24	4
Daily crude oil production	2.6 million barrels	2.1
Daily heating oil production	5,000 tons	1,700
Percentage with drinking water	50%	32
Percentage with sewage service	24%	20

Source: Special Inspector General for Iraq Reconstruction

The New York Times

David Y. Lee for The New York Times

Stuart W. Bowen Jr., right, yesterday with, from left, James R. Kunder; James Jeffrey, a State Department aide; and Joseph A. Christoff.

Mr. Bowen's office has pointed out that another $40 billion in Iraqi oil money and seized assets of Saddam Hussein's regime was also made available for reconstruction and other tasks at one time or another. Last week, Robert J. Stein Jr., one of four former United States government officials in Iraq who have been arrested in a bribery and kickback scheme involving that money, pleaded guilty to federal charges.

Mr. Bowen pointed out in his testimony that the news on reconstruction in Iraq is not all bad. Despite the recent financing and performance shortfalls, the rebuilding program now seems to be much less ridden by fraud, corruption and chaos than it was in the early days when people like Mr. Stein were in charge.

Shortfalls in public services are linked to a ceaseless 'insidious insurgency.'

James R. Kunder, assistant administrator for Asia and the Near East at the United States Agency for International Development, in the State Department, emphasized things like what he called a 30 percent "potential increase" in electricity output because of new and reconditioned power generators in Iraq.

"We have done a lot of reconstruction work in Iraq over the last couple of years," Mr. Kunder said. "We did not meet all of the goals, the ambitious goals, we originally intended," he conceded.

Mr. Christoff of the accounting office said the latest numbers may actually overstate how well Iraqis have been served by the reconstruction program.

Water numbers, for example, often focus on how much drinkable water is generated at central plants, he said. But he said 65 percent of that water was subject to leaking from porous distribution pipes, which often run next to sewage facilities.

"So we really don't know how many households get potable, drinkable water," Mr. Christoff said.

Mr. Christoff also brought another new figure to the hearing: he said that on a recent trip to Baghdad, the American forces there had told him that they would need another $3.9 billion to continue training and equipping Iraqi forces, in part so that they can better protect the infrastructure.

The money would presumably be included in a 2006 supplemental funding request in which the Bush administration has said it would ask for more money to support the conflicts in Iraq and Afghanistan, an official at the Office of Management and Budget said. The administration "told us it would include this type of expenses," the official said, adding that no total for Iraqi security forces has yet come directly from the White House.

If the $3.9 billion that the American forces believe they need is actually appropriated, it would bring the total amount spent simply on training and equipping the Iraqi Army and the police to about $15 billion.

Senator CONRAD. Let me just ask you—this is from the New York Times from February 9th, and this was testimony by the Special Inspector General for Iraq Reconstruction before the Foreign Relations Committee. In that story, the lead paragraph is, "Virtually every measure of the performance of Iraq's oil, electricity, water and sewage sectors has fallen below preinvasion levels" even though we have spent $16 billion of American taxpayer money on Iraq reconstruction. Specifically on percentage of drinking water before the war, according to the Inspector General, 50 percent had it before the war. Now only 32 percent do.

On percentage with sewage service, 24 percent before the war, only 20 percent now.

So who are we to believe?

Secretary RICE. Let me give you the numbers. I have worked with the Inspector General and I actually went over his briefing before he gave that briefing. He came and gave the same briefing to me.

On potable water, millions of persons served prewar 5.5, 2005 average 8.6. We hope by the end state, that 12.5 will be the case.

Sewage, in millions of persons served, prewar about 0.5 average, in 2005, five. So the numbers have been going up on water and sewage.

The problems, you are absolutely right, Senator, have been on oil and electricity.

Senator CONRAD. Wait, wait, wait. This is the Inspector General's testimony before the Foreign Relations Committee. He says yes, oil is down. Daily crude oil production down from 2.6 million barrels to 2.1. Daily heating oil production down from 5,000 tons to 1,700.

But he says specifically drinking water, 50 percent had it before the invasion. Now only 32 percent do. Percentage with sewage service, 24 percent had it before the war and now only 20 percent do.

Secretary RICE. I think this may be an issue of whether we are talking about delivery or capacity. We have increased the capacity for clean water for several million Iraqis and for 4 million Iraqis in sewage.

Senator CONRAD. Can I say to you though, what matters to people is getting it. And what the Inspector General said very clearly is that in virtually every measure the performance of Iraq's oil, electricity, water and sewage sectors has fallen below preinvasion levels. We can improve capacity and that is great. But at the end of the day what matters to people is that they get it.

Secretary RICE. That is true, Senator, but without improved capacity more Iraqis are not going to get it.

You are right, we have concentrated on improving the capacity to deliver these services. The reason that we now have moved from rather large scale reconstruction projects, as I say reconstruction with a large R, to smaller scale more local reconstruction projects is to make certain that there is also better delivery for Iraqis.

Senator CONRAD. Let me stop you there, if I can, because in this article it goes on to say in one sense focusing on the plummeting performance numbers misses the point. The real question is whether the Iraqi security forces will ever be able to protect the infrastructure from insurgent attack.

That leads me to this question. This is an article that appeared in the Washington Times on December 3rd saying that “Funds may be lacking for ample Iraqi army... The U.S. general in charge of shaping an Iraqi army raised the prospect yesterday that the new Baghdad government will not have sufficient money” to fund the army envisioned by our Administration.

The Washington Times

SATURDAY, DECEMBER 3, 2005

Funds may be lacking for ample Iraqi army

By Rowan Scarborough
THE WASHINGTON TIMES

The U.S. general in charge of shaping an Iraqi army raised the prospect yesterday that the new Baghdad government will not have sufficient money to fund the 10-division army envisioned by the Bush administration.

Since Iraq's security is projected to depend on an army of that size, it raises the question of whether Iraq will have the right size land force to allow large numbers of U.S. troops to go home after 2006, when the new government would start budgeting more of its defense needs.

Army Lt. Gen. Martin Dempsey said plans are to create a 160,000-soldier army, tapping a pot of $10 billion in U.S. funds that also will be used for a police force, border guards, highway patrol, navy and an air force.

"But they may not end up

see **WAR,** ***page A5***

Let me ask you this because this is a budget committee. As much as we are interested in foreign relations here—and I think every Senator is—our primary responsibility to our colleagues is budget matters. These things raise two questions in my mind that are directly budget related.

We have the Inspector General saying things are getting worse there across a broad metric of delivering services to people, even though we have provided a lot of money. In fact, I think we have approved downsizing of expectations. It says, in this story, it was striking given that $30 billion of American taxpayer money has already been dedicated to the task.

So the American people have been very generous already. And they are saying in this article that, according to the Inspector General and other witnesses before the Committee, they need more than $56 billion for reconstruction.

What of that amount do you think the American taxpayers will be asked to finance?

Secretary RICE. Senator, let me say first that the taxpayers' dollars that we have spent have modernized aspects of the Iraqi infrastructure. For instance, creating more capacity will allow us to deliver more. The first is to create more capacity.

Then you can deliver services. What we are now really focusing on is how to make that delivery work, which is why I think you will see, both in our budget request and in what will be a supplemental request, that the focus is actually not on large funding for reconstruction projects. Rather, we are focusing on funding for provincial reconstruction efforts that will be more decentralized, but will allow us to work with local governments to deliver services. It will focus more on creating capacity in the Iraqi ministries so that they can also deliver services. In effect, we have given them a real boost in the infrastructure itself, in helping to modernize it, helping to create its capacity.

We are now going to have to work with others, and there are pledges from other countries that have not yet been paid, not yet been actually handed over to the Iraqis for infrastructure, that I think we will use it to help them to continue the infrastructure modernization.

You will not see large numbers in our budget requests for further infrastructure projects. What you will see is funding for maintenance. You will see that we want to spend down the remaining money in the Iraq Reconstruction Fund (IRF–2). We have committed that money. Finally, we want to have provincial reconstruction efforts that will allow us to help the Iraqis to deliver services.

Senator CONRAD. Let me just say you need to mark me down as a skeptic. According to the Inspector General, he says by virtually every measure things are going in the wrong direction, not the right direction with respect to delivering services to people there. And they say the $56 billion is not going to be enough. This is the testimony before the Foreign Relations Committee.

I tell you, I am very concerned that we are going to be asked for a boatload of additional funding. And as I have pointed out, things that are terribly important to my constituents, including essential air service being cut more than half, Rural Utility Service being cut

30 percent. There is an enormous challenge in the Middle East. We also face big challenges in our own Midwest.

And I would say to you that this trajectory does not look good to me. And this notion that there is going to be a tremendous need for additional money, including for the Iraqi army, and we seem to be the ones that keep ponying up. We have to find a way to share this burden because I can tell you, patience is wearing thin.

Secretary RICE. Thank you, Senator.

I agree that we need to find a way to share the burden. In fact, we do have a significant amount of money that has been pledged to Iraqis that has not yet been appropriated to them. We need to work to get people to pay those pledges. Some of that money is for exactly the kinds of projects and you are talking about.

But I want to be very clear, the United States has about $2.9 billion remaining in the IRF. We intend to spend that, continue the spending on infrastructure of that money. We intend to use that money in smaller scale projects that will allow for more rapid delivery.

Our focus in this supplemental and in this budget is on making the Iraqis more capable of delivering their own services by working at the local level with provincial teams and working at the national level with ministry teams to make better use of the infrastructure that we have helped to provide.

However, there are still problems.

Senator CONRAD. Could you say that again? Could you just educate us here? When you say in the IRF, is that a term of art?

Secretary RICE. I am sorry. That was in the Iraqi Reconstruction Fund. Sorry.

Senator CONRAD. It is referred to in that way?

Secretary RICE. Yes, that is where the money was appropriated by the U.S. Congress.

Senator CONRAD. The thing that is so striking to me, I have had my staff every 30 days provide me with an update about how things are going with these matters. And every month I get these reports and things are not getting better. That is what is so striking to me.

And now we have the Inspector General coming up here and testifying that in almost every one of these areas things haveten worse since before the war, and that the estimates of the cost are going up, up and away. And now they say there may not be the funds for the Iraqi army that we want to turn the responsibility for security over to.

What is your anticipation there? Are they going to have the funds necessary to stand up an army that can provide security?

Secretary RICE. Senator, I think the Iraqis and the new Iraqi government recognizes that one of their first responsibilities is going to be to provide security themselves. Yes, theoretically, you could end up with not enough money for the Army. But that is what budgeting is about and that is what programming is about. The Iraqis are going to have to budget and program hopefully with some help from others in the international community, as well, to be able to meet their security needs.

They have two problems right now that we are helping them work on. One is that while it is true that oil revenue has been down because even though oil production and export was at prewar levels in the summer, there have been insurgent attacks against the pipelines making much more difficult the export of oil, which is a huge source of revenue for the Iraqis.

We are working to try and improve that situation so that oil production and oil export can go back up.

The other piece of that is that the Iraqis are working to eliminate some of the subsidies that are a huge drag on their budget. They also have a number of debt relief pledges that when they have an IMF program, can be met.

So there are sources of revenue for the Iraqi government. It is a matter of their budgeting and programming that they are going to have to meet to cover their security needs.

I would expect that that is going to be a very important conversation with the new government.

Senator CONRAD. My time has expired. I must say that I am increasingly skeptical when I look at the data that I am receiving about what is happening with the infrastructure of Iraq by virtually every measure.

I was just handed another review—down, down, down. I will tell you, I think we have a huge problem on our hands here. If they do not have the funds to stand up the Army necessary to provide security to their people, it makes me extremely concerned about what will be asked of our people. I thank you.

Chairman GREGG. Thank you. Senator Sessions, do you have a questions? We have about seven-and-a-half minutes left on this vote.

Senator SESSIONS. I will try to be brief.

First, I would like to compliment you, Madame Secretary, on your commitment to review and transform the State Department. As a member of the Armed Services committee, the Defense Department is intensely reviewing its investments and how it spends its money, what its priorities are, what the future will look like, and trying to configure that department to meet those challenges.

The State Department does not have weapons systems and things of that nature. But likewise, I think it is healthy that you are challenging, asking people where you really need embassies, where you need to have people stationed.

And you may get push back from Congress or from people who prefer to be stationed in Germany than some Third World country. But you have to make those decisions. And I hope that if you do that you ask for support from this Congress. I think you will get it.

I am also pleased that you are requesting funds for democracy in Iran. It was not too long ago that I met an Iranian who fled Iran and he was so sincere. It just really brought tears to your eyes to talk about his love for his country and the difficulties that they have, his belief that so many of the people there want a better life, they want freedom. And I think that is a policy we should encourage.

And I think the President, by saying this openly and appealing to the people of Iraq, we are not hostile to them but we want them to simply have a better life, a freer life, that it is the right thing.

You have been asked about the Iraq war and the reconstruction effort. Fundamentally I guess—I would ask you this way.

The State Department's responsibilities now include the infrastructure and the political progress in Iraq in trying to work with the new government of Iraq and assist them and encourage them to do things that would be in the long-term best interest of that country. The military is challenged and oftentimes have to carry the load, but they are executing policies that are consistent with the State Department policies; is that correct?

Secretary RICE. Yes, absolutely.

Senator SESSIONS. In other words, this is a sovereign, Iraq, now. We relate to Iraq through the State Department, our Ambassador, not by a military force that operates on its own will throughout that country; is that correct?

Secretary RICE. Absolutely, Senator. What happens is that, first of all, we have found in a number of parts of the world, and Iraq is one and Afghanistan is another, that the strong integration of our military and political efforts, our military and diplomatic personnel, has to really be achieved. So you will not see a closer working relationship than between Ambassador Khalilzad and General Casey. They are joined at the hip. You rarely see one without the other these days.

That gives us the ability to deal with the Iraqi government in a way that unifies what we need to do to continue to defeat the insurgency, with what we are trying to do to build the new Iraqi state.

You need to vote. I will stop there.

Senator SESSIONS. Thank you.

I would just say that Secretary Rumsfeld was complimentary of the relationship. But as Chairman John Warner mentioned in our last hearing with the Secretary, that we talk about jointness within the military. We need a jointness within State, Commerce, Defense and within DOD as we deal with these complex issues. And I hope that you will work toward that.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Madame Secretary.

We have a vote on. You have been very generous with your time. I do not think you should have to sit here and wait for Senators to arrive after the vote. So we are going to adjourn the hearing and we appreciate the input.

More importantly, we appreciate the job you do for this country. You are an exceptionally good spokesperson and manager of the diplomatic affairs of our Nation and we are very fortunate to have you as a public servant. Thank you.

Secretary RICE. Thank you very much, Senator.

Chairman GREGG. The hearing is adjourned.

[Whereupon, at 10:45 a.m., the hearing was concluded.]

PREPARED STATEMENTS

Statement of Michael B. Enzi

Senate Budget Committee Hearing:
The President's Fiscal Year 2007 Budget Proposal
The Honorable Condoleezza Rice
February 16, 2006

Michael B. Enzi

Thank you, Mr. Chairman.

First, let me welcome and thank Secretary Rice for testifying before the Budget Committee today. Between this hearing today and your testimony before the Senate Foreign Relations Committee yesterday, it looks like you have had a busy week on Capitol Hill. Before I go any further, I wanted to recognize your leadership as America's top diplomat. As we continue to fight the War on Terror, you recognize how crucial it is to continue to work with the international community to bring peace and stability to some of the most volatile regions. You have done a great deal to advance our nation's priorities abroad.

I am also pleased to hear that you are looking into moving people and resources in our diplomatic corps in reaction to the change in the types of threats we face. America now faces a much larger threat from smaller, rogue groups instead of the historical nation-state actors. I was surprised to hear that the United States currently has as many diplomats in Germany that we have in India. We see our military evolving to meet post Cold War threats and I am pleased to hear that the State Department is changing as well. This is a difficult process, but one that is essential for the security of our nation.

You are in a unique position this year as the head of one of the very few agencies that received an increase in President Bush's Fiscal Year 2007 budget proposal. As you know, International Affairs discretionary programs received an 11.4% increase. Although I am a strong proponent of fiscal responsibility, I recognize the need to support efforts to make the world a safer place to live.

Specifically, I am pleased that the President's budget request included $22.7 million for the African Development Foundation (ADF). I have been extremely impressed by this organization and its ability to partner with individual nations to address the needs of their citizens.

In Fiscal Year 2005, the Foundation's budget of $18.8 million helped 227 business enterprises create or sustain 112,000 jobs, generate more than $40 million in revenues, and deliver more than $21 million in goods to global markets This year, ADF will begin to implement a new five-year strategic plan that ensures that the Foundation has both a larger resource base to fund projects and is effectively creating new projects in areas of greatest need. This new plan is premised upon ADF identifying new ways to leverage additional funds from the private sector and from African governments to significantly expand its highly successful programs. ADF is taking a good and solid approach to development that I hope our other development agencies will look to ADF as an example of successful development.

In addition, I will continue to follow the progress being made on the Capital Master Plan for the renovation of the United Nations headquarters. I share my Senate colleagues' concerns about the increasing costs of plan, but I am also concerned about the safety and security issues for the United Nations complex if no renovations are made. The State Department and the U.S. Mission to the United Nations have been playing an important role in the progress of renovation plans. I would encourage you to keep meeting with interested members of Congress to ensure we can support the project and increase the safety of the building with realistic and sound financial practices.

Thank you again for agreeing to testify in front of this committee today.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Pete Domenici (#1 & #2)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, I have heard complaints about the resources available at India Consulates. I am told there is a 4- or 5-month backlog for interviews of visa applicants.

1) Are you aware of the long delays in obtaining such appointments?
2) What are your plans to address this backlog so that companies can plan for future business activity?

Answer:

We are aware of the delays and are addressing them through increased staffing and streamlined procedures. The Bureau of Consular Affairs closely monitors the wait times for visa interview appointments at all posts, and has been actively engaged with the India posts to address their backlog. The backlog in India is due to an ever-increasing demand for visa services which is difficult to keep pace with. We have, however, begun to see the results of initiatives taken to reduce wait times, including two new contracts implemented in October 2005 to provide information, schedule appointments, and facilitate off-site fee collection at all our posts in India. The new procedures are more efficient, provide greater accountability, and permit better internal control over the types of cases given priority. Special procedures are in place to give priority to students, exchange visitors, and certain business travelers.

In addition, consular staffing for the India posts has vastly improved over the past two years. A significant number of new positions have been added and more are planned. In addition, we have provided temporary assistance to boost capacity and cover staffing gaps. To better manage workloads among the various posts, India has also been designated as a single, countrywide consular district for visa adjudication, which allows the four posts to offer appointments and shift officers to address workload surges.

Question for the Record Submitted to
Secretary of State Condoleezza Rice
Senator Pete V. Domenici (#3)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, I want to thank you for all your help last year in pushing through the MOX negotiations with Russia. We have an agreement that has been initialed by both the U.S. and Russia and the final agreement is working its way through the Russian bureaucracy for a signature later this spring.

1) Can you give me a status update as to when the final agreement will be formally signed with the Russian Foreign Minister?

Answer:

The Russian Government still has some formalities to complete before signing the liability protocol for plutonium disposition, and has yet to give us a specific date. However, Russia has assured us that it intends to sign the text that was agreed upon last July. (The United States has been prepared to sign the protocol since August.)

While we are disappointed with the delay in signing, it is important to note that this is not impeding any significant U.S.-Russian cooperation in this critical undertaking. The Russian Federation just recently completed its year-long review of Russia's disposition program, during which time most cooperation was necessarily suspended, and we are now actively engaged with Russia on exploring program directions that will garner Russian commitment, political as well as financial. The absence of such commitment since 2000 has been the major factor accounting for the delays in this cooperation.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator John Cornyn (#1)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, you recently announced with Secretary Chertoff the *Joint Vision for Secure Borders and Open Doors*. As part of this initiative, you announced that the Department of State will begin issuing passport cards – a cheaper alternative to the passport – that would allow U.S. citizens to comply with the new document requirements that go into effect for land borders in 2008. I applaud that announcement, but I am concerned about your Department's ability to issue a sufficient number of passports – and new passport cards – by the end of 2007. Could you please describe what efforts your Department is taking to meet the deadlines and whether the U.S. Senate needs to consider an extension of that deadline for the land border environment?

Answer:

To help meet the expected surge in demand for U.S. passports, the Department has underway a multi-year effort to increase our passport adjudication and production capacity. In FY 2003, we processed fewer than 7 million passports. That number grew to more than 10 million in FY 2005; we expect it to increase to a sustainable level of 17 million in FY 2008.

With support from the Congress, we have been able to secure funding necessary to meet this increased demand, including by receiving authority to hire in FY 2005 an additional 105 staff to adjudicate the increased number of passport applications. To meet continuing growth, we expect to add 130 government staff in FY 2006, and another 89 in FY 2007. These employees, who manage our passport function and provide adjudication services, are aided by large numbers of contract staff who handle those functions that are not "inherently governmental".

The Department has also begun transitioning its Charleston Passport Center (CPC) to an adjudication center. Later this year, CPC will cease passport production and concentrate solely on adjudicating passport applications only. The facility will operate at least two shifts per day plus routine weekend work to help meet the demand for passports. At the same time, the Department will stand up a passport production facility that will serve as a passport book personalization center. We have already solicited proposals from private vendors to supply and operate, with government oversight, such a facility (or facilities). Production center(s) will be responsible for "personalizing" the passport, i.e., printing the data page, performing quality control functions, and mailing the passports to customers. We also intend to use this facility to produce passport cards. We expect startup of the book personalization center during the 4th quarter of CY 2006. We anticipate that these actions will result in greater efficiencies that, coupled with additional staff, will permit us to continue providing first-rate customer service.

**Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator John Cornyn (#2)
Senate Budget Committee
February 16, 2006**

Question:

Secretary Rice, your Department works closely with the Department of Homeland Security to ensure that other countries facilitate the repatriation of their nationals after they have been ordered deported from the United States. For example, when the Department of Homeland Security apprehends Central American nationals on the Southern Border, it is necessary to obtain travel documents from the home country before the U.S. can remove the aliens. The Department of Homeland Security has recently begun video teleconferencing with Honduras to speed up the travel document issuance, but delays still exist with other countries. What steps is the Department of State taking with respect to those other countries?

Answer:

The issue of the removal of criminal deportees is one where the Department of State and the Department of Homeland Security have a very close working relationship. Aliens who have been incarcerated in the United States often do not have the identity documents that would allow us to return them to their home country under an order of deportation. In most instances, the Department of Homeland Security is able to secure documentation in a regular manner from the Embassies or Consulates of these individuals. However, there are a number of countries where the issuance of these travel documents is delayed. Working with the Department of Homeland Security, Department of State officials both overseas and here at home approach officials of foreign governments to encourage them to issue documents. An officer from the Department of Homeland Security, Immigration and Customs Enforcement, Office of Detention and Removals, is detailed to the Department of State to ensure the most effective possible cooperation between our two departments as we approach foreign governments on this issue.

State and DHS have identified several countries of particular concern, due either to the large number of criminal deportees awaiting deportation or the lack of responsiveness by the foreign government in issuing the necessary travel documents. Both Departments are working directly with the countries involved to secure rapid issuance of the necessary documents. We are engaged in a regular series of meetings with several foreign missions to press them on the need to come forward with these travel documents, and to offer our assistance in processing these individuals. While we have had some success, it has come slowly. We aim to resolve these issues through diplomatic means, but we also have other tools at our disposal, including the provisions of Section 243(d) of the Immigration and Nationality Act, which allows us to impose visa sanctions, under some circumstances, to encourage governments to meet their responsibilities to accept the return of their citizens.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice
Senator John Cornyn (# 3)
Senate Budget Committee
February 16, 2006

Question:

I have been watching with growing concern the recent presidential elections in Latin America. These elections have produced an undeniable leftward trend as well as increased anti-American sentiment. Please explain how we can justify a 4.3 percent cut in foreign aid funding to the region at this time.

Answer:

Foreign assistance for the region has nearly doubled since the start of this Administration, from $862,452,000 in FY 2001 to $1,696,841,000 in FY 2007. Although the FY 2007 request for Latin America represents an overall decrease of one percent from the FY 2006 request, it does not reflect a reduced commitment to Latin America. We have prioritized our foreign policy goals against available resources and competing demands for assistance. For example, a reduction for middle income countries where the need is not as great allows us to increase assistance in areas such as Africa, where the need is greater. Moreover, in addition to FY 2007 foreign assistance, we will be providing Millennium Challenge Corporation (MCC) funding to Nicaragua, Honduras, and Paraguay. Since the MCC was established in 2004, it has approved compacts for Nicaragua ($175 million) and Honduras ($215 million). On February 8, MCC's Board approved a $37 million program for Paraguay as a Threshold Country. MCC funding has increased the total resources available to the region.

**Question for the Record submitted to
Secretary of State Condoleeza Rice by
Senator John Cornyn #4
Senate Budget Committee
February 16, 2006**

Question #4

I continue to be concerned with securing federal information systems. The federal government collects and manages a vast amount of information and much of it is sensitive or personal in nature. In addition, the systems that maintain that information are increasingly interconnected. Therefore, there is a growing risk of unauthorized access to these systems and information.

The Federal Information Security Management Act of 2002 (FISMA) requires federal agencies to annually report on their information security efforts to OMB. The subsequent "Federal Computer Security Report Card" that GAO developed based on the information form the reported information gave the Department of State a grade of "F" in 2002, "F" in 2003 and "D+" in 2004.

a) While the Department's Grade has gotten better there still seems to be room for improvement. Generally, what efforts has the agency undertaken to improve its FISMA performance?

Answer:

The State Department is encouraged that the House Committee on Government Reform recognized State last year as the agency with the single largest improvement in its numerical FISMA score, with a gain of more than 30 points. More work needs to be done to manage our inventory of information technology assets, including contractor systems more effectively. Once resolved, we expect that we will achieve higher FISMA grades.

Some of the efforts the Department has undertaken to improve our FISMA performance include: 1) appointing a Chief Information Security Officer to provide centralized, management attention to information security, 2) improving our inventory of applications and certifying and accrediting them to rigorous standards, 3) creating of an industry certification for staff members conducting certification and accreditation based on the Departments reputation for excellence in conducting these reviews, 4) instituting and maintaining Plans of Actions and Milestones (POAMs) to track progress in resolving identified information security weaknesses and 5) asserting a leadership role among all government agencies in threat assessment, incident detection, and incident response.

The Department's Bureau of Diplomatic Security's Cyber Threat Analysis Division (CTAD) received the National Security Agency's 2005 Rowlett trophy. This award is given annually to the U.S. Government organization that makes the most significant contribution to the improvement of national information systems security, operational information assurance readiness.

Question for the Record submitted to
Secretary of State Condoleeza Rice by
Senator John Cornyn #4
Senate Budget Committee
February 16, 2006

Question #4 (b)

What is the status of the Department's efforts to inventory information systems?

Answer:

The Department established a Department-wide inventory of information systems beginning in 2003 with an examination of our stovepiped inventories. We have reconciled our data with OMB requirements and now have a web-based tool to maintain and manage the inventory of information systems and is linked to the approval/procurement process for new systems.

The Department's CIO continues to work closely with both OMB and the Inspector General to ensure that all applicable requirements are effectively addressed. As a result, this inventory tool is being updated and refined, where necessary. In addition, the Department will invest in technological solutions that assist discovering any unreported assets.

Question for the Record submitted to
Secretary of State Condoleeza Rice by
Senator John Cornyn #4
Senate Budget Committee
February 16, 2006

Question 4 (c)

What is your guidance to management personnel on the importance of protecting information and networks?

Answer:

The Department has a comprehensive training program for information security responsibilities, from an on-line computer security awareness course covering topics such as Department computer policies, phishing and online safety up to a two hour course for staff at the Assistant Secretary level focused on their responsibilities relating to protecting information and information systems under their purview.

We continue to refine and improve the delivery of our awareness training and are evaluating a very successful product used by USAID, "Tips of the Day," to assist in this effort. This product enhances our awareness program by providing the ability to reach out to all staff on a daily basis with a message tailored to the employees' role.

In addition, the Department's Certification and Accreditation program reinforces the significance and importance of information security to management personnel. Balancing the risk of exercising un-assured business activities against the information assurance processes and their underlying security requirements is a senior management responsibility. Therefore, system ownership for the purposes of information system certification and accreditation is always assigned to a senior executive within the bureau operating the information system or application.

Question for the Record submitted to
Secretary of State Condoleeza Rice by
Senator John Cornyn #4
Senate Budget Committee
February 16, 2006

Question #4 (d)

What ongoing activities are you pursuing to ensure that information security practices are followed throughout the agency?

Answer:

The Department, under the leadership of the CIO and CISO, developed a comprehensive information system security program plan that identifies the laws, regulations, and policies for the Department offices that support these authorities. This program provides a central repository of all relevant and applicable information, which promotes and advances information security, to operational security and compliance reporting efforts. The primary goal is and will remain to capture an overall picture of operational security efforts and where possible, integrate Federal compliance reporting. The integrated operation will mature from disparate information security and assurance functions to a mature risk managed operation that is centrally coordinated. This transformation will result in:

- Reduction in costs for operational security and compliance
- Improved security posture for the Department
- Increased compliance with Federal mandates

- Quality evidence through compliance reporting and 3rd party reviews
- Combined and efficient management process for information security

The Department continues to certify and accredit major application and general support systems as required by FISMA. This process ensures, via independent review at least once every three years that information security requirements are met. As part of the C&A program, a new Site Evaluation and Verification (E&V) Program has been established in order to enhance the protection of the Department networks and computing resources as well as to provide the CIO, the CISO and senior managers periodic assessments of cyber security at domestic and overseas locations. By conducting targeted checks for compliance with configuration standards and scanning frequently for potential weaknesses, the Site E&V Program enables the Department to monitor its security gaps and help ensure that system owners fulfill their authorization obligations. The Evaluation and Verification process also bolsters the Department's ability to address key FISMA requirements regarding the periodic testing and annual evaluation of security policies and procedures.

The Department's Cyber Security Incident Program (CSIP) went into effect January 1, 2006. The CSIP enhances the protection of the Department of State's Sensitive But Unclassified cyber infrastructure (OpenNet+) by identifying, evaluating, and assigning responsibility to employees who breach or fail to comply cyber security requirements. Patterned after the Security Incident Program for the mishandling of classified information (12 FAM 550), the CSIP makes employees aware of their individual cyber security responsibilities and deters unauthorized activity. The CSIP applies to all users of Department networks.

To date, the Department has identified 52 incidents, all of which fall under the violation category, and which break out as follows: 37 incidents of unapproved software, 5 incidents of prohibited hardware or electronic devices connected to OpenNet+, 3 incidents of improper access to Internet sites or services, 6 incidents of downloaded malicious code and 1 non-compliance with critical security configuration. Although, January 1st through June 30, 2006 is an amnesty period, employees are notified of the incident that has occurred, what computer security policy they have violated, the referral actions that would be taken if the amnesty period were not in effect (i.e., to Human Relations/Employee Relations for disciplinary action and to Diplomatic Security for security clearance/investigation review) and referral to our website to review the remedial training module. We are using this six months to emphasize education and to fine-tune the reporting mechanisms and roles and responsibilities of the ISSOs (Information System Security Officers) and RSOs (Regional Security Officers). This effort is proceeding well and we will be providing periodic reports on incident stats via Department Notices and worldwide cables in a continuing effort to maintain a high level of computer security awareness.

Integral to both the Site Evaluation and Verification efforts and the Cyber Security Incident program is the local Information Systems Security officer. The Department is currently enhancing its Information Systems Security Officer program to pursue professionalization of the increasingly important job of protecting government systems and data. As we have transitioned from a collection of closed networks to an open, worldwide network, the Department has worked tirelessly to keep Information Systems Security Officers in the field informed of the latest vulnerabilities and mitigation techniques. ISSOs ensure security policy is consistently applied and enforced; maintains the security posture of the information systems and sites under their purview; serves as the first responder to security incidents and performs cyber security awareness training for staff at their facilities.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Robert Menendez (#1)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, the State Department is a member of CFIUS. What were your recommendations on this deal? Did you express concerns over Dubai's history and concerns about terrorism?

According to Treasury's website on CFIUS, the President can block a foreign acquisition of a US corporation if he finds:

- There is credible evidence that the foreign entity exercising control might take action that threatens national security; and
- The provisions of law, other than the International Emergency Economic Powers Act, do not provide adequate and appropriate authority to protect the national security.

When your team reviewed these standards, which I assume they did, what assessment did they make?

I am concerned about the transparency of the decision process. Can you explain exactly how these decisions are made, how relevant public officials and the public [are] informed before these decisions are made?

Answer:

The State Department has a rigorous review process for all CFIUS transactions. Every transaction is sent for scrutiny and analysis to experts in international security, defense trade, nonproliferation, intelligence, terrorism finance, and political-military affairs, as well as the appropriate regional specialists. In this case, those included staff from our Office of Arabian Peninsula and Iran Affairs. In addition, we brought in experts on maritime transport and security. All of these experts looked at the proposed transaction from various angles, considering the possibility of terrorist activity. They were aware of the history of our relationship with the United Arab Emirates (UAE), including past shortcomings (such as recognition of the Taliban regime in Afghanistan prior to 9/11) as well as its exemplary support for the United States in the global war on terror, the UAE's assistance to U.S. and coalition forces, its help in tracking and shutting down terrorist financing networks, and its participation in port security initiatives such as the Container Security Initiative and the Megaports Initiative.

Our experts also liaised with the Department of Homeland Security and recognized that U.S. government agencies would continue to exercise full authority over all aspects of port security and that Dubai Ports had agreed to honor all of the security agreements signed by P&O. At the conclusion of this review, the State Department determined that there were no outstanding national security issues.

We are certainly aware of the strong interest in a better process to keep Congress informed about CFIUS, and we are currently assessing ways to enhance our efforts in this regard.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Robert Menendez (#2)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, we all recognize that we are in a crisis with Iran. Just this week, we learned that Iran has resumed uranium enrichment at their main plant in Natanz, a step in building a nuclear weapon. Iran has, at times, threatened to withdraw from the nuclear Non-Proliferation Treaty, has curtailed IAEA access, continues to break promises, and lie about their nuclear activities.

- If the Security Council fails to impose sanctions, what are your plans for Iran? Would you consider a plan to have the U.S., Europe, and other countries impose sanctions, without the Security Council?
- If so, how would this impact the international oil market? How would these sanctions impact Iran? How would OPEC states react?

Answer:

We are confident that a strong majority of UNSC members recognize the imperative of the Security Council addressing the threat posed by Iran's pursuit of a nuclear weapons capability, and agree that the UNSC should reinforce the ongoing efforts of the IAEA. We expect the UNSC to take up the Iran issue in March, after the IAEA Board of Governors discusses Iran the first week of March. For some time we have been consulting transparently and constructively with other Security Council members on how the Security Council might address the Iran issue. We are encouraging the Security Council, as an initial step, to adopt a Presidential Statement (PRST) that calls on Iran to comply fully with the IAEA Board's repeated requests, including resuming a full suspension of all enrichment-related and reprocessing activities, cooperating fully with the IAEA, ratifying promptly an Additional Protocol, and provisionally implementing the Additional Protocol pending its ratification.

Such a statement from the Security Council, which lends the Council's weight to the IAEA's efforts in Iran and the IAEA Board's calls on Iran, would add significant pressure on the Iranian regime to comply. However, if Iran defies such a UNSC request as it has defied the past nine IAEA Board resolutions, we would expect the Council to consider taking additional measures to increase pressure on Iran to comply.

We have made clear that in raising pressure on the Iranian regime to abandon its nuclear weapons intentions and activities, we do not seek to harm the Iranian people. We hope the international community can persuade the Iranian regime to end its pursuit of a nuclear weapons capability before the UNSC is forced to take serious measures. But if Iran defies the UNSC, as it has defied the IAEA Board, we would join with the EU3 and others in instructing the UNSC to use the full range of its authority to compel Iran to change course. Most members of the UN Security Council clearly agree with this approach.

We are currently examining a number of options for applying greater pressure on Iran, independently of action by the IAEA and the UNSC. For example, we are encouraging countries that maintain relations with Iran to use what leverage they have – diplomatic, political, even economic and commercial – to persuade Iran to change course. We expect other countries will take steps to do so.

Regarding the impact of global measures against Iran on world oil markets, I don't want to speculate on hypothetical scenarios. Obviously, Iran is a major oil producer, and withholding its crude from market would have an impact on world prices. It would also have a significant impact on the Iranian economy. As the International Energy Agency (IEA) has pointed out, however, consuming countries hold significant strategic petroleum reserves, which could be used to mitigate the impact on world markets.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Robert Menendez (#3)
Senate Budget Committee
February 16, 2006

Question (Part 1):

I would also like to point out that Iran seems to be in the process of making friends in our own neighborhood. Apparently, Iran has said that it would like to help Venezuela develop a "peaceful" nuclear program and has held friendly talks with both President Chávez and newly elected President Morales in Bolivia. I would also note that Venezuela voted against referring Iran to the Security Council and is developing a close relationship with Hamas.

- How does the Administration plan to deal with this issue in our relationships with Venezuela and Bolivia?

Answer:

The Administration has made clear to the Government of Venezuela, both privately and publicly, that cultivating ties with Iran undermines its democratic credibility in the eyes of the international community. This is especially so at a time when the international community — led by the United States, the European Union, Russia, and China — is united in our effort to get Iran to honor its obligations under the Nuclear Non Proliferation Treaty. Assistant Secretary Shannon conveyed this message to the Venezuelan Ambassador on February 14 as well as our concerns about

Hamas. The U.S. Embassy in Caracas has also made this clear to officials in Venezuela. Ultimately, the Venezuelan government has a choice to play a constructive role internationally or to side with undemocratic regimes.

Regarding Bolivia, we had seen press reports that in January 2006, then president-elect Evo Morales was considering stopping in Iran as part of a pre-inauguration tour to nations in the Western Hemisphere, Europe, and Asia. He did not visit Iran on that tour. If the Government of Bolivia were to cultivate ties with Iran, it would complicate our relationship.

Question (Part 2):

Given the Administration's decision to slash development funding to Latin America, what is the U.S. doing to improve our influence in the hemisphere so we can unite our neighbors in the fight against nuclear non-proliferation?

Answer:

Foreign assistance for the region has nearly doubled since the start of this Administration, from $862,452,000 in FY 2001 to $1,696,841,000 in FY 2007. Although the FY 2007 request for Latin America represents an overall decrease of one percent from the FY 2006 request, it does not reflect a reduced commitment to Latin America. We recognize the need to expand outreach efforts and this year will continue our public diplomacy initiatives aimed at Latin American publics to widen support for U.S. policies in the region. We will also engage in vigorous counter-programming to debunk Cuban and Venezuelan populist myths while showcasing the USG's sustained efforts to improve the lives of millions in the Hemisphere. We have an excellent non-proliferation record in this hemisphere. Beginning with the Treaty of Tlatelolco, this Hemisphere has played a leadership role in nuclear non-proliferation. All of the countries in the Hemisphere are parties to the Nuclear Non-Proliferation Treaty and no countries, other than the United States, have nuclear weapons or active programs to develop them. We continue to support a Summit of the Americas-mandated Experts Group on Confidence and Security Building measures, including sponsoring workshops and seminars on development and implementation of a new generation of confidence and security building measures to strengthen civilian control of the military and address emerging transnational threats to security, thereby fostering a climate of trust, transparency, and cooperation in the Hemisphere.

Question for the Record Submitted to
Secretary of State Condoleezza Rice
Senator Robert Menendez (#4)
Senate Budget Committee
February 16, 2006

Question:

Russia and China agreed to report Iran to the UN Security Council on the condition that immediate sanctions were not imposed. Iran will also be meeting with Russia next Monday about Russia's offer to enrich uranium for Iran.

- If Iran decides to reject Russia's offer yet again, how does the Administration plan to get both Russia and China on board to take a hard stance against Iran's nuclear activities, given their economic ties to Iran?
- If Iran continues to string Russia and the rest of the world along with negotiating the enrichment deal, how long is the United States willing to wait?

Answer:

As the UN Security Council takes up the Iran issue, we hope that discussion will shine a spotlight on Tehran's nuclear program. We remain committed to working with Russia, China, India, the EU3 and EU, and others as we enter this new phase of diplomacy at the UNSC. We expect the UNSC will now seek to reinforce the IAEA's ongoing efforts in Iran and lend its weight in calling on Iran to take the steps that the IAEA Board of Governors has repeatedly called on Iran to take. The specifics of UNSC action will depend on the active consultations among Council members.

We are encouraging the UNSC, as an initial step, to issue a formal call for Iran to comply fully with the IAEA Board's repeated requests, including resuming a full suspension of all enrichment-related and reprocessing activities, cooperating fully with the IAEA, and ratifying promptly the Additional Protocol. This would reinforce the ongoing efforts of the IAEA and lend the Council's weight to the IAEA Board's calls on Iran to take steps to rebuild confidence.

If Iran defies the UNSC, as it has defied the past nine IAEA Board resolutions, we believe the UNSC should then consider additional measures to seek Iran's compliance. As diplomacy enters this new phase, we are committed to working with others in the international community – particularly Russia and China – to seek a peaceful, diplomatic solution. Such a solution must include Iran giving up its pursuit of a nuclear weapons capability.

Russia and China have been integral in efforts to persuade Iran to abandon its pursuit of a nuclear weapons capability. Russia and China both voted to support the IAEA Board's February 4 resolution that reported Iran to the UNSC and have been engaged in active high-level diplomacy with Iran. We will continue to encourage Russia and China to explore what additional bilateral measures they can take with Iran to help persuade Iranian leaders to change course. Both countries have significant commercial relationships with Iran, for example, which gives them leverage over Iranian decision-making. We continue to consult closely with Russia and China on this question, and we welcome their participation in the growing international consensus calling on Iran to renounce its nuclear weapons program.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Robert Menendez (#5)
Senate Budget Committee
February 16, 2006

Question

Why did the Administration not pressure President Abbas to forbid Hamas from participating in the election?

Answer:

Our commitment to democracy is not measured by the achievement of a particular electoral result; the evolution of democracy is a process, and that process does not always produce outcomes that are in accordance with our desires. Elections are just one part of the democratic process; with governing comes responsibility. And so what has happened in the Palestinian territories is an election that was free of violence, that was free and fair, but that brought to power a terrorist organization. Hamas, having won a clear victory over Fatah in the Palestinian elections, will now face new responsibilities and the decisions it takes will have consequences for the future of our relationship with the Palestinian Authority, the peace process, and our assistance in the Palestinian territories.

Question

I understand that you said yesterday that you do not support any money going directly to the PA and that you are re-evaluating the Administration's original budget request of $150 million to help Palestinian efforts to promote democratic reform, economic revitalization, and rule of law. What is the Administration's next step? How do you plan to use this money?

Answer:

The President's FY 2007 Budget includes a $150 million request for West Bank/Gaza in the State Department's Economic Support Fund account. This request is under review through an inter-agency process, as is all other assistance to the Palestinians. The goal is to ensure that our assistance program continues to reflect U.S. policy goals in the wake of the Hamas victory in legislative polls, and is consistent with our obligation to ensure that no USG funds provide material support for Hamas, a designated Foreign Terrorist Organization. We are going through our programs on a case-by-case basis and we will advise and consult further with the Congress when that review is completed. Our FY 2007 request will be amended consistent with the outcome of the review of existing programs and our consultations with the Congress.

Question

What is the Administration doing to help create a united front on funding to Hamas?

Answer:

Together with our Quartet partners, we have outlined a strategy based on both principle and pragmatism. The January 30 Quartet statement expressed our belief that the Palestinian people have the right to expect a new government to address their aspirations for peace and statehood. With governing comes responsibility. The Quartet stated that future assistance to any Palestinian government will be reviewed against that government's commitment to three principles: nonviolence, recognition of Israel, and acceptance of previous agreements and obligations. It is not possible to pursue a peaceful life while engaging in terrorism, nor is it possible to make peace with a country whose very right to exist is denied. Thus, we have placed the onus squarely on Hamas. Hamas will now have to bear responsibility for the decisions it makes and face up to the consequences of those decisions, which will shape the international community's approach to issues involving the Palestinians and regional peace-making efforts.

As we review our own assistance programs, we have encouraged our partners in the international community to do the same, based on the principles set forth by the Quartet. The international community has a critical role to play as we move forward, and we are working to ensure that Hamas receives the consistent message that it must commit to the principles of nonviolence, recognition of Israel and acceptance of previous agreements.

Until a new government is formed, we are cooperating with the international community to facilitate the work of the caretaker government. In the last month, we have worked with Arab governments and the international community to stabilize the finances of the Palestinian Authority and we are continuing to do so. In December Saudi Arabia and Qatar pledged additional support for the PA, thanks largely to the efforts of Quartet Special Envoy Jim Wolfensohn. We continue to maintain contact with President Abbas and Acting Finance Minister Jihad Al-Wazir to maintain the financial viability of the caretaker government.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Robert Menendez (#6)
Senate Budget Committee
February 16, 2006

Question (Part A): Year after year, the President continues to decimate funding to the Western Hemisphere. And year after year, I stand before the Administration and ask why this Administration continues to ignore our neighbors in this region. This has been the third year in a row that I have had to raise this issue at the budget hearings.

It is shocking to me that the President's budget not only slashes core development funding to the Western Hemisphere by 21.6%. And Development Assistance, in particular, was hit the hardest, with a cut of 28.5%.

- Why are you cutting the core development funds to the countries in our own neighborhood?

Answer:

Decreases in Development Assistance (DA) and Child Survival and Health (CSH) reflect USAID's refocus of assistance to target greater relative need in Africa, shifted from middle income countries (e.g. Mexico), and MCA-eligible countries where the governments are proposing programs that overlap with those in traditional accounts (e.g. Honduras and Nicaragua). It also reflects the overall reduction of the DA and CSH accounts (- $363 million) from FY 2006 enacted levels. The Administration reduced funding for CSH, the "core" health account by $136 million. Most of this reduction is attributable to a reduction in the part of our contribution to the Global

Fund to Fight AIDS, TB, and Malaria that comes from the CSH account. The FY 2007 request for Latin America represents an overall decrease of one percent from the FY 2006 request. It does not reflect a reduced commitment to Latin America.

Question (Part B):

- Why are you cutting core development funding to fund MCA, when the President promised he would not do that?

Answer:

Foreign assistance for the region has nearly doubled since the start of this Administration, from $862,452,000 in FY 2001 to $1,696,841,000 in FY 2007. Although the FY 2007 request for Latin America represents an overall decrease of one percent from the FY 2006 request, it does not reflect a reduced commitment to Latin America. We have prioritized our foreign policy goals against available resources and competing demands for assistance. For example, a reduction for middle income countries where the need is not as great allows us to increase assistance in areas such as Africa, where the need is greater. Moreover, in addition to FY 2007 foreign assistance, we will be providing Millennium Challenge Corporation (MCC) funding to Nicaragua, Honduras, and Paraguay. Since the MCC was established in 2004, it has approved compacts for Nicaragua ($175 million) and Honduras ($215 million). On February 8, MCC's Board approved a $37 million program for Paraguay as a Threshold Country. MCC funding has increased the total resources available to the region.

Question (Part C):

- Why have you ignored Congressional report language and specific language in the appropriations bill restoring funds to the Western Hemisphere? Last year's bipartisan House report on the Foreign Affairs appropriations bill said, "The Committee is disappointed that USAID has ignored Committee report language from prior years urging that greater emphasis be provided for programs in Latin America...The Committee is concerned that the Central American nations received disproportionate reductions in the request and does not believe that this reflects the priorities of United States economic, trade, humanitarian and immigration policies with these neighboring countries."

Answer:

Foreign assistance for the region has nearly doubled since the start of this Administration, from $862,452,000 in FY 2001 to $1,696,841,000 in FY 2007. Although the FY 2007 request for Latin America represents an overall decrease of one percent from the FY 2006 request, it does not reflect a reduced commitment to Latin America. We have prioritized our foreign policy goals against available resources and competing demands for assistance. In addition to FY 2007 foreign assistance, we will be providing Millennium Challenge Corporation (MCC) funding to Nicaragua, Honduras, and Paraguay. Since the MCC was established in 2004, it has approved compacts for Nicaragua ($175 million) and Honduras ($215 million). MCC funding has increased the total resources available to the region.

We believe our overall funding is at a level that will help us achieve our foreign policy goals in Central America – even as we incorporate transformational diplomacy strategies across the board that will result in more effective foreign assistance. We have in fact requested additional resources to better focus on those activities that will stimulate growth and be truly transformational. To stimulate growth in the CAFTA-DR states, in addition to the $20 million in Economic Support Funds (ESF) and $20 million in Development Assistance (DA) that has been requested for labor and environment, we have requested $30 million for rural development in the Dominican Republic, El Salvador, and Guatemala ($10 million each).

Our funding request reflects our commitment to focus assistance on trade and capacity building as we believe our greatest benefit can be drawn from trade and economic growth. U.S.-accumulated direct investment in the region is $325 billion, and two-way trade between the U.S. and the region was $443 billion for the first 11 months of 2005. The CAFTA-DR agreement has now entered into force with El Salvador as of March 1, to be followed as soon as possible with Nicaragua, Honduras, Guatemala, and the Dominican Republic, and eventually Costa Rica.

Question for the Record submitted to Secretary of State Condoleezza Rice by Senator Robert Menendez (#7) Senate Budget Committee February 16, 2006

Question:

Yesterday in the hearings at the Foreign Relations Committee, Senator Sarbanes asked why the funding for UN peacekeepers in Cyprus had been eliminated and you said you would have to get back to him. I am hoping to hear that answer today. Frankly, I am not reassured by the idea that you will find a way to fund the UN peacekeepers if they are still needed.

- What reason do you have to believe that such a force will not be needed in the future? Can you explain the reason that you eliminated these funds?

Answer:

The United States has been and remains a strong supporter of the United Nations' role in seeking a comprehensive settlement in Cyprus. UNFICYP has been an important part of this effort, and we will continue to work closely with it so that it remains an effective force supporting the eventual reunification of Cyprus. As you noted, the Department's FY 2007 budget proposal includes no funding for the UNFICYP mission. UNFICYP's mandate is expected to be renewed again for six months in June against current fiscal year funding. Should the pace of the political process require further renewals into FY 2007, we believe we will be able to reallocate funds within the CIPA account to continue our support for UNFICYP and its important mission.

Progress toward a Cyprus settlement will require creative thinking and constructive dialogue. The United States is encouraging the United Nations and the parties to the dispute to work together to move the Cyprus settlement process forward. We welcome all proposals that seek to break the current deadlock, and hope that all parties will engage and remain flexible and creative. The United States stands ready to assist the United Nations and the parties in this effort.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Jim Bunning (#1)
Senate Budget Committee
February 16, 2006

Question:

Could you comment on how the Department of State plans to continue facilitating the spread of democracy in the Middle East while also combating the rise of politically elected Islamic extremist groups?

Answer:

Supporting the growth of freedom and democracy in the Middle East has been and continues to be a top priority for the President and the Department of State. Through the resources and programs of State's Middle East Partnership Initiative, Bureau of Democracy, Human Rights and Labor, and public diplomacy programs and USAID's bilateral foreign assistance programs, the U.S. Government continues to support and facilitate democratic reform across the region. We will continue to support free, fair and competitive elections and will work to encourage democratically elected governments to govern democratically.

To combat the rise of elected Islamic extremist groups and to continue to encourage reform, democracy and openness, the U.S. Government will increase its support for the emergence of viable alternatives to autocratic regimes on one side and extremists who hide behind the cover of religion, on the other. We will continue to focus our efforts through the vehicles of moderate political parties, independent media, and civil society organizations in order to give voice to the aspirations of the majority who favor a moderate, democratic form of governance. We will also work with willing governments to reform state institutions to strengthen the rule of law and transparent governance. These efforts will be coupled with outreach to the international community and increased coordination of international efforts to arrive at a unified message for newly elected leaders: that they have come to power through democratic processes and they now have the responsibility to rule accordingly and must give up and renounce violence and terrorism.

Question for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Jim Bunning (#2)
Senate Budget Committee
February 16, 2006

Question:

Secretary Rice, in January of this year, you launched your new initiative of transformational diplomacy. In doing so, you described your plans for the global repositioning of Foreign Service officers and your vision for the future of the Department of State. Do you believe this new initiative is adequately reflected in the budget? And how do you plan to achieve these goals?

Answer:

As previously stated, the Department began in Fiscal Year 2006 to redistribute 100 positions, mostly from Europe and Washington, to countries like China, India, Nigeria and Lebanon, where additional staffing will make an essential difference. I am is committed to making maximum use of our existing resources by reprogramming several hundred additional positions over the next several years. The Transformational Diplomacy objectives in these areas can not be achieved through internal redistribution alone.

Therefore, the President has requested 70 new State Department positions in FY 2007 for Transformational Diplomacy. Congress' approval of those positions is critical to the Department's ability to ensure that the United States is in a position to carry out its responsibilities in this area and to meet the serious challenges presented in transformational diplomacy. The Department anticipates allocating most of the new positions overseas in Africa, the Middle East, and South Asia, including some in new American Presence Posts. With the support of the Congress, the United States can demonstrate important progress in addressing head on the transformational issues that are increasingly faced overseas.

Questions for the Record Submitted to Secretary Condoleezza Rice by Senator Jim Bunning (#3) Senate Budget Committee February 16, 2006

Question:

Secretary Rice, as you may know, I have been extremely vocal over the years in ensuring that the Federal Flight Deck Officer (FFDO) program to arm pilots is properly implemented by the Transportation Security Administration. At this time this program is only implemented on domestic flights. It has the potential to be implemented on international flights but doing so would require bilateral agreements between the United States and the flights' destination countries. In the past the Department of State has been reluctant to pursue these agreements. Do you see this changing in the future?

Answer:

The legislation that created the Federal Flight Deck Officer program, 49 USC 44921, states as follows: "In consultation with the Secretary of State, the Under Secretary may take such action as may be necessary to ensure that a **Federal flight deck officer** may carry a firearm in a foreign country whenever necessary to participate in the program."

The Department and the Transportation Security Administration have discussed possibilities for expanding the Federal Flight Deck Officer (FFDO) program to international air service, including the legal and policy challenges of obtaining necessary agreements with foreign governments to do so. In 2003, the Department and TSA asked the European Civil Aviation Conference (ECAC) to canvass its 42 member states not only on an extension of the FFDO program to flights to their territories but also on how ECAC member states would respond if, by reason of circumstance or diversion, an FFDO participant carried his or her weapon on a flight to their territories without authorization. After conducting the survey, the ECAC Secretariat informed the U.S. Government that ECAC had polled the member states and there was a uniformly negative view of authorizing the extension of the U.S. FFDO program to their territories. None of the ECAC countries had a similar program for arming the crews of their airlines. Moreover, ECAC explained that if a US pilot *inadvertently* brought a firearm into a country in Europe, the responses could range from arrest of the pilot(s) to terminating bilateral air services agreements with the U.S. ECAC underscored that U.S. pilots overseas would be subject to the respective countries' laws, just as their pilots are subject to American law while in the United States.

Following this unanimous, negative reaction from such a large number of the United States' major aviation markets, the Department and TSA have not sought out other countries' views, in part because it was considered prudent for the United States to gather more experience with the FFDO program domestically before approaching other governments.

If DHS decides that it is an appropriate time to expand the FFDO program, the Department of State stands ready to assist in that effort.

Questions for the Record Submitted to
Secretary Condoleezza Rice by
Senator Jim Bunning (#4)
Senate Budget Committee
February 16, 2006

Question:

Iraq Reconstruction Efforts – Department of State vs. the Pentagon
There are growing questions about the relationship between the Departments of State and Defense in areas of security assistance, humanitarian relief and reconstruction. Can you address how your new foreign assistance strategy might delineate areas of responsibility between State and the Pentagon?

Answer:

As the President's National Strategy for Victory in Iraq states, "Progress along each one of the political, security and economic tracks reinforces progress along the other tracks." The three tracks are fundamental to our counterinsurgency, counterterrorism campaign and our effort to help Iraqis build a democratic, stable and prosperous country that is a partner in the war against terrorism. All USG agencies coordinate closely to carry out their respective roles in each track. Our fundamental operating principle is that transition to Iraqi responsibility cannot be sustained without integrated progress on all three tracks.

Because success in the political, security, and economic realms are intertwined, foreign assistance funding must be an important tool in our overall effort to defeat the terrorists and neutralize the insurgency.

The Department of Defense assistance programs in Iraq have a specific focus on building the capacity of the Iraqi Ministries of Interior and Defense, which complements the focus of Department of State programs capacity-building in key non-security Iraqi ministries (e.g., Ministry of Finance, Planning and Development, Ministry of Oil, Ministry of Electricity).

There are several specific cases where the Department of State and Defense are, and will continue to be, operationally integrated to advance the President's strategy. For example, U.S. efforts in the field, including the three state Department Provincial Reconstruction teams already up and running, integrate US military and civilian efforts. Their and our other integrated field teams will lead efforts to build the capacity of local and provincial governments and leaders to deliver essential services to their communities, engage Iraqi citizens in the decision-making process, and build the trust of Iraqis in their government. Specific attention will be paid to creating synergies between State Department funding and the Commander

Emergency Reconstruction Program (CERP) Funds in order to achieve a force-multiplier effect.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Mike Crapo (#1)
Senate Budget Committee
February 16, 2006

Question:

Food Aid:

The President's 2007 budget proposes that the Administrator of USAID have the authority to use of to 25 percent of P.L. 480 Title II funding as cash to purchase food aid regionally in locations closer to where the aid is needed. A similar provision was included in the President's FY 2006 budget, and Congress rejected it.

The United States must have the ability to provide food aid quickly in response to emergency needs. If enhancements need to be made to ensure that domestically produced in-kind food aid reaches those in need in a timely manner, then those improvements should be pursued. However, the U.S. in-kind food aid system must be maintained and not eroded into a cash for purchase or cash only system. U.S. farmers and ranchers produce safe, nutritious, and abundant commodities, and I am concerned that this proposal would decrease the ability of our food aid programs to utilize our domestic food resources by transferring funds for cash purchases.

I understand that the Administration has opposed proposals calling for cash only food aid donations in World Trade Organization (WTO) negotiations. However, proposals to redirect food aid funds for cash purchases of foreign commodities seem to be a step toward monetization of food aid. Can you please explain the Administration's intentions in terms of food aid?

Answer:

What is paramount to the P.L. 480 Title II program is having adequate food aid available when needed to save lives. As part of the President's FY 2007 Budget, the Administration requested that the Administrator of USAID be granted authority to use up to 25% of appropriated Title II funds for the local or regional purchase and distribution of food to assist people threatened by a food security crisis.

- Food purchased in the U.S. normally takes up to four months to arrive at its destination, and there may be no U.S. commodities available in the region where they are needed. Food purchased locally, however, can reach beneficiaries within days or weeks.

- The ability to use a portion of Title II for local and regional purchase will allow the U.S. to move with greater speed and flexibility to save lives and prevent famine.

- Such speed is sometimes necessary when an emergency occurs with little notice (e.g., a natural disaster or an outbreak of fighting), food deliveries are unexpectedly interrupted (e.g., a pipeline break), or a cease fire allows rapid access to populations in need.

- Our U.S.-grown food will continue to play the primary role and will be the first choice in meeting global needs. We plan to use local and regional purchases judiciously where the speed of the arrival of food aid is essential.

Question for the Record Submitted to
Secretary of State Condoleezza Rice
Senator Mike Crapo (#2)
Senate Budget Committee
February 16, 2006

Question:

Do you believe that significant measures to combat corruption should be considered before direct aid, international financial institutional programs, and debt forgiveness are made?

Answer:

The United States must pursue aggressively, and where appropriate expand our bilateral, regional and multilateral programs that serve to promote transparency and good governance. Combating corruption is one of the most important processes for a developing country government to undertake to increase economic growth, and for the benefits of economic growth to spread throughout society. President Bush has placed high emphasis on such efforts through U.S. assistance programs like the Millennium Challenge Account (MCA), which supports countries that control corruption, invest in their people and promote economic freedom. The principles underlying the MCA are also the bedrock of USAID's and the State Department's anticorruption programs throughout the world. A number of the indicators used by the Millennium Challenge Corporation to evaluate country performance were developed by the World Bank and the

International Monetary Fund, who also employ these principles in their work. These agencies and institutions, in cooperation and partnership with developing countries, are working to create a new development model that provides assistance based on shared responsibility, country ownership of the development process, strong policy environments, a focus on equity and achieving measurable results. This approach will help ensure that all aid is used more effectively.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Debbie Stabenow (#1)
Senate Budget Committee
February 16, 2006

Question:

Every day 415 trucks full of municipal solid waste enter Michigan from Canada bound for Michigan landfills. In recent years U.S. Customs agents have found illegal currency, illegal radioactive medical waste, and illegal drugs in these trash shipments. The trucks are virtually impossible to screen and inspect due to their highly compacted contents, but only one-tenth of one percent of the trucks are physically inspected. I am extremely concerned about the threat Canadian trash trucks present to our national security. Are you aware of the bilateral treaty the U.S. signed with Canada in 1986 (*The Agreement Concerning the Transboundary Movement of Hazardous Waste)* that mandates that Canada notify us all of incoming trash shipments and allows us to object to the shipments? When will the Administration begin enforcing the treaty? What are you doing to implement the treaty?

Answer:

The *Agreement Between the Government of the United States of America and the Government of Canada Concerning the Transboundary Movement of Hazardous Waste* ("bilateral agreement") was modified in 1992 to establish a framework for notice and consent for municipal solid waste (MSW) shipments. However, such a framework does not become effective until both sides have put in place the necessary domestic authority to implement the notice and consent requirements, and neither the U.S. nor the Canadian government has yet obtained such authority. Because of this, it is not possible at this time to estimate when the full framework contemplated in the Agreement would be implemented and effective.

The U.S. Environmental Protection Agency (EPA) needs additional authorities under the Resource Conservation and Recovery Act (RCRA) to be able to require a notice and consent process for all transboundary MSW shipments. In the meantime, the Administration has worked within current authorities to build a MSW framework with Canada. In 2005, EPA and Environment Canada conducted a pilot project to obtain voluntary notices from exporters of Canadian MSW. The City of Toronto, the Municipality of Peel and several commercial exporters provided a total of fourteen notices that equaled roughly 40% of the total volume of Canadian MSW disposed in Michigan landfills. In addition, a joint EPA-Michigan initiative inspected waste sent to Michigan landfills from March through October 2005 to see if imported and domestic wastes appeared to be in accordance with Michigan's solid waste laws. The inspection results indicate that there appear to be very few problems for the Canadian and the Michigan shipments with respect to their compliance with solid waste laws.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Debbie Stabenow (#2)
Senate Budget Committee
February 16, 2006

Question:

Tomorrow the Office of the Inspector General at the Department of Homeland Security will release a report that Senator Levin, Congressman Dingell, and I requested regarding the screening of Canadian trash trucks at Michigan's border. The OIG reports that the process needs improvement – including a risk analysis and a standard screening process. Given the enormous risk trash shipments present to Michigan, is the Administration prepared to object to trash shipments under the treaty?

Answer:

The Agreement framework does not become effective until both sides have put in place the necessary domestic authority to implement the notice and consent requirements. Neither the U.S. government nor the Canadian government has obtained such implementating authority at this time.

The Department of Homeland Security (DHS) recognizes the possibility that the importation of municipal solid waste could be used as a means to convey illicit materials into the country. The relevant ports of entry in Michigan are equipped with radiation portal monitors that are used to detect sources of radiation, and large scale imaging systems that use x-ray or gamma-ray technology to screen entire truckloads of imported products. DHS is also identifying future technologies through their Science and Technology Directorate, and the Domestic Nuclear Detection Office to increase the effectiveness of screening and examining municipal solid waste and the many other commodities that arrive at our borders. DHS has implemented a risk management approach that uses intelligence, law enforcement data bases, commercial data and other sources of information processed through a targeting system to identify high-risk shipments. Levels of examination are then adjusted to the risk presented by the specific shipments. DHS welcomes opportunities to improve security and is committed to responding appropriately to the recommendations of the DHS Office of Inspector General.

Questions for the Record Submitted to Secretary of State Condoleezza Rice by Senator Debbie Stabenow (#3) Senate Budget Committee February 16, 2006

Question:

In April 2005, the Department of State and the Department of Homeland Security unveiled the Western Hemisphere Travel Initiative (WHTI) to satisfy a provision of the Intelligence Reform and Terrorism Prevention Act of 2004 requiring all travelers entering the United States from Canada, Mexico and the Caribbean have documents that verify their citizenship. Currently, the only document that is secure and verify citizenship is a passport. You and Secretary Chertoff recently announced a new travel document that U.S. citizens in border communities could use to cross the border in lieu of a passport – the "Passport Card." What plans does the State Department have to alleviate the difficulty faced by the casual traveler when he or she has to spend a considerable sum for travel documents to cross the border for an evening gambling and dinner?

Answer:

Section 7209 of the Intelligence Reform and Terrorism Prevention Act of 2004 (IRTPA), requires the Secretaries of State and Homeland Security to develop a plan for all travelers to present a passport or "other document, or combination of documents, deemed by the Secretary of Homeland Security to be sufficient to denote identity and citizenship" when crossing U.S. land borders. DHS has ultimate responsibility for determining acceptable alternative documentation.

The Department of State looks forward to producing the passport card, announced by Secretaries Rice and Chertoff on January 17, as part of their Joint Vision: Secure Borders, Open Doors in the Information Age. The passport card, which will be marketed as the People, Access, Security, Service (PASS) card, will be a secure, biometric-enabled citizenship and identity document that carries the rights and privileges of a standard U.S. passport, but which may only be used for travel across U.S. land borders. Border residents or other frequent travelers across the land border will be able to apply for the card at the 7,500 plus facilities around the United States currently accepting passport applications. We have significantly expanded our network of passport acceptance agents in the last several years and we continue to work with our acceptance agent partners (mainly designated U.S. Postal Service post offices, clerks of courts and county clerks) to make the passport application process easily accessible to all Americans.

We will also be launching a campaign to inform and guide the public through the WHTI transition process and address concerns that arise.

Questions for the Record Submitted to
Secretary of State Condoleezza Rice by
Senator Debbie Stabenow (#4)
Senate Budget Committee
February 16, 2006

Question:

Are you confident that the State Department will have staff and infrastructure in place to meet the deadlines for new travel documents that you have set for the end of this year and next? In particular, what plans do you have to educate the people in my state and other border states of the new requirements and how they can get the travel documents they need.

Answer:

To help meet the expected surge in demand for U.S. passports, the Department has underway a multi-year effort to increase our passport adjudication and production capacity. In FY 2003, we processed fewer than 7 million passports. That number grew to more than 10 million in FY 2005; we expect it to increase to a sustainable level of 17 million in FY 2008.

With support from the Congress, we have been able to secure funding necessary to meet this increased demand, including by receiving authority to hire in FY 2005 an additional 105 staff to adjudicate the increased number of passport applications. To meet continuing growth, we expect to add 130 government staff in FY 2006, and another 89 in FY 2007. These employees, who manage our passport function and provide adjudication services, are aided by large numbers of contract staff who handle those functions that are not "inherently governmental".

The Department has also begun transitioning its Charleston Passport Center (CPC) to an adjudication center. Later this year, CPC will cease passport production and concentrate solely on adjudicating passport applications only. The facility will operate at least two shifts per day plus routine weekend work to help meet the demand for passports. At the same time, the Department will stand up a passport production facility that will serve as a passport book personalization center. We have already solicited proposals from private vendors to supply and operate, with government oversight, such a facility (or facilities). Production center(s) will be responsible for "personalizing" the passport, i.e., printing the data page, performing quality control functions, and mailing the passports to customers. We also intend to use this facility to produce passport cards. We expect startup of the book personalization center during the 4th quarter of CY 2006. We anticipate that these actions will result in greater efficiencies that, coupled with additional staff, will permit us to continue providing first-rate customer service.

Both the Department of State and the Department of Homeland Security recognize that there are a host of issues that must be addressed thoroughly to implement the WHTI smoothly and successfully. Both agencies have undertaken frequent outreach to meet with stakeholders in the communities that will be most affected by the WHTI to explain the details of the requirements and to give citizens an opportunity to voice their concerns. We have updated our website at travel.state.gov to include current information on WHTI, and have partnered with travel associations, airlines, tourist boards, and others to help get the word out about upcoming changes to U.S. travel regulations.

A critical part of successful implementation is public participation in the regulatory process. With this in mind, jointly with DHS, we published an Advance Notice of Proposed Rulemaking (ANPRM) in September 2005 that generated several thousand public comments. This comment period, however, is not the only opportunity the public will have to review and comment upon our plans. In early spring, DHS and State will issue the proposed rule for air and sea travel (Phase I of the proposed WHTI implementation plan) with a proposed effective date of December 31, 2006. Public comments will be solicited and carefully reviewed and considered during the drafting of the final rule. In addition, we will embark upon an additional period of public outreach to obtain comments on the proposed implementation plan. A separate rule for the land border implementation phase will be issued late in 2006 or early in 2007. Throughout the rule-making phase, we will consider and work to respond to the concerns of all stakeholders.

THE PRESIDENT'S BUDGETARY PROPOSALS FOR THE DEPARTMENT OF HEALTH AND HUMAN SERVICES

WEDNESDAY, MARCH 1, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:22 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Bunning, Ensign, Conrad, Murray, Nelson, and Stabenow.

Staff present: Scott B. Gudes, Majority Staff Director; and Dave Fisher, health policy director.21Mary Ann Naylor, Staff Director and Sarah Kuehl, analyst for social security, transportation and medicare.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will convene the hearing. I apologize to the Secretary. The understanding was that we were going to have a vote at 10 and then we were not going to have a vote at 10, so we have been in the practice of running back and forth to the floor.

The Secretary obviously has a huge portfolio relative to the responsibilities of the Federal Government, and some of it is the day-to-day activity of maintaining the health and welfare of the Nation, and some of it involves significant issues of how we protect ourselves from the threats of a biological attack or potential influenza outbreak or some other major disease event. And equally important to that is the portfolio of the senior citizens' Medicare and Medicaid accounts, which we know are going to be under huge pressure as we move into the out-years.

This committee has spent a lot of time focusing on that issue, trying to put in context what we are looking at in the out-years, and I respect and congratulate the administration for bringing forward a budget which attempts to address in a small way the Medicare issue. And last year, of course, we made some progress on the Medicaid issue as a result of the hard work of the Secretary.

Whether we are going to make progress on the Medicare issue this year is very much an issue, and that is something I want to hear from the Secretary, how he thinks we can—what his road map is for accomplishing that.

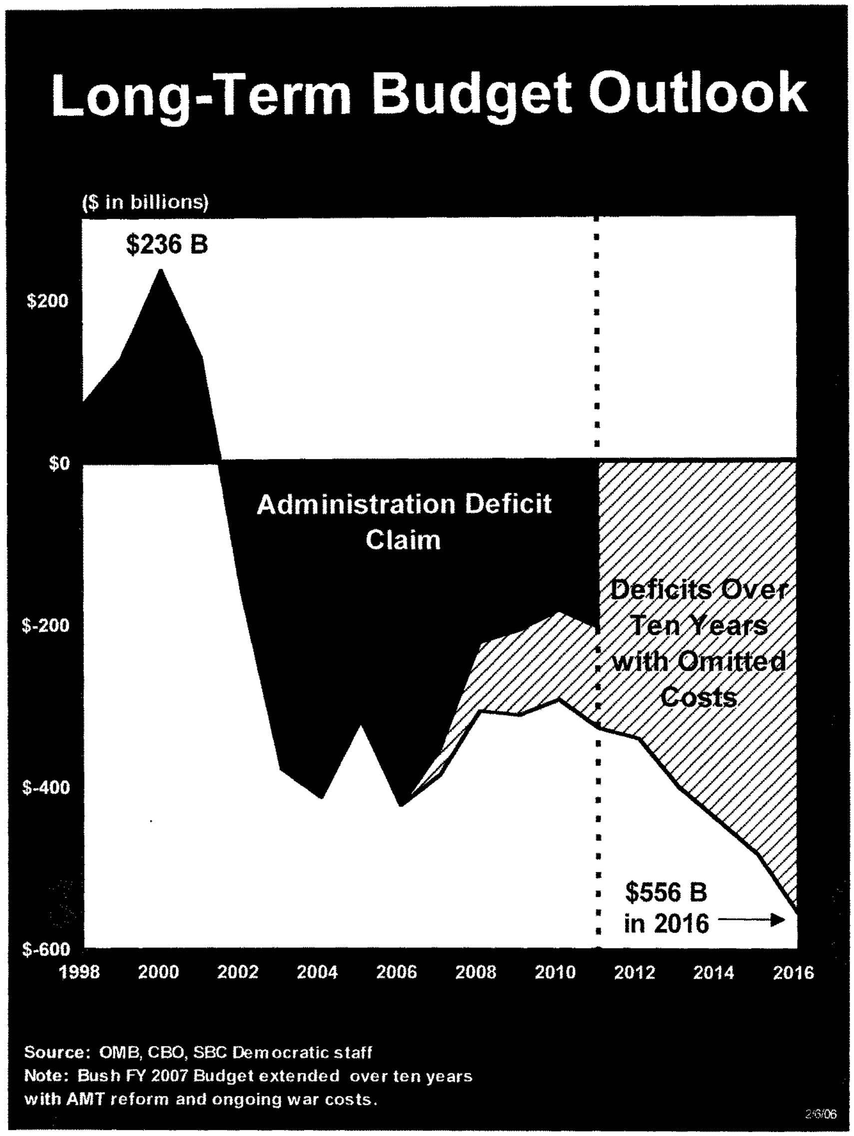
And so we look forward to your testimony. Obviously, most of your Department has been given a budget which is very constricted, and the non-defense discretionary accounts under the President's proposal essentially are flat funded, and those would almost all affect accounts within your jurisdiction. But, of course, the entitlement accounts, like Medicare, are not and they are exploding. And there is a genuine bipartisan effort here in the Congress in support of the President's efforts to try to get us ready for the potential of a pandemic flu outbreak, and that obviously has been budgeted for.

So we look forward to your testimony, and thank you for taking the time to come here, and now I will yield to the Senator from North Dakota.

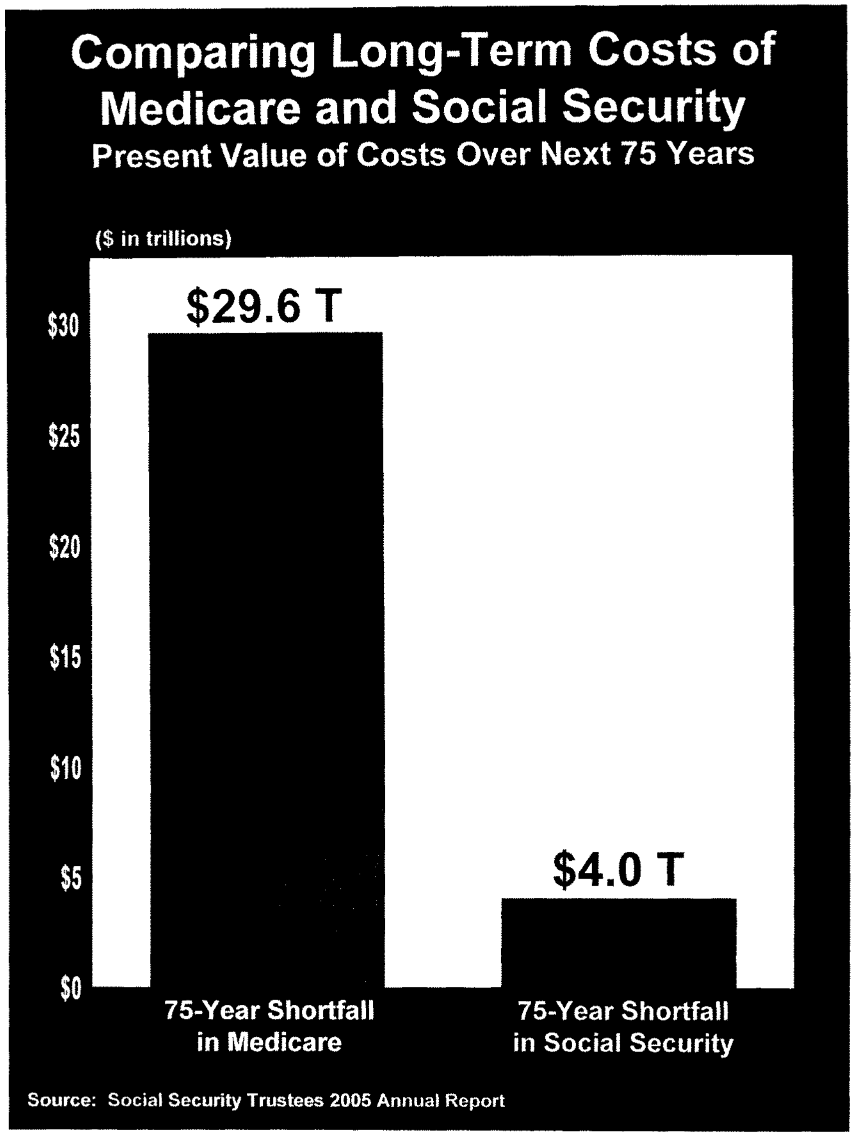
OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you, Mr. Chairman, and thank you for calling this hearing, and thank you, Mr. Secretary, for being here. I apologize as well for the unpredictability of the Senate. I have high regard for you both personally and professionally, as I have expressed to you, both publicly and privately.

I do not have high regard for this budget, and let me just run through some of what I see are the serious deficiencies of this budget.

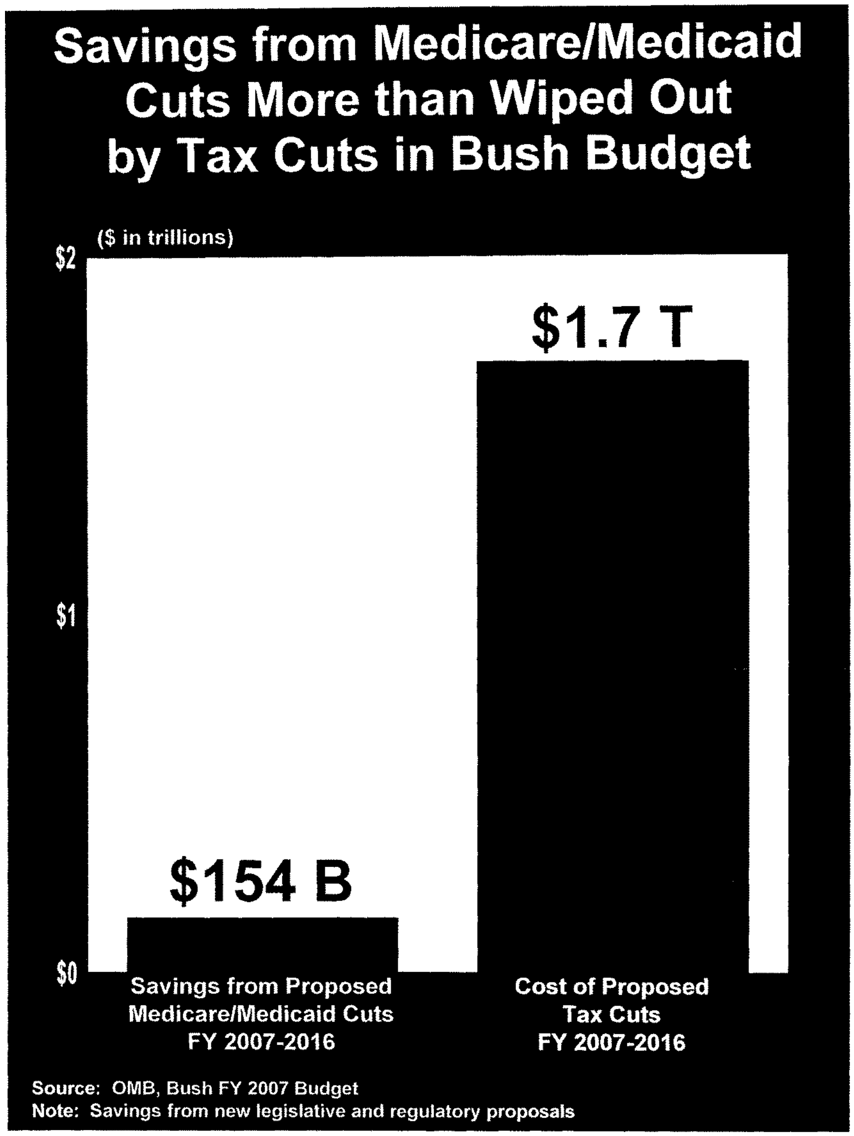

Long-Term Budget Outlook
($ in billions)
$236 B
$200
$0
$-200
$-400
$-600
Administration Deficit Claim
Deficits Over Ten Years with Omitted Costs
$556 B in 2016
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
Source: OMB, CBO, SBC Democratic staff
Note: Bush FY 2007 Budget extended over ten years with AMT reform and ongoing war costs.
2/6/06

We heard from the administration the deficit is going to be cut in half over the next 5 years, but they only get there by leaving out things: war costs, the costs of fixing the alternative minimum tax, and the full cost of the tax cuts beyond the next 5 years. When you put all those things back in, this is our projection of where the deficit heads, and we do not think that is a healthy direction. The growth of the debt is even more alarming. As you know, the debt is growing much more rapidly than the deficit. This year the President says the deficit is going to be in the $400 billion range, which I think somewhat overstates the deficit for this year. But the debt will go up, according to our calculation, $630 billion this year, and every year for the next 5 years under the President's budget proposal we see the debt increasing $600 billion or more each and every year.


Comparing Long-Term Costs of
Medicare and Social Security
Present Value of Costs Over Next 75 Years
($ in trillions)
$30
$25
$20
$15
$10
$5
$0
$29.6 T
$4.0 T
75-Year Shortfall
in Medicare
75-Year Shortfall
in Social Security
Source: Social Security Trustees 2005 Annual Report

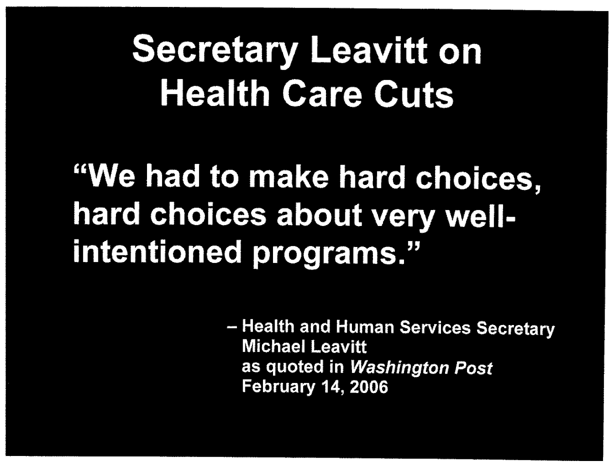
You understand this challenge very well. As we look at the unfunded liabilities of the country, Medicare is by far the biggest. This is the 75-year shortfall in Medicare, $29.6 trillion. It is more than 7 times the projected shortfall in Social Security. And, by the way, I think the projected shortfall in Social Security is somewhat overstated for technical reasons I will not go into, but I do believe the shortfall in Medicare is very real. And it is the thing that is going to swamp the boat.

Let's go to the next chart.


Savings from Medicare/Medicaid Cuts More than Wiped Out by Tax Cuts in Bush Budget
($ in trillions)
$2
$1
$0
$154 B
$1.7 T
Savings from Proposed Medicare/Medicaid Cuts FY 2007-2016
Cost of Proposed Tax Cuts FY 2007-2016
Source: OMB, Bush FY 2007 Budget
Note: Savings from new legislative and regulatory proposals

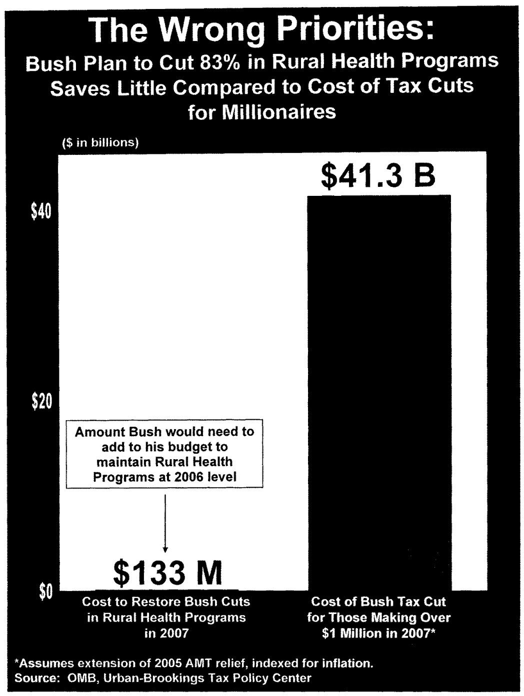
Then I look at the specifics of the President's budget, and for 2007 through 2016, he proposes $154 billion in savings from Medicare and Medicaid. But during that same period, he proposes tax cuts of $1.7 trillion, more than 10 times as much. Frankly, I do not think these proposed tax cuts are affordable given the fact we cannot pay our bills now and given the priorities of the American people.

Let's go to the next chart.



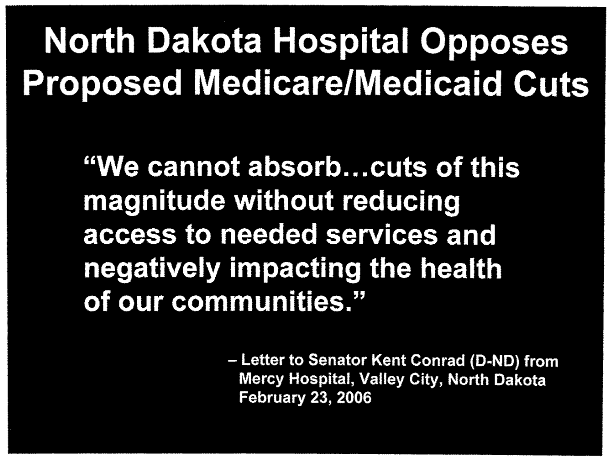
This is a statement, Mr. Secretary, you made that I very much agree with: "We had to make hard choices—hard choices about very well intentioned programs." I agree that these are hard choices. I do not agree with the choices that have been made because I do not see any justification for having 10 times as much tax cuts as we are having in terms of spending savings.

Let's go to the next slide if we could.

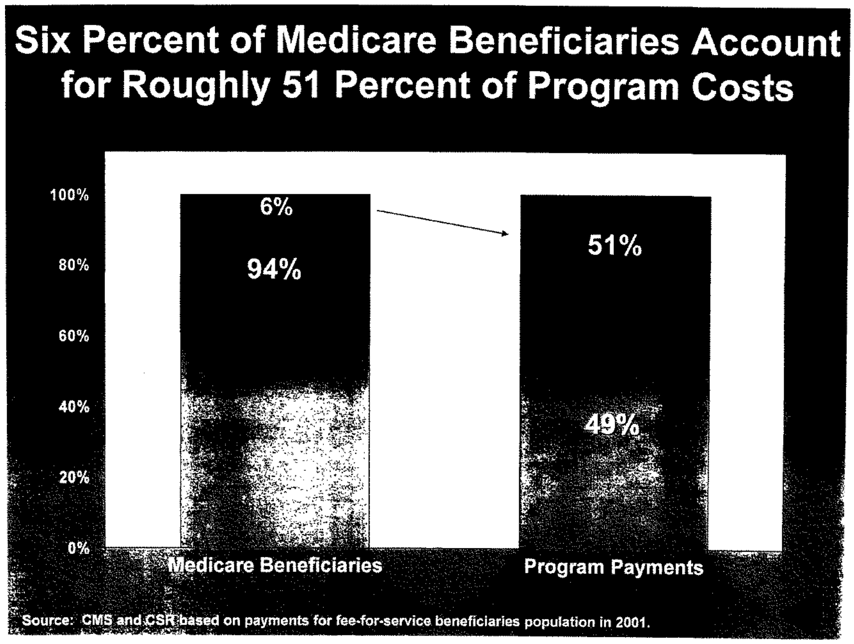


Then we get to an issue of priorities. In the President's budget, he would cut rural health care programs $133 million. During this same year, tax cuts, the cost of the tax cuts going to those who earn over $1 million a year is over $41 billion. You know, I think we are going to have to go to the wealthiest among us and say, you know, everybody has to sacrifice here. We are at war. We are piling up debt at a record rate. We have to get everybody here pulling the wagon. We cannot be saying to those who are the wealthiest among us, "You get a pass."

Let's go to the next slide.



This hospital administrator back home says, “We cannot absorb cuts of this magnitude without reducing access to needed services and negatively impacting the health of our communities.” This is from the head of Mercy Hospital in Valley City, North Dakota. Valley City is a town close to where we were when you were with me in Fargo, and this is the consistent message I am getting back from back home.


Six Percent of Medicare Beneficiaries Account for Roughly 51 Percent of Program Costs
100%
80%
60%
40%
20%
0%
6%
94%
51%
49%
Medicare Beneficiaries
Program Payments
Source: CMS and CSR based on payments for fee-for-service beneficiaries population in 2001.

Let me go to my last slide because this goes to the question of what do we do about all this. This to me is the most compelling statistic: 6 percent of Medicare beneficiaries account for roughly 51 percent of program costs. I think collectively we have to focus like a laser on that fact—6 percent of Medicare beneficiaries are using over half of the Medicare budget. This to me is the major opportunity to both save money and get better health care outcomes, because I do not think we are doing a good job of coordinating the care. The result is these people are taking many, too many prescription drugs, many of which work against each other. They are being subjected to all kinds of duplicate testing. And these factors actually make their health worse and cost the taxpayers massive amounts of money. Of course, it costs the patients massive amounts of money, too.

So I hope that in this hearing today we are able to have a conversation about what could we do that would be effective at saving money here and improving health care outcomes. And then, Mr. Secretary, I just want to say I am going to try to focus on avian flu and what the plans are there and what we need to do to get ready, because I am convinced the risk is enormous, and you and I have had a long conversation on this matter before to talk about the strategy for how we get ready to combat a pandemic, whether it was avian flu or caused by some other virus.

I thank the Chair. I thank the Secretary.

Chairman GREGG. Thank you, Senator, and we welcome you, Secretary. We also welcome Vince back, Vince Ventimiglia, who has been a friend and a tremendous asset to the Senate for many years, and now I know is the same for your office, and has written most of the major health legislation that has come out of the Senate over the last 6 years.

So we would like to hear what you have to say.

STATEMENT OF HON. MICHAEL O. LEAVITT, SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary LEAVITT. Well, thank you, Mr. Chairman and Senators. Thank you very much for having me here. I am here to speak of a budget that is a large budget, $700 billion. You well know that it is broken into two general pieces. There is the entitlement budget and then there is the discretionary budget. The discretionary budget is about $75.5 billion of that nearly $700 billion. The balance of it is the entitlement budget.

The discretionary budget that I will present to you today is roughly down $1.5 billion. This is a deficit reduction budget. As Senator Conrad pointed out, there are hard decisions that have to be made in this kind of a context, and today I am here to talk with you about how I went about making the decisions I made. There will be areas on which we have disagreement, where you would have made different choices than I did. My purpose is simply to tell you the basis on which I made my suggestions.

But I do want to speak for a moment about the same subject that you have raised, both of you, and that is the entitlement budget. This is of grave concern to me. It is to the President. You have expressed it in trillions of dollars. A trillion is a startling number on its face. I have begun to focus on this in a different way, and that is, what is the percentage of the gross domestic product that these expenditures make up?

As you are aware, we recently put out a report indicating that health care in total is now over 16 percent of the gross domestic product. By 2015, we are projecting it will be 20 percent. But an even more startling statistic than that is that Medicare alone today is 3.3 percent of the gross domestic product. If you project forward, by 2040 it becomes 8.14 percent of the gross domestic product. If you go into the same range where you were looking into the 70-, 75-year range, it becomes 14 percent of the gross domestic product. Once you get to that point——

Senator CONRAD. Medicare alone?

Secretary LEAVITT. Medicare alone. Medicare alone.

Now, I have to confess that when I get to that point, I am discouragingly amused by those numbers because no economy in the world will be viable at that point. And so for us to project that far is a mathematic exercise because we will have been eliminated from the competition economically. And the capacity to sustain it simply will not be there. So we need to act, and I want to be clearly and firmly on record. This budget does present some modest ideas on how to get started. The President has been speaking about the need for bipartisan action, and I hope we will get a chance to talk about that some today.

This is a Budget Committee. You deal in the strategy of the budget and, therefore, I think it would be helpful for you to know how I have approached this strategically. There are new initiatives that are proposed in the budget. A good example of that would be the Health IT budget. These tend to be things that I believe will help us find efficiencies and that will help stave off costs in the future.

Another example of that would be the HIV/AIDS treatment and testing program—again, new initiatives you will find. You will find some Presidential initiatives that continue to be funded here. For example, the President's community health centers initiative is a good example, his faith-based initiatives. Again, these are commitments that he has made that we have continued to press forward on. You will see a substantial commitment to bioterrorism and pandemic funding, subjects that I know are of interest to this committee.

I have found dollars in this budget to fund those new initiatives or initiatives that I think are highly efficient initiatives by looking for funds that are one-time and moving them into that category, looking for programs that are being addressed by a multiple of agencies and eliminating those duplications.

I have looked for funds that are carryover that I could move into those areas, and there are a number of programs in the budget that we propose be eliminated or cut or reduced before that were not, and I have gone back and included those.

I have also then said to my colleagues who were helping prepare the budget, I want to lay out a series of principles, and I want you to take every investment that we make and I want you to lay it against those principles, and it might be helpful for you to know what my principles are. You will obviously have identified your own.

I am looking for investments that are targeted. We do a lot of general investment in Federal budgets. I am interested in looking for places where the specific need is. We are brilliant at proportionate distribution. We are not as good at finding targeted benefit, and so I hope you will see that reflected here, targeted benefit.

I am a big believer in prevention. Health care in general, we have to redefine health care not to mean treatment. It needs to be prevention giving equal rigor to just treatment. And so prevention you will see emphasized.

You will see an emphasis in actually delivering services as opposed to infrastructure. This is a deficit reduction budget. We all know infrastructure is important, but you will see me opting and tilting toward treatment of people as opposed to building the infrastructure where I had to choose between two.

You will see a bias on my part toward consumer choice. You will see a bias on my part toward markets because I believe they find greater efficiency. You will see a clear inclination on my part to invest in new technology, recognizing that there are a lot of research projects that may have run their course, and we ought to be investing in new opportunities as opposed to those things we have been perhaps investing in a long time that are not producing benefit.

HHS is a huge Department. There are many silos, and so you are going to find a bias on my part toward things that cover the entire Department. I have tried to find ways—things where there are two different agencies or operating division that may, in fact, be investing in the same thing, I have tried to bring those together. What that means is that sometimes it looks like there is a reduction, when in reality I have just brought them together. You will see that I have tried to bias our investment toward the things that I can demonstrate are being efficient. So those are the principles.

Now, you will also, as I indicated, you will see an inclination on our part to invest on a risk basis as opposed to simply a proportionate basis. Those are the principles.

Now, we undoubtedly will have disagreements on how to apply those principles, and you will have your own, and we are now presenting this budget for the legislative branch to go ahead and exercise its priorities. But I am delighted to be here today to defend my own judgments and be helpful in the conversation. So thank you, Mr. Chairman.

Chairman GREGG. Thank you, and I agree with your approach, by the way, especially this concept of picking issues you can solve versus trying to do a broad-brush approach.

But on the grounds of being helpful—we are going to start the clock here. On the grounds of being helpful, this is the problem: I want to do a $35 billion adjustment in Medicare. I think it needs to be put in the context of what it represents. I think Medicare over the next 5 years will spend something like $2.2 trillion. The rate of growth of Medicare is somewhere in the vicinity of 48 percent over that period; that if we were to do $35 billion in savings in Medicare and the rate of growth, that would reduce the rate of growth to 45 percent or something like that; that it is really—the proposals that the White House has put forward came out of the MedPAC study, as I understand it, primarily, which was an independent group of health professionals, do not have a partisan axe to grind, are not part of the administration, and essentially said these are places we can save some money that make sense. It is primarily changing the market basket for hospitals. And the failure, of course, to move forward in this area means that we are just allowing the cliff to come closer, and without any plan for how we are going to get over the cliff, get past it.

So the baby-boom generation is not going away. It is here, and it is going to retire, and it is going to double the size of the retirement community. And as Senator Conrad has pointed out in his numbers and as we have tremendous testimony in that creates a $26 trillion unfunded liability, you mentioned that goes up to 14 percent of GDP, which is a number that is not comprehensible or even viable in any scenario. It would basically wipe out our children and their capacity to have a decent lifestyle.

So the question becomes: How do we do this? How do we actually put in place $35 billion—which is a lot of money but in the context of the overall spending on Medicare, it still means Medicare would be growing at 45 percent. It still means it would be spending $2.2 trillion plus over the next 5 years. So how do we do that? Because I have wandered around the halls talking to my colleagues, and I do not sense that on the other side of the aisle there is any support for it. And, of course, on our side of the aisle, moving into an election year, the response is, "Well, can't we put this off?"

So give me the road map that gives me 51 votes to pass this concept of reducing Medicare by—reducing the rate of growth of Medicare from 48 percent down to 45 percent.

Secretary LEAVITT. Senator, let me break my thoughts into two parts.

The first is we ought not to have this conversation without acknowledging that underlying all of our worry here is the fact that Americans are not living very healthy lives right now, and that it is, in fact, driving our health care costs through the roof. Senator Conrad used a chart that showed a small percentage eating up a big piece. Some of that is end-of-life issues, but a big part of it is people who suffer from chronic illness. Roughly 75 percent of all of the expenditures in our health care general come from people who have chronic illness. That has substantially increased over the last number of years. Those are diseases that are to some extent preventable and to a large extent manageable, and in my judgment, has to become, as was indicated earlier, part of our focus on how can we inspire Americans to live healthier lives, because we are paying a price. They are paying a price in—they are paying the physical pain. We are all paying the fiscal pain. And we will. So that has to be a big part of it.

But let's deal with Medicare as a program for just a moment and how we go about navigating the treacherous political waters that are involved in this dilemma.

I would just offer this observation: I think it is unlikely that any one Congress is going to act in a way as to be bold enough to fix this problem with a silver bullet. It is not likely. It is also my judgment that it is difficult to get legislative bodies or political bodies in general to deal with these issues, and that we may need to set up a construct that over time holds the discipline for that to occur. The President's budget proposes or suggests that we use a hard trigger, that is to say, that if, in fact, 45 percent of the revenue—45 percent of the proceeds going to fund Medicare come from general revenues, anything above that would trigger reductions in the program or would require some kind of action on the part of Congress to deal with it.

I think ultimately that is the road map, Mr. Chairman, and a lot of refinement will have to be made to that, but this is a first step of a series of small actions that would need to be required if we were to achieve it.

Chairman GREGG. Thank you. I will come back. I have additional questions, obviously, but my time has expired, and I will turn to the Senator from North Dakota.

Senator CONRAD. Thank you, Mr. Chairman.

In my questioning, I am going to really try to focus on avian flu because I am extremely concerned about the threat to our country. I told the Secretary, as he came in, that I have just been reading this book. The Secretary tells me he has read it twice cover to cover. I have read about half, and half is enough to make your hair stand on end. This is about the 1918 flu epidemic and how devastating it was worldwide. Nobody really knows how many people died. Some estimates are as high as 100 million people died.

We know that there is an enormous risk with avian flu, and whether it is avian flu or some other pandemic, it leaves us with the same questions; that is, are we doing everything we can do to prepare for this threat?

The Washington Post
Monday, February 13, 2006

Pandemic Preparedness

THE ARRIVAL OF avian flu in Africa means that the bird epidemic is officially out of control. None of the methods used against it so far — mass vaccination of poultry flocks in China, mass bird slaughter across Southeast Asia — has prevented wild birds from spreading the H5N1 virus across the globe, to Italy, Greece, Bulgaria and Azerbaijan, as well as Siberia and Indonesia. The flu has probably been killing birds in Africa for many months and will probably not be stopped: In poor countries with weak or nonexistent veterinary controls, where chickens are the only source of protein and no compensation for farmers for loss of their livestock is likely, it will be impossible to enforce either mass vaccinations or mass slaughter.

Knowing the flight path of migratory birds, many predicted the disease would arrive in Africa. But predicting a disaster and being prepared for a disaster — as this country learned during Hurricane Katrina — are not the same thing. Despite high-level attention paid to this issue, by President Bush as well as the United Nations, neither Africa nor the international community is even remotely prepared for an epidemic of avian flu or for a human disease that could develop if the virus mutates.

Congress has allocated $280 million for flu surveillance and preparedness abroad, but none of that money has been spent yet. The United Nations has appointed David Nabarro, a senior flu expert, to coordinate international efforts — but many donors' projects still duplicate one another. The international health system, such as it is, remains totally inadequate. The World Health Organization cannot send more than a handful of officials to any one country. The Food and Agriculture Organization, which theoretically deals with the animal side of the problem, employs fewer veterinarians than the U.S. Centers for Disease Control and Prevention. So strapped is the world for health personnel that after conducting a flu pandemic simulation exercise at the recent World Economic Forum in Davos, Switzerland, Mr. Nabarro stated that the maintenance of water and power systems in a real pandemic might prove key, since it may become "more important to concentrate on the essentials of life for those who are living than it is to focus on the treatment of those who are sick."

Progress has been made in the realm of antivirals, drugs such as Tamiflu and Relenza that can relieve flu symptoms. Roche, the maker of Tamiflu, is negotiating licensing agreements with companies in China, India and Vietnam so that they can produce generic versions. The WHO has a stockpile of Tamiflu, enough to be used in a concentrated manner should one or two outbreaks begin in a country with no stockpile of its own (as is the case in most of Africa). But it is no closer to mass capability than the United States, which has a stockpile of 4.3 million courses of Tamiflu. The administration's goal is 81 million courses, but no one knows when it will be reached. Of course, there is no guarantee that antivirals work: The virus may mutate and become resistant to Tamiflu anyway.

Given the overwhelming challenges of preparation as well as the uncertainties surrounding antivirals, it would make the most sense to focus on a vaccine. And vaccine research is being carried out, in Vietnam, China, Russia and Hungary, as well as the United States. But although meetings among international scientists will be held this summer, in the hopes that they will exchange information and speed up research, officials at the Department of Health and Human Services agree that they still "don't have visibility" about what everyone is doing. Furthermore, some U.S. companies say that they remain confused about this country's vaccine development program, which lacks a timeline, leadership and clear incentives for the private sector.

In other words, cross your fingers. Maybe the pandemic will never come.

Let me put this up. This is a Washington Post—I am sure you read, Mr. Secretary, this editorial from February 13th. And I would direct your attention to the last full paragraph, and it says, "Given the overwhelming challenges of preparation as well as the uncertainties surrounding antivirals, it would make the most sense to focus on a vaccine. But although meetings among international scientists will be held this summer in the hopes they will exchange information and speed up research, officials at the Department of Health and Human Services agree they still don't have 'visibility' about what everyone is doing." In other words, there is not much coordination.

"Furthermore"—and this is what I would like you to respond to specifically—"some U.S. companies say that they remain confused about this country's vaccine development program which lacks a timeline, leadership, and clear incentives for the private sector."

Mr. Secretary, is there a timeline? And where is the leadership? And what are the clear incentives for the private sector to produce a vaccine?

Secretary LEAVITT. I have met on a number of occasions now directly with the heads of all of the producers of vaccines in the United States. The President has met with them as well. They made clear to us that they need three things in order to proceed with the development of vaccines. The first is protection from the liability that historically has been there when a vaccine was developed in a rapid fashion.

Senator CONRAD. OK. Let's take them each in turn. Have we done that?

Secretary LEAVITT. Yes, we have.

Senator CONRAD. OK.

Secretary LEAVITT. We have done so.

Senator CONRAD. OK. So they got—that is No. 1. No. 2?

Secretary LEAVITT. The second is that they need to have some certainty that there will be a market if they produce the vaccine. The answer to that is yes, we would be the market if such a vaccine were needed.

Senator CONRAD. And what has been done to make certain that they understand that that is the case?

Secretary LEAVITT. Well, we are now in the process and will within a matter of days or a couple of weeks announce a series of contracts that we have negotiated after response to requests for proposals that will drive forward not just the development of new facilities, but also the development of new technologies in the cell-based manufacturing realm. We are quite optimistic. Because we are still in procurement, I cannot be more specific than that, but I can tell you that in a very short time we will have deployed the resources, the first phase of the resources that Congress appropriated just a little under 2 months ago, not just in the area of vaccine, new cell-based vaccine and facilities, but also adjuvant technologies and also rapid diagnostics.

Senator CONRAD. And, Mr. Secretary, will you keep the committee informed as to your progress on that point?

Secretary LEAVITT. Indeed I will. In fact, I will be issuing within 2 weeks a full report to the Congress and to the American people on our progress on our comprehensive plan for pandemic preparedness, and I will periodically do that. The vaccines are one part of a comprehensive plan. I am currently involved now in 50 State summits. By the end of this week, I will have done 18, and we have virtually every other State now scheduled or in active conversation. And by the end of April, we will have accomplished that.

Senator CONRAD. And what is the third point? You mentioned there are three things that pharmaceutical makers have said are necessary: point No. 1 was protection from liability; second was certainty of market. The third?

Secretary LEAVITT. Regulatory streamlining. They made clear that if we go through the normal process of approvals through the FDA of facilities, that it will elongate the process in a way that would be defeating to our ambition. And so I am working directly with the Food and Drug Administration. They are going to be using a streamlined and—not short-cut, but a streamlined process where we are essentially approving as they are developed, as opposed to waiting until they are developed and then approving.

Senator CONRAD. And is there any action required by the Congress to accomplish regulatory streamlining?

Secretary LEAVITT. No. We got the authorities in the defense authorization budget that appropriated the money, as well as where needed. We can proceed and we are proceeding, and I think you will find when the report is issued that we are making rapid and aggressive progress.

Senator CONRAD. Do you have a timeline with respect to vaccine development?

Secretary LEAVITT. Well, yes, we do. I can tell you that it will likely be 3 to 5 years—now that is a timeframe, but what we are essentially doing, Senator, is we are involved in co-venturing with the pharmaceutical manufacturers or the vaccine manufacturers a series of new technologies. It is possible that one of those will break through. We are not just counting on one. We are counting on multiple strategies. We have multiple strategies we are working at the same time.

Senator CONRAD. What do we do if the pandemic hits before that 3- to 5-year period?

Secretary LEAVITT. Let me provide you some insight or at least offer some insights on vaccines as a strategic component of our plan.

Any way you look at it, if we have a pandemic virus that begins to transmit from person to person, we are likely to be through—we will most certainly be the first 6 months without a vaccine because it takes that long, even in our most ambitious plans, to identify the virus and be able to develop a vaccine, go through the testing element and get it manufactured. So let's assume that it happened in a remote village in Thailand today. It would likely be 30 days, maybe 45 days before it came to the shores of the United States. At that point it would begin to move. We would be in full alert by that time and have implemented our National Response Plan and will have identified samples and have gone to the process of identifying the vaccine.

Any way you look at it, we are going to be 6 months before we have the capacity to start providing those vaccines, and we will undoubtedly have been through the first wave of the pandemic, and we will be dependent upon good public health measures to protect us, and that is why the other components of the plan are so important.

Chairman GREGG. Thank you.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. I would like an opening statement to be put into the record, if it is all right.

Chairman GREGG. Of course.

Senator BUNNING. Thank you.

[The prepared statement of Senator Bunning follows:]

Jim Bunning

Statement for Senator Jim Bunning
Budget Committee Hearing
March 1, 2006
HHS Budget

Mr. Chairman. Thank you for holding this important hearing today. The budget submitted to Congress for the Department of Health and Human Services makes some significant changes to many of the programs under its control, and I know many of these changes will be controversial.

In the 2007 budget, the Administration has proposed curtailing discretionary spending by $1.5 billion for Fiscal Year 2007. This will mean that several programs will either receive a cut in spending or will be eliminated, including programs for rural health and the Centers for Disease Control and Prevention.

Other programs, like the National Institutes of Health, will receive flat funding.

The Administration has also proposed reducing spending in the Medicare program by $2.5 billion in 2007 and $35.9 billion over five years, along with proposing a number of legislative and administrative changes to Medicaid which will save a little over $13 billion over 5 years.

This won't be an easy task. Last year, we worked on a deficit reduction bill which saved $10 billion from the Medicaid and Medicare programs. It wasn't easy getting this bill through Congress and onto the president's desk.

However, spending by the federal government must be brought under control if we don't want to leave a legacy of sky-high taxes for our children and grandchildren. With the baby boomers beginning to retire, I'm afraid that if Congress doesn't take a hard look at Medicare and Medicaid, along with our other entitlement spending, these programs will be overtaxed and too expensive to operate – potentially leaving many Americans without the supports they had expected.

Finally, I want to say a few words about the new Medicare prescription drug benefit. The program has been in effect for about two months, and there have certainly been some problems with the start up. However, I am confident that "HHS" and the Centers for Medicare and Medicaid (CMS) can work through all these issues.

I also think it's important to point out that for millions of beneficiaries the benefit is working well. About one million prescriptions are being filled every day through the program. Although we still have work to do, that is quite an accomplishment.

I look forward to hearing Secretary Leavitt's testimony and appreciate the time he has taken to be here today. Thank you.

Senator BUNNING. Your budget that you have proposed for HHS includes a reduction in mandatory spending of $2.5 billion in fiscal year 2007, $35 billion over 5 years. The budget also includes some legislative and administrative changes that would save about $13 billion in Medicaid over the same period of time. That is a $48 billion savings. I want you to tell me why the administration feels these changes are so important this year, especially, not last year or the year before, why are we doing it this year?

Secretary LEAVITT. Well, Senator, this has to be a long-term strategy because what we are doing this year is only an increment of what ultimately has to be done to keep these programs sustainable. When you compile the impact of Medicaid and Medicare together, we are seeing growth rates that are simply unsustainable in the long term. And, frankly, they are not as efficient.

Now, we believe that we will see substantial improvement based on authorities that were granted in the statutes in the Deficit Reduction Act. We think we will begin to see States innovate and that many changes will be made that will improve Medicaid as a program and allow us to begin serving more people with basic health care.

Senator BUNNING. For more efficient spending of our money for that?

Secretary LEAVITT. That is correct. I also am optimistic that we will see our capacity to assist more people with basic health care as opposed to having relatively fewer people have unlimited care increase. And that is a basic strategic change that I believe is beginning in Medicaid.

Senator BUNNING. You have also proposed in your budget to allow States to use drug formularies in their Medicaid programs like in the private sector. What kind of change do you think this will have on the States' Medicaid programs and beneficiaries? In other words, are we really going to allow the States themselves that do get waivers, particularly—Kentucky just got a waiver. Will that really impact the cost not only for the Federal Government but for the State government, because we are going to run about a $750 million deficit in Kentucky unless we do something very dramatic.

Secretary LEAVITT. Senator, the States have needed to have the same tools that any private sector manager of benefits would have, and one of those would be formularies, the ability to use generic drugs where necessary or to find a class of drugs where there may be more than one alternative, one being much cheaper. When we are providing prescription drugs to a large population, having that management tool is an absolute necessity.

Senator BUNNING. You as the Secretary of Health and Human Services, how do you get the message out that when you reduce the growth in a program, it is not a cut?

Secretary LEAVITT. I repeat——

Senator BUNNING. In other words, if you are reducing the growth in Medicaid and Medicare over a period of time from 48 to 45 percent, how do you get that message out when other people are trying to pound and say that we are actually cutting the program?

Secretary LEAVITT. Well, I have found the phrase useful to express the fact that we are allowing it to grow at a slower rate.

Senator BUNNING. Who is listening?

Secretary LEAVITT. Well, you and I are.

Senator BUNNING. Well, I know that, but who else? The American people, are they listening? Or can you get that message out so that people understand if we don't do something by 2030 or 2035, three programs, mandatory programs, are going to take up 75 percent of the total budget of the United States of America?

Secretary LEAVITT. Well, not only are the Governors listening, they are speaking. They know that this is true, and it is beginning to crowd out in their States many of the other important duties that they undertake, such as education and public safety. They have led the charge to this committee and to others to say we need the tools. What we want is to be able to provide coverage, to provide assistance to a larger group of people. And we can do that and be able to make the program more efficient if we have the flexibility.

Now, I believe Congress has made a historic step in the Deficit Reduction Act in providing a whole series of tools. We are working with States and propose even more tools that would allow States that capacity. Medicaid is thought of as one program. The reality is it serves a whole series of different groups of people. The dilemma has been we have tried to use one approach to cover everyone. We will be far better if we can acknowledge that Medicaid does serve people who are aged and who are disabled and children who are in protected classes, and they have very specific needs. It also serves a lot of people who just need help buying insurance, and the needs of one group are different than the other. And what has been important is to provide States with the capacity to meet those needs with specific tailored approaches.

Now, a big step was taken by the Congress with the Deficit Reduction Act. It has given States a new set of tools, and I believe that those tools will have a profoundly important role in being able to help us meet the needs of those groups in a better way.

Senator BUNNING. Thank you. My time has expired.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. And welcome, Secretary Leavitt. It is a pleasure to see you again, and while I have concerns about the budget, I have great admiration for you and have enjoyed working with you in your different hats that you have come before us with.

Secretary LEAVITT. Thank you, Senator.

Senator STABENOW. First, a couple of comments and then a question. When we look at Medicare cuts in the budget, hospitals, nursing homes, home health providers and so on, in terms of reimbursement cuts, what we see in the State of Michigan, with major manufacturers, major employers providing private insurance, is a cost shift. I don't see that saving money. I think there are things that we can do to save money as you talk about managing, whether it is chronic diseases or dealing with Health IT that I want to ask you about, but just for the record, Mr. Chairman, I do not see where we save dollars by cutting reimbursements that mean people end up either in emergency rooms sicker than they should be, getting treated, and then the cost is given to employers who see their rates go up, or hospitals who raise rates because their reimbursements are less through Medicare.

So this has become a huge issue for our major employers in the country and certainly in Michigan when we look at the cost shifting that is going on.

What I believe saves money—and I know you do as well from what you have talked about before—are initiatives like Health IT. And I am pleased that we were able to pass the legislation dealing with interoperability.

But my question deals with where do we go from here, because when we look at the budget, we see $116 million in for the Office of—it appears that there is about $53 million in for small grants, which is not going to do much. I mean, that is what? A couple of hospitals, maybe. I do not know. But it is not very much in terms of getting us where we need to go, and yet David Brailer's office has testified that hundreds of billions—hundreds of billions of dollars can be saved by doing what you have spoken about, what I have spoken about.

Senator Olympia Snowe and I have legislation that would allow some flexibility by using Medicare trust fund dollars to be used to purchase hardware, software, training, which we know will save the Federal Government, Medicare, Medicaid, as well as the private sector dollars. Tax incentives for physicians to be able to have accelerated depreciation to purchase the hardware, software, and so on.

Could you speak to how you see us moving ahead on something that is clearly a bipartisan initiative? We have leaders in both parties speaking out, the President, yourself, and yet I do not see the movement in this budget that allows us to get there quickly and in the context of what we are talking about in terms of savings that has to occur in these programs. I do not understand why we are not moving more quickly, and certainly we would welcome your support for the legislation that Senator Snowe and I have introduced.

Secretary LEAVITT. Thank you, Senator. Could I answer your question in the context of the first subject you raised, which was physician reimbursements and how that in and of itself does not "save money." It, in your suggestion, moves it from one account to the other.

This is a prime example of how we have to change the entire way we think about health care and reimbursements. If we had Health IT in place where we were able to measure the impact of health care as opposed to the number of procedures, if we were able to pay physicians on the basis of performance and improvement in health, we would be able to have a rational way of seeing that trend turn down. What is lacking at this point is a way to collect that data in a consistent and clear way.

Health IT is a critical part of that. There are two parts of Health IT. The first is adopting, that is to say, how do we get computers in every office and have everyone able to use them, and then the second is interoperability, the ability for those systems to work together so we have a consistent way of doing it.

One of the worries is that if we are not fueling people buying systems that are not compatible, then, in fact, what we are doing is essentially investing our way into a state of incompatibility.

Now, we are working hard on both of those accounts. They have to happen at the same time. I can tell you that by the end of this year we have four significant breakthrough projects that will begin to move us on a pathway of standards. One will be doing away with the medical clipboard as we know it. When you walk into a doctor's office, they always ask you to fill out your information again and again. We are creating a set of standards where every system that is now on the market could essentially have one system so that you could go into a doctor's office, present yourself, and some way that you would identify, and all of that information would be available. That will be a big step forward, and we believe that by the end of this year, those standards will be available.

Another area is in chronic disease management. I indicated earlier to Senator Conrad that 75 percent of all expenditures are in the area of chronic disease. Many of those diseases now are able to be monitored by devices that are external to a doctor's office or a hospital. It is, again, Health IT. But that will allow us to do that in a more efficient way.

Those are the kinds of things we are doing, and by the end of this year, we will have not just one but four breakthrough projects that are paving the way for this level of interoperability. At the same time we have to be working on adoption, as you have suggested.

Senator STABENOW. Well, and, Mr. Secretary, I appreciate what you are working on. I know there are already, in fact, standards within the Department, and interoperability, I support doing that. But creating standards does not put the PC in front of the person that checks you in at the doctor's office or create the dollars to buy the information software that is already out there. There is amazing software, as you know, that is out there right now that could be used.

I would just suggest that we have talked about pay for performance, but the first thing is pay for use. They have to be able to get the equipment, and when we look back at this whole question of what is being cut, we are talking about reducing hospital reimbursements, home health, nursing homes, on and on, and then we are saying, by the way, we want you to go out and invest in hardware and software and train people. I do not see that as compatible when we talk about compatibility. And if we—it takes time to get these systems in place, and if we wait until every T is crossed and I is dotted on standards, we are losing time, critical time that could be put into saving money the right way, rather than cutting access to health care for people.

And so I would urge you to look at what we have suggested, which is not general fund dollars, but a way for us to jump-start this and move it down the line.

I know that we started our own systems in the Senate before they were interoperable. We still do not have all of the systems interoperable, and yet everybody got up and going, got on e-mail, got their websites set up, and we are connected in some ways. And we have built from there. You can also go backward on interoperability, as I understand it, so that it does not have to be waiting until the perfect standards are in place.

In this time when we are cutting and using strategies that take away resources and, I would say, take away health care, Health IT is a very important way to do something that is positive, bipartisan, and doable. But I think we can be moving much more quickly than we are.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

Mr. Secretary, I would like to followup on some of the issues that Senator Stabenow raised. Specifically, I would like to address the issue of health information technology. I am going to be holding a hearing in my Commerce Subcommittee on technology, innovation and competitiveness on this very issue. We held a hearing on the issue in July and I believe another hearing is warranted. I would appreciate it if you could come and testify at the hearing because we do not have the time to delve into the topic of health information technology in detail today. I know that you have issued several requests for proposals to accelerate the adoption of health information technology. I would like to invite you and some of the organizations who have been awarded contracts as a result of the RFPs to testify before my subcommittee. The hearing will provide Senators with an update on where health information technology stands today. Everyone I have talked with believes that health information technology will reduce duplication and cut down on administrative costs such as transcription and billing. Clearly, information technology has enormous potential to reduce medical errors, improve quality of care and lower health care costs.

I was recently in a car accident. If I would have had an electronic health record the physician who treated me would have instantly been able to obtain personal and medical information about me to determine how best to treat me. Instead, I was required to provide personal and medical information to the physician while I was in a neck brace lying on a stretcher. It is much easier to have that type of information readily available on an electronic health record. Electronic health records can also help ensure that physicians have the information they need to make appropriate clinical decisions.

I would like to discuss interoperability. We need to develop interoperability standards to support electronic data exchange. Physicians and other health care professionals are hesitant to invest in information technology systems. Frankly, they do not want to invest ina system that will not be able to exchange information with anyone else. Currently, there are health care systems that have developed their own interoperability standards with their own network of doctors. This is happening today. I have had several meetings in the last several months with groups that have developed interoperable systems. We need to rapidly increase these efforts.

I agree with putting out tax credits and perhaps we should allow full expensing to encourage health information technology. There are a lot of barriers to the adoption of information systems in health care. The interoperability piece is absolutely going to be key.

I would also like you to comment on the area of best practices. I believe we need to develop and encourage the use of best practices so that doctors and patients have the information they need to make appropriate clinical decisions. However, this has not been a big focus of health information technology. It seems to me that health information technology is how we drive best practices. Only about half of the doctors in the nation are utilizing best practices. The use of best practices is very common in business, but we are still not using best practices in medicine. I believe we will see dramatic results when through the use of best practices.

Could you please comment on how we can drive best practices into private health insurance programs and large government programs such as the Medicare and Medicaid programs? I would alos be interested to learn what types of savings could result from the full implemetation of health information tecnology as well as the savings that could be achieved through the use of best practices.

Secretary LEAVITT. Let me say to both you and Senator Stabenow, I am as impatient on this as you are. This is something that needs to happen. Interoperability is critical to this. There are remarkable systems that you can go through and name the systems—Kaiser Permanente, Intermountain Health Care, Cleveland Clinic. I mean, you can go all the way through the country and find centers of excellence where they have—the Veterans Administration. They have brilliant systems where they can track their entire health record, but they cannot talk to each other. And that is what we have to solve, is a way to bring them together.

Now, how do we achieve interoperability? I would suggest there are three alternative paths. The first is for the Federal Government to step up and say this is the way it is going to be. This is the interoperable standard. You will meet this. Well, that fails—it almost always fails and is not a good path.

The second option I call the last vendor standing. We will just let everybody fight it out until they have one standing. Well, that does not work because there are lots of different ways to get to the same path.

The third way is messy and it is hard and it is frustrating, but it is the only way, and it is a collaboration, and in my mind, it ought to be led by Government. And that is exactly what we are doing. We have established the American Health Information Community. For the first time, we have brought together the Department of Defense, the Department of Veterans Affairs, all of the HHS entities, the States, the private sector, the communities, and we are saying to the world we are going to adopt as Government, which makes up 46 percent of all the dollars paid, we are going to adopt a set of standards, and we want the world to know that.

But we want them to be the right standards, so we are going to collaboratively develop them, and then you need to know we are going to adopt them.

Well, when you are 46 percent of the market, you are going to move the market. And we believe that in a very short period of time—I indicated at least four breakthrough projects—the market will begin to move, and we will start to see interoperability.

Frankly, the world does not lack computers. It lacks interoperability. And once we have achieved that—now, I don't think we ought to be waiting until we have perfect interoperability. I for one would be delighted if I could say to my health provider, "Send my lab results to me electronically, and let it fit into a record that I will create." That would be not the perfect step, but it would be a very important step. I was talking with a colleague of mine who went to the doctor. She took her children to the doctor, and she had to be away from work for a day. I said, "How did it go?" She said, "Well, it went fine, but I spent the first half a day being a medical courier. I had to go to three speciality doctors. I had to pick up brown envelopes with tests in them. Then I had to take them over to a specialist so they could read it."

There is no reason that has to be that way. They could, with the click of a mouse, send those in electronic form. And they should not need to do that. And those are the kinds of policy changes that will get us steps forward.

I will confess to you that this is not happening as fast as I would like it to, but it is a big, cumbersome, and complicated problem. But I believe we are on the right path.

Senator ENSIGN. Mr. Chairman, Secretary Leavitt did not comment on the area of best practices. Mr. Secretary—could you please address best practices?

Secretary LEAVITT. Well, you can get lots of estimates on what kind of efficiency this would create. Many believe it is as much as 30 percent. When you are talking about 30 percent of $1.9 trillion, that is a lot of money. Now, others say it is less than that but still significant. There is no question in my mind that money is part of it, but it is not the only reason.

What is the savings to my colleague of not having to take a day off of work? That is big. What is the value of having a best practice that will save my life because I did not get a hospital infection or an adverse drug effect. Those are huge savings that are not reflected in that 30 percent.

Senator ENSIGN. Mr. Chairman, the reason that we are focused on the money aspect of best practices is because we are beginning to work on the budget. Even if we did not save any money through the use of best practices it would be worth implementing best practices it simply because of all of the other side benefits. I think that best practices is absolutely one of the most important areas that we can focus on as far as our health care system and as far as our budget is concerned. Best practices certainly have the potential to curb health care costs. At the same time, best practices will ensure that Americans have access to evidence-based health care when they need it the most. This is exactly why this Congress needs to be focused on doing everything that we can to bring best practices to fruition as quickly as we possible.

So I thank you, Mr. Chairman.

Chairman GREGG. Thank you. We just need to apply it to veterinarians.

Senator Murray.

Senator MURRAY. OK. I don't think I will touch that.

Thank you very much, Mr. Secretary, for being here to talk about the budget for Medicare and Medicaid, and I agree with Senator Stabenow's original comments where she started out talking about just reducing the dollar amount we spent here does not necessarily save us a lot of money unless we focus on really prevention and programs like preventive health block grants and maternal and child health program, HCAP, those kind of programs that are preventive, that keep people from coming in and using costly health care dollars. So it concerns me that those programs are cut in our budget.

But I want to focus my questions today on what is happening in the reality of us shifting costs in terms of saving money, and specifically let me talk about the VA, because as all of us know, we went through a very difficult situation last year where the VA finally told us after months of saying that there are long lines, people are not getting access to care, we have a crisis, that they indeed were short well over $1 billion in VA health care. And we had to come up with additional dollars to face that last year.

Well, what I am hearing now—and we had a VA Committee hearing yesterday—is that a number of States, because of the shifting burden to them to care for the Medicaid population, looking for ways to save money, are working to treat veterans who qualify for Medicaid, shifting them back to the VA. And it was shared with us that an analysis was conducted by Missouri's auditor in 2004. It found that Missouri could save $5.5 million if veterans who received benefits through Medicaid had instead received care from the VA.

Missouri is not the only State doing this. My home State of Washington recently identified veterans who enrolled in public assistance programs and introduced 2,000 veterans back to the VA system, saved my State $4 million, but that cost is shifted back to us. And it makes me very concerned because 5 percent of Medicaid recipients are veterans today. We have an obligation to care for them. But we have not budgeted for that. That will have a huge budget implication back at us, and I am curious if you are aware of this trend and whether you expect it to continue.

Secretary LEAVITT. I have to confess, Senator, that is the first I have heard that. I am not surprised that States are looking to the Veterans Administration to cover those who are eligible. That does not surprise me. But I am not aware of the trend that you have spoken of, and it is worthy of investigation.

Senator MURRAY. Well, it is an important one because it comes back and hits us, and we have to make sure that we have the dollars for the VA. I don't think any of us want to be sitting there in July saying we are $1 billion short again. But I think we need to be aware that that is what happens.

And a second similar shift, a number of seniors are telling me that when they call Medicare to ask about the Part D drug benefit, they are being told—asked, in particular, if they are a veteran, and if they are, telling them, well, don't sign up for Part D, go into the veteran system—which then, by the way, covers all their health care and they deserve that and we should not turn them away. But it is shifting that cost from Medicare to the VA, and again, it has a budgetary implication.

So I did not know if you were aware that people are being told that.

Secretary LEAVITT. We have been working to help people get prescription drug coverage by whatever means possible, and I will tell you that I have been in, I think, 44 States talking with seniors about the Medicare Part D. And routinely people will say, "I am a veteran, and I am happy with that system." And so as a matter of course, people who are eligible——

Senator MURRAY. Sure. I did not have a problem with it. It has a budget impact because it is not just their prescription drugs. If it a senior just looking for prescription drugs, they shift to the VA, and it covers their entire health care. They cannot just go in and ask for a prescription. They then get all of their health care there. It is a cost. It is one that we owe to our veterans. But it is going to have tremendous budget implications, and I think we—it makes me very worried about our veterans budget again, as I was concerned last year with these shifts from Medicaid and Medicare moving back onto our veterans system and us not providing the resources for it.

So just saying we are going to reduce Medicaid costs does not necessarily save money. I just want us all to be aware of that, and we are going to have huge implications from that.

And my time is short, but I did want to just mention that I appreciated you being out in my State recently working with my Governor to come up with additional—I think it was $15 million for our dual-eligibles. It is, as you know, a huge challenge across the country as the prescription drug plan is going into effect. The dual-eligibles are rightfully—really, it is a very disconcerting problem that has an impact on our physicians, on our senior citizen homes, on our pharmacists themselves. And I appreciate you coming out with the announcement to help our State with this co-payment issue for dual-eligibles.

But I did want to find out from you, this is not new money, it is my understanding. It is simply a recalculation of the State's clawback. I just want to make sure my State is not going to end up at the end of the day with this bill sitting in their lap, and if you cannot provide me with the information today, if you could give me a detailed answer on that, I would really appreciate it.

Secretary LEAVITT. I am actually able to give you a fairly detailed answer on this. The good news on the prescription drug benefit is that enrollment continues to go up dramatically and the costs are going down, and they are going down because the competitive nature of the market now has driven them down. And one of the benefits of that is that we have been able to reduce the amount of money that the States have to reimburse the Federal Government. And in the case of the State of Washington, it was a little over $14 million.

That announcement came at a very good time because your Governor was interested in being able to cover the $1 and the $3 copay. Some States have chosen to do that. Washington State was not one who had. And so the Governor went to the legislature and proposed it, and I understand that authorities have been granted, and she is now able to use that $14 million.

It is important, as I have communicated to her, that she recognize that is a one-time proposition. We do not know what will happen next year. We like to think that they will continue to go down, but——

Senator MURRAY. And you have the flexibility within the law, just so I understand, to be able to say we are not going take the clawback?

Secretary LEAVITT. It was a recalculation of the clawback. It was just a recalculation. Because of the cost savings, the amount that they would need to pay was $14 million less.

Senator MURRAY. So it is not an additional cost to the Federal Government?

Secretary LEAVITT. It is not. Nor is it—let me restate it for clarity. The State of Washington had budgeted——

Senator MURRAY. And other States, I am understanding.

Secretary LEAVITT. Right. When the Medicare Modernization Act was passed, it took the dual-eligibles and moved them from Medicaid over to Medicare. That would have been a substantial savings to the State because they would no longer carry that responsibility. And so Congress concluded that the financial benefit to the States should be phased in and started with 90 percent of the first year of the cost of that would need to be repaid, and some people have called that the clawback.

Senator MURRAY. Yes.

Secretary LEAVITT. Each year that reduces by a certain amount, 5 percent a year until it gets to 75 percent. That was calculated, and the amount—let me just say it was this big—

[indicating] for the State of Washington.

When we recalculated it, seeing the new savings that were involved because the costs of the drugs were less, instead of being this much that they needed to pay back, it was this much—

[indicating]. And the savings that they no longer needed to pay to the Federal Government was the $14 million.

Senator MURRAY. But you are saying that was 1 year only?

Secretary LEAVITT. I am saying that would be 1 year.

Senator MURRAY. All right.

Secretary LEAVITT. Actually, that might repeat because—it very well could repeat because the savings will be—you know, one would like to think they will be permanent. We do not know. The market may continue to drive them down, and it may be even more. But the point is the $14 million was coincidental to the fact that she needed $14 million. It was a stroke of good fortune, and it solved a problem, and they will need to wrestle with a permanent solution. But it may, in fact, be permanent, because the actual amount they will have to repay will go down 5 percent every year. So I guess now that I think about it, it would very likely be at least dependable, maybe not permanent.

Senator MURRAY. Sure. All right. Thank you, Mr. Chairman.

Chairman GREGG. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your public service, and thank you for your service as EPA Administrator as well as Secretary.

About the time that you were coming in as Secretary—it has been a couple of years, hasn't it?

Secretary LEAVITT. A year. Time flies.

Senator NELSON. Well, then, just before you came in, we had had a little dust-up in Florida with some harassment of senior citizens cracking down on their importation of a minimal supply of prescriptions from Canada, either by the Internet or by mail. This was before you came in as Secretary, and I had assurances from the head of the Food and Drug Administration that since they have a lot on their plate, what they were not intending to do was to harass senior citizens, and that they were not going to implement a program whereby the confiscation of these prescriptions were occurring, where there was a 90-day supply or less of the prescriptions ordered by mail or by the Internet. And so we have gone along the last couple of years under that policy.

Lo and behold, starting about November, apparently that policy has changed. And I have been getting complaints from all over Florida, and especially so in the last couple of weeks, to the tune of 130 complaints. And what that would indicate is there are a lot of people out there, because when I get a complaint, it is usually the tip of the iceberg and there is a lot underneath. A hundred and thirty complaints is fairly sizable, that suddenly their prescriptions had been confiscated.

Now, of course, one of the things that comes to mind, first of all, I have raised a lot of sand about this because this was the policy of Food and Drug, which is under your administration, but I am also concerned, Is there any linkage between trying to drive citizens, senior citizens, out of purchasing where they can get them at half the dollar value of the retail price, by driving them out of getting them from Canada into the prescription drug benefit Part D.

And so I want to ask you that for the record, if you could clarify what are your policies.

Secretary LEAVITT. Senator, I can give you some insight on this. I have done some investigation myself.

The Food and Drug Administration has worked in a cooperative way with the Customs Service, and generally what happens, if there is an event involving a prescription drug, it is referred to the FDA by the Customs Service. The FDA frankly has been spending some time, but for the most part focused on other things, but the Customs Service in the last year has been given independent authority and developed independent of the FDA the capacity to deal with these matters and, you know, not always required to check with the FDA on the implementation of such a policy or, for that matter, the adjudication of that kind of a matter.

What you are seeing is a substantial increase in activity by the Customs Service, and as I understand it, what they do is send to the recipient of the drugs a letter saying: We have these. It is not in accordance with the law. Would you like us to refer this to the FDA for testing?

The recipient then has an opportunity to do that, and the FDA then receives it, and the FDA then is able to determine whether or not it is appropriate or not.

So I want to make three points. The first is what you are seeing is an increase in activity by the Customs Service.

Senator NELSON. Indeed, and that has been confirmed, to the point 7 times greater what it has been in the last couple of years.

Secretary LEAVITT. The second point is, whether one agrees with it or not, it is the law.

And the third point is I wanted to just give you some sense of why there is concern about this. We have a rather well-protected distribution system of drugs and, for that matter, food in this country. I have been concerned about drug counterfeiting. The FDA recently, as an example, found a website called "Canadian Generics." It had the Canadian flag. It had all kinds of motion to it. I think it may even have the Canadian anthem, for all I know, but it was all focused on Canadian generics.

Our investigators bought drugs from this site. We tracked the transaction. It turns out the website was actually managed in Belize. It turns out that the ISP was in China. It turns out the check we sent them was cashed in the Virgin Islands. And the postmark on the drugs came from Dallas, Texas.

When we tested the drugs—there were a series of them that we ordered—every single one of the drugs had active ingredients that were dramatically different than represented. In some cases, it was half. In other cases, it was twice. In one case, we had a syringe that was brilliantly counterfeited. You could not tell the package from the original one that would be developed by a manufacturer. But instead of the solution in the syringe being according to specifications, it was tap water.

The point is that there is a danger here, and there is a need for buyers to beware and to be very careful about who it is they are buying drugs from. It is currently the policy of the United States to protect the distribution system of our drugs in that way.

Now, again, I wanted to tell you that in the context of I think the increased activity that you are seeing is a function, as you have confirmed, of the Customs Service. That is the role FDA plays and why we are being quite concerned about counterfeiting. The World Health Organization indicates that it is now a $35 billion industry. Law enforcement people tell me that if you take a trunkload of capsules of crack cocaine and you set it side by side a trunkload of phony Viagra, you will get a lot more money out of the phony Viagra than you would the crack cocaine, and the penalties for getting caught are substantially less.

So we are seeing a substantial amount of increase in the level of trafficking in counterfeit drugs, and so the intensified concern on behalf of the Customs Service is not just in enforcing the law. There is a legitimate public harm that could, in fact, occur here.

Senator NELSON. I understand that, and you need to understand the flip side of this, that we want you to go after all of the counterfeit, and that is what the law is for. There are certain established procedures that the Food and Drug Administration over the course of the last year, because of its policies, seeing that a small supply of prescriptions to seniors coming from reputable pharmacies in Canada, that the possibility of harm is de minimis and they know it, and given the fact that the FDA has so much on its plate, then it was not going to cause the confiscation of seniors' drugs. And the flip side you need to hear from us as we, the legislative branch, advise to you, the executive branch, and hold you accountable is that there are seniors out there that are having difficulty making ends meet. They cannot afford the retail price of drugs. They either are confused and have not signed up because of the multiplicity of plans, or where they try to sign up, they find that the cost is way more than they could get the drugs. And rather than having to sacrifice on other necessities, since they have to have their prescriptions, they buy them where they can get them at half the retail price.

Now, that is the side that you need to hear in the implementation of the policy. So I take it that your final answer then is you see no causal connection with trying to force seniors into prescription drug Part D Medicare.

Secretary LEAVITT. Senator, we have had no change in policy, and I can tell you that I know of no causal connection between those. I do think your points are sound ones, and that is, we need to help seniors have access to the prescription drugs that they need. We need to work hard to make certain that they know about the benefits of the prescription drug benefit. We also need to do our best to inform them of the difficulties that can come in having drugs that are not pure and not well protected.

You know, I acknowledge that there is this ongoing policy debate about what our law is, but I do want to assure you there has been no change in policy.

Chairman GREGG. Thank you.

We doubled the spending on NIH by 2003. We have taken a few years basically to pause that spending so they could absorb it and effectively use it, which I think was appropriate.

I notice this budget once again essentially freezes NIH funding. Is the demand for research being adequately met by NIH at this time?

Secretary LEAVITT. Well, Senator, you appropriately—this is a flat proposal on our part. It ought to be recognized that there is a $30 billion investment here, and we are working to find ways in which we can use that money better. One example is that we are pressing hard on having trans-institute investment. Instead of just having institutes invest on their own, this is a good example of what I talked about going across agencies and breaking out of silos.

For example, the genetics and environment initiative that you will see represented here, that will benefit all 27 Institutes. Dr. Zerhouni has what he calls his road map where they are identifying high-priority basic science that does not need to be done in every single one of the institutes. I frankly felt pretty good about keeping NIH level-funded in a deficit reduction budget.

Now, I know that we would all be happier if we had resources to do otherwise, but I feel good about the commitment that we have made, and I feel good about the strategy that we are deploying to make certain that those important initiatives keep going forward.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

I would like to go back to the avian flu question. I don't know if you saw the February 17th opinion piece in Newsday. This is what they said. The headline was "The Next Disaster." It said, "The U.S. Government has done little of consequence to prepare for the possible rise of the epidemic. Congress has allocated $280 million for flu surveillance, but none of it has been spent. Now it is too late to use the money effectively. President Bush has set a goal of creating 81 million courses of Tamiflu, but the United States has a current stockpile of only 4.3 million courses of Tamiflu. And it is unclear how quickly pharmaceutical companies can produce more. The real hope lies in the development of new, more effective bird vaccines. Crash programs are underway in Asia and the United States, but there is little, if any, coordination among them. Bird flu may not become a pandemic, but Washington must be prepared for it and devote more money and greater urgency to preventing it, and time is running out."

Can you tell us how much is in this budget to confront a potential pandemic?

Secretary LEAVITT. In total, the President has requested $7.1 billion. The Congress has funded thus far $3.3 billion of it. We have embarked on a multi-strategy comprehensive plan, and I would be happy to go through each piece of it. I would like to point out——

Senator CONRAD. But how much money is in this budget?

Secretary LEAVITT. Well, in this budget we have $2.3 billion, and there is an ongoing $350 million.

Senator CONRAD. $2.3 billion.

Secretary LEAVITT. When you combine the $3.3 that Congress allocated in the last budget period and this $2.3 billion plus $350 million, and then we will undoubtedly be making a request for the third year, that will get you to the $7.1 billion that the President has requested.

Senator CONRAD. Let me ask you this: Is $2.3 billion all that you can use to prepare for this, or could more be done?

Secretary LEAVITT. Senator, there is always more, but we believe that the $7.1 billion provides a comprehensive approach and, frankly, will have put us on a crusade to create vaccines, to put stockpiles of antivirals in place, to create technologies that do not exist today to work with a monitoring network around the world and around the United States, and to bring to a level of readiness never before achieved in the United States for any kind of a medical disaster. We see this as not just having value in the context of a pandemic, but for any medical emergency, be it bioterrorism, a nuclear attack, or in some kind of natural disaster. We believe that this is combined with the almost $7 billion that has been spent on surge capacity since 2002, this is a rigorous and quite aggressive campaign to prepare.

Senator CONRAD. Let me just say this to you: that my reading of this book on what happened in 1918 is that an awful lot of well-meaning people did not respond aggressively enough. And I am very concerned that we are headed in that direction again.

When I hear you say 3 to 5 years on the vaccine front, that sounds like a long time to me. And in any event, we would have to face 6 months of the scourge before we would be ready to respond.

Is there anything that could be done to shorten those time periods?

Secretary LEAVITT. That is a question that has been posed to every vaccine manufacturer and every scientist I could find, and I am persuaded, Senator, that simply the nature of the process of building and manufacturing vaccines requires that period. When you make a vaccine, it needs to be tested. You are putting into the arm of people a virus or some component of a virus that has an impact on their body, and we have learned from sad experience that if we are not doing it in a safe way, it is possible to cause harm. And that is the major component.

Now, we do have manufacturing deficits right now. We do not have the capacity in this country. That is, frankly, the subject of 20 years of neglect. One of the good things that will come from this is that we will not only create the capacity to generate vaccines in a pandemic, we will also take care of the problem we have on vaccines for the annual flu.

But any way you look at it, we are going to have to do two things: more capacity and new technology. You cannot get to the 300 million courses that we aspire to get to in 6 months using eggs. We have to use cells, and that capacity does not exist. When that editorial was written, we were 47 days into our funding cycle. We are already issuing substantial procurements in that period of time. I don't know how it could be done faster.

Senator CONRAD. Let's go back to this question. Is there a way through more investment to be prepared for this capacity need sooner than the 3- to 5-year time period?

Secretary LEAVITT. That is precisely the question we have issued to the entire vaccine world. We did not give them 3 to 5 years. We said: Come to us with your ideas. Show us how you can create a vaccine and technology in the shortest amount of time possible.

They are responding in a competitive marketplace. We have multiple providers who have stepped forward with good ideas and smart people. We have asked them not to do anything short of putting their best people, and, frankly, that has been a—we have had to offer the kind of co-investment that we are making in order to incent them to do that.

Senator CONRAD. And how much is that co-investment?

Secretary LEAVITT. Well over $1 billion of the 3.3 this year.

Senator CONRAD. And let me just go back to this, my final question. If we wanted to do more to speed this process, are there things we could do?

Secretary LEAVITT. Senator, I am persuaded that there are five components to readiness. The first is having antivirals in sufficient proportion. We will be at 20 million courses of antivirals by the end of this year. We have stepped that up substantially. We are working with the States to create their stockpiles and means of distribution.

The second is vaccines. We——

Senator CONRAD. If I could just stop you, No. 1 is when you say antivirals, you are talking there about Tamiflu and——

Secretary LEAVITT. Tamiflu and other antivirals——

Senator CONRAD. Relenza?

Secretary LEAVITT. Primarily Tamiflu. You and I have had conversations——

Senator CONRAD. Yes.

Secretary LEAVITT [continuing]. About Tamiflu and its limits, but it is a very important part of our plan.

The third part is in monitoring. We are developing with the world a monitoring network. Now, I need to tell you that I have personal doubts about whether or not you are going to be able to find the spark when it happens. It is a big world, and there are lots of people, as we are seeing. It has now spread over—well, we have seen it in 20-plus more countries over the course of the last 2 months. This morning it is being reflected in cats in Africa and in new countries. I mean, it is spreading across the world. I do not believe that there is any reason to believe we will not see wild birds in the United States with the virus.

Senator CONRAD. It is just a matter of time.

Secretary LEAVITT. It is just a matter of time, maybe very soon. It is not inconceivable that we could see a domestic flock. Neither of those would be emergencies or crises or things that we have not seen before. We can deal with that. What becomes a pandemic is when we see person-to-person transmission.

Now, any way you look at this, the first 6 months of a pandemic we are dependent upon basic public health, social distancing, every business having a plan, every school, every church, every county, every tribe having a plan.

Senator CONRAD. And we do not have that, do we?

Secretary LEAVITT. When it comes to a pandemic, we are overdue and we are underprepared. But we are moving with dispatch, perhaps at greater speed and with greater opportunity to do something about this than any generation in humankind has had before.

Now, that is exactly the reason why I am going personally to 50 States with Governors, holding pandemic summits, not just to talk to public health people but to talk well beyond public health, to school principals, to superintendents, to college presidents, to corporate planners. We are talking with community leaders. We are talking with faith-based organizations.

Senator CONRAD. Can I just say to you, Mr. Secretary, with great respect, when I read the reactions of public health people, what they are telling me and what they are saying publicly is that the response is woefully inadequate, that we do not have the resources, that if it comes down to it, if we have a pandemic, the medical essentials are going to be in grossly short supply.

Ventilators—if there is one thing I have heard consistently, it is that we are going to immediately have a crisis with ventilators; that we are going to have a crisis with hospital space; that we are going to have a crisis with public health providers. And, I mean, this is what I get back from them, that we are not prepared. And when I talk to people in business, their response is, "We are not prepared." And I have great respect for you. I think we have to do more. I think we have to have a more ambitious plan than we have that I see so far.

Secretary LEAVITT. Senator, is there time for me to give you a response.

Senator CONRAD. Certainly. You can always respond.

Secretary LEAVITT. I am spending a very high percentage of my time—I know you do not doubt that. This concerns me greatly. I spent weeks walking through medical shelters during Katrina. I saw people who had come from every State to help their fellow citizens in distress. I learned a couple of lessons from that. One is sometimes we have to think about the unthinkable, and what you are suggesting, I agree with.

Second is that a pandemic is different than any disaster that we prepare for. It is different than an earthquake, it is different than a hurricane, it is different than a bioterrorism event—in two ways: The first is it happens everywhere at the same time. It will happen in Seattle and Santa Fe and Sarasota and Syracuse at the same time.

I saw in the paper recently a public health official, like one that you referenced, saying, "Look, what the Federal Government does not understand is that we count on them for ventilators when we have any kind of a problem like an earthquake or a bioterrorism event, and we are all going to come there at the same time."

Senator CONRAD. I just read that very——

Secretary LEAVITT. That is exactly what we do get, and the reason I am going from State to State to say to them any community that fails to prepared on the basis of the expectation that the Federal Government will be able to step in at the last minute and throw them a lifeline will be sadly mistaken.

Yes, we have an obligation at the National Government, and we are responding to it. We are developing vaccines; we are developing antivirals. We are working to develop stockpiles. We are going out to the States. We are working on our border issues. We are exercising at the Cabinet level. We are working internationally. All of those things are roles that the National Government has to play, and we are playing them.

But communities need to prepare. We have to be a voice, a warning that we will not have the capacity to respond to every community if it is happening at one time. If they need ventilators, we will have some, but it will not be nearly enough to go to every community. And maybe they ought to be thinking about whether they need ventilators or a new swimming pool. If they are concerned about preparation, public health is a public responsibility of local government, not because we do not want to respond, not because we have not got the wallet for it, but because you cannot manage a pandemic in that atmosphere. There are too many places. We will be responding to as many as 5,000 different communities at the same time.

This is an important principle in the management of a pandemic. The foundation is local preparedness.

Senator CONRAD. Let me just conclude by saying I agree with that. I also believe deeply that the Federal Government has a leadership role. I think you believe that as well. And I must say as I look at this and I look at $2 billion to confront something that could be the disaster of our lives, could be the disaster of our time, I just do not think it is enough. I do not think it represents the kind of commitment that we need to make in light of the potential danger. This potential danger is so extraordinary, and we need to—I think we need to do much more.

Chairman GREGG. Mr. Secretary, we appreciate your time. I want to followup on that briefly. You know, as former chairman of the HELP Committee and as chairman here, I have been intimately involved in this. And I do not want to leave this hearing with the sense that you folks have not been doing an extraordinary amount to try to prepare, both in this and the area of bioterrorism.

This $7 billion that you have asked for is outside the budget. I mean, it is an emergency funding. You have asked for another 2.3, I think, outside the budget. It will come to you. And the issue I have sensed, looking at it on fairly close analysis, is—as you pointed out earlier, the first issue is how you get people to start producing vaccine. The vaccine industry in this country basically was destroyed by the legal community. And so I drafted language—actually, Vince drafted the language, I think. But we drafted language which Senator Frist has been a strong supporter of, and we put it in and we have hopefully taken care of that legal issue. But we still do not have a vaccine production capability in this country of any capacity, and I know you are working to get that up to speed. Because we understand that when this happens, every country is going to need vaccine. There is going to be a unique situation. Every country is going to need vaccine, and the country that produces it is going to keep their own, and so we have to have a domestic vaccine capability, and I know you are—and we put this $5 billion in the pipeline for bioterrorism, and now we have $7 billion in the pipeline for avian flu. That is a lot of money on the table that hopefully the marketplace will respond to, and I know you are working to make sure they do.

So it is not an issue in the area of vaccine; it is not an issue of having the money or the Federal Government commitment. It is the issue of not having the structure; it is not having the infrastructure and building that infrastructure is something we are committed to. And I think the Federal Government has done yeoman labor here to try to make the playing field attractive and force the action to occur. And so I congratulate you for that.

The secondary issue is just the nuts and bolt of addressing a pandemic or bioterrorism event. It involves things like stockpiling ventilators, but other things, you know, masks, syringes, gloves—none of which are made in the United States any longer in any significant amount. So we have to buy them from somewhere, and I have been putting a lot of pressure. We had Dr. Gerberding earlier in another forum, and I asked her: When are we going to have our stockpiles up to speed? And do we have a timeframe for it? And she said yes, we do, we will have the adequate stockpiles by June—and she said she would confirm this, and I would like you to confirm it—of syringes, of masks, and of the other what you would call mundane activities of dealing with people who are sick. So we are moving in that area.

And then we have the issue of quarantine, which I understand you are aggressively pursuing. So there is a lot going on in this area, and the commitment of resources is huge. Are we moving as quickly as we want? No, but I don't think it is so much a lack of commitment on your part—in fact, just the opposite. I think the part of the administration has been huge, and it has been a bipartisan support here. Obviously Senator Harkin has played a major role. But it is really a fact that we don't have infrastructure and we don't have production capability. And we have never really thought through how you quarantine 20 percent of a population, how you do it and how you handle a bed surge of that size.

So it is not something you can just wave a wand at and solve, and so I just—well, first off, I want to make sure that Dr. Gerberding was right, that we are going to have this stuff stockpiled by June. And, second, I do want to say that I appreciate the huge amount of attention and energy that is being put into this and into the bioterrorism effort. And I understand that it comes down to getting the antitoxins and the antivirals and the vaccine industry up to speed to accomplish it.

Secretary LEAVITT. Senator, I want to say if there is a bioterrorism event or an earthquake or a hurricane or a nuclear event, we have the capacity to take to a spot stockpile, and we can deliver it anywhere in the country in a very short period of time. But I don't want to in any way mislead you or anybody else. If we have a pandemic and we are having to deal with, as a country, 5,000 different communities, it is unrealistic to think that we are going to be able to serve them out of national stockpiles other than, say, antivirals. We will have sufficient, between what we have in our——

Chairman GREGG. If I can stop you there, my understanding was that we were—our game plan was to stockpile for a pandemic, with the capacity to handle mundane activity of dealing with sick people, specifically syringes, masks, gloves, you know, so that we——

Secretary LEAVITT. All that will be in it, and we will be able to deliver it to a certain point. But this is a different kind of emergency than what we are accustomed to dealing with, and for that matter—well, let me pose it differently.

I was in Florida at a pandemic summit, and we were having this conversation with the Governor of Florida, Governor Bush. He said, "How long do these last?" Well, that is the second difference. Not only do they happen everywhere at once, they last a year or a year and a half. They come in waves. He said, "In a year, a year and a half?" He said, "I have had two hurricanes down here—eight hurricanes in the last 2 years."

So we have the potential of having a hurricane in the middle of a pandemic. There is no reason to think that a bioterrorist event couldn't occur during the middle of a pandemic.

So for us to empty our stockpiles out with the idea that no other event could occur may put the Federal Government in a position where we are not able to respond to the things we are uniquely prepared to respond to.

I go back to the fact that we need help here in being able to communicate the urgency of State and local governments, of every business, of every school, of every college, thinking through what their own needs are going to be.

Chairman GREGG. I think everybody appreciates that point. Having a State plan is critical, and I know you have asserted and demanded State plans everywhere. But I guess I misunderstood, because my understanding was that we were—that part of this $7 billion was basically the capacity to stockpile nationally, obviously spread across the country, the everyday needs that we would not be able to import for medical care. I am not talking vaccine here. I am talking, you know, what we just—the things we just——

Secretary LEAVITT. I think there is $212 million going into increasing stockpiles of consumable medical. That is a lot of gauze masks and a considerable number of ventilators. But if you try to stretch that over 5,000 communities——

Chairman GREGG. Well, OK.

Secretary LEAVITT. Now, antivirals, that is a different proposition. We are working with the States. The challenge there is not having them. It is distributing them. It is having the capacity to put pills in the palms of people's hands at the right—within 24 to 48 hours. I think this is an important conversation because if you have been left with the impression that in our stockpile is the capacity to respond to every community, every village, every city, every hospital's needs for consumables, I do not think we are there.

Chairman GREGG. Well, I guess I must have misunderstood, but that was the impression I had. So we will followup on it.

Secretary LEAVITT. Yes.

Chairman GREGG. Thank you.

Secretary LEAVITT. Thank you.

Chairman GREGG. We appreciate your time, appreciate your effort, and appreciate your service.

Secretary LEAVITT. Thank you.

[The prepared statement of Secretary Leavitt follows:]

Testimony
Before the Committee on Budget
United States Senate

The President's FY 2007 Budget Request for the Department of Health and Human Services

Statement of

Michael O. Leavitt

Secretary

U.S. Department of Health and Human Services

For Release on Delivery
Expected at 10:00 am
Wednesday, March 1, 2006

Good morning, Mr. Chairman, Senator Conrad, and Members of the Committee. I am honored to be here today to present to you the President's FY 2007 budget for the Department of Health and Human Services (HHS).

Over the past five years, the Department of Health and Human Services has worked to make America healthier and safer. Today, we look forward to building on that record of achievement. For that is what budgets are — investments in the future. The President and I are setting out a hopeful agenda for the upcoming fiscal year, one that strengthens America against potential threats, heeds the call of compassion, follows wise fiscal stewardship and advances our Nation's health.

In his January 31st State of the Union Address, the President stressed that keeping America competitive requires us to be good stewards of tax dollars. I believe that the President's FY 2007 budget takes important strides forward on national priorities while keeping us on track to cut the deficit in half by 2009. It protects the health of Americans against the threats of both bioterrorism and a possible influenza pandemic; provides care for those most in need; protects life, family and human dignity; enhances the long-term health of our citizens; and improves the human condition around the world. I would like to quickly highlight some key points of this budget.

We are proposing new initiatives, such as expanded Health Information Technology and domestic HIV/AIDS testing and treatment that hold the promise for improving health care for all Americans. We are continuing funding for high-performing Presidential initiatives, including Health Centers, Access to Recovery, bioterrorism and pandemic influenza; and we are also maintaining effective programs such as Indian Health Services, Head Start, and NIH medical research.

We are a nation at war. That must not be forgotten. We have seen the harm that can be caused by a single anthrax-laced letter and we must be ready to respond to a similar emergency — or something even worse. To this end, the President's budget calls for a four percent increase in bioterrorism spending in FY 2007. That will bring the total budget up to $4.4 billion, an increase of $178 million over last year's level.

This increase will enable us to accomplish a number of important tasks. We will improve our medical surge capacity; increase the medicines and supplies in the Strategic National Stockpile; support a mass casualty care initiative; and promote the advanced development of biodefense countermeasures through NIH to a stage of development so they can be considered for procurement under Project BioShield.

We must also continue to prepare against a possible pandemic influenza outbreak. This budget includes a $2.3 billion allowance for the second year of the President's Pandemic Influenza plan. These funds will enable us to meet several important goals, including providing pandemic influenza vaccine to every man, woman and child within six months of detection of sustained human-to-human transmission of a bird flu virus; ensuring access to enough antiviral treatment courses sufficient for 25 percent of the U.S. population; and enhancing Federal, state and local as well as international public health infrastructure and preparedness.

The President's FY 2007 budget also provides more than $350 million for important ongoing pandemic influenza activities such as safeguarding the Nation's food supply (FDA), global disease surveillance (CDC), and accelerating the development of vaccines, drugs and diagnostics (NIH).

The budget includes a new initiative of $188 million to fight HIV/AIDS. These funds support the objective of testing for three million additional Americans for HIV/AIDS and providing treatment for those people who are on state waiting lists for AIDS medicine. This initiative will enhance ongoing efforts through HHS that total $16.7 billion for HIV/AIDS research, prevention, and treatment this year.

The budget maintains the President's commitment to the doubling of NIH, and includes important cross-cutting initiatives that will move us forward in our battle to treat and prevent disease – $49 million for the Genes, Environment and Health Initiative and $113 million for the Director's Roadmap. In addition, it contains an additional $10 million for the Food and Drug Administration to lead the way forward in the area of personalized medicine and improved drug safety.

One of the most important themes in our budget is that it increases funding for initiatives that are designed to enhance the health of Americans for a long time to come. For instance, the President's budget calls for an increase of nearly $60 million in the Health Information Technology Initiative. Among other things, these funds support the development of electronic health records (to help meet President Bush's goal for most Americans to have interoperable electronic health records by 2014); consumer empowerment; chronic care management; and Biosurveillance.

The Budget also includes several initiatives to protect life, family and human dignity. These include, for example, $100 million in competitive matching grants to States for family formation and healthy marriage activities in TANF. And it promotes independence and choice for individuals through vouchers that increase access to substance abuse treatment.

In the area of entitlements programs, I want to begin by congratulating you and other Members of Congress for having successfully enacted many needed reforms by passing the Deficit Reduction Act (DRA). DRA supports our commitment to sustainable growth rates in our important Medicare and Medicaid programs. It also strengthens the Child Support Enforcement program.
The Deficit Reduction Act also achieves the notable accomplishment of reauthorizing Temporary Assistance for Needy Families (TANF), which has

operated under a series of short-term extensions since the program expired in September 2002.

Medicaid has a compassionate goal to which we are committed. Part of our obligation to the beneficiaries of this program is ensuring it remains available well into the future to provide the high-quality care they deserve. Last year when I made my statement before this Committee, I said that the growth in Medicaid spending is unsustainable. With its action on many of our proposals from last year in the Deficit Reduction Act, the Congress has made Medicaid a more sustainable program while improving care for beneficiaries. The President's Budget proposals build on the DRA and include a modest number of legislative proposals which improve care and will save $1.5 billion over five years in Medicaid and S-CHIP and several administrative proposals saving $12.2 billion over five years.

This Administration has also pursued a steady course toward Medicare modernization. In just the past three years, we have brought Medicare into the 21st century by adding a prescription drug benefit and offering beneficiaries more health plan choices.

Medicare's new prescription drug benefit provides seniors and people with disabilities with comprehensive prescription drug coverage, the most significant improvement to senior health care in 40 years. Millions of seniors and people with disabilities are already using this benefit to save money, stay healthy, and gain peace of mind. According to CMS' Office of the Actuary, Medicare's drug coverage will have significantly lower premiums and lower costs to federal taxpayers and states, as a result of stronger than expected competition in the prescription drug market. Moreover, beneficiary premiums are now expected to average $25 a month – down from the $37 projected in last July's budget estimates. The Federal government is now projected to spend about 20 percent less per person in 2006 and, over the next five years, payments are projected to be more than ten percent lower than first estimated. So taxpayers will see significant savings. And state contributions for a portion of Medicare drug costs for beneficiaries who are in both Medicaid and Medicare will be about 25 percent lower over the next decade. All these savings result from lower expected costs per beneficiary; projected enrollment in the drug benefit has not changed significantly.

Our work to modernize Medicare is not done. Rapid growth in Medicare spending over the long-term will place a substantial burden on future budgets and the economy. The President's FY 2007 Budget includes a package of proposals that will save $36 billion over 5 years and continue Medicare's steady course toward financial security, higher quality, and greater efficiency.

The bulk of these Medicare savings will come from proposals to adjust yearly payment updates for providers in an effort to recognize and encourage greater productivity. These proposals are consistent with the most recent recommendations of the Medicare Payment Advisory Commission. To ensure more appropriate Medicare payments, the Budget proposes changes to wheelchair and oxygen reimbursement, phase-out of bad debt payments, enhancing Medicare Secondary Payer provisions, and expanding competitive bidding to laboratory services. Building on initial steps in the Medicare Modernization Act, the Budget proposes to broaden the application of reduced premium subsidies for higher income beneficiaries. Finally, the President's Budget proposes to strengthen the Medicare Modernization Act provision that requires Trustees to issue a warning if the share of Medicare funded by general revenue exceeds 45 percent. The Budget would add a failsafe mechanism to protect Medicare's finances in the event that action is not taken to address the Trustees' warning. If legislation to address the Trustees' warning is not enacted, the Budget proposes to require automatic across-the-board cuts in Medicare payments. The Administration's proposal would ensure that action is taken to improve Medicare's sustainability.

President Bush proposes total outlays of nearly $700 billion for Health and Human Services. That is an increase of more than $58 billion from 2006, or more than 9.1 percent.

While overall spending will increase, HHS will also make its contribution to keeping America competitive. To meet the President's goal of cutting the deficit in half by 2009, we are decreasing HHS discretionary spending by about $1.5 billion in the next fiscal year.

I recognize that every program is important to someone. But we had to make hard choices about well-intentioned programs. I understand that reasonable people can come to different conclusions about which programs are essential and which ones are not. That has been true with every budget I've ever been involved with. It remains true today. There is a tendency to assume that any reduction reflects a lack of caring. But cutting a program does not imply an absence of compassion. When there are fewer resources available, someone has to decide that it is better to do one thing rather than another, or to put more resources toward one goal instead of another.

Government is very good at working toward some goals, but it is less efficient at pursuing others. Our budget reflects the areas that have the highest pay-off potential.

To meet our goals, we have reduced or eliminated funding for programs whose purposes are duplicative of those addressed in other agencies. One example of this is Rural Health where we have proposed to reduce this program in the Health Resources and Services Administration, given that HHS administers 225 health and social services programs that provide resources to rural areas. In addition, the Medicare Modernization Act contained several provisions to support rural health, including increased spending in rural America by $25 billion over ten years. For example, it increases Medicare Critical Access Hospitals (CAH) payments to 101 percent of costs and broadens eligibility criteria for CAHs. Moreover, recognizing that Congress adopted many of our saving proposals last year, we are continuing to make performance-based reductions.

Our programs can work even more effectively than they do today. We expect to be held accountable for spending the taxpayers' money more efficiently and effectively every year. To assist you, the Administration launched ExpectMore.gov, a website that provides candid information about programs that are successful and programs that fall short, and in both situations, what they are doing to improve their performance next year. I encourage the Members of this Committee and those interested in our programs to visit ExpectMore.gov, see how we are doing, and hold us accountable for improving.

President Bush and I believe that America's best days are still before her. We are confident that we can continue to help Americans become healthier and more hopeful, live longer and better lives. Our FY 2007 budget is forward-looking and reflects that hopeful outlook.

Thank you for the opportunity to testify. I will be happy to answer your questions.

[Whereupon, at 12:01 p.m., the committee was adjourned.]

PREPARED STATEMENTS

Michael B. Enzi

Statement of Senator Michael B. Enzi
Senate Budget Committee Hearing
FY2007 Department of Health and Human Services Budget Request
March 1, 2006

I would like to thank Chairman Gregg for calling this hearing today. HHS' total outlays under the FY2007 budget request are nearly $700 billion. The majority of this spending is on the mandatory side of the ledger, on Medicare and Medicaid. However, a large component is also discretionary money. In fact, the Department's discretionary budget authority is second to the Defense Department. Both the size and scope of the HHS budget make oversight an essential part of the process in order to ensure federal dollars are wisely spent.

I would like to welcome Secretary Leavitt to the Budget Committee today. Secretary Leavitt, I am looking forward to your testimony, and am particularly interested in your views on containing mandatory spending at HHS. Mandatory spending constitutes 90 percent of total HHS spending, and under the President's budget, is slated to increase 10 percent over FY2006. I am looking forward to learning more about your proposals to slow the growth of entitlements like Medicare and Medicaid—as well as your proposal that would provide $500 million in FY2007 for the chronically ill. As you know, the HELP Committee reported out the State High Risk Pool Funding Extension Act, which the President signed last month. I am looking forward to continuing our work together on providing additional assistance to the chronically ill.

Discretionary spending at HHS constitutes about 10 percent of the total HHS budget, and is slated for a 2 percent reduction under the President's Budget request. As Chairman of the HELP Committee, I have jurisdiction over these discretionary programs, some of which will be reauthorized this year. Because federal dollars are limited, the HELP Committee is using the authorization process to review and strengthen programs under our jurisdiction—to make sure they are cost effective, and touch as many people as possible.

We need to contain spending now, instead of passing the bill to our children and grandchildren. I look forward to hearing Secretary Leavitt's testimony.

Statement for the Record
From Senator Russell D. Feingold
For the Hearing on the HHS FY07 Budget Requests
March 1, 2006
Senate Budget Committee

Opening Statement

I thank the Chairman and Senator Conrad for holding this hearing today. I would also like to thank Secretary Leavitt for being here. I am pleased that the committee is focusing on the Health and Human Services budget, as the funding levels for the programs within HHS have a direct effect on many people in the state of Wisconsin and across the country. This hearing provides a chance to look more closely at the numbers requested by the administration, and to better understand the President's health and welfare-related goals.

Like many other Americans and members of Congress, I am deeply concerned about the proposed budget for Health and Human Services. At a time of rising poverty levels and rising health care costs, this budget proposes cuts to many of the programs that address these problems. These cuts are being done under the guise of reducing the federal deficit but I think they are really just a sign of the Administration's misplaced priorities.

The HHS budget request includes drastic cuts to programs that provide vital health care services to millions of Americans, even going so far as to eliminate 21 health programs that help serve as a safety net for individuals and communities that fall between the cracks of society. One of these proposed eliminated programs is a program very dear to me, the Rural Access to Emergency Devices program. Despite aggressive efforts last year to keep this program going, funding was cut by 83% and this year the President has proposed to eliminate the program, which helps rural communities purchase defibrillators. I am disheartened by these cuts, and I want to hear an explanation of why they won't jeopardize the health and safety of our constituents.

We can and should do better for the many Americans who depend on the programs in the Department of Health and Human Services. This proposed budget will result in families losing essential health, education, and job training services that provide assistance for people in need, and that is unacceptable. I look forward to working with my colleagues to come up with a fiscally responsible budget but I will continue to oppose efforts to pay for this Administration's misplaced priorities by undermining programs that help those in most need of a helping hand.

Statement of Senator Tim Johnson
Budgeting Hearing for the Department of Health and Human Services
March 1, 2006

Last month, the President released his Fiscal Year 2007 budget, a proposal that sets the wrong priorities for our nation. I am deeply concerned about how this budget will impact access to care for South Dakotans through Medicare and Medicaid. I am also fearful that should some of the health research cuts move forward any strides we've made in this area will slow, if not move backwards.

This budget is wrong for South Dakota and our priorities, putting the needs of the wealthy in front of the needs of every day Americans and our future health as a nation. This budget proposes $35.9 billion in Medicare cuts over five years. These cuts reduce payments to health care providers. Hospital inpatient and outpatient payments would be reduced in South Dakota by by $31.124 million. State home health reimbursements would be frozen at 2005 levels, reducing payments by roughly $3.9 million. This cut would come on top of the just passed budget reconciliation, which will reduce home health payments in South Dakota by about $2.26 million over five years. Additionally, skilled nursing facility reimbursements would not be provided an inflationary update, costing South Dakota nursing homes about $1.86 million. These cuts will make it even more difficult than it already is for rural providers to keep their doors open.

This budget also proposes an additional $17 billion in cuts to Medicaid, cuts that follow the enactment of $6.9 billion in Medicaid cuts that were part of the budget reconciliation package. These cuts will be devastating to local community pharmacies and reduce access to some health care services for low-income people in need. I recently held a Medicare Part D roundtable in Rapid City, South Dakota which was attended by many pharmacists. They were all saying the same thing. They cannot continue to be asked to provide a health care service at a loss. This budget is asking them to do that, something I simply cannot accept.

The President's budget also cuts discretionary programs at the Department of Health and Human Services by $1.5 billion. These cuts chip away at important rural health programs that ensure that South Dakotans have access to care, and take several steps backward with regard to important health advancements, inadequately funding medical research.

NIH is the primary source of basic biomedical research and has played a critical role in improving the quality and length of lives for literally millions of Americans. In late December, the President signed into law an appropriations bill that made the first cut to NIH since 1970. The President's new budget proposal cuts funding for 18 of the 19 institutes for 2007, including research for cancer, heart disease and diabetes.

Funding for the National Cancer Institute would be reduced by $40 million. Cancer is the second leading cause of death, and every year a million more people are diagnosed with the disease. This disease is also the number one killer of people over the age of 85. Given these statistics, it is not advisable to cut funding for cancer research, and in fact, we should be increasing funding in this area.

A $40 million cut means that NCI would award 80 fewer new, competing research grants in FY07 than it did in FY06. That's an 8 percent cut in the number of potential medical breakthroughs that have gone through the peer-review process, received an excellent score, and are worthy of NIH funding. Those 80 promising ideas will have to wait for another day.

But NCI isn't the only cancer program that's facing a cut. The President's budget also cuts the Center for Disease Control's cancer prevention programs by $3 million. That includes a $1.4 million cut to the National Breast and Cervical Cancer Early Detection Program. This program currently serves just 1 in 5 eligible women. A $1.4 million cut translates into 4,000 fewer women getting screened. This program has been a very effective prevention tool in South Dakota.

Finally, the budget proposes the complete elimination of the National Children's Study or NCS. The federal government has already invested $50 million dollars in this large longitudinal study which will study over 100,000 children over 20 years, providing important information about the major causes of many childhood illnesses. One of the current 7 research centers is located in South Dakota, and should the President's proposed cuts be restored, South Dakota State University will begin signing up between 4,000 and 5,000 children for participation in the study.

I am extremely frustrated with the priorities that that the Administration has put forward. These cuts to health programs are not right for South Dakota and I will be doing all I can as a member of the Budget and Appropriations Committees to reverse these misguided proposals.

ANSWERS TO QUESTIONS SUBMITTED

Senate Budget Committee
Response to Questions for the Record, by Secretary Michael O. Leavitt
October 11, 2006

<u>The Honorable Robert Menendez</u>

<u>Patient Navigator</u>
1.)
Question:
Are you familiar with the patient navigator concept?

Answer:
Yes, I am familiar with the concept of patient navigator programs providing outreach to communities to seek preventative care and coordinate health care services for individuals who are at risk for chronic disease. One of the pioneers of this clinical management concept was the Ralph Lauren Center for Cancer Care and Prevention, a partnership between Memorial Sloan Kettering and North General Hospital in Harlem, New York, which operates a patient navigator program to help patients and family members deal with the complexities of the health care system. By coordinating health care services through a patient navigator patient screening for cancer or other chronic diseases for further diagnosis and treatment may be shortened. I want to thank you for your leadership in sponsoring the Patient Navigator legislation when you were in the House of Representatives.

2.)
Question:
Do you think that the patient navigator program is something you could support and will you recommend funding for it?

Answer:
The Patient Navigator Outreach and Chronic Disease Prevention Act authorizes appropriations through fiscal year (FY) 2010 for HHS to establish a competitive grant program designed to help patients access health care services. The authorization calls for a demonstration grant program to evaluate the impact of patient navigator programs on improving health care outcomes, with authorized levels of $2 million in fiscal year 2006 and $5 million in fiscal year 2007. However, to date, the Congress has not provided appropriations to launch this program.

In developing the HHS FY 2007 budget, tough choices had to be made in view of the country's finances. Among the criteria I used for including a program in the FY 2007 budget was whether it provided direct services. Under this condition, the Patient Navigator program was not a part of the HHS FY 2007 budget.

3.)
Question:
What can we do to get the program implemented within HRSA as soon as possible?

Answer:
Even though the Patient Navigator program was not included in the HHS FY 2007 budget, the Health Resources and Services Administration is developing preliminary plans should funding be included from the Congress for FY 2007.

<u>Medicare Prescription Drug Benefit</u>

1.)
Question:
While I am pleased to hear that CMS will be reimbursing states for the costs they have incurred, I am wondering what you think CMS could have done differently to have

avoided some of the problems, that arose with implementing the drug benefit, such as the need for states to step-in to provide emergency coverage?

Answer:
Many of the start up problems with implementation of the drug benefit resulted from a beneficiaries who enrolled or switched plans late in a month, particularly dual eligible beneficiaries,. We are taking action to address these issues so that all beneficiaries enrolled in a Medicare prescription drug plan can obtain their medications without incident. CMS also is working to correct data transmission problems between Medicare, health plans, pharmacists, and the States.

While considerable progress has been made, change of this magnitude in such a short time span is bound to encounter some difficulties. CMS is very concerned about anyone who has experienced problems in obtaining their medicines. To that end, CMS appreciates the efforts States have made during this transition period in ensuring that dual eligible beneficiaries and other low-income subsidy entitled beneficiaries receive the prescription medication they need.

On Thursday, February 16, 2006, the Centers for Medicare & Medicaid Services (CMS) approved the applications of 45 States (including the District of Columbia) to participate in a Medicare demonstration project that will reimburse States for their efforts to assist dual eligible beneficiaries and low-income subsidy entitled populations in obtaining and accessing Medicare Part D coverage. Through this demonstration, CMS will ensure that States are appropriately reimbursed.

2.)
Question:
When do you anticipate the states will start receiving reimbursements, and when will they be expected to pay the clawback?

Answer:
As you know, on Thursday, February 16, 2006, the Centers for Medicare & Medicaid Services (CMS) approved the applications of 45 States (including the District of Columbia) to participate in a Medicare demonstration project that will reimburse States for their efforts to assist dual eligible beneficiaries and low-income subsidy entitled populations in obtaining and accessing Medicare Part D coverage. Through this demonstration, CMS will ensure that States are appropriately reimbursed.

Under the demonstration, states will submit information to a CMS contractor, in a specified format, on costs that the State incurred relative to the provision of Part D drugs to dual eligible and low-income subsidy entitled beneficiaries. This information will include claims-level data on payments made to pharmacies, as well as information detailing administrative costs that are eligible for reimbursement under the demonstration. CMS will reimburse states directly based on eligible claims received. CMS's contractor will be responsible for submitting the state claims data to Part D plans in order to reconcile the state payments made for Part D drugs with claims that should have been paid by the Part D plan and determine the final payment due to States.

Upon receipt of appropriate and correct claims data from a state, we plan to provide estimated payments within four weeks. CMS recently contracted with Public Consulting Group to coordinate claims processing, payment and reconciliation between the States and the Medicare prescription drug plans.

The phased-down state contribution or "clawback" is a monthly payment for states. The clawback calculation reflects a portion of state savings due to the transfer of full-benefit dual eligibles from Medicaid to Medicare Part D. During the first year of the program, states will pay 90% of the estimated savings. Each subsequent year this percentage will decrease until it reaches 75% in 2014.

The monthly phased-down State contribution payment process, which was originally scheduled to begin in January 2006, was delayed while CMS addressed state concerns related to Medicare Prescription Drug

Improvement and Modernization Act of 2003 (MMA) implementation. These issues are now well on the way to resolution, and we believe the Part D benefit is working well for the vast majority of full dual eligible beneficiaries. The billing process began with the April bill, which was sent on April 13th to the states and was due May 1st, with no interest or offset assessed for state payments made by the 25th of May. The April bill was based on the actual full dual eligible enrollment for those enrolled in Part D that was submitted by the states on their March monthly enrollment files.

In addition to the April bill for March enrollment, the billing package also includes a combined bill for the January and February full dual eligible enrollment months. States have two options for payment of this bill. The January/February bill may be paid in its entirety along with the bill for March enrollments, or it may be paid over the next 8 months using the attached payment schedule.

Preventive Health and Health Services Block Grant

1.)

Question:

We know that the only way to stay healthy is to see a doctor when you are healthy. During a time of rising health care costs, it is critical that we stop taking a reactive approach to medicine and encourage more preventive health measures. I know that this administration has recognized the need to focus on preventative health care. That is why I am puzzled at the decision to eliminate the Preventive Health and Health Services Block Grant. This block grant helps fund a wide variety of preventative health measures across the country. In my state of New Jersey, the grant helps fund everything from increasing immunization rates for at-risk children, reducing risk behavior and encouraging nutrition for teens, providing home meals and healthy heart programs for targeted minority populations, to cancer services and chronic disease prevention. All of these are in line with the Healthy People 2010 initiative that your department supports. Can you explain why this grant program was cut?

Answer:

The Preventive Health and Health Services Block Grant (PHHSBG) has been an important flexible source of funding to states for prevention, providing 61 grantees (50 states, the District of Columbia, two American Indian Tribes, and eight U.S. territories) the autonomy and flexibility to tailor prevention and health promotion programs to their particular needs. PHHSBG fills gaps in categorical funding, and allows states and communities to respond rapidly to emerging health problems.

Given current constraints on the Federal budget, the FY 2007 President's Budget proposes the elimination of the PHHS Block Grant, a decrease of $99 million below the FY 2006 Enacted level. While this funding will no longer be available, the FY 2007 President's Budget proposes appropriations language providing authorization for states to utilize funds within categorical grant programs for purposes related to those conducted by PHHSBG funds. This language would provide states with a source of flexible funding in the absence of PHHSBG funds.

2.)

Question:

How are we seeking to help our populations, especially those who have the least resources and access to information to be healthy?

Answer:

HRSA

The Health Resources and Services Administration (HRSA) is the principal Federal agency charged with increasing access to basic health care for those who are medically underserved. HRSA works to expand access to high-quality, culturally competent health care; improve health outcomes among America's minority communities; and enhance direct medical care through the use of information and telehealth technology. Through a range of programs and initiatives including Health Centers, Ryan White CARE Act programs, maternal and child health programs and focusing on the health care needs of rural America, HRSA improves access to care for more than 20 million uninsured or underserved individuals. The HRSA budget supports programs that have shown success in providing direct health care and reduces or eliminates funding for programs that have failed to demonstrate results or are similar to other activities.

Health Centers: The budget includes funding toward two goals: complete the President's commitment to significantly impact 1,200 communities through new or expanded access points, and begin a new initiative to establish new health centers in poor counties. In FY 2007, an additional 1.2 million individuals will receive health care through more than 300 new or expanded sites in medically underserved communities throughout the Nation. Of the over 300 new sites, 80 will be in poor rural and urban counties consistent with the President's goal of establishing new health centers in the poorest counties in the Nation. A total of $52 million from the increase requested in FY 2007 is directed to the poor county initiative, including $4 million for planning grants for poor counties interested in creating access to primary care services. By the end of FY 2007, 15.8 million patients will be receiving affordable primary and preventive health care at 4,015 sites across the country. Consistent with Secretary Leavitt's charge to transform the healthcare system, Health Centers are effectively targeted to eliminate health disparities and provide a range of essential services. An estimated 86 percent of Health Center patients are at or below 200 percent of the Federal poverty level. Forty percent of Health Center patients have no health insurance and 64 percent are racial or ethnic minorities. Further, 84 percent of Health Centers provide pharmacy services on site or by paid referral, 82 percent provide preventive dental care, and 75 percent provide mental health and substance abuse services. The budget request includes $45 million in no-year funding for the Health Centers Federal Tort Claims Program, which provides medical malpractice coverage for the increasing number of Health Center employees. The request provides $3 million to improve the 340B Drug Pricing program which provides drugs at discounted prices to participating safety-net clinics and hospitals. In FY 2007, funds will be used to improve the collection and analysis of manufacturer drug pricing information to ensure that 340B participants are charged accurate prices for drugs and for other program improvements. Participants in the 340B program include certain Federal grantees and disproportionate share hospitals, such as Health Centers, Ryan White grantees, Hemophilia Treatment Centers, IHS funded tribal clinics, Office of Population Affairs Title X family planning programs, and CDC funded STD and TB programs.

Ryan White, HIV/AIDS: Each year, Ryan White CARE Act programs provide services to approximately 571,000 individuals who have little or no insurance. The FY 2007 request includes $2.2 billion for Ryan White activities, an increase of $95 million over FY 2006 for a new Domestic HIV/AIDS initiative. Of the $95 million, $70 million will address the on-going problem of State waiting lists and provide care and life-saving medications to those newly diagnosed as a result of increased testing efforts. The remaining $25 million will be used to expand outreach efforts by providing new HIV community action grants to intermediaries including faith and community-based organizations, and to provide technical assistance and sub-awards to grassroots organizations. Combined with $93 million in new CDC funding, a total increase of $188 million is requested for this initiative in FY 2007.

Maternal and Child Health Block Grant: The Maternal and Child Health (MCH) Block Grant supports Federal and State partnerships that provide gap-filling prenatal health services to more than 2.3 million women and primary and preventive care to more than 26.8 million infants and children, including approximately 1 million children with special health care needs. The budget provides $693 million for the MCH Block Grant. The Deficit Reduction Act of 2005 provides $3 million in mandatory funding in FY 2007 for the development and support of family to-family health information centers.

Office of Rural Health Policy: The Office of Rural Health Policy promotes better health care service in rural America. The Office is charged with informing and advising the Department of Health and Human Services on matters affecting rural hospitals, and health care, coordinating activities within the Department that relate to rural health care, and maintaining a national information clearinghouse, the Rural Assistance Center (http://www.raconline.org/). The Office works both within government at Federal, State and local levels, and with the private sector -- with associations, foundations, providers and community leaders -- to seek solutions to rural health care problems.

CDC

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CDC has a special responsibility to address health problems and promote health among those people who have the least resources and least access to information. CDC extends special efforts to ensure that public health interventions are reaching those people with the most severe health problems and with the least access to resources and information in a variety of ways. Examples include:

Filing Gaps in Preventive Care – Breast and Cervical Cancer Screening and Immunization Services:

CDC's National Breast and Cervical Cancer Early Detection Program (NBCCEDP) provides potentially life-saving screening to uninsured and underserved women ages 50-64, filling a screening gap in our national health care system. More than three million women have received mammograms and cervical cancer screenings through the program. The national screening program has contributed to the notable decline, in recent years, in breast and cervical cancer deaths by providing access to screening services, increasing breast and cervical cancer awareness and education, and inherently changing health-seeking behaviors in women for whom screening services are not otherwise available or accessible.

The Well-Integrated Screening and Evaluation for Women Across the Nation (WISEWOMAN) Program helps women in need gain access to screening and lifestyle interventions that can reduce their risk for heart disease and other chronic diseases. The program offers screenings and interventions to women participating in the National Breast and Cervical Cancer Early Detection Program for obesity, sedentary behavior, poor dietary habits, high blood pressure, high cholesterol, and smoking. Some programs also screen women for diabetes or osteoporosis, because these conditions also are affected by nutrition and physical activity. WISEWOMAN project staff provide referrals when treatment is needed. The programs have provided more than 120,000 lifestyle interventions. In 2004 and Mid-2005, over 19,000 women were screened. For women followed in 2005, cholesterol levels dropped from 211 milligrams per deciliter to 207, estimated risk of heart attack in the next 5 years decreased.

The Vaccines for Children (VFC) program, established in 1993 under the Omnibus Reconciliation Act (OBRA) as Section 1928 of the Social Security Act, provides funding to 61 immunization programs. The federally-purchased vaccines are distributed to public health clinics and VFC-enrolled private providers.

- Under the current law, VFC provides vaccines to children (0 -18 years of age) who are eligible for Medicaid, American Indian or Alaska Native, uninsured, and/or underinsured children who present at federally qualified health centers (FQHCs) or rural health clinics (RHCs).

- In 2004, the program provided approximately 40% of the doses of pediatric vaccines distributed in the U.S. These vaccines were administered by 45,000 provider sites, 75% of which are private practice sites and 25% public sector sites.

- The VFC program also funds the pediatric vaccine stockpiles, which can be used to interrupt disease outbreak situations and ameliorate short-lived production problems, which are likely to occur from time to time.

CDC's Immunization grant program was launched in 1963 by Section 317 of the Public Service Health Act to ensure individuals of all ages have access to immunization services. The majority of Section 317 program funds are dedicated to routine childhood programs, with a smaller portion remaining for adult immunization programs. The discretionary program, annually appropriated, provides funding to 64 immunization programs, and federally-purchased vaccines are distributed to public health clinics as funds permit. In 2004, the program reached about 8% of all U.S. children. Under the current law, Section 317 primarily provides vaccines to children who present at health departments for immunization services but are not eligible for the VFC program or are underinsured but not able to receive VFC vaccine due to legislation designating specific health centers provide vaccines.

The ability to provide critical vaccines to the American population has been challenging during the last few years due to the increasing number of routinely recommended vaccines with higher prices and the fragility of the vaccine supply. As a consequence, there is a greater need for ensuring that a safety net to provide vaccines to underinsured children exists, valuable stockpiles of vaccines are readily accessible, and, there are few financial disincentives for manufacturers to produce necessary vaccines.

To address VFC program challenges the Administration's legislative proposal would expand access to underinsured children seeking immunization services in state and local public health clinics. The VFC program currently provides vaccines for underinsured children only if they are vaccinated at designated FQHCs or RHCs. However, the capacity of FQHCs and RHCs to vaccinate underinsured children is insufficient. While there are approximately 3,000 FQHCs enrolled in the VFC program, they are not equally distributed throughout the country. Due to the limited number of FQHCs and RHCs, many underinsured children seek vaccination at public health clinics. With the VFC expansion, approximately an additional 5,000 state and local health department clinics will be able to provide VFC vaccines to underinsured children. Increasing access points for VFC eligible children will allow those who have been previously denied VFC vaccine at public health clinics to be vaccinated with the full series of routinely recommended vaccines.

The limited capacity of the FQHCs and RHCs strains the Section 317 immunization grant program. For example, results from a January 2003 survey indicated that children in some states were denied pneumococcal conjugate vaccine at state and local health departments due to funding limitations in the program. Since that time, influenza vaccine, meningococcal conjugate vaccine, Tdap vaccine, and hepatitis A vaccine have been added to the routinely recommended childhood immunization schedule. These expensive new vaccines will be incompletely implemented unless the Administration's VFC proposal is accomplished.

Reaching Out to Under-Served Populations and Populations Most Severely Impacted:

Across CDC's programs, from Chronic Disease Prevention and Health Promotion, to Injury Prevention, Environmental Health, HIV, STD, and TB prevention, CDC's programs identify those populations most severely impacted and those facing particular barriers to good health, and work to ensure that health protection and health improvement efforts address the health of those most in need. For example:

CDC's Racial and Ethnic Approaches to Community Health (REACH 2010) program funds 40 communities to address health barriers faced by racial and ethnic minority groups. REACH 2010 communities are demonstrating that we can reduce health disparities and that we can improve health among those most severely impacted. The REACH 2010 initiatives are activating community members to seek better health. They are bridging gaps between the health care system and community members - reducing disparities in who receives vital preventive care both by empowering community members with the information they need to seek appropriate care, and by changing health care practices. To accomplish this, they use media campaigns, community outreach, lay health advisors, family and group education, community-wide education and mobilization, and ongoing collaboration with health care service organizations in their communities to change these organizations and their relationship with the communities they serve.

CDC's Diabetes Prevention and Control Program works on unique solutions to diabetes, where the dispersion of the population across a wide area makes traditional approaches difficult. The National Diabetes Education Program (NDEP) is a joint effort involving CDC and NIH and over 200 partners. It is designed to improve treatment and outcomes for people with diabetes. NDEP provides funding and technical assistance to eight national minority organizations for five years to promote culturally appropriate diabetes prevention and control resources and strategies in their communities.

The National Diabetes Prevention Collaborative is a HRSA led project that CDC, HRSA and the Institute for Healthcare Improvement jointly work to improve diabetes care and pre-diabetes prevention performance measures through improved care delivery systems, increased access, and decreased health disparities among medically underserved populations. Results indicate that the Diabetes Collaborative models are successful in improving the A1C blood test rates and effectively identifying pre-diabetes.

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CDC's Diabetes Program has also developed targeted messages for Hispanics, a population particularly impacted by diabetes. The National Diabetes Education Program has reached 3.6 million Hispanics to date with Public Service Announcements, media broadcasts and print media.

CDC's National Center on Birth Defects and Developmental Disabilities' (NCBDDD) most successful prevention activities center around conditions with a strong evidence base for prevention. In the case of folic acid, research that folic acid consumption before and during early pregnancy was applied through the establishment of fortification policies mandated by the Food and Drug Administration. This policy has seen dramatic reduction in the occurrence of birth defects preventable through folic acid (26% decline). Despite declines, disparities have persisted. Hispanics had the highest rates of these conditions before, and still have the highest rates. NCBDDD's strategies for reducing the occurrence of these conditions among Hispanics include 1) health communication efforts designed specifically to reach this population, and 2) system-wide interventions such as targeted fortification schemes for corn flour—a staple of the Hispanic diet. Corn flour sold in US often is not labeled as enriched and thus not required to contain folic acid and other added nutrients.

3.)
Question:
How do we expect to prevent incidence of obesity, diabetes, heart disease, and other serious health problems if we cut the finding sources for preventative health care?

Answer:
In addition to PHHS Block Grant funding, CDC provides national leadership and funds state and community programs for the prevention of heart disease and stroke, diabetes, and obesity.

Currently, CDC funds 32 states and the District of Columbia for heart disease and stroke prevention programs. Program priorities include: the prevention and control of high blood pressure; the prevention and control of high blood cholesterol; improving emergency response; knowing signs and symptoms; calling 911; improving quality of care to prevent and manage high blood pressure, stroke and heart disease; and the elimination of disparities.

CDC's Nutrition and Physical Activity Program to Prevent Obesity and Other Chronic Diseases funds 28 states to use systematic approaches in communities to build lasting and comprehensive efforts to fight obesity. Promoting regular physical activity and healthy eating and creating environments that support these behaviors are essential to reducing the epidemic of obesity. Early 2005 results show that: Twenty states reported a total of 72 legislative changes, including: a Medicaid weight-management program; new parks and trails; and worksite incentives for improved nutrition and physical activity behaviors. States also reported 44 new environmental changes providing increased pedestrian and bicycle safety, as well as healthier food choices in schools and communities.

All 50 states and the District of Columbia are funded for Diabetes Control and Prevention Programs. These programs are translating diabetes prevention and control science into clinical and public health practice. The programs are demonstrating results in increasing eye and foot exams, self-monitoring of blood glucose, and pneumonia and influenza shot levels for people with diabetes.

Nearly a third of our nation's children and adolescents are overweight or at risk of becoming overweight. CDC provides funds to 23 state departments of education to implement Coordinated School Health Programs that reduce chronic disease risk factors such as poor eating habits, physical inactivity, and tobacco use. Schools have a critical role to play in promoting the health and safety of young people and helping young people establish lifelong healthy behavior patterns.

Steps to a Healthier US funds states, cities, and tribal entities (40 communities) to implement integrated chronic disease prevention and health promotion efforts focused on reducing the burden of diabetes, obesity, and asthma, as well as addressing physical inactivity, poor nutrition, and tobacco use. Funding supports the following:

- Implementing community, environmental, educational, media, and policy interventions in schools, communities, health care, and workplace settings.
- Establishing an alliance of partnerships and coalitions committed to participating actively in planning, implementation, and evaluation activities.
- Using measurable program objectives and specific indicators of progress to support ongoing program improvement.

Cuts to Health Professional Training
1.)
Question:
Cuts to health care Professional training 1.The Title VII health professions training program provides health professionals with the training to respond to needs of special and underserved populations and increases the racial and ethnic diversity of the health care workforce. This budget would cut funding for Scholarships for Disadvantaged Students from"$47 million this year to $10 million for next year and would eliminate all other Title VII professional training programs. Without these programs, we are shutting doors of opportunity, and reducing accessible healthcare for underserved communities . Minority health professionals are more likely to serve minority and underserved populations; if we are not increasing the diversity of our :workforce then we are also jeopardize the access these populations have to health care. What impact do you think these cuts will have on communities and on diversity in healthcare?

Answer:
In view of the country's budget deficits, we cannot continue to fund all programs. In making budget decisions, we have looked closely at how well funding is addressing national health care priorities in terms of providing services and producing results.

Regarding the health professions training programs, we do not have shortages in every area of medicine or in every area of the country. Our greatest needs are in the provision of services and health care providers to our most underserved areas (most especially rural areas and underserved populations. We have therefore concentrated our budget funding on Community Health Centers and on the NHSC, the latter being our most successful health manpower training program in targeting the most underserved areas and populations. Evaluations of the health professions training programs, where we have not included funding reflect minimal to no benefit for the underserved.

We share your concern about the need for diversity in our health care workforce. The funding which we have requested for Scholarships for Disadvantaged Students will support 6,300 disadvantaged students, and the program will continue to facilitate the training of health practitioners from disadvantaged backgrounds. Since 2001, we have requested increased support and funding for the NHSC, which not only best targets services to underserved populations, but provides very substantial support for the training of minority students in health workforce manpower training. In FY 2005, 51 percent of NHSC Scholars were racial/ethnic minorities, as were 28 percent of Loan Repayors. Similarly, the Community Health Centers serve a population that is 63.5 percent minorities. We have indeed seen a need to improve access to health care in underserved minority communities and our budget requests have reflected this focus.

2.)
Question:
What else is the Department doing to ensure we are having greater cross-section of Americans participating in the health care workforce? How do you see community health centers recruiting minority professionals when the funding for training minorities is being cut so drastically?

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Do you believe there isn't a need for improvement when it comes to serving minority communities, either through training individuals to become health professionals or providing services to underserved communities?

Answer:
In nurse training programs, our budget requests for increased funding have reflected the clear nationwide shortage of nurses, while agreeing with Congress in focusing recently enacted nurse training programs on critical shortage facilities and basing the new Scholarship program on financial need.

Regarding Title VII health professions training programs, a General Accountability Office (GAO) evaluation report showed no link between Health Professions training programs in general and changes of supply, distribution, and minority representation of health professionals. Studies show that health professions training programs have shown little payoff for services for the underserved populations in which minorities are most substantially represented: analyses find that 8 of every 10 health care providers that benefited from the Health Professions programs' long term training support did not practice in health care shortage, underserved areas. We are recommending reduction in funding for Scholarships for Disadvantaged Students, but the requested funds will support 6,300 disadvantaged students and the program will continue to facilitate the training of health practitioners from disadvantaged backgrounds.

We have requested increased funding and support for programs which have focused and targeted providing services in underserved areas and to underserved populations–namely, Community Health Centers and the NHSC. Although these programs are not designated by name as minority service programs per se, they do serve the most underserved populations in the Nation, and minorities represent 63.5 percent of Health Center patients. The National Health Service Corps (NHSC) also targets awards to individuals who demonstrate characteristics that are significantly related to a probably success in a career of service to the underserved.

<u>NIH</u>
1.)
Question:
Heart disease stroke, and cancer continue to be leading causes of death in New Jersey and across the counl ly - New Jersey has the 9th highest incident of cancer in the nation. Can you explain how research and treatment for diseases such as cancer, heart disease, and strokes will not be adversely affected when the largest cuts are going to the National Cancer Institute and the National Heart Lung and Blood Institute?

Answer:
The recent doubling of the NIH budget resulted in an explosion of information about the human genome, which has enabled us to move faster in science and technology and to use these advances to expand our focus on the entire cancer continuum of discovery, development, and delivery. In addition, we are beginning to reap the benefits of the new molecular technologies that are enabling us to understand cancer as a disease of altered genes and biological processes – a disease process that can be interrupted and controlled. The National Cancer Act of 1971 provided us with the national commitment to pursue our Challenge Goal, but the accomplishment of the Human Genome Project and the new generation of advanced biomedical technologies have placed it within reach. With gene and protein microarrays, nanotechnology, information technologies, and advanced molecular imaging systems, this goal is fast becoming a reality. Despite budget cuts, we are determined to manage our resources to continue to take advantage of these opportunities. The current budget environment will require us to refocus our efforts on the most promising scientific opportunities that will have the broadest impact.

Likewise, the doubling of the NIH budget greatly increased the ability of the NHLBI to benefit the Nation by capitalizing on a number of outstanding and timely scientific opportunities. The current budget constraints were not unforeseen, and NHLBI's longstanding prudent fiscal policies have placed it in a reasonably good position to weather this relatively lean period without compromising the momentum of ongoing research. NIH continues to make strategic investments in trans-NIH initiatives, like the NIH

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Roadmap for Medical Research; a new program to support new investigators; a new initiative to study the interaction of Genes and the Environment on health; and Clinical and Translational Science Awards. These initiatives will preserve our investment in biomedical research and support medical advancements that will improve the length and quality of human life during a tight budget period. NIH is working hard to maintain the pace of scientific advances and to translate them into cures and treatments as quickly as resources allow.

2.)
Question:
Leading scientists continue to attribute their breakthroughs to NIH funding. At a time when our society is faced with global competition, how do you defend cutting the very research institutes that have been attributing to our country's medical success?

Answer:
NIH continues to make strategic investments in trans-NIH initiatives, like the NIH Roadmap for Medical Research; a new program to support new investigators; a new initiative to study the interaction of Genes and the Environment on health; and Clinical and Translational Science Awards. These initiatives will preserve our investment in biomedical research and support medical advancements that will improve the length and quality of human life during a tight budget period. NIH is working hard to speed the pace of scientific advances and to translate them into cures and treatments.

3.)
Question:
What kind of progress do you feel is being made in regards to minority health disparities? Do you feel that health disparities among minority communities no longer exist? If so, then why are there cuts to the National Center for Minority Health and Health Disparities?

Answer:
Health disparities research has moved to the front burner across HHS and throughout many of the Nation's research institutions. At the NIH, for example, there has been an increased focus on research across multiple disciplines to examine diseases, health conditions, and various factors contributing to the disparity in health among underserved populations such as racial/ethnic minorities, individuals in medically underserved communities including urban and rural populations, and the poor.

There is also now an increased awareness about the issue of health disparities, and through national outreach campaigns such as the annual *Take A Loved One for A Check-up Day* and *Celebra La Vida Con Salud,* more racial and ethnic minorities are paying closer attention to their health. We are also now engaging the faith-based and community-based organizations in this effort.

Health disparities in minority communities still exist in the United States. The National Center for Health Statistics at CDC continues to report compelling statistics on health disparities. As the Nation's racial and ethnic minority populations continue to increase and the country's demographics changes, the elimination of health disparities among racial and ethnic minorities remains a high priority for the Department of Health and Human Services. The HHS partners with and continues to expand its network of partners among institutions, organizations, the private sector, and individuals and provided funding support to establish health disparities research, research capacity-building, research training and outreach programs in various racial/ethnic communities in the country.

The investment of the NCMHD in health disparities has steadily increased from $130 million in 2001 to $194 million in 2005. The issue of health disparities is a priority for the Department and for the NIH, and we are committed to continue increasing our investments in health disparities through the work of all of NIH's Institutes and Centers, including the NCMHD.

<u>Seniors and Family Caregiver Issues</u>

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1.)
Question:
I recently introduced legislation in the Senate to address the growing needs of our family caregivers. This legislation would double the National Family Caregiver Support Program, which provides a wide range of services for older persons. I'm particularly concerned to see that this program has been cut in the budget, and I'm wondering how you see our country preparing for the growing population of seniors. Could you expand on how this budget anticipates and addresses the growing senior population and their changing needs?

Answer:
In only a few years, the National Family Caregiver Support Program has become a significant element of the core services provided by the network of aging organizations. Federal funds for this program have increased by 30 percent, from $124.98 million in 2001 to $162.41 million in 2006. The network has been very successful in reaching out to over 12 million people with information about the program in fiscal years 2003 and 2004, and in providing direct services to over 600,000 caregivers in each of those two fiscal years. The FY 2007 budget proposal for the Administration on Aging is designed specifically to enhance the support that is available to elderly people and caregivers through the core programs of the Older Americans Act. The centerpiece of our FY 2007 budget proposal for AoA is the "Choices for Independence" demonstration. This demonstration will provide tools across the aging network that will enable elderly people, caregivers, and those who serve them gain access to significantly greater resources than are available under the Older Americans Act. Choices for Independence has three components that build off existing HHS investments, such as Aging and Disability Resource Centers, Cash and Counseling, Evidence-Based Disease Prevention grants, and the Own Your Future campaign. The innovative new approaches that form the foundation of the Choices initiative will help AoA's core programs be more efficient and effective. This is especially true for the Caregiver program in that consumer choice options are very likely to increase direct support of family caregivers and significant providers of care.

2.)
Question:
My mother suffers from a horrible disease that too many seniors face - Alzheimer's. Unfortunately, this disease is only expected to become more prevalent - by 2050- as many as 16 million Americans could have Alzheimer's: I would think that focusing on this issue now will save money in the long term. Can you discuss what the consequences would be of cutting the Alzheimer's demonstration grant and how HHS plans to meet those needs elsewhere? What funding will go towards addressing caring for those with Alzheimer's and providing the resources and support that families need?

Answer:
The FY 2007 budget seeks to continue the AoA's efforts to integrate best practices and program initiatives into our existing core services programs, for which we have been able to document strong quantitative performance over the past five years. Integrating Alzheimer demonstration activities into AoA's core program structures will provide a more constructive and effective means to consistently address this need. Since 1991 Alzheimer's demonstrations, in every state, have highlighted effective approaches for serving people with this disease. As a significant number of States have already done, it is time to move away from the continued demonstration of this activity, and to completely integrate the models and the lessons that have been learned into AoA's core programs, especially the National Family Caregiver Support Program. Activities associated with support of people with Alzheimer's disease and those associated with the broader Caregiver program will benefit from the modernization that the Choices for Independence initiative will bring to the aging network. In addition to the program effects associated with people with Alzheimer's disease, the Choices demonstration will have an additional impact as it empowers consumers by helping them make informed decisions about existing care options, by helping them to plan ahead for their long-term care needs, and by streamlining access to publicly supported long-term care programs.

<u>Children</u>
1.)
Question:

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This budget cuts the Medicaid program by 14 billion dollars over 5 years. When over 50 percent of Medicaid recipients in the United States are children - that is over 26 million children - cuts to this program are essentially stacking the deck against them. In my own state of New Jersey, 24 percent of the state's children are enrolled in Medicaid, not to mention more than 264,000 children in New Jersey that are uninsured. When] add these cuts to the cuts being made to child care ($1.03 B in cuts over 5 years) and preventative care for newborns. I have a hard time seeing how this budget is going to help those at the dawn of life.

When we know the benefits of keeping kids healthy and the money that it saves our healthcare system, why would we under fund and zero-fund the very programs that give our kids a healthy start - programs that help put them on a path to a healthy life?

I'm happy to see that $4.9 billion in spending has been set aside for the administration's "Cover the Kids" outreach initiative, which seeks to work with states, schools' and community organizations to enroll eligible children in SCRIP and Medicaid. I'm just wondering how you anticipate the states to afford this increased enrollment when the very Medicaid funds needed to provide services to these kids are being cut.

Answer:
The President's "Cover the Kids" (CTK) proposal provides $100 million annually in grants to States, schools, and community organizations to enroll and provide coverage to many eligible, but not enrolled, children in Medicaid and SCHIP. The proposal increases SCHIP spending by $69 million in FY 2007 and $330 million over five years. The proposal increases Medicaid spending by $203 million in FY 2007 and nearly 2 billion over five years.

The President's FY 2007 Budget also contains important administrative reforms that are critical to preserving the Medicaid program. Without these changes, Medicaid's projected growth rates would put even greater pressure on state budgets. These critical reforms, in part, not only promote greater efficiency of the Medicaid program, but also make it possible to provide outreach funding – such as the annual grants under the CTK program – that are critical to expanding Medicaid and SCHIP coverage to the millions of eligible but un-enrolled children nationwide.

The Honorable Russell D. Feingold

1.)
Question:
Since the beginning of January, I have been hearing from advocacy groups and individuals in Wisconsin that many Medicare beneficiaries are unable to get their prescription drugs through Medicare Part D. The implementation problems in the state have caused a crisis for those who were unable to receive critical prescriptions such as insulin transplant medications, and cancer drugs. I appreciate CMS working with my office and Wisconsinites to fax these individual problems; : however, I am still getting phone calls from people who can't get their drugs, and those calls don't appear to be slowing down. I know that you have said that you and Dr. McClellan are both working to fix these problems, but it is becoming obvious that band-aid faxes are not going to affect the systemic problems in this program. What are you doing to address these large-scale, systemic problems? (People still not getting their medications).

Answer:
CMS did experience some systems challenges in the early weeks of the program, but the vast majority of them have now been addressed. Ensuring that beneficiaries who enroll in a Medicare prescription drug plan have access to the drugs they need is a top priority for CMS. We will continue to address any systemic issues – large or small – as they arise.

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2.)
Question:
The prescription drug program implementation has been particularly difficult for long term care residents, administrators, and staff. Many of the requirements in Part D cause bureaucratic nightmares for patients, providers, and staff alike. This is especially difficult for long-term care facilities in rural areas that do not have many options for pharmacies drug plans that understand their needs, I would like to know what you are doing to address the needs of long-term care residents, and what are you doing to work with drug plans in order to ensure that they understand the needs of the facilities.

Answer:
CMS is committed to ensuring that Medicare beneficiaries in long-term care (LTC) facilities continue to receive the medications and pharmacy services they need without interruption. CMS continues to work with pharmacists and other healthcare providers, advocacy groups, and agencies to provide all beneficiaries residing in LTC facilities with access to affordable prescription drug coverage, enhanced compliance with treatment regimens, and improved health and reduction of adverse health effects.

With the help of our Web Tool, 1.800 MEDICARE, and a facsimile number whereby the nursing home facilities fax lists of residents to us, CMS was able to help nursing homes identify the drug plans in which their residents had been assigned prior to the January 1, 2006 start date of the Medicare prescription drug program.

Currently, Medicare plans are required to contract with a broad network of long term care pharmacies to deliver to nursing homes that meet our regulatory standard, in order to provide convenient access to beneficiaries. CMS requires that all plans are able to deliver prescription drugs to all nursing homes in their regions. We have special performance and service criteria for nursing home residents and have a special election period for these individuals. The coverage determination, grievance, exceptions, and appeals processes, as specified in the final regulation, will ensure that LTC residents receive quick determinations regarding the medications they need. Additionally, full-benefit dual eligible LTC residents who need to change prescription drug plans to better accommodate his or her pharmaceutical needs and pharmacy affiliations, may do so at any time.

CMS has ongoing communication with the long-term care industry, which include weekly calls with trade associations and long term care pharmacy associations (AAHSA, AHCA, the Alliance for Quality Nursing Home Care, AMDA, and LTCPA) to address specific issues implementation issues that impact the long-term care community. CMS also uses the Minimum Data Set (MDS) distribution channel and intermediary newsletter as a way to communicate information. To date, CMS has already supplied the industry with an extensive amount of Part D materials.

3.)
Question:
I am sure you are aware of the importance of Automated External Defibrillators, or AEDs. We place AEDs in Federal buildings; in fact there are AEDs in the Humphrey Building, where your office is located. The reason that we have AEDs in the HHS buildings, the Senate buildings, and the Capitol, is because they can save the lives of people who suffer sudden cardiac arresr. AEDs are an inexpensive, effective method of saving lives, and we think that this is a worthwhile expense.

The Rural Access to Emergency Devices Grant Program provides funding for States to purchase AEDs, place them in rural communities unable to afford to purchase them, and train community members to use them. You have proposed eliminating this program in the FY2007 budget even though there are thousands of rural communities across the country that do not have access to AEDs. I would like an explanation beyond the official justification, of why you requested the elimination of this program. I would also like to know if you think enough has been done to get AEDs into the hands of people in rural communities.

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Answer:
The Administration believes the most dire need for AEDs in the rural communities has largely been satisfied. In addition, there are other programs through which any remaining need may be addressed, such as the Rural Health Services Outreach Grant Program. Furthermore, the cost for AEDs has dropped dramatically in recent years, making them much more affordable without the need for Federal assistance.

4.)
Question:
While oral health in America has improved dramatically over the last 50 years, these improvements have not occurred evenly across all areas, and an estimated 25 million Americans live in areas lacking adequate dental services. Astoundingly, as many as eleven percent of our nation's rural population has never been to a dentist. The problem is exacerbated by the fact that our dental workforce is aging - more than 20 percent of dentists nationwide will retire in the next ten years and the number of dental graduates by 2015 may not be enough to replace these retirees. As a consequence, Wisconsin! like many states is facing a serious shortage of dentists, particularly in rural areas.
The Health Care Safety Net Amendments of 2002 included the Collins-Feingold Dental Health Improvement Act) which authorized a new state grant program administered by the Health Resources and Services Administration that is designed to improve access to oral health services in rural or underserved areas. Last year, this program was appropriated $2 million, which was the first time it had received funding. I would like to get more information on the implementation of this program and an update on where the agency is in terms of distributing funds for this program.

Answer:
Guidance for this new grant program's applications has been developed and will be disseminated shortly to potential applicants/grantees.

The FY 2006 appropriation is projected to fund 18-20 State grants at an average of $100,000 per grantee. It is anticipated that this program will support activities in States that are geographically dispersed throughout the United States and support a group of projects that address the dental workforce needs of underserved urban and rural populations.

The Honorable Debbie Stabenow for Secretary Leavitt

Federally Qualified Health Centers
1.)
Question:
I am a big supporter of community health centers and I have worked with Senator Bond to increase funding for this great program. Although over the past 4 years, there have been over 700 new community health center sites with the increased funding provided by Congress, my understanding is that, during that same period, upwards of 1,000 additional applications which met all requirements were submitted, but which you could not fund due to lack of available funding. Is that correct?

While we all support the continued expansion of the Health Centers program, it is critical for future budget planning that we know how many would be health centers are out there that still aren't receiving grant funds. Would you please provide to the Committee the total number of applications submitted for each year beginning in FY 2001, the number that were scored as fully acceptable or higher and the number that were actually funded?

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Answer:

The following table provides the requested application information for FY 2002 through FY 2005. The President's Health Centers Initiative began in FY 2002.

	FY 2002	FY 2003	FY 2004	FY 2005
Applications	628	650	705	357
Scores FA* or higher	378	424	486	257
Awards	302	188	129	158

(*FA – fully acceptable)

The Honorable Bill Nelson

1.)

Question:

According to the National Head Start Association, only half of eligible children receive Head Start services because of a lack of funding. They estimate that the President's budget proposal will cut 19,000 children from the program next year because funding is frozen and won't keep pace with inflation. Can you explain to us why the Bush Administration isn't making Head Start funding a priority?

Answer:

We do not agree with NHSA's assertion that Head Start has taken a "hit" in the President's FY 2007 budget. Head Start will be funded at its FY 2006 level. No Head Start program will sustain any funding reduction in FY 2007 if the President's request is approved and there should be no reduction in the number of children served.

The Head Start program has seen significant growth in the last several years, most of which has been used to support staff salary and fringe benefit increases. Between FY 1995 and FY 2005, for example, the Head Start budget increased by 94 percent while enrollment increased by only 21 percent. In many of those years staff received increases which were two to three times the rate of inflation. Head Start grantees have considerable flexibility in how they use their Head Start grant funds, and we believe they can design budgets, with their current funding levels, which will reflect high quality programs that will serve the same number of children they were able to serve last year.

I also want to note that there is not agreement on the extent of Head Start's unmet need. While there are many low-income four year olds not served by Head Start our data suggest that virtually all four year old children whose parents want to enroll their child in a pre-K program have done so. Head Start, unlike years ago, is not the only option available to parents of preschool age children. There are billions of dollars made available to child care providers throughout this country and many low-income four year olds are served in these programs. Moreover, there are an increasing number of states which are investing in pre-K programs and our research suggests that many parents are choosing to send their children to these programs rather than to their local Head Start program.

2.)

Question:

Over the last few years, unfortunately, the Bush Administration has not provided Head Start programs with the funding they need to ensure high quality. Programs in my state have told me that they will have to cut back 'transportation services, reduce the number of hours of operation, and cut staff to make their budgets. Shouldn't we be providing these programs with the money they need to get the job done well for children instead of squeezing them as the Administration's budget would do?

Answer:

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We believe Head Start programs do have sufficient funding to provide high quality services. The average annual cost to serve a Head Start child in FY 2005 was $7,287, and this represents only the federal Head Start funds invested in these children. It does not include a required grantee match of 25 percent, which would represent another $1,800 per child. Nor does it include support from such programs as USDA's Child and Adult Care Food program, which we estimate at $500 per child nor support from such other programs as, for example, Medicaid/EPSDT and the Child Care and Development Block Grant. Head Start programs are receiving resources that equal nearly $10,000 per child per year for, in most cases, a part-day part-year program. We believe this is a generous investment in each Head Start child and ought to allow Head Start programs the ability to provide high quality services to all enrolled children and families.

I also would like to note that the President's FY 2006 proposed funding level for Head Start did not propose a $57 million decrease. Rather that decrease was necessary because of the Congressionally mandated 1 percent rescission in all federal discretionary programs.

The Honorable Tim Johnson

1.)
Question:
I know you have been focused through clinical trials and translational research on ways to better connect the cancer centers and build' collaborative science. How will the cuts to NCI budget affect its ability to bring these recommendations to reality?

Answer:
The Cancer Centers Program provides support for the entire spectrum of cancer research. It serves the majority of peer-reviewed scientists who receive NCI funding by providing support for research from the laboratory to the clinic and by providing infrastructure support for the conduct of early phase trials. Cancer centers also move research from the clinic into the community. Centers reduce direct costs to grantees, support technology and services and provide access to expertise for the education of new investigators. Although the proposed budget will reduce the funding for the Centers program, NCI will be able to manage the resources of the Centers to continue to take advantage of the advantages that are gained by this collaborative research enterprise. For FY 2007, $ 447 million is being requested for support of the Cancer Centers Program.

2.)
Question:
I understand that the budget proposes that no funds are included for the National Children's Study and that ongoing planning activities will be brought to a close by the end of the Fiscal Year 2006. Given the federal government has already invested $50 million dollars for this study'~ and the significant impact such a study will have on human health, how do you justify cutting this program?

Answer:
No funds for the NCS are included in the President's budget for FY 2007, due to concerns about the substantial long-term costs of this 25-year study. However, the planning and preparation for the National Children's Study have been well documented, and could provide a useful base for a study at some point in the future. In addition, there is much useful information to be gleaned from the results of the pilot studies alone.

3.)
Question:
As you know, South Dakota is one of many states that have assisted in the coverage of dual eligibilities during their transition to Medicare Part D. 'While the application process for the state to apply for a CMS waiver was very simple! I am concerned that the actual process of submitting claims for payment electronically may be complicated. What are

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HHS and CMS doing to ensure that states are provided with timely and appropriate reimbursement?

Answer:
CMS appreciates the efforts States have made during this transition period in ensuring that dual eligible beneficiaries and other low-income subsidy entitled beneficiaries receive the prescription medications they need. On Thursday, February 16, 2006, the Centers for Medicare & Medicaid Services (CMS) approved the applications of 45 States (including the District of Columbia) to participate in a Medicare demonstration project that will reimburse States for their efforts to assist dual eligible beneficiaries and low-income subsidy entitled populations in obtaining and accessing Medicare Part D coverage.

Under the demonstration, states will submit information to a CMS contractor, in a specified format, on costs that the State incurred relative to the provision of Part D drugs to dual eligible and low-income subsidy entitled beneficiaries. This information will include claims-level data on payments made to pharmacies, as well as information detailing administrative costs that are eligible for reimbursement under the demonstration. CMS will reimburse states directly based on eligible claims received. CMS's contractor will be responsible for submitting the state claims data to Part D plans in order to reconcile the state payments made for Part D drugs with claims that should have been paid by the Part D plan and determine the final payment due to States.

CMS will continue to work expeditiously with States in processing the claims for this demonstration to ensure that America's most vulnerable populations continue to receive the care they need.

4.)
Question:
I am concerned that the fast approaching May 15 deadline for enrollment without penalty is going to be a big problem. Does CMS and/or HHS have the authority to extend this deadline? If so, what would the circumstances have to be in order for the agency and/or department to take this step?

Answer:
CMS and HHS do not have the authority to extend the May 15, 2006 initial enrollment deadline for all beneficiaries. The MMA does allow the Secretary to establish special enrollment periods under specific circumstances, such as for involuntary loss of creditable coverage, errors in enrollment or exceptional circumstances. CMS has used this authority to establish special election periods extending enrollment through 2006 for certain populations, such as those displaced by Hurricane Katrina or who qualify for the low-income subsidy.

<u>The Honorable Lindsey O. Graham</u>

1.)
Question:
As a result of the Deficit Reduction Act, a large segment of imaging reimbursement will now be based on a different payment methodology. Section 5102(b) of the Deficit Reduction Act carves out one particular service and reimburses it in a completely different manner than other physician services. What are the advantages of changing from the Medicare physician fee schedule to reimbursing physicians under a hospital outpatient prospective payment system?

Answer:
In 2006 Medicare is paying a physician $903 for doing an MRI of the brain or an MRI of the abdomen. Medicare will also pay a Hospital Outpatient Department (OPD) $506 for the exact same test. Thus,

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Medicare is paying almost $400 or 78 percent more for doing these MRI imaging tests purely depending on whether the test is performed in an OPD or a physician's office. Similarly, Medicare will pay 267 percent more for doing an ultrasound guidance for artery repair in a physician's office than an OPD ($228 vs. $62). These comparisons do not include a physician's interpretation of the test for which Medicare will pay a separate fee. There is no consistency in the percentage that the physician fee schedule exceeds the hospital OPD payment amount. The percentage difference varies by procedure.

In the context of: (1) significantly larger payments under the physician fee schedule than the OPD for the same service for certain imaging services, (2) site neutral payments for the same service identified by MedPAC as a long term goal under Medicare fee-for-service payment systems, (3) rapid growth in Medicare spending for imaging services for several years, (4) MedPAC raising methodological issues that suggest relative values under the physician fee schedule for imaging services would be too high, combined with a lack of procedure and equipment specific information on alternative equipment utilization assumptions to use in the practice expense formula to address such issues, section 5102(b) of the Deficit Reduction Act of 2005 establishes a payment limit for the technical component of imaging services. The provision requires that Medicare not pay a physician more than Medicare would pay the OPD for furnishing the same imaging procedure. A physician's interpretation of the test for which Medicare will pay a separate fee is not affected by the provision.

2.)
Question:
As you may be aware, capping all in-office imaging at the lesser of the Medicare physician fee schedule or the hospital outpatient rate will result in cuts of up to 75 percent for some procedures and 50 percent for other critical procedures, such as MR.I of the brain and 11R.I of the lumbar spine. While I support efforts to reduce over-utilization of imaging services, I am concerned that certain physicians and imaging centers may be unable to withstand these cuts and could be driven from the marketplace, thereby forcing patients in a community to only have the option of going to the hospital to receive these types of procedures, Imaging centers leave rural and medically underserved communities, what might be the impact on the hospitals and the communities they currently serve?

Answer:
It is hard to justify paying physicians more than Medicare pays OPDs for furnishing the same imaging service. This step to level the playing field between physicians' offices and hospital OPDs only applies to procedures where Medicare pays more in physicians' offices; the DRA cap provision does not apply to all imaging procedures furnished in physicians' offices. In addition, the percent that Medicare payment rates for physicians' exceeds OPDs are not all as large as the examples cited above; in numerous cases, the differential is 10 to 20 percent. Thus, the overall impact is not expected to be as dramatic as the example of some procedures. I do not believe that physicians' offices or imaging centers will stop practicing medicine or that beneficiary access would be limited to OPDs. Nor do I believe that the provision would have an impact in rural or medically underserved communities.

The DRA provisions will be implemented through notice and comment rulemaking. These proposals are expected to be published this summer and will allow for a 60 day public comment period. A final rule will be published by November 1, 2006 and will be effective for services furnished on or after January 1, 2007.

3.)
Question:
Has the Department of Health and Human Services done any analysis ort the ability of a physician's office or imaging centers to continue to offer critical, lower compensated imaging services, such as mammography? What would the impact to the health care

community be if the only venue where a large segment of lower compensated procedures could be performed was in the hospital setting? Do you anticipate the utilization of these lifesaving screening services will increase or decrease?

Answer:
Screening and diagnostic mammography procedures would not be impacted by this provision. The Medicare statute requires that payment amounts for both screening and diagnostic mammography services be the same in both physicians' offices and hospital outpatient departments. Thus, this provision would have no impact on a woman's timely access to these important services.

The Honorable Michael B. Enzi

1.)
Question:
As you know, my Committee passed and the President recently signed into law the State High Risk Pool Funding Extension Act of 2005. Expanding coverage for the uninsured population continues to be a top priority of mine and I would like to learn more about your proposal which establishes a competitive grant program for the chronically ill. The President's budget details that $500 million would be available annually for this initiative; could you please tell me more about what you envision for this program?

Answer:
The President's FY 2007 Budget proposes providing $500 million per year to encourage states to test innovative methods for covering their chronically ill residents. These grants will be awarded through a competitive process. Legislative language addressing this proposal is under development.

THE PRESIDENT'S FISCAL YEAR 2007 BUDGET PROPOSAL FOR THE DEPARTMENT OF DEFENSE

THURSDAY, MARCH 2, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Alexander, Conrad, and Nelson.

Staff present: Scott B. Gudes, Majority Staff Director; and Mike Lofgren, professional staff member.

Mary Ann Naylor, Staff Director and Jamie Morin, analyst for national security.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will call the hearing to order. We very much appreciate Secretary England and Admiral Giambastiani and Ms. Jonas coming up today to talk to us about the defense budget. They are obviously a high-powered group representing very well the Pentagon and serving our country well and we appreciate their service to our nation. We appreciate the difficult task they have, especially with the pressures presently on the Department of Defense and the many men and women we have in the field defending us across the globe, but especially in Iraq and in Afghanistan. We obviously thank them for their extraordinary service.

The issue, of course, on the budget is one that is difficult. Could we pull up that chart, please? The discretionary side of the Federal budget is basically half non-defense and half defense. For the last 2 years, we have essentially frozen non-defense spending and the President has actually asked for a decrease in non-defense discretionary spending this coming year. Defense, on the other hand, has received extremely robust support as a result of the attack of 9/11 and the war that we are involved in, primarily, but also because we recognize that in the late 1990's, there was much too much of a draw-down in defense.

But this chart here reflects the rate of growth of defense from 2000, when the core budget was at $292 billion, to 2007, when the core budget was up to $460 billion. In addition, on top of that, there has been what I call a, well, let us call it a shadow budget of emergency spending for defense, which has basically been outside the budget process and, as a result, has therefore not been subject to any fiscal discipline because there have been emergencies and it has represented fairly significant spending, primarily focused on fighting the war in Iraq and Afghanistan.

And the question which our committee has is how long can we sustain this and at what levels can it be sustained, and I think there are serious issues here. Also, whether or not it is appropriate to have this ancillary budget moving along for the Defense Department which is essentially outside the Congressional budgeting process in that it is all done by emergency and therefore not subject to any significant discipline as the basic budget is.

The other question which I have, which I know somebody will address, is what is the core? What is it being used for? How is it— it has grown so large, what is its main thrust? If you look at the cost of fighting the war, the actual on-the-ground cost in Iraq is about $6 billion a month and the on-the-ground cost in Afghanistan is, I think, about $1.5 billion a month. That adds up to $85 billion, approximately, a year, and so the question becomes, to what extent is the core supporting that versus emergency funding and to what extent should the core support that?

So those are some of the questions I have. We have a bit of a conundrum, to put it simply. We are confronted with an extremely stringent budget on the discretionary side in the area of non-defense spending, but on the defense side, there appears to be very little control. As a result, we have questions about whether there is some way to put projections which are more predictable into the process and which are going to be affordable as we move into the out years in the defense accounts.

That all being said, there is absolute commitment by this Congress and certainly the administration to support our people in the field with whatever they need. That is critical. That is obviously why the budget has gone up so much in many areas, but we do have issues and questions regarding areas outside the actual fighting of the war.

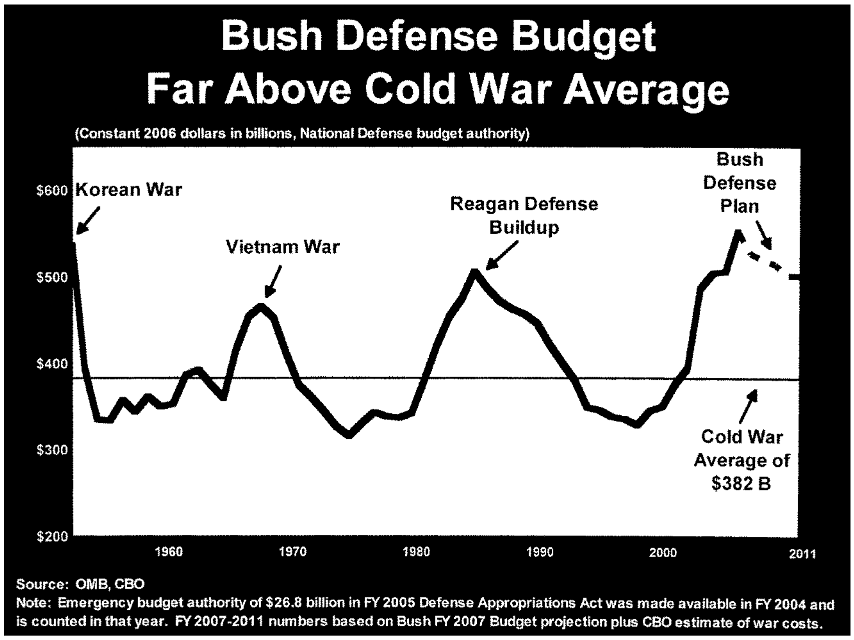
So we look forward to your testimony and your thoughts and ideas as to how we address this, and we don't really have a whole lot of thoughts and ideas. That is why we are asking for your input on it.

I will now yield to the Senator from North Dakota.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. First of all, I want to thank the Chairman, first of all, thank him for holding this hearing; second of all, thank him for the excellent questions that he has just posed because this has to be faced up to.

Let me just start with the first chart that tries to put in context where we are in comparison to previous conflicts in terms of defense spending. This chart is expressed in constant 2006 dollars, so we are comparing apples to apples. You can see going back to the Korean War, we are over $500 billion a year in terms of expenditure expressed in 2006 dollars. The Vietnam War was well below $500 billion a year. The Reagan defense buildup got to about $500 billion a year. And then we went into a long trough of reduced spending because of the cold war dividend, the end of the cold war peace dividend that was through several administrations. And now, the very dramatic ramp-up because of the attack of 9/11 and the conflicts in Afghanistan and Iraq.


Bush Defense Budget
Far Above Cold War Average
(Constant 2006 dollars in billions, National Defense budget authority)
$600
$500
$400
$300
$200
Korean War
Vietnam War
Reagan Defense Buildup
Bush Defense Plan
Cold War Average of $382 B
1960
1970
1980
1990
2000
2011
Source: OMB, CBO
Note: Emergency budget authority of $26.8 billion in FY 2005 Defense Appropriations Act was made available in FY 2004 and is counted in that year. FY 2007-2011 numbers based on Bush FY 2007 Budget projection plus CBO estimate of war costs.

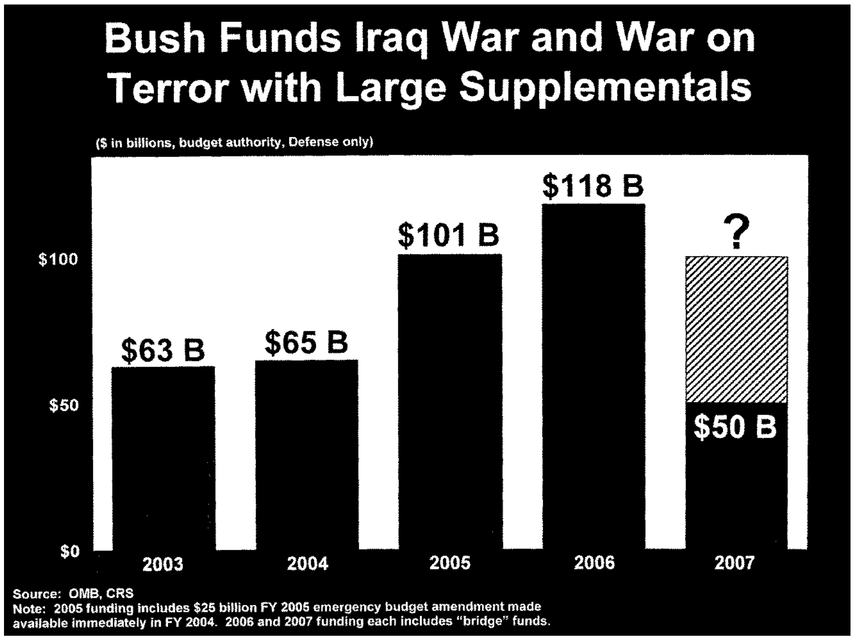
Where we are now, we can see we have actually reached a high compared to previous conflicts. We are above where we were in Korea. We are above where we were in Vietnam in constant dollars, so let us go to the next one.

Bush Administration Belittled Suggestions War Would Be Costly

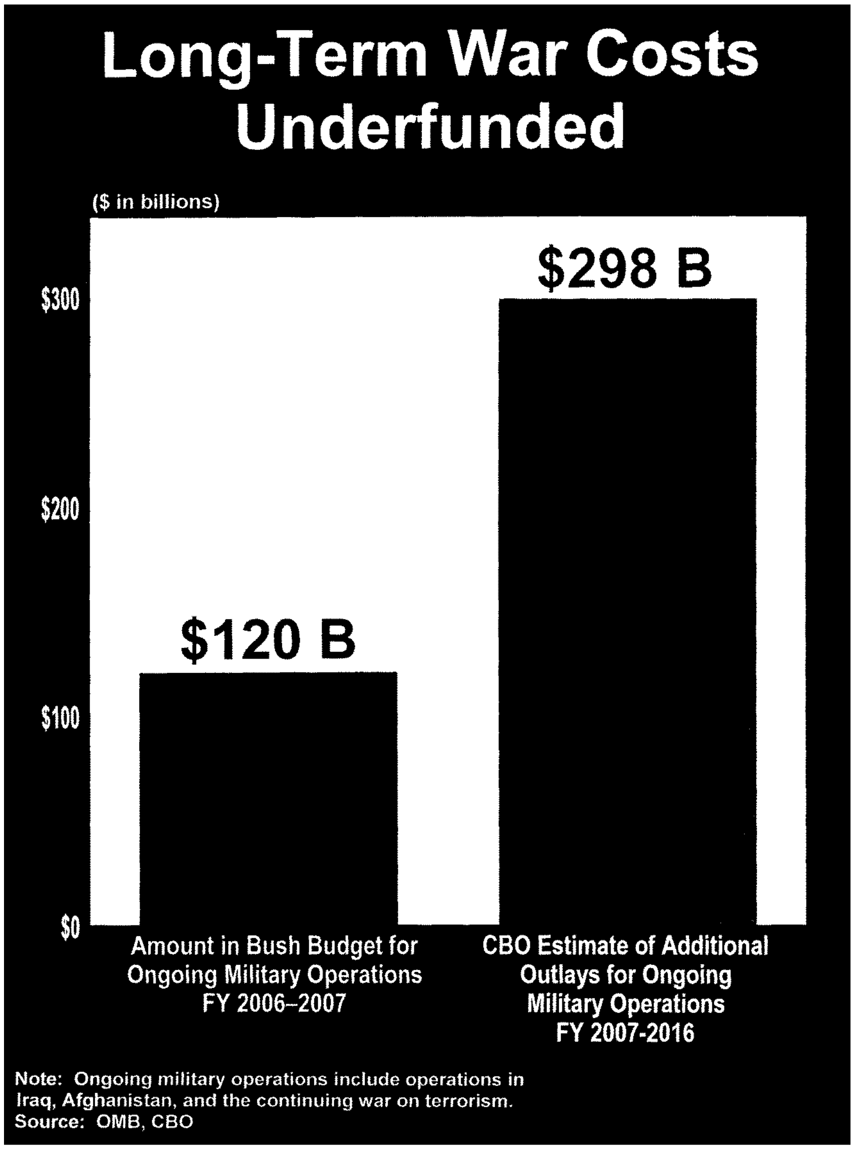
STEPHANOPOULOS:	"What should the public know right now about what a war with Iraq would look like and what the cost would be?"
RUMSFELD:	"...The Office of Management and Budget estimated it would be something under $50 billion."
STEPHANOPOULOS:	"Outside estimates say up to $300 billion."
RUMSFELD:	"Baloney."

— Defense Secretary Donald Rumsfeld
Interview on ABC's "This Week with George Stephanopoulos"
January 19, 2003

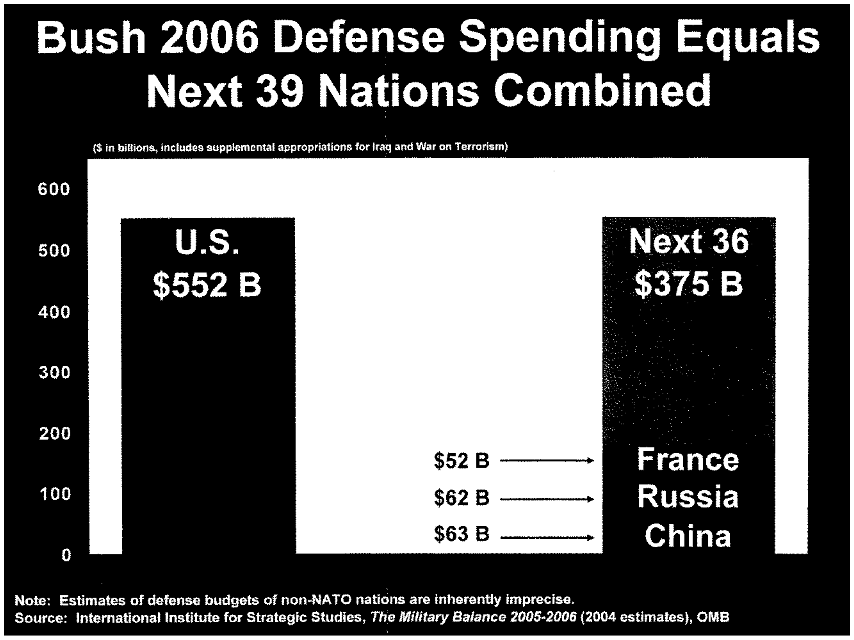
I think we all recall that at the time we entered into Iraq, that there were people in the White House who said it was going to cost $100 to $200 billion, and administration officials including the Vice President discounted that, said it wasn't accurate. The Secretary of Defense discounted it. Here is one exchange that occurred on a talk show. George Stephanopoulos asked, "What should the public know right now about what a war with Iraq would look like and what the cost would be?" Secretary Rumsfeld, "The Office of Management and Budget estimated it to be something under $50 billion." Stephanopoulos, "Outside estimates say up to $300 billion." The Secretary of Defense said, "Baloney."


Bush Funds Iraq War and War on Terror with Large Supplementals
($ in billions, budget authority, Defense only)
$100
$50
$0
$63 B
$65 B
$101 B
$118 B
?
$50 B
2003
2004
2005
2006
2007
Source: OMB, CRS
Note: 2005 funding includes $25 billion FY 2005 emergency budget amendment made available immediately in FY 2004. 2006 and 2007 funding each includes "bridge" funds.

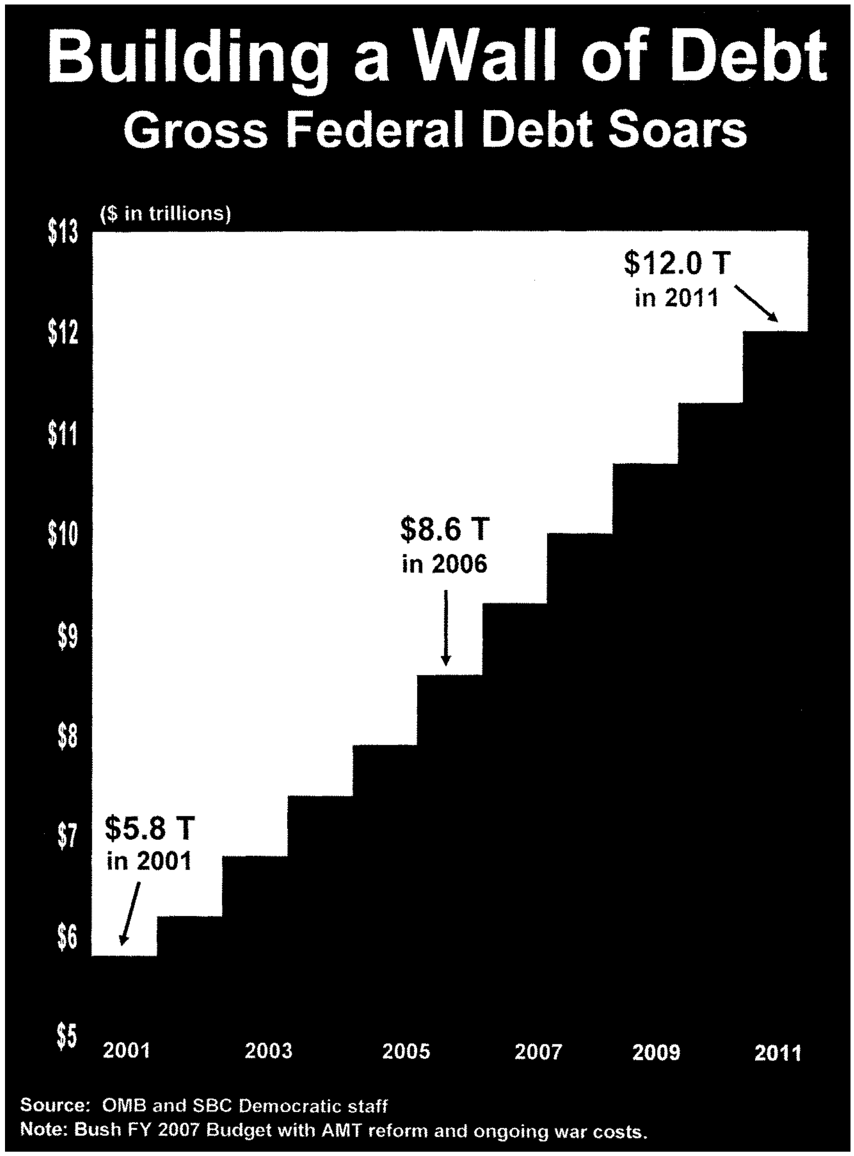
Well, so much for baloney. We are now at $397 billion and counting. The Secretary of Defense suggested it was going to be $50 billion. That is what is known as being wrong by a country mile. So here the supplemental in 2003, $63 billion; 2004, $65 billion; 2005, $101 billion; 2006, $118 billion; 2007, $50 billion so far and counting. Let us go to the next one.


Long-Term War Costs Underfunded
($ in billions)
$300
$200
$100
$0
$298 B
$120 B
Amount in Bush Budget for Ongoing Military Operations FY 2006–2007
CBO Estimate of Additional Outlays for Ongoing Military Operations FY 2007-2016
Note: Ongoing military operations include operations in Iraq, Afghanistan, and the continuing war on terrorism.
Source: OMB, CBO

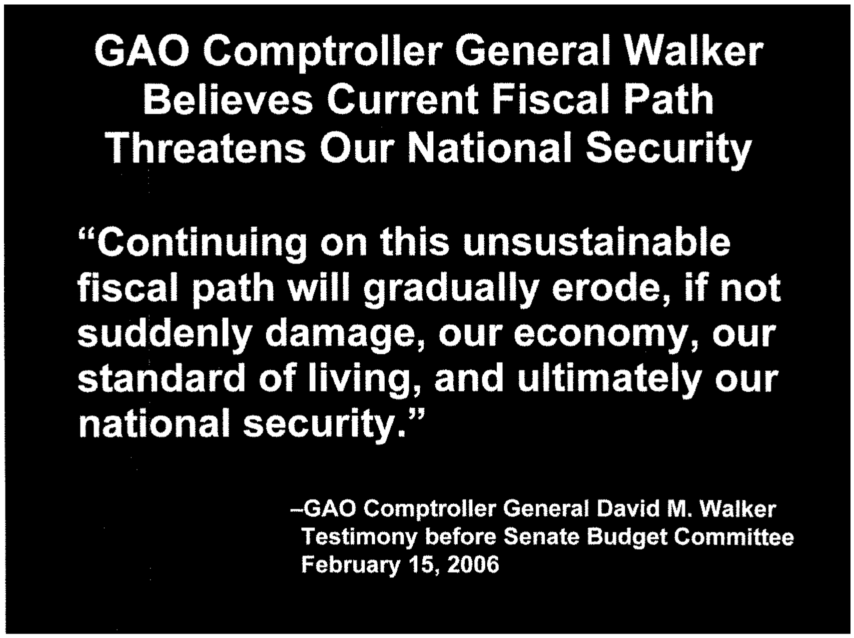
In this budget the President has provided in 2006 and 2007 $120 billion. The numbers from CBO for 2007 to 2016 say we had better be counting on almost $300 billion. We have to have full disclosure here. It is pretty hard to budget if we are not being given the full facts and if we are not being given serious estimates of what the costs are going to be. Let us go to the next one.


Bush 2006 Defense Spending Equals
Next 39 Nations Combined
($ in billions, includes supplemental appropriations for Iraq and War on Terrorism)
600
500
400
300
200
100
0
U.S.
$552 B
Next 36
$375 B
$52 B
$62 B
$63 B
France
Russia
China
Note: Estimates of defense budgets of non-NATO nations are inherently imprecise.
Source: International Institute for Strategic Studies, The Military Balance 2005-2006 (2004 estimates), OMB

Again, to put in context, the United States now spending $552 billion a year on defense. That is more than the next 39 nations combined. Now, I think there are serious questions about this analysis, I would be the first to say. I am not sure how you compare us to China, for example. It maintains a bigger army than we do, pay them virtually nothing. So just a cost comparison may not be fully revealing, but I think we do need to understand roughly where we are. Let us go to the next one.


Building a Wall of Debt
Gross Federal Debt Soars
($ in trillions)
$13
$12
$11
$10
$9
$8
$7
$6
$5
$12.0 T
in 2011
$8.6 T
in 2006
$5.8 T
in 2001
2001
2003
2005
2007
2009
2011
Source: OMB and SBC Democratic staff
Note: Bush FY 2007 Budget with AMT reform and ongoing war costs.

This also has to be understood and that is the skyrocketing debt of the country. If this doesn't sober up people, I don't know what will. I am about ready to wonder what is going on in our country with respect to our leadership when nobody seems to give a fig what happens to the debt of the country. The debt is absolutely skyrocketing. The President said he was going to have maximum pay-down of the debt. There is no pay-down of the debt. The debt has gone up, up and away every year. The debt has gone up over $3 trillion in 5 years, and if the President's plan is adopted, it is going to go up another $3 trillion and reach $12 trillion by 2012, and all of this at the worst possible time, before the baby boomers retire. If you think there are tough budget choices happening now, we haven't seen anything yet. We have not seen anything yet, because this is an utterly unsustainable course.


GAO Comptroller General Walker Believes Current Fiscal Path Threatens Our National Security
"Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security."
–GAO Comptroller General David M. Walker
Testimony before Senate Budget Committee
February 15, 2006

We had the Comptroller General here before the Senate Budget Committee last month. Here is what he said. "Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security." I think the Comptroller General is telling the truth. Collectively, we have a responsibility to face up to this, and that means every part of the budget has to be scrutinized and has to be disciplined.

With that said, I want to say and I want to make very clear, this committee will support—the Congress will support every dollar that is needed for national security and we will stand shoulder-to-shoulder with the President in providing for our men and women in uniform and for the defense expenditures that are required to protect this nation. That is an absolute commitment from this Senator, and I believe the overwhelming sentiments.

With that said, we have a major challenge, and Senator Gregg said it well. If we are going to budget, we have to have people being frank with us about what the real costs are. This continuing submission of supplementals that are unpredictable when, in fact, we know that the costs are going to be—we have known every year that the costs were going to be far more than what was being put in the budget.

So with that, I again thank the Chairman. I think this is a very important hearing, and I thank the witnesses. I thank you for being here. I thank you for your service to the nation. I also ask you to help us begin to grapple with this exploding national debt, because it is a matter of national security.

Chairman GREGG. Thank you.

Secretary England and other panel members, however you wish to proceed.

STATEMENT OF GORDON ENGLAND, DEPUTY SECRETARY, U.S. DEPARTMENT OF DEFENSE; ACCOMPANIED BY TINA JONAS, COMPTROLLER, U.S. DEPARTMENT OF DEFENSE

Mr. ENGLAND. Mr. Chairman, if I can start, and Senator Conrad, thanks. I do want to thank you for the opportunity to be here today. This is my first opportunity to appear before the committee and it is an important dialog. Admiral Giambastiani, who is the Vice Chairman of the Joint Chiefs of Staff, and Tina Jonas, who is our Comptroller, are with me today who worked in preparing the budgets. I mean, we do a lot of the detail work. Hopefully, today we can have a constructive dialog and we look forward to it and we appreciate the opportunity. I thank you for the opportunity to be here today.

This is a critical time for our nation and I appreciate both the comments in terms of your words of encouragement to support our men and women in uniform because obviously it is essential. We have these magnificent people who are the cloth of our nation who literally put their lives and limbs on the line every day to preserve our freedom and liberty and it is important that we support them in every single way we can and I appreciate your comments in that regard.

Regarding the budget, one comment I will make is in fiscal year 2007, we are asking for $439.3 billion and also a $50 billion allowance in terms of a supplemental tied to that, and that is a lot of money and is 7 percent above last year, so it is a lot of money and we recognize and understand that. However, I don't believe, frankly, that we are crowding out the rest of the Federal Government. I worry about it going the other way, frankly.

If you look at it in terms of the GDP, we are actually a much smaller percentage now than we were in the past. I mean, we are now, this year, including this supplemental, about 3.7 percent of GDP, and so Mr. Conrad, you are right. The numbers are large, but in terms of what the country can afford for its national defense, and we were spending 4.6 percent during the Gulf War, 9 percent during Vietnam, between 11 and 12 at the height of our involvement in Korea, and, of course, it was gigantic during World War II. So the percentage today, it is a lot of money but it is not a huge percentage in terms of the insurance and the freedom and liberty that we enjoy with our men and women in uniform.

This is a more expensive force, there is no question about it. It is an all-volunteer force. That is a more expensive force. On the other hand, it is a much more capable force and we ask them to do much more than we have asked them to do in the past.

There are a number of threats. First of all, we are all familiar with this long war against the terrorists and that is an ongoing war we have today, but we also have other threats that we need to be aware of and we need to budget for, we need to deter and be prepared to defeat. We have hostile states or non-state actors that could acquire and use weapons of mass destruction, and we are familiar with those today, and they can use those to devastating effect. Guarding against this threat and preparing for the possible consequences of WMD require new technologies and skills as well as enhanced counterproliferation efforts. We also have a possibility of a major emerging power could choose a hostile course. Therefore, it is important that we shape the force to discourage a pure military competitor and be able to defeat such a military, if necessary, in the future.

Meeting these challenges requires fostering cooperation with emerging powers while hedging against possible surprise while maintaining our military superiority. So traditional state-based threats are still a concern to the nation. They are being kept at bay precisely because the Nation has been so well prepared, and this is a case, frankly, if thanking this committee and the other committees and the American people for letting us do that, and it has worked. It has worked for this nation now for many years.

Now, all of these challenges have a bearing on the security of the homeland, so detecting, deterring, and defeating threats far from shore, in our judgment, is the very best and likely the only way to keep America safe. But the Department of Defense is also prepared in working to defend America closer to home, and we continue to provide support to other agencies of the U.S. Government for our homeland security missions.

So in short, our nation today faces far more diverse challenges and far greater uncertainty about the future global security environment than perhaps we ever have in the past. So it is, indeed, a dangerous time for America. It is expensive. But on the other hand, that is the first obligation of government, is to provide for the common security of the nation. I can assure you that myself and Admiral Giambastiani, Tina Jonas, the Secretary, and all my colleagues in the Department of Defense, we understand this is indeed the taxpayers' money. We understand it is their money that they allow us through you to spend on the security and we work very, very hard to spend this money appropriately and correctly. So we understand this is the taxpayers' money and you have our pledge that we will do everything we can to manage this money appropriately for the American people.

I will comment, I appreciate both of you being here today and your comments because at the end of the day, the war we are in, and particularly this war against the terrorists, is a war of will. This is a war of will and commitment and resolve. The cold war lasted for 40 years. This will be another long but totally different kind of war. But just like the cold war, it was many administrations and many Congresses where we had bipartisan support in terms of funding to protect and defend a nation and it is going to require the same sort of effort.

I mean, this is, first and foremost, a war of will, determination, and commitment that we will prevail over a very, very long period of time and it will take a bipartisan effort. While parties may disagree on lots of other issues, this is one issue where they absolutely need to come to consensus. Otherwise, we will not be able to prevail in this long war. So I appreciate your bipartisan support and your comments here today and we do look forward to your questions, to a constructive dialog. We understand it is indeed a lot of money.

I would like to ask Admiral Giambastiani if he would just make a few comments, and then we will get down to questions. Thank you very much.

[The prepared statement of Mr. England follows:]

Statement of Deputy Secretary of Defense Gordon England

FY 2007 Budget

Before the Senate Budget Committee

March 2, 2006

Mr. Chairman, Members of the Committee,

Good morning.

Thank you for the invitation to meet with you to discuss the Department of Defense's 2007 budget request. This is the first time I've met with this Committee, so I'm particularly pleased to have this opportunity, and I look forward to a constructive exchange.

With me today are with two of my close colleagues, Comptroller Tina Jonas and the Vice Chairman of the Joint Chiefs of Staff, Admiral Ed Giambastiani. The three of us have been deeply involved in the process of setting the Department's priorities for this budget request. Hopefully, we can fully inform you about the defense budget and answer your questions.

As you know, this is a critical time for America. We're a nation at war. This war is a daily reality for our men and women in uniform, who are stationed around the world or serving here at home, defending freedom and liberty along with our friends and allies.

America is fighting against dispersed networks of terrorist extremists. They know they can't succeed with conventional methods, so they use asymmetric means to challenge us and our allies. Their goal is to break our resolve and shatter our way of life. This struggle is not likely to end any time soon. The Cold War lasted for 40 years.

One of al-Qaeda's ringleaders, Ayman al-Zawahiri, said in 2001, "The need is to inflict the maximum casualties against the opponent…for this is the language understood by the west, no matter how much time and effort such operations take." This enemy is adaptable and relentless, and will continue the attack wherever he finds the opportunity. Though we didn't choose this fight, we don't have the option of walking away.

Victory in this Long War requires that our military continue to adopt unconventional, irregular, and indirect approaches to eliminate the enemy's ability to strike.

But the Long War is only part of the nation's security challenge.

Hostile states or non-state actors could acquire and use weapons of mass destruction, to devastating effect. Guarding against this threat, and preparing for the possible consequences of a WMD event, require new technologies and skills, as well as enhanced counter-proliferation efforts.

The nation also faces the possibility that a major or emerging power could choose a hostile course. China is the country with the greatest potential to compete with us militarily, and they are also on the rise as a scientific, technological and economic competitor.

Meeting these potential challenges requires fostering cooperation with China and other emerging powers, while hedging against possible surprise by maintaining our military superiority. Traditional, state-based threats are still a concern. They have been kept at bay precisely because our Nation has been so well prepared.

Of course, all of these challenges have a bearing on the security of our homeland. Detecting, deterring, and defeating threats far from our shores is the best and, likely, the only way, to keep America safe. But the Department of Defense is also prepared to defend America closer to home, and the Department continues to provide support to other agencies of the US Government for homeland security missions.

In short, our Nation faces far more diverse challenges, and far greater uncertainty about the future global security environment, than ever before. The only sure way to protect the American people is to make sure that the President has at his disposal as wide a range of options as possible.

The Department's portion of the President's 2007 budget request reflects the nation's priorities and the Department's best responses to the security context I've just described. It provides essential resources to defend the American people, our homeland, and our way of life. This budget request lets our commanders prepare to meet both traditional and asymmetric threats. It maintains conventional military superiority while enhancing irregular warfare capabilities. It positions the Department to work closely with partner nations and to help them develop needed capabilities to address the global threats we face together. This budget reflects the Nation's firm commitment to provide the proper quality of life for our service members and their families. Soldiers, sailors, airmen, and Marines who serve so selflessly are the heart and soul of our warfighting capacity and capability, and we owe it to them to take care of them and their families.

This budget request is the product of a year's hard work by our senior civilian and military leaders. It reflects the basic tenets of the long-term strategic vision in the 2006 Quadrennial Defense Review, which was submitted to Congress a few weeks ago. The full effects of the QDR will appear in future budget cycles, but this budget request does include some "leading edge" investments, that support the QDR's vision for the future.

I urge this Committee to fully support the President's national defense request, including the $50 billion allowance for FY 2007 war costs. The Department of Defense is asking you for 439.3 billion dollars this year. This is nearly a 7% increase over the budget that was enacted for 2006. Now, this may seem like a lot of money – and it is. But America is spending a much smaller percentage of GDP on defense now than it did in the past. This year's request is projected to be about 3.7% of GDP, but it was up to around 4.6% in 1991 during the Gulf War; 8.9% in 1968 during Vietnam; and 11.7% in 1953 at the height of our involvement in Korea. You have my personal commitment that with the budget you entrust us with, the Department will be diligent in ensuring that the funds are wisely spent.

The initiatives that are reflected in the '07 budget are part of a longer-term continuum of change and adaptation. The President charged the Department of Defense, in the wake of 9/11, to make the changes necessary to adapt to a more dynamic and less certain world. During the beginning of the long war these past five years, our military has been continually learning and adapting, and this budget request is an important milestone in that process of ongoing transformation.

You may wonder how the Department of Defense plans to meet a much broader array of challenges without doubling or even tripling the size of our force. The answer is that we have worked very hard to improve the flexibility of the force, by reorienting existing capabilities, eliminating unnecessary redundancy and improving our expeditionary capabilities to allow us to revise our global force posture. An important initiative has been helping partners and allies improve their own capacities and capabilities so they can better share the burden. The Department has also spent a substantial amount of time making organizations, structures and processes more efficient to better realize our strategic vision and to support our warfighters. Finally, a critical initiative for which we need explicit Budget Committee support is our proposed change to TRICARE fees – essential to sustaining our outstanding military health care program.

At his Inauguration in 1961, President Kennedy told the nation, "In the long history of the world, only a few generations have been granted the role of defending freedom in its hour of maximum danger." In his own short life, he helped to lead one such generation. Our generation has been handed that mantle of responsibility.

We owe it to our men and women in uniform, to provide them with the resources and support they need, to get the job done. And we owe it to our nation, to correctly assess the security challenges we face and to prepare appropriately to meet them. The proposed budget responds to these needs.

Meeting these goals will also require a strong, bipartisan consensus on national security, of the kind that defeated the communist threat. It will require unity of effort, and the sustained will of the American Congress and the American people. With that united will, and the hard work and sacrifices of our men and women in uniform, the Department of Defense will be able to provide the security so inseparable from the freedom we all enjoy.

Thank you for your commitment to this most profound endeavor.

STATEMENT OF ADMIRAL EDMUND P. GIAMBASTIANI, JR., VICE CHAIRMAN, JOINT CHIEFS OF STAFF, U.S. DEPARTMENT OF DEFENSE

Admiral GIAMBASTIANI. Thank you, Mr. Secretary, Chairman Gregg, Senator Conrad, Senator Alexander. Thank you for the opportunity to represent our men and women in uniform today before you. I am pleased and proud to appear here with Deputy Secretary Gordon England and also Comptroller Tina Jonas. The three of us have worked together very closely over the last 7 months since I have returned to the Pentagon from 3 years as a combatant commander and I look forward to working with them as we discuss the 2007 President's budget that is presented to you today.

I would like to make three brief points, if I could. First, I would like to thank each of you and the Members of Congress for your strong support of our men and women in uniform, to continue that support in the midst of this long war that Secretary England has talked about against extremists and terrorists, one where the enemy is attempting to destroy the resolve of the American people.

We have carefully examined our requirements against available resources. We believe from the military perspective that the President's budget allocation of this $439.3 billion maintains that support at the right level. I look forward to discussing in more detail the capabilities this budget will deliver to our troops.

While this is a considerable sum of money, as you all have pointed out, we recognize that it is less than we have historically spent during wartime as a percentage of our national wealth. I am, along with Secretary England, fully committed to ensuring that the taxpayers' money is well spent.

Second point, we come today having just completed a several year long processes of fundamental importance to the Department. These include, one, the Quadrennial Defense Review, which we have just submitted to the Congress; the second, and required by law, the Chairman of the Joint Chiefs of Staff assessment our ability to execute the National Military Strategy; and finally, of course, the President's fiscal year 2007 budget development.

In all of these processes that we have gone through to submit these papers, we have had unprecedented collaboration and dialog amongst the senior civilian and military leaders of the Defense Department, and not just those in the Pentagon, frankly, but also our commanders in the field represented by our combatant commanders. We have literally spent thousands of man hours listening, questioning, analyzing, and learning as we have worked together. In fact, this is an unprecedented amount of time, in my experience in all the budgets we have presented in my 36 years in the service, that I have ever seen us spend, civilian and military, putting these papers, studies, reviews together.

Based on this, I can tell you categorically that our armed forces are fully capable of executing every portion of the National Military Strategy and that this budget supports prosecuting the war on terror, it supports accelerating transformation, it supports enhancing joint warfighting, and finally, improving the quality of life and service of our troops and our families.

The final point I would like to make, as long as we fight this long war against a ruthless enemy, we are doing it with an all-volunteer force. I have seen both sides of this military, in a conscript force and in an all-volunteer status. In fact, I was a recruiter at the beginning of the all-volunteer force. Congress brought that decision forward to us, frankly, with the military and the Defense Department resisting moving to an all-volunteer force. It is more capable, it is more expensive, but there are none of us in the senior leadership who would ever go back to a conscript force.

I think this is significant and we need to ensure this commitment is fully recognized, rewarded, and valued. I know that all of you value our service members' service, sacrifice, and commitment, and again, we thank each of you for your support.

Because this is the first war we have fought with an all-volunteer force, attraction and retention of quality people are more important than they have been in our previous history. The fact that it will be a long war amplifies this consideration. Although we are now on new ground in some respects, experience teaches us that we attract individuals, but we retain entire families in our military. A keystone of attracting and retaining the best America has to offer is maintaining a superb health care system, a system that Congress authorized for service members and their families back in 1995.

As you know, the cost of that benefit has increased substantially since 1995. Let me give you a couple of figures. The cost has doubled in the last 5 years, from 2001 to 2006. It has gone from $19 billion to $37 billion, and it is projected to increase to $64 billion in 2015. Despite this increase, there have been no premium changes since 1995 when Congress instituted this program. It is a superb health care program by the response from our folks within the Defense Department, but in particular in what we Joint Chiefs care about is our uniformed members and their families.

The Joint Chiefs have discussed this in length and in detail. We believe the legislation you passed in 1995 was superb and is superb today, and we want to see it sustained going forward with this health care program. Because of that, and based on our belief that the cost to the individual was reasonable in 1995, we recommend that you re-norm the 2006 cost shares to the 1995 level. That will allow us to maintain this superb health benefit for our families and ensure that it is there 20 years from now.

Some very important points to underscore about this recommendation that are included in the President's budget. First of all, it doesn't affect any active duty members. The second thing is it applies to retirees under 65 only. And finally, it maintains the catastrophic cap of $1,000 for active duty families and $3,000 for retirees. So fundamentally, our recommendation is to take the benefit enacted in 1995 and update it in a fiscal sense to 2006.

Thank you again for the opportunity to testify today and to represent our men and women in uniform and we are ready to answer your questions, sir.

Chairman GREGG. Thank you, Admiral. Did you say you have been wearing the uniform for 36 years?

Admiral GIAMBASTIANI. Yes, I have been wearing the uniform for 40—four years at the Naval Academy.

Chairman GREGG. Thank you. That is extraordinary service.

Can we go back to that chart? The essence of the budget question is this. How do we, in the context of the overall spending of the Federal Government, and accepting your argument, which I do accept, that our commitment to the national defense as a percentage of gross national product is not historically high, even though the numbers are historically high, how do we get out of this process of budgeting by emergency, which basically means we are not budgeting at all. We simply give you an open-ended check subject to your sending up a supplemental, and the issue is this. If you look at those emergencies that have come up and you look at what the spend-out is in Iraq and Afghanistan, which is about $85 billion a year right now, we are actually exceeding a spend-out on the on-the-ground costs in Iraq and Afghanistan.

A lot of this supplemental has been base activity, not a lot, but, for example, in the supplemental that was just sent to us, we have $3.5 billion for repositioning the Army under the new modular approach, which isn't an emergency. I mean, that is a decision that should have been in the context of the core budget. It does seem to me that we have been at this now long enough so that there should not be a necessity for these major supplementals to come up here, but it should be sent up as part of the budget.

Are we essentially saying, by sending these supplementals, that the core budget is not being used to fight this war in Afghanistan and Iraq and that the war in Iraq and Afghanistan is being fought by emergency supplementals? If we are not saying that, then why are we sending up emergency supplementals? Shouldn't we be putting it into the core budget? Shouldn't the budget that was sent up to be an accurate reflection of what we are going to spend for this year not have been $434 billion, but shouldn't it have been $550 billion, because you know these numbers are coming at you. They are pretty predictable right now. You have been in Iraq long enough to know what the number is for next year for sure. Maybe you don't know what the number is for 3 years from now. I certainly hope it is going to be a lot less, but why this process of running two sets of books?

Mr. ENGLAND. Mr. Chairman, if I could just comment, first of all, I guess I need to say what Secretary Rumsfeld said at a hearing, and that is it is above my pay grade how we do this. This is, frankly, worked out by the Appropriations Committees' leadership, OMB, and the President in terms of how to do this and the base budget and the supplemental.

Now, look, you could do it either way. Frankly, the supplemental is much later data. I mean, in the supplemental, it is not only the costs of the war in terms of the number of troops and what we have on the ground, so we know what that is at a later time in the budget when we turn it in. It is much more precise data for you in the supplemental.

We also replace equipment that is damaged or worn out or destroyed as a consequence of the war, and that is included in the supplemental. So these are not numbers that are easily predicted. In the supplemental, we do have significant support for the numbers because we know—we are a lot closer to what those numbers are when the supplemental is submitted as opposed to trying to estimate well in advance.

As you know, like today, we are doing the 2008 budget. I mean, if we were trying to plan that far ahead for Afghanistan and Iraq, it would be very difficult to do that. So my own judgment is we have more accurate numbers the way we are doing it now, but the decision in terms of what categories and this process is really worked out at a much higher level, and so——

Chairman GREGG. Well, why are you putting in these supplementals things which are not related to Iraq that are core questions of how the Army is structured, for example?

Mr. ENGLAND. Well, in some cases, like for the modular Army, an agreement was reached that we would have it in a supplemental until 2007, so this time, in 2006, you will see dollars in there for the modular Army in the supplemental, but in 2007, they are in the base budget. So we are transitioning to the base budget where we do have definitive numbers, and we went through a transition in that particular case.

Admiral GIAMBASTIANI. If I could, Senator Gregg, just to followup on this modularity question, one of the reasons why it was put into the supplemental was to accelerate the modularity. I just returned from Iraq a couple of weeks ago and I was in Tal Afer up north in Iraq, where the Third Armored Cavalry Regiment was being relieved by the First Armored Division First Brigade Combat Team. That First Brigade Combat Team is the last Army brigade that will go over that hasn't had any of the modularity put into it, and the reason why the Army has been able to accelerate it is because on very short notice, this modularity money was put in over the last 2 years into the supplemental. So I would tell you that we are doing this on the fly and the Congress has really helped us out there.

Chairman GREGG. I appreciate that, but it just seems to me that it is being done in a way that essentially prejudices the rest of the budget, because it means the defense budget, what you send up here for a defense budget has no relevance to the real budget because you are 15, 20 percent off of what you are actually spending every year, which goes to a larger philosophical issue, which is this.

The defense budget is very large and you are fighting a war on terrorism with it. Now, a large percentage of the defense budget doesn't appear to be directed at the war on terrorism. It is directed at what you have referred to, I believe, as the pure military threat, which is understandable, I guess, although if you take the ten nations after America that spend money on national defense and combine their national defense costs, I think it is less than what we spent. But let us assume that there is a rising pure military threat, and I presume you are referring to China but don't want to use that term. So you have a core budget directed at trying to make sure that we are strategically strong enough to deal with a pure military threat.

If we are fighting terrorism, the fight on terrorism doesn't appear to me to be purely a military exercise. A large percentage of the terrorism effort has to be intelligence. A large percentage of the terrorism exercise has to be nation building, which is not necessarily a good role for the military, but it is what you have been drawn into in Iraq and Afghanistan. A large percentage of the fight on terrorism has to be defending our domestic homeland and protecting our borders.

And yet when you look at this budget the way it is coming at us, the military is absorbing the vast amount of the structure of the fight on terrorism, and we are actually starving or treating as step-children things like the Coast Guard and the Border Patrol, who basically protect the borders. We are treating as step-children the effort at nation building, or we are doing it indirectly through the Defense Department, which isn't the best vehicle to do it through. And the question of intelligence, I don't think we can get into, but it has been a robust commitment to intelligence, but certainly there is still, compared to what the commitment is to the Defense Department, it is not anywhere near the significance of the rate of growth, and that is because you are on the front line in the hot war, so to say, in Iraq and in Afghanistan.

And so I guess, and this probably isn't something you can answer, but I guess my question is, are we allocating these resources for fighting terrorism correctly amongst the various responsibilities in light of the fact that this isn't your typical war? This is a different undertaking. This is an undertaking where you have to know who your enemy is before he attacks you because by the time he attacks you, it is too late. This is a war where you have to say to the nations that are in the Middle East, listen, democracy works and we are going to show you how it works because we are going to help you rebuild and be democracies. And this is a war that says, we have to know who is coming in and out of this country because that is where the threat is.

Mr. ENGLAND. If I could just make a comment, Mr. Chairman. First of all, the level of spending, I want to followup a little here for the Vice Chairman, because he talked about medical. We spent—in our base budget, we have $39 billion is our medical bill. That is $2 billion more than the entire defense spending for Germany—$2 billion more than the entire country of Germany. And by the way, here is an opportunity, and here is where we ask your support, because frankly, we haven't been able to control some of these costs in the past.

Here is an opportunity for the Congress to help us on this. I mean, here is a case where literally we can save $11.2 billion and we don't jeopardize any single person active, nobody over 65. We find ourselves in the situation where in this medical arena, our premiums are so low and our benefits so significant that companies, when people leave the military and go to work for a company, the company pays them cash, some companies, not to take their medical but to stay on our program, and municipalities and States. They will not even let their people take their medical coverage. They are required to take the medical coverage on DOD. So slowly, every retired person from the U.S. military is staying on our health care program and it is one reason it is going up significantly.

So if we can just literally adjust our rates for inflation, we help ourselves and this committee significantly. So there are some things that we can help change, perhaps, the pattern in the future which are, frankly, very painless to do. So we encourage you to help us in that regard.

Chairman GREGG. We can certainly put language in. Obviously, we are not the authorizing committee, but we can say we are assuming in this budget that your recommendation in this area will be pursued. I have no problem with that.

Mr. ENGLAND. Good, and I appreciate it, because we have not been successful in the past. I mean, these benefits have basically been handed to us to some extent by the Congress and we end up paying this very large bill, so here is an opportunity to help us in the other direction and I sincerely appreciate your comment, Mr. Chairman.

The comment about the whole fight against terrorism, we have just completed the Quadrennial Defense Review that was directed by the Congress. We spent a whole year working extraordinarily hard at this in terms of the strategic direction of the Nation and the Department specifically as we see future threats to America. And we went back and adjusted the 2007 budget to the extent we could. So the 2007 budget has a number of changes as we transition and transform the force for both the war on terror and the conventional threats in the future.

My assessment is that we worked very hard to do the very best assessment we can as we go forward, and we have put more money in our special forces, a lot of moneys in the intelligence side of this business. We have done a lot of work to restructure for exactly the reasons you have stated.

I also will tell you, I agree with you completely. The Department of Defense cannot win this war. This is beyond just the Department of Defense. I mean, this will take the entire Federal Government and all aspects of Federal power to win this long war. And in fact, in the Quadrennial Defense Review, our view is it not only takes all aspects of national power, but all aspects of international power, our friends and allies, because these are international threats to the peace and security and freedom and liberty.

So we have in our budgets going forward, and in 2007, we made adjustments just for language skills, cultural skills, reshaping the kind of force we have. It is all now starting to show up in our budgets and some of that is in the 2007 budget that you will be looking at this year.

Chairman GREGG. Admiral Giambastiani.

Admiral GIAMBASTIANI. Chairman, I might mention a couple of other comments here. One of the things that Senator Conrad put up was a chart from the International Institute for Strategic Studies, the lists of expenditures of other countries. What is fascinating is there is no section in the IISS that talks about extremists, terrorists, and all of these threats that are non-nation states. And so how do you calculate that and who is out there calculating it?

As a matter of fact, I am making an intervention with them to see when they are going to start putting that into what they call traditionally today their military balance. I have been looking at that for the last 17 years. I did a fellowship back in 1990 and 1991 where I spent a lot of time looking at that. But I would just tell you, there is no comparable section in there that talks about these extremist groups that are going after weapons of mass destruction, that are looking for biological weapons. If a small group has a nuclear weapon and it only costs them a small amount of money, that is very bad.

So what we have done in this Quadrennial Defense Review that the Deputy has talked about is we have looked at asymmetric threats. We have looked at non-traditional warfare, irregular warfare, the intelligence it takes to help the overall community so that the military and the Defense Department can do its share to respond to these threats. How can we, for example, increase the number of capabilities we have to render safe nuclear weapons if we find them? How do you deal with biological threats in our chemical-biological defense program, and there is a whole section, frankly, in here, page 52 and 53 in the QDR, that talks about things just like that and the weapons of mass destruction area in the render safe place, in the dealings with rogue states with nuclear weapons.

So what I would tell you is that we have spent a significant amount of time trying to look at how we can not only deal with the conventional side of the military, which is what we were designed to do, clearly, in the past, but also how we can increase the amount of intelligence we have—we call it intelligence, surveillance, and reconnaissance, for example, in the use of unmanned vehicles—not just satellites, but increase our human capability, increase our foreign language capability, and increase our ability to do what we call find and fix targets, not just finish them. The military is very good at No. 3. It has to be better at the find and the fix, and so does our entire intelligence community.

So a lot of what this Quadrennial Defense Review has done is to give us a substantial vector change to try to go after these irregular, asymmetric threats, recognizing again that not just the military in the United States can do it. This is a coalition event. This is an allied event. And it is an interagency non-governmental event.

Chairman GREGG. Thank you.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman, and I think you are asking very important questions. In some ways, this is a bit of a frustrating exercise perhaps for both of us because the three of you aren't responsible for the things that cause us to have these questions.

I must say, I feel there has been some "hide the ball" going on here by the administration. I think the evidence is pretty clear for that. They tell us early on the war is going to cost $50 billion. Now it has cost $397 billion. Every year, they come up with these big supplementals. Last year, they asked for $120 billion of supplementals for the year that we are in now. So actually, they first asked for $50 billion. Now they come and ask for another $70 billion, so that is $120 billion. Now we are being told it is only going to be a $50 billion supplemental for next year, and you will excuse us if we are pretty skeptical about that.

It seems unlikely to this Senator, and perhaps to the Chairman, as well, that that $50 billion is really what you anticipate, because just doing the math, it would suggest that the cost of the conflict in Afghanistan and Iraq is going to somehow going to dramatically be reduced in 2007.

Secretary England, I am going to say to you, I have great respect for you. I was somebody who is behind the scenes and publicly strongly supported your elevation to this position. Admiral Giambastiani, I very much enjoyed our visit yesterday and have great respect for you and your service to our country. Ms. Jonas, I have always been impressed by you.

But that isn't the point. The point is, we have to be straight with our colleagues about what things are going to cost. That is our responsibility. And it doesn't look like people are being straight with us about what the costs are going to be for 2007, that there is this continuing kind of "hide the ball" about what things are going to cost.

I would just say to you, Secretary England, do you really believe that the $50 billion that is in the budget is all that is going to be asked for in 2007, or is it more likely that the administration is going to come right back like they did this year and ask for another big chunk of change?

Mr. ENGLAND. Senator, my understanding is that the $50 billion is not to be a projection of our needs for next year. My understanding, and again, this was a decision by OMB and, I believe, the appropriators and leadership, but my understanding is that the $50 billion really followed the action by the Congress, that is, the Congress put in $50 billion the prior year as a transition funds and that this was a follow-on to the Congressional initiative to put the $50 billion in. So I don't believe this was—I am quite confident this is not an estimate of future expenditures. It is to have a vehicle in the budget so that we can continue to execute the war while we then prepare detailed supplementals.

I, frankly, would disagree that anyone is hiding the ball. In the supplemental, you will find a lot of detail in terms of very specific costs, and in my judgment, very traceable——

Senator CONRAD. Well, wait, wait, wait. Come on, now. Let us be straight. You have just said that this isn't a prediction of what next year's spending is going to be. That is what a budget is. You know that full well. The purpose of a budget is to state what the cost is going to be, and this isn't a statement of what the cost is going to be. It is hiding the ball. I don't know how you can say it is not hiding the ball. Last year, they said $50 billion and then they come and ask for another $70 billion right away.

Mr. ENGLAND. But Senator——

Senator CONRAD. And next year, they say it is going to be $50 billion and you and I both know they are going to be coming and asking for a lot more money.

Mr. ENGLAND. But the dilemma, Mr. Conrad, is trying to estimate costs when you don't have a basis to estimate. I mean, we do not know what the war will cost us next year. Hopefully, we will have less troops. Hopefully, we will have less equipment destroyed. There will be more Iraqi military stood up. So it is an unpredictable environment.

Again, I guess you could do this either way. The decision, like we said, is above my pay grade. You could do this either way, but it does seem to me that the Congress gets a much better base in which to act than if we just literally tried to, quote, guess numbers in the future, and it would be largely guessing numbers in the future. So this way, we do give you a defined budget and a defined supplemental. But again, it is above my pay grade how to do this.

It would seem to me, however, that you get much better data through the supplementals than if we tried to estimate that far ahead, because again, we are preparing today the 2008 budget. It would be very hard to predict what those expenditures would be in that period of time when we are actually executing a 2008 budget. I mean, there is the tyranny of the budget. There is a long period of time in preparation before you get to execution.

Senator CONRAD. I just say to you, hope is not a plan. A budget is supposed to be a plan. A budget is supposed to be our best estimate of what things are going to cost, and I would respectfully say to you, I don't believe this is a best estimate of what it is going to cost, and that to me is hiding the ball. I don't think it serves anyone well.

Mr. ENGLAND. Well, again, the $50 billion, my understanding is not an estimate of the future. It was literally to follow the Congressional——

Senator CONRAD. I know, but we are just going over the same ground. Mr. Secretary, the purpose of a budget is to estimate what we are going to spend, and what we have before us, frankly, I don't think is a serious estimate of what we are going to spend, and it has proved to be the case repeatedly. I mean, we started this when the war began and the Secretary said it was baloney that this thing would cost $300 billion. We are over $300 billion now. So, you know, it is important—our responsibility to our colleagues is to try to have a best estimate of what things are really going to cost. That is what a budget is about.

Chairman GREGG. Would you yield?

Senator CONRAD. Yes, I would be happy to yield.

Chairman GREGG. To try to put this in a number context, it does not appear that any part of the core, which is this year $434 billion and next year estimated to be $460 billion, is anticipated to be used for on-the-ground expenditures in Iraq or Afghanistan. And if you take the average of the last 4 years, it is about $90 billion supplementals to do the on-the-ground expenditure in Iraq and Afghanistan.

So I guess my question, which is a follow-on to Senator Conrad's question, is why aren't you folks telling us, we aren't going to spend any of the core on the on-the-ground expenditure in Afghanistan or Iraq. We have an average expenditure of $90 billion over the last 4 years for on-the-ground expenditures. So, therefore, it is reasonable to presume that we are going to get a supplemental in that range.

Mr. ENGLAND. Well, again, above my pay grade, Mr. Chairman, but I can tell you, my view is if we came in and just said, we need $90 billion and we were literally looking ahead 2 years and sort of guessing the future, I don't believe that would be supported by the Congress and I don't believe that you can—the next thing, then, everyone wouldn't have a great deal of support for that number. I don't believe you can do that. We do not have enough clairvoyance to look that far ahead and give you firm estimates for numbers.

So the choice is, we give you very firm numbers in terms of the supplementals or we try to go way ahead and predict them, and again, we could do it either way, but the decision was to do it this way, and again, we are the implementors of those decisions made by OMB and the Appropriation Committee and the leadership of the Congress and the President. There are different ways to do it. That was the way that was decided and that is the way we have prepared the budget, sir.

Senator CONRAD. I would like to ask one other question, if I could——

Chairman GREGG. I apologize.

Senator CONRAD. Why don't you go around, or go ahead and I will catch it on the second round.

Senator ALEXANDER. Please go ahead, Senator Conrad.

Senator CONRAD. I will go off that subject. I hope that it gets expressed up the line, the frustration that we have, because——

Mr. ENGLAND. We understand.

Senator CONRAD. You know, we do try to present our colleagues with a realistic estimate of what things are going to cost, and if people don't share with us realistic estimates, we can't do our job.

Let me just raise a question that I raised with the Admiral yesterday. I tried to give a heads-up that I would ask this question, because I think it is a serious concern. This is from the Washington Times of December 3. Funds may be lacking for ample Iraqi army, and it goes on to talk about the U.S. general in charge of shaping an Iraqi army raised the prospect yesterday the new Baghdad government will not have sufficient money to fund the army envisioned by our administration. The President has said repeatedly that we will stand down as the Iraqi army stands up, and the question that is being raised is will the Iraqi nation state have sufficient funding to be standing up an army? Have you had a chance to look into that, Admiral, or Secretary England, either one?

The Washington Times
SATURDAY, DECEMBER 3, 2005

Funds may be lacking for ample Iraqi army

By Rowan Scarborough
THE WASHINGTON TIMES

The U.S. general in charge of shaping an Iraqi army raised the prospect yesterday that the new Baghdad government will not have sufficient money to fund the 10-division army envisioned by the Bush administration.

Since Iraq's security is projected to depend on an army of that size, it raises the question of whether Iraq will have the right size land force to allow large numbers of U.S. troops to go home after 2006, when the new government would start budgeting more of its defense needs.

Army Lt. Gen. Martin Dempsey said plans are to create a 160,000-soldier army, tapping a pot of $10 billion in U.S. funds that also will be used for a police force, border guards, highway patrol, navy and an air force.

"But they may not end up

see **WAR,** ***page A5***

Mr. ENGLAND. I can say this, Senator, that we have been very sensitive that the Iraqi army can stand up an army that can do the job they need to do and also is affordable by the Iraqis, and the Iraqis do not need an army like the United States of America. I mean, they need an army to provide for security and stability in their country. So it is a different kind of army than we have, frankly, and we are training the army and, frankly, equipping the army now to be able to do those jobs rather than us do those jobs in Iraq. So I can tell you it is sensitive. I can't tell you the detail. I can just tell you from a policy, philosophy point of view, we do want them to stand up an army that is obviously sustainable by them over a long period of time.

Senator CONRAD. But you must have estimates of whether or not they really have the financial capability to provide for the kind of army that is necessary to do the job that we envision for them.

Mr. ENGLAND. Mr. Conrad, I would have to get back to you. Perhaps Tina Jonas or the Admiral. I just don't have those estimates. But we would be pleased—I would be pleased to get back with you on that subject and meet with you in your office. I just don't have those numbers——

Senator CONRAD. I just think this is a centrally important question to our strategy. When the Admiral and Ms. Jonas were in my office yesterday, I alerted them that I would ask this question, because it seems to me for the purposes of our planning, we have to know, do the Iraqis really have the resources to have an army to stand up? That becomes a pretty central question.

Mr. ENGLAND. Tina, can you——

Ms. JONAS. Mr. Conrad, I don't have the precise number in front of me, but the Iraqis are providing—paying for the salaries of the army that is being stood up. As you know, we are asking for additional funds in the supplemental, about $5.9 billion between Iraq and Afghanistan, to continue to train and equip them. But I will say, and Admiral Giambastiani may want to talk to certain aspects of the capability, this is a concern of the Secretary, and as the Deputy Secretary just mentioned, we are very conscious of the fact that we should not be building something that they cannot sustain.

Admiral GIAMBASTIANI. I think the only thing I could add, Senator Conrad, to what the Deputy and the Comptroller have said to you is, No. 1, General Dempsey, as both a NATO commander and as a U.S. commander, has spent substantial time since he has taken over as the multinational training head to work with the ministry responsible, MOD, and now with the MOI, the Ministry of Interior, to look at the needs long-term for the government. Because the government is in transition, clearly, and because they are still building ministries, there is still much work to be done.

But the point is that we are looking for a sustainable Iraqi solution and we are looking for a sustainable Afghan solution in both cases. And if that takes help from coalition and allied members, which it has—for example, large numbers of tanks have come in from Hungary, large numbers of small arms and weapons and ammunition have come in from a number of NATO allies, and these are all important parts of equipping. I did that for part of my time in my last job as a NATO Supreme Allied Commander.

And what I would say to you is that working with these ministries, the attempt of these estimates, if you will, is for them to sustain it and not build something they can't sustain, as the Deputy has said.

Chairman GREGG. Senator Alexander, thank you for your generosity in time.

Senator ALEXANDER. Thank you, Mr. Chairman.

Mr. Secretary, Admiral, Ms. Jonas, thank you for being here. I want to shift the subject a little bit.

A few weeks ago, in Nashville, I sat down for a couple of hours with our Adjutant General, Gus Hargett, and the Commander of the Tennessee forces that have been in the National Guard in Afghanistan—the 278th unit, which has had 3,000 Tennesseeans in Iraq, and the 844th engineering unit. It was a very interesting visit. Ten thousand of our 13,000 National Guardsmen and women have been in Iraq or Afghanistan. Much of the equipment used by the Guard units, specifically the 278th and the 844th engineering unit, was left in Iraq following their return. It is now being used by the units that replaced them. That makes sense. Other Guard units across the country are in the same situation. Undoubtedly, many of the Governors who were here this week talked with you about that.

So my question is about the funding and the pace of replacing the equipment of the National Guard units, and I would specifically like to know how much money is allocated in this budget to replace this equipment, and what is the time line for spending it, and what does that level of funding and pace of spending say about the use of the Guard in Iraq and Afghanistan in the future years?

Ms. JONAS. Senator, thank you for the question. I would just like to point out that over the program plan that we have in this budget, which is from year 2007 to 2011, we have added $21 billion for Guard equipment. On average, we are spending—we are going to be doubling—over that program period, we will have doubled what we spent during the 1990's. We were spending, on average, $12 billion during the 1990's for Guard equipment, so we will have doubled that, and that is in the baseline budget.

In addition, we are requesting, I believe it is $1.7 billion in the supplemental for Guard equipment. So I think there is a recognition that that is very important and we put some emphasis on it, sir.

Senator ALEXANDER. Would it be possible for you to tell me how much of that is in this year's budget?

Ms. JONAS. Yes. I am sorry. The amount that we are spending for the Army and Air Guard in the 2007 budget is $23.1 billion.

Senator ALEXANDER. And are your plans definite enough for spending to be able to say how much of that would be allocated to the 278th and the 844th engineering unit for this next year?

Ms. JONAS. OK. We would have to get back to you for——

Senator ALEXANDER. No, that would be fine, but, I mean, could you—that would be a big help to them.

Ms. JONAS. Sure.

Senator ALEXANDER. Following that, your request reduces the planned number of National Guard combat brigades from 34 to 28. How much does this save over the period of, say, the 4-year period you just described or any period you might choose, and is most of that personnel or is most of that equipment or how do you divide that?

Ms. JONAS. Admiral Giambastiani might want to talk to the restructuring of the Guard.

Admiral GIAMBASTIANI. Let me just discuss the restructuring for a second. What is important to remember is that we are looking at fully equipping all of these National Guard brigade combat teams. That has never happened in the history of the National Guard, that we have——

Senator ALEXANDER. The 28 that we will end up with?

Admiral GIAMBASTIANI. Twenty-eight, 34, 32, whatever number you pick and whatever we have had in the past, we have never fully equipped, to my knowledge, any of these brigade combat teams, and the intent here within the baseline budget is to fully equip 28 brigade combat teams, retain the total number that we have today of brigades. These are not just brigade combat teams, but support brigades, which is 34, whatever number you take. The total is 106 between the combat teams and the support brigades, and retain 106, transition a number of these into engineering and other support units which we feel will be better postured and structured to support homeland defense, contingency operations, national disasters, and the rest. But we will have a much more capable brigade combat team force where we don't have to take people from one unit to another to send them forward and the rest.

Now, your question is—one of the questions you asked, I don't have an exact number, but do you save money over the people or over the equipment if you take down the number of brigade combat teams, and the answer is it is mainly in the equipment because most of these brigades would be heavy brigade combat teams which require lots of armored personnel carriers, tanks, and other things which are very expensive, comparatively speaking, than trucks are, engineering equipment, and other things like that. So the cost differentials are really in the equipping of the heavy brigade combat teams, Senator.

Senator ALEXANDER. Thank you. That is very helpful. I assume that in all of this, you are working with the States and the Governors to try to make sure that the equipment you replace fits into what they perceive their needs are for homeland security and disaster relief, things they may be called upon to do?

Admiral GIAMBASTIANI. Yes, sir. The Department and the Army has made a commitment to equip all of these brigades properly. That is very, very substantial. You know, a number of the Guard leaders have been skeptical of this in the past, and frankly, you have a very solid commitment and the amount of money that is in there, the $21-plus billion that are in our program, is unprecedented and is really quite—to the Guard leaders, their eyes——

Senator ALEXANDER. So you are telling me we are going to have 28 combat brigade units that will be better equipped than they ever have been before?

Admiral GIAMBASTIANI. Yes, sir, both manned, equipped, and trained, all three of those.

Senator ALEXANDER. And that would suggest to me that they, while none of us can predict the future, that they would be prepared to serve in the same kind of role again that they were called upon to serve in Iraq and Afghanistan——

Admiral GIAMBASTIANI. Yes, sir.

Senator ALEXANDER [continuing]. If that need ever arose?

Admiral GIAMBASTIANI. What I would tell you is, that our reserve force within the military has always been what we call a strategic reserve. So if we need brigade combat teams, for example, in the combat support, we have always built in some time to get them properly trained and sent over and the rest. Well, we have had to use them as an operational reserve here during Operation Iraqi Freedom, Operation Enduring Freedom. In fact, we have had upwards of 39 percent of our deployed forces have been Reserve component, both National Guard and Reserve. Today, it is actually running at a little less than 20 percent.

But the point is that we need to have them structured as not only a strategic reserve, but as an operational reserve in the future, and in order to do that, the Department has to step up and properly man, train, and equip them, and that is the purpose of the program.

Senator ALEXANDER. That is very helpful. Thank you. And if you could get back to me at your convenience with any details you have about those units I asked about.

Thank you, Mr. Chairman.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I would like to pursue just a little different line of questioning here.

About 12 years ago, the Congress passed legislation that dealt with the issue of government procedures and results. It is called the Government Procedures and Results Act. That program under the administration is referred to as PART, and I have pulled down off the Internet—the White House has an Internet where these programs are listed and there are a number of departments, frankly, that have not done a very good job. But the Department of Defense, you have four program areas in which your ratings were, results were not demonstrated.

RESPONSE TO SENATOR ALLARD'S QUESTION

The Department of Defense Training and Education Programs-Other Training and Education consists of three disparate programs: Off-Duty Voluntary Education; Junior Reserve Officer's Training Corps; and Civilian Education and Training.

During last year's PART development cycle it was determined late in the process that these programs would be included and, frankly, these programs were improperly combined and the metrics selected failed to properly measure the effectiveness of these programs. This was recognized by OMB, but a grade of "not demonstrated" was assigned to the programs in order to permit the Department to properly reevaluate them. In coordination with OMB, we have divided these programs into three separate areas and are actively working with OMB to successfully evaluate them during this year's PART cycle.

Funding reductions based on the results of the FY 2005 PART asessment would be premature, particularly at a time when costs for pursuing higher education opportunities are escalating around the country. Study after study has proven that the Voluntary Education program is a key recruitment and retention tool that impacts positively on militaru job performance, mission accomplishment, and disciplinary issues. DoD has reacted to this dynamic by changing policy to require fewer out-of-pocket expenditures on the part of our Service members. Reduction of funding for this program would have a negative impact on troop morale at a time that would be inopportune for continued readiness.

Now, if the program is listed on here, it is either rated as ineffective or results not demonstrated, and when they list it as results not demonstrated, what it means—a rating of results not demonstrated indicates that a program has not been able to develop acceptable performance goals or collect data to determine whether it is performing.

You only have four, which is good, but my question to you is can you elaborate on how you are using this and if you can address these four programs specifically, I think it would be helpful to me and the committee so that we know how these are performing. Those four programs, one is the defense communications infrastructure. The other one is defense small business innovative research, technology transfer. The other one is Department of Defense training and education programs, other training and education. And the fourth is the Marine Corps expeditionary warfare.

The Marine Corps is taking steps to define specific long-term performance measures for Marine Corps Expeditionary Operations. Below is the history of that effort:

a. PART is a component of the President's Management Agenda to evaluate the entire Federal Government every 5 years. In 2005 it included the USMC.

b. PART consists of responses to a series of stock strategic planning, program management, and program accountability questions and associated cost, schedule, and performance data. Two questions pertain to a limited number of long-term performance measures.

c. The USMC submitted responses to all questions and data requested and also provided the USMC Expeditionary Manuever Warfare Capability List (ECL) containing a substantial number of goals and measures. OMB deemed this list to be too comprehensive and requested instead the USMC provide a subset of priority long-term performance measures.

d. There was no approved short list of long-term performance measures used to describe the USMC at that time. This resulted in the USMC PART getting a "Results Not Demonstrated" rating by OMB.

e. The USMC has requested a PART Abbreviated Reassessment for 2006 to address this. The Marine Corps Combat Development Command (MCCDC) has been tasked to develop a short list (approx 4) specific long-term performance measures for evaluating Marine Corps Expeditionary Warfare. Draft measures are due to OMB 14 April and final measures 23 June 2006.

The ECL contains 230 pages of desired capabilities (or goals) for near-term 2005-2011, mid-term 2012-2018, and far-term 2019+ time frames in the key warfighting functions of Joint and Multinational Enabling, Strategic Agility, Operational Reach, Tactical Flexibility, and Support and Sustainment. These include a substantial number of long-term measures that could be tracked. The Deputy Commandant, Programs and Resources (DC, P&R) tasked the DC, MCCDC to develop a short-list of measures that focus on outcomes and meaningfully reflect the purpose of the USMC that can be tracked. The USMC requested 2006 PART Abbreviated Reassessment will address this.

I wondered if any of you, by chance, would be prepared to elaborate on these four programs in the Department of Defense that are not meeting the standards as far as that Act is concerned.

Mr. ENGLAND. Senator, if I can just try here, I can't speak specifically about each of the four programs, but the last—what I do is I try to review a whole set of metrics across the Department, both for the Government Procedures and Results Act, then we have the President's scoreboard we have and we have our own measures and metrics. We have a large complex department. A lot of it has not performed well in the past.

Additional Information submitted by Mr. England

OMB's Program Assessment Rating Tool (PART) review completed in February 2006 rated the DoD Small Business Innovation Research and Small Business Technology Transfer (SBIR/STTR) program as "results not demonstrated". This is one of four DoD programs to receive such a rating.

The Department is taking several actions to address the issues raised by OMB's PART review. First, we are tracking company commercialization records and utilizing a commercialization assessment in our proposal selction process. Our tracking will reduce the likelihood of funding companies that repeatedly fail to commercialize their technologies. Second, we are taking steps to help successful awardees transition more SBIR/STTR derived technologies. Section 9 of the Small Business Act prescribes fixed percentages of the extramural budget for research development, test and evaluation be expended for the SBIR/STTR programs. Therefore, the Department cannot reduce funding for SBIR/STTR. Lastly, the Department is also participating in OMB's on-going PART assessment of the Federal government-wide SBIR/STTR.

The SBIR/STTR programs have long been a source of high-value technology for the warfighter. For example, Small Arms Protective Inserts (SAPI) plates and handheld speech translation devices, both widely in use in critical operations in Iraq, Afghanistan, and around the world, were initially developed through SBIR. The Department is committed to ensuring the SBIR/STTR programs improve and remain valuable sources of technology for the warfighter.

Senator ALLARD. Well, I understand all that——

Mr. ENGLAND. But my comment is, in almost every case, our trend lines were up. That is, we were doing better in almost all categories, and so I was encouraged, because we do track these and manage all the programs now——

Senator ALLARD. I think it has improved gradually, I just have these four programs and I think it is important. The President has suggested in those programs where they don't meet these standards, he is reducing their funding by 3.6 percent, and the rest of the programs that have done well, he has increased them by 1 percent. You may not be able to give me the specifics on these four programs, but I think the committee and I would appreciate, if you haven't, review them a little bit and give us a little more detail on these.

Response to Senator Allard's request for information

The Administration has used the Program Assessment Rating Tool (PART) to assess 70 percent, or $309 billion, of DoD FY 2007 resources requested in the budget, and 5 percent, or $16 billion, are in programs rated Results Not Demonstrated (RND). A RND rating does not necessarily mean that a program is not performing; it means there is not sufficient performance information available to assess whether the program has achieved its goals.

Only 4 of the 32 DoD PART programs are rated RND. Those four programs are:

(1) Communications Infrastructure
(2) Marine Corps Expeditionary Warfare
(3) DoD Training and Education Programs; Other Training and Education
(4) Small Business Innovation Research/Technology Transfer

The first three programs were rated RND because they did not have program-wide metrics that adequately measure program performance. To address this issue the Department is developing performance measures for these programs that will meet the PART standard. For example, the PART on the Other Training and Education program assessed three dissimilar programs; therefore, standard metrics do not demonstrate and assess the programs accurately. The Department is seeking to divide this program into three separate PARTs to allow a more focused assessment.

The fourth program, Small Business Innovation Research, needs to improve its allocation processes. Toward this end DoD is tightening eligibility requirements for programs to participate in the Small Business Innovation Research program.

Mr. ENGLAND. No, we will. We will get back to you specifically. I will comment, it is an excellent question on the four areas. In the Quadrennial Defense Review, Senator, we made a specific effort in the Quadrennial Defense Review to address the way that the Department is managed and the processes in the Department to make sure that we run everything effectively, and so we are, as a consequence of the QDR, we are putting out road maps in terms of how we improve the fundamental processes in the Department so that in all these areas of measuring and metrics, we will be able to show continuous improvement.

So it is an excellent question and it is a very sensitive area to us to make sure that we continuously improve the way we are running the Department. And as the year progresses, I mean, I would be pleased to get with you or have you come meet with us and just discuss what we are doing in the Department to improve our business process, because frankly, there is a lot of room for improvement and we understand that.

ADDITIONAL INFORMATION SUBMITTED FROM MR. ENGLAND

The Department has made significant progress towards improving our business practices. I would like to highlight a few actions being taken within the DoD to transform our business operations:

1. First we have estasblished strong governance and senior executive involvement through the establishment of the Defense Business Systems Management Committee (DBSMC).
    a. I chair the committee, with the USD(AT&L) as vice-chair;
    b. Members include USD(C), USD(P&R), ASD(NII), the Servic Secretaries, and Directors of the major Defense Agencies.
2. In September 2005, we established DoD business process standards and systems that are focused on improving our end-to-end integration and financial transparency. These formed the basis for the establishment and implementation of the Business Enterprise Architecture (BEA) and our Enterprise Transition Plan (ETP).
3. I have established four Investment Review Boards (IRB) that collectively review every defense business system as an investment annually and review all system development or modernization programs greater than $1M prior to the obligation of funds.
4. I have directed the establishment of a new defense agency, the Defense Business Transformation Agency (BTA0, that is charged with consolidating all OSD enterprise level effort on business transformation under a single agency. The BTA will become our Center of Excellence for transformational best practives and continuous process improvement.
5. On March 15, 2006, we submitted to Congress our first update to the ETP and BEA. We have met the majority of our planned performance milestones, both at the DoD Enterprise level and within the Services.

Senator ALLARD. During this last break, I had an opportunity to go and visit a number of our defense companies. They specialize in satellites, getting the satellites up in the air as well as missile defense. As you know, a good deal of the satellites that we put out in space has to do with communications.

Mr. ENGLAND. Yes.

Senator ALLARD. It is vital, and I think it is vital for your efforts to build this jointness between the various branches of government, or of the armed services. The message that I left with the companies is that one area that they have been notorious about is not sticking with their budgets and not being able to stick with the time lines when they bring these proposals into the Department of Defense. I explained to them, you know, when you don't meet those—if you don't make an attempt to stick with time lines, you only attempt to keep your agreements, we lose support of the Congress for these, and I am a strong supporter of the armed services programs. So that is kind of what I told them. I notice on here the defense communications infrastructure is on one of those lists, and so I hope that I can get a little more detail back on that.

While I am on the satellites and our space programs, I have also noticed that—and I think space, by the way, is very, very important. If we don't have our space assets operating, all branches of government are impacted. Now, it happens to be under the jurisdiction of the Air Force. The Air Force had combined their space programs with their strategic command and I have heard rumors that the current general of U.S. Space Command, who is retiring, his replacement may not be a four-star general. It may be something less, and I have written a letter to Secretary Rumsfeld on this.

I think these programs are so vital that we need to make sure we have the best leadership and people that have the experience, because these are complicated, difficult, and I am hoping that maybe you can respond to the rumors and what we picked up that there may be an attempt to downgrade this position and there may not be as much emphasis on space communications as we would hope there would be.

Admiral GIAMBASTIANI. Senator Allard, with regard to the commander of the Space Command in the Air Force, I think you have just been given bad information, to be frank with you.

Senator ALLARD. All right. Very good. And my understanding, do they have—someone called the office and said that they thought they had somebody lined up that would be a four-star or working on somebody——

Admiral GIAMBASTIANI. Sir——

Senator ALLARD. You can't comment on that?

Admiral GIAMBASTIANI. I will just tell you that the process is working and I think you have been given bad information.

Senator ALLARD. OK, very good. I am glad to hear that, all right.

The other issue I wanted to bring up, there is some discussion among members of the Senate about a 2-year budget. What is your attitude about a 2-year budget in light of the fact that we are having a hard time making projections to this committee on military spending and we keep finding we are having to go into supplemental spending? I am one that supports the idea of a 2-year budget, but hearing the comments that are going on here from the Chairman and the Ranking Member on this committee, the thought struck me is how would the Defense Department deal with a 2-year budget and if it is an idea that appeals to you or not. I would like to hear a comment on that?

Mr. ENGLAND. Tina, why don't you try first.

Ms. JONAS. Sir, an interesting point that you raise, and one thing we have done within the Department at the Secretary's urging is to try to reduce the churn and amount of staff time we spend on developing budgets, and so we have gone to what we call an on-year and an off-year process for current year and out-year budgeting, and that has had some—we were in an off-year this year within the Department and we will do an on-year next year.

You know, we would adjust. If the Congress decided it was the best thing to do, I am sure the Department would adjust. I do agree that we spent an awful lot of staff hours in the Department deciding resource decisions, so anything we can do to simplify and streamline the process is a good thing to do.

We will have every year, probably, some requirement to adjust the budget during the year of execution, and we do that in a couple of different ways. One way we do it is through a mid-year review, which you are familiar with. OMB does that, as well. And we send up reprogrammings if we need to make adjustments for fact of life. So that is one way that we deal with the year of execution.

A second way is if we have to ask for a supplemental, and we have had plenty of discussion on supplementals here this morning, so I don't need to belabor that. But we would have fuel, for example. In this supplemental that you will see, it is not strictly war-related. There is some adjustment because of the price of fuel. That is just a fact of life adjustment we would always have to make.

So it is an interesting idea, sir. I would obviously defer to the Congress as to what they think is the best for them.

Senator ALLARD. OK. Mr. Chairman, my time has expired. I had one more question. I am wondering if I may pursue that. It has to do with National Guard.

Chairman GREGG. Yes.

Senator ALLARD. NATO has taken this policy where each country in NATO is going to specialize in a certain type of endeavor as a part of it. They look at the whole NATO aspect and then each unit. And so in National Guard and our National Reserves, I am under the impression that we are working at trying to get various units or brigades to specialize in certain areas and then take those units and then fully manpower them in those areas and also give them equipment they need, and by doing this, what we do is we avoid duplication and unnecessary costs as far as the National Guard program. Is this approach being followed in the National Guard and Reserves, and are we seeing cost savings as a result of that?

Admiral GIAMBASTIANI. Senator, first, if I could just address the NATO side to make sure that we all have what I consider to be the correct information, as a former NATO commander, along with Jim Jones, we have a certain number of countries within NATO that we have what we call full-service militaries. Some of the smaller countries are working on very—it is not a particularly great term, but niche capabilities, special operations, others where they are particularly good at them.

Senator ALLARD. Yes, that is what I am referring to.

Admiral GIAMBASTIANI. Exactly, and there are a number of countries that, in fact, are specializing in those so that they can be very good in certain things. You take the Czechs, for example, they have chemical and biological outfits. The Norwegians have fighters, but they have special forces. They have mountain training. And we spent a lot of time with the centers of excellence throughout NATO. So the answer is yes, but there are certain militaries that are full-service militaries within NATO.

With regard to the National Guard, what I would tell you is I pulled out two sheets here just to let you know. Besides infantry, if you will, armor, these heavy brigade combat teams, light brigades, and the rest, besides the 28 brigade combat teams we are talking about, you have combat aviation brigades where we are going, theater aviation brigades, fires, battlefield surveillance brigades, combat support brigades, they are called maneuver enhancement, sustainment brigades, air defense artillery, engineer, military police, chemical, military intelligence, signal, explosive ordinance disposal, quartermaster, medical, and the rest. Obviously, there is a sizable number of these.

Just to give you the breakout for use, as I said, 28 brigade combat teams in the Army National Guard. There are none in the Army Reserve. Inside the multi-functional support of that list I gave you, the Army National Guard will have 44 and the Army Reserve will have 11, for a total of 55 there. And then for what we call functional support brigades, they are directly functional single-source specialties, there will be 34 in the National Guard and 47 in the Army Reserve.

Senator ALLARD. So there is some effort——

Admiral GIAMBASTIANI. Yes.

Senator ALLARD [continuing]. Moving forward so we avoid this costly duplication that happens among the Guards.

Admiral GIAMBASTIANI. Yes, sir, and I think you will find that the Army's plan here is a sensible one as they have tried to work with all of the Adjutants General, as they have explained to the Governors, and as they have tried to bring forward that has some relevance to not only supporting our forces forward when we need to bring them up and support with combat service and service support, but frankly, also provide us homeland defense capability, provide us national disaster and contingency response.

Senator ALLARD. So you are working with Northern Command in that regard, I suppose?

Admiral GIAMBASTIANI. Yes, sir.

Senator ALLARD. OK. Was that addressed in the Quadrennial Review?

Admiral GIAMBASTIANI. Yes, sir. You will find a number of sections where we talk about these types of capabilities and our increase in support of homeland defense, for example, and how we are restructuring overseas.

Senator ALLARD. Thank you, Mr. Chairman.

Admiral GIAMBASTIANI. Yes, sir.

Chairman GREGG. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman. Mr. Chairman, I have three subjects that I want to touch on and I will try to make it brief, depending on the comments of the two gentlemen, and I don't mean to leave out the lady but I want to specifically address my comments to the Secretary and to the Admiral.

First of all, I want to thank you, Admiral. You, after many conversations with me and others, weighed in at an appropriate time with a letter from Secretary Rumsfeld, to use his words, that oil and gas rigs in the Eastern Gulf of Mexico, east of the military mission line, would be, his word, "incompatible" with the testing and training mission of the Department of Defense. That was a timely letter because as Senator Martinez and I have approached this, trying to look out for the interests of the Defense Department, given the fact that the Chairman of the Energy Committee is coming forth with a plan to drill in four million new acres in the Eastern Gulf, I want to thank you. Oh, well there is the Chairman of the Energy Committee right here. I didn't see him.

Your letter was most timely and I appreciate that as it is under consideration in Senator Dominici's committee right now. So thank you for alerting us to that, and Senator Martinez and I have drawn the lines in a plan that we have offered and hopefully we will have some ability to discuss it and try to work it out with Senator Domenici. But thank you for your clear statement of it being one of the largest testing and training areas and how important it is to the defense preparedness of our nation.

I want to mention two other items. We have, Mr. Secretary, an inconsistency in our policy with regard to widows and orphans. Widows and orphans are a cost of war, and that has been an established policy ever since Abraham Lincoln so declared it. Congress changed the law to automatically enroll the survivors of those lost while on active duty. But because of an offset against disabled and indemnity compensation, many of those enrollees end up receiving nothing from the survivors' benefit plan.

There are those of us who have tried to eliminate that offset, and in fact, in an amendment that I offered last fall, the Senate voted 92 to six to eliminate that offset, and then when it got into conference, it was stripped out. That cost is estimated to be $9 billion over 10 years, and it is a cost of war to help those widows and orphans and I wish you all would take another look at that, because the administration has opposed the elimination of that offset. I don't think that that is right and I don't think it is fair.

Now let me ask you, Mr. Secretary, on the third question. As you know, we have been going round and round on the 12 carrier minimum in the midst of a war. I just simply, the QDR has come down. It is in law now that we have to have 12 carriers. The QDR is saying that you want 11 carriers. Could you try to give some rationale why, in the middle of a war, especially with the evidence of China's naval buildup, for a budgetary decision is it not penny-wise and pound foolish to eliminate one of the carriers when, in fact, if you ever had to reverse that it takes $10 billion and over 7 years to build a new one? Would you share with us your thoughts?

Mr. ENGLAND. Senator, I will.

The QDR examined that earlier decision by the Department of the Navy and also concurred that the 12th carrier was not needed. First, that 12th carrier is not in very good condition. In fact, today it has no airplanes because of years and years of being a reserve carrier and not having the planned maintenance, et cetera. So it would take years and years to bring it up to par.

But the main reason is that if you look at our carrier fleet, our new carriers will sustain 1,000 sorties a day. It used to be down in less than a 100 if you go back in time. So today I believe we do like 330. We are going to go to about 630 sorties and eventually 1,000 sorties a day off of a carrier. In addition, our airplanes, much longer range, much more capable. And with precision weapons, along with our airplanes, our sustainment power of particularly our nuclear carriers is much more than our conventional carriers. If you put all this together, we just have a vast amount of tactical air power.

In fact, in the QDR we looked at the whole tactical air situation because of the Navy, Marine Corps and Air Force, because there is this just a terrific capability now that we have. If anything, we are vastly overmatched.

When you look at all of that, we just do not need the carrier. It is something that may be nice to have but we do not need it. If you go back to the Vietnam war we had, I believe, like 30 different sorties, 30 different attacks against the Tran Quan Bridge. And it took 30-some airplanes each time. And we did not take that bridge out after 1,000 attacks against the bridge until we had our first precision weapons that took the bridge out. Now all of our airplanes have precision weapons. We take that out in one strike.

As a matter of fact one B–52 with precision weapons can take out 90 different targets.

So it is a question of the capability has improved to the point that we just do not need that number of carriers anymore. And that was the conclusion of the military and the civilians and the Department of Defense as part of the Quadrennial Defense Review.

Senator NELSON. As you know, it is no surprise to you that there is a difference of opinion with regard to that. But let us assume that at the end of the day that your position prevails and that there are less than 12. Maybe there is 11, maybe there is 10. In a few years it could well be 10 because the one that is being built now is being considerably delayed. So it could be that we are down to 10.

But assuming that is the case. When you were Secretary of the Navy and in front of the Armed Services Committee on another policy decision, in light of Pearl Harbor, the eggs in one basket theory. Instead of all the carriers being in one port, Norfolk, you as well as the CNO had expressed that you ought to disperse those assets on the Atlantic coast of the United States.

Would you care to offer any update on that statement that you had made last year?

Mr. ENGLAND. No, my judgment is still the situation, Senator. That is that the Kennedy should be retired and a nuclear carrier should be in Florida to replace the Kennedy to get some dispersion. That would give us two carrier ports on the East Coast and the West Coast. And I believe that is still the plan of the Department of the Navy to do that, to have a replacement carrier in Florida, a nuclear carrier, which would be advantageous just in terms of dispersion.

The concern there was always weapons of mass destruction. Even though carriers are at sea, the maintenance facilities, et cetera, are all still there and the crews, et cetera. So having some dispersion would be of value to the Department of the Navy. So I would say that is still a legitimate conclusion, Senator.

Senator NELSON. Admiral, do you concur?

Admiral GIAMBASTIANI. Sir, I have not dealt with the port location issue personally. I have discussed this in some detail with the Secretary or with the CNO, and I would just tell you that having dispersion of all of those assets, I can remember one Christmas, it is the only time I have ever seen it where we had five nuclear carriers all sitting next to one another. And that is not something we would like to routinely do.

Senator NELSON. Thank you. Thank you, gentlemen. Thank you for your public service.

Mr. ENGLAND. Thank you, Senator. Good to see you again, sir.

Senator NELSON. Thank you. Thank you, Mr. Chairman.

Chairman GREGG. Senator Domenici.

Senator DOMENICI. Mr. Secretary, I came principally just to thank you for all of your hard work. It seems to me you are on double duty these days. And you still look pretty good.

Mr. ENGLAND. Thank you.

Senator DOMENICI. You are holding up fairly well.

Mr. ENGLAND. For a man my age.

Senator DOMENICI. You do not want to compare ages. That would probably put me in a position of outdoing you.

I guess I am getting a little concerned, more concerned each year, about our failure to include the full supplemental, the full expectation of the Iraq war in the budget. I understand this year again you are going to use the $50 billion fiction because the rational apparently is that is what we have been doing.

How long do you think we are going to keep on doing this?

Mr. ENGLAND. Senator, the $50 billion, again my understanding is it is not an estimate. It is only a—it basically does what the Congress did the previous year, which is put the $50 billion in terms of along with the budget.

Senator DOMENICI. I say it is a fiction. We just pick it out. It is not realistic. It is not showing us what the Defense Department is actually costing. We are sort of assuming that the war is a separate entity, and how much longer does that have to go on until it becomes part of the regular budget? We should assume that it is part of what we are going to pay. Another 2 years?

Do you understand what I am talking about?

Mr. ENGLAND. I understand Senator. We earlier had the discussion, I comment then that this is really above my pay grade. This is a decision by the Appropriation Committee and the leadership of the Congress and the OMB and the President to have the supplementals. And you can either put it in the budget or in a supplemental.

Frankly, my view is you get much better numbers and much better support in the supplemental because otherwise we are today preparing the 2008 budget. We would literally have to "guess" ahead. There is this tyranny of the budget process. It takes a long time.

So we are preparing the 2008 budget. We would have to look ahead literally several years and try to predict and literally guess those numbers, which be very, very hard to do that we could not support them at that time.

So it is a decision as to which way to go. It could go either way. But frankly, my judgment is there is better numbers in the Congress with the supplemental but that is obviously a judgmental decision.

Senator DOMENICI. Just one last question that has to do with whether we are meeting our quota with reference to the volunteers signing up for our military. We had a couple of questions in here that I am not going to read back on. But could the Admiral or one of you talk to me just for a moment? I am sure it has been asked. But where are we?

I read one thing in the newspaper and then I hear something from the military. Could we get something official from you all?

Mr. ENGLAND. Sure. The Admiral has the numbers but I can tell you. For the last 8 months we have met all of our recruiting goals for all of our services. Do you have the specific numbers there, Admiral?

Admiral GIAMBASTIANI. I do. And Senator, what I would like to do you is what I am going to give you is that tally as of the end of January. We expect the official tally to come out for the month of February here within a couple of days. But all indications are that we have made goal in February also. That is what I understand. Those are draft remarks.

But what I will tell you is the U.S. Army has made it, as the Secretary mentioned, for the last 8 months in a row. The Navy has made it for the last 11 months in a row. The Marine Corps for 16 and the Air Force for 16.

And obviously along with that we are at unprecedented retention rates across our services. Every one of them. In fact, all services are greater than 100 percent retention, which is pretty remarkable.

And then on the National Guard side, the Army National Guard through the end of January has made it 4 months in a row and was at 109 percent in January. The Army Reserve has made it 5 months in a row and was at 100 percent. The Marine Corps has made it 11 months in a row and was at 100 percent in January. The Air Force Reserve was at 100 percent and has made it 12 months in a row.

The only one that has missed in January was the Navy Reserve. And frankly, there are some goal adjustments that are going on inside the Navy with regard to the Reserve, I understand.

So that is what I can give you for official totals. And we will give you a roll up of that here, if you would like.

Senator DOMENICI. Would you also, for the record, tell us what kind of bonuses and/or changes have been made in an effort to meet these goals, say over the last year?

Admiral GIAMBASTIANI. Yes, sir. We will give that to you for the record.

ADDITONAL INFORMATION FOR THE RECORD

Through the continued support of the Congress, we are fortunate to have a wide range of incentives to offer as we aggressibely compete in a challenging recruiting environment to recruit the best and the brightest into our ranks and retain those that we already have.

The Department has three primary enlistment incentives-enlistment bonuses, the Montgomery GI Bill (MGIB) College Funds (Kickers), and a College Loan Repayment Program. The Services, based on their needs, offer these incentives to encourage enlistmens into critical or hard-to-fill specialities and to fill seasonal needs.

Enlistments bonuses are cash incentives designed to induce people to enlist and serve in military occupations experiencing personnel shortages. The legislative maximum for enlistment bonuses is $40,000 for the Active Components and $20,000 for the Reserve Components (based on increases enacted in NDAA '06). Bonuses are generally paid for skills that are understaffed, arduous (such as combat arms), and those that require a high degree of technological skills. Additionally, enlistment bonuses are used to evenflow the new recruits into the Service training bases by encouraging entry onto active duty during traditionally difficult accession months.

The Montgomery GI Bill (MGIB) and College Funds are valuable tools in our professional recruiter kit bags. The MGIB is offered to most personnel who enter the Service for the first time. Service members may receive up to 36 months of benefits for approved programs of education or training. Those enrolled in the MGIB have their pay reduced by $100 per month for 12 months, or $1,200. This money is not refundable.

The current monthly MGIB benefit for an individual serving at least 36 months on active duty and enrolling full-time in an approved program in $1034 per month for up to 36 months providing a potential total benefit of $37,224. This rate is reduced for less than full-time educational enrollment and for less than a three-year active-duty commitment. Funding for this benefit comes from the Department of Veterans' Affair budget.

In addition to the basic MGIB benefit, the Services may offer an increased benefit, call a "kicker," for enlistment in certain critical or hard-to-fill skills. This kicker plus the basic MGIB benefit are commonly referred to as the Service College Funds. The statutory limit for the kicker is $950 per month and is currently offered by the Army, Navy and Marine Corps. The Services contribute an actuarially determined amount to the DOD Education Benefit Fund for each individual accessed with a college fund.

The Reserve Components offer the MGIB Selected Reserve (SR) program as well. Their program is actually a recruiting and a retention incentive since it is not limited to only personnel service in their first term of service. The requirement for the MGIB-SR program is for an individual commit to a six-year term of service. The member is then eligible to receive an educational benefit of up to $292 per month for 36 months. The monthly benefit is based on class load and the amount is adjusted annually based on the Consumer Price Index. The cuurent maximum benefit for this program is $10,512. The member is not required to contribute financially to this program. Additionally, all of the Reserve Component Services are authorized to offer a kicker (discretionary, based on Service needs/skills requited) up to $350 per month.

The last in the major triad of incentives legislated and offered is the College Loan Repayment Program (LRP). The LRP allows the Services to repay certain Federally guaranteed educational loans for enlistments in military specialties designated by the Service Secretary. Only loans existing prior to entrance onto active duty are eligible. Currently, the Army, Navy and Air Force offer LRPs.

The Active Army and Navy will repay loans up to $65,000, while the Air Force limits the LRP to $10,000. The Marine Corps does not use this incentive in either their active or reserve recruiting programs. The Reserve Components (less the US Army and Navy) use this program as well, however the level of repayment is less than that in the active programs. New recruits that enlist under the LRP option are ineligible for enrollment in the MGIB.

Our retention programs are strong and successful in both in Active and Reserve compnents. Service men and women are staying in because they are proud of what they are doing in Iraq and Afghanistan and want to see it through. Here again, the Congress has better enabled us to keep the best of our Service members by enabling us to offer them first-rate bonuses that show them our high regard for their past and future service. These are discretionary programs, which like the enlistment bonuses, are used based on the needs of the individual Services. Both the Active Component retention bonus is $90k (increased from $60k in NDAA 06). The maximum allowable retention bonus for the Reserve Component is up to $15k (based on needs of the Service, length of reenlistment and number of prior reenlistment bonuses for that individual). Additionally, for critical job specialities (e.g. Special Forces) a Critical Skills Retention Bonus (CSRB) Program is provided where the Services may pay (based on needs, skills, etc) up to $200k (for the Active Component) and up to $100k (for the Reserve Component) over the career of the individual.

In addition to the increased level of enlistment and reenlistment bonuses enacted in NDAA 06, this legislation also had other components, which are helping in the recruiting efforts of the Services. It increased the maximum age for enlistment to 42 and also authorized the Army a referral bonus program. In this program, a serving member of the Army will be paid $1,000 upon the successful completion of initial training for any person that he or she refers.

The programs detailed above are vitally important to the success of our progessional recruiting and retention personnel across the Armed Forces. We are confident that with the continued support of the Congress on robust programs such as these, the personnel required to successfully prosecute the War on Terrorism will be there.

Mr. ENGLAND. I can tell you, Senator, just for the record though, in this budget there is close to $2 million, $1.9 billion, for bonuses and incentives are included in the fiscal year 2007 budget. And we will give you breakdown of those specifics.

ADDITIONAL INFORMATION FROM MR. ENGLAND

The Department has three primary active-duty enlistment incentive-enlistment bonuses, the Montgomery GI Bill (MGIB) College Funds (kickers), and a Loan Repayment Program. The Services offer these incentive to encourage enslitments into cvritical or hard-to-fill specialites. For Fiscal Year (FY) 2007, the Services have budgeted $431 million for these purposes.

The National Defense Authorization Act (NDAA) for FY 2006 raised the limit that may be paid to a new recruit for an enlistment bonus from $20,000 to $40,000. The Army and Navy are using this increased authority to target those especially difficult skills formerly contrained by the $20,000 limit. The NDAA also authorized the Army to provide a $1,000 referral bonus to Soldiers who refer an applicant for enlistment. The Army already has over 1,000 leads from referrals and sees this new program growing daily.

Thanks to Congressional support, most bonus authorities for Reserve componenets have been increased over the past year in an effort to bolster our recruiting efforts, and the components are using these increased bonuses and incentives to recruit quality Service members. In the education benefits arena the basic MGIB allowance received its annual increase, now at $297/month, and the new chapter 1607 benefits for Reservists who were mobilized are being implemented-significantly increasing the education benefit allowance. In the area of recruiting incentives, Reserve component enlistment and affiliation bonuses more than doubled to $20,000 for six year contracts, and prior service enlistment bonuses also increased to $15,000 for six year contracts. Additionally, in an effort to resolve some junior grade officer shortages, the officer accession bonus was increased to $10,000. To help ensure that we retain these quality members, reenlisment bonuses have been increased to $15,000 for a six year commitment. Also, the critical skills retention bonus was expanded to include Reserve component members with skills that are critically short. This expanded authority allows us to pay up to $100,000 over the course of the Reservist's career. These benefits, along with innovative programs, are proving to be extremely helpful in turning around Reserve component recruiting in a difficult environment.

Senator DOMENICI. Thank you very much. Thank you, Mr. Chairman.

Chairman GREGG. Thank you.

Do you have a projection for how many troops will be in Iraq over the next 12 months?

Admiral GIAMBASTIANI. I guess the way I would answer that is that it is condition based as we continue to stand up the Iraqi security forces. And by Iraqi security forces I mean both Iraqi army and Iraqi police forces, since the Defense Department is now running the police training for the last 3 months or so.

The numbers are about 232,000 I believe today, Iraqi security forces. And those numbers are going up substantially. And as they come up and continue to take over battle space, which has been happening routinely. Just a month ago the Iraqis took over about the size of Kentucky where they have the lead.

Just to give you an idea, yesterday morning I was on a video teleconference with General Casey and General Chiarelli. This was the Secretary of Defense, the Chairman and myself. And we were getting a briefing from him. General Chiarelli has now been in theater for about 6 weeks. He had left for a year, had served as the Baghdad area U.S. Commander and came back.

And when he left there were only three Iraqi security force battalions, Iraqi army battalions that actually owned battle space. Today the number is well over 40 and going up very rapidly.

So from his perspective how those forces are growing is substantial. I just remind you that we also have two less brigade combat teams right now than we did 6 months ago. One of them is in Kuwait on what we call a prepared to deploy order if we need it, but it is a reserve. This is significant. And we fully expect that as the political situation continues to mature hopefully within Iraq, and as the security forces continue to build, General Chiarelli felt very, very pleased at the performance of the Iraqi army in particular because of their very good performance security-wise here as a result of the destruction of the Golden Dome up in Samarra.

So what I am saying to you sir is it is condition-based but the Iraqi forces are making great progress. They have accelerated their fielding. And they are performing exceptionally well based on our experience. But again, it is condition based.

Chairman GREGG. That being the case, it sounds like you are saying you are not going to be adding more force?

Admiral GIAMBASTIANI. I do not expect us to add forces. But of course when we have elections, when we have parliamentary things, as certain things come up we do get requests from the commanders on the ground and we will move forces, for example, from Kuwait into Iraq or somewhere else.

Chairman GREGG. Assuming that we are not adding more force, and assuming that there is a chance we may be drawing down force, is it safe for us to assume that the average cost over the last 4 years would be a number that might be a reasonable number for the next supplemental year, next year's supplementals?

Admiral GIAMBASTIANI. I cannot estimate the costs. What I am telling you is that from a security force standpoint, dealing with the numbers.

Chairman GREGG. What I am saying is we have historical cost for maintaining this level of force, which hopefully we will actually be drawing down as we stand up force. That historical cost appears to be about $90 billion supplemental request.

Is it reasonable to assume that that is what the supplemental will be next year? Or in that range, assuming historical factors?

Mr. ENGLAND. Senator, I think obviously if you assume historical factors you come out with that number. The unknowns are a lot of what is in the supplemental is also the repair and replacement, the resetting of the force. And until we actually complete this activity, we do not know what that end cost is for resetting and the repair of the equipment.

So there is this unknown that is always out there in terms of——

Chairman GREGG. I accept the fact that there is an unknown. But I also accept the fact that zero is the wrong number, which was the number you sent up last year. So we put $50 billion in. And it appears to be the wrong number.

And so I am trying to figure out what is a number that, assuming all of these unknowns, is still a reasonable number within the context of the history of the costs. And it seems to me that $90 billion is probably a number that is somewhere in the ballpark. it is lower than last year or this year and higher than the prior years. Just a thought.

In any event, we have to address it. If we do not get guidance from you, we still have to address it. So I am just trying to get a sense.

Admiral GIAMBASTIANI. Chairman Gregg, if I could just mention one thing. We send over every 90 days, as required by Congress, a report to Congress on the stability and security in Iraq. There is an unclassified section which is called Measuring Security and Stability. And then there is a classified supplement that specifically talks about the Iraqi security forces and makes some projections.

Deputy Secretary England has signed out that document here just on the 17th of February. And we sent it over. We presented it to all four of the Armed Services and Defense Appropriations Committees, in addition to the Intelligence Committees of the

House and the Senate. And in there it talks about some projections of where we see the Iraqi security forces being.

So that happens to be only one component of it, but you will see that it talks about the projections that we are giving and the build-up from where we are today of 232,000 forces to a number that is substantially larger than that.

Chairman GREGG. Which is obviously very good news.

Admiral GIAMBASTIANI. Yes, sir.

Chairman GREGG. We certainly hope that you accomplish that. And one presumes that leads to lower troop levels on our part.

Admiral GIAMBASTIANI. Yes, sir. And that is what I am trying to pass on, sir.

Chairman GREGG. I am trying to say that we have reached the high water mark. So we ought to be able to pick an average of the high water mark, which are the last 4 years, and be fairly close to where you hopefully will be next year.

Senator Conrad.

Senator CONRAD. I just want to associate myself with the remarks of the Chairman and the remarks of the former chairman, Senator Domenici.

I think we have been engaged in a fiction on budgeting. When you talk about Congress doing the $50 billion last year, that was in response to the Administration saying nothing. They said you do not need to add any money. At least that was what was in their budget.

So the frustration that you are witnessing here is there is a feeling here that we have not been quite leveled with on what the costs are and what they are going to be. And there is a lot of reason for us to feel that way.

Let me just ask a final question, if I can. This is what we are spending on fighters, $11.1 billion, long-range bombers $740 million. And in that context, the proposal in the budget is to retire 20 percent of our bomber fleet, to reduce the number of B–52s from 93 to 56 when we are a decade away from the next generation of long-range strike planes being available. I just want to say to you it strikes some of us as unwise to reduce the bomber fleet that dramatically.

These B–52s, as was part of your own testimony here this morning, have extraordinary capability. I think, Secretary England, you referenced that one B–52 can carry enough armament to take out 90 targets.

I found it surprises constituents when they find out we only have 93 B–52s in the active inventory. We have one more that is at NASA, for a total of 94. And they are talking about going to 56, when we are more than 10 years away from the next generation of long-range bomber being available.

So I just want to send that message, that some of us are not going to be supportive of that kind of dramatic drawdown of the B–52 force without some replacement in our sights.

With that I want to again thank the witnesses. I want to thank you, Secretary England. Thank you for your service to the Nation.

I certainly want to thank the Admiral, as well. I very much appreciate it. I did not have the chance, I told you my wife is Italian. I did not tell you, she is one of those people that ran away from home and joined the Navy and had a great career and is enormously proud of serving in the United States Navy, and also very proud of her Italian heritage.

Admiral GIAMBASTIANI. I am proud of her being Navy and I am glad to see that I was as smart as she was.

Senator CONRAD. And to Ms. Jonas, as well, we have high regard for your professionalism.

Mr. ENGLAND. Can I take just 30 seconds on the bomber issue?

Senator CONRAD. Certainly, absolutely.

Mr. ENGLAND. This is an issue that I think we agreed on, in terms of the importance of bombers. As a matter of fact, we said we need to start working on the next generation bomber, which is in the QDR. So that was one of the efforts of the QDR. And we have money in the budget to do that, by the way, to actually start the next bomber.

The B–52s are literally venerable old work horses and they have been upgraded and they do a wonderful job. But some of the B–52s are not venerable work horses. They are worn out old work horses and they are really not of value to us and they are past the point of being useful.

So this was really an effort to the very best——

Senator CONRAD. Can I stop you on that point? Because I do not think that is true. We have—Minot Air Force Base in North Dakota is home to the Attrition Reserve. Those planes, to my knowledge, have all been upgraded. All of the planes have been treated the same, even though some are in the Attrition Reserve. All of them have had been given upgrades.

Is that not correct?

Mr. ENGLAND. Senator, I will get back with you. My understanding though, as I recall the discussion, and the Admiral may recall some of this, I believe there is 18 that do not fly at all.

Senator CONRAD. No, I will tell you, that is bad information. We have talked about bad information here. All of the planes are flown. All of the planes have been upgraded.

That is alarming to me when you say these things that I know are not right. Those planes have been upgraded. Those planes fly. And we have been very careful to do that. This Committee has been very aggressive to make certain that was done.

Mr. ENGLAND. The Admiral is about to correct me on this subject, sir.

Admiral GIAMBASTIANI. I normally do not correct my boss——

Mr. ENGLAND. Please do.

Admiral GIAMBASTIANI [continuing]. But in this case I will publicly help him out here.

We understand completely what you have said. They are called Attrition Reserve aircraft because we do not normally have them in a line unit. But obviously, as you well know, we take those Attrition Reserve aircraft, we have upgraded them. We have put them in a line unit for a short period of time, flown them, make sure they are upgraded.

The reason is that if you do not do that, you cannot have them ready for service if you need them.

We have looked at the bomber force. We all, most of us within the Defense Department, at least for example me as the Vice

Chairman and I will speak for myself, are a very strong proponent of the bomber force. I think I am the only Navy admiral I know of that has actually flown a two-and-a-half hour mission in a B–2, for example.

What I would tell you as that in the beginning in Afghanistan, we had Air Force bombers and Navy tactical aviation off of carriers. We did not really have other things flying, other then of course tankers and AWACS and all of those big aircraft that we are flying which were so important to our effort.

But the Secretary is dead on. There is a very strong commitment to a follow-on bomber force. And in the next President's budget and in our future year defense program that we will present after this year of deliberation, you will see more on this bomber force and where we are going. We will put lots more granularity into it.

Senator CONRAD. I appreciate that.

I just am concerned about the bathtub effect that is being created here. I think it is unwise in terms of the national security. And this will be something Congress will want to review.

Admiral GIAMBASTIANI. Yes, sir.

Chairman GREGG. Again, I want to join my colleagues in thanking you for your service. Thank you for taking the time to come up and testify before the Committee. It is very useful for us, obviously, and we appreciate all that you do. But we especially appreciate all that the men and women who are on the front lines in this war are doing.

Mr. ENGLAND. Mr. Chairman, thank you very much. Mr. Conrad, thank you. It is a pleasure being with you today. Thank you very much, sir.

Chairman GREGG. The hearing is adjourned.

[Whereupon, at 11:54 a.m., the committee was adjourned.]

PREPARED STATEMENTS

Michael B. Enzi

Statement of Michael B. Enzi

Senate Budget Committee Hearing:
The President's Fiscal Year 2007 Budget Proposal
March 2, 2006

I would like to thank the Honorable Gordon England, Deputy Secretary, Department of Defense, and Admiral Edmund P. Giambastiani, Jr., Vice Chairman, Joint Chiefs of Staff, Department of Defense, for testifying today before the Senate Budget Committee. I am looking forward to hearing your views on the President's budget proposals for the Department of Defense.

Last month, President Bush laid out a budget proposal that encourages fiscal discipline and restraint. However, the President also included a 7 percent increase for the Department of Defense. I am strongly supportive of ensuring that Congress provides the financial support necessary to fight the ongoing war on terror. As you know, the Department of Defense represents over half of all discretionary spending in the budget. Like all federal agencies, it is important for the Budget Committee to utilize our oversight to ensure that the Department of Defense is using their funding in an appropriate manner. Coming before the Committee today is a step in the right direction and I appreciate your willingness to testify.

This year's budget proposal came to Congress along with a Quadrennial Defense Review (QDR) examining the future of our national defense for the next twenty years. I support this review process and believe we must continue to look forward to the threats and needs of our nation. I am especially interested in proposals related to our land-based nuclear program and the future follow-on mission for the Minuteman III missiles. This is an important program for our national security and I strongly encourage the Department of Defense to continue to plan for the future in this area.

One issue I am concerned about is the continued use of supplemental requests for additional funding. However, I am pleased that the President Bush considered the most recent supplemental request when he submitted his Fiscal Year 2007 budget proposal last month.

The continued use of supplemental requests simply reinforces my support for pre-funding within the budget. If we include a line item in the budget to put aside funds for the inevitable "emergency", the use of supplementals for natural disaster recovery as well as defense spending would go down. The concept of pre-funding is not a new proposal. This is the same theory that the average American uses when they set money aside for future expenses such as home repairs or their child's education. Congress continually supports and encourages people to save money. However, we do not adopt the same concept within our own budget. The American people know that it is wise to be prepared for the future and the federal budget should reflect this same idea.

Thank you again for being with us today and I look forward to your testimony.

Answers to Questions submitted from Senator Ron Wyden by Mr. Gordon England

The President's Fiscal Year 2007 Budget Proposal

Question #1

A Pentagon audit identified $263 million in unjustified charges from Kellogg, Brown and Root (KRB) as part of its bill for a no-bid contract to deliver fuel in Iraq. However, the Army recently announced that it is going to pay almost all of these excessive charges.

The Army says that they have to pay these disputed charges because they fall within the terms of the contract. When $253 million worth of questionable and unsupported charges are still technically within the bounds of a contract, it indicates to me that the Army isn't reading the fine print before signing contracts.

Is the Pentagon instituting any reforms to ensure that this kind of sweetheart contract doesn't happen again?

Answer

The RIO I contract was a cost plus award fee contract of the type described in FAR 16.405-2. Under the contract, the contractor's costs are reimbursed and the contractor earns a 2% base fee and an award fee, which can range from 0 to 5%. The award fee is not a "performance bonus" but is an earned fee based on criteria set out in the award fee plan in the contract.

No unsupported costs were paid. The contractor either provided support for costs or withdrew the costs from the proposal. The contracting officer found most questioned costs, which KBRS actually had incurred in executing the mission, should be reimbursed. However, he excluded just over half of those costs from the amount used to calculate the award fees paid to KBRS; refused to reimburse some $3.8 milion in costs; and did not pay a claim for $5.4m in interest. In addition, he excluded the entire amount of the $28.5m claim submitted on Task Order 4 from the amount used to calculate the base and the award fees.

The award fee determining official also considered the issues identified in the DCAA audits in making his fee determinations. The results was that KBRS also earned a lower percentage of the available pool. Award fees ranged from 4% to 68% of the maximum 5% award fee. All fees were awarded in accordance with the award fee plan set out in the contract, which placed more emphasis on timely mission accomplishment than on cost control and paperwork.

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