S. HRG. 111–733

CONCURRENT RESOLUTION ON THE BUDGET FISCAL YEAR 2011

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

January 28, 2010–THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011-2020

February 2, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL

February 4, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET AND REVENUE PROPOSALS

February 9, 2010–CRISIS AND AFTERMATH: THE ECONOMIC OUTLOOK AND RISKS FOR THE FEDERAL BUDGET AND DEBT

February 11, 2010–SETTING AND MEETING AN APPROPRIATE TARGET FOR FISCAL SUSTAINABILITY

February 23, 2010–DEFENSE BUDGET AND WAR COSTS: AN INDEPENDENT LOOK

February 24, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET FOR THE DEPARTMENT OF TRANSPORTATION

March 4, 2010–DEPARTMENT OF DEFENSE FISCAL YEAR 2011 BUDGET REQUEST

Printed for use of the Committee on the Budget

CONCURRENT RESOLUTION ON THE BUDGET FISCAL YEAR 2011

S. HRG. 111–733

CONCURRENT RESOLUTION ON THE BUDGET FISCAL YEAR 2011

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

January 28, 2010–THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011-2020

February 2, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL

February 4, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET AND REVENUE PROPOSALS

February 9, 2010–CRISIS AND AFTERMATH: THE ECONOMIC OUTLOOK AND RISKS FOR THE FEDERAL BUDGET AND DEBT

February 11, 2010–SETTING AND MEETING AN APPROPRIATE TARGET FOR FISCAL SUSTAINABILITY

February 23, 2010–DEFENSE BUDGET AND WAR COSTS: AN INDEPENDENT LOOK

February 24, 2010–THE PRESIDENT'S FISCAL YEAR 2011 BUDGET FOR THE DEPARTMENT OF TRANSPORTATION

March 4, 2010–DEPARTMENT OF DEFENSE FISCAL YEAR 2011 BUDGET REQUEST

U.S. GOVERNMENT PRINTING OFFICE

58–153pdf WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

CONTENTS

HEARINGS

Page

January 28, 2010—The Budget and Economic Outlook: Fiscal Years 2011–2020 1
February 2, 2010—The President's Fiscal Year 2011 Budget Proposals 77
February 4, 2010—The President's Fiscal Year 2011 Budget and Revenue Proposal 151
February 9, 2010—Crisis and Aftermath: The Economic Outlook and Risks for the Federal Budget and Debt 229
February 11, 2010—Setting and Meeting an Appropriate Target for Fiscal Sustainability 301
February 23, 2010—Defense Budget and War Costs: An Independent Look 371
February 24, 2010-The President's Fiscal Year 2011 Budget for the Department of Transportation 445
March 4, 2010—Department of Defense Fiscal Year 2011 Budget Request 487

STATEMENTS BY COMMITTEE MEMBERS

Chairman Conrad.......... 1, 77, 151, 229, 301, 371, 445, 487
Ranking Member Gregg 7, 84, 158, 378
Senator Bunning 40
Senator Merkley 399
Senator Session 236, 352

WITNESSES

Gordon Adams, PhD, Professor of International Relations, School of International Service, American University 394, 397
Douglas W. Elmendorf, Director, Congressional Budget Office 10, 13
Honorable Timothy F. Geithner, Secretary, US Department of the Treasury 160, 164
Simon Johnson, PhD, Ronald A. Kurtz (1954) Professor of Entrepreneurship, Massachusetts Institute of Technology, Sloan School of Management, and Senior Fellow, Peterson Institute for International Economics 242, 246
Honorable Raymond H. LaHood, Secretary, US Department of Transportation (Accompanied by Chris Bertram, Chief Financial Officer, US Department of Transportation) 454, 456
William H. Lynn, III, Deputy Secretary of Defense, US Department of Defense; Accompanied by Robert F. Hale, Under Secretary of Defense (Comptroller) and Chief Financial Officer, US Department of Defense 487, 489
Maya MacGuineas, President, Committee for a Responsible Federal Budget, and Director, Fiscal Policy Program, New America Foundation 320, 325
Donald Marron, PhD, Visiting Professor, Georgetown Public Policy Institute 253, 255
Honorable Peter R. Orszag, Director, Office of Management and Budget 87, 90
Rudolph Penner, PhD, Institute Fellow, Urban Institute Co-Chair, Committee on the Fiscal Future of the United States 337, 341
Carmen M. Reinhart, PhD, Professor of Economics, and Director, Center for International Economics University of Maryland 238, 240
Honorable Alice M. Rivlin, PhD, Director, Greater Washington Research, The Brookings Institute 311, 313

Page

Paul K. Van Riper, Lieutenant General, United States Marine Corps (Retired) 410, 412
Cindy WIlliams, PhD, Principal Research Scientist, Security Studies Program, Massachusetts Institute of Technology 378, 381

QUESTIONS FOR THE RECORD

Senator Byrd 128, 214
Senator Cardin 481
Senator Cornyn 521
Senator Crapo 211
Senator Enzi 138
Senator Feingold 226, 522
Ranking Member Gregg 41, 142, 205, 472, 509
Senator Merkley 149
Senator Murray 145, 218
Senator Nelson 42, 481
Senator Sessions 123, 294, 512
Senator Stabenow 517
Senator Warner 131
Senator Whitehouse 269, 298, 438, 442, 518
Senator Wyden 477, 514

THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011–2020

THURSDAY, JANUARY 28, 2010

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

The Committee met, pursuant to notice, at 9:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Feingold, Nelson, Stabenow, Cardin, Whitehouse, Merkley, Gregg, Grassley, Enzi, Sessions, Bunning, and Alexander.

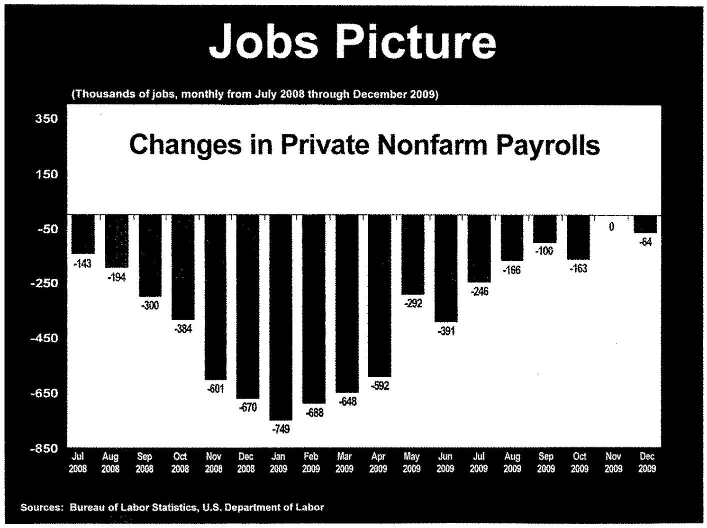
Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

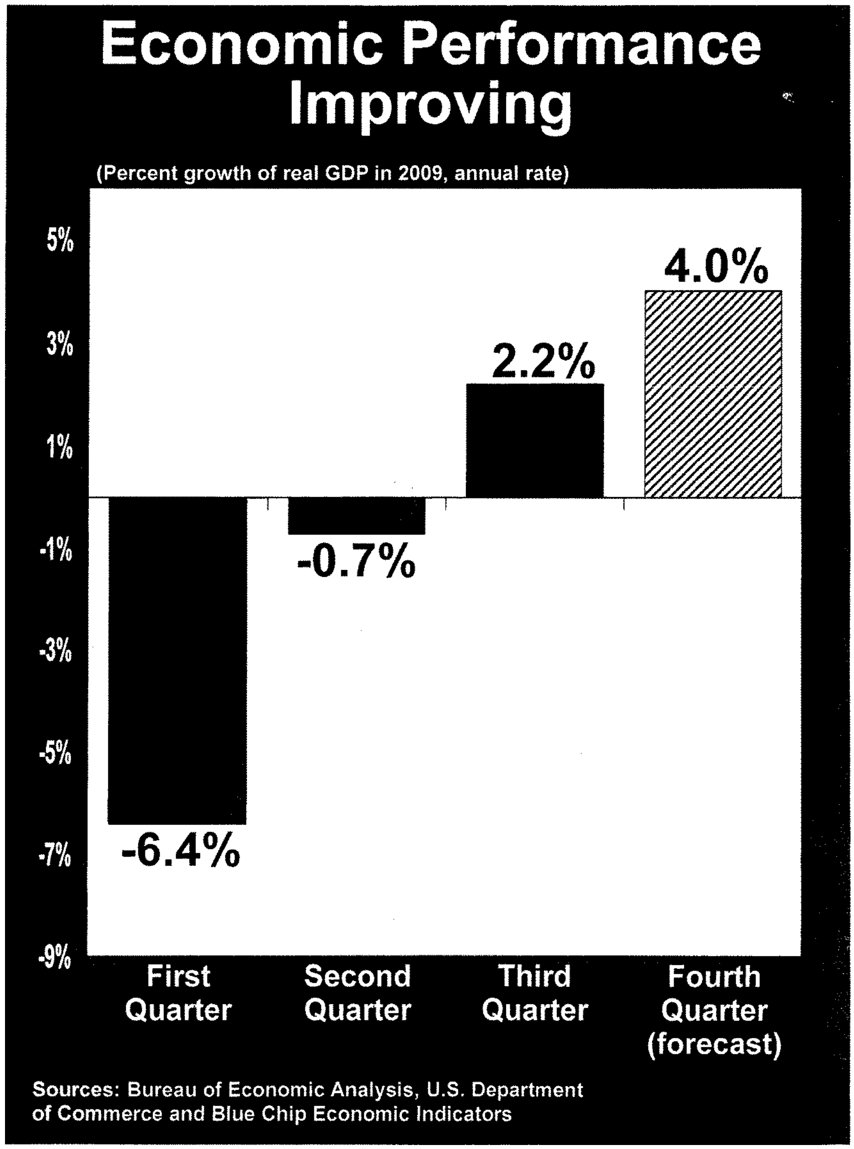
Chairman CONRAD. The hearing will come to order.

First, we want to welcome the CBO Director here to the Budget Committee to report on the latest CBO estimates. And before we begin that, I want to publicly thank Director Elmendorf for the really extraordinary effort he and the people at CBO have made over the last year with an unprecedented workload, and I mean truly unprecedented. I know firsthand that he and his people have worked nights, weekends, repeatedly, repeatedly, repeatedly, under extraordinary time pressures and with real complexity. And I must say, even though there have been times I disagreed with Director Elmendorf's views, sometimes strenuously, I absolutely respect his independence and his integrity. And I think he has won the respect of people on both sides of the aisle who have seen that he has tried to call them straight. And that is the best that we can ask for, and it really is, I think, high professionalism from Director Elmendorf and from the people at CBO. And, again, I have had my disagreements on some of their findings on things that mattered a lot to me, but what is important is that we do have an independent scorekeeper that has integrity. And certainly Director Elmendorf has proved that, and I appreciate it.

Let me just turn briefly to my remarks about the subject at hand. The jobs situation across the country is very much in the front of everyone's mind, and if we look at the changes in payrolls going back to July of 2008, we can see we reached a peak of job loss in January of 2009. Virtually every month we have seen some improvement, and in November, we actually had no jobs lost, no net jobs lost; in December, 64,000. So a dramatic improvement from the 700,000 that were being lost a month in January of 2009.

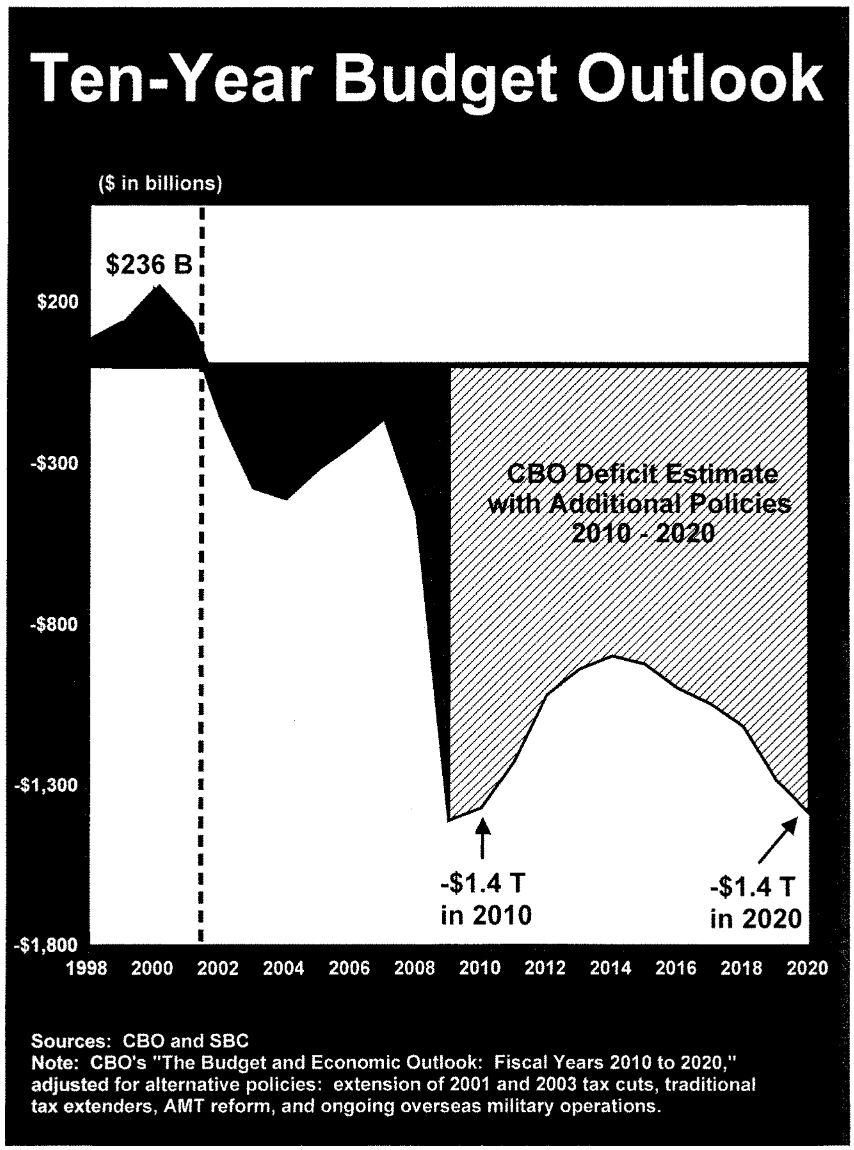


The same pattern can be seen in terms of the economic growth in the economy, the first quarter a negative 6.4 percent, improving each quarter; so fourth quarter, according to the Blue Chips, we can anticipate growth in the fourth quarter of last year of 4 percent. Some are now saying it may be even stronger than that.

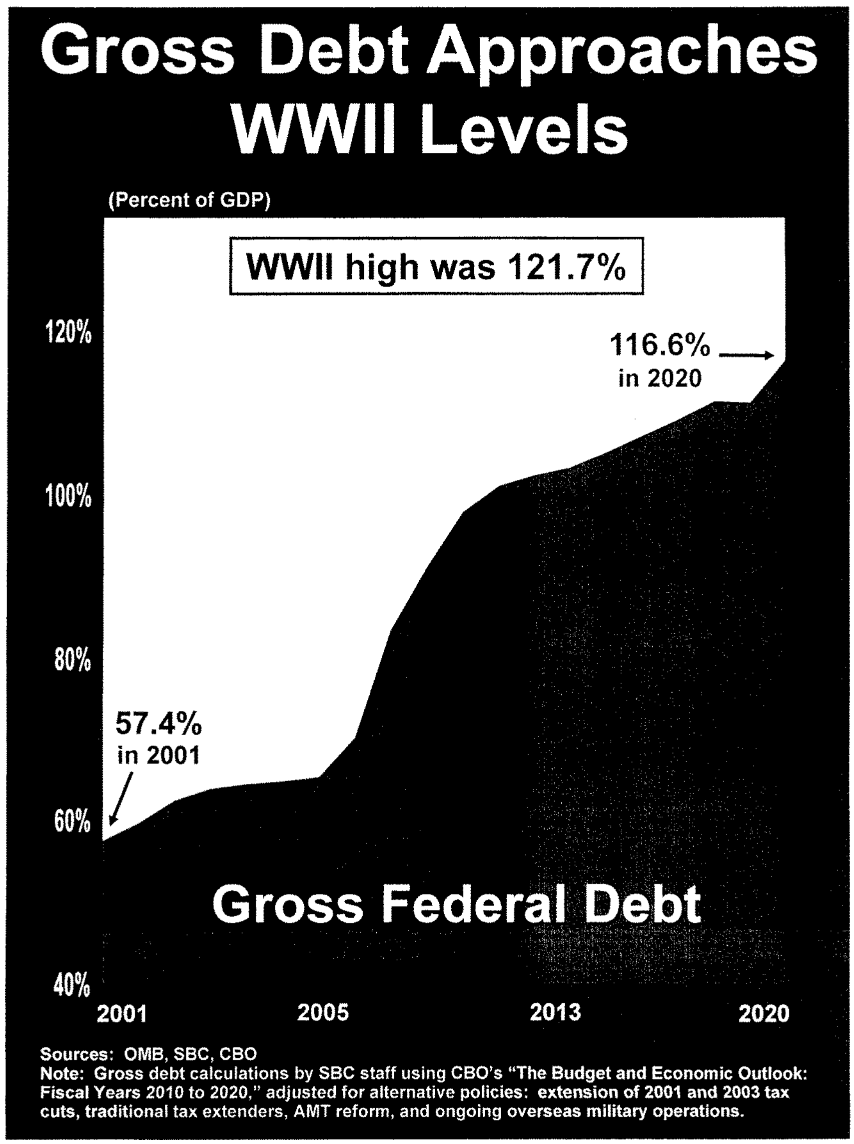


So things have moved from the edge of the precipice. I believe very strongly we were on the brink of a global financial collapse before actions that were taken by the Congress, the President, and I would include the previous President, because the actions of his administration at the end I think were part of the response from the Government, both the administration, the Congress, and, of course, the Federal Reserve, taking actions to provide liquidity to prevent a collapse. Those actions did forestall, I believe, what would have been the worst recession since the Depression.

But it leaves us with a long-term budget outlook that is truly daunting, and we cannot flinch from that. We cannot deny it. We have to face up to it. The 10-year budget outlook worst-case scenario is as this chart depicts. We see improvement for the next 5 years, but then it starts to turn and move the other way if we do not act, and act we must.

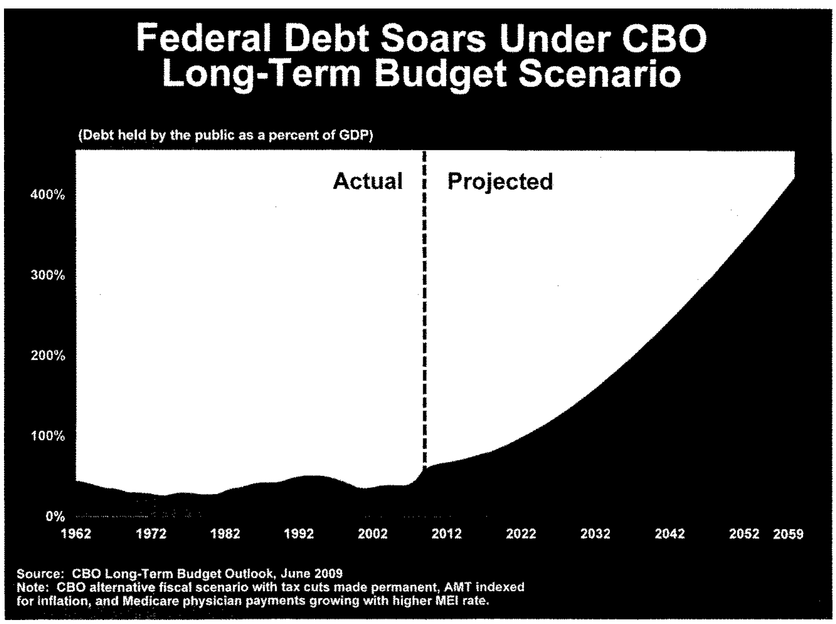


The gross debt now is approaching World War II levels, and let me just indicate that I know the economists like to focus on debt held by the public. I like to focus on the gross debt because, for budget purposes, all the debt has to be repaid, and debt can only be repaid out of current revenues. And so the fact is if we are looking at what is going to have to be dealt with from a budget standpoint, we have to consider gross debt. Those borrowings from the trust funds are real. They must be repaid. They are backed by the full faith and credit of the United States. And when I look at the gross Federal debt, I see it exceeding 100 percent by 2020—and, in fact, before that.



The World War II high was 121.7 percent. Now, to put this all in perspective, other countries, industrialized countries, do have higher debt-to-GDP. Japan I believe at this point is in the 189-percent-of-GDP range. But there are real consequences for that. I believe Japan is about to have their debt downgraded because people see the risk of debt of that magnitude.

More alarming and more concerning to me is the long-term trajectory, and if we look at the long-term budget outlook from CBO, we see debt, with all policies extended, all current policies extended, reaching 400 percent of GDP by 2059. There is no one that thinks that is a sustainable course. So anybody that tells us, well, you do not have to do anything, you do not have to worry about these things, we can just continue as we are, they are not telling us the truth. And this is not just my judgment. It is the judgment of Senator Gregg, the Ranking Member here. This has been the testimony before this Committee of this head of the CBO, of the previous head of the Congressional Budget Office, of the head of the Office of Management Budget, of the former head of the General Accounting Office, of the Chairman of the Federal Reserve, of the current Secretary of the Treasury, of the previous Secretary of the Treasury.



So it is critically important that we honestly describe our circumstance. Our circumstance requires action on the debt.

Colleagues, let me quote from CBO on the budget outlook: “The Federal fiscal outlook beyond this year is daunting. Accumulating deficits will push Federal debt held by the public to significantly higher levels. With such a large increase in debt plus an expected increase in interest rates, as the economic recovery strengthens, interest payments on the debt are poised to skyrocket. Without changes to Federal fiscal policy involving some combination of lower spending and higher revenues, rising costs in health care and from the aging population will rapidly drive the size of the Federal debt."

CBO on the Budget Outlook

"...[T]he federal fiscal outlook beyond this year is daunting.... [A]ccumulating deficits will push federal debt held by the public to significantly higher levels....

"With such a large increase in debt, plus an expected increase in interest rates as the economic recovery strengthens, interest payments on the debt are poised to skyrocket....

"Without changes to federal fiscal policy – involving some combination of lower spending and higher revenues... – rising costs [in health care and from the aging population] will rapidly drive the size of federal debt...."

– CBO's *Budget and Economic Outlook: Fiscal Years 2010 to 2020*
January 2010

Now, I do not know what could be more clear. I do not know what could be more clear.

Yesterday, or perhaps the day before, I used a chart on the floor that showed the historical context of our spending and revenue. That chart showed that current revenue is the lowest it has been in 60 years. If we look at last year and this year, revenue as a share of the gross domestic product, the lowest it has been in 60 years; spending, the highest it has been in 60 years as a share of the gross domestic product. The difference between a revenue level of about 15 percent of GDP and an expenditure level of 26 percent of GDP, that is an 11-percent gap. We would not qualify for membership in the European Union with deficits of that magnitude. They do not permit it. They do not permit entry for countries that have deficits of that level.

Senator GREGG. Over 3 percent.

Chairman CONRAD. Yes, I think their limit is 3 percent.

So, look, this is the reality that we confront. The President was right to focus on this last night, and it is our responsibility to focus on it as we put together a budget for this year and the years beyond.

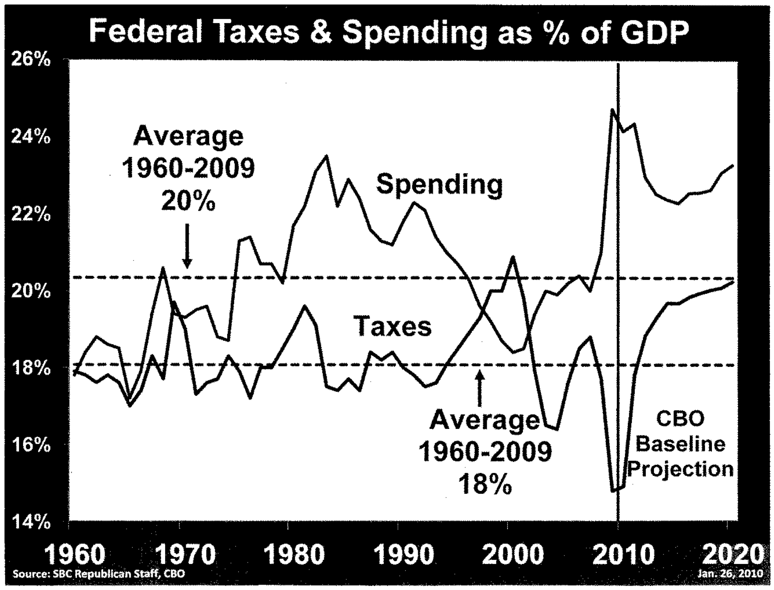
With that, I call on the distinguished Ranking Member, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Obviously, I second everything you have said about the problems we have as a Nation and that we are confronting relative especially to the debt. As you have said, the debt is the threat. And it is more than a threat now.

It is a cataclysmic event facing us which is going to basically give our children a Nation they cannot afford and a lower standard of living than we have had in our generation.

I want to put one chart up because I think it is the most telling chart that I have seen in recent years.



This chart takes the CBO numbers and projects them out. What the Chairman was talking about is the line that is through the middle, the axis line, which shows the red line at its height—the red line being spending—and shows the blue line at its nadir, which is the taxes line. And that is where we are today, this massive gap, which is generated in large part by the recession, but also because much of the spending is recessionary driven, and obviously the drop in tax revenues is recessionary driven.

But what is also shows in stark terms is that when we return to some level of "normalcy," to use I guess it was Herbert Hoover's term—no, it was Harding's term—when revenues return to their historic levels, we still have a massive gap because spending is not returning to its historic levels, which makes the obvious point that the problem is primarily a spending problem. Even if you get your revenues back to where they have been on average for the last 40 years, you do not solve our problem, and we continue to pile on this debt, and we get to a position, regrettably, in the very near future where our debt is so large that, like a dog, we cannot catch our tail. In other words, we will not be able to afford the interest payments on that debt. The world community and our own Nation will begin to be suspicious of our capacity to pay our debt down, which will lead to an inevitable crisis of significant proportions relative to the value of the dollar, relative to our ability to sell debt, and relative to the productivity of the Nation as we have to probably dramatically raise the cost of Government on the productive side of the ledger.

So this is a problem of inordinate proportions, and it is in large degree a spending issue. And, thus, we have to start addressing it on the spending side, obviously. There are others who want to address it on the revenue side. But I believe that we have got to address the issue where it lies, and this chart unequivocally points out that it lies in the fact that we are taking the size of the Government from its historic level of about 20 percent of GDP up to 25, 26, 27, potentially up to 30 percent of GDP.

Well, how do we address that? Last night, the President said, related again that he wanted to freeze non-defense discretionary. Well, that is good language, but not a lot of money. I mean, it is a lot of money for us individually. It would actually be a lot of money for the State of New Hampshire. But in the context of what we are facing in deficits, it is not a lot of money. The "lot of money" comes on the entitlement side, not on the non-defense discretionary side, and that is where we have got to set our course and try to do something.

Unfortunately, I did not hear anything about controlling the entitlement accounts, and, in fact, on balance, if you take all the new programmatic ideas that were put on the table last night—and there were a whole series of them that were put out. I have not added them up yet, but I am sure that they far exceeded by a factor of, I suspect, 4 or 5 what was represented as would be saved under a discretionary freeze, a non-defense discretionary freeze. So actually spending under the proposals from last night goes up again.

We need to face up to this. You know, it is like that old TV ad, Fram oil filter ad, "You can pay me now or pay me later." But the "later" is coming fast. This is no longer an over-the-horizon event. It is on the horizon and closing fast. And I will be interested to hear from the Director what he thinks the closing date is. When does the Nation hit the wall? We know that Japan is hitting it right now. Their debt is about to be downgraded, it appears. And when are we going to get to that point? And is it not a predictable event right now that that will occur in our Nation? And when that occurs, that is when you have basically stepped off the insolvency cliff, and it is very hard to catch yourself as you fall off an insolvency cliff. So I will be interested in hearing what the Director says.

I also want to join with the Chairman in thanking him for his extraordinary work and his team's extraordinary work over the last few months, an incredibly intense period with the scoring of the health care bill. And the integrity and fairness of CBO really gave the whole exercise a lot more—well, it made me feel comfortable that we were at least getting good numbers on a bad bill and we were getting honest and fair numbers on a bad bill. And that is what CBO should do. It should be the fair umpire around here, and you have really done an extraordinary job of being the fair umpire, and we thank you for that.

Chairman CONRAD. Director Elmendorf, just before you begin, I want to amplify something Senator Gregg said. I have had people suggest to me that any commission that would consider our long-term debt would make adjustments to Social Security and Medicare. I think we have got to look people in the eye and say yes. There is really no alternative.

Medicare is cash-negative today. The trustees tell us it will be insolvent in 8 years. Social Security is cash-negative today, and your report of the day before yesterday says that it will be cash-negative every year except two for the future.

You say in your report it will go cash-negative on a permanent basis in 2016. So anybody that says you do not have to make any changes to those programs, programs I strongly support—I lost my parents when I was young. I got Social Security; it helped me go to college. So I understand its importance in people's lives. I understand the importance of Medicare in people's lives. I have seen it in my own family. But the suggestion we do not have to do anything is just not being straight with people.

And so I hope as this debate goes forward we just do not fall back into the same old divide of you cannot cut this, you cannot add any revenue here. I personally believe given the nature of the baby-boom generation that has doubled the number of people who are eligible for these programs, you are going to have to do something on the revenue side as well.

So I again welcome you to the Committee and again thank you for your and your team's extraordinary work during these last many months.

STATEMENT OF DOUGLAS W. ELMENDORF, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Mr. Chairman and Senator Gregg, for your very kind words about our work at CBO.

Exactly 1 year ago today, I testified before this Committee for the first time as the newly minted Director of the Congressional Budget Office, and on behalf of all of us at CBO I want to express our appreciation for the support that both Senator Conrad and Senator Gregg have shown for our work over the past year, which means a great deal to us.

To you and to all the members of the Committee, I appreciate the invitation to testify today about CBO's annual outlook for the budget and the economy.

Under current law, CBO projects that the budget deficit this year, fiscal year 2010, will be about $1.35 trillion, or more than 9 percent of the country's total output. That deficit would be only slightly smaller than last year's deficit, which was the largest as a share of GDP since World War II.

We expect that revenues will grow modestly this year, primarily because we expect a slow pace of economic recovery.

We expect that outlays will be about even with last year's level as a decline in Federal aid to the financial sector is offset by rising outlays from the stimulus packages and for other purposes.

Debt held by the public will reach $8.8 trillion by the end of this fiscal year, or 60 percent of GDP—the largest burden since the early 1950's.

Looking beyond this fiscal year, the budget outlook is daunting. Again, under current law, CBO projects that the deficit will drop to about 3 percent of GDP by 2013 but remain in that neighborhood through 2020. By that point, interest payments alone would cost more than $700 billion per year.

Moreover, maintaining the policies embodied in current law that underlie those projections will not be easy. It would mean, for example, allowing all the tax cuts enacted in 2001 and 2003 to expire next year as scheduled, and not extending the temporary changes that have kept the alternative minimum tax, or AMT, from affecting more taxpayers.

But as you know, many policymakers have expressed their intention not to let current law unfold as scheduled. If instead they extended all of the 2001 and 2003 tax cuts, indexed the AMT for inflation, and made no other changes to revenues or spending, the deficit in 2020 would be twice the size of the deficit that we project under current law. Debt held by the public would equal 87 percent of GDP and be rising rapidly.

The baseline projections also assume that annual appropriations will rise only with inflation. If instead policymakers increased such spending in line with GDP, which is about what actually happened over the past 20 years, the deficit in 2020 would be two-thirds again as large as we project under current law.

In sum, the outlook for the Federal budget is bleak.

To be sure, forecasts of budget and economic outcomes are highly uncertain. Actual deficits could be significantly smaller than we project or significant larger. We believe that our projection balances those risks.

One set of factors contributing to the bleak budget outlook are the financial crisis and severe recession along with the policies implemented in response. Analysts define the end of a recession as "the point at which output begins to expand again." By that definition, the recession appears to have ended in mid-2009. However, payroll employment, which has fallen by more than 7 million since the beginning of the recession, has not yet begun to rise again, and the unemployment rate, as you know, finished last year at 10 percent—twice its level of 2 years ago.

Unfortunately, CBO expects that the pace of economic recovery in the next few years will be slow. Household spending is likely to be dampened by weak income growth, lost wealth, and constraints on their ability to borrow. Investment spending will be slowed by the large number of vacant homes and offices.

In addition, although aggressive action by the Federal Reserve and the fiscal stimulus package helped moderate the severity of the recession and shorten its duration, the support to the economy from those sources is expected to wane.

Employment will almost certainly increase this year, but it will take considerable time for everyone looking for work to find jobs, and we project that the unemployment rate will not return to its long-run sustainable level of 5 percent until 2014. Thus, more of the pain of unemployment from this downturn lies in front of us than behind us.

A deep recession and protracted recovery mean under current law lower tax revenues and higher outlays for certain benefit programs. CBO estimates that those automatic stabilizers will increase the budget deficit by more than 2 percent of GDP in both 2010 and 2011. In addition, CBO projects that last year's fiscal stimulus package will increase the deficit by roughly 2 percent of GDP this year and by a smaller amount next year.

As the economy recovers and the effects of the automatic stabilizers and legislated policies fade away, the budget deficit will shrink relative to GDP. However, as I have noted, the projected deficit remains large throughout the decade even under current law. And if current law is changed in some way that more closely matches current policy, as many people perceive it, the amount of Government borrowing relative to GDP would be unprecedented in the post-war period.

A large and persistent imbalance between Federal spending and revenues is apparent in CBO's projections for the next 10 years and will be exacerbated in coming decades by the aging of the population and the rising costs of health care. That imbalance stems from policy choices made over many years.

As a result of those choices, U.S. Fiscal policy is on an unsustainable path to an extent that cannot be solved by minor tinkering. The country faces a fundamental disconnect between the services that people expect the Government to provide, especially in the form of benefit payments to older Americans, and the tax revenue they are prepared to send to the Government to finance those services. This fundamental disconnect will have to be addressed in some way if the Nation is to avoid serious long-term damage to the economy and to the well-being of the population.

Thank you. I would be happy to take your questions.

[The prepared statement of Mr. Elmendorf follows:]

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

The Budget and Economic Outlook: Fiscal Years 2010 to 2020

before the
Committee on the Budget
United States Senate

January 28, 2010

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, January 28, 2010. 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 Conrad, Senator Gregg, and Members of the Committee, thank you for inviting me to testify on the Congressional Budget Office's (CBO's) most recent analysis of the outlook for the budget and the economy. My statement summarizes CBO's new economic forecast and baseline budget projections, which cover fiscal years 2010 through 2020. Those estimates were released on Tuesday in the report titled *The Budget and Economic Outlook: Fiscal Years 2010 to 2020.*

The Congressional Budget Office projects that if current laws and policies remained unchanged, the federal budget would show a deficit of about $1.3 trillion for fiscal year 2010 (see Table 1). At 9.2 percent of gross domestic product (GDP), that deficit would be slightly smaller than the shortfall of 9.9 percent of GDP ($1.4 trillion) posted in 2009. Last year's deficit was the largest as a share of GDP since the end of World War II, and the deficit expected for 2010 would be the second largest. Moreover, if legislation is enacted in the next several months that either boosts spending or reduces revenues, the 2010 deficit could equal or exceed last year's shortfall.

The large 2009 and 2010 deficits reflect a combination of factors: an imbalance between revenues and spending that predates the recession and turmoil in financial markets, sharply lower revenues and elevated spending associated with those economic conditions, and the costs of various federal policies implemented in response to those conditions.

The deep recession that began two years ago appears to have ended in mid-2009. Economic activity picked up during the second half of last year, with inflation-adjusted GDP and industrial production both showing gains. Still, GDP remains roughly 6½ percent below CBO's estimate of the output that could be produced if all labor and capital were fully employed (that difference is called the output gap), and the unemployment rate, at 10 percent, is twice what it was two years ago.

Economic growth in the next few years will probably be muted in the aftermath of the financial and economic turmoil. Experience in the United States and in other countries suggests that recovery from recessions triggered by financial crises and large declines in asset prices tends to be protracted. Also, although aggressive action on the part of the Federal Reserve and the fiscal stimulus package enacted in early 2009 helped moderate the severity of the recession and shorten its duration, the support coming from those sources is expected to wane. Furthermore, spending by households is likely to be constrained by slow growth of income, lost wealth, and limits on their ability to borrow, and investment spending will be slowed by the large number of vacant homes and offices.

Under current law, the federal fiscal outlook beyond this year is daunting: Projected deficits average about $600 billion per year over the 2011–2020 period. As a share of GDP, deficits drop markedly in the next few years but remain high—at 6.5 percent of GDP in 2011 and 4.1 percent in 2012, the first full fiscal year after certain tax provisions originally enacted in 2001, 2003, and 2009 are scheduled to expire. Thereafter, deficits are projected to range between 2.6 percent and 3.2 percent of GDP through 2020.

Those accumulating deficits will push federal debt held by the public to significantly higher levels. At the end of 2009, debt held by the public was $7.5 trillion, or 53 percent of GDP; by the end of 2020, debt is projected to climb to $15 trillion, or 67 percent of GDP. With such a large increase in debt, plus an expected increase in interest rates as the economic recovery strengthens, interest payments on the debt are poised to skyrocket. CBO projects that the government's annual spending on net interest will more than triple between 2010 and 2020 in nominal terms, from $207 billion to $723 billion, and will more than double as a share of GDP, from 1.4 percent to 3.2 percent (see Figure 1).

Moreover, CBO's baseline projections understate the budget deficits that would arise under many observers' interpretation of current policy, as opposed to current law. In particular, the projections assume that major provisions of the tax cuts enacted in 2001, 2003, and 2009 will expire as scheduled and that temporary changes that have kept the alternative minimum tax (AMT) from affecting many more taxpayers will not be extended. The

Table 1.

CBO's Baseline Budget Outlook

	Actual 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total, 2011-2015	Total, 2011-2020
							In Billions of Dollars							
Total Revenues	2,105	2,175	2,670	2,964	3,218	3,465	3,625	3,814	3,996	4,170	4,352	4,563	15,941	36,836
Total Outlays	3,518	3,524	3,650	3,613	3,756	3,940	4,105	4,335	4,521	4,712	5,000	5,250	19,065	42,883
Total Deficit (-) or Surplus	**-1,414**	**-1,349**	**-980**	**-650**	**-539**	**-475**	**-480**	**-521**	**-525**	**-542**	**-649**	**-687**	**-3,124**	**-6,047**
On-budget	-1,551	-1,434	-1,076	-757	-659	-608	-619	-659	-659	-669	-765	-793	-3,719	-7,263
Off-budget[a]	137	86	96	108	120	133	139	138	134	127	116	107	595	1,216
Debt Held by the Public at the End of the Year	7,544	8,797	9,785	10,479	11,056	11,556	12,055	12,595	13,133	13,678	14,329	15,027	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	14.8	14.9	17.8	18.8	19.3	19.7	19.7	19.8	19.9	20.0	20.1	20.2	19.1	19.6
Total Outlays	24.7	24.1	24.3	23.0	22.5	22.4	22.3	22.6	22.6	22.6	23.1	23.3	22.9	22.8
Total Deficit	**-9.9**	**-9.2**	**-6.5**	**-4.1**	**-3.2**	**-2.7**	**-2.6**	**-2.7**	**-2.6**	**-2.6**	**-3.0**	**-3.0**	**-3.7**	**-3.2**
Debt Held by the Public at the End of the Year	53.0	60.3	65.3	66.6	66.3	65.6	65.4	65.5	65.5	65.7	66.1	66.7	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	14,236	14,595	14,992	15,730	16,676	17,606	18,421	19,223	20,036	20,823	21,667	22,544	83,425	187,719

Source: Congressional Budget Office.

Note: n.a. = not applicable.

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

baseline projections also assume that annual appropriations rise only with inflation, which would leave discretionary spending very low relative to GDP by historical standards. If the tax cuts were made permanent, the AMT was indexed for inflation, and annual appropriations kept pace with GDP, the deficit in 2020 would be nearly the same, historically large, share of GDP that it is today, and debt held by the public would equal nearly 100 percent of GDP.

The Budget Outlook

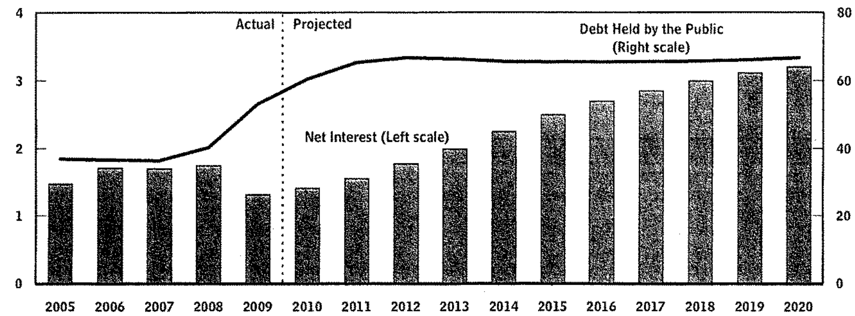
In 2010, under an assumption that no legislative changes occur, CBO estimates that federal spending will total $3.5 trillion and revenues will total $2.2 trillion. The resulting deficit of about $1.3 trillion would be just $65 billion less than last year's shortfall and more than three times the size of the deficit recorded in 2008. Total outlays are projected to increase by just $5 billion, while revenues are projected to rise by $70 billion. The deficit for this year is on track to be about as large as last year's because an expected decline in federal aid to the financial sector will be offset by increases in other outlays, particularly spending from last year's stimulus legislation and outlays for income support programs, health care programs, Social Security, and net interest. At the same time, revenues are projected to increase only modestly primarily because of the slow pace of economic recovery forecast by CBO and the lagged effect of the recession on tax receipts.

In 2011, according to CBO's baseline projections, the deficit falls to $980 billion, or 6.5 percent of GDP, as the economy improves, certain tax provisions expire as scheduled, and spending related to the economic downturn abates. Revenues are projected to rise by about $500 billion, an increase of 23 percent, while outlays are projected to increase by $126 billion, or 4 percent.

Figure 1.

Debt Held by the Public and Net Interest

(Percentage of gross domestic product) (Percentage of gross domestic product)

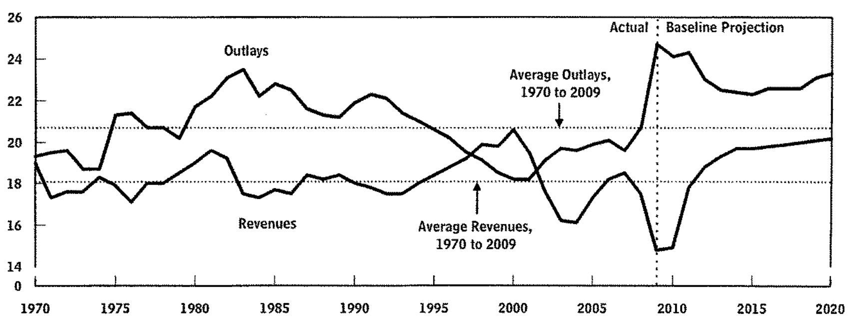


Source: Congressional Budget Office.

Figure 2.

Total Revenues and Outlays

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Looking beyond 2011, CBO's baseline projections show outlays remaining between 22.3 percent and 23.3 percent of GDP (compared with 24.1 percent in 2010) (see Figure 2 on page 3). Continued economic growth will allow payments for unemployment compensation and other benefit programs to subside, and discretionary spending is assumed to increase slowly. However, the retirement of more members of the baby-boom generation and rising health care spending per person will cause outlays for Medicare, Medicaid, and Social Security to continue to grow fairly rapidly.

The baseline projections show revenues rising to 20.2 percent of GDP by 2020 (compared with 14.9 percent in 2010), with most of the increase stemming from individual income tax receipts. Almost half of the increase in those receipts relative to the size of the economy can be attributed to the expiration of provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA), as well as other expiring tax provisions; the remainder is due to the economic recovery and structural features of the individual income tax system.

The Economic Outlook

Severe economic downturns often sow the seeds of robust recoveries. During a slump in economic activity, consumers defer purchases, especially for housing and durable goods, and businesses postpone capital spending and try to cut inventories. Once demand in the economy picks up, the disparity between the desired and actual stocks of capital assets and consumer durable goods widens quickly, and spending by consumers and businesses can accelerate rapidly. Although CBO expects that the current recovery will be spurred by that dynamic, in all likelihood, the recovery will also be dampened by a number of factors. Those factors include the continuing fragility of some financial markets and institutions; declining support from fiscal policy as the effects of ARRA wane and tax rates increase because of the scheduled expiration of key tax provisions; and slow wage and employment growth, as well as a large excess of vacant houses.

In CBO's forecast, real GDP increases by 2.1 percent between the fourth quarter of 2009 and the fourth quarter of 2010 and by 2.4 percent in 2011 (see Table 2). Given CBO's estimate of growth in potential output, those GDP growth rates will narrow the difference between actual output and potential output (the output gap) only slightly. Growth of real GDP will accelerate after 2011, spurred by stronger business investment and residential construction. For 2012 through 2014, CBO projects that real GDP will increase by an average of 4.4 percent per year, which would close the output gap completely by the end of 2014.

Even though economic activity began to increase again during the second half of 2009, the unemployment rate continued to rise, finishing the year at 10.0 percent. Hiring usually lags behind output during the initial stages of a recovery because firms tend to increase output first by boosting productivity and by raising the number of hours that existing employees work; adding employees tends to occur later. CBO expects that the unemployment rate will average slightly above 10 percent in the first half of 2010 and then turn downward in the second half of the year (see Figure 3). As the economy expands further, the rate of unemployment is projected to continue declining until, in 2016, it reaches 5 percent, which is equal to CBO's estimate of the rate of unemployment consistent with the usual rate of job turnover in U.S. labor markets.

Reflecting the large amount of slack in the economy, inflation will decrease further from its already low level in 2009, CBO forecasts. The core price index for personal consumption expenditures (that is, the PCE price index excluding the prices of food and energy) will rise by about 1 percent (on a fourth-quarter-to-fourth-quarter basis) in 2010 and by 0.9 percent in 2011. The overall PCE price index will rise by 1.4 percent in 2010 and 1.1 percent in 2011.

CBO's forecast anticipates slower growth in 2010 and 2011 than does the forecast of the *Blue Chip* consensus (reflecting the views of about 50 private-sector economists). Most private forecasters probably assume that the Congress will not allow previous tax cuts to expire as scheduled. If CBO assumed, in contrast with the assumption of its baseline, that all of the expiring tax provisions were extended beyond 2010, the agency's forecast of the level of real GDP at the end of 2011 would be in line with the forecast of the *Blue Chip* consensus (although real GDP in later years would be diminished relative to the baseline projection by the greater accumulation of government debt). CBO's forecast for inflation is roughly in line with that of the *Blue Chip* consensus in 2010 but significantly lower in 2011.

Table 2.

CBO's Economic Projections for Calendar Years 2009 to 2020

	Estimated	Forecast		Projected Annual Average	
	2009	2010	2011	2012–2014	2015–2020
		Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP	-0.4	2.1	2.4	4.4	2.4
GDP Price Index	0.9	1.0	0.9	1.2	1.7
PCE Price Index	1.4	1.4	1.1	1.2	1.8
Core PCE Price Index[a]	1.5	1.0	0.9	1.1	1.7
Consumer Price Index[b]	1.7	1.6	1.1	1.3	1.9
Core Consumer Price Index[a]	2.0	1.1	0.9	1.2	1.9
		Calendar Year Average			
Nominal GDP					
Billions of dollars	14,253	14,706	15,116	17,816[c]	22,770[d]
Percentage change	-1.3	3.2	2.8	5.6	4.2
Unemployment Rate (Percent)	9.3	10.1	9.5	6.5	5.0
Interest Rates (Percent)					
Three-Month Treasury bill rate	0.1	0.2	0.7	2.9	4.6
Ten-Year Treasury note rate	3.2	3.6	3.9	4.5	5.5

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

Note: GDP = gross domestic product; PCE = personal consumption expenditure.

a. Excludes prices for food and energy.

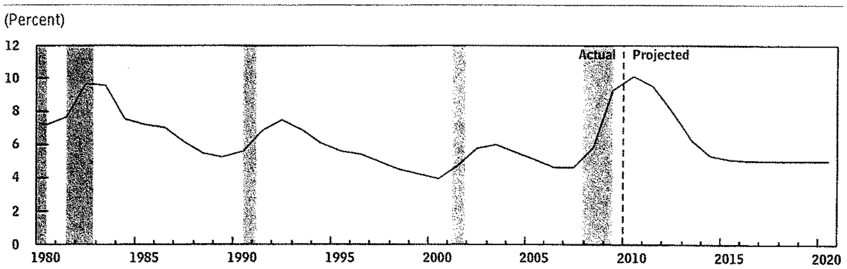
b. The consumer price index for all urban consumers.

c. Level in 2014.

d. Level in 2020.

Figure 3.

Unemployment Rate



Source: Congressional Budget Office.

Note: The shaded bars indicate the duration of recessions.

Chairman CONRAD. Well, first of all, thank you for that. Sobering but truthful.

I wrote you some time ago and asked you to analyze and have your people help analyze various measures to help strengthen the economy and help create jobs at this time of continuing economic weakness. And you and your people came back with an analysis, and I would like to talk for a few minutes about your views with respect to what measures to help the private sector employ more people would be most effective and would be most effective in a way that is timely.

As I read your analysis, your top three most impactful policy changes for increasing jobs in 2010 were, No. 1, tax assistance for businesses that would hire additional people; additional tax assistance for small business through small business expensing; and as I read the report, the extension of unemployment insurance—that those three would have the biggest bang for the buck and the most immediate impact. Is that correct?

Mr. ELMENDORF. I would just distinguish among those three, Mr. Chairman. In our review, the incentive for greater business investment would be less effective than tax credits for firms that increase their payroll or additional benefits for people who are unemployed. For many years, economists have believed that temporary tax incentives can have a powerful stimulative effect, particularly because of their temporariness and, thus, the need to take the action now. I think, unfortunately, the experience of the last decade, when these sorts of incentives have been tried on several occasions, has somewhat dampened economists' enthusiasm for those approaches because they appear to have been less successful in stimulating investment.

I think one piece of intuition for that is that when firms have a lot of unused capacity, as they do today, and a lot of uncertainty about the course of the future demand and the use of that capacity, they may be less responsive even to cut-rate opportunities to do more investment.

So that would be the least effective of the three you mentioned, according to our analysis.

Chairman CONRAD. Which would be the least effective?

Mr. ELMENDORF. The business incentives. The incentives for business investment, which I think was one of the ones that you mentioned. The ones that would be more effective, in our judgment, would be increasing payments to people who are unemployed, particularly because they are very short of income and likely to spend a large share of the money they receive very quickly; and, second, incentives for businesses that increase payrolls because that puts money into the economy, but also provides this particular incentive to do more hiring. And the effectiveness depends a good deal, in our judgment, on just how that incentive is structured.

Chairman CONRAD. I see. I was perhaps not hearing you right. I thought in your original response you were putting the jobs credit in the same camp as the small business expensing. What you are saying, what I hear you saying is the two things with the biggest pop would be, in essence, a tax break for businesses that hire people, No. 1, on the business incentive side. And the other thing that you see in your analysis that would help is the unemployment insurance extension.

Why would that be of assistance in terms of jobs?

Mr. ELMENDORF. The chain of reasoning is basically that if people receive money and then they spend it, that demand for goods and services then means that those businesses that are selling products have the revenue to hire more people and see a need to hire more people because they need to step up their production to meet this increased demand, the normal process through which extra demand increases jobs.

Chairman CONRAD. I am running out of time here, so I want to go to the third element that we talked about, the small business expensing. As I read the report, that was seen as positive in terms of helping with the job situation in the country today.

Mr. ELMENDORF. Well, I think that is right. I did not mean to say it would have no effect. It just, in our judgment, would be less effective than the other two items that you mentioned.

Chairman CONRAD. Yes.

Mr. ELMENDORF. Yes, we do think there is some effect of reducing the price of buying investment goods, particularly for a time-limited period, which then would encourage businesses, if they were thinking of doing investment in the future, to do it right now.

Chairman CONRAD. Are there any other things that would be as effective as those three, or more effective, for 2010?

Mr. ELMENDORF. Those are the ones that we think of as being most effective. The one thing, I would just broaden a bit this increased aid to the unemployed. One can just give money to other people in the form of tax cuts or increased benefits. The effectiveness depends—in our judgment, the effectiveness in spurring overall economic activity and job creation depends on how much of that money is spent; and, thus, giving it to people who are unemployed is particularly effective because they are likely to spend a large share of it. But one could achieve effects that would be somewhat smaller by giving benefits to other people as well.

Chairman CONRAD. And with respect to infrastructure, as I read your report, that would be more effective in 2011 than 2010? Is that a correct reading of your report?

Mr. ELMENDORF. Yes, that is correct. Our judgment, and I think it has—it was our judgment a year ago, and it has been confirmed by the experience of the past year, is that most infrastructure dollars move into the economy somewhat slowly. There are projects—resurfacing of roads, and I drive on some, and I appreciate that they are resurfaced. That can happen pretty quickly when money is made available. But many other infrastructure projects, the more substantial projects, have fairly long lags, and it takes some time to get that money out the door.

That is not a judgment, of course, about whether those projects are worth doing or not worth doing from any other perspective. But as a question of pure macroeconomic impact, they tend to take some time to take effect.

Chairman CONRAD. I thank you for that.

Senator Gregg?

Senator GREGG. You have highlighted the fact that one of the primary drivers of the growth in the government and the spending which is going to create this structural deficit is health care costs, especially as it relates to the aging population, is that correct?

Mr. ELMENDORF. Yes, that is right.

Senator GREGG. Now, you sent us a letter, myself and the Chairman a letter, that said that if you wanted to control health care costs, there were two primary things that could occur that you suggested. One of them was that the amount of deductibility for health insurance should be reduced so that people were actually paying more of a share of their health insurance rather than having it tax deductible, isn't that correct?

Mr. ELMENDORF. Yes, and the "should" is your term. We don't make recommendations. But what we did write to you was that there are a few levers the government controls and that was——

Senator GREGG. That is a primary lever.

Mr. ELMENDORF. Yes.

Senator GREGG. So when we hear the House talking about—the House leadership talking about changing health care so that insurance is fully deductible and so that the Cadillac plans are given advantageous tax treatment, that is actually going in the wrong direction?

Mr. ELMENDORF. I think from the perspective of cost control, it is a very widespread view among experts that reducing the tax subsidy for more generous insurance is one of the very important levers the government has, and that taking—and that not employing that lever then reduces the extent of cost control, all else equal.

Senator GREGG. Also in the health bill that passed, there was a massive savings expected in Medicare. I believe you estimated $500 billion over the first 10 years. A trillion dollars was our estimate over the first 10 years of full implementation, $3 trillion over the first 20 years of full implementation. The Medicare savings were used to expand other activities of the government, specifically the expansion of Medicaid and the new entitlement that was in the bill.

If those dollars were used, which were saved from Medicare, to shore up Medicare in some manner, a Medicare reserve fund or something that would basically be paying down debt, could you give us a thumbnail estimate as to how much that might help correct the out year structural problems we have?

Mr. ELMENDORF. I can't do a quantitative calculation in my head, but your logic is certainly correct, Senator, that we estimated almost $500 billion in Medicare savings over the 10-year projection period and increasing amounts over time in an amount that we have not separately quantified——

Senator GREGG. Let me try to confine the question, then. If you didn't use it to expand the government but you used it instead to try to shore up the Medicare system by reducing the debt, wouldn't that have a significant positive effect for Medicare but also—because it would make it more solvent, theoretically—but also for the debt situation?

Mr. ELMENDORF. Yes, Senator. If we used those same savings to pay down debt, that would be a significant improvement in the budget outlook.

Senator GREGG. There has been a lot of talk about the fact that TARP money is available to spend somewhere else. First, the law doesn't allow that. It is supposed to be used to reduce the debt. But I just want to clarify the fact that there is no TARP money, that all this money has to be borrowed, right? I mean, every cent of TARP money is borrowed from China or from somebody, right?

Mr. ELMENDORF. There is just one pool of government money and everything else is a sort of accounting treatments to keep track of it for various purposes. But yes, if more is spent through the TARP, that is just more that is spent.

Senator GREGG. And more that is borrowed?

Mr. ELMENDORF. And more that is borrowed.

Senator GREGG. And more that goes on the Federal debt?

Mr. ELMENDORF. And more that goes on the Federal debt.

Senator GREGG. So there is no piggy bank over here that somebody has as a reserve fund somewhere in some desk drawer down at Treasury that they can use to create a new small business program or a new housing program or whatever they want to do. It has to be borrowed from somebody, right?

Mr. ELMENDORF. That is right.

Senator GREGG. The freeze that the President has suggested, and I give him credit for using the term "freeze" and for stepping forward on that turf and I thank them for doing that, but I am trying to quantify it, because the deficit this year you projected at $1.34 trillion, was that your number?

Mr. ELMENDORF. For this fiscal—yes, 1.35 I said, but yes, that is correct.

Senator GREGG. So $1.35 trillion. If we were to do a non-defense discretionary freeze, give me the number that that would be adjusted for inflation and not adjusted for inflation.

Mr. ELMENDORF. So if we did a full—our report shows what would happen with a full discretionary freeze. So if one froze discretionary appropriations for defense and non-defense for a full 10 years——

Senator GREGG. Just non-defense, the proposal that the President——

Mr. ELMENDORF. So, unfortunately, we don't have enough details about the President's proposal to do that calculation. I know only what I have seen in the newspapers. When we receive the President's budget next week, we can do that calculation. But until we know exactly which categories are included, excluded——

Senator GREGG. Well, how about a range? It would range, wouldn't it, between $15 billion and, say, $25 billion, somewhere in that range, right?

Mr. ELMENDORF. Well, so in the—again, it depends crucially what happens after the freeze. So if you freeze for 3 years, if you then go back up to the level you would have been at otherwise, then the savings are just in those 3 years and they are small. If you maintain the—if you freeze and then grow from the end of the freeze but don't jump back up, then you can achieve significant savings over the remaining years, and that is obviously a policy choice that the Congress will have to make.

Senator GREGG. What I am trying to get at here, obviously, is compared to the deficit this year, which is going to be $1.35 trillion, we are talking about this year saving, if you did a non-defense discretionary freeze of maybe 1 percent or 10 percent—what——

Mr. ELMENDORF. Yes, it is even less than that. So we think a freeze on all discretionary appropriations would only save $10 billion in fiscal year 2011.

Senator GREGG. So it is a step in the right direction, but it has—that is a lot of money, but it still has a marginal impact on what we——

Mr. ELMENDORF. As a share of the total deficit problem, it is a small step.

Senator GREGG. Thank you.

Chairman CONRAD. Senator Feingold?

Senator FEINGOLD. Mr. Chairman, let me begin by thanking you and the Ranking Member for your bipartisan efforts to get our long-term fiscal house in order, and in particular for your Fiscal Commission amendment to the debt limit measure. As you know, I had some concerns with the concept of a Special Fiscal Commission. I don't think we should be outsourcing the job that we should be doing. But I share your frustration at the consistent failure of Congress to confront our long-term budget problems.

And as is the case for many issues that we consider, there comes a moment when you have to decide, and in the Senate, you can't vote maybe. So even though I am not entirely comfortable with this approach, I decided to support the amendment. And while it didn't get the 60 votes it required under the unanimous consent agreement, I was encouraged that it was supported by the majority of the Senate.

Of course, as is obvious from the Director's testimony, it will only get tougher, in particular, when we finally have to consider specific spending and revenue policies to correct the problem. There will be enormous pressure to resist such a correction, and that is appropriate. It is the way of a democracy. When that day comes, and I hope it comes soon, our country will be best served if that date concentrates all of our minds.

I thank Director Elmendorf for all his work and the work of the CBO. Please know that some of us truly appreciate the work of the CBO and I acknowledge, as the Chair and the Ranking Member did, the pressures you face, perhaps because we are responsible for a whole lot of that pressure. I also want to acknowledge the limitations of any economic forecasts and especially those under which the CBO operates. Keynes said, never predict. If you do predict, predict frequently. Congress won't allow you to obey either of these admonitions, though. However, you are wise enough to recognize the spot in which we place you and to include language in your report regarding the uncertainty of your projections.

In that regard, I have a place on my bookshelves for the Budget and Economic Outlook Report CBO issued in January of 2001. It was the first report that included a rather stunning summary figure about the uncertainty of CBO projections. It showed a shaded fan of possible budget outcomes, with the darker central areas of the fan being more likely and lighter outer areas being less likely. Even under the worst scenario in that figure, at the faintly shaded low end of the fan, the budget was still projected to be in rough balance. Of course, the fan was based on what the current policies were at that time, and that is important, because as it turned out, that report was also the last Budget and Economic Outlook prepared by CBO before Congress enacted what would be a stunning set of policies that led to the biggest fiscal turnaround in our history.

In less than 3 years after that report, Congress enacted two massive tax cut bills, it authorized two wars, and it enacted a massive entitlement program under Medicare, and none of those enormously expensive measures were paid for. Each and every one of them was added to the bill we are leaving our children and grandchildren. And sadly, each and every one of them remains with us today.

As I read the report, CBO projects that extending the Bush-era tax cuts and just indexing the alternative minimum tax for inflation would add over $4.5 trillion to our deficits over the next 10 years. And while it is difficult to project the cost over the next 10 years of the legislation which created the Medicare prescription drug benefit, Medicare's chief actuary estimates the legislation will end up costing $534 billion, more than half-a-trillion dollars, over its first 10 years.

One of the policies with the biggest potential impact in future budgets, of course, is the cost of the ongoing wars in Iraq and Afghanistan. As I read CBO's report, the outlays projected in the baseline for the wars in Iraq and Afghanistan and related activities for the next 10 years are $1.4 trillion. Of course, that is the baseline, and CBO is constrained in the assumption it makes for that baseline. Our actual policy is not likely to be the one which is reflected in the baseline.

CBO anticipates by providing two alternative budget scenarios, but even under the alternative which CBO estimates will produce the greatest savings relative to the baseline, reducing the number of troops deployed in Iraq and Afghanistan to 30,000 by 2013, over the next 10 years will cost about $400 billion. And under CBO's middle-ground alternative, reducing the number of troops deployed by 60,000 by 2015, over the next 10 years, the cost is nearly three-quarters of a trillion dollars.

Mr. Chairman, every penny of those costs is added right to our deficits. That has been our policy for the past 10 years and it continues to be our policy. We aren't paying for those wars. We are just running up the enormous tab we are already leaving our children and grandchildren.

Director Elmendorf, there is a telling statement in the Budget and Economic Outlook Report which notes that if CBO assumed that all the expiring tax cuts were extended beyond 2010 and they weren't paid for, the long-term effect would be to lower future GDP because of the greater accumulation of debt. Is it not also the case that the greater accumulation of debt that results from failing to fully pay for the wars in Iraq and Afghanistan will also mean future GDP will be lower than it otherwise would be?

Mr. ELMENDORF. Yes, Senator.

Senator FEINGOLD. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Bunning?

Senator BUNNING. Dr. Elmendorf, welcome.

Mr. ELMENDORF. Thank you, Senator.

Senator BUNNING. When you appeared before this committee last year, I asked some questions about CBO's practices. Now that you have had a year of experience as Director, I would like to ask you about these policies again.

Current CBO practice assumes that any law that increases spending will be permanent. On the other hand, current CBO practice assumes that any tax decrease will not be permanent. Do you have any plans to address this inconsistency?

Mr. ELMENDORF. No, Senator, we don't. As I understand our policies, they are consistent across spending and taxes in the sense that when a proposal is put forward, if it is enacted to be a permanent policy, then it is scored at that time as the effects it would have over the 10-year budget window. If it is enacted to be temporary, then it is scored as having those effects, and——

Senator BUNNING. That was not my question.

Mr. ELMENDORF [continuing]. Into the baseline.

Senator BUNNING. That was not my question. My question was current policy of CBO——

Mr. ELMENDORF. Right——

Senator BUNNING [continuing]. On spending, that any increase in spending would be permanent. On the other hand, CBO's practice assumes that any tax decrease will not be permanent. Is that the current policy of CBO?

Mr. ELMENDORF. I think not every spending policy is viewed as being permanent, but many of them are. Yes, that is right, Senator.

Senator BUNNING. OK. I think it is common sense that tax relief helps business grow. When the business grows, it will pay more taxes. As I am sure everybody here knows, factoring this effect into budget estimates is known as dynamic scoring. Do you have any plans to use dynamic scoring at CBO?

Mr. ELMENDORF. We do not intend to incorporate the effects of policies on macroeconomic conditions in our estimates. Of course, the tax estimates themselves are done by the staff of the Joint Tax Committee, so that particular branch, the question really needs to be directed to them. But for our part, we do not intend to incorporate those effects. We do try, when we can, to provide analysis for you and other members of the macroeconomic effects, as we do every year for the President's budget and have for some years now. But we don't incorporate those and don't intend to incorporate those in our estimates of particular legislation.

Senator BUNNING. Then your answer is no?

Mr. ELMENDORF. That is right.

Senator BUNNING. OK. Do you believe that extending the so-called Bush tax cuts will have a positive or a negative effect on the economy?

Mr. ELMENDORF. We think that extending those tax cuts would have a positive effect on the economy in the year or two at the beginning because they would encourage spending and thus encourage job creation of the sort that I was discussing earlier. Over a longer period of time, if those tax cuts are extended permanently and no other changes are made to spending or revenues, then we think that the larger debt that would arise would lower the level of economic impact.

Senator BUNNING. In other words, if they were extended on not a permanent basis but a temporary basis of two or 3 years, you think that would help the economy?

Mr. ELMENDORF. That would certainly, again, help the economy in the period when they were—in those first few years. Again, there would be—even for those few years, of course, there would be a good deal of additional debt accumulated and that would have some drag in later years if it were not offset in some other policy change.

Senator BUNNING. OK. During my time in Congress, which has been unbelievably long——

[Laughter.]

Chairman CONRAD. Not so long.

Senator BUNNING. Twenty-four years. I have worked to advance the creation of a strong domestic fuel industry that would provide our government agencies with a safe, secure supply of fuel regardless of policies, global policies of oil. To this end, I have authored legislation that would provide incentives for this through a mix of loan guarantees and tax credits, as well as providing multi-year procurement contracting authority for our government agencies. Aside from providing marketplace stability through price certainty, I believe this allows for more consistency in the budgeting process. As the energy demands within our government agencies continue to grow, do you believe it is important to provide our government with the authority to enter into these multi-year procurement contracts?

Mr. ELMENDORF. As you know, Senator, we don't make policy recommendations, but I understand and agree with your point that uncertainty in future costs, all else equal, complicates the budget process. But I can't judge the specific ways in which you would make those costs more certain and costs that might be——

Senator BUNNING. I understand what you are saying. Thank you. Thank you, Mr. Chairman. Thank you.

Chairman CONRAD. Thank you, Senator Bunning.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, and first, I want to thank you for your ongoing leadership, you and the Ranking Member, in focusing us on long-term deficits while at the same time talking about what we need to do in the short run to create jobs. I appreciate your balance on both of those, which are so critical.

I wanted to take a moment and just ask that we re-look at two charts, Mr. Chairman, that you had put up. One of those—because I think it is important. Let me just start by saying, it is important to look, not for the purpose of blame but for the purpose of understanding what works and what doesn't work, to look at the last 8 years and to look at before then and sort of what has worked, what has not worked.

When I came into the Budget Committee in 2001, we were debating what to do with the largest surpluses in the history of the country—the largest surpluses in the history of the country. That period in the 1990's was focused on innovation, education, also balancing the budget, but very much focused on investing in people and in innovation and in growing jobs, 20 million new jobs plus.

Eight years coming in, different economic policies were put into place, ones that focused on tax cuts at the top, hoping they would trickle down to middle-class families, two wars not paid for, a prescription drug bill not paid for, we go from huge surpluses, the largest in the history of the country, to largest deficits.

So I don't think it is insignificant as we now look at different policies and that we are looking at how do we go back to, in some ways, what worked in the 1990's that created jobs and created surpluses, to look at what has happened in the last year.

The first thing is the fact that this is not insignificant, Mr. Chairman, that we are, in fact, moving in a direction of less people losing their jobs, and hopefully we are going to see people beginning to have a net plus in terms of creating jobs. That is not insignificant.

I also don't think it is insignificant, Mr. Chairman, that the economy is improving. I mean, we have, in fact, put in place different policies than the last 8 years. And at least part of that, when we look at the Recovery Act, I was very pleased that the effort I championed on Cash for Clunkers had such an immediate impact in a small amount of time, and some economists certainly have credited that with some of the boost in—short-term boost in GDP. But it is not insignificant.

So I think it is important to stress that different policies are beginning to swing this in a different direction, and I think that is important. Now, we are focused on, again, as we were in the 1990's, middle-class tax cuts. We are focused on investments in innovation, in education, and in jobs, and I think that is very significant.

I wanted to ask, Mr. Elmendorf, and again, I want to join my colleagues in thanking you for the incredible job that your staff have done, particularly around health care, which was an incredibly stressful 24-hour-a-day effort and thank each of you for doing that.

Mr. ELMENDORF. Thank you, Senator.

Senator STABENOW. But you talked about how infrastructure spending has a delay, and so what I assume, that the dollars that we passed last February in the Recovery Act would have more impact this year than last year?

Mr. ELMENDORF. So the infrastructure dollars, yes, that is correct.

Senator STABENOW. And——

Mr. ELMENDORF. It is also true more generally for the program, but infrastructure, it is definitely the case. There is much more impact this year than last year.

Senator STABENOW. So you would expect in 2010 that we would see more impact and more jobs created as a result of that?

Mr. ELMENDORF. Yes, that is correct.

Senator STABENOW. OK. Could you talk about how growing the economy, just a little bit more in terms of creating jobs in the economy, will help us reduce the deficit? It is different than sort of a top-down approach, about how putting money in the pockets of Americans, middle-class people, and creating jobs grows the economy.

Mr. ELMENDORF. So as you are saying, Senator, increase in economic growth, declining unemployment would increase the revenues the government collects under current law and it would decrease the benefit payments that go out to unemployment insurance and formerly the Food Stamp program, now Supplemental Nutrition Assistance, and so on.

In rough terms, we and the staff of the Joint Committee on Taxation think about a dollar of extra GDP or total income raising government revenue by about 25 cents. So there is a substantial feedback effect. We show in our outlook that if the economic growth is stronger than we project over the next year or two or three or more, that would lead to smaller deficits. If it is weaker than we project, that would lead to larger deficits, and I keep emphasizing the uncertainty, but we think risk on both sides.

Senator STABENOW. Right. And so it would be fair to say that—and I appreciate your critique in terms of what would be most effective for us, but focusing on some kind of jobs-specific credit for business as well as unemployment extension as well as some other investments that we can make, that that not only creates jobs, but that also helps us tackle the deficit, is that correct?

Mr. ELMENDORF. That is right. It does. Again, you do understand that scale of deficit now, this year and next year and so on, is very large. We would have to be unbelievably far off, even by the standards of the fan chart that was shown, in terms of economic growth to take that problem away, but it is a step in the right direction.

Senator STABENOW. And I am certainly not minimizing what is a huge issue for us.

And then finally, I just wanted to reemphasize, in all the work that we did last year and we continue to do to tackle health care costs, which I believe also creates jobs—it certainly does in my State of Michigan and I think across the country—if you might just reiterate again your feeling in terms of tackling health care costs as an important part of addressing the deficit and, in fact, the work of your great staff indicated that the bill, as passed in the Senate, would reduce the deficit, I believe, by $132 billion in the first 10 years, and then a much larger amount—I have heard different numbers now, but certainly a much larger amount in the second 10 years. Do you still believe that tackling health care costs is a critical part of bringing down the deficit?

Mr. ELMENDORF. Certainly, reducing Federal spending for health care is almost a necessary part of pulling the budget into a sustainable trajectory over time because a significant part of the growth of the budget gap, the deficit, comes from rising health costs. Whether particular sorts of health reform are effective in reducing the government's spending on health depends, of course, on the specific reforms. As you say, our estimate is that the bill that passed the Senate and also the bill that passed the House would have a small effect of deficit reduction in the first 10 years.

Again, as Senator Gregg indicated, $130-some-billion is large by many, many standards, but not by the standard of the size of the deficit we project. So by our estimation, if those bills were allowed to unfold as written, they would be a step in the direction of reducing the deficit, but only a small step.

Senator STABENOW. But the second 10 years and the Senate bill?

Mr. ELMENDORF. The second 10 years, again, we think in both bills that they would slightly reduce budget deficits in the second 10 years. We have not given dollar values ourselves, as you know, but just expressed this as really ranges of GDP, and that is because we want to emphasize the vast uncertainty that surrounds that. But our view, again, is that if both bills were allowed to unfold as written, they would represent slight reductions in the budget deficit over the second 10 years, as well.

Senator STABENOW. Thank you. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Grassley?

Senator GRASSLEY. Thank you, Dr. Elmendorf. I want to ask you—and I got here late, I hope it hasn't been asked by other people—about the bank tax, widespread agreement with the President among taxpayers and Members of Congress that financial institutions should repay every dime that they have received from the government for financial stability. The President recently proposed what he calls a Financial Crisis Responsibility Fee to help facilitate the repayment.

Obviously, a lot of us agree with the goals that the President articulated. Before Congress is asked to vote on legislation imposing such a fee, it will be very important to understand the potential impact on consumers, the criteria for applying the fee to some entities and not others, and the implication for securing the stability of these institutions.

So does the CBO know if the fee will get passed on to consumers in any manner? If so, how will it be passed on to consumers? And second, will the fee reduce the amount of bonuses paid by financial institutions subject to the fee?

Mr. ELMENDORF. So Senator, we and the staff of the Joint Tax Committee are hard at work trying to answer the many questions that you have sent us regarding this fee and we hope to get back to you shortly on at least some of them. Other questions will have to wait until we get more details ourselves about the proposal in order to answer.

I don't think I have a good short answer to your questions. The incidence of the fee, who it is who will bear the burden—and somebody will, right. We understand there is no other pool of money in the sky for it to come out of. It will be borne by somebody. How much will end up being passed into loan costs or into lowering interest rates paid on deposits versus how much would get passed to the shareholders or to the managers is a very hard question and we just don't have an answer to that now, and I doubt even at the end we will have an answer that we will have great conviction about because it is an uncertain business. But we are working on that analysis, but I am afraid we just don't have any useful answer to that question at this point.

Senator GRASSLEY. OK. Well, then I will be glad to wait, and thank you for your consideration. More importantly, thank you for studying it in depth, and hopefully, you will have some real concrete answers for us.

I want to go to interest rates and the publicly held debt. Your baseline projects that debt held by the public will exceed 60 percent of GDP in 2010, begin approaching 70 percent of GDP by 2020, and those are your figures. I happen to have read other places where some people expect at the 10-year window they might even get up into the high 80's or 90 percent of GDP. Anyway, net interest costs on this debt are estimated to rise from over $200 billion this year to over $700 billion in 2020, a threefold increase. What are the implications for our economy on such large interest payments?

Mr. ELMENDORF. So, Senator, just to say quickly, I think the difference that you are seeing between what we projected and some other projections really rests on different assumptions about the path that fiscal policy takes. As you know, our baseline assumptions assume current law, but we have discussed in our outlook and I did say in my comments that you weren't able to be here for that if, in fact, some laws were changed in a way that more closely match what most people think of as current policy on the tax or spending side, that the deficits would be substantially larger, and I actually used a figure of 87 percent of GDP at the end of the 10-year window under some alternatives.

The borrowing by the government has different sorts of costs for the economy. One is that that debt crowds out investment in real capital, in business, plant, and equipment of the sort that makes people more productive and raises incomes over time. And that happens incrementally year by year every time more debt is accumulated. Debt also poses a risk of some more cataclysmic event in which investors might decide that they were not willing to hold Treasury debt at anything like the current interest rates or became unwilling to hold U.S. dollar assets in the way they have at this point.

That is a risk, and economists are very bad at trying to analyze how big the risk is or what a triggering event might be. All that we can really say as analysts is that that risk increases as the debt rises relative to GDP, because that means that debt would have to become an increasing share of the portfolios of investors and that raises the risk of their reassessing their decisions. But whether there is a tipping point, and if so, at what level of debt relative to GDP it would occur, we just don't know.

All we know, again, is that the risk is rising, and as we move our debt from the 60 percent of GDP it will be the end of this year higher over the next decade, we are moving increasingly into territory that we have not seen in this country in more than 60 years and that we don't see in very many other developed countries, and I think there is a warning in that, but it is not a warning that I am able to quantify in any way.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Grassley.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. It certainly is a sobering analysis, and we all need to focus on this issue. I want to make one observation first about the Ranking Member's comments and your response, that there is just one pool of money, that whenever we change your baseline assumptions, whether on spending or on revenues, if it increases spending or reduces revenues, it means more borrowing. That is the point that you made, and that is true whether we change your assumptions on TARP funds or we extend tax cuts that are not in the baseline. It means more borrowing. In addition, if we enact new tax cuts or increase troop levels beyond what is in the baseline, all that means more borrowing and makes forecasts even worse in the future. I thank you for reminding us of that constantly.

I want to follow on the Chairman's point about how we can stimulate the economy, which would then improve the forecast and help us deal with the long-term fiscal dilemma we face.

I was interested in the response to the Chairman's question about the most effective ways. If we can help businesses hire more employees, that obviously is going to help us on the forecast. Last night, the President brought up help for small businesses. I was pleased to hear him say that because historically most job growth has occurred with small businesses. Coming out of this recession, the more we can inspire confidence with small business to put on more employees, the faster we will see the job growth that is going to be necessary for our economy. So targeting the tax credit for new hires to small businesses will have a very positive effect.

I want to make one additional point. You mentioned that the expensing, although positive, is not quite as strong as the job credits for new employment. I want discuss the availabiity of credit. I can just tell you, in Maryland small businesses that want to expand do not have the same access to credit as larger companies. That is a fact. Much of that is because they do not have the same type of relationships that larger companies have with alternative financial institutions that can get them through this period.

One of the proposals that is being made is to try to ease the manner in which small businesses can access credit, not by changing the ground rules that would allow them to get credit, but just making it easier for them to obtain that in hopes that that would help expand our economy.

So I would just like to get your assessment as to the availability of credit as one factor. If we can make it easier for small businesses to access credit so that they can carry out a business plan that is also reinforced by a jobs credit for new hires, how could that have a positive impact on our future outlays?

Mr. ELMENDORF. I have a couple of observations. You are certainly right that small businesses have been—their access to credit has been particularly hurt by the financial crisis of the past few years, and we can see that in the reports of small business owners themselves.

We did not as part of this project about stimulating employment growth focus on ways to improve access to credit. It just was not an area that we considered, so I do not have much to say specifically about how one might help that and what particular means might be effective at addressing that problem.

I would say on the more general question of encouraging employment, a lot of jobs are made in small businesses. A lot of jobs, unfortunately, are lost in small businesses as well. They are very volatile. Some succeed and some, unfortunately, do not. There is not really anything in the economic analysis that suggests that one should focus employment incentives on small businesses.

If you can encourage large businesses to hire more, those count as jobs, too, of course. Those can bring down the unemployment rate. Those can create incomes that will create demand for other goods. Those would create additional tax revenue and so on.

So there is nothing that says that the—regardless of how many jobs are created in which sector under normal times, there is no reason to think that focusing job credits on small businesses would be more effective dollar for dollar in raising employment than allowing the same credits for big businesses as well as small businesses.

Senator CARDIN. Well, I would clearly agree that we need to focus on our entire economy. I just tell you anecdotally that for a small company that extra dollar is so important today in making their decisions. In some cases, it determines whether they will decide to go after a contract or not. The incentive difference between a small company and a large company is much greater and historically we have seen more job growth from smaller companies. But you are correct. I agree with you. We have got to concentrate on the entire economy. I was just pleased to see the President recognize the need that we have not yet reached small businesses through our economic programs as effectively as we need to for stimulating our economy.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Enzi?

Senator ENZI. Thank you, Mr. Chairman. First I want to thank Director Elmendorf for all the good work that he did on health care and I appreciate all the time that your staff had to put into analysis day after day and night after night and weekend after weekend. And now that we're in budget season, I am concerned that the Federal Government has not been a good partner in the economic recovery. Businesses need a stable environment to make plans for the future, purchasing plans, production decisions, hiring plans, strategies to manage cash-flow. They cannot be made in a vacuum.

But how can the business community plot a path toward growth and recovery when the future is clouded by the uncertain fate of major initiatives like health care reform, forced paid sick leave, expiring income taxes, the estate tax, and the business tax extenders? My question is: Is it logical to assume that Congress' failure to act on these initiatives has had a negative impact on the job creation and the economic growth? And if so, is it possible to quantify the magnitude of that impact? Should Government be a better partner in this recovery and move quickly to address some of the low-hanging fruit such as the business tax extenders? Would that have an effect?

Mr. ELMENDORF. I think you are correct, Senator, that uncertainty about future Government policy is weighing on business decisions. I cannot quantify it, and I think it is not as important an uncertainty, of course, as uncertainty about the future demand for products, future sales, which is the predominant uncertainty weighing on businesses. For example, on the small business front, although they do report problems getting credit, they also report that their biggest uncertainty is whether they will be able to sell their goods. So I think that is the biggest uncertainty which is weighing on business decisions to invest and hire. But I think uncertainty about Government policy is also playing some role.

Senator ENZI. Continuing the theme of taxes and uncertainty, there is some question in the business community about the fate of the income tax cuts that Congress passed in 2001 and 2003. As you know, small business is the engine of our economy. And many of those small businesses file their taxes as partnerships or limited liability corporations and subchapter S corporations, and they pay income taxes according to the rate schedule for individuals, which puts a lot of them in that over $250,000 category. Consequently, the fate of the marginal rate cuts in 2001 are very important to them, and you do talk about some of the impact of that on page 45, and I appreciate that.

CBO's current policy forecast for real GDP growth in 2011 is 2.4 percent. The Blue Chip forecast is 3.1 percent. The Federal Reserve is 3.4 percent.

Is it correct to say that the CBO predicts that our failure to extend all of the 2001 and 2003 tax cuts will reduce economic growth by seven-tenths to a full percent of GDP next year? And is it wise to sacrifice the opportunity for growth in this economic environment? If the Government wanted to be a good partner in recovery and reduce uncertainty in the business climate, it seems logical that Congress should act quickly to permanently extend all the tax cuts, especially those rates that affect small business. What would be your take on that?

Mr. ELMENDORF. Senator, we do think that if you and your colleagues were to extend those tax cuts on a temporary basis, that would provide a stimulus to economic growth next year. We think if you were to extend the tax cuts on a permanent basis, that would actually supply an even larger stimulative effect next year because people would tend to spend a larger share of taxes they thought would be cut for some period of time.

The problem is, of course, that if you do that and take no other steps, then the deficit outlook is quite a bit bleaker, and over time, unless other steps are taken, that extra debt would hold down economic activity.

So just as our estimate for the stimulus package last year had an increase in economic activity in the short run but some dampening effect toward the back half of the 10-year window, an extension of the tax cuts—again, with no other changes in policy—would have an important stimulative effect up front but would depress economic activity later on in the 10-year projection window.

We do think that a large share of the gap between our economic projection of the next couple of years' growth and that of outside forecasters probably stems from this difference in fiscal policy assumptions. Of course, we stick with current law, and they are making some guess of what you will do, which we do not and should not do ourselves. And we do not quite know their assumptions, but if we changed ours to include a permanent extension of the tax cuts, that would raise economic growth over the next couple of years in our forecast by more than a percentage point. But, again, I will come back to baseline projections that would show deficits twice the size that we are showing now at the end of the 10-year window, and that is the other part of the problem that you and your colleagues are confronting.

Senator ENZI. Let me switch quickly to education for a short question. Using the 2009 baseline, CBO scored the savings in the Student Aid and Fiscal Responsibility—SAFR—bill at $87 billion. But a subsequent estimate provided to Senator Gregg estimated only $47 billion in savings when the market risk was factored in. Given your advised baseline estimates and the fact that a number of schools have switched to direct loan programs, how much do you approximate that the previous score will change given the new baseline and assumptions?

Mr. ELMENDORF. We do not think that that score would change very much because there are some offsetting factors at work. So it is true that the switch, because more people in schools have already switched to the direct lending, that has an effect in one direction. On the other hand, we have lowered our forecast for interest rates a little bit over the next decade in response to the weak economic conditions, and that has an effect in the other direction. I do not think we have completed an estimate yet, but the work in progress suggests not much net difference from what we reported last year.

As you say, there is a significant difference between the official score, which is based, of course, on the Federal Credit Reform Act of 1990, and an alternative that tries to incorporate market risk in the way that Senator Gregg asked us to produce for him.

Senator ENZI. Thank you. I will submit some followup questions on that in writing.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Enzi.

Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman——

Chairman CONRAD. Senator Nelson, if you would just withhold for a minute, I just want to thank you for your strong support of the initiative that Senator Gregg and I advanced. Nobody was a stronger advocate for that or pushed harder for it, and I just want to publicly acknowledge the work that you did on the debt control commission.

Senator NELSON. Mr. Chairman, the fact that we only got 53 votes for setting up a commission in the statutes that you and Senator Gregg proposed I think is a shame. We had to reach the 60-vote threshold under the Senate rules to get it, and we only got 53 votes. And there were how many against, forty——

Chairman CONRAD. Forty-six.

Senator NELSON. Forty-six against having a statutory commission to get the national debt problem under control. That says a lot about the willingness of folks to get our fiscal house in order.

I wanted to thank you, Dr. Elmendorf. You have done yeoman's work in all of the requests that we have had to you for scoring as we considered this health care bill.

Let me go back to one of the Chairman's charts. Is it true that if we took the Senate health insurance reform bill—call it broader, the Senate health reform bill, that debt, the long-term Federal debt, would come down?

Mr. ELMENDORF. It would come down by a little bit, Senator. I——

Senator NELSON. Well, I want to ask you about that because you said in the second 10 years—if I recall, your projection was if the Senate health bill passed, the second 10-year period it would come down in the range of $650 billion to $1.3 trillion.

Mr. ELMENDORF. So the way we put that was as a share of GDP, Senator, and some people have taken to doing their own calculations of GDP in that second decade and doing the multiplication. But we deliberately stuck with percentages of GDP, but that chart is still relevant. Actually, you can bring the chart back up. We said that the bill would reduce the deficit between a quarter and half a percent of GDP. So over a decade, that amounts to 10 times that, so that would be 2.5 to 5 percent, 2.5 percent to 5 percent of GDP.

You can see on that chart—take the end of that second decade at 2029. Debt is going from 100 percent of GDP to 200 percent of GDP over the space of—I cannot be sure, but a decade or two. So we are taking 5 percentage points off the level for that second decade. It is lower, but I think if we were to hold up a chart next to that chart, to be honest, you would have trouble detecting the difference.

Senator NELSON. Well, now, is it not true that one of the things that you cannot score when you do a score for the Senate health bill is the insurance reforms, things like that insurance companies cannot suddenly cancel you for pre-existing conditions, and we are going to set up accountable care organizations that are going to follow the patients through Medicare, the emphasis on primary care doctors so that they have to get a doctor that will go and say you need to go to this specialist, electronic records so that one physician to the next knows what the other has done and, therefore, you do not have to repeat all of these tests that we find in the Medicare system right now where the Medicare recipient goes to this specialist, this specialist, this specialist, all not knowing what the other specialists are doing, and they are duplicating tests? That is something you cannot score. Isn't that right?

Mr. ELMENDORF. Well, we try. Estimating the effects of those kinds of changes on the budget is very difficult, and certainly there are other analysts who think that we have produced estimates of the budgetary effects that are too pessimistic and other analysts who think we have produced estimates that are too optimistic. And either group could be right. The uncertainty is great. But we do think we have balanced the risks in the projections that we have provided.

Senator NELSON. Well, you certainly agree that health care is a big part of our Federal spending and it is going to affect that huge debt in the future.

Mr. ELMENDORF. Yes, absolutely.

Senator NELSON. And so maybe there are things like on the private sector, these insurance market reforms that we have got to get into, some of which I just mentioned will affect the Federal budget that it are difficult for you to score.

Mr. ELMENDORF. Yes, it is certainly difficult for us to score. The uncertainty—everything we do is uncertain. The uncertainty here is particularly large. And, of course, as you are suggesting also, the effect on the budget deficit is not a summary measure of everything that might matter in legislation. It is just one aspect. But it is the aspect on the table at the moment.

Senator NELSON. Today—and I will conclude with this—we are going to be voting on a so-called pay-as-you-go amendment, and that sounds awfully good. But there are going to be certain exceptions for it. There is going to be an exception for the AMT. We are not going to pay for that for 2 years. All of bringing doctors up to what they should have been getting under Medicare that has this acronym called SGR, that is not going to be paid for for 5 years. I wonder if it is a pay-as-you-go amendment. And the whole thing, we are going to forgive about $1.6 trillion that we are not going to pay, and the consequence of that when you add the debt service to it is going to be about $1.9 trillion.

Mr. ELMENDORF. We have not done those estimates precisely, but that does sound like the ballpark that we expect the numbers to be in, yes. And those provisions, those exceptions—adjustments, as they are called in the legislation—do suggest the deficit will be larger than if you and your colleagues passed a similar bill that did not have those adjustments.

Senator NELSON. Thank you, Mr. Chairman.

Senator GREGG [presiding]. I understand Senator Whitehouse is headed in this direction. Do we know how far away?

Does anybody else wish to ask any followup questions of the Director?

[No response.]

Senator GREGG. We have got a vote starting at 10:30. Does the Director mind waiting for a couple of minutes for Senator Whitehouse?

Mr. ELMENDORF. No. As long as you would like me to wait, Senator.

Senator GREGG. Well, I can ask you something while we are waiting. Following up on this PAYGO issue, do you have an estimate of how many times the Congress has waived PAYGO in the last 2 years?

Mr. ELMENDORF. No. I certainly wish I did now, but I am afraid that I do not.

Senator GREGG. Would the number, the total gross amount in waivers that has occurred under—of items that should have been subject to PAYGO be, in our estimate, approximately $400 billion?

Mr. ELMENDORF. I am sorry, Senator. We cannot do that in our heads.

Senator GREGG. Well, I will hypothesize that it is a fairly big number and that PAYGO has become a fairly meaningless exercise around here because it either gets gamed, waived, or avoided with regularity. Is that not true?

Mr. ELMENDORF. I think our judgment and the judgment of other analysts is that in the 1990's, when there was a bipartisan——

Senator GREGG. 1990's.

Mr. ELMENDORF. Yes, when there was a bipartisan concern about rising Federal debt, that the PAYGO rules and the discretionary spending caps helped to restrain actions that might otherwise have increased the budget deficits. But by the end of the 1990's, as you know, when the deficits were turning into surpluses, then those rules were widely ignored. So they are not by themselves binding, but they can be helpful, again, in our judgment, when people are already——

Senator GREGG. If the will is there, they are useful. If the will is not there, they are not useful.

Mr. ELMENDORF. I think that is right, Senator.

Senator GREGG. Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Chairman Gregg.

Senator GREGG. Thank you.

[Laughter.]

Senator WHITEHOUSE. Dr. Elmendorf, thank you for coming back to us again. Just a couple of quick questions.

First, the President's Council on Economic Advisers has calculated that the excess cost and waste in the health care system is in excess of $700 billion a year. The New England Health Care Institute has calculated that it is around $850 billion a year. The Lewin Group—and I think it is probably their number that former Treasury Secretary Paul O'Neill used, because they are coincident—puts the number for excess cost and waste in the health care system annually at $1 trillion a year.

Do you believe that those studies are in the general right order of magnitude?

Mr. ELMENDORF. I think that seems the right ballpark. I mean, as we noted in our letter to Senator Gregg and Senator Conrad in June, there is a widespread view among analysts that a lot of money is not being used effectively, judging principally by comparing different parts of the country which spend a lot and those that do not.

It is impossible to quantify precisely. I would not use the word "calculate."

Senator WHITEHOUSE. I did not say that——

Mr. ELMENDORF. I would make an educated guess.

Senator WHITEHOUSE. But your educated guess is that that is the right ballpark.

Mr. ELMENDORF. Certainly hundreds of billions of dollars, I think that is right.

Senator WHITEHOUSE. In your written testimony, you state that the recovery will be dampened by a number of factors, including, and I quote, declining support from fiscal policy as the effects of ARRA, the American Recovery and Reinvestment Act, wane. That states a proposition in the negative. Would you be prepared to state the proposition in the positive?

Mr. ELMENDORF. As we wrote in our report on policies to stimulate employment growth, we think that appropriate fiscal measures can spur economic activity and job creation in the next few years. Or an alternative positive version—I am not sure what you want—is that we believe—and we have written this many times, and I said this in my remarks—that the seamless package has spurred economic activity and has increased the level of employment relative to what would have occurred without the legislation.

Senator WHITEHOUSE. So it has been good in terms of getting us out of the economic ditch we were in?

Mr. ELMENDORF. We think that it has shortened the duration and reduced the depth of the recession relative to what would otherwise have occurred.

Senator WHITEHOUSE. And that, I would suggest, works under the general category of good.

Mr. ELMENDORF. Yes, I think that is right, Senator.

Senator WHITEHOUSE. Not to be too fussy about it, but I think that is right.

One other question. What are your observations about the extent to which the foreclosure crisis continues to operate as a drag on the economy? And to what extent, if at all, do you believe that a sort of clear market solution like resort to bankruptcy court for families who are in trouble on their home, first mortgages on their primary residence, might help provide clarity in the market so that banks and everybody else can respond? And would that move the foreclosure crisis behind us more rapidly if we had that kind of a clear market signal coming out of bankruptcy courts as people have the chance to get their cases called and heard rather than sit on the phone for many hours with banks finding ever new corners of their telephone answering system to be thrust into?

Mr. ELMENDORF. So we do think that the foreclosure crisis continues to be a very serious problem, obviously for the families that are involved, but also in macroeconomic terms. And there are analysts who worry a good deal that house prices will take another turn down as more foreclosed properties appear on the market. So that is a drag. And I think that greater clarity reaching the end of that process would indeed help to stimulate economic growth.

We have not analyzed, however, particular ways of achieving that clarity, and I think in general the experience of the last few years suggests that the greatest clarity can be achieved with a large injection of funds and that achieving clarity with a smaller injection of funds is pretty challenging. So I think those are the issues one would have to weigh, but we have not done a study of that at this point.

We are in the process of working more on that topic, and we may be able to report to you about that shortly.

Senator WHITEHOUSE. OK. As an observer of markets and economic behavior, if you give banks the opportunity unilaterally to decide how much they are going to lose on a mortgage that is underwater rather than allow a market-neutral process to make that determination, what effect does that have on getting quickly and accurately to the real number and enabling the economy to move on?

Mr. ELMENDORF. I think whether the other process is faster than the current process depends on just what structure you set up and how it is run and what the incentives are of the people who are running it. I do not think I can answer that question in general terms.

I also think that there is an issue—we have a process under which contracts were negotiated and signed, and I think there are legitimate concerns about changing those contracts and the process through which problems are resolved. It does not mean we should not. I am just saying that there are other complexities about the effects over time as well, and that is why it really requires an analysis. We just have not done it yet.

Senator WHITEHOUSE. Although the efficiency of the American bankruptcy system has been one of the great assets of our economy. There was a very good piece on this in the Economist magazine just a few weeks ago. It is one of the sort of prides of the American economy. The bankruptcy system is nothing new. It has existed for I think as long as the Republic has. And it applies to every single type of debt, including debts that the banks hold, except for one kind, and that is the poor residential mortgage holder who years ago for political reasons was carved out of that and denied access to the same quick established resource that every other debtor has access to.

And so I just want to push back a little bit against what I thought was your implied theory that this would be something novel or peculiar if we allowed this to happen. It actually lifts a novelty and a peculiarity out of the system and restores it to its traditional general basis.

Mr. ELMENDORF. I think that is right, but it would be a novelty in the mortgage market, and there are studies that suggest that that particular novelty or peculiarity of mortgages has helped to keep mortgage interest rates down. So there may be a tradeoff between what one is doing for people who end up in trouble versus what one is doing to people who do not end up in trouble. And I am just suggesting why I do not feel like I can off the cuff analyze your particular proposal. But I understand your concerns.

Senator WHITEHOUSE. Well, very good. Thank you for your testimony. I am sorry I went a little bit over, and I appreciate very much Senator Gregg's patience in allowing me to have this time.

Senator GREGG. Does anybody else have any questions?

[No response.]

Senator GREGG. Well, again, I want to thank on behalf of the Chairman and myself you and your staff for the extraordinary job you do. We were just sitting here saying to each other the amount of work that you folks have done in the last few months has just been exceptional, and the quality of it has also been exceptional, and the integrity of it has been exceptional, and we thank you for it.

Mr. ELMENDORF. Can I just say, Senator, that I feel very, very fortunate to work with such a talented and dedicated group of people at CBO, and I am very grateful to you and to Senator Conrad and to Chairman Spratt and Congressman Ryan for giving me the opportunity to do that. Thank you.

Senator GREGG. Thanks.

[Whereupon, at 10:36 a.m., the Committee was adjourned.]

STATEMENT SUBMITTED FOR THE RECORD

Jim Bunning

Statement of Senator Jim Bunning for 1/28/10 SBC Hearing

Good morning. Thank you, Chairman Conrad and Ranking Member Gregg for holding this first hearing of "Budget Season." I also thank Director Elmendorf for taking time to appear before this committee.

As almost all Americans know by now, the United States is facing a nearly unprecedented level of debt. According to the latest budget review released by CBO on Tuesday, this is certainly the case. The estimated deficit for fiscal year 2010 is $1.35 trillion. That represents 9.2 percent of our gross domestic product. This year is the second-largest share of GDP that we have seen since during World War II. Last year, when the deficit was 9.9% of GDP, was the largest share since then. So, I suppose we have made an improvement. However, experts are predicting that if Congress passes certain legislation, and it almost definitely will, then 2010 could end up on top with the highest deficit-to-GDP ratio in over 60 years.

CBO is right to describe the projected deficit under current law as "daunting." We have to keep in mind that the estimates that we are working with are based only on what laws are on the books. Now, we do know that current law will change, mostly by extending certain existing tax cuts with bipartisan support and also through war spending. However, we can expect these and anticipate their effect on the budget to a large extent. This is why we must be very careful with any new legislation that we pass. For instance, while CBO did its job when it scored the health bill passed by the Senate right before Christmas with a net savings, any person taking an honest look at the budget knows that it was going to end up costing hundreds of billions of dollars in the years beyond what CBO is charged with analyzing.

In other news related to the federal budget this week, I see that President Obama is proposing a freeze in domestic spending at current levels for three years, exempting defense, veterans, intelligence, and foreign aid programs. I applaud this move. Frankly, this is something that the Bush Administration should have done years ago. However, we should not view this move as anything more than a start. Freezing discretionary spending for a few years will do nothing to address the looming entitlement crisis we are facing. For instance, Social Security is projected to begin facing deficits in 2016, only six years away—the length of one Senate term. Furthermore, according to a board of trustees report issued last year, it is expected that Medicare Part A will become insolvent in 2017. A three-year freeze of discretionary spending will do nothing to fix these problems. President Obama has made an important gesture, but he has to do more. Entitlements must be addressed.

Finally, we received some news on a piece of old rampant government spending, as opposed to new rampant government spending. We learned this week that the American Recovery and Reinvestment Act of 2009, often referred to as the "stimulus bill", cost more than we even imagined at the time. At passage, it was estimated to have cost $787 billion, not including the added cost of interest payments. However, new estimates put it at $862 billion.

QUESTIONS FOR THE RECORD

Judd Gregg

Question for the Record
From Senator Judd Gregg
For Dr. Douglas Elmendorf
The Budget and Economic Outlook: Fiscal Years 2011-2020
January 28, 2010
Senate Budget Committee

The President's FY2010 budget proposed to eliminate the federal government's guaranteed student loan program, the Federal Family Education Loan program (FFEL), and begin originating all new federal student loans through the Direct Loan program (DL) by July 1, 2010. At the time, CBO scored the President's proposal against the March 2009 baseline, which, using standard credit reform accounting, estimated a savings of $87 billion over the 2010-2019 period. This summer, CBO provided an alternative, more informative estimate that showed the proposal would save only $47 billion over the ten-year period, if an adjustment for market risk was made.

Using the January 2010 baseline and its accompanying assumptions, how would CBO estimate the President's FY 2010 budget FFEL termination proposal now? Please provide details on how your new assumptions for loan volume, including each program's share of the total, and interest rates have changed from the March 2009 baseline and how these adjustments change the baseline costs for each program. How do these changes in baseline costs affect the estimate of the President's proposal, under both the usual credit reform methodology as well as the methodology that adjusts for market risk?

1/28/10

Question for Director Elmendorf from Sen. Gregg:

Judd Gregg

CBO's report on job creation ("Policy Options with a Substantial Proportion of Impacts Beginning in 2011") states "most of the increases in output and employment from this option [infrastructure] would probably occur <u>after</u> 2011. (emphasis added)" During the question and answer period of today's hearing, however, you told the Chairman that infrastructure would be more effective in 2011 than 2010 for creating jobs. Be that as it may, wouldn't it be more accurate to say that infrastructure has the most effect in 2012?

<u>Senator Gregg</u>

CBO's report on job creation ("Policy Options with a Substantial Proportion of impacts Beginning in 2011") states "most of the increases in output and employment from this option (infrastructure) would probably occur after 2011 (emphasis added)." During the question and answer period of today's hearing, however, you told the Chairman that infrastructure would be more effective in 2011 than 2010 for creating jobs. Be that as it may, wouldn't it be more accurate to say that infrastructure has the most effect in 2012?

A. CBO's report on job creation ("Policy Options with a Substantial Proportion of Impacts Beginning in 2011") indicated that most of the increases in output and employment from the infrastructure option would occur after 2011, and it is correct to say that most of the effect of the infrastructure option is indeed after 2012.

Bill Nelson

Budget Committee Hearing on
The Budget and Economic Outlook: Fiscal Years 2011-2020
Questions for the Record
Senator Bill Nelson
1/28/10

- Director Elmendorf, as I understand it, there are three major factors contributing to the spike in the budget deficit:

  1. Declining revenues caused by the recession and fewer tax receipts;
  2. Increased spending caused by our safety net programs and other automatic stabilizers that automatically increase spending when the economy slows down. For example, more people opt to retire and collect Social Security benefits during a recession because there are fewer jobs available; and
  3. New spending and tax cuts that seek to stimulate consumer demand, growth, and employment. This includes our stimulus bill, TARP, the homebuyer tax credit, and other legislation passed since the downturn began.

  Now, many on the other side focus exclusively on this third category, and particularly, new spending. But I believe these other factors – declining tax receipts and automatic stabilizers – are larger contributors to the rising deficit. *Are you able to quantify this effect? How much of the budget deficit is an inevitable consequence of the recession, and how much of the deficit reflects our own activist efforts to kick start growth? Any sense what the deficit might be if Congress had not taken steps to stimulate the economy?*

- Our federal government is heavily dependent on foreign creditors, and particularly China, for continued financing. What are CBO's assumptions regarding the willingness of foreign creditors to continue buying U.S. debt well into the future? In light of these projected deficits, what do you see in terms of the long-term value of the U.S. dollar? Will our borrowing costs rise as foreign creditors take an increasingly critical look at our long-term solvency?

- The report notes that one of the changes CBO made in the baseline is for spending on Build America Bonds, because the demand for them has been higher than expected. You added $26 billion in expected spending over the next 10 years.

Did you also estimate the number of jobs created by the projects that will be financed by these bonds and then factor in the related effects on tax revenue and unemployment benefit costs?

Reply to Questions for the Record
Senate Budget Committee Hearing: The Budget and Economic Outlook
On January 28, 2010

Senator Bill Nelson

Director Elmendorf, as I understand it, there are three major factors contributing to the spike in the budget deficit:

1. Declining revenues caused by the recession and fewer receipts

A. CBO estimates the budget deficit for FY2010 will be $1,349 billion. CBO has estimated the downturn in the economy—that is, the difference between actual GDP and CBO's estimate of potential GDP--contributed about $373 billion to that year's budget deficit. The difference between the two--$976 billion—is considered the structural deficit.

It is possible to create a range of estimates for what the deficit would have been if ARRA has not been implemented, but CBO cannot estimate the effects of some of the other federal interventions, such as the TARP, because CBO has not been able to estimate a range of the effects of those policies on the economy.

CBO has estimated that, in the absence of ARRA, our forecast for GDP would have been lower in FY-2010 by between 1.2 percent to 3.3 percent. Rough calculations of the budgetary effect on FY-2010 of such alternatives indicate the better GDP outcome improved the budget deficit by $70 billion to $190 billion. Of course, the cost of ARRA for FY-2010 would have to be deducted from those amounts to derive the net budgetary effect of ARRA.

2. Increased spending caused by our safety net programs and other automatic stabilizers that automatically increase spending when the economy slows down. For example, more people opt to retire and collect Social Security benefits during a recession because there are fewer jobs available.

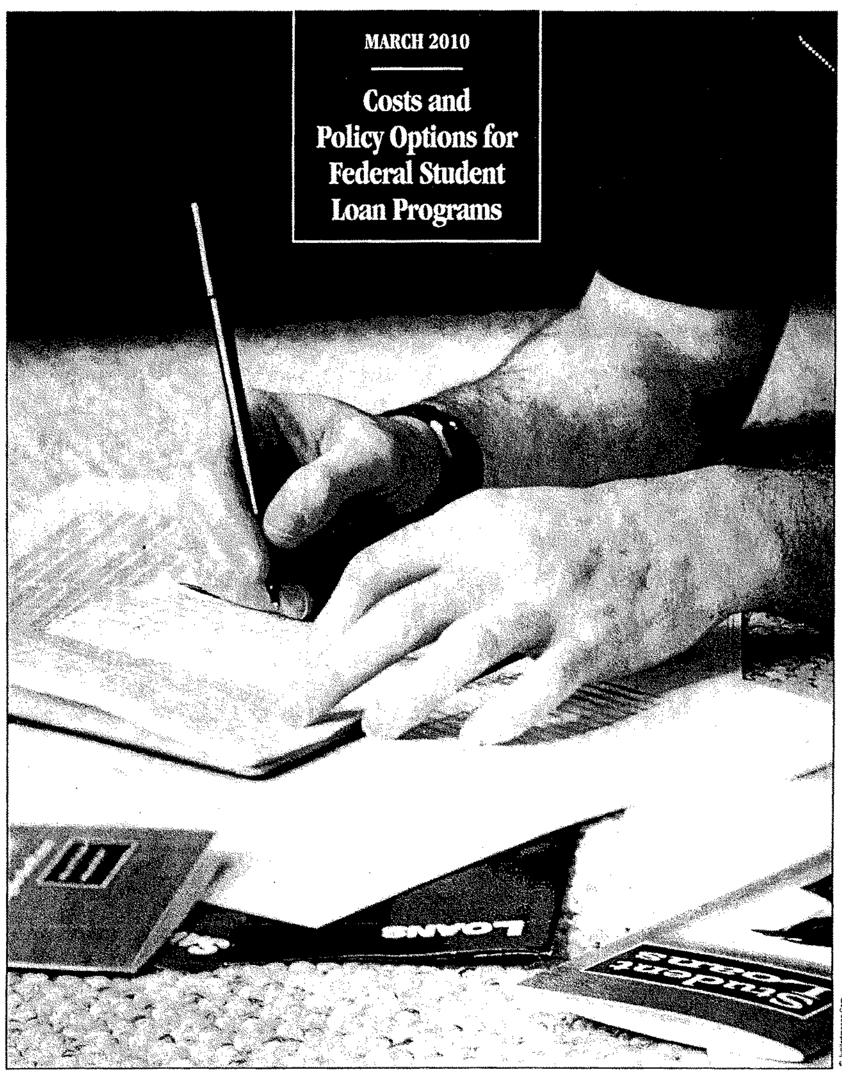
A. The CBO baseline forecast assumes the current account deficit—roughly the amount of net foreign investment that flows into the United States per year—will be on the order of $640 billion a year over the next ten years. This is slightly less than the $680 billion annual average current account deficits of the last five years, and CBO assumes that investors will be willing to provide that level of investment without requiring significantly higher interest rates (although interest rates on Treasure debt do increase in the forecast).

As part of that forecast, CBO assumes that the dollar will fall steadily over the next ten years (the nominal trade-weighted dollar falls by about 20 percent over that time). This helps reduce the trade deficit in the future, but because net investment income (which also affects the current account) gradually decreases, the current account does not decline significantly.

SUPPLEMENTAL MATERIAL IN ANSWER TO RANKING MEMBER GREGG'S SUBMITTED QUESTION ON STUDENT LOANS

CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

A
CBO
STUDY



A CBO STUDY

Costs and Policy Options for Federal Student Loan Programs

March 2010

The Congress of the United States ■ Congressional Budget Office

Notes

Unless otherwise indicated, the years referred to in this study are federal fiscal years (which run from October 1 to September 30). In several instances, statistics are given for calendar years or for academic years (which run from July 1 to June 30). Federal laws and regulations governing higher education frequently refer to academic years.

Numbers in the text and tables may not add up to totals because of rounding.

Preface

The federal government helps students finance higher education through two major loan programs—one that guarantees loans made by private lenders and one that makes loans directly to borrowers. The two programs offer similar types of loans on similar terms to borrowers, but they differ significantly in how they are funded and administered. Those differences cause the guaranteed loan program to have a significantly higher rate of federal subsidies—as calculated for the federal budget under the rules of the Federal Credit Reform Act—than the direct loan program has. However, such subsidy-rate estimates do not include the costs to taxpayers that stem from the risks involved in making student loans, nor do they include federal administrative costs (which are recorded separately in the budget). More-comprehensive, fair-value estimates, which include such costs, indicate higher subsidy rates for both programs, although direct loans continue to show a marked cost advantage over guaranteed loans.

This Congressional Budget Office (CBO) study—prepared at the request of the Ranking Member of the Senate Budget Committee—compares the budgetary and fair-value costs of the federal student loan programs. It also looks at several options for modifying those programs, including eliminating the guaranteed loan program after July 1, 2010, and expanding direct lending. In keeping with CBO's mandate to provide objective and impartial analysis, this report makes no recommendations.

The study was written by Deborah Lucas, CBO's Associate Director for Financial Analysis, and by Damien Moore of CBO's Macroeconomic Analysis Division, under the direction of Robert Dennis and Kim Kowalewski. Deborah Kalcevic of CBO's Budget Analysis Division produced some of the cost estimates, under the direction of Peter Fontaine and Sam Papenfuss. Justin Humphrey provided helpful comments on earlier drafts, as did Janice Eberly of the Kellogg School of Management at Northwestern University. (The assistance of an external participant implies no responsibility for the final product, which rests solely with CBO.)

Chris Howlett edited the manuscript. Maureen Costantino prepared the report for publication, with assistance from Jeanine Rees, and produced the cover. Monte Ruffin produced the printed copies, Linda Schimmel coordinated the print distribution, and Simone Thomas prepared the electronic versions for CBO's Web site (www.cbo.gov).

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

March 2010

Contents

Summary vii

Overview of Federal Student Loan Programs 1

- Types of Loans 1
- Loan Terms 1
- Loan Volume 2
- Administration and Funding 3

Factors That Affect the Costs of Direct and Guaranteed Lending 4

- Payments to Lenders 4
- Comparison of Costs by Function 5

Budgetary Costs of the Student Loan Programs 8

Fair-Value Costs of the Student Loan Programs 8

- Accounting for Costs Omitted from FCRA Subsidies 9
- Fair-Value Subsidy Estimates 10
- Sensitivity Analysis 11

Policy Options 13

- Reducing the Federal Cost of the Guaranteed Loan Program 14
- Restructuring Loans 15

Appendix: Assumptions and Analysis Underlying CBO's Fair-Value Subsidy Estimates 19

Tables

1. New Direct and Guaranteed Student Loans, by Fiscal Year 3

2. Lending Functions in the Direct and Guaranteed Loan Programs 5

3. Projected Fair-Value and FCRA Subsidy Rates for Representative Loans and Borrowers, by Fiscal Year 10

4. Components of Estimated Subsidy Rates for Loans Made in Fiscal Year 2020 12

Box

S-1. Effects of the Financial Crisis viii

Summary

The federal government makes financing for higher education widely available through two programs: the Federal Family Education Loan (FFEL) program, which guarantees loans made by private lenders, and the William D. Ford Federal Direct Loan Program (FDLP), which makes loans directly to borrowers. The two programs are similar in many respects. By statute, they offer a similar variety of loans with comparable interest rates and repayment options for all qualifying borrowers. Those loan terms are usually more generous than what would be available from private sources. Schools, which choose which program to participate in, play an important role in administering the loan application process and in counseling students about the financing options available to them. In both programs, the federal government bears almost all of the losses when borrowers default.

The FFEL program and the FDLP differ, however, in the ways in which they are administered and funded. In the guaranteed loan program, loans are administered by financial institutions—such as Sallie Mae, commercial banks, and nonprofit agencies—that act as FFEL lenders.[1] Those lenders usually raise the money to make loans in the private capital markets. By contrast, in the direct loan program, the Department of Education and its contractors manage most administrative functions, and loans are funded through the Treasury.

Lending through the federal student loan programs has grown rapidly over time, with that growth accelerating in the past decade. Between 2000 and 2009, the volume of outstanding federal student loans more than quadrupled, from about $149 billion to about $630 billion. During that period, about three-quarters of the student loans made each year were originated in the guaranteed loan program.

Private lenders in the guaranteed loan program faced a sharp increase in funding costs during the recent financial crisis, leading to concerns about the future availability of guaranteed loans. To ensure an uninterrupted flow of credit for students, lawmakers enacted legislation in 2008 that gave the Department of Education temporary authority to buy newly originated loans from FFEL lenders. Through a combination of those purchases and direct loans, about 88 percent of the total dollar amount of federal student loans made in the 2008–2009 academic year was funded by the government (see Summary Box 1). Despite the new legislation, the guaranteed loan program's share of origination volume fell to 69 percent in the 2008–2009 academic year. Since then, uncertainties about funding for the FFEL program and about possible legislation affecting it have led more schools to switch to the direct loan program. The Congressional Budget Office (CBO) projected in its March 2010 baseline that, under current law, the share of guaranteed student loans would continue to decline gradually for the next few years before leveling off at 40 percent starting in 2013.

Budgetary Costs of Direct and Guaranteed Student Loans

Despite the many similarities between the FDLP and the FFEL program, the latter is significantly more costly for the federal budget. For example, CBO recently estimated that the President's proposal to eliminate the FFEL program and replace it with additional direct lending would save the government a total of $62 billion between 2010

1. Sallie Mae was originally a government-sponsored enterprise chartered by the Congress to provide liquidity to the secondary market for student loans (the market in which loans are bought and sold). It is now a private company that specializes in providing financial services to students, including FFEL and private student loans.

Summary Box 1.

Effects of the Financial Crisis

In the wake of the financial crisis that began in August 2007, investors became wary of buying asset-backed securities—even those backed by obligations with a federal guarantee, such as guaranteed student loans.[1] Many lenders in the Federal Family Education Loan (FFEL) program that had relied heavily on the sale of asset-backed securities to finance new guaranteed loans faced much higher funding costs, which the fixed statutory payments from the Department of Education were insufficient to cover. Because the FFEL program provided nearly 75 percent of federal student loans at that time, the prospect that lenders would stop making new loans threatened to seriously disrupt the availability of credit for higher education.

Lawmakers responded by passing the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA).[2] That law authorized the Department of Education to provide funding to FFEL lenders, primarily by purchasing their loans but also by providing them with backup lines of credit. Between the initiatives in ECASLA and the direct student loan program, the federal government ended up financing about 88 percent (by dollar volume) of the federal student loans made in the 2008–2009 academic year.

ECASLA's effect on the federal budget has been to lower the cost of the student loan programs. Purchasing guaranteed loans allows the Department of Education to avoid some of the payments it would have made to FFEL lenders. Once the loans are purchased, payments from the government to FFEL lenders cease, and the loans are serviced and administered by the department's contractors. Thus, the purchased loans have the same costs as direct student loans.

Despite improvements in the financial markets last year, FFEL lenders continued to rely heavily on the enhanced federal support to obtain financing for student loans. Concerns about the availability of private capital led lawmakers to extend ECASLA to cover loans made for the 2009–2010 academic year.[3]

The federal government has also provided support to the private student loan market by allowing lenders to borrow from the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF).[4] Before the financial crisis, the private loan market was an important source of financing for higher education for some students (such as those who had exhausted the dollar limits on federal student loans or who did not qualify for federal loans). During the crisis, many lenders suspended or discontinued their private student loan programs because of the sharp increase in funding costs and worries about the deteriorating credit quality of borrowers. Although some activity has resumed in that market, the terms offered to borrowers on private student loans have remained stringent, and lenders have relied on federal backing through the TALF to obtain funding at affordable rates.

1. Asset-backed securities are financial instruments whose interest and principal payments stem solely from the income generated by the assets that serve as collateral for the securities. Securities backed by student loans are created by bundling those loans together and selling investors claims to a portion of the loans' cash flows. In the case of federally guaranteed student loans, the securities are structured so that federal payments for default claims on the loans are passed along to the holders of the securities.
2. Public Law 110-227.
3. The Department of Education reports that under the authority in ECASLA, it purchased roughly $50 billion in FFEL loans through the end of fiscal year 2009. The department estimates that it will buy another $62 billion in loans under the extended authority that ends on July 1, 2010, for total purchases of about $112 billion.
4. The Federal Reserve created the TALF in November 2008 to provide liquidity for certain types of asset-backed securities, including those backed by student loans. Issuers of asset-backed securities can borrow from the facility at interest rates set by the Federal Reserve, using asset-backed securities as collateral. The TALF is scheduled to stop operating later this year.

and 2020.[2] Although the federal cost per dollar of student loans originated varies from year to year and among different types of loans, a loan made in the FFEL program consistently shows a much higher budgetary cost than if it had been made in the direct loan program.

The budgetary costs of the direct and guaranteed loan programs are recorded in the federal budget using the standard procedure specified in the Federal Credit Reform Act of 1990 (FCRA).[3] That law says that the costs of a federal loan or loan guarantee should be estimated in the year the loan is disbursed as the net present value of the federal government's expected net cash flows over the life of the loan or guarantee. Those cash flows are discounted to their present value using the Treasury's borrowing rates.[4]

Fair-Value Costs of Direct and Guaranteed Student Loans

Cost estimates made under FCRA do not provide a comprehensive measure of the cost to taxpayers of the federal student loan programs, for two main reasons. First, the FCRA methodology does not include the costs to taxpayers that stem from certain risks involved in lending—risks that private investors would require compensation to bear. In particular, although the FCRA methodology accounts for average losses from defaults, it does not recognize a cost for the risk that losses from defaults will be higher during periods of market stress, when resources are scarce and hence most valuable. Such "market risk" is excluded from FCRA estimates because that methodology discounts expected future cash flows at Treasury borrowing rates rather than at higher interest rates that incorporate the price of risk.[5] Second, FCRA estimates do not include administrative expenses, which are recorded separately in the budget each year on a cash basis (that is, undiscounted). That treatment mixes together current-year administrative costs for outstanding loans and for newly originated loans.

In this study, CBO compares the costs of making a loan in the FDLP and guaranteeing a loan in the FFEL program, calculated as specified in FCRA and also at fair value—a broader measure that includes administrative costs and the cost of risk. The fair value of an asset or liability corresponds to its market value under normal market conditions (or, in the absence of such conditions, to an approximation of what the value would be under those conditions). In general, a fair-value subsidy occurs whenever the government accepts terms on the financing or services it provides that are less stringent than the terms that participants in private markets would require for taking on comparable obligations and risks.

Taking into account the costs of risk and administration has the effect of significantly increasing the estimated cost of both the direct and guaranteed loan programs; it also narrows—but does not eliminate—the cost difference between the two programs. For instance, CBO recently estimated that whereas loans issued in the direct loan program between 2010 and 2020 would reduce the deficit by a total of $68 billion under FCRA accounting, those loans would increase the deficit by $52 billion on a fair-value basis.[6] For loans issued in the FFEL program, the projected cost over that period increases from $22 billion under FCRA accounting to $105 billion on a fair-value basis. The savings from implementing the President's proposal to replace FFEL loans with direct loans decline from a total of $62 billion over the 2010–2020 period under FCRA accounting to $40 billion on a fair-value basis.

2. Those savings stem from a $68 billion reduction in subsidy costs (which do not include the government's administrative expenses), partly offset by a $6 billion increase in administrative expenses, which are funded separately in annual appropriation acts. See Congressional Budget Office, letter to the Honorable Judd Gregg about the budgetary impact of the President's proposal to alter federal student loan programs (March 15, 2010).

3. CBO's method for estimating those costs is described in Congressional Budget Office, *Subsidy Estimates for Guaranteed and Direct Student Loans* (November 2005).

4. Net present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. The present value depends on the rate of interest (the discount rate) used in the calculation.

5. Student loans also entail prepayment risk: the risk that students will pay back loans more rapidly if future interest rates fall and more slowly if future rates rise, reducing the value of the government's claims. That risk, however, is less important than market risk for student loans. Investors in securities backed by student loans also assign a price to other types of risk, such as liquidity risk (the risk that the securities may not be easy to sell quickly without having to offer a price concession). CBO takes into account all of those risks in its fair-value estimates.

6. Congressional Budget Office, letter to the Honorable Judd Gregg about the budgetary impact of the President's proposal to alter federal student loan programs (March 15, 2010).

To calculate fair-value subsidies, CBO generally used the same assumptions as for its FCRA estimates, except with regard to discount rates and administrative costs. In place of Treasury rates, CBO used discount rates that included an estimate of the risk premium (the additional return in excess of Treasury rates) that private investors would require to bear the risks of student loans. CBO estimated those discount rates on the basis of interest rates on private student loans and other data from the private student loan market.[7] The estimated discount rates also took into account differences between private and federal student loans (in the terms of the loans and the characteristics of borrowers); past and present market conditions; and the expectation that conditions in financial markets will improve in the next several years. In addition, CBO included the administrative costs incurred by federal agencies in its fair-value subsidy estimates, because a private entity would need to be compensated to bear those costs.

Subsidy rates—the cost per dollar of loan originated—vary from year to year with the composition of borrowers in each program and the mix of loan types. To present FCRA and fair-value estimates that are informative about the differences in the cost of lending under the two student loan programs, this study shows subsidy rates that are based on a representative loan (holding the characteristics of borrowers and the mix of loans fixed) made in the FFEL program in specified time periods.

CBO's calculations indicate that if subsidies were computed on a fair-value basis, student loans made in both the direct and guaranteed loan programs would impose costs on the federal government, and those costs would represent a significant share of the principal value of the loans issued. For instance, whereas on average over the 2010–2020 period a representative loan issued in the direct loan program has a *negative* subsidy rate of 9 percent under FCRA (meaning that it reduces the deficit), the same loan has a *positive* subsidy rate of 12 percent on a fair-value basis. For the FFEL program, the average subsidy rate on a representative loan over that period is 5 percent under FCRA and 20 percent on a fair-value basis.

Thus, measuring costs on a fair-value basis narrows the difference between the costs of loans made in the guaranteed and direct lending programs, but it does not eliminate the gap. CBO estimates that if a representative guaranteed loan made during the 2010–2020 period was instead originated in the direct loan program, the savings in subsidy rates would be 8 percentage points (20 minus 12) on a fair-value basis, compared with about 13 percentage points (5 minus -9, with rounding) under FCRA accounting.

Those estimates, which are based on the economic assumptions underlying CBO's March 2010 baseline, are very sensitive to projections of interest rates and estimates of discount rates. However, the conclusions that fair-value subsidy rates are positive for both programs and higher for the guaranteed loan program hold under a broad range of assumptions about interest rates, discount rates, and other market conditions.[8]

The higher costs in the guaranteed loan program (on both a FCRA and a fair-value basis) result mainly from the way in which the government compensates FFEL lenders. Payments to those lenders are fixed in legislation rather than set through a mechanism—such as a competitive bidding process—that ties reimbursement to actual costs incurred. In general, those statutory payments appear to exceed lenders' basic administrative costs and their funding costs under normal market conditions (although during the financial crisis, the payments proved too low to cover the surge in lenders' borrowing costs).[9] Because FFEL lenders must compete to attract borrowers, any difference between the statutory payments they receive and their basic costs is mostly absorbed by increasing marketing efforts, enhancing the administrative services they provide, or offering other benefits to schools

7. Many of the lenders that make guaranteed student loans also offer private student loans. Private loans are generally taken out by students at expensive undergraduate institutions or professional schools who have reached the dollar limit on federally guaranteed loans or by students who do not qualify for federal loans.

8. The conclusion that costs are higher for both programs on a fair-value basis is a logical consequence of including costs that are excluded under FCRA; only the size of the effect depends on specific assumptions. The amount by which the FFEL program appears more expensive than direct lending is sensitive to the rate chosen to discount the government's payments to FFEL lenders. With a sufficiently high—but unrealistic—discount rate, the FFEL program would appear to be less expensive than the direct loan program.

9. The College Cost Reduction and Access Act of 2007 (Public Law 110-84) reduced payment rates to FFEL lenders and guaranty agencies, which narrowed the difference in costs between the two programs. But in CBO's estimation, a considerable cost difference remains.

and students. Thus, competition between lenders benefits schools and borrowers rather than lowering costs to the government. In addition, FFEL lenders fund their loans in the capital markets, which introduces additional costs and risks to the program that do not arise when loans are funded through the Treasury.

Options for Changing Federal Student Loans

In recent years, many proposals have been made to modify the federal student loan programs. Some of those proposals focus on the cost disparity between the guaranteed and direct lending programs. For example, the President's 2011 budget calls for ending the FFEL program's authority to guarantee new loans on July 1, 2010, and switching entirely to the direct lending program to realize the savings from that program's lower costs. The House of Representatives recently passed legislation (H.R. 4872, the Health Care and Education Affordability Reconciliation Act of 2010) to carry out a similar change, and the Senate is currently considering that legislation.[10]

Policy options that could help bring the subsidy rate of the FFEL program closer to that of the direct loan program include having the government buy all student loans from FFEL lenders shortly after origination but allowing the lenders to retain their current administrative functions; cutting payments to those lenders; and auctioning off the right to lend under the program. Such cost-saving measures would probably cause FFEL lenders to reduce service levels, prompting more schools to switch to the direct loan program.

Federal costs could be made more predictable—and the subsidies provided to different cohorts of students could be made more uniform—by indexing the interest rates on student loans to market interest rates. Under current law, subsidies vary considerably from year to year because the interest rates charged to borrowers are fixed by statute and unrelated to market interest rates.

Other options to alter the student loan programs aim to address policy goals—such as improving the affordability and availability of student loans or reducing defaults—by modifying the terms offered to borrowers. For example, one way to help students would be to lower the interest rates charged on federal student loans. However, broad-based reductions in interest rates would entail significant costs to the government. For instance, reducing the scheduled interest rates charged to borrowers on new loans by 1 percentage point would increase the subsidy rate on guaranteed loans by 6 percentage points on a fair-value basis.

Policymakers have also considered changes aimed at lessening the hardships that borrowers face in repaying federal student loans. Those proposed changes include expanding options that make repayment terms contingent on income, that eliminate a portion of an outstanding loan (forgiveness), or that allow a borrower to delay repayment (forbearance or deferment). Although more-lenient repayment terms may lower default rates, they increase costs to the federal government by lengthening the average time that loans are outstanding at subsidized interest rates. The costs of income-contingent repayment, or of loan forgiveness or forbearance, are generally higher on a fair-value basis than under FCRA accounting, because borrowers are more likely to take advantage of those opportunities in economic downturns, when the value of the forgone payments is greatest.

10. On September 17, 2009, the House passed the Student Aid and Fiscal Responsibility Act of 2009 (H.R. 3221), which would also phase out the FFEL program.

Costs and Policy Options for Federal Student Loan Programs

The Department of Education oversees various programs to help students pay for the costs of postsecondary education. This Congressional Budget Office (CBO) study focuses on the two largest student loan programs created under the authority of the Higher Education Act of 1965 (as amended):

- The Federal Family Education Loan (FFEL) program, which dates back to the mid-1960s, guarantees student loans made by private-sector lenders.
- The William D. Ford Federal Direct Loan Program (FDLP), which began operating in 1994, makes loans directly to students or their parents.

Overview of Federal Student Loan Programs

Both the guaranteed and direct loan programs have experienced rapid growth as increasing numbers of students have sought higher education and as the costs of school attendance have soared. The two programs offer virtually identical types of loans, which carry similar interest rates, repayment options, and other terms. However, significant differences exist in the way the programs are administered and funded, which have implications for their costs to the federal government.

Types of Loans

The FDLP and the FFEL program offer many kinds of loans. Eligibility and some loan terms depend on a student's course of study (for example, undergraduate, graduate, or medical); the identity of the borrower (student or parent); and whether the student qualifies for more favorable loan terms on the basis of need.

Both programs offer so-called Stafford loans to undergraduate and graduate students. Those loans make up the bulk of federal student loans, accounting for more than 80 percent of new loan volume each year (excluding consolidation loans). In a typical year, a little over half of Stafford loans (by volume) are "unsubsidized" and the rest are "subsidized." Those labels refer to the terms of the loans, not to whether the federal government incurs subsidy costs for the programs. With subsidized Stafford loans—which are available depending on the income and assets of students and their parents—borrowers generally are not charged interest while they are in school and during certain other periods, and undergraduate borrowers are charged lower interest in some years.

Besides Stafford loans, both the FDLP and the FFEL program offer so-called PLUS loans to parents of undergraduate students and to graduate and professional students who have reached their borrowing limits for Stafford loans. In addition, both programs offer consolidation loans, which allow most borrowers with more than one outstanding federal loan to refinance them into a single obligation.[1]

Loan Terms

The terms offered to borrowers—interest rates, borrowing limits, fees, and repayment options—are set by statute and are almost identical under the direct and guaranteed loan programs. Since July 2006, new Stafford loans

1. Consolidation loans offer extended repayment terms and a fixed interest rate equal to the weighted average of interest rates on the loans being consolidated (rounded up to the nearest eighth of a percentage point). For more about consolidation loans, see Congressional Budget Office, *The Cost of the Consolidation Option for Student Loans* (May 2006). For budgetary purposes, CBO treats a consolidation loan as an extension of the original loan rather than as a new loan. Thus, the subsidy estimates in this analysis, both budgetary and fair-value estimates, include the incremental costs of loan consolidation.

have carried a fixed interest rate.[2] (Loans originated earlier carry a variable rate that is indexed to the interest rate on three-month Treasury bills.) Setting a fixed interest rate that is not linked to a market rate has several effects: It causes the rate of federal subsidies provided to different cohorts of students to vary considerably, and it makes the budgetary costs of student loan programs more variable from year to year.

Statutory restrictions limit the amount of money that can be borrowed—both annually and cumulatively—from the federal lending programs. The limits, which are identical under the two programs, depend on the type of loan, the course of study, and the costs of attending a given school.[3]

Although interest rates and borrowing limits are almost identical for direct and guaranteed loans, the fees that borrowers pay to take out a student loan vary slightly between the two programs.[4] For guaranteed loans, the government charges borrowers a fee equal to 1 percent of the loan amount when their loan is disbursed. That origination fee goes toward paying claims to FFEL lenders when borrowers default. The government also charges a 1 percent origination fee on direct loans, but part of the fee is returned to students if they repay their loan on time (the rest is remitted to the Treasury). Thus, the average amount that students pay in origination fees is lower on direct loans.

When students complete or withdraw from a course of study, they typically receive a six-month grace period during which no loan payments are due, although interest continues to accrue on their loans. (With subsidized loans, no interest accrues during the grace period.)

2. That rate was initially set at 6.8 percent for both subsidized and unsubsidized Stafford loans. For subsidized loans to undergraduates, however, the rate follows a declining schedule: 6.0 percent in the 2008–2009 academic year, 5.6 percent in 2009–2010, 4.5 percent in 2010–2011, and 3.4 percent in 2011–2012. After that, it reverts to 6.8 percent.

3. For example, as of July 1, 2008, the cumulative limits on outstanding Stafford loans are $31,000 for loans taken out as a dependent undergraduate and a total of $138,500 for loans taken out as an undergraduate or graduate student. Limits for medical students are higher.

4. A notable exception to the similarity of interest rates between the two programs is that the fixed rate for borrowers of PLUS loans made on or after July 1, 2006, is 7.9 percent for direct loans and 8.5 percent for guaranteed loans.

Stafford loans have flexible repayment plans that last up to 30 years; they also have deferment and forbearance provisions that allow borrowers to temporarily stop making payments because of financial hardship, a return to school, or other reasons.[5] For qualifying student borrowers, several repayment plans are available in which scheduled loan payments vary with the borrower's income.[6]

Federal student loans are considered to be in default after 270 days of missed payments—a much less stringent criterion than applies to private student loans and other consumer credit. However, student loans of any sort (direct, guaranteed, or private) are rarely forgiven in bankruptcy proceedings, and there is no statute of limitations on their collection.

Loan Volume

The demand for federal student loans has risen rapidly in recent decades, aided by a series of legislative changes that expanded the federal programs and relaxed limits on the amounts borrowed.[7] Between 1990 and 2009, the total dollar volume of new loans originated each year grew at an average rate of roughly 9 percent. In the past five years alone, new originations increased by nearly three-quarters: from $56 billion in 2005 to $97 billion in 2009 (see Table 1). As a consequence, the total amount of federal student loans outstanding rose from $381 billion to

5. During a deferment or forbearance period, payments are not required but interest still accrues. (In the case of subsidized Stafford loans, the government pays the interest during deferment.)

6. Three different plans exist: "income-based repayment," "income-sensitive repayment," and "income-contingent repayment," all of which have slightly different rules. For instance, under income-based repayment, monthly payments are capped at a percentage of the borrower's discretionary income; the cap is based on the borrower's income and family size. Single borrowers who earn less than $50,000, and married borrowers with two children who earn less than $100,000, have their monthly payments capped at less than 10 percent of their gross income. For a description of the various plans, see FinAid, "Income-Based Repayment," available at www.finaid.org/loans/ibr.phtml.

7. For example, the unsubsidized Stafford loan program, established in 1992, extended eligibility to higher-income borrowers by removing an income test, and the volume of those loans grew rapidly. Starting in 2006, the PLUS loan program increased the availability of federal loans to graduate students; that program has also grown quickly. Borrowing limits, both annual and cumulative, have been raised several times since 1995. On PLUS loans, for instance, changes allowed for borrowing up to the full cost of a student's education.

Table 1.

New Direct and Guaranteed Student Loans, by Fiscal Year

	2005	2006	2007	2008	2009
			Volume of New Loans (Billions of dollars)		
Direct Loans	12.6	12.2	12.5	17.8	29.7
Guaranteed Loans	43.2	46.7	51.8	57.9	66.8
Total	**55.8**	**58.8**	**64.4**	**75.7**	**96.5**
			Number of New Loans (Millions)		
Direct Loans	3.0	2.8	2.7	3.7	6.1
Guaranteed Loans	10.3	10.8	11.6	12.7	14.5
Total	**13.3**	**13.7**	**14.3**	**16.5**	**20.6**

Source: Congressional Budget Office based on data from the Department of Education.

Note: These numbers reflect net commitments, excluding consolidation loans.

$631 billion over that period. Approximately two-thirds of the growth in the FDLP and the FFEL program has resulted from a rise in the number of borrowers, and one-third has stemmed from larger loan balances per borrower during the 1995–2009 period. The increasing demand for student loans has coincided with extraordinary growth in the cost of higher education—which, since the 1980s, has reportedly risen at an annual rate that was 3 percentage points higher than the general increase in prices.[8]

Historically, the guaranteed loan program has been the main source of federal credit assistance for higher education. It accounted for an average of about 75 percent of the total dollar amount of federal student loans originated between 1998 and 2008. That program's share fell from 81 percent in 2008 to 69 percent in 2009, as some schools switched to the direct loan program to avoid uncertainties about the availability of guaranteed student loans during the financial crisis (see Summary Box 1 on page viii). Furthermore, the government financed a large percentage of the guaranteed loans originated in 2009 through loan purchases by the Department of Education. Since then, the number of schools participating in the FFEL program has continued to decline. CBO projects that under current law, guaranteed loans will account for 55 percent of all new federal student loans in 2010 and smaller shares thereafter, leveling off at about 40 percent beginning in 2013.

Some students who have exhausted their eligibility or who do not qualify for federal loans turn to the private student loan market for financing. Private student loans are offered by many of the same lenders that participate in the FFEL program. But whereas the federal government determines eligibility and loan terms for federal direct and guaranteed student loans, and assumes the risk of default, lenders play those roles for private loans. Data on the size of the private student loan market are scarce, but one estimate put originations at about $22 billion in the 2007–2008 academic year—implying that the private market was about one-quarter the size (by dollar value) of the market for federal student lending in that period.[9] The volume of the private student loan market appears to have fallen off sharply in the wake of the financial crisis.

Administration and Funding

The direct and guaranteed student loan programs differ in how they are administered and funded and in how the government pays for administration and funding. In the guaranteed loan program, the federal government guarantees loans that are administered and funded by FFEL lenders, including private financial institutions and nonprofit organizations. FFEL lenders are compensated for those activities on terms set by statute under the Higher Education Act. In the direct loan program, by contrast, the Department of Education makes loans directly to

8. College Board, *Trends in College Pricing, 2009* (Washington, D.C.: College Board, 2009).

9. Mark Kantrowitz, "Characteristics of Private Student Loan Borrowers Who Do Not Use Federal Education Loans" (published by FinAid.org, June 7, 2009), www.finaid.org/educators/20090607private_vs_federal_loans.pdf.

qualifying borrowers and manages all aspects of the lending process. It hires private contractors, selected in a competitive bidding process, to perform some administrative functions, and it funds loans through the Treasury.

Schools play an important role in both programs in administering the loan application process and counseling students about the financing options available to them. Schools also must decide which program to participate in. When choosing between the direct and guaranteed loan programs, schools consider such factors as which program provides better administrative and other services and which program seems more beneficial to their students.

Factors That Affect the Costs of Direct and Guaranteed Lending

The FDLP and the FFEL program differ markedly in their costs to the federal government. The main reason is that payments to FFEL lenders are set legislatively at an average amount that is higher than the costs to the FDLP of administering and funding direct loans. Those additional payments to lenders accommodate the higher marketing and funding costs of the guaranteed loan program and the higher level of services that it offers to schools and students.

Payments to Lenders

The way the government compensates lenders under the FFEL program is set by statute and is only weakly related to the actual costs that lenders incur. Lenders receive regular quarterly payments from the government—known as special allowance payments (SAP)—that are a percentage of the principal value of their outstanding guaranteed loans. That percentage equals the prevailing interest rate on high-quality three-month commercial paper plus an additional amount—called a spread—minus the interest rate that borrowers contractually pay on the loans.[10] That arrangement effectively transfers to the government the interest payments that lenders receive from borrowers. In return, the commercial-paper rate plus a small portion of the spread is intended to cover lenders' normal costs of acquiring the funds to make loans in the capital market.[11] The rest of the spread goes toward covering administrative costs and other expenses incurred by lenders.[12] The statutory amount of the spread varies by type of loan and type of lender. For example, payments to for-profit FFEL lenders include a spread of 1.79 percent on Stafford and PLUS loans and 1.19 percent on consolidation loans. Spreads paid to nonprofit lenders are 0.15 percentage points higher.

Lenders also pay and receive a variety of other, relatively small, fees and payments that affect their total compensation. In addition, when borrowers default, the government pays FFEL lenders a fixed fraction—currently set at 97 percent—of the principal and accrued interest owed (see the section on collection below).[13]

In deciding whether to offer guaranteed loans, lenders weigh the value of those various payments against the costs and risks associated with participating in the FFEL program. If statutory payments to lenders fall short of covering their costs—as happened during the financial crisis before additional federal support became available—lenders have the option to stop participating. But when payments to lenders exceed the basic cost of administering and funding loans, there is no mechanism for the government to recoup the excess.

Competition among lenders means that a substantial portion of any excess payments will be used to attract and retain business, such as by spending more on marketing or improving services to students and schools. Those services include discounts to borrowers for on-time payment and support services to financial aid offices, such as software systems and educational materials.[14] (To the extent that lenders are shielded from competition, some portion

10. Commercial paper consists of unsecured promissory notes that large corporations or banks issue to raise money for short-term needs.

11. During the recent financial crisis, FFEL lenders' funding costs increased well above the commercial-paper rate, and the fixed spread did not accommodate those increases.

12. The College Cost Reduction and Access Act of 2007 (Public Law 110-84) reduced SAP spreads from previous levels. Although no major lender withdrew from the program in the following year, the level of benefits offered to borrowers declined. Lenders further cut services and benefits when the financial crisis increased their funding costs.

13. From the lender's perspective, a default terminates the stream of special allowance payments and triggers claim payments from the government. Prepayments of loans similarly terminate the stream of spread payments and result in redemption of principal from the borrower.

14. The extent of such inducements is limited by the Higher Education Act, and enforcement has increased in recent years.

Table 2.

Lending Functions in the Direct and Guaranteed Loan Programs

	Direct Loan Program	Guaranteed Loan Program
Source of Funding	Government (Through the Treasury)	Private capital markets (Through securitization and banks)
Assumption of Default Risk	Government (100 percent)	Government (97 percent)[a] Lenders (3 percent)
Origination	Government (Through schools)	Guaranteed lenders (Through schools)
Servicing	Government (Partly through subcontractors)	Guaranteed lenders (Partly through subcontractors)
Collection	Government subcontractors and Treasury Offset Program[b]	Guaranty agencies for three years, then government subcontractors and Treasury Offset Program[b]

Source: Congressional Budget Office.

a. Under current law, the government's share is set to decline to 93 percent beginning in 2013.

b. The Treasury Offset Program enables the Department of Education to collect from delinquent borrowers by having the Treasury withhold a portion of their federal transfer payments, such as tax refunds or Social Security benefits.

of any excess payments will be retained by lenders.)[15] In the direct program, by contrast, the likelihood of excess administrative payments is diminished by the practice of hiring private contractors through a competitive bidding process.

Comparison of Costs by Function

Lending involves a number of basic functions: origination, servicing, collection on loans in default, risk assumption, and funding. Identifying the differences in how those functions are carried out between the two programs (summarized in Table 2) is helpful in understanding why cost differences arise.

The comparisons below are based on the normal operations of both programs. Thus, they do not reflect the effects of the temporary provisions that lawmakers enacted in 2008 to ensure an uninterrupted supply of credit to students during the financial crisis (see Summary Box 1 on page viii).

Origination. Origination refers to all of the steps required to issue a loan, from application to final approval and disbursement of funds. Most loans in both the direct and guaranteed loan programs are originated through school financial aid offices, which many students rely on to obtain information and advice about loan products and lenders.[16] In carrying out the origination function, schools use software and other support services provided either by the Department of Education (for schools in the direct loan program) or by FFEL lenders (for schools in the guaranteed loan program). Because FFEL lenders compete with one another to attract and retain business, they incur marketing and other expenses that are avoided with direct lending. Those higher origination expenses do not directly affect federal costs because they are not reimbursed, but they do affect whether a given amount of federal payments is sufficient to induce lenders to participate in the guaranteed loan program.

Servicing. Servicing involves the administrative functions associated with billing and collecting interest and principal payments on loans that are in good standing. The government and FFEL lenders rely on many of the same private contractors to perform those functions, and the Department of Education uses a competitive auction process to select its contractors and determine payments

15. For instance, schools encourage students to borrow from a list of "preferred lenders," which thus have a competitive advantage over lenders not listed.

16. An exception is consolidation loans, which are often obtained independently of a financial aid office.

for them. Hence, servicing costs are similar under both programs.

Collection. When a loan made under either program goes into default, it is typically transferred from a regular servicer to a "special servicer" that focuses on collection and recovery. In the direct loan program, those special servicers are private contractors, which the Department of Education chooses through competitive bidding. As an incentive to increase recovery rates, compensation is structured so that contractors keep a share of the money they recover.

In the FFEL program, guaranty agencies—state or private nonprofit entities that administer the federal guarantee and provide a variety of programs and services to schools and borrowers in their state—act as the special servicers. For loans that default, guaranty agencies pay FFEL lenders the insured amount of outstanding principal and interest, using funds supplied by the Department of Education. The guaranty agency then holds and seeks to collect on the delinquent loans for up to three years, keeping a share (that is fixed by law) of any collections.[17] Although that compensation is not determined competitively, it is close to what contract special servicers in the direct loan program receive.

Guaranteed loans that remain outstanding after three years of nonpayment are transferred to the Department of Education and effectively become direct loans. The department and its contractors continue to try to collect on the loans after the transfer and remit the net amounts collected to the Treasury.

Risk Bearing. Since the criteria that determine eligibility for federal direct and guaranteed loans are identical, the two programs attract similar groups of borrowers.[18] Thus, the risks arising from the behavior of borrowers are also similar. The most significant of those risks is the risk of default. The options for borrowers to prepay a loan at any time without penalty or to seek forbearance or deferral also create risks.

Although the risks arising from defaults and prepayments, and the cost of those risks to society as a whole, are much the same for the two programs, the way they are allocated differs. In the direct loan program, the federal government—and hence taxpayers—retain all of the risk. In the guaranteed loan program, the federal government assumes most of the risk, but some of it is transferred to FFEL lenders (and to a lesser extent to the holders of securities backed by guaranteed student loans). The partial shifting of risk to FFEL lenders occurs primarily through the way they are compensated by the government, as well as through the 3 percent loss on loans that default.

Although FFEL lenders are protected by the federal guarantee from most of the losses from default, they bear risk because the government's special allowance payments to them end if a loan is prepaid or goes into default; those payments are reduced if a loan is consolidated by the same lender. When default or prepayment rates are high, lenders may not recover the administrative costs associated with making guaranteed student loans. Thus, the structure of the special allowance payments exposes lenders to market risks, and lenders require higher compensation to participate in the FFEL program because of that risk exposure.[19] The way in which guaranteed loans are funded also transfers a small amount of default and

17. Currently, guaranty agencies receive 16 percent of the recovered amounts (or 8 percent if the recovery is achieved by consolidating the loan). The Department of Education and its contractors may also collect on delinquent guaranteed loans during that three-year period.

18. Despite the similarity of borrowers, some differences in default rates exist between the programs. Default rates on consolidation loans, for example, have been significantly higher in the direct loan program than in the guaranteed loan program. Borrowers can consolidate loans under either program, and FFEL lenders can choose whom they market consolidation loans to at an individual level; therefore, it appears that FFEL lenders have been able to avoid offering consolidation loans to borrowers who are close to default. In addition, guaranty agencies have a financial incentive to rehabilitate the loans of borrowers in default by consolidating them into the direct program.

    Default rates also vary somewhat between the two programs because the programs serve different schools, which attract different groups of students (in terms of backgrounds and economic prospects). Specifically, the FFEL program serves a larger proportion of higher-risk borrowers, as evidenced by its higher default rates. Although CBO takes such differences into account in projecting the cost of each program, they are not relevant for comparisons of the structural factors that determine the cost differences between the programs. Thus, CBO holds the mix of loans constant in the subsidy estimates in this analysis.

19. The Department of Education can decline to accept default claims for loans that have not been properly serviced, which gives rise to a small amount of performance risk for lenders.

prepayment risk from lenders to the capital markets, although contracts are generally structured to minimize the exposure of investors in student-loan-backed securities to the default risk of the underlying loans.

Furthermore, the funding mechanism for guaranteed loans creates some additional risks that are absent in the direct loan program. For instance, the possibility that a lender may not properly service loans—or, more generally, that other problems will interrupt the lender's ability to make payments or cause it to forfeit the federal guarantee—is a source of risk whose costs are avoided by raising funds through the Treasury. Such risks are usually insignificant, but during the recent financial crisis, they probably contributed to the sharply higher funding costs for FFEL lenders.

Financing. The capital markets provide the funding for student loans in both the direct and guaranteed loan programs, but through different mechanisms. In the direct loan program, the government funds loans by issuing Treasury securities. In the FFEL program, lenders fund loans either on their own balance sheets (with deposits or other borrowing) or, more often, by securitizing the loans—that is, by bundling them together to create student-loan-backed securities that are sold to private investors in exchange for a claim to part of the principal and interest payments generated by the underlying loans. Those securities generally carry a variable interest rate that equals the rate on commercial paper plus a fixed spread.[20]

Because the government reimburses FFEL lenders by formula and not according to their actual funding costs, those costs do not directly affect the government's spending. Nevertheless, the government must pay FFEL lenders enough to cover their expenses in order for the program to continue, so the costs that lenders incur to obtain funding affect the extent to which the costs of the guaranteed loan program can be reduced.

Funding a student loan involves two types of costs: the administrative costs associated with obtaining funds and the rate of return that investors require to provide the funding. Securitizing student loans (or raising funds privately by other means) involves higher administrative costs than borrowing through the Treasury does. FFEL lenders that securitize loans incur administrative expenses such as fees to investment bankers to structure and market the securities, fees to the Securities and Exchange Commission, legal fees, and the ongoing costs of managing receipts and payments. The Treasury avoids some of those expenses, and because it issues a very large volume of securities, it benefits from administrative economies of scale in doing so.

The rate of return that investors require depends on the amount and types of risks associated with the claims they receive. FFEL lenders pay higher interest rates than the Treasury does to obtain funds—typically about half a percentage point more under normal economic conditions. (During the recent financial crisis, the rates that investors demanded to hold securities backed by guaranteed student loans peaked at more than 2 percentage points above the Treasury's borrowing costs.) How much of that difference represents a true cost disadvantage for the FFEL program is hard to determine. For instance, if investors in those securities assumed some of the default risk from the underlying student loans, the higher rates could be fair compensation for protecting taxpayers from that risk.

The government guarantee and the structure of student-loan-backed securities protect investors from almost all of the default risk on the underlying loans, so default risk does not seem to explain the higher cost of funds for FFEL lenders.[21] Nevertheless, investors in those securities are exposed to counterparty risk—the possibility that a lender will encounter problems that interrupt its ability to make timely payments or that it will make a servicing error that forfeits the federal guarantee. Investors also bear liquidity risk—the risk that the securities may not be easy to sell quickly without having to offer a price concession.

Several other characteristics of student-loan-backed securities also help explain why investors demand a higher

20. The mismatch between fixed-rate student loans funded with variable-rate debt does not expose FFEL lenders or investors to additional risk because the government effectively swaps fixed student loan payments from lenders for variable interest rate payments to lenders. Most of the variable interest rate payments from the government are passed on to holders of the student-loan-backed securities (the rest is kept by the lenders).

21. FFEL lenders often provide additional protection to investors by retaining a junior claim on a securitized loan pool that pays off only after other investors are repaid in full. Because the securities carry a variable rate, investors also face minimal prepayment risk.

yield on them than on Treasury securities. For example, securities backed by student loans are less liquid, and they are subject to state and local taxes (which Treasury securities are exempt from). Inferring how much those differences contribute to truly higher costs for private funding is difficult. Some of the Treasury's apparent advantages are transfers rather than gains, or they come at a cost to taxpayers. The exemption from state and local taxes has an offsetting cost to the localities that lose tax revenue. The greater liquidity of Treasury securities comes at least in part at a cost to taxpayers—liquidity is enhanced by the safety that stems from the federal power to transfer risk from investors to taxpayers. The scale of Treasury borrowing also contributes to liquidity, but the ability to borrow on so large a scale may also depend on the transfer of risk to taxpayers.

Other characteristics that cause investors to demand a higher return on student-loan-backed securities probably reflect inefficiencies in funding government-guaranteed securities using securitization (or other private means). The complexity of student-loan-backed securities relative to Treasury securities makes them harder to value, and the costs that investors must incur to obtain information and expertise about them reduces their liquidity. Because the underlying student loans are guaranteed by the government, costs incurred to understand the securities and evaluate counterparty and other risks have little apparent value to society. Furthermore, the variation in funding costs that exists among FFEL lenders suggests that some lenders in the program are considerably less efficient than others and that, hence, their higher funding costs have no offsetting benefit to taxpayers.

To the extent that FFEL lenders pay more to fund their borrowing than can be attributed to a transfer of risk from taxpayers to the private sector, the FFEL program has a true cost disadvantage because of counterparty risk, liquidity risk, and securitization inefficiencies not present in the direct loan program. Lenders can profitably remain in the FFEL program only to the extent that special allowance payments compensate them for those additional costs.

Budgetary Costs of the Student Loan Programs

CBO and the Office of Management and Budget calculate the budgetary costs of federal student loan programs on an accrual basis according to guidelines specified in the Federal Credit Reform Act of 1990 (FCRA). Under that law, the cost—known as a credit subsidy—of new federal loans and loan guarantees is recorded in the budget in the year the loans are disbursed. The credit subsidy is calculated as the net present value (as of the year of disbursement) of the government's expected cash flows over the lifetime of a loan or guarantee, using interest rates on Treasury securities of comparable maturity to discount the estimated cash flows. Those subsidy estimates do not include the government's expenses for operating the programs (including the costs of originating, servicing, and collecting on loans); such administrative expenses are shown elsewhere in the federal budget on a cash basis.

By that FCRA accounting, the guaranteed loan program has consistently appeared to be more costly per dollar of lending than the direct loan program. Indeed, FCRA subsidy rates—the subsidy cost per dollar of loan amount—have frequently been negative for the direct loan program, meaning that the loans were credited in the budget with creating savings for the government.

FCRA subsidy rates for loans originated in the direct and guaranteed loan programs—and the difference between the two programs' subsidy rates—vary over time with changing market conditions and program rules. Some of the variation occurs because the terms on loans offered to students and the government's payments to lenders are fixed by statute, whereas the Treasury interest rates used to discount cash flows vary widely as market conditions change. In 2009, FCRA subsidy rates were negative for both programs because the fixed interest rate on new loans was much higher than rates on Treasury securities of similar maturity, which were at historically low levels.

Fair-Value Costs of the Student Loan Programs

Although they are used for federal budgeting, FCRA subsidy estimates are not comprehensive measures of the costs of the federal student loan programs, for two main reasons: They do not take into account the cost of some of the risks that student loans impose on taxpayers, and they omit most administrative costs (which are recorded elsewhere in the budget).[22] Because of the different structures of the direct and guaranteed loan programs, those

22. The same limitations apply to subsidy estimates for other federal credit programs that are accounted for under FCRA.

omitted costs are greater, on balance, in the direct program, which leads to an overstatement of cost differences between the two programs. For those reasons, some analysts have asserted that the reported difference between the subsidy rates of the direct and guaranteed loan programs is not meaningful.[23]

Fair-value subsidy estimates, which include the cost of risk and administrative costs, provide a more comprehensive measure that allows the costs of the two programs to be compared on a level playing field.[24] The fair value of an asset is the price that the asset would bring if it was sold in an orderly transaction between willing market participants on a specified measurement date.[25] In general, the government furnishes a subsidy—on a fair-value basis—whenever it accepts terms on the financing it provides that are more favorable than the terms that participants in private markets would demand to take on comparable obligations and risks.[26] The cost of credit subsidies is ultimately borne by taxpayers, because gains and losses on federal loans or loan guarantees ultimately must be covered through the tax system.

Measured on a fair-value basis, the government's costs of making a loan in both the direct and guaranteed loan programs are higher than those costs as measured under FCRA, and subsidy rates are uniformly positive, meaning that each new dollar of lending under the programs costs the government money. In addition, the adjustments for risk and administrative costs lessen the difference between the two programs relative to FCRA estimates. Even with those adjustments, however, the average subsidy rate on a representative guaranteed loan remains higher than if the same loan was originated in the direct program.[27] The main reason for the higher subsidy rate on guaranteed loans (both on a fair-value basis and under FCRA) is that the costs of administering the FFEL program, including payments to lenders and guaranty agencies, exceed the administrative costs associated with lending through the direct loan program.

Accounting for Costs Omitted from FCRA Subsidies

CBO's fair-value subsidy estimates employ many of the same assumptions and methods that are normally used to estimate costs under FCRA. The two main differences are that discount rates include a risk premium (the additional return that private investors would require to bear the risks of student loans), and federal administrative costs are fully allocated between the two programs.

Using Treasury interest rates to discount expected cash flows on risky loans generally produces higher estimated values for the loans than what private investors would willingly pay for them. Consequently, when the government offers loans to risky borrowers on fair-value terms, those loans appear to make money for the government (that is, they have negative subsidy rates as calculated under FCRA). Moreover, the greater the riskiness of those loans, the higher are the expected gains to the government under FCRA accounting. Similarly, FCRA accounting understates the fair-value cost to the government of federal loan guarantees, and that understatement is higher the greater the risk that is involved. To infer the effects of risk on the fair value of federal obligations for student loans, CBO relied mainly on data about the interest rates charged to borrowers in the private student loan market. CBO also considered patterns in the rates charged for other types of consumer credit.

Excluding administrative costs from FCRA subsidies understates the cost of both programs, but particularly of the direct program, in which all administrative functions are handled and paid for directly by the Department of Education. In the guaranteed loan program, by contrast,

23. See, for example, Dennis Zimmerman and Barbara Miles, "Substituting Direct Government Lending for Guaranteed Student Loans: How Budget Rules Distorted Economic Decision Making," *National Tax Journal*, vol. 47, no. 3 (December 1994), pp. 773–787; and Kevin Bruns, "The Hidden Costs of Direct Loans," *Chronicle of Higher Education*, vol. 53, no. 42 (June 22, 2007).

24. Although fair-value estimates are not used in budgeting for federal credit obligations, CBO values the government's asset purchases under the Troubled Asset Relief Program on what is effectively a fair-value basis, using procedures similar to those specified in FCRA but adjusting for market risk as directed by the Emergency Economic Stabilization Act of 2008.

25. See Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 157: Fair Value Measurement* (September 2006), p. 2.

26. In general, an economic subsidy can exist even though a program has positive net income if the costs that are used to determine net income are not comprehensive. The conceptual issues surrounding estimates of economic subsidies for credit programs are described in Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees* (August 2004).

27. Unless otherwise noted, average subsidy rates are based on averages across all types of loans projected to be originated from 2010 to 2020.

Table 3.

Projected Fair-Value and FCRA Subsidy Rates for Representative Loans and Borrowers, by Fiscal Year

(Percent)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average, 2010–2020
Fair-Value Estimates (Using risk-adjusted discount rates and including administrative costs)												
Direct Loan Program	13	13	11	7	9	11	12	13	13	13	13	12
Guaranteed Loan Program	16	21	20	18	19	20	20	20	20	20	20	20
FCRA Estimates[a] (Using Treasury discount rates and excluding administrative costs)												
Direct Loan Program	-18	-14	-13	-12	-10	-7	-6	-4	-4	-4	-4	-9
Guaranteed Loan Program	-11	1	4	4	6	7	8	8	8	8	8	5

Source: Congressional Budget Office.

Notes: Subsidy rates show the impact on the federal deficit of a dollar's worth of lending under a given program. For example, a subsidy rate of 13 percent means that each dollar of lending increases the deficit by 13 cents.

The subsidy rates in this table are based on the mix of loan types and borrower characteristics projected for the Federal Family Education Loan (FFEL) program in each time period. Thus, the rates reported for the direct loan program represent the cost of making a typical FFEL loan in the direct loan program instead of in the FFEL program. The rates shown here for the direct loan program using the FCRA methodology do not correspond to CBO's published estimates for the direct loan program.

a. Subsidy rates calculated according to the procedures specified in the Federal Credit Reform Act of 1990 (FCRA) are used for federal budget estimates. Those subsidy rates exclude administrative costs (including payments to Department of Education contractors, certain statutory payments for collection costs, and statutory payments to guaranty agencies).

the government payments that compensate FFEL lenders for administrative functions are included in FCRA subsidy rates (categorized as interest). To account fully and symmetrically for federal administrative costs in its fair-value subsidy estimates, CBO allocated the various federal administrative costs between the two programs and between newly originated and outstanding loans on the basis of information from the Department of Education and private lenders. For each program, CBO discounted the lifetime administrative costs for each cohort of borrowers to the disbursement date and included the total in its estimates of fair-value subsidy costs.[28] (For additional information about the discount rates and adjustment for administrative costs, see the appendix.)

Fair-Value Subsidy Estimates

CBO's estimates of subsidy rates for new federal student loans over the next decade are considerably higher on a fair-value basis than under FCRA accounting (see Table 3).[29] Those subsidy rates are based on the characteristics of a representative FFEL loan—one that reflects average default and prepayment behavior by borrowers and the average mix of loan types under current law. The subsidy rates are also based on projections of interest rates and other market conditions from the economic outlook that underlies CBO's March 2010 baseline budget projections. A number of factors account for the year-to-year

28. One reason for excluding administrative costs from subsidy estimates is the difficulty of dividing total costs among individual loan cohorts. However, certain costs, such as for servicing and collection, are relatively easy to estimate, and there are standard approaches for allocating fixed costs among programs.

29. The results presented in this section differ from those in the *Budget of the United States Government: Federal Credit Supplement*, which is prepared by the Office of Management and Budget. That agency reports the costs of consolidation loans separately from the costs of the Stafford or PLUS loans being consolidated. CBO, by contrast, treats consolidation loans as extensions of the original loans, consistent with the principle of recognizing the value of a contractual right (in this case, the right to consolidate) at the time it is granted.

variation in subsidy rates, including rising interest rates and declining risk premiums. The upward trend in market interest rates accounts for the general pattern of higher subsidy rates over time. A slightly offsetting effect for the fair-value estimates is that the risk premium is projected to gradually fall to normal levels as conditions in financial markets improve, which decreases the relative cost of fair-value subsidies in later years.

Adjusting for risk and administrative costs narrows the gap in average subsidy rates on a representative loan between the two programs relative to FCRA estimates but does not eliminate it. On a fair-value basis, the average subsidy rate over the 2010–2020 period is 8 percentage points (20 minus 12) higher for a loan originated in the guaranteed loan program; under FCRA, it is about 13 percentage points (5 minus -9, with rounding) higher. The gap is narrower on a fair-value basis because payments to FFEL lenders are less costly to the government when the risk of those payments is taken into account.

Components of the subsidy rates can be illustrated using estimates for 2020 on a fair-value basis and on an alternative basis in which all cash flows are discounted using Treasury rates—similarly to FCRA estimates, but with the inclusion of administrative costs. The divergence in average subsidy rates is driven largely by the difference between the government's payments to lenders in the guaranteed loan program and federal administrative costs in the direct loan program (see Table 4). The higher cost of payments to lenders in the FFEL program is only partly offset by the share of default losses retained by those lenders. The subsidy rates for the portion of cash flows associated with borrowers' repayments are almost identical in the two programs, regardless of the discount rate used to value them.[30] Payments to guaranty agencies that exceed the amount necessary to cover their costs of collecting on defaulted loans add to the cost of the FFEL program, but by an insignificant amount.

The student loan programs affect not only federal spending but also revenues from corporate income taxes. The different degrees of public and private involvement in the direct and guaranteed loan programs mean that more corporate tax revenues are generated under the guaranteed loan program. Those revenue effects are not included in CBO's subsidy estimates (although they are accounted for elsewhere in the budget). A 2005 study by PricewaterhouseCoopers estimated that the corporate tax receipts produced by the FFEL program had a present value of 1.5 cents per dollar of loans originated.[31] That figure is probably smaller today because of recent reductions to lenders' special allowance payments. Furthermore, the PricewaterhouseCoopers study did not include tax receipts from private-sector contractors for the direct loan program, which would further diminish the difference. Hence, incorporating the effect of taxes would offset only a small portion of the estimated cost difference between the two programs.

Sensitivity Analysis

CBO's fair-value subsidy estimates are highly sensitive to assumptions about a variety of uncertain factors, such as the effect of risk on discount rates and the allocation of federal administrative costs between programs. Nevertheless, under a wide range of assumptions, the guaranteed loan program is consistently more expensive than the direct program, and both programs' subsidy rates are significantly positive on a fair-value basis.

Sensitivity to Risk Adjustment of Discount Rates. The rates used to discount cash flows on federal student loans, which CBO inferred primarily from interest rates charged on private student loans, involve considerable uncertainty, for several reasons. First, rates from a private market may not accurately represent the risk of federal loans (for instance, loan terms and characteristics of borrowers differ). Second, those rates can fluctuate considerably over time with market conditions. If the risk premium for student loan cash flows was 1 percentage point higher than that assumed in CBO's base case, subsidy rates would increase by 6 percentage points for a typical loan made in the FFEL program, and by 8 points if the same loan was made in the direct program. (A reduction of 1 percentage point in the risk premium would decrease subsidy rates by the same amounts.) In the case of direct loans, that effect is most easily understood as the higher discount rate reducing the value of future repayments. For guaranteed loans, greater market risk has the effect of

30. A small difference arises because in the direct loan program the government pays for certain benefits to borrowers.

31. PricewaterhouseCoopers, National Economic Consulting Group, *The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs* (Washington, D.C.: Pricewaterhouse-Coopers, March 3, 2005), available at www.studentloanfacts.org/resources/.

Table 4.

Components of Estimated Subsidy Rates for Loans Made in Fiscal Year 2020

(Percent)

	Fair-Value Subsidy		Subsidy Computed with Treasury Discount Rates[a]	
	Guaranteed Loan Program	Direct Loan Program	Guaranteed Loan Program	Direct Loan Program
Loan Disbursement	100.0	100.0	100.0	100.0
Present Value of Loan Payments[b]	-89.5	-88.8	-103.5	-102.7
Loan Subsidy	10.5	11.2	-3.5	-2.7
Federal Administrative Costs[c]	0.7	2.2	0.8	2.5
Lenders' Share of Default Losses	-1.3	n.a.	-0.3	n.a.
Payments to Lenders[d]	9.4	n.a.	13.0	n.a.
Payments to Guaranty Agencies[e]	0.9	n.a.	1.0	n.a.
Total Subsidy	**20.2**	**13.4**	**11.0**	**-0.2**

Source: Congressional Budget Office.

Notes: All components of the subsidy are based on the mix of loan types projected for the Federal Family Education Loan (FFEL) program in 2020. Thus, the subsidy rate reported for the direct loan program represents the cost of making a typical FFEL loan in the direct loan program instead of in the FFEL program.

n.a. = not applicable.

a. The subsidy rates shown in these columns do not follow the methodology specified in the Federal Credit Reform Act. Although cash flows are discounted at Treasury rates, as required under FCRA, they include various administrative costs and other payments that CBO would normally exclude to comply with FCRA requirements.

b. Includes collection costs and origination fees. The present value of loan payments for the direct loan program is different than for the guaranteed loan program because borrowers in the direct program pay lower interest rates on PLUS loans and may receive other discounts.

c. Excludes collection costs, which are included with loan payments.

d. Includes special allowance payments to lenders minus various statutory fees that lenders pay (and excluding lenders' share of default losses, which is shown separately). Lenders may use those payments to offer benefits to borrowers and services to schools as well as to defray various costs of financing and administering loans.

e. Includes fees for loan processing and account maintenance. (Payments received for loan collection are included with loan payments.)

increasing the present value of payments made on guarantee claims for defaulted loans.

Incorporating a risk premium into estimates also lowers the present value of some federal payments to lenders, which narrows the cost difference between the two programs. The rates that CBO used to discount those projected payments differ from the rates it used to discount loan cash flows, because the two streams of cash flows involve different amounts of risk and differ in the extent to which they depend on fixed versus variable interest rates. CBO's imputation of the discount rate for payments to FFEL lenders depends in part on the interest rate spread over Treasury rates that those lenders pay to finance their guaranteed student loans. That spread has varied over time and among lenders, ranging from as little as 0.3 percentage points above the yield on Treasury securities for the most efficient lenders to more than 2 percentage points during the financial crisis.

The appropriate discount rate for federal payments to FFEL lenders depends on how much of the spread over Treasury rates that lenders pay to fund their borrowing can be attributed to an offsetting savings to taxpayers from a transfer of risk to the private sector. The greater the transfer of risk, the higher the appropriate discount rate, but the amount of that risk transfer is highly uncertain. CBO discounted the variable-rate payments at a rate that was 0.3 percentage points higher than the comparable Treasury rate. Increasing that spread above the

Treasury rate to 0.6 percentage points decreases the subsidy rate on FFEL loans by about 2 percentage points.

Sensitivity to Administrative Costs. For its fair-value calculations, CBO divided unallocated cash administrative costs between the two programs according to their relative dollar amounts of loans outstanding. That approach may overstate the administrative costs of the guaranteed loan program if most administrative functions are performed by FFEL lenders. An alternative approach, which provides the most favorable case with regard to the cost of the guaranteed loan program, is to assume that all of the unallocated administrative costs reported by the Department of Education are used for expenses of the direct loan program. With that change in assumptions, the difference between the average cost of the two programs falls from about 8 percentage points to 5.5 percentage points.

Policy Options

Policymakers have considered a variety of modifications to the federal student loan programs—some aimed at reducing the costs of the programs to the government and others intended to change the loan terms available to borrowers. In evaluating options to modify those programs, it is useful to consider the various ways in which federally backed credit for education can improve social welfare, as well as the potential drawbacks of such credit.

The benefits to students from federal loans may exceed the fair-value cost to the government of providing them if the private market for student loans operates imperfectly. For example, private lenders cannot profitably lend to all borrowers if they cannot effectively evaluate differences in the risk of default. Because their ability to evaluate that risk is limited, in a purely private market some borrowers would wind up being denied credit.[32] However, some evidence suggests that federal policy has been effective at easing such constraints for most students.[33] Thus, when considering new policies to relieve financial constraints, it may be most cost-effective to focus on constraints faced by subsets of the population that still have limited access to what they perceive as affordable credit (or other means of financing an education). It may also be cost-effective to examine policies in which the government adjusts repayment terms to accommodate borrowers' risky or low-paying career choices or to help borrowers during periods of financial distress. Such policies can provide valuable insurance that would not be feasible for borrowers to obtain privately because of the losses it would entail for private lenders.

The benefits of subsidizing education may also outweigh the costs when education produces benefits for society in addition to the private benefits enjoyed by the student. Students may fail to take those social benefits into account when making choices about their education, which provides a case for government subsidization. A number of studies offer evidence of such social benefits.[34] Others, however, suggest that social benefits have proved difficult to identify and quantify and that the case for further subsidizing higher education may be weaker than the case for the current level of subsidies.[35]

An unintended consequence of making subsidized credit available is that it may cause some people to overinvest in higher education. Such overinvestment could take the form of students' choosing formal higher education in place of cheaper on-the-job training or instead of entering the labor force sooner. Students may also be harmed by easy access to credit if they underestimate the burden of paying off their loans later on. In addition, there are

32. Although the government is unlikely to have an advantage over the private sector in evaluating risk, it can alleviate borrowing constraints by lending to people who would be denied credit by private lenders (thereby providing a subsidy to those borrowers).

33. For example, one study concludes that fewer than 8 percent of student loan borrowers are constrained; see Pedro Carneiro and James J. Heckman, "The Evidence on Credit Constraints in Post-secondary Schooling," *Economic Journal*, Royal Economic Society, vol. 112, no. 482 (October 2002), pp. 705–734.

34. See Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence from Longitudinal and Repeated Cross-Sectional Data," *Journal of Econometrics*, vol. 121, no. 1–2 (July–August 2004), pp. 175–212. In that analysis, Moretti concluded that college education creates positive spillovers in productivity and wages. See also Eric Hanushek and Ludger Woessmann, *Do Better Schools Lead to More Growth? Cognitive Skills, Economic Outcomes, and Causation*, Working Paper No. 14633 (Cambridge, Mass.: National Bureau of Economic Research, January 2009). In that analysis, the authors found empirical evidence of a causal relationship between educational attainment and growth rates among countries. For a discussion of the relationship between post-secondary education and social mobility, see Robert Haveman and Timothy Smeeding, "The Role of Higher Education in Social Mobility," *Future of Children: Opportunity in America*, vol. 16, no. 2 (Fall 2006), pp. 125–150.

35. See James J. Heckman and Peter J. Klenow, "Human Capital Policy," in Michael Boskin, ed., *Policies to Promote Capital Formation* (Stanford, Calif.: Hoover Institution, 1998).

probably some borrowers for whom the availability of federal student loans does not alter their educational attainment. In the case of those borrowers, a federal credit subsidy is simply a transfer payment to them from taxpayers as a group.[36]

Reducing the Federal Cost of the Guaranteed Loan Program

Policy options that have been discussed for lowering the federal cost of the FFEL program include replacing it entirely with direct lending, funding all federal student loans through the Treasury but continuing to have private lenders perform administrative functions, cutting government payments to lenders, reducing the guarantee percentage on loans, and auctioning off the right to lend under the program.

Replace Guaranteed Lending with Direct Lending. The President's 2011 budget proposed eliminating the FFEL program after July 1, 2010, and replacing it with an expansion of the direct loan program.[37] CBO recently estimated that under FCRA accounting, that proposal would reduce mandatory spending by a total of $68 billion over the 11 years from 2010 through 2020.[38] At the same time, however, discretionary spending for administrative costs in the direct loan program would increase, so the net budgetary savings over the 2010–2020 period would amount to about $62 billion. The savings on a fair-value basis (taking into account the cost of market risk and the present value of future administrative costs) were estimated at about $40 billion for that period. The cost reduction results primarily from eliminating federal payments to FFEL lenders that exceed the administrative costs associated with loans in the direct program. The savings are smaller on a fair-value basis because that measure, which takes into account the risk associated with those payments, assigns them a lower cost to the government and thus finds a smaller benefit from eliminating them.

36. Because transfer payments must be paid for with taxes that distort people's incentives to work and invest, such subsidies have social costs as well.

37. The House of Representatives recently passed legislation (H.R. 4872, the Health Care and Education Affordability Reconciliation Act of 2010) that would implement that proposal, and the Senate is considering the legislation.

38. Congressional Budget Office, letter to the Honorable Judd Gregg about the budgetary impact of the President's proposal to alter federal student loan programs (March 15, 2010).

Finance Guaranteed Loans Through the Treasury. An option that would avoid the higher funding costs of the FFEL program and prevent disruptions in the supply of credit would be to fund all federal student loans through the Treasury. Under that approach, the Treasury would buy the loans made by FFEL lenders, but the infrastructure of the FFEL program would be retained for other administrative functions. At the same time, payments from the government to lenders could be reduced by the amount of the savings from lower funding costs. To realize similar savings from that change as from eliminating new guaranteed lending entirely, however, compensation for administrative services under the FFEL program, including services performed by guaranty agencies, would have to be set on a competitive basis rather than by statute, as in current law.

Switching to financing all federal student loans through the Treasury would increase the amount of federal debt outstanding, but that increase would be offset by a decrease in federally guaranteed private debt. Because federal obligations would essentially be unchanged, and because federal debt would increase by only a small percentage, CBO expects that the effect on the government's borrowing costs would be negligible. However, the increase in the size of the federal debt would affect its relation to the statutory debt ceiling.

Reduce Payments to Lenders or the Percentage of the Federal Guarantee. CBO's analysis suggests that a major reason for the higher cost of the FFEL program is the fact that, under normal conditions in financial markets, statutory compensation to lenders exceeds estimated administrative costs in the direct loan program.[39] Lowering lenders' spread over the interest rate on three-month commercial paper by, for instance, 0.4 percentage points from current levels would reduce the fair-value subsidy rate on guaranteed loans by 3 percentage points.

Another way to reduce the cost of the FFEL program would be to lower the guarantee percentage. Currently, the government guarantees 97 percent of a loan's outstanding principal and interest for most lenders; that figure is scheduled to fall to 95 percent in 2013. Lowering the guarantee to 90 percent would reduce the fair-value

39. The abnormally high funding costs for FFEL lenders in the current market environment have absorbed those excess payments, but CBO expects that making guaranteed loans will again become profitable for lenders as market conditions improve.

subsidy rate on guaranteed loans by 2 percentage points. Cutting the guarantee percentage could have the effect of narrowing the set of potential investors willing to buy student loans—because riskier loans require more expertise to evaluate—thereby increasing the funding costs of FFEL lenders and the compensation necessary to induce them to participate in the program.

Reducing special allowance payments or the guarantee percentage could have other consequences as well. Such cuts might leave some lenders with too little cash coming in to recover their funding and administrative costs, even under normal market conditions. Some lenders would probably leave the program and be replaced by lower-cost lenders or by the direct loan program. Lenders would also be likely to reduce the benefits and services they offer to borrowers. Moreover, FFEL lenders might find it unprofitable to serve borrowers or schools whose loans have higher risks and are more costly to finance and administer, which could force those schools into the direct loan program. Cutting payments to or protections for lenders would also increase the probability that emergency interventions would be needed in the event of future market disruptions. Those effects are hard to quantify—because of the difficulty in assessing costs across the diverse range of schools, borrowers, and lenders in the guaranteed loan program—and CBO did not attempt to do so.

Add Competitive Auctions. Auctioning off the rights to originate or hold guaranteed student loans has been proposed as a market-based alternative to cutting lenders' payments or the guarantee percentage. In a well-designed auction, the winning bids would reflect the cost of funding and administering loans for the most efficient lenders, eliminating the excess profits that arise when compensation is fixed in legislation.[40] To explore this possibility, the College Cost Reduction and Access Act of 2007 mandated a pilot auction program for PLUS loans. But the initial attempt to implement it failed to attract any bidders, and the program was postponed for two years.

Several factors may limit the ability of auctions (or any similar mechanism) to substantially reduce the difference in subsidy rates between the two loan programs. Historically, private lenders have offered better service at greater cost than the direct program does. Lenders may bid less aggressively if they expect that they will need to maintain higher service levels to attract borrowers—particularly if winning an auction does not guarantee exclusive access to a pool of borrowers. Similarly, lenders' administrative costs include marketing expenses, which winning bidders will continue to incur if the auction does not guarantee them a certain volume of lending, and which they will therefore factor into their bids. Furthermore, to the extent that FFEL lenders have higher financing costs, the bid price will continue to incorporate those higher costs. Collusive bidding is also a concern, especially in an industry dominated by a few large participants.

Restructuring Loans

The Congress has periodically changed the interest rates and other terms on federal student loans to meet goals such as increasing the affordability and availability of credit for students or preventing defaults. The structure of student loans also affects the level and volatility of federal program costs (as measured on both a fair-value and a FCRA basis).

Interest Rates. Policy options for modifying the interest rates charged to borrowers include raising or lowering the current fixed rates; indexing those fixed rates to a market interest rate; or changing from fixed rates to variable rates, with an upper limit, or cap, on the variable rates. In the past, the direct and guaranteed loan programs have switched several times between charging a fixed interest rate set in statute and charging a variable rate (tied to a market index) with a cap. Since July 2006, loans made under either program have carried fixed interest rates.

Since 1998, borrowers have been able to consolidate their Stafford and PLUS loans into a single loan with a fixed interest rate equal to a weighted average of the interest rates on the underlying loans. For borrowers with variable-rate loans, the right to consolidate is a valuable option—in many cases it allows borrowers to lock in fixed interest rates that are well below the alternatives available in private markets. Taking into account historical variation in interest rates (and using discount rates adjusted for risk), CBO concluded that the right to consolidate variable-rate loans added approximately 2 percentage points to the subsidy rates for direct and guaranteed student loans.[41]

40. For an assessment of the options and issues involved in designing an auction program, see Department of Education and General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, GAO-02-84SP (December 18, 2001).

41. Congressional Budget Office, *The Cost of the Consolidation Option for Student Loans*.

The federal costs of the student loan programs are very sensitive to the interest rates on the loans. For instance, each decrease of 1 percentage point in the interest rate charged to borrowers increases the fair-value subsidy rate by approximately 7 percentage points. The increase is slightly higher for FCRA subsidy rates (because discounting at a lower rate makes reductions in interest payments that occur in the future more costly to the government in present-value terms).

Fixing by statute the rate charged to borrowers has the effect of adding considerable volatility to the cost of the federal student loan programs over time, whether measured under FCRA accounting rules or on a fair-value basis. Under the assumptions of a fixed 6.8 percent rate on Stafford loans and future interest rate levels and volatility consistent with experience, the fair-value subsidy rate on a loan issued in 2014 would have a 10 percent probability of being at least 6 percentage points more than currently projected purely because of variation in future interest rates. Setting interest rates by statute also causes the subsidies that different cohorts of borrowers receive to differ considerably; the greatest benefits go to students who happen to attend college when market interest rates are well above the statutory rate on student loans.[42] Conversely, when market interest rates are low, students receive relatively little federal subsidy.

One way to avoid large fluctuations in the subsidy cost of federal student loans over time would be to index interest rates to a market rate. In the case of fixed-rate loans, the yield on long-term Treasury securities could provide an appropriate index; for variable-rate loans, the yield on short-term Treasury bills could provide such a base.[43] A concern about indexing is that it exposes students to the possibility of being charged high interest rates. However, high interest rates tend to occur during periods of high expected inflation, when future income is also likely (though not certain) to grow at a faster-than-average rate. An alternative approach that would make subsidies less volatile than under current law, but that would protect students from unusually high interest rates, would be to index interest rates and also put a cap on them. Such a cap exists now for variable-rate student loans that were made before the switch to fixed rates in July 2006.

Repayment Terms. The repayment terms offered to borrowers affect the costs of the student loan programs because they can influence the probability and severity of defaults as well as the length of time that subsidized loans remain outstanding. Repayment terms also have a significant impact on the welfare of borrowers—for instance, by affecting how much flexibility they have in their future career choices. Options for modifying those terms include changing the current forbearance and deferment policies and introducing additional loan-forgiveness policies that would be contingent on a borrower's income or career.

In the past, student loans had the highest rates of default of any federal credit program. High default rates are not surprising given that most student borrowers have few assets after graduating and student loans are unsecured. Default rates and losses from defaults have fallen dramatically over time, however, because of various factors specific to the loan programs as well as other legal and economic developments. Changes to the bankruptcy code generally prevented federal student loans from being discharged, or erased, during bankruptcy proceedings (with some exceptions). In addition, use by FFEL lenders of the default-averting provisions of federal student loans—such as forbearance and deferment, which allow borrowers to temporarily stop making payments—has become more common.[44] And individual schools and lenders have increased their oversight of loan performance. In particular, the Department of Education excludes schools and lenders from participating in the student loan programs if they exceed specified thresholds for two-year default rates on individual cohorts of loans.

42. Offering similar subsidy rates to all cohorts may be perceived as fair. However, policymakers might want to offer different subsidies to different cohorts for various reasons. For instance, cohorts that graduate when the labor market is weak tend to experience persistently poorer employment prospects, which may justify a higher subsidy for those groups. There is considerable variation in the amount of time between when a borrower takes out a loan and when repayment begins, and market conditions may change in the interim. Thus, the variation in subsidy rates over time caused by fixing interest rates by statute is unlikely to efficiently help borrowers who graduate during recessions.

43. A return to variable-rate lending would transfer to students the interest rate risk that is now borne by the government.

44. Private lenders also offer forbearance on nonguaranteed student loans because doing so for a borrower who faces a short-term liquidity problem can be less costly to a lender than trying to collect on the same loan in default. Nevertheless, the use of forbearance on student loans is less pervasive in the private market than in the federal programs.

Some of the decline in default rates may also have resulted from the strong performance of the overall economy and the growth in demand for college graduates over the past several decades. However, in the aftermath of the recent deep recession, with the unemployment rate remaining high, default rates may be above their recent levels for at least the next few years.

Although forbearance and deferment policies avoid some defaults, they also entail significant costs for the government because they lengthen the average repayment period of a loan at below-market interest rates. Under current law, forbearance for as long as three years is available to borrowers who can show evidence of financial hardship.[45] In addition, borrowers in both programs can defer repaying existing loans by starting a new course of study. And students have a six-month grace period after they leave school before they must begin repayment. Data suggest that a typical borrower spends about three years in grace and deferment.

The recovery rate on defaulted loans—the present value of the cash flows recovered for each dollar of loans in default (net of the costs of collection)—also affects the cost to the government from borrowers' defaults. The Department of Education has strong collection mechanisms available that bolster its recoveries. The inability of borrowers to have their student loans discharged in bankruptcy proceedings extends the period over which delinquent loans can be collected to the entire lifetime of the borrower.[46] Besides using private loan-collection agencies, the department can garnish the wages of delinquent borrowers and use the Treasury Offset Program to collect a portion of federal transfer payments (such as tax refunds or Social Security benefits) that they receive.

The department can charge the full cost of collecting on a defaulted loan to the borrower, which theoretically means that 100 percent of the outstanding principal and interest on the loan is collectible. In practice, however, recovery rates are lower than that because some borrowers never repay in full (such as those who evade collection, remain in a perpetual state of poverty, become disabled, or die) and because the department has discretion to negotiate settlement terms and waive collection costs. From a fair-value perspective, even if 100 percent of the outstanding principal and interest, plus collection costs, were recovered by rehabilitating or consolidating a loan, the private sector would value that recovery at less than 100 percent. The reason is that the collection process extends the time that the loan is outstanding and earning an interest rate less than market rates.

Strong collection mechanisms reduce the costs of default to the federal government, but they may harm the very populations that student loans are intended to help. Delinquencies on student loans are reported to the national credit bureaus, which reduces those borrowers' ability to obtain further credit, jobs, and housing, especially if they fail to complete their course of study. That situation has led some policymakers and analysts to advocate broadening the existing provisions for loan forgiveness and income-contingent repayment, which currently play only a minor role in the student loan programs.

Greater loan forgiveness and more reliance on income-contingent repayment have also been proposed as options to reduce the debt burden on certain groups of students. The idea is that borrowers who have less ability to pay because of a personal misfortune or choice of career (such as the military, public service, or teaching) should be allowed to pay less for their education than borrowers with greater resources. In a carefully designed program, some of the costs of subsidizing borrowers who ultimately are less able to repay their loans may be covered by charging higher fees or interest rates to borrowers who can repay—much as insurance programs do. Such insurance provisions would be unique to federally provided credit because the ability to cross-subsidize borrowers depends on having market power: In a competitive private market, if a single small lender tried to charge a high-income borrower an above-market rate, the borrower would repay the loan with money borrowed at a lower rate from another lender. The federal government can avoid that problem by setting rates that are lower than market rates, including for high-income borrowers.

45. Some deferments also are available on a hardship basis.

46. For other types of unsecured loans, state-level statutes of limitations typically prevent loans from being collected beyond a certain window of time (generally 3 to 10 years).

Appendix: Assumptions and Analysis Underlying CBO's Fair-Value Subsidy Estimates

The Congressional Budget Office's (CBO's) fair-value estimates of the cost of student loan programs depend on the same cash flows assumed for the estimates that follow the accounting procedures specified in the Federal Credit Reform Act of 1990 (FCRA). However, to calculate the fair-value estimates, CBO used additional information and assumptions in order to allocate federal administrative costs between the direct and guaranteed loan programs and among different loan cohorts as well as to derive discount rates adjusted for risk. This appendix describes the information and assumptions that CBO used.

Administrative Costs

The federal costs that CBO classifies as administrative are recorded in the budget on a cash basis, as required by FCRA, for both student loan programs.[1] In the Federal Family Education Loan (FFEL) program, the Department of Education directly bears some of the administrative costs of guaranteed loans (such as the costs of collecting on loans that have been in default for more than three years and of supporting schools' financial aid offices); those costs are recorded together with the total administrative costs for the direct loan program. At the same time, some of the department's payments to FFEL lenders (which cover administrative costs such as loan servicing) are classified in the budget as part of mandatory interest payments, and the present value of those costs for each loan cohort is included in FCRA subsidy estimates.[2] As a result of that accounting, the administrative costs that appear in the budget on a cash basis are a mixture of costs from old and new student loans and from the FFEL and direct loan programs. To estimate the lifetime federal administrative costs attributable to newly originated loans in each program for its fair-value estimates, CBO relied primarily on data from the Department of Education. Detailed information on administrative costs was limited; CBO used data from the 2006 program year to impute the normal allocation of federal administrative costs, by activity, between the two programs. Because the factors that determine administrative costs and the proportion coming from each program are likely to be similar from year to year (under normal market conditions), that approach is unlikely to create a bias in estimates for future years, in CBO's judgment. The sensitivity analysis discussed earlier in this study also shows that the resulting estimates are not very sensitive to assumptions about the allocation of federal administrative costs.

In 2006, the annual appropriation to the Department of Education for the direct and guaranteed loan programs totaled approximately $800 million. In information given to CBO at that time, the department reported allocating about $200 million of the appropriation to servicing contracts in the direct loan program, $30 million to origination contracts in the direct loan program, and $200 million to recovery contracts in both programs. In its base-case analysis, CBO assumed that approximately

1. Some of the programs' administrative costs are mandatory, and others are discretionary. The mandatory portion involves items in the guaranteed loan program, such as fees to guaranty agencies, that are required by law to be paid.

2. Those payments also cover benefits to schools and borrowers that might not be considered basic administrative costs. In addition, the Office of Management and Budget's FCRA subsidy estimates include federal payments to guaranty agencies for collection costs and fees, but CBO's FCRA subsidy estimates do not.

half of the unallocated $370 million was attributable to administration in the guaranteed loan program, one-quarter to administration in the direct loan program, and the remaining one-quarter to administration in the Pell grant program. Those amounts yield an estimate that the government's annualized origination and servicing costs equal about 0.3 percent of outstanding loan balances in the direct loan program and 0.1 percent in the guaranteed loan program. To produce fair-value subsidy rates, those estimates of administrative costs were applied to projected loan balances and discounted to the present.

The costs incurred by FFEL lenders and guaranty agencies do not directly affect government spending because federal payments to lenders do not depend directly on lenders' actual expenses. However, an estimate of those expenses is necessary to calculate the cost of capital for student loans and to identify the causes of the higher costs in the FFEL program.[3] Using an analysis of the reported administrative costs of a large FFEL lender in 2006, CBO estimated that origination and servicing costs totaled 0.67 percent of outstanding balances for guaranteed loans, slightly more than twice the costs in the direct loan program. The greater costs for FFEL lenders can be attributed at least in part to higher service levels to students and schools, as well as to higher marketing costs arising from the need to compete with other lenders. CBO's estimates of administrative costs for FFEL lenders involve considerable uncertainty, both because data are limited and because administrative costs are likely to vary greatly among lenders according to their size and efficiency.

Fair-Value Cost of Capital

The cost of capital refers to the expected return that private investors require on a risky security to be willing to buy it. CBO used the interest rates charged to borrowers on private student loans, adjusted for administrative costs, as the starting point for inferring the fair-value cost of capital for federal student loans. That cost of capital in turn was used to derive risk-adjusted discount rates.

The main lenders in the private loan market are also the largest FFEL lenders: Sallie Mae, major national and regional commercial banks, and nonprofit entities. FFEL lenders have a competitive advantage over other potential entrants in the private student loan market because of economies of scale in marketing, systems administration, and funding as well as the experience gained from guaranteed lending. Borrowers turn to private lenders—whose rates usually exceed those on federal student loans—when they have exceeded their federal lending limit or do not qualify for a federal loan.

An important consideration in using private student loans to infer the cost of capital for federal loans is whether the risks of federal and private student loans are similar. Several factors suggest that private loans may be safer: Repayment is usually over a shorter period, and students with low credit scores are unlikely to be given loans. However, students who take out private loans tend to have higher levels of total indebtedness, which could reduce recovery amounts in cases of default. Private lenders also have the risk of adverse selection—students who are poor credit risks will be more inclined to try to borrow than students who are likely to repay. The federal programs are less susceptible to adverse selection because, by offering very favorable rates, they are more likely to attract safe borrowers as well as riskier ones. CBO assumed similar loss rates on federal and private loans on the basis of those offsetting considerations and limited data that suggest that historical loss rates from defaults have been broadly similar.[4]

The first step in adjusting for risk in CBO's fair-value calculations is to estimate what portion of the spread between the interest rate charged to borrowers on private loans and the rate on Treasury securities of comparable maturity represents the student loan risk premium—the compensation that private investors require to invest in student loans over and above expected losses from default.[5] Before the recent financial crisis, lenders typically charged borrowers variable interest rates on private

3. Administrative costs affect the interest rates that private lenders charge to borrowers because that is how lenders recover those costs. Administrative costs for FFEL and private lenders are likely to be similar, given that the large FFEL lenders also make private student loans. CBO used the interest rate charged on private loans, adjusted downward for the portion covering administrative costs and other factors, to infer the cost of risk.

4. That inference is based on confidential data provided to CBO by a private lender. There is no public source of data on default and recovery rates for private student loans.

5. Private student loans generally carry variable rates, whereas federal student loans carry fixed rates. Nevertheless, the spread between the rate charged on a private variable-rate loan and a short-term Treasury rate is a reasonable proxy for the premium that investors require for the default risk associated with federal student loans.

student loans that were about 4 percentage points higher than the London interbank offered rate, or Libor (a short-term rate that banks charge other high-quality banks to borrow). Conceptually, that spread includes compensation for expected default losses, administrative costs, and a risk premium. CBO attributes approximately 2 percentage points of the spread to administrative costs and losses from defaults, which leaves 2 percentage points as an estimate of the premium over Libor for private student loans in 2006, when credit conditions were relatively easy. At the time, Libor rates were about 0.3 percentage points over Treasury rates, implying a risk premium of 2.3 percentage points.

During the financial crisis, spreads on student loans widened sharply, and private loans became much harder to obtain. CBO recently collected information from a large lender about rate spreads on private student loans and the credit quality of borrowers. Adjusting for administrative costs, and taking into consideration the disrupted market conditions, CBO estimates that the fair-value risk premium on private student loans was about 4 percentage points over Treasury rates in early 2010.[6] CBO assumes that after 2013, the risk premium will gradually decline to a long-term level of 2.5 percentage points as market conditions return to normal and the economy improves.

FFEL lenders' net receipts reflect a combination of payments from borrowers, the federal government, and the capital markets in which the loans are funded. Considering the combined effect of those net payments suggests that some of the lenders' cash flows should be discounted at close to a short-term Treasury rate, whereas others are affected by default and prepayment risk and should be discounted at a higher rate that is based on the inferred risk premium on student loans. CBO takes those considerations into account in determining the fair-value discount rates for payments to FFEL lenders.[7]

Estimating Subsidy Rates

CBO computes fair-value subsidy rates for the direct and guaranteed loan programs by applying discount rates imputed from the cost of capital to the programs' various cash flows. In the direct loan program, the stream of borrowers' payments net of collection costs and some administrative costs is discounted at the Treasury rate plus a spread that varies from 1 percentage point to 6 percentage points depending on the default rate associated with the type of loan. The subsidy rate for the direct loan program is the present value of cash flows per dollar of loans, net of the amount disbursed and up-front fees. The components of the subsidy for a direct loan (assuming the risk profile of a typical loan made in the FFEL program) are shown in Table 4 on page 12.

To properly account for differences in the risk of different cash flows in the guaranteed loan program, CBO computes subsidy rates by considering two sets of cash flows whose difference equals the government's net cash flows. The first set is borrowers' payments of principal and interest to FFEL lenders. The second set is the net payments that lenders receive from borrowers and the federal government, which include special allowance payments, payments of default claims, and various fees.[8]

The first set of payments (from borrowers to lenders) is valued in the same way as for the direct loan program: by discounting expected cash flows using a Treasury rate plus a risk premium that is adjusted for the risk of the loan pool in question. The second set of payments (from borrowers and the government to lenders) generates a stream of variable payments that is indexed to a short-term commercial-paper rate, plus a fixed spread, plus the amounts recovered from the government if a loan defaults. CBO discounts the variable payments and principal payments at a rate that is only slightly above the rate

6. The reported rates charged on private loans in 2009 ranged from Libor+4 percentage points to Libor+13 percentage points, with an average of Libor+11 percentage points. CBO judged that the high average spread reflected not only the riskiness of borrowers but also the shortage of risk capital in the market; as a result, CBO based its estimate of the cost of capital on a below-average spread.

7. To discount the variable-rate payments included in lenders' special allowance payments under FCRA, CBO uses a Treasury rate that corresponds to the maturity of the underlying loans. Fair-value estimates discount the payments at a short-term rate because variable-rate liabilities are economically equivalent to short-term liabilities. The effect of using a long-term Treasury rate is typically to bias downward the present value of those payments relative to their fair value.

8. In this breakdown, any benefits to borrowers that are paid by the lender are excluded from the first set of cash flows and included in the second set. Certain payments to guaranty agencies and other federal administrative costs are omitted from this breakdown, but CBO took their contribution to the subsidy into account; that contribution is computed by applying discount rates that reflect the risk of those cash flows.

on short-term Treasury securities, because the value of those cash flows is largely unaffected by default risk. However, some components of a lender's cash flows, such as its share of credit losses and a portion of the fixed spread received, are more risky because they are sensitive to borrowers' defaults and prepayments. Consequently, those components are discounted at higher rates.

A large part of the stream of combined payments from the government and borrowers to FFEL lenders corresponds to what the lenders pay out in interest to holders of the student-loan-backed securities that they issue. Principal on such securities is redeemed as loans are repaid or default. Holders of the securities typically earn a variable interest rate (indexed to Libor) plus a spread. The spread has averaged about 0.2 percentage points under normal market conditions, but it widened to as much as 2 percentage points during the recent financial crisis. Equivalently, the rate is about 0.5 percentage points over the rate on short-term Treasury securities during normal times. That spread is difficult to understand given that the federal government bears most of the risk of loss associated with the securities and that the floating rate coupon helps insulate investors from price fluctuations. In its base-case estimates, CBO attributes about three-fifths of the normal spread over Treasury rates to a transfer of risk from the government to lenders. CBO judges that the remainder is attributable to a cost disadvantage for FFEL lenders resulting from counterparty risk, liquidity risk, and securitization inefficiency that are not present in the direct loan program.

THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL

TUESDAY, FEBRUARY 2, 2010

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

The Committee met, pursuant to notice, at 10:02 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Wyden, Nelson, Sanders, Whitehouse, Warner, Merkley, Gregg, Sessions, Ensign, and Alexander.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

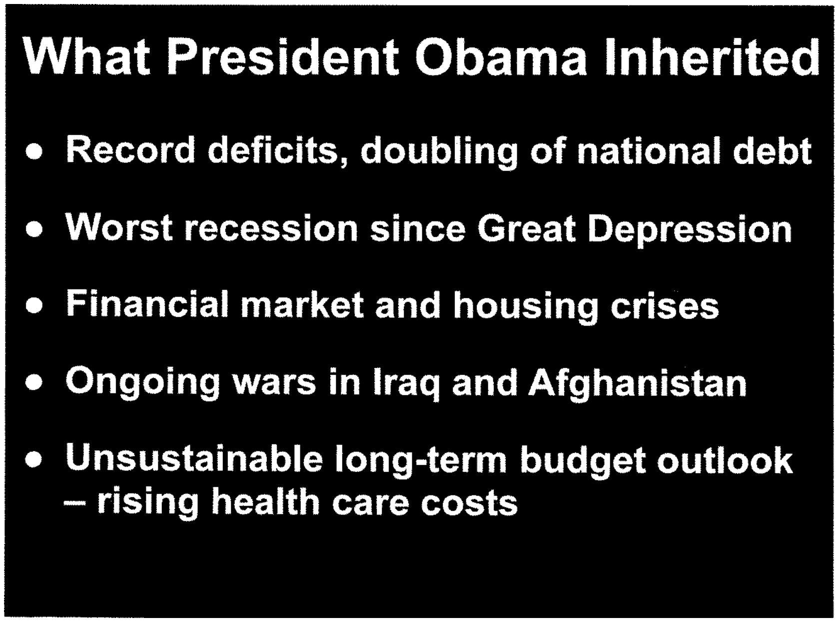
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

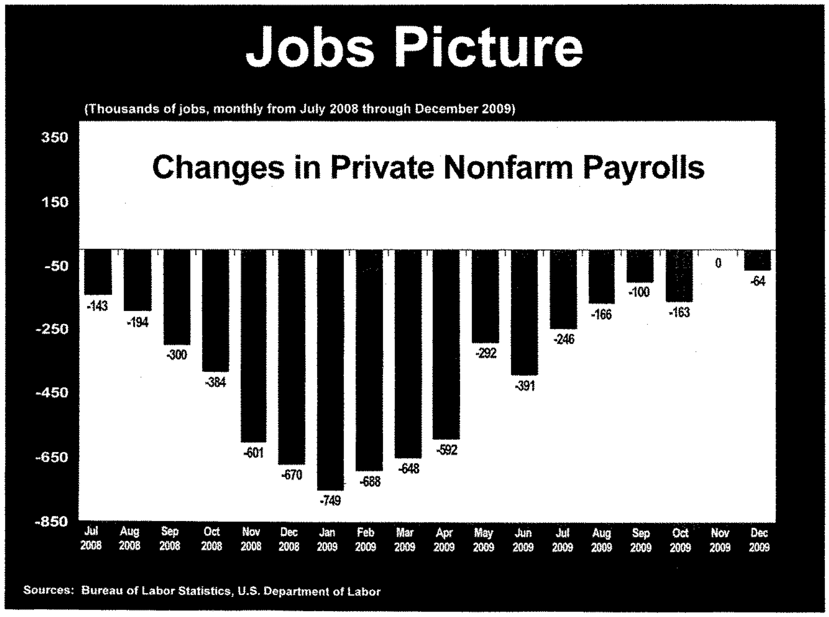
I want to thank Director Orszag for being here this morning. I want to thank all members of the Committee who are here and who are on their way. We know there are many other hearings underway on the budget in other venues today, and we appreciate and respect that. It is important for us on the Budget Committee to hear directly from the Budget Director.

Let me just go through a couple of slides to begin and then go to Senator Gregg for his opening remarks and then give the Director a chance to make his presentation, and then we will go to questions. I think we will stick to 5-minute rounds this morning and go to a second round if members are desirous of doing that.

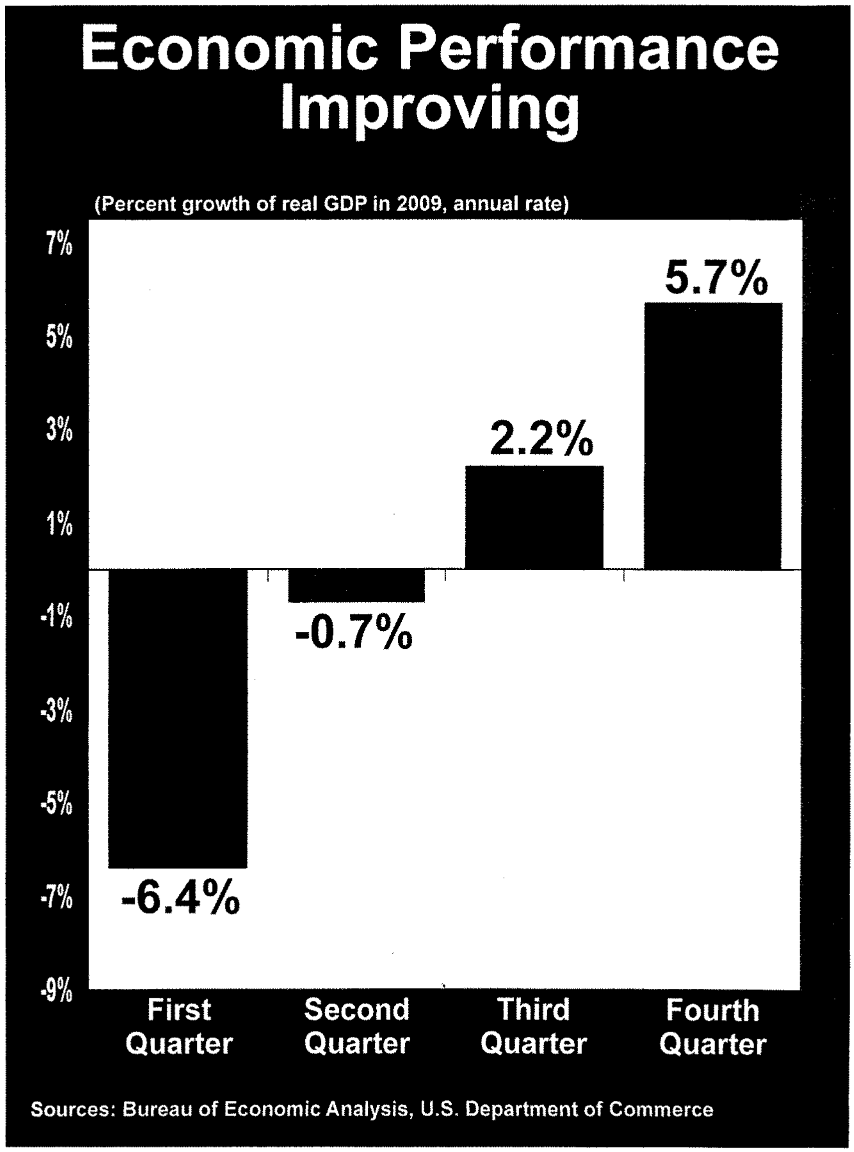
I think it is important to put in context what we confront. This President inherited the most dire situation any President has faced since Franklin Roosevelt: record deficits; a doubling of the debt had occurred before he came to office; the worst recession since the Great Depression; crises in the financial markets and the housing markets and the energy markets; ongoing wars in Iraq and Afghanistan; and an unsustainable long-term budget outlook with dramatically rising health care costs, and we know the story.



The previous administration, to their credit, and this administration took a series of steps when the economic downturn became apparent, and the result has been an improvement in the jobs picture. If we recall in January of last year, the economy was losing over 700,000 jobs a month. Now, that has been reduced in December of last year to 64,000 jobs. And while that is of cold comfort to those who have lost their jobs or who are worried about losing their jobs, it is a dramatic improvement from where we started.



The same is true on economic performance. In the first quarter of last year, economic growth was a negative 6.4 percent. In the most recent quarter, that improved to 5.7 percent.



If we look at some of the specifics in the President's budget, we see on the revenue side major proposals to further reduce revenue. Extending the 2001 and 2003 tax cuts for those with incomes below $250,000, the estate tax at the 2009 level, the alternative minimum tax relief—that combination is over $3 trillion of tax relief. In addition, there is other tax relief for families and businesses of almost $300 billion as well as temporary recovery measures of about $80 billion.

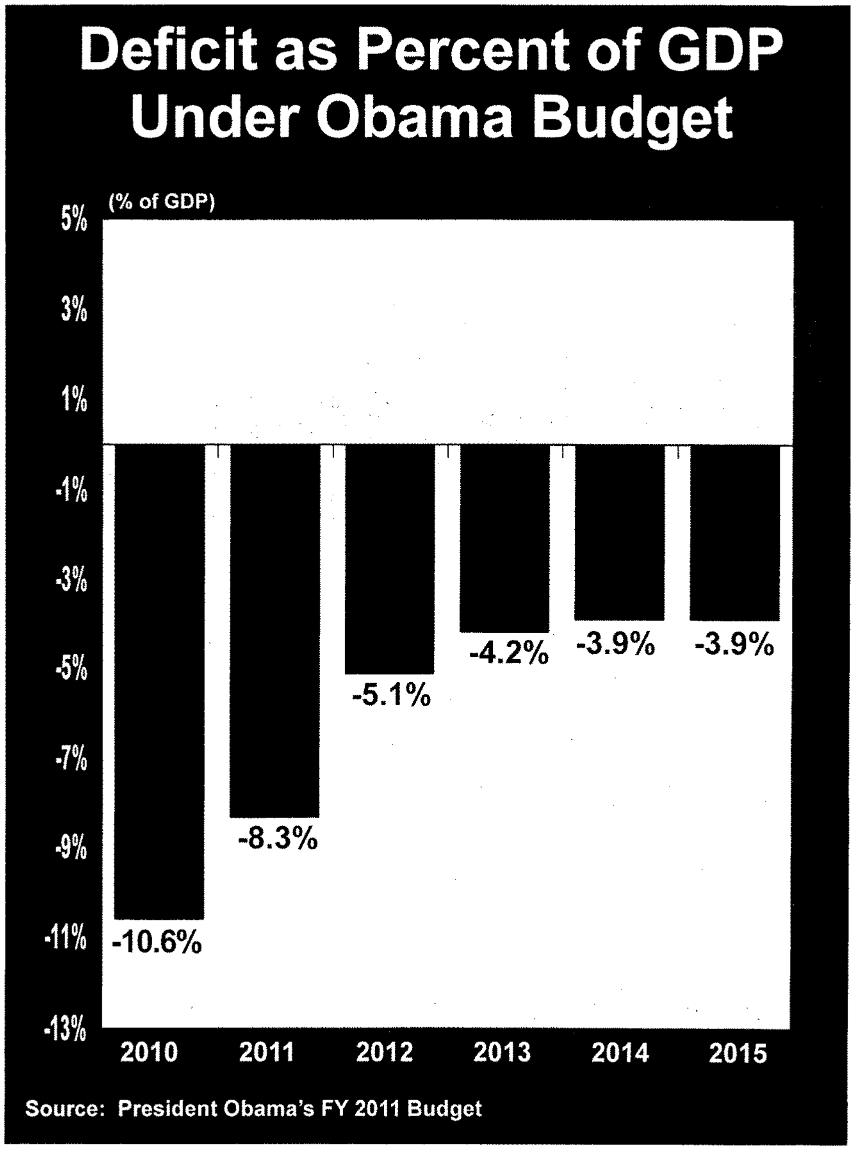
On the other side of the ledger, there are health care reform revenues that represent an average of what the Senate and House has done, $743 billion; limiting the itemized deductions to a 28-percent rate raises $291 billion; the international tax reforms previously proposed and again included in this budget, $122 billion; a financial crisis responsibility fee on the largest banks of $90 billion; other loophole closures and reforms of $309 billion. If you net it all out, it is an additional package of tax reduction of $1.9 trillion.

Revenue Proposals in Obama 2011 Budget

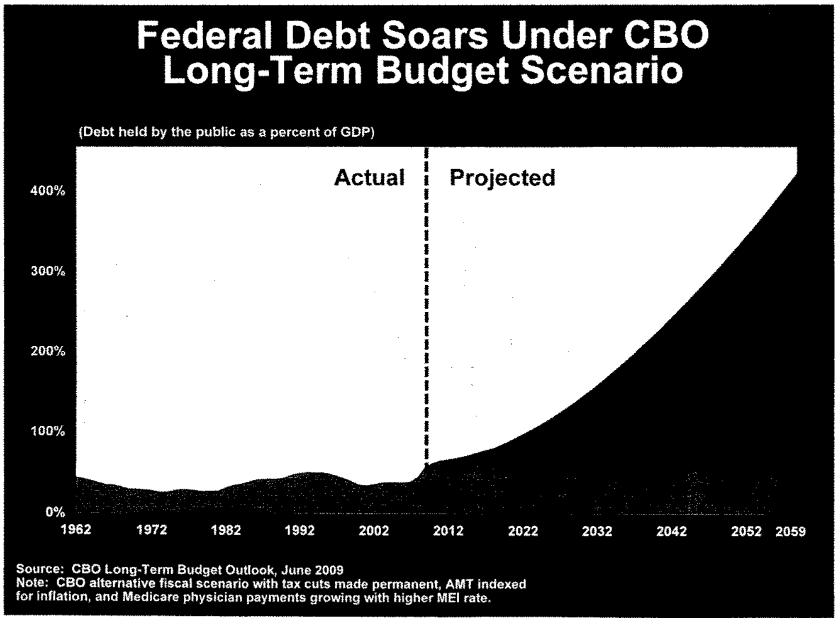
Extend 2001 and 2003 tax cuts for those under $250,000; estate tax at 2009 level; AMT relief	-$3.1 T
Other tax relief for families and businesses	-$293 B
Temporary recovery measures (Making Work Pay, bonus depreciation, other jobs initiatives)	-$83 B
Health reform revenue (placeholder)	$743 B
Limit itemized deductions to 28% rate	$291 B
International tax reforms	$122 B
Financial crisis responsibility fee	$90 B
Other loophole closers and reforms	$309 B
Total Tax Cuts	-$1.9 T

Source: OMB
Note: 2011-2020; totals include the refundable portion of tax proposals.

If we look at the deficit path for the first 5 years—and I look at the first 5 years because Congress, when we do budgets, virtually all of the time do 5-year budgets—the deficit is coming down as a percentage of GDP from 10.6 percent in 2010 to 3.9 percent in 2015. That is the good news.



On the other side of the ledger is the long-term outlook. In the long-term outlook, the Federal debt continues to rise in an unacceptable and unsustainable way, according to CBO's long-term outlook, to a projected debt in 2059 of 400 percent of GDP. Let me indicate that is a worst-case scenario because it includes extending all of the spending, and it includes extending all of the tax cuts that are already in place. Nonetheless, we are on an unsustainable course by any measure.



And let me just say that when I look at this budget, I strongly agree with the President's budget in the short term. It is absolutely imperative that we not allow the economy to slip back into recession. I have strong disagreement with the long term, and I must say that. I do not know any other way to say this than to be brutally honest with everyone. Short term, I believe it is absolutely essential that we provide additional liquidity to prevent a double dip. Our friends in Japan have warned us repeatedly: Do not try to cut your deficit prematurely at a time of economic weakness; you will only push the economy back into recession. I believe that. And so I believe the President is taking us in the right direction over the next several years.

But I must say I am very concerned about the long term because I believe we are on an unsustainable course. I have said it many times. I believe it deeply. And it has to be addressed, and the President's 10-year outlook I do not think is the path that we can take as a Nation.

Senator Gregg and I proposed a commission, and I know in fairness to the administration that they are relying on that approach to deal with the long-term circumstance we face. I hope very much that that works. The President said, on establishing a bipartisan fiscal commission, that, "A decade of irresponsible choices has created a fiscal hole that will not be solved by a typical Washington budget process that puts partisanship and parochial interests above our shared national interest. That is why, working with Congress, we will establish a bipartisan fiscal commission charged with identifying additional policies to put our country on a fiscally sustainable path." I believe in that approach.

President Obama on Establishing Bipartisan Fiscal Commission

"A decade of irresponsible choices has created a fiscal hole that will not be solved by a typical Washington budget process that puts partisanship and parochial interests above our shared national interests. That is why, working with Congress, we will establish a bipartisan fiscal commission charged with identifying additional policies to put our country on a fiscally sustainable path..."

– President Barack Obama
The Budget Message of the President
The Budget for Fiscal Year 2011
February 1, 2010

I have spoken to the Vice President's office on Friday and asked them to reach out to Republican leaders because, while we had negotiated with the White House a way of proceeding, it is important now that Republican leadership be consulted to see their ideas for the make-up of the commission, the rules under which it would operate, to see if agreement can be found with them. I very much hope that that will be the case.

I believe that it is absolutely essential that we have a look this year from a group who has the responsibility to come up with a long-term plan, one that would get us to 3 percent of GDP as a deficit by 2015, but much more challenging and what I believe is absolutely imperative is a longer-term plan that brings us to balance and that deals with the long-term debt threat.

With that, I will turn to my colleague Senator Gregg for his opening comments. Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and thank you again for reminding us of the seriousness of the problem and the issue and the failure of this budget, honestly, to address that issue in the out-years—and in the short term, for that matter, as far as I am concerned.

You know, it is really not what this administration inherited that is quite as important as what our children are going to inherit. And in both this budget and the budget that came last year, they are going to inherit a country whose debts are rising at such a rate and have risen to such a level as a result of deficit spending that the Nation will be unaffordable for them.

I actually think it is malfeasance to present a budget which, by its own terms and numbers, leads us down a path which ends in insolvency for this Nation. And that is not my assessment of this budget. That is the assessment of the administration's view of this budget in the long run. We go into insolvency. It is unsustainable. Unsustainable under any form what is proposed in this budget if we intend to continue to have a vibrant Nation to pass on to our children.

The blame falls in a lot of different places, and you can blame it on the past administrations. You can blame it on the generation that is huge and is about to retire. You can blame it on this administration that is exploding the size of Government in a variety of different areas. But blaming is not going to do us any good. Let us talk about solutions. Let us talk about resolving this.

Unfortunately, this budget, as it is presented, is filled with small ideas and smaller actions in the areas of how you get this long-term issue under control, and what we do not need are a lot of bunts and singles and hit-and-runs. We need somebody to step up to the plate with some ideas that are going to lead to doubles and triples and home runs. We can no longer afford to play small ball on this issue.

I want to put in some context how I see this problem. Could you put that one chart up there?

The revenue side is a big issue for us right now because in a recession revenues drop, and they have dropped more precipitously in this recession than probably in any recent recession. But CBO projects—and I would note that CBO's baseline projections are for lower deficits than the deficits under the Administration's policies—CBO projects that revenues will jump back to their normal historic level of 18.2 percent fairly quickly because of additional revenue that comes in when the tax cuts expire at the end of this year, and that they will exceed that level, getting up to 20 percent of GDP essentially, which would be well above their historic levels.

The problem, of course, is that spending has not only spiked as a result of the desire to float the economy through using the liquidity of the Government, but it is also spiking because there is being put in place programmatic activity which radically expands the size of the Government. And so spending goes up astronomically as a percent of GDP to levels not seen really in any time except for when we have been at war. And it does not come down. That is the real horror of this budget. And the proposal is that when you get out 10 years—and you cannot blame George Bush 10 years from now—when you get out 10 years, the deficits are going up, and the debt has crossed into a place where recovery is virtually impossible from it because you are like a dog chasing your tail. You cannot catch it.Debt service will amoutn to $800 billion by CBO's estimate, potentially $1 trillion. And as a result, there is no light at the end of the tunnel. It is pretty black. And there may be a stone wall out there that we are headed toward.

So what should we do? Well, I would have liked us to use a statutory commission, as the Chairman and I proposed, because I think that that is the only way you can pull together a group of people and have it be bipartisan. You need that initial vote where a bipartisan vote actually occurs that creates the commission because that gives it the imprimatur of bipartisanship that is so critical. An Executive order by definition is an Executive order, and, therefore, it is partisan and it is not part of the Congress, and so it has got fundamental flaws there.

And then, second, you need a statutory structure because you have to have an up-or-down vote, you have to have fast-track, and you cannot have an amendable vehicle or else too many games are played around here.

And would a task force have solved all the problems? No. But would it have addressed a big chunk of the solution? Yes. And should everything be on the table? Absolutely. Some people on my side did not vote for it because they did not think that there should be any tax policy on the table. That is foolish. You have to have everything on the table. The people on your side did not vote for it because they did not want Social Security or something else on the table. That is foolish. You have to have everything on the table.

So that was, in my opinion, the best approach, but it failed. I hope we will bring it back. We were seven votes short. We ought to be able to bring it back and pass it.

I saw this Congress, members of the other party, cast 60 votes for a couple of items around here, so they ought to be able to get 43 if we can get 17. Maybe we can get a few more on our side.

Independent of that, we have got to think of bigger approaches to this. That is the bottom line. You cannot do this a freeze on discretionary non-defense items post-2010. What is that? Ten billion dollars on a $1.6 trillion deficit? I mean, sure, it is the right sentiment, but it does not get you anywhere. That is small ball. That is not even a bunt.

An Executive order commission probably gets you a nice report, but it does not get you action. There are a number of programs which the administration has suggested eliminating. I will vote to eliminate them. Unfortunately, most of them have been proposed before, and they have not been accomplished. I think we have got to think in a little bigger context here. Let me suggest four things that we could do.

First, we could freeze all discretionary spending today, really make a statement that we are going to freeze annual appropriations. In fact, if you want to make it a real freeze, make it a freeze less earmarks. That is a number that will get you a little bit of money.

Second, it is inexcusable that the TARP (Troubled Assets Relief Program) is being used as a piggy bank. Inexcusable. The language of the TARP was very specific. Monies paid back were supposed to go to debt reduction. Once we got past the crisis, which we have by all accounts, including the Secretary of the Treasury and the Chairman of the Fed, we should not be drawing down more TARP money. Those dollars should be lapsed, and the moneys that are repaid should go to debt reduction. You are talking hundreds of billions of dollars there.

Third, there is no excuse for spending stimulus money after 2010. And that is a lot of money. There is money being spent under that stimulus package that occurs in 2014, 2015, 2016, 2017, and 2018. How can you justify that? Clearly, those dollars should be lapsed.

And, last, let me take an idea that was put forward by the other side of the aisle, a very courageous idea, in my opinion. The other side of the aisle in their health care bill suggested adjusting Medicare spending by $500 billion. Actually, it was $1 trillion when fully implemented over a 10-year period. Regrettably, rather than using that money to stabilize Medicare, they took that money and then created major new entitlements with it. They took Medicare funds that should be used for Medicare and funded a brand new series of entitlements.

Well, if you were willing to vote to make those types of tough decisions on Medicare, do it again, but use the money to stabilize Medicare. Put it in a Medicare stabilization fund, and you will get some very significant out-year savings, and they will be really positive.

Those are some ideas. I am sure there are some ideas from the other side of the aisle on tax policy that could also be considered. But as a very practical matter, let us stop talking about these little ideas, and let us stop putting forward budgets like this which represent a death certificate to the American dream for our kids, because that is what this is if we continue on this path. Our kids are not going to be able to participate in the American dream because their lives will be mortgaged, and their capacity to be prosperous will have been fundamentally undermined by the debt we will have put on their backs.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Ranking Member and thank him for his strong statement. I would say, you know, this is a time I think unlike any other as I look at our national history since the Great Depression, and it really does require us—it requires the very best from all of us. We have got to go beyond—I like your description "small ball." I really do think it is a time that requires us to come up with a comprehensive, long-term plan that demonstrates to the American people, that demonstrates to our colleagues, that demonstrates to our creditors that we are equal to, as a great Nation, facing up to this long-term challenge. And we simply have to do it.

With that, we turn to Director Orszag. Thank you for your service. I know you are somebody who in your history has certainly had an eye on fiscal responsibility and a commitment to it, and we are fortunate to have you in this position. The country is fortunate to have somebody of your ability and your vision in that job. Welcome and please proceed.

STATEMENT OF THE HONORABLE PETER R. ORSZAG, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. ORSZAG. Thank you very much, Mr. Chairman, Senator Gregg, members of the Committee. This year's budget focuses on three main things: first, job creation in the near term; second, middle-class security; and, third, beginning the task of putting the Nation back on a path to fiscal sustainability. Let me just pause and give a little bit of background before turning to what we should be doing on those topics.

We just came through a year in which a second Great Depression was averted. At the end of 2008, the economy was declining by more than 5 percent on an annualized basis. At the end of 2009, it was increasing by more than 5 percent on an annualized basis.

Although the economy is now expanding, the employment market remains too weak. The unemployment rate is 10 percent, and there are 7 million fewer jobs today than in December 2007, which is why the administration has put forward items like a jobs and wages tax credit and why this budget invests in education, innovation, and clean energy.

Second, let us look at the pre-existing condition with regard to our fiscal situation when the administration took office, and, actually, if I could have Senator Gregg's chart put back up, that would be terrific.

In January 2009, the Congressional Budget Office issued its Economic and Budget Outlook, which at that time showed an increase in Federal spending from 20.9 percent of the economy in fiscal year 2008 to 24.9 percent in 2009. This was, again, before the Obama administration took office, so presumably was not a reflection of our policies. And, similarly, if you look at where that green line is, that increase in spending and that decline in revenue was already apparent in January 2009. So it cannot be attributed to the policies that have been put in place since then.

Similarly, with regard to the projected deficits, if you look out over the decade from January 2009 forward, the projected deficit was $8 trillion at that point. That reflects two main factors. One was the fact that the 2001 and 2003 tax cuts and the Medicare prescription drug benefit were not paid for; they were deficit financed. That added more than $5 trillion to the projected deficit. And, second, the economic downturn, precisely what you see here, a decline in revenue as the economy weakens and an expansion in spending on things like unemployment insurance and food stamps and other automatic stabilizers built into the Federal budget that help to mitigate the economic downturn, but that do temporarily expand the deficit, added more than $2 trillion to the projected deficit.

So that is the situation that we face. We do face a very substantial medium-term deficit, and we also face a jobs deficit. So what are we doing?

First, the budget includes a $100 billion jobs package, including the new wage and jobs tax credit that I already mentioned to try to spur hiring among small businesses in particular, and it is worth pausing to examine the logic there. As I already mentioned, real GDP has started to increase, but employment growth typically lags behind economic growth. And one of the things that we are hoping to accomplish through a jobs package is to shorten that lag between when you have a statistical recovery and when you have a jobs recovery, and shorten the time between when income picks up or aggregate demand picks up and when employment picks up.

Second, with regard to our fiscal deficits, what are we doing? The first step in the face of this kind of problem is to make sure you do not make the problem worse, and the administration is particularly pleased that the Senate has now joined the House in embracing a concept that the administration has also embraced, statutory pay-as-you-go legislation, which embeds in law that basic principle. Do not dig the hole any deeper when you already have a hole. If this policy and this principle had been in place in the past, our out-year deficits would be only 2 percent of GDP, and debt as a share of the economy would be declining.

Second, economic recovery will help to reduce the deficit over time, moving the deficit from roughly 10 percent of the economy today to about 5 percent of the economy by 2015. That 5 percent of the economy is too high. It is above our fiscal target of roughly 3 percent of GDP, which is also consistent with balancing the budget, excluding interest payments on the debt. So how do we get from 5 to 3?

The first thing that we do is we put forward a set of specific proposals that would reduce the projected deficit over the next decade by $1.2 trillion—I would note the largest deficit reduction both in dollar terms and as a share of GDP in over a decade embodied in any administration's budget proposal. This includes steps like the financial services fee, which raises $90 billion and also helps to repay taxpayers in full for the costs of TARP. It includes allowing the 2001 and 2003 tax cuts for those making more than $250,000 a year to expire as scheduled in 2011, which reduces the deficit by roughly $700 billion. And I would note, Senator Gregg, I appreciate the suggestions you made. I did a rough calculation. I think they come in total roughly to the same amount as simply extending those high-income tax cuts which I know many in your party would support, so perhaps we could go through that in more detail.

It includes eliminating fossil fuel subsidies which amount to $40 billion over the next decade. And it also includes the 3-year freeze on non-security discretionary funding which would reduce the deficit by $250 billion over the next decade. And I would note this is not an across-the-board freeze on non-security discretionary spending. We are increasing investments in education, where we are putting an additional $3 billion into elementary and secondary education. We are increasing investments in research and development, which is up 6 percent in this budget. And in clean energy, in addition to eliminating fossil fuel subsidies, there is more than $6 billion in clean energy R&D and related activities embodied in the budget.

All of that put together, again, $1.2 trillion, but it does not get us to where we need to be. I think it has been long recognized, including through the leadership of Senator Gregg and Senator Conrad, that a bipartisan process is necessary to get us the rest of the way there. We supported a statutory commission. In the absence of a statutory commission, we support an Executive order commission. This has to be done on a bipartisan basis, and we are calling for a commission and with the goal of not only addressing our long-term fiscal imbalance, but also balancing the budget, excluding interest payments on the debt, by 2015 which would get us the rest of the way there to our fiscal target.

Finally, let me just note that over the very long term—this was all with regard to the next decade. Over the very long term, the key driver of our deficits is the rate at which health care costs grow. The legislation that both the House and Senate passed would not only reduce the deficit over the next decade, but also put in place the key infrastructure that would help to reduce costs and improve quality over time thereafter, which is one reason why the administration is so focused on getting that legislation done.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503
WWW.WHITEHOUSE.GOV/OMB

Testimony of Peter R. Orszag,
Director of the Office of Management and Budget
Before the Committee on the Budget, United States Senate
February 2, 2010

Chairman Conrad, Ranking Member Gregg, and Members of the Committee, thank you for inviting me to testify this afternoon about the President's Fiscal Year 2011 Budget.

I come before you after a trying year for the Nation. One year ago, the economy seemed on the verge of a severe collapse, perhaps leading to a second Great Depression. Together with the Congress, the President worked aggressively to stabilize the financial system and bring the economy back from the brink. The worst now appears to be behind us. However, the country faces two significant and ongoing challenges: high unemployment and a medium- and long-term fiscal situation that will ultimately undermine future job creation and economic growth. It took years to create the current jobs gap and our budget deficits, and it is our responsibility to start addressing them without delay.

Rescuing and Rebuilding the Economy

Let me start by reviewing where we have been.

A little more than a year ago, in the fourth quarter of 2008, real GDP was declining at a rate of more than 5 percent per year. In that quarter alone, household net worth fell by almost $5 trillion, dropping at a rate of 30 percent a year. In terms of employment, the fourth quarter saw a loss of 1.7 million jobs—the largest quarterly decline since the end of World War II and a number only to be exceeded by the next quarter when 2.1 million jobs were lost.

This bleak economic picture was reflected in the trillion dollar gap between how much the economy had the potential to produce and how much it was actually producing. Last year, for example, this output gap of roughly $1 trillion represented nearly 7 percent of the estimated potential output of the economy. This "GDP gap" motivated enactment of the American Recovery and Reinvestment Act (the Recovery Act) just 28 days after we took office, to start filling this hole and jumpstart the economy.

The Recovery Act contains three parts. Approximately one-third is dedicated to tax cuts for small businesses and 95 percent of working families. Another third goes toward emergency relief for those who have borne the brunt of the recession. For example, more than 17 million Americans have benefited from extended or increased unemployment benefits, and health insurance was made 65 percent less expensive for laid-off workers and their families relying on COBRA. In addition, aid to State, tribal, and local governments has helped them to close budget shortfalls, saving the jobs of hundreds of thousands of teachers, firefighters, and police officers. The final third of the Recovery Act is devoted to investments to create jobs, spur economic activity, and lay the foundation for future sustained growth.

Over the past year, the evidence suggests that the Recovery Act has made a substantial difference. Estimates—from the Council of Economic Advisers, as well as respected private forecasters such as Goldman Sachs and Mark Zandi of Moody's Economy.com—suggest that the legislation added roughly three percentage points to economic activity in the third quarter. The result is that, as 2010 opens, the U.S. economy is back from the brink. Financial markets are far more stable, and real GDP is expanding.

Although real GDP growth has turned positive, American businesses were still shedding jobs in the third and fourth quarters. The unemployment rate was 10.0 percent in December 2009, and there are 7 million fewer jobs than when the recession began in December 2007. While there are some early indicators of labor market improvement, such as rising productivity and the hiring of temporary workers, there is much left to do.

The increase in unemployment has had devastating effects on American families. Far too many workers who would rather be earning a paycheck are forced to accept unemployment, and are worrying about how to pay their mortgage, keep their health insurance, and continue to provide for their families while they try to find another job. As the President has said, the coming months will continue to be difficult ones for American workers, and, regardless of the GDP numbers, the recovery will not be real for most Americans until the job market turns around.

This is why, in the short term, it is critical that we take steps to jumpstart job creation in the private sector. And that is why the Administration will work with Congress to implement a jobs creation package along the lines of what the President announced in December 2009. It should include:

- *Help for small businesses to expand investment, hire workers, and access credit.* Small businesses play a crucial role in a dynamic economy. The Administration is calling for expansions or extensions of Recovery Act tax relief for small businesses that will encourage investment and job growth, along with a new, short-term tax incentive to encourage small business hiring and support employment. More than 1 million small businesses will receive a tax cut from this latter proposal, which will extend a $5,000 tax credit to small businesses for every new job they add in 2010 and will also reimburse them for the Social Security payroll taxes they pay on real increases in their payrolls this year.

- *Investments in America's roads, bridges, and infrastructure.* The Administration is also calling for new investments in a wide range of infrastructure, designed to get out the door as quickly as possible and continue a sustained effort at creating jobs and improving America's productivity. And we support financing infrastructure investments in new ways, allowing projects to be selected on merit, as was done through the Recovery Act's TIGER program, and leveraging money with a combination of grants and loans.

- *Investments in energy efficiency and clean energy.* The Administration is seeking a new program to provide rebates for consumers who make energy efficiency retrofits; such a program will harness the power of the private sector to help drive consumers to make cost-saving investments in their homes. We are also calling for expansion of successful, oversubscribed Recovery Act programs to leverage private investment in energy efficiency and create clean energy manufacturing jobs.

In addition to these priority investments, the Administration supports immediate steps to lend additional help to those most affected by the recession. The Budget therefore proposes to extend emergency assistance to seniors and families with children, unemployment insurance benefits, COBRA tax credits, and relief to States, Indian tribes, and localities to prevent layoffs. And the Budget also extends tax relief to 95 percent of working families through an additional year of the Making Work Pay tax credit.

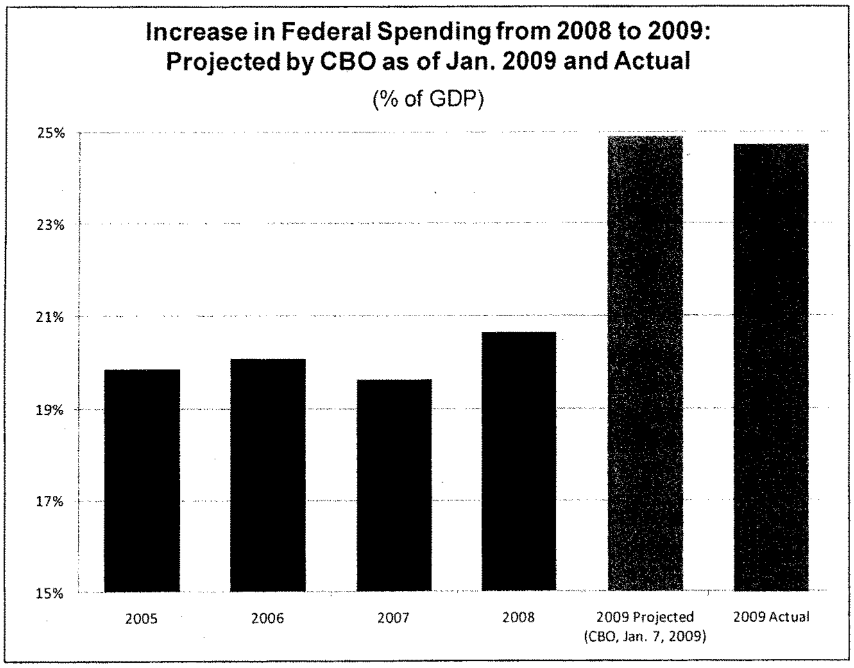
Restoring Fiscal Discipline

Unfortunately, we face not just this jobs deficit but also a substantial fiscal deficit. On the day the Administration took office, the budget deficit for 2009 stood at $1.3 trillion, or 9.2 percent of GDP—higher than in any year since World War II. And, over the following ten years, projected deficits totaled $8 trillion.

Short-term deficits

The deficit increased substantially in fiscal year 2009, which began on October 1, 2008. Given the depth of the economic downturn in late 2008, an increase in the deficit as we entered 2009 was to be expected—and, indeed, such an increase was temporarily desirable because it increased aggregate demand in the economy. (During a recession, the key to economic growth is the demand for the goods and services the economy could produce with existing capacity—and in that situation, temporary increases in the deficit are beneficial to help put the economy back on track.) The increase in the deficit during 2009 reflected a decline in revenue and an increase in spending, both of which were primarily linked to the economic downturn and both of which were already apparent before the Administration took office.

For example, on January 7, 2009, the Congressional Budget Office (CBO) issued its Economic and Budget Outlook for Fiscal Years 2009-2019. In that document, CBO projected that government spending would rise from 20.9 percent of GDP in fiscal year 2008 to 24.9 percent of GDP in fiscal year 2009. In reality, government spending in fiscal year 2009 turned out to be roughly what had been predicted a year earlier (24.7 percent), according to CBO's updated Economic and Budget Outlook issued in January of this year. (The mix of spending was slightly different from what CBO had initially projected, with somewhat lower mandatory spending and somewhat higher discretionary spending as a share of the economy.)



Medium-term deficits

In addition to the 2009 deficit, the Administration also inherited an $8 trillion ten-year deficit. Even these figures, moreover, understate the fiscal shortfall the Administration actually inherited for the next decade. As of last winter, the depth of the current recession was not yet fully apparent. Since we released our Budget overview last February, the deterioration in our economic and technical assumptions added another $2 trillion to the deficit through 2019, as it became clear that we were in the midst of the worst recession since the Great Depression.

As a result, without changes in policy, deficits would total $10.6 trillion over the next ten years—and would fall from their current levels to an average of about 5 percent of GDP in the second half of the decade.

This unsustainable starting point largely reflects three factors: a failure to pay for policies in the past, the impact of the economic downturn, and the steps we took to mitigate that downturn.

- More than half of these deficits can be linked to the previous Administration's failure to pay for the 2001/2003 tax cuts and the prescription drug bill. Over the next ten years, these two unpaid-for policies are slated to add $5.8 trillion to the deficit, including interest expense on the additional associated debt. Put differently, if these two policies had been paid for, projected deficits—without any further deficit reduction—would be about 2 percent of GDP per year by the middle of the decade, and we would have been on a sustainable medium-term fiscal course.

- The recession that began in December 2007 also adds considerably to the projected deficits. When the economy enters a recession, the Federal Government's receipts automatically fall and the costs for certain programs, such as unemployment insurance, automatically rise. Over the next ten years, these automatic stabilizers are projected to add about $2.4 trillion to the deficit, including interest expense.

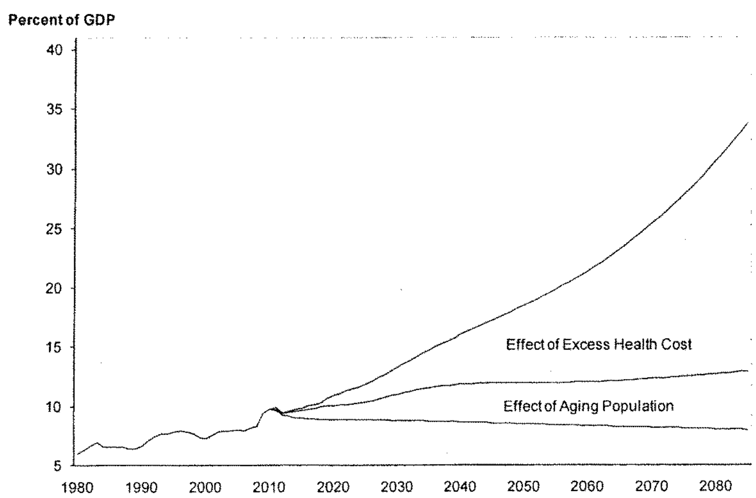
- Finally, it is worth noting that the Recovery Act—which, as discussed, has been key to restoring economic growth—plays a relatively small role in the projected deficits compared to these other costs. Over the next ten years, the deficit impact of the Recovery Act is less than one-tenth the size of the costs associated with 2001/2003 tax cuts, the prescription drug bill, and the automatic effects of the recession on the Federal budget.

Summed together, this fiscal legacy—the unpaid-for 2001/2003 tax cuts and prescription drug bill, as well as the worst recession since the Great Depression and our necessary response to it—accounts for $9 trillion of the projected deficits under current policies. They are the reason that our medium-term deficits are on an unsustainable course.

Long-term deficits

As our horizon extends beyond the next decade, the role of health care costs in driving our budget deficits becomes more prominent. The figure below shows the projected growth of Medicare, Medicaid, and Social Security spending over the next 75-years, assuming historical excess cost growth continues. This illustrates that we are on an unsustainable path. Within the next half century, spending on these three programs is projected to exceed 20 percent of GDP, more than double their current share of the economy. The fact remains that we cannot close the long-term fiscal shortfall without slowing the rate of health care cost growth. Reducing excess cost growth by 15 basis points (0.15 percentage points) generates more savings than closing the entire Social Security deficit over the next 75 years.

Sources of Projected Growth in Medicare, Medicaid, and Social Security



Policies to Reduce the Deficit and Restore Responsibility

That is how these projected deficits over the next decade arose and how our long-term fiscal future is dominated by health care costs. But whatever their cause, our future prosperity may be threatened if we do not address our medium- and long-term fiscal trajectory. So what are we doing?

First, we have already taken action to ensure that we do not make the hole any deeper. The Administration proposed and Congress is on the verge of enacting statutory pay-as-you-go (PAYGO) legislation. PAYGO forces us to live by a simple but important principle: Congress can only spend a dollar on an entitlement increase or tax cut if it saves a dollar elsewhere. In the 1990s, statutory PAYGO encouraged the tough choices that helped move the Government from large deficits to surpluses, and it can do the same today. To repeat what I have already said, the failure of the previous administration to abide by the PAYGO principle accounts for over $5 trillion of our projected deficits. And, while both houses of Congress had already taken an important step toward righting our fiscal course by adopting congressional rules incorporating the PAYGO principle, enacting statutory PAYGO will strengthen enforcement and redouble our commitment.

The President's Budget represents another important step toward fiscal sustainability. The Budget reduces deficits by $1.2 trillion over the next 10 years—not including savings associated with our presumed ramp-down of operations in Iraq and Afghanistan. If those savings are included, deficit reduction under our Budget comes to $2.1 trillion. Furthermore, the President's Budget cuts the inherited deficit in half as a share of GDP by the end of the President's first term,

The deficit reduction steps include:

- *Imposing a three-year freeze on non-security discretionary funding.* Over the past year, a surge in Federal spending has helped to bolster macroeconomic demand, while also funding long-needed investments that are helping to build a new foundation for economic growth. But, as the economy recovers, we need to rebalance our spending priorities, as we transition from jumpstarting the economy to restoring fiscal sustainability. That is why the President's Budget proposes a three-year freeze in non-security discretionary funding (that is, discretionary funding outside of defense, homeland security, veterans affairs, and international affairs), with funding thereafter increasing roughly with inflation. The proposed freeze in non-security discretionary funding from 2010 to 2011 is well below the 5 percent average growth in such funding since the early 1990s. And over the next 10 years, this policy saves $250 billion relative to continuing the 2010 funding levels for these programs adjusted for inflation.

  The non-security discretionary freeze allows some agency budgets to expand even while others are constrained, and expands some investments while curtailing others. Education, job training, and R&D provide vivid examples. Sound investments in education are crucial to building the skills and productivity of the Nation's current and future workers. Even while expanding funding overall and significantly expanding the successful Race to the Top competition, the President's Budget will eliminate 6 discretionary programs and consolidate 38 K-12 programs into 11 new initiatives that emphasize competition in allocating funds. This will give communities more choices around activities and hold grantees accountable for results.

And to keep Americans building new and competitive skills throughout their working lives, the Budget provides $19 billion for job training and employment programs Government-wide, a $1.1 billion, or 6 percent, increase from 2010. This level includes two new innovation funds that will test and evaluate new approaches to training disconnected youths, building regional partnerships, and supporting apprenticeships. The Budget will also support a ten-year extension of Trade Adjustment Act assistance for American workers who have lost their jobs due to imports or shifts in production overseas, and provide additional support for training in green jobs.

Similarly, R&D is a cornerstone of a thriving economy, and the Budget features $61.6 billion for civilian research and development—an increase of $3.7 billion, or 6.4 percent, over 2010 levels. But while continuing the commitment to double funding for three key basic research agencies—the National Science Foundation, the Department of Energy's Office of Science, and the National Institute of Standards and Technology—the Budget also eliminates programs that are not effectively achieving their goals. For example, the Budget cancels NASA's Constellation program, which was intended to return astronauts to the Moon by 2020, but has run severely behind schedule and over-budget. In place of Constellation, the Budget proposes to leverage international partnerships and commercial capabilities to set the stage for a revitalized human space flight program, while also accelerating work—constrained for years due to the budget demands of Constellation—on climate science, green aviation, science education, and other priorities.

- *Requiring the financial services industry to fully pay back the costs of the Troubled Asset Relief Program (TARP).* Assisting the financial services industry was necessary to prevent an even worse financial meltdown—and even greater repercussions throughout the entire economy. But this step rewarded firms that had taken excessive and unreasonable risks. While the Administration's sound management of the TARP program has caused its expected cost to fall by $224 billion since the 2010 Mid-Session Review to about $117 billion, shared responsibility requires that the largest financial firms pay back the taxpayer as a result of the extraordinary action taken. Congress recognized this when it wrote the legislation authorizing TARP by requiring the President to propose a way for the financial sector to pay the costs of the program. The Administration is therefore calling for a Financial Crisis Responsibility Fee on the largest Wall Street and financial firms that will last at least 10 years, but longer if necessary, to compensate the taxpayers fully for the extraordinary support—both direct and indirect—that they provided. This fee would be limited to financial firms with over $50 billion in assets. As it would be based on an institution's size and exposure to debt, it would also further the Administration's financial reform goals by encouraging firms to reduce their size and leverage—which were two major contributors to the financial crisis.

- *Allowing the 2001-2003 tax cuts for households earning more than $250,000 to expire.* The Budget proposes allowing most of the 2001/2003 tax cuts to expire in 2011, as scheduled, for those families making more than $250,000 ($200,000 for single individuals). The additional revenues gained would be devoted to deficit reduction. These tax cuts were unaffordable at the time they were enacted, and remain so today. The Budget would simply return the marginal tax rates for these wealthiest Americans to what they were prior to 2001. Altogether, allowing these tax cuts to expire would save $678 billion over the next ten years relative to current policy.

- *Limiting the rate at which itemized deductions can reduce tax liability to 28 percent for families with incomes over $250,000.* Currently, if a middle-class family donates a dollar to its favorite charity or spends a dollar on mortgage interest, it gets a 15-cent tax deduction, but a millionaire who does the same enjoys a deduction that is more than twice as generous. By reducing this disparity and returning the high-income deduction to the same rates that were in place at the end of the Reagan Administration, the Budget raises $291 billion over the next decade.

- *Eliminating funding for inefficient fossil fuel subsidies.* As we work to create a clean energy economy, it is counterproductive to spend taxpayer dollars on incentives that run counter to this national priority. To further this goal and reduce the deficit, the Budget eliminates tax preferences and funding for programs that provide inefficient fossil fuel subsidies and undermine efforts to deal with carbon pollution. The Budget proposes eliminating 12 tax breaks for oil, gas, and coal companies, closing loopholes to raise nearly $39 billion over the next decade.

Health Insurance Reform

In addition to these specific policies to address the medium-term deficit, the Administration has also faced head-on the primary driver of our long-term fiscal shortfall—rising health care costs. Both the House and Senate health insurance reform legislation would not only reduce the deficit over the next decade as scored by the non-partisan CBO, but perhaps more importantly would create an infrastructure that would help to improve quality and constrain costs over the long term.

Both bills would aggressively test different approaches to delivering health care and move toward paying for quality rather than quantity. In the Recovery Act, we took steps toward greater quality at lower cost by making historic investments in health information technology and research into which treatments work and which do not. Comprehensive health insurance reform would build on these investments by providing tools and incentives for physicians, hospitals, and other providers to improve quality. For example, by bundling payments and establishing accountable care organizations, as well as by creating disincentives for dangerous and unnecessary re-admissions and health-facility acquired infections, physicians and hospitals will be induced to redesign their systems, coordinate care to keep people healthy, and avoid unnecessary complications

It is also vital that reform include a Medicare commission—composed of doctors and other health care experts—that can enable the health system to keep pace with innovation and the dynamic health care marketplace. The commission will help to make sure that reforming the health care system is not a one-time event, but rather an ongoing process over time, creating a continuous feedback loop where we generate more and better information about what is working in the health care delivery system and then rapidly bring those initiatives to scale. Lastly, reform should include an excise tax on the highest-cost insurance plans. The proposed tax on "Cadillac" health insurance plans will do more than help pay for reform; it will curtail the growth of private health insurance premiums—by providing employers with an incentive to seek higher-quality and lower-cost health benefits that will generate higher take-home pay for American workers and their families. In other words, the excise tax will help to slow health care cost growth and thereby also give Americans a pay raise.

Congress must now deliver on this promise of fiscally responsible health reform—the stakes are high, both for the millions of Americans who lack a stable source of health insurance coverage and for the fiscal wellbeing of the Nation itself. I echo the President's commitment last week to hear any and all ideas for a better approach to fiscally responsible health reform, and I also echo his challenge to Congress that it must not walk away from comprehensive reform with the finish line so near.

*****

Taken together, the more than $1 trillion in deficit reduction proposed by our Budget represents an important step toward fiscal responsibility over the medium term, and the health legislation under consideration would help to reduce deficits over the longer term.

Fiscal Commission

The President has now proposed two budgets that reduce outyear deficits. But the Administration is not yet satisfied. Even with this substantial deficit reduction, we will still face unsustainable medium- and long-term deficits.

The only way to solve the remainder of our fiscal challenge is to solve it in a bipartisan fashion. That's why the President has called for the creation of a bipartisan Fiscal Commission to identify policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run.

Specifically, in addition to addressing our long-term fiscal imbalance, the Commission is charged with balancing the budget excluding interest payments on the debt by 2015. This result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers. The magnitude and timing of the policy measures necessary to achieve this goal are subject to considerable uncertainty and will depend on the evolution of the economy. In addition, the Commission will examine policies to meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government.

Conclusion

The policies we have enacted in the last year and those proposed in the President's Budget seek to restore economic and fiscal health after years of poor decisions. While we have much work left to do to accomplish this goal, our economic freefall has been stopped; financial markets have calmed; and the Recovery Act returned our economy to growth in the third quarter of last year. On the fiscal front, the President's Budget puts on the table more than $1 trillion in deficit reduction over the next ten years by imposing historic restraint on the growth of non-security discretionary funding and restoring fairness and balance to the tax code.

These are key steps forward, but they are not enough. Although the rate of job loss has slowed dramatically, job gain has not yet begun, and the Administration will not be satisfied until the many Americans seeking work can find it. Moreover, while our Budget significantly reduces projected deficits, they remain undesirably high.

The Administration is committed to addressing these challenges facing our Nation, and I look forward to working with you in the weeks and months ahead to do so.

Chairman CONRAD. Thank you, and thank you for your testimony.

Let me, first of all, go to this notion of excluding interest payments from the calculation of deficits and debt, or at least of deficits. I guess I understand the concept, but it strikes me, when I look at where we are headed, interest payments in this budget, net interest is expected to rise from $188 billion this year to $840 billion by 2020—$840 billion in interest.

Now, the interest has to be paid, so I do not understand how it makes any sense to be excluding interest from the calculations. What is the thinking there?

Mr. ORSZAG. Senator, it is not that we would exclude it from the calculations, but as you know, economists have often focused on the so-called primary budget, which is the budget excluding such interest payments on the debt. The reason to do so is you are then isolating the sort of programmatic side of the budget as opposed to, as you correctly point out, net interest must be paid, and isolating the programmatic part of both expenditures and revenue. And so a concept that economists have often focused on is what is happening to the primary balance, that is, the budget excluding interest payments.

It turns out that balancing the budget excluding interest payments in 2015 is consistent with an overall budget deficit of 3 percent of GDP in that year. So the fiscal target of 3 percent and balancing the primary budget or the budget excluding interest payments turn out to be the same goal.

Chairman CONRAD. All right. Put me down as a skeptic.

Mr. ORSZAG. OK.

Chairman CONRAD. I understand, to me, you know, when we start excluding things, for whatever purpose, I think we tend to just mislead ourselves about really the gravity of the situation. And as I look at the trend that we are on as a country, I see a very grave situation, a dire situation. And, again, I give the administration high marks for what you have done thus far to avert what I believe would have been a global financial collapse.

I was in the room with the previous Secretary of the Treasury, with the head of the Federal Reserve, and that long weekend in which hour after hour we were advised of the impending collapse of major financial institutions, not only here but around the world. Anybody who was there had to be sobered by how close we came to a financial collapse.

So I give the administration and, frankly, I give the previous administration at the end of that administration high marks for responding to what could have been a depression as severe as the previous depression.

But now we are looking ahead, going forward, and again, in the short term, I believe we have to be very careful not to move too quickly to deficit reduction, and I am a deficit hawk. I have felt this way my entire life. I think we have to be very careful not to prematurely reduce the deficit because, in many ways, we are facing what the Japanese did. The Japanese call it a balance sheet recession because their businesses, their financial institutions are unable to generate the type of economic activity necessary to sustain growth because their balance sheets have been impaired. And in that circumstance, the only one big enough to come to the table to fill the demand gap is the Federal Government, and if it doesn't, economies crater. That is reality. That is a fact.

With that said, we then look to our long-term circumstance. So I believe, and believe strongly, it is critically important that we run deficits and add the debt in the short term. But I also believe just as passionately that as the recovery takes hold, we then must pivot and deal with the long-term debt. And the place where I would fault this budget is I don't see the pivot. I don't see the pivot. I don't see the focus on bringing down that long-term debt.

I don't see us getting below, as I look at the numbers, 5 percent of GDP in the next 10 years. And I know there are other estimates, but looking at the way CBO will judge this, my own sense is we are probably not going to get below 4.5 percent of GDP. That is too high, especially given what is happening with the retirement of the Baby Boom generation and the debt we have already by that time accumulated.

So help me understand, what is the administration's thinking with this long term? I am certain you don't see this as a sustainable circumstance. So how is it going to be addressed?

Mr. ORSZAG. No, we don't view the long term as on a sustainable course. I would note three things. First, that is precisely why we are calling for a commission along the lines that you have already tried to embody in a statutory version.

Second, it is another reason why we do believe comprehensive health legislation is crucially important.

And finally, I would just note, there are alternatives that have been put forward. For example, Senator Gregg's colleague on the House side, Mr. Ryan, has put forward a plan that would eliminate the long-term deficit, and that is a significant accomplishment. But it is worth examining how that is done.

The way it is done is taking the Medicare program and turning it into a voucher program for those 55 and below, which would shift risk onto individuals and beneficiaries, and then have that voucher not keep pace with health care costs over time, which would shift expected costs onto individuals. And then there are a variety of other changes, but that is the big driver. It is possible to address our long-term fiscal problem that way, and that would be worthy of debate.

So again, I am going to come back and say we strongly favor a Fiscal Commission, in part because we agree. The fiscal course that we are on out in 2020 and 2030 and 2040 is unsustainable and it needs to be addressed.

Second, if we don't address rising health care costs, there is nothing else that we are going to be able to do that will alter that basic fact, and there are lots of parts of the legislation that both the Senate and the House have passed which would help with that problem.

And finally, it is worthy of further discussion, some of the other proposals that are out there, and that is partly what we would hope the commission would do.

Chairman CONRAD. Senator Gregg?

Senator GREGG. I must just take a bit of difference with your comments. It is not 2020 and 2030 that we need to worry about. It is 2017, 2015, when our bonds are no longer salable or become very expensive and we are not able to defend our currency because we have got so much debt. And the signs are pretty clear that that is where we are headed. I mean, the Japanese already face the problem. Their debt is being downgraded. The Chinese have made it clear they are not going to purchase debt at the rate that they were. So we have got this problem. It is no longer on the horizon. It is closing fast.

I want to talk about one specific here. The President today is going to announce he is going to take—and I am quoting from a statement, which I assume is his quote from his speech, and it is going to be in New Hampshire, ironically—"that is why today I am announcing a proposal to take $30 billion of money that was repaid by the Wall Street banks and use it to create a new small business lending fund."

Then I want to read to you from the law, the TARP law. That is money from TARP. The TARP law says "revenues of and proceeds from"—that are recovered from the banks—"shall be paid into the general fund of the Treasury for reduction of the public debt." That is "shall."

This proposal violates the law. Are you intending to amend the TARP law?

Mr. ORSZAG. Senator, my understanding is that the proposal would require new legislation to implement, so it would only be done with Congressional approval and a change in the law, sir.

Senator GREGG. So you are proposing to add $30 billion to the debt?

Mr. ORSZAG. We are proposing to put $30 billion into a new program that would help promote small business activity because small businesses are suffering from a lack of access to credit currently.

Senator GREGG. It comes from deficit financing.

Mr. ORSZAG. Relative to simply repaying the debt, yes.

Senator GREGG. Well, you know, I mean, how are we going to get this under control if on the day that you are up here telling us that you are going to be fiscally responsible, you are proposing language which is going to spend $30 billion of repaid TARP money which specifically was supposed to be used to pay down the debt? The whole concept of the TARP was—and I was in the room, also, with Senator Conrad, and this was debated at some length—the whole concept of the TARP was that as we recoup the money, we would use it to pay down the debt because we were borrowing it from Americans and from the Chinese. Now with this proposal, that is not going to happen. It has become a piggy bank——

Mr. ORSZAG. Well, Senator——

Senator GREGG [continuing]. A piggy bank which adds to our deficit, adds to our debt, and gets put on our kids' backs.

Mr. ORSZAG. The degree to which shifting funds would add to our debt or deficits depends on what the net subsidy rate would be on that new activity. Remember, the purpose of TARP was to address problems in our financial markets, and it has been remarkably successful in bringing credit spreads back down to normal levels.

One of the lingering problems in our financial markets, however, is access to credit for small businesses. That is why in this budget we are——

Senator GREGG. No, no, no. You can't make that type of statement with any legitimacy.

Mr. ORSZAG. OK.

Senator GREGG. You cannot make that statement. This is the law.

Mr. ORSZAG. Small businesses are suffering from——

Senator GREGG. Let me tell you what the law says.

Mr. ORSZAG [continuing]. Lack of credit——

Senator GREGG. Let me read it to you again, because you don't appear to understand the law. The law is very clear. The moneys recouped from the TARP "shall be paid into the general fund of the Treasury for reduction of the public debt." It is not for a piggy bank because you are concerned about lending to small businesses——

Mr. ORSZAG. And this would require new legislation——

Senator GREGG [continuing]. And you want to get a political event when you go out and make a speech in Nashua, New Hampshire. That is not what this money is for. This money is to reduce the debt of our children, that we are passing on to our children. And you ought to at least have the integrity to be forthright about it and say that is what you are doing. You are adding to the debt that our kids are going to have to pay back, when you are claiming at the same time——

Mr. ORSZAG. Senator, with respect——

Senator GREGG [continuing]. That you are being fiscally responsible.

Mr. ORSZAG. Senator——

Senator GREGG. Let me ask you another question, because clearly, we are not going to agree on this and you are not going to follow the law. Second——

Mr. ORSZAG. Sorry, I do—excuse me. We will be following the law. This would involve legislation——

Senator GREGG. Well, then you are not going to be able to do it unless Congress——

Mr. ORSZAG. Yes, exactly——

Senator GREGG [continuing]. Gives you the authority to do it.

Senator SANDERS. Yes. That is how laws are made usually. Congress passes them.

Senator GREGG. Did the Senator from Vermont make a statement? Well, the Senator is wrong. This is the law as it stands today. There is no law on the books which allows-——

Senator SANDERS. And Congress can amend the law——

Senator GREGG. There is no law on the books, Senator, that allows you to take that money and spend it.

Senator SANDERS. And he is indicating he is going to go to Congress to amend the law.

Senator GREGG [continuing]. To do it.

Chairman CONRAD. Please. No. We don't operate that way in this committee. People seek recognition through the Chair. We don't have ad hominem debates here. That is not the way this committee is going to function, period.

Senator GREGG. On another——

Chairman CONRAD. The witness gets a chance to respond. The Senator asked the question and I will extend his time so the witness has a chance to respond——

Mr. ORSZAG. Very briefly——

Chairman CONRAD [continuing]. Then the Senator will have an additional chance.

Mr. ORSZAG. Very briefly, the proposal would involve—would require new legislation, so it would be fully consistent with existing legislation, and the net impact on the deficit would depend on the net subsidy rate for the new activity. It would not be a net cost in terms of the budget deficit of $30 billion.

Senator GREGG. That is an extraordinary answer. What you are essentially saying is that when this TARP money comes back in, you are going to change the rules so that you can spend it, not put it toward debt reduction.

Mr. ORSZAG. If Congress agrees, sir.

Senator GREGG. Right, but, I mean, the purpose was to reduce the debt, and you are not going to use it to reduce the debt at the same time that you are alleging that you are trying to pursue a course of small steps, small ideas, of fiscal responsibility. So you have got a law on the books which says specifically, reduce the debt. You are going to change it so you can spend the money, add to the deficit.

Mr. ORSZAG. I would just say again, one of the lingering problems in the economy today, one of the reasons why we are not getting the job creation that we need is that small businesses lack access to credit. There are a variety of steps the administration favors taking, including expanded activity at the Small Business Administration, including this new proposal which would require Congressional approval to try to address that problem.

Senator GREGG. Thank you.

Chairman CONRAD. Senator Murray?

Senator MURRAY. Thank you, Mr. Chairman, and I look forward to that discussion. We have a lot of small businesses in my State that are really struggling with capital today, so I look forward to that debate as we get into it in Congress, as well.

Dr. Orszag, I do want to talk a minute about a subject that I know you understand is of importance to me and that is the DOE's EM, environmental management, budget. We are in a different place from last year when the EM budget had a proposed cut, and I do want to thank you for the proposed increase, which is an acknowledgement that the Federal Government does have an obligation to clean up those sites across the nation. I think it is important that the people in the country see that the administration is going to put their money where their mouth is when it comes to meeting those very important moral and legal obligations of cleanup.

Having said that, I am sure you expected that I would have some specific questions about Hanford, which is in my home State of Washington, and I am worried that it appears that DOE is once again offsetting base program work with ARRA dollars. That was never the intention of those funds and it sets up a huge hurdle to overcome when the money is gone. From what I have seen throughout the budget, ARRA is not being used as an offset in very many other places. I am also very concerned that there is some significant reduction to groundwater work.

Now, my time is limited and I have some specific questions. I would just like to ask you if we can sit down with some of the folks on your team to understand how you made those decisions and work our way through it.

Mr. ORSZAG. Absolutely. I would be delighted to do that.

Senator MURRAY. OK, great. I also wanted to talk to you about the Corps of Engineers budget, because as you may be aware, in my home State of Washington, we have a dam—it is called the Howard Hanson Dam—that has significant seepage problems that is prohibiting the Corps from operating it at a fully authorized level of flood protection to a lot of our downstream communities.

There is currently a study underway to determine the permanent fix for that dam in the Corps' Dam Safety Seepage Stability Correction Program, and I understand the Corps is also conducting studies on about 70 other projects, as well. All of those studies are proposed to be funded for $49 million in the fiscal year 2011 budget, and I am concerned that that level of funding won't be sufficient to undertake that many studies. Do you believe that the $49 million will give the Corps their full capability to follow through on all those studies that are being required?

Mr. ORSZAG. We do believe that it would give the Corps adequate capability, but we can again, in the discussion that we are going to have with you, sit down and walk you through that.

Senator MURRAY. OK, because it is really important that we get those studies done so that we can begin the construction in 2012 because it will be significant damage if that doesn't get fixed.

Also, I wanted to just say that I am really pleased to see the policy changes in the VA budget providing greater access for non-disabled veterans with modest incomes. That is something we have been pushing for a long time. It recognizes those veterans and I want to thank you for that.

I do want to ask you about the Veterans' construction budget for both major and minor construction dollars. We know that the number of beneficiaries is going to increase by about 550,000 non-disabled veterans by 2013. That is especially concerning to me because of the increasing demands of both disabled veterans that we are seeing coming home and from previous wars, and also the unique needs of female veterans, which we are seeing a huge increase of and we need to meet, as well. And, by the way, increasing the construction budget for the VA would provide construction jobs, and that is, I know, an important goal for the budget, as well.

So I just wanted to ask you this morning what your rationale for reducing the overall construction budget by 15 percent in VA is.

Mr. ORSZAG. Well, again, although there is a reduction from 2010, we are still at historically high levels for the construction account and we believe it will allow VA to focus on its highest priorities in terms of its construction. And this is in a context, also, in which the VA budget has gone up between 2009 and 2011 by 20 percent.

Senator MURRAY. And that is mostly for beneficiaries that——

Mr. ORSZAG. It is mostly for beneficiaries.

Senator MURRAY [continuing]. We have a huge increasing need for, so we can't ignore that.

Mr. ORSZAG. Yes.

Senator MURRAY. But I am also specifically worried about the construction dollars. These are projects out across the country that we have been working on trying to get built to meet the demands of the VA. So reducing the construction budget in particular by 15 percent is a real concern to many of us, and——

Mr. ORSZAG. I understand that, and again, I would just again emphasize, even with that, it is still at an historically high level, and I know that Secretary Shinseki and others would be delighted to walk you through in more detail.

Senator MURRAY. And we will definitely be asking them that.

Mr. ORSZAG. OK.

Senator MURRAY. OK. Thank you.

Chairman CONRAD. Senator Alexander?

Senator ALEXANDER. Thanks, Mr. Chairman.

Dr. Orszag, thank you for being here. I have three suggestions and a question.

Mr. ORSZAG. OK.

Senator ALEXANDER. So my first suggestion is to suggest that whoever came up with the idea of leaving the interest payments out of the budget, you might gently tell them you ran it up the flag pole and it didn't do very well.

Mr. ORSZAG. Can I intervene very quickly? No one is talking about leaving interest payments out of the budget, and I know the Chairman had asked about this before. They are absolutely in the budget. The only question is are there intermediate steps to balancing the overall budget where you have other targets that are——

Senator ALEXANDER. Well, if——

Mr. ORSZAG. No one is talking about excluding interest payments from the budget.

Senator ALEXANDER. Well, whatever. In my own view, it ought to be first. If I went in to borrow money to buy a house and I told the——

Mr. ORSZAG. Absolutely.

Senator ALEXANDER [continuing]. I told the banker, look, in 10 years, my interest payment is going to be 15 percent of my income, but I am going to put that on another account, I don't think he would make the loan. That is one suggestion.

Suggestion two, Senator Gregg's suggestion of four pretty big steps, I hope you will take those seriously. I do. We have had a difficult time here in the Senate with comprehensive bills. You know, comprehensive health care has been very hard. Comprehensive economy-wide cap-and-trade has been very hard. Comprehensive immigration, even though we had Senators from both parties who were working on it, was very hard. We may do better step by step to go in the right direction.

Those were four pretty good steps. Start the freeze right away. Stop using TARP as a piggy bank. Don't spend the stimulus money after 2010. Find some money in Medicare to use to strengthen Medicare. I can think of others. You probably can, too. So I think you would find bipartisan support for steps in that direction and I hope that will be taken seriously.

Third——

Mr. ORSZAG. Senator, can I clarify on that——

Senator ALEXANDER. Yes.

Mr. ORSZAG [continuing]. Because, again, on the Medicare reductions, there was some opposition from members of your party. So if——

Senator ALEXANDER. Because you spent it for a new program.

Mr. ORSZAG. OK. I just wanted to clarify.

Senator ALEXANDER. That was the problem.

Mr. ORSZAG. OK.

Senator ALEXANDER. That is the problem, and I think that is what Senator Gregg said. There was a lot of opposition for that.

On the Fiscal Commission, you might want to consider following a suggestion about bringing that up again, amending it, and finding out what the problems are. I mean, it has 17 Republican votes. If the President with 59 or 60 votes can't pass something that is important to him, it is going to be a long 4 years. So that is a good start, and maybe there are some adjustments that could be made in the statutory commission.

My own view is that working on that is much more likely to get a result than an Executive Order, no matter how well intended that might be. President Bush had a very good Executive Order creating a panel on tax reform. It never saw the light of day.

So those are three suggestions.

Mr. ORSZAG. Thank you.

Senator ALEXANDER. Now, here is my question. There is a lot of talk about inheritance, and members of the administration say, rightly, that they inherited a debt, inherited a recession. That is exactly right. But the question is what you do with your inheritance. That is what we are talking about here.

And it seems like that what we are saying here is that, aha, I see the problem. The boat is sinking and it has a hole in it, and your solution is to put some more holes in it with big increases in spending. There is the stimulus bill, the auto bailout, the appropriations bills, the spending for health care, and the spending for the jobs bill. And I have a specific one to ask you about, which is what you propose to do with Pell Grants.

We all like Pell Grants. I am a former university president and was Education Secretary. I am a big backer of Pell Grants. But in your budget, as I read it, we would increase spending for these college scholarships by $14 billion, nearly $15 billion. We are up around $34 or $35 billion a year. We would then spend $118 billion over 10 years to fund the existing maximum grant award, and then we would spend $69 billion over 10 years to increase it according to the cost of living plus 1 percent, and then we would take all of that money, which is about a half-trillion dollars over 10 years, and make it mandatory spending.

Now, I was invited to a summit with the President at the White House last year, which I appreciated very much, where all of the concern was about entitlement spending. How can you justify adding a half-trillion new dollars over 10 years in Pell Grant spending from the discretionary side to the mandatory automatic pilot side?

Mr. ORSZAG. Well, Senator, I think the objective there is that, as you know, education is one of the underpinnings of not only the middle class—living the middle class dream, but also of economic growth. And so in addition to our elementary and secondary education reforms, we also want to be promoting college attendance, because one of the things that has happened over the past decade or so is that increase in average educational attainment among the U.S. population, which was a tail—I am sorry, a wind at our backs in terms of economic growth, has now tailed off and it is no longer rising. So we need to go additional steps and again promote not only college attendance, but college completion. That is what this proposal is aimed at getting at.

Senator ALEXANDER. Thank you, Mr. Chairman. My time is up.

Chairman CONRAD. I thank Senator Alexander.

Senator Nelson?

Senator NELSON. Dr. Orszag, thank you for your public service and for trying to get your hands around this budget deficit and the problems facing the country.

I want to ask you a friendly question and I want to ask you an unfriendly question.

Mr. ORSZAG. OK. Which one first?

Senator NELSON. The friendly question, but you are going to think it is unfriendly.

Mr. ORSZAG. OK.

[Laughter.]

Mr. ORSZAG. Great.

[Laughter.]

Senator NELSON. I am going to zero into a specific part of the budget. The President, with regard to the future of manned space flight, appointed a Blue Ribbon Panel. Basically, in your budget that you have announced, you have accepted the recommendations of the Blue Ribbon Panel, which is called the Norman Augustine Panel, with the exception of what they said for meaningful human space flight for the future of what you had to spend.

Here is what the Augustine Commission said. Human exploration beyond low-earth orbit is not viable under the fiscal year 2010 budget guideline. We agree with that. And they went on to say, meaningful human exploration is possible by increasing annual expenditures by approximately $3 billion in real purchasing power above the 2010 guidance. And, of course, you haven't done that.

Do you want to explain? And that is my friendly question.

Mr. ORSZAG. OK. I can't wait for the unfriendly one.

[Laughter.]

Mr. ORSZAG. Senator, as you know, we increase NASA funding by $6 billion over the next 5 years, including an increase between 2010 and 2011, despite an overall non-security discretionary freeze. So NASA is one of the agencies experiencing an increase.

I would also note, and I will leave the science to my colleagues, Dr. Holdren and others, but that Mr. Augustine has issued a statement strongly in support of the direction that is reflected in this budget for the future of NASA.

Senator NELSON. I choose to disagree with that characterization. It was a namby-pamby watered-down statement that was oblique, at best.

Alright. So, in essence, you are saying that in the totality of spending and so forth that you all couldn't afford the Augustine's recommendations of $3 billion a year for human space flight.

Mr. ORSZAG. No, I don't know that that is the way I would describe it. I think that, again, under the leadership of our scientific and NASA leaders, there is a new course being charted for the future of human space flight that involves more advanced technologies, longer-range R&D, investments in technologies that will help us leapfrog existing technologies and allow us to have human space flight to different parts of the solar system.

Senator NELSON. All of which are necessary, all of which were in the Augustine Commission report and of which you have embraced, but you can't do it on the cheap and that is the big difference. OK.

Now for my final question. You accepted the Augustine Commission's report saying that we are going to develop a commercial rocket that will be a space taxi that will basically get us to and from the International Space Station. You extended the Space Station to 2020. I mean, we have spent $100 billion and are still constructing it. We now need to make it pay off like a national laboratory. All of that is good.

The problem is that you have put all the eggs in the basket of assuming that those commercial rockets are going to work and that NASA is not going to have to spend a lot more in making those commercial rockets manned, safe for humans. And you have cutoff the testing and development of an alternative rocket. There is no fail-safe position. If those commercial rockets don't work, then for the foreseeable future of the next decade or so, we are going to be relying on the Russians just to get to and from our Space Station.

Now, that is what I wanted to talk to you privately out there about and we were interrupted. I want you to take that for consideration, and that has got to be changed, Dr. Orszag.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Nelson, and since I am the one who interrupted you, I apologize. I know that you were in the middle of a discussion with Director Orszag and I needed to have a discussion about some other issues, but——

Senator NELSON. No, you didn't interrupt. It was Senator Gregg.

[Laughter.]

Chairman CONRAD. We were together.

Senator GREGG. Well, I apologize.

Chairman CONRAD. Senator Ensign?

Senator ENSIGN. Thank you, Mr. Chairman.

Dr. Orszag, I appreciate all of the work. I know anybody who works for the administration puts in incredible hours and I know you want to do the right thing for the country, just like the rest of us. We may have disagreements on how we go about doing that, but certainly I think we all have the same goals in mind.

One of the things that was said earlier was about the Japanese budget during the 1990's, the lost decade, and I have heard some talk about this and it seems to me to be mischaracterized, because it was a lost decade. Everybody agrees on that. The question is, did they put the brakes on government spending or was it too much government spending?

Well, in 1991, 32 percent of their GDP was government spending. By 2000, it was up to 38 percent of GDP. They had six different stimulus bills during the 1990's on government spending, infrastructure-type projects. It did not take them out of that lost decade. It wasn't government spending that did it.

The reason I think that is an important point to make is simply because it is just like the whole debate about the Great Depression. Was it government spending that was taking us out of the Great Depression? Well, we lasted a long time during the Depression with all of the various things that FDR tried to do, and with good intentions. But it wasn't until World War II that we came out of the Great Depression.

I guess the point is that the debt, the long-term debt, is a threat to the actual viability of the United States economy, just like it is for a country, or a company, just like it is for a State, just like it is for a city or a family. Too much debt makes it impossible to meet your obligations. That is what bankruptcy is about. Well, we are heading in that direction. I think Senator Gregg and Senator Conrad have talked a lot about this. This is not something theoretical. This is becoming real.

The question that I have for you is, do you have a best guess at what point that our debt would be downgraded? How much debt? As a percentage of GDP or a total number, do your economists have a guess at what point we will be downgraded, or where the Chinese will say, yes, we are maybe not going to buy any more of that debt or we are at least, if we are going to, we want higher rates on that debt? Have you guys kind of projected that out?

Mr. ORSZAG. Senator, I do not think we are close right now. I think it is worth pointing out we are in an exceptional period where private borrowing has collapsed. Total borrowing, as a share of the economy, which was roughly 30 percent of GDP in 2006, plummeted to single digits, if not roughly zero. And, in that context, it is not surprising, if you look at interest rates, the 10-year treasury bond is yielding less than 4 percent.

The issue really is as private borrowing picks up, and you go out over time, interest rates will rise, and at that point we have to get ahead of the problem, which is why again we are putting forward a trillion dollars in deficit reduction, we think a bipartisan process is necessary, and so on and so forth.

So it is not an immediate issue, but it is an issue that needs to be addressed before it becomes a crisis. And I agree with the Chairman and, frankly, with Senator Gregg and others that we need to get ahead of the problem.

Senator ENSIGN. In getting ahead of the problem, though, and the reason I brought up about the Japanese, is that these Congresses and the Presidents always seem to wait. They seem to say, you know we are not going to make the tough decisions today. It is easier to put it in a budget that we are going to do deficit reduction in the future, instead of now.

OK, you had a stimulus bill last year. Argue the merits of the stimulus bill back last year. But then during the appropriations bills, those were plussed tremendously on top of the stimulus bills, and this year as well. Why do we not start last year, go at least year's level and start this spending freeze?

I am glad that at least you put this spending freeze forward. That is at least something.

By the way, I think you are going to have a lot of trouble with your side of the aisle with that spending freeze. I think you are going to have a lot of political trouble. I will support you in it, but I think that you will have a lot of trouble with folks on your side to get that done.

But, having said that, it would seem to me that we cannot keep kicking this ball down the road. We need to address it and address it now.

Mr. ORSZAG. Well, the challenge really is, Senator, from my perspective, that we face those large fiscal deficits, but we also do have this massive jobs deficit.

And I guess I do have a different reading of both history and my view of how economies operate, that in a downturn temporary measures, including measures like the Recovery Act, help to reduce unemployment, help to spur economic activity. In that context, it is counterproductive to start reducing the deficit too quickly. I think that is the history of 1937, where that was attempted, and we threw the economy back into recession.

Senator ENSIGN. Well, just to finish up here, Mr. Chairman, 1937, think about how long the recession had gone on. Think about how much money had been spent. Right?

And remember, it was Republicans that also increased, dramatically increased government spending at that point. There were also trade laws.

I hope that the Administration actually will push free trade, so we do not go into a protectionist type of a mode and repeat some of the mistakes. But also, I think the government spending, every time you take a dollar to the government, that is a dollar out of the private sector, and we should be putting those dollars and creating private sector jobs instead of government jobs. It is just a difference in philosophy.

Thank you.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman.

Let me begin by saying something to my friend, Senator Gregg, through the Chairman—through the Chairman—and that is I really do not like being lectured on deficits when you and many members of your party helped cause the situation we are in right now.

People voted—Senator Gregg, I believe you were one of them—for a war in Iraq which some people will think will cost two or three trillion dollars, but you forgot to pay for that war.

You and other people voted for tax breaks for the wealthiest 1 percent, cost $600 billion. Forgot to pay for that.

You voted for a prescription drug Medicare bill, which will cost $400 billion, that does not negotiate prices with the pharmaceutical industry. Forgot to ask how that was going to be paid for.

You voted for a bailout, and I believe you want to repeal the inheritance tax, which will cost a trillion dollars over a 10-year period, benefiting the top three-tenths of 1 percent.

I voted against all of those things. So, please, please spare the lectures on deficit reduction.

Now——

Senator GREGG. May I say through the Chair that this Senator's factual position is inaccurate?

Senator SANDERS. You did not vote for every one of those things?

Senator GREGG. I did not vote for the drug benefit, and I have not proposed eliminating the inheritance tax.

Senator SANDERS. All right, we have you on Google. All right. But you did vote for the wars.

Senator GREGG. Yes, I believe we should protect ourselves as a Nation first——

Senator SANDERS. But without worrying about how you were going to pay for those.

Senator GREGG [continuing]. To defend the Country.

Senator SANDERS. All right.

Dr. Orszag, now I am going to be rough on you. I did not want to be nonpartisan about this.

[Laughter.]

Senator SANDERS. I applaud the President for keeping in his budget a proposal to let all of the Bush tax breaks for the wealthiest 2 percent expire at the end of this year. My question is why have you not moved to do that this year?

We have a situation where the top 1 percent earns more income than the bottom 50 percent. According to the Citizens for Tax Justice, if we repealed all of the 2001 and 2003 tax breaks that went to the wealthiest 1 percent alone, we would save over $100 billion this year. Why not?

Mr. ORSZAG. Senator, it was our view that they were scheduled to expire at the end of the year and that that was just the best way forward.

Senator SANDERS. Really? We know that they were set to expire. But I am asking you, when we have the most unequal distribution of income in the entire industrialized world, why did you not ask the top 1 percent to start paying their fair share this year?

Mr. ORSZAG. There are a variety of ways of answering that question. I think one of them is that we were shifting to deficit reduction gradually over time, including in 2011 and 2012, and that 2010 was not seen as the year to be reducing the deficit, given the depth of the economic downturn.

Senator SANDERS. Well, I surely do not agree with that.

And, by the way, let me say I think you did a lot of good things in this budget, which I applaud, and I think absolutely that in the midst of the worst economic recession since the Great Depression we have got to do everything that we can to put people to work and to make taxpayers out of them and to fight our way out of this horrendous economic situation.

But let me ask you this in terms of the budget. You chose to exempt the Pentagon from the budget. I could quote——

Mr. ORSZAG. Well, from the freeze, yes.

Senator SANDERS. From the freeze, right. Right. I am sorry.

There is a lot of belief that a huge Pentagon budget which has significantly increased in recent years, that a lot of that money is not necessarily directed toward fighting the fights we are in right now against international terrorism. But, among other things, there are weapons systems designed to fight the cold war, that there is an enormous amount of waste.

I mean people like Don Rumsfeld talked about trillions of dollars not being able to be accounted for.

Why was the Pentagon exempted from the freeze?

Mr. ORSZAG. Well, first let me say that there were constraints placed on the Pentagon budget. It was exempted from the freeze because we are at war and we think during a time of war our first priority is to protect our soldiers.

But let me just talk for a second about the steps that Secretary Gates is taking. At this time last year, we proposed canceling the F–22 fighter jet. Most people thought we would not succeed. We did. Cancelled the Presidential helicopter.

He has come back this year and made it very clear, no more C–17s——

Senator SANDERS. I apologize. I just have a little bit more time, and so I want to ask you a third question. And I do understand that, but I think that is a whole area where there is potential savings that we can and should be looking.

Mr. ORSZAG. We agree.

Senator SANDERS. The last thing is the President, I think appropriately, understands that many senior citizens in this Country are hurting. There is not going to be a Social Security COLA this year. He supported the concept of doing what we did in the stimulus package, providing $250 per senior and disabled veteran, which I think make a lot of sense. It is in your budget.

Mr. ORSZAG. It is.

Senator SANDERS. But is that something you are going to fight for?

Mr. ORSZAG. It is in our budget, and we are going to fight for everything in our budget.

Senator SANDERS. OK. Thank you.

Chairman CONRAD. Thank you.

Senator WARNER.

Senator WARNER. Thank you, Mr. Chairman.

Let me first associate myself with both the comments that you and the Ranking Member made about the need to break the logjam on the deficit reduction. I was a strong supporter of the statutory approach on deficit reduction. I wish the Administration had actually come onboard earlier for that approach. I was appreciative of their support at the end.

I am a new Senator, but it seemed to me that when folks sign up to be co-sponsors of a piece of legislation, the expectations are they are going to go ahead and vote in favor of that legislation, particularly when they have been on record time and again supporting that we have to break out of the normal process and do this in a bipartisan way.

I had a family emergency on the day of that vote and flew back. It sure did seem like the process was a little bit cooked when a lot of my colleagues on the other side who had been longtime supporters of this, had the chance to get that critically important piece of legislation passed through the Senate, that when the time to put their names down as yeas, that they were not there.

I would echo what the Ranking Member said, we ought to bring it back up, and we ought to. I will continue to work with my colleagues on this side of the aisle.

A lot of new members were very supportive of that effort. I would love to hear again from my friends on the other side of the aisle, those who had been on record as supportive of that proposal, over time, why, when we were this close to getting it done, they chose that suddenly now is not the right time when clearly all of the data support that the current approach is unsustainable. The current process has not proven the ability to move beyond small ball.

And I again would urge the sponsors of the legislation to continue to bring it back up, and we ought to try to get more folks on this side. But, gosh, it sure would be great to have folks who had been long-term supporters, who put their name on as co-sponsors, to step up and actually adhere to that and be part of the solution.

I also want to make one other comment. I do not fully agree with my colleague, the Senator from Vermont, on the defense budget. I do think from the freeze, because the Nation is at war, we need to have more flexibility there.

But I would agree that without putting some pressure on the Pentagon budget you end up not having any notion of constraint. For example, an issue that I know Senator Nelson would greatly disagree with me on this, but there is a debate about home-porting of aircraft carriers. Norfolk does an incredibly good job of that at this point. Your budget puts forward spending. You estimate $600 million. I think more realistic estimates are north of a billion dollars on adding this additional facility in Florida when the Navy has a $36 billion backlog in terms of already identified needs.

I am hoping that as we see more of this budget laid out, that the Navy or the Administration will outline what is being bumped from that list of existing priorities to add a billion dollars of additional spending that I do not think, in terms of need or defense policy, clearly had not been identified as a need until the waning days of the last administration—how suddenly this is going to trump the $36 billion of unmet needs the Navy has already identified.

Let me get to my question. I appreciate very much the task force that the Chairman and the Ranking Member have given me, and Senator Whitehouse and others on the other side, to look at performance goals. Jess Zients, your chief performance officer, has said performance goals need to be part of this budget. I am not sure they have been fully laid out and there was supposed to be input from the Congress and the public. I would like to hear whether there was that input from the Congress and the public.

But one of the things that is terribly important, and actually quoting President Reagan, one of the things hardest to kill is a government program. You have indicated, and the President has indicated in the past that he was going to go through line by line and find those programs that could be eliminated. You suggested 121 programs last year that would have saved $17 billion. We actually ended up only approving $6.8 billion of those.

With this year and the out-year deficit being as bad as it is, I was a little disappointed that in this year's budget you have only, in aggregate, indicated program eliminate that would account for $23 billion in savings in 2011, which is about a half a percent of our overall budget. Why not identify more programs and would you be willing to work with us in seeing if we could identify more where we could actually eliminate some of these programs going forward?

Mr. ORSZAG. Absolutely. We are open for ideas.

And I note with regard to the high priority performance goals, they actually are embodied in the documents that we sent out. So, in the Analytical Perspectives chapter volume, starting on Page 75, we go through it.

Senator WARNER. Did the individual agencies go out and solicit from the Congress and the public the way they were supposed to?

Mr. ORSZAG. They varied, and the one of the reasons that we were so interested in publishing them is to solicit that kind of feedback and commentary now, to the extent that additional commentary is always welcome.

Senator WARNER. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

And welcome back, Director Orszag. It is good to be with you. I think that in this Committee you are likely to run into disagreement on a whole variety of subjects from various sides, but I do not think it is appropriate to question your integrity, and I just want you to know that I at least have full confidence in that, even in areas where we may disagree.

An observation, a recommendation and a question. The observation is that, as Senator Alexander was kind and accurate enough to admit, the problems of the deficit that you inherited were considerable. He said that is exactly right, and it sure is exactly right.

I just wanted to add as an observation that at the time the Bush Administration came into power the trajectory that CBO had anticipated for the Federal Government was into absolute surplus. And when the Bush Administration is criticized for the deficits that it ran up, what is usually left out because it starts at a zero baseline is the surpluses that they were in line for, had they really kept the Clinton policies going.

Our calculation, for what it is worth, is that the net effect of the difference between the Bush policies and where CBO, at the day that Bush took office, projected the economy and the deficit to go is nearly $9 trillion, which is an absolutly astonishing amount of fair weather debt at a time when none of the Keynesian steps for supporting an economy in steep contraction through Federal spending made any sense. That is my observation.

My recommendation is this: Back, I guess quite a while ago, James Carville observed that it is the economy, stupid.

When it comes to the deficit, it strikes me that it is health care. To the extent that it is location, location and location in real estate, it is health care, health care and health care on the deficit. I see you nodding, and I know that you agree with that.

The reason that I did not support the statutory fiscal commission is that it looked like it came at the health care question too much with fiscal knives and not enough with comprehensive delivery system reform. As you know, I am a very keen advocate of delivery system reform.

I think the goals and the extent of the target are very enormous. I mean really astonishing. If there is a trillion dollars worth of waste every year in our health care system, or $850 billion—or, as the President's Council of Economic Advisors guesstimated, north of $700 billion—whatever it is, it is a very big number, and there is a great deal of very good stuff in the health care reform legislation that targets that.

CBO was not able to score it because it takes a lot of management and a lot of experimentation and a lot of executive effort to deploy those tools, but they are there.

In the event that the Republican blockade of significant health care reform persists, and now at 41 votes they have the ability to make it absolute, I would urge that you investigate—and I am happy to participate in any way you think I would be useful—how much of that stuff you can get done through executive order. Really push it because the clock is ticking on this stuff. If we do not get started now with these programs, in the out-years we will have lost critical time, and that critical time turns into critical dollars.

I think anybody who is serious about the deficit has to be serious about moving the delivery system reform part of the health care agenda, and you simply cannot be serious about the deficit with the one hand and continue to blockade that section of the legislation on the other.

The question is this: Looking out long term at the economy, if we continue to subsidize carbon pollution and continue to lag behind the emerging clean energy technologies in international competition, particularly with the Chinese but also with many of the European Union companies, what long-term effects do you anticipate on our economy if we are slow to make that transition from subsidizing carbon pollution to adequately and competitively supporting clean energy emerging technologies?

Mr. ORSZAG. There are two effects. One is the effects of failing to address climate change and the effects that has on the economy, and the second effect is as the rest of the world moves to a clean energy future we would be losing opportunities to be the world leader in a crucially important market. That is why we, in this budget, propose eliminating fossil fuel subsidies, and it is why we have more than $6 billion in funding for clean energy research and development related activities, so that we can leapfrog and become the world leader in a green energy future.

Senator WHITEHOUSE. I appreciate that.

Thank you, Chairman.

Chairman CONRAD. Thank you, Senator Whitehouse.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

And thank you for your presentation, in particular, the emphasis on creating jobs and helping the middle class. I want to see us be as bold and aggressive in assisting working American families as we have been in assisting major financial institutions, and in that regard I did want to ask you about housing because housing is a key component of the success of our economy and the success of our families.

Just a quick review here, in the budget: Discretionary spending would be down $2 billion. Mandatory spending would be down $11 billion. Guaranteed loan commitments would be down $170 billion. Direct loan disbursements would be down $145 billion. USDA's program for multi-family activity in rural areas would be zeroed out. And then we have the HAMP program that very little money has actually been disbursed on because of the great difficulty in families getting through the trial period and into permanent programs.

Taken as a whole, I am very concerned that this is not the bold, aggressive outreach, in a very important part of our economy that would be equivalent to the bold, aggressive outreach there was to save our major financial institutions. So I just would like you to spend a couple minutes on that if you could.

Mr. ORSZAG. Sure. There actually is a significant amount of housing-related activity in this budget, including an important measure to address homelessness through the HEARTH Act, significant expansions in the Department of Housing and Urban Development's activities surrounding assistance for people including tenet-based assistance, project-based assistance and related activities, some increase in programs that are dedicated to assisting the elderly with their housing.

And then more broadly, and this returns to some of the earlier discussion, but as you know the Administration's efforts, working with the Congress and others, to stabilize financial markets has helped to stabilize mortgage rates and generated more than a thousand dollars savings for the average borrower in terms of their mortgages. That is a crucial step.

Now with regard to the HAMP program which you mentioned, there are in excess of 800,000 families that have experienced a modification through that program. The problem really is in taking, expanding that number and then taking the temporary modifications and making them permanent. Under Secretary Geithner's leadership and working with Secretary Donovan and others, there is very active effort to try to streamline that program, so we can get the temporary modifications not only expanded but also make them permanent.

Senator MERKLEY. OK. Let me just say I am not satisfied with your response. The housing for the elderly is being dropped from $825 billion in 2010 to $274 billion. While some of the other increases you mentioned are here, as a total, we still have a $2 billion drop in the discretionary spending. So I think picking out just a few that are plussed up presents a misleading picture of our overall housing effort.

Also, the monetary policies you referred to that decrease the cost of the home mortgage for families, this is very true, but it is also being phased out of the next 3 months. So that change would also contribute to a change in the picture as we approach this.

So I will not spend more time on that, but I just wanted to raise it because I think it is an important component, and it looks like it falls short.

I wanted to turn from that to interest, and on Page 149 of the budget there is a presentation of the interest, net interest in 2009, looking at $187 billion. By 2020, it rises to 912.

So I thank you for having interest in here, but I also wonder since many of us are very concerned. It has been mentioned by some of my colleagues that our assumptions about interest rates are critical because not only is our debt increasing, but interest rates are at a historic low, and there is certainly the possibility of those interest rates increasing dramatically which would further amplify what is now about a fourfold increase in the cost of interest that is in this budget over a 10-year period.

So maybe you could just mention the interest assumptions——

Mr. ORSZAG. Sure.

Senator MERKLEY [continuing]. And what higher assumptions, the impact higher assumptions might have and the risk that poses to us.

Mr. ORSZAG. Sure. First on interest rates, if you turn to Table S13 which is on Page 177 of that same document, you can see the path of interest rates on, for example, the 10-year note which might be the most illuminating, rising gradually over time. And that is mostly because again, as I had mentioned earlier, as private borrowing picks up and there are alternative investment opportunities, one should expect investors to diversify their portfolios to some degree, and that puts upward pressure on treasury yields.

Senator MERKLEY. Thank you for pointing me to those assumptions. I appreciate that, and I hope that the 5.3 percent assumption holds because otherwise we are in a much worse condition.

I am out of time, so a last sentence, and that is I am wholeheartedly behind taking funds and moving them to support our community banks. That is a proposal that I have been advocating for. But I would recommend that we take that $30 billion out of the $200 billion currently unspent rather than the funds that are being returned. It seems to me that that would address some of the issues that are being raised right now.

But I think we could all—we ought to all be able to get behind the notion that if our community banks are not recapitalized and they cannot lend to small businesses, our small businesses are not going to thrive, our communities are not going to thrive. It is going to be a very long recession.

Thank you.

Mr. ORSZAG. If the Chairman would allow me just 30 seconds, just to clarify one thing because I did not have a chance to fill in the detail, with regard to housing and the Department of Housing and Urban Development's budget, the decline that you see is mostly because there is an offsetting receipt. You can see it in the Federal Housing Administration line in 2011, and that is the primary explanation for the apparent decline in the HUD budget. But we could followup in more detail.

Senator MERKLEY. That would be terrific. Thank you.

Chairman CONRAD. I thank the Senator. I thank all Senators who have participated today. I especially thank the Director for being here.

Just before you leave, I want to kind of recap. Again, as I look at what happened, my own belief is that the United States had a series of policies on both the monetary side and the fiscal side that led us to the brink of collapse.

I believe there was an overly loose monetary policy by the Federal Reserve after 9/11. It was understandable for some period of time after 9/11, but it continued too long.

Simultaneously, there was an overly loose fiscal policy under the control of Congress and the Administration, and this goes to the previous administration. That was on their watch—massive deficits, a doubling of the debt, a dramatic increase in foreign borrowing.

And it is the combination of an overly loose monetary policy and overly loose fiscal policy, all within a context of deregulation, that created the seed bed for bubbles to form. And bubbles did form. And it was not just a housing bubble, although we certainly saw that. There was also an energy bubble, a commodity bubble. I distinguish an energy bubble from a commodity bubble because, for example, wheat went up tp almost $20 a bushel.

Bubbles ultimately burst, and when they do there is enormous economic wreckage. It was critically important for the administration, the previous administration at its end and this administration at its beginning, coupled with the Federal Reserve, to provide liquidity because there was not economic activity on the private sector side. Had government not stepped forward, there would have been an absolute collapse.

On the question of what history teaches us, with Japan, I can only cite top Japanese economists who have advised us: Do not try to cut your deficit too quickly.

Now this is coming from me. I am a deficit hawk. I am very concerned about long-term debt. But I also recognize if government does not step into the breach when the private sector, because their balance sheets are impaired and because they do not have demand, pulls back—if the government does not step forward, there is no one to keep the economy from going right off the cliff. So, yes, these policies added to deficits and debt in the short term. They were exactly the right thing to do.

The argument that I have is the longer term—the longer term—because my concern is when I look beyond 5 years I see deficits of a trillion dollars a year as far as the eye can see, and I see debt continuing to grow as a share of the gross domestic product in a way that is clearly unsustainable. Part of it fueled by demographic changes. Part of it fueled by economic changes. Part of it fueled by structural changes in the economy.

If we do not face up to it, I believe that will fundamentally threaten the economic security of the United States. I believe that will create another seed bed, a seed bed that could lead to a run on the dollar, which would then require very precipitous action.

The former Secretary of the Treasury, Robert Rubin, who I think has, from all observers, gotten very high grades for the economic policy that he pursued as Secretary of the Treasury under the Clinton years, has called me several times in the last years, warning about his concern about the long-term growth of debt and what it could mean for interest rates.

Senator Merkley, I am very pleased that you raised that issue because these forecasts tend to flow from what is happening now, and typically forecasters miss it at the turn. We saw that when things were going down. We have seen it repeatedly when things were going up. The forecasters miss it on the low side, they miss it on the high side because they are forecasting from what is.

Unfortunately, none of us can predict with clarity what will be. What we do know is that we are running outsized risks. That is the point former Secretary Rubin has made to me repeatedly. It is what I personally believe.

I believe we are running on the long term, outsized risks, and we have got to right-size this budget.

And again, I give the Administration high marks on what they have done to respond to this crisis. I think history will show they helped avert a global financial collapse.

Anybody that was in that room, and this was with the previous Secretary of the Treasury under the previous administration, as the news came in on the weekend we were negotiating the first TARP, it was truly perilous times. I do not think the Country has ever really been made aware to how close we came to not just a financial collapse here, but a global financial collapse.

I see that Senator Wyden has arrived.

Senator WYDEN. Thank you very much, Mr. Chairman. I want to welcome the Director as well, and I want to express my appreciation, first of all, to the Director for the support in the budget for management and also restoration of forestry. This is going to be particularly important because in eastern Oregon, as the Director knows since we have talked about this, we have been able to achieve a real breakthrough in the timber wars. We have been able to get the timber industry and the environmental community together on a proposal that we believe will get saw logs to the mills, help us generate biomass, a clean source of energy, and also protect old growth. So I am very appreciative of the Director and the folks in your office for working closely with us on this because I think that particular account for management and restoration work will be a huge plus.

Just a couple of questions, if I might. In the Build America bonds area, which, as the Director knows, I authored and I have championed now for a number of years, we have been able to achieve a remarkable success. What we thought might generate about $5 billion worth of bonds, since the program really did not start until late in the spring, ended up at the end of the year with just under $64 billion worth of bonds being issued, and it is projected to rise to about $130 billion this year.

I am very pleased that the administration looks to make this program permanent. I think that is a real plus. I have just one question. There appears to be a proposal to modify it to allow for operating expenses to be included and also refinance, and, Mr. Director, I would like to continue to work with you in that area because what we envisioned when I and Senator Thune and Senator Talent and others worked on this is that you got the most on the job creation side with new efforts. Would it be possible to continue this dialog with you?

Mr. ORSZAG. Absolutely. Yes.

Senator WYDEN. That would be great. One last question, and I gather a couple of my colleagues touched on the issue of military spending. I just want to read you a quote that was in an important article by George Wilson, who I think consistently is one of the most knowledgeable people who writes on this subject. He said a couple of days ago, "Two-thirds of our casualties in the Iraq war were inflicted by hidden bombs that the bad guys set off by cell phones or other simple devices available at Radio Shack."

So what has become clear to me is that to best protect the country in a dangerous time when we deal with terrorist threats is to try to address a lot of those kinds of concerns rather than some of these big projects of dubious value that seem to always manage to make it through the Congress because they have got support in a variety of congressional districts.

Tell me, if you would, particularly since the President said that the overall budget would not be cut, how can you, as you all go forward with budget decisions, advance the kind of thinking that I think George Wilson lays out correctly in this article and help us to steer clear of these projects that to me, when you hold them up to the light, get you a lot more spending and not the value we need to protect our troops in a dangerous time?

Mr. ORSZAG. Well, Secretary Gates in particular is very focused on reforming the procurement part of the budget, the defense budget, which is where those big projects or big weapons systems are. You will hear more from him about this year canceling or terminating things like additional purchases of C–17 cargo aircraft, which are not seen as being militarily necessary; canceling the alternative engine for the F–35; eliminating the CGX ship for the Navy, and so on and so forth. There is a whole series of terminations and reductions that the Defense Department has put forward, and what he is trying to do is reform the procurement budget, in particular, to avoid those overbudget and militarily unnecessary projects that seem to get—or weapons systems that seem to get funded even though the military does not ask for them.

Senator WYDEN. Mr. Director, I will only say I am anxious to work with you and Secretary Gates in that area, because that image of the bad guys in effect, whether it is Radio Shack or somewhere else, going on out there. I sit on the Intelligence Committee, obviously cannot get into anything classified, but I think what that article that I quoted lays out is one of our biggest challenges, and it is not going to be achieved with these huge weapons systems that end up costing us billions but a much more focused kind of attack on the kind of example that I cite, and I am anxious to work with you and the Secretary on it, and I appreciate the chance to continue this discussion in the days ahead.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Wyden, and thank you for your leadership on this Committee.

Very few Senators dig into as many topics and as in-depth a way as Senator Wyden. Whether it is tax reform or health care reform, Senator Wyden listens to his colleagues and then really does his homework. And it is very important to this Committee, and I appreciate it very much.

Dr. Orszag, thank you again for your willingness to serve. It is not always easy. There are a lot of strong emotions, as we could see here today, a deep concern about the direction that we are headed long term, and I know you share that concern, and your record is very clear on that subject.

I just want to make clear that this Committee fully appreciates not only your professionalism but your integrity, and we are very fortunate to have people of your character and your quality in public service. Thank you, and we look forward to working with you in the days ahead.

Mr. ORSZAG. Thank you, Mr. Chairman.

Chairman CONRAD. The Committee will stand in adjournment.

[Whereupon, at 11:42 a.m., the Committee was adjourned.]

QUESTIONS FOR THE RECORD

FY 2011 OMB QFR

Senator Jeff Sessions

As you know, 5-year statutory spending caps with low 1-2% annual increases were very helpful in reducing the deficit in the 1990s and achieving years of surpluses. Do you believe that similar caps can be helpful to reduce the deficit today?

The President's Budget makes the hard decisions necessary to freeze non-security discretionary funding for a three year period from 2011-13. The proposed freeze in non-security discretionary funding is well below the 5 percent average annual growth in such funding since the early 1990s. And over the next 10 years, this policy saves $250 billion relative to continuing the 2010 funding levels for these programs adjusted for inflation.

The Administration believes that the current mechanisms in Congress for holding funding to desired levels—in particular, the 302(a) and 302(b) allocations as set under the Congressional Budget Act—are sufficient to restrain funding growth as we have proposed, and we urge Congress to use these mechanisms to do so. At the same time, the Administration is also open to further discussions about how the existing rules for enforcing discretionary funding levels could be strengthened.

Senator Jeff Sessions

Although there has been much talk of entitlements such as Social Security and Medicare causing our poor fiscal situation, isn't it true that combined these programs have actually been running surpluses for many years, and therefore our current deficits can be attributed to discretionary spending?

Under any fair accounting, discretionary spending is not the principal driver of federal deficits—and cannot explain why the budget went from trillions in projected surpluses at the beginning of the last decade to trillions in projected deficits now. Non-security discretionary spending (discretionary spending exclusive of international affairs and the Departments of Defense, Veterans Affairs, and Homeland Security) is temporarily elevated now due to Recovery Act investments to get the economy going again, but, as a share of the economy, it would fall to its lowest level in more than 50 years by the middle of the decade under the President's Budget. And, although security discretionary spending has increased as we entered two wars, these costs, while large, are substantially smaller than other factors that have driven the budget from surplus to deficit.

The medium-term projection of unsustainably large deficits primarily reflects three factors: a failure to pay for policies in the past, the impact of the economic downturn, and the steps we took to mitigate that downturn.

- Over the next ten years, the prior Administration's failure to pay for the 2001/2003 tax cuts and the 2003 prescription drug bill are slated to add $5.8 trillion to the deficit, including interest expense on the additional associated debt.
- The recession that began in December 2007 also adds considerably to the projected deficits. When the economy enters a recession, the Federal Government's receipts automatically fall and the costs for certain programs, such as unemployment insurance, automatically rise. Over the next ten years, these automatic stabilizers are projected to add about $2.4 trillion to the deficit, including interest expense.
- Finally, it is worth noting that the Recovery Act—which, as discussed, has been key to restoring economic growth—plays a relatively small role in the projected deficits compared with these other costs. Over the next ten years, the deficit impact of the Recovery Act is less than one-tenth the size of the costs associated with 2001/2003 tax cuts, the prescription drug bill, and the automatic effects of the recession on the Federal budget.

Summed together, this fiscal legacy—the unpaid-for 2001/2003 tax cuts and prescription drug bill, as well as the worst recession since the Great Depression and our necessary response to it—accounts for $9 trillion of the projected deficits over the coming decade if current policies were continued.

It is also worth noting that, over the long term, rising health care costs become the primary driver of deficits. If historical health cost growth were to continue, Medicare and Medicaid would more than double as a share of the economy over the next 40 years—swamping any plausible change in discretionary spending. That is one of the reasons why the Administration is committed to completing health reform this year that reduces costs, improves quality, and reduces federal deficits by more than $100 billion over the coming decade and far more thereafter.

Senator Jeff Sessions

The president's budget projects that debt held by the public will exceed 60 percent of GDP in FY 2010, and begin approaching 80 percent of GDP by 2020. The European Union requires that member countries keep their debt levels below 60 percent of GDP to, among other considerations, preserve the strength of the Euro. This suggests that our mounting debts will begin to pressure the U.S. economy, and weigh on the dollar, in the near term.

1) Is this an appropriate metric for the U.S. as well?

2) The annual increases in debt held by the public in the president's budget moderate in the middle of the decade, but picks up again by the end of the 10 year budget window. Does this suggest that the fiscal situation actually worsens at the end of the 10 year window?

The Administration believes that the U.S. should stabilize its debt-to-GDP ratio once the economy recovers. Under current economic projections, this would result in a debt-to-GDP ratio between 60 and 70 percent.

While deficits will fall over the next several years as the economy recovers, our budget projections show fiscal pressures intensifying throughout the coming decade as health care costs continue to rise and increasing numbers of baby boomers retire. Between 2008 and 2020, spending on Medicare, Medicaid, and Social Security is projected to increase by nearly 3 percent of GDP. This is why the Administration is focused on enacting health care reform legislation to reduce health care cost growth and on working in a bipartisan way through a fiscal commission to achieve fiscal sustainability over the long run.

Senator Jeff Sessions

The CBO projects that Medicare's HI trust fund, which ran a deficit of $9 billion in 2009, will be exhausted by 2016 (one year earlier than it previously projected in the March 2009 baseline). Democrats have argued that the Senate health care bill would extend the life of Medicare, but can Medicare savings (i.e. reductions in projected Part A outlays and increases in projected HI revenues) in the legislation provide additional resources to pay future Medicare benefits while simultaneously providing resources to pay for new programs outside of Medicare?

According to the CBO's analysis, health reform legislation would reduce the national deficit by more than $100 billion in the first decade and by as much as $1.3 trillion in the decade after that. This substantial deficit reduction will make it easier for the federal government to meet all its obligations—including those for Medicare—in future years.

The health legislation will also extend the life of the Medicare HI trust fund, since proposed Medicare HI savings, as a matter of trust fund accounting, are credited toward the trust fund. The Medicare actuaries project that health reform will extend the life of the HI Trust Fund by five years under the legislation passed by the House and nearly ten years under the legislation passed by the Senate.

These are each worthy—though distinct—ends. Reducing the Federal deficit improves the financial position of the government overall, while extending the life of the HI trust fund helps ensure that Medicare continues to be a source of security for America's senior citizens.

In sum, the health reform legislation being considered by Congress should help to both improve the overall financial position of the federal government and, as an actuarial matter, extend the life of the HI trust funds—both of which are accomplishments but which should not be conflated.

Senator Jeff Sessions

The Chinese believe that successes in their space program do more to advance and inspire students into Science, Technology, Engineering, and Math (STEM) education than actual STEM spending. They cite the "Apollo Generation" of scientists in the US. Will the US fall behind the Chinese in space supremacy and will that cause less young Americans to be inspired to go into the sciences?

The President's new direction for NASA expands American leadership in space exploration by increasing our technological capabilities, reducing costs, and creating new mission possibilities and opportunities. The moon race victory from 40 years ago was a national triumph, but it is time to move ahead to an era where America leads in the exploration of the entire solar system.

Further, the President's plan for NASA should help inspire and equip the next generation of scientists. Rather than focus on only the moon, this plan will expose young Americans to a myriad of launches, demonstrations, and exploratory missions. In the coming years, NASA will send a spacecraft into the Sun's atmosphere. The American commercial space industry, in a partnership with NASA, will build a fleet of spaceships to transport crew and cargo to the International Space Station (ISS). Astronauts will conduct innovative and exciting experiments – including those developed by students – aboard the ISS. Inflatable space habitats and automated rendezvous and docking systems will be developed, tested, and demonstrated. Ambitious robotic missions will explore exciting destinations within our solar system – and send back the HD video to classrooms to inspire the world.

And, as these exciting space programs help to inspire students, NASA programs like "Educate to Innovate" and "Summer of Innovation," will equip students to pursue careers in STEM fields.

Senator Robert Byrd

Practically and politically - we cannot balance the budget by looking for savings in domestic discretionary accounts alone, which comprises only 12 percent of the Federal budget. For many years, the previous Administration pursued a dangerous practice of squeezing the budgets of domestic agencies, in order to offset costs in other areas of the budget. We learned from the previous Administration that failing to invest in America has consequences. Freezing domestic discretionary spending may make for good politics in the short-term, but it ultimately fails to yield enough savings, and can leave domestic agencies unable - sometimes dangerously so - to fulfill their missions.

The President's budget includes $168 billion in the Fiscal Year 2010 and $159 billion in the Fiscal Year 2011 for military and related operations in Iraq and Afghanistan.

• I commend the Administration for budgeting for these wars, but I believe we should be paying for them as well. Does the Administration agree?

• The Congress has appropriated $1.1 trillion for military operations in Iraq and Afghanistan. For the foreseeable future, the costs are expected to exceed $100 billion annually. How does the Administration propose to offset these war-related costs?

The Administration is committed to returning the Federal Government to a sustainable fiscal path—including the costs of military operations in Iraq and Afghanistan. Further, the Administration believes that the costs for these operations should not be considered in isolation but rather in the context of the budget as a whole.

That is why the Budget does not simply assume that the cost of such operations will unrealistically disappear, as was the case under the budgets of the previous Administration. Instead, it includes about $160 billion of funding per year in 2010 and 2011 for overseas contingency operations, and, as a placeholder, assumes an average of $50 billion per year from 2012 through the end of the decade. Thus, the cost of ongoing operations in Iraq and Afghanistan are accounted for as part of the total spending in each fiscal year. Furthermore, note that the base operations in those countries do not rely on emergency supplemental funding, although the Budget does request supplemental funds to support the President's decision to increase troop levels in Afghanistan during FY 2010. And, after this year, we propose that all operations in Iraq and Afghanistan be funded through the normal appropriations process.

The Budget takes an important step toward achieving fiscal sustainability with these costs accounted for and includes more than $1.2 trillion in deficit reduction over the next ten years. As a share of the economy, this represents more deficit reduction than proposed in any President's budget in over a decade. Achieving this deficit reduction requires Congress to enact the Administration's proposals, including a fee on the largest financial institutions and the expiration of most of the 2001/2003 tax cuts for families making more than $250,000.

Senator Robert Byrd

The Chemical Safety and Hazard Investigation Board, as authorized by Congress, is charged with investigating industrial chemical accidents. One of such accidents was less than two weeks ago at a DuPont facility in Belle, West Virginia, and resulted in the tragic loss of life. In responding to the incident, there were comments from the Board that other investigations may be delayed because the agency is understaffed and unable to meet the full extent of its mandate by Congress. A December 10, 2009, article in the Houston Chronicle reported two incidents that occurred in the Houston area would not be investigated, because the agency did not have the manpower to maintain ongoing investigations while taking on new investigations. Chairman Bresland noted "We would like to investigate more accidents but that would require additional resources from Congress." The President's budget proposes to reduce funding for the Board - from $11.2 million in the Fiscal Year 2010, to $10.8 million in the Fiscal Year 2011.

• What kind of message does it send to workers in the chemical industry when the President proposes to reduce funding for the investigative body tasked with finding ways to improve workplace safety?

The Administration values the important role of the Chemical Safety and Hazard Investigation Board (CSB) in contributing to the safe operation of chemical and industrial facilities. In the FY 2011 Budget, the Administration requests an increase in the CSB's operating budget, which supports its investigations.

The FY 2011 President's Budget requests $10.8 million for CSB, which appears to represent a decrease of $347,000 from the FY 2010 enacted funding level of $11.147 million. However, the FY 2010 enacted budget included $600,000 in one-time funding for a National Academy of Sciences study to examine the use and storage of methyl isocyanate, including an examination of the cost of alternatives at the Bayer CropScience facility in Institute, West Virginia. Because the $600,000 does not support the CSB's operating budget and its ability to conduct chemical accident investigations, CSB's operating budget for FY 2010 is more accurately characterized as $10.547 million. Thus, the FY 2011 President's Budget increases the level of funding available for CSB to conduct accident investigations by more than $250,000. With this additional funding, we expect CSB to increase its capacity for investigations.

Senator Robert Byrd

In November, I wrote to you about the Administration's Memorandum of Understanding (MOU) entitled "Implementing the Interagency Action Plan on Appalachian Surface Coal Mining." The MOU noted that "Federal agencies will work ... to help diversify and strengthen the Appalachian regional economy and promote the health and welfare of Appalachian communities. This interagency effort will have a special focus on stimulating clean enterprise and green jobs development.... "

In my letter, I asked you to assist in outlining a clear and binding interagency strategy for promoting economic diversification in Appalachia, including appropriate resources for affected agencies.

I would appreciate your providing me with an update on your efforts, as well as a description of budgetary resources by agency in the President's request that have been set aside for this endeavor.

In 2009 the Appalachian Regional Commission (ARC) worked with the White House Council on Environmental Quality (CEQ) on strategies to create green energy jobs in Appalachia and specifically in West Virginia. Other Federal partners have joined the effort, and the focus expanded from energy and green jobs to a broader emphasis on strengthening and diversifying the Appalachian economy, with green jobs being one part of that discussion. Within the ARC's $76 million FY 2011 Budget, the Administration calls for $10 million to be devoted to economic diversification activities in Appalachia. In addition, the Environmental Protection Agency (EPA) has set aside $5 million in its Clean Water programs to support continued implementation of the Appalachian Coal Mining Interagency Action plan.

A number of related Federal activities focusing on Appalachia are now underway. One example is an interagency effort to boost the efficiency and competitiveness of existing manufacturing businesses in selected Appalachian States, known as "E3" (energy, economy, environment). This initiative includes the ARC, EPA, the Department of Commerce's Hollings Manufacturing Extension Partnership, the Department of Energy, and the Department of Labor.

Finally, the Administration is spearheading a new interagency process through ARC to better deploy and coordinate Federal resources in Appalachia to promote economic diversification. This effort, known as the "Appalachian Regional Development Initiative," engages at least thirteen Federal agencies, including the Departments of Agriculture, Commerce, Education, Energy, Health and Human Services, Housing and Urban Development, Interior, and Labor as well as EPA and the Small Business Administration.

This interagency task force plans to hold five meetings or "listening sessions" across Appalachia to gather information from stakeholders on local economic challenges and opportunities and to learn from them how Federal programs can better meet their needs, with three of these sessions already scheduled for this March. It is the expectation that each session will consist of approximately 60 to 70 community leaders/stakeholders who participate in the various daily economic development activities of the region.

Meetings will include staff from ARC's Local Development Districts as well as representatives from the various sectors of the Appalachian economy including: education, healthcare, business and workforce development, tourism, local leadership, transportation, and telecom. After data has been collected and synthesized from the listening sessions, a sixth session will be held in Washington, DC with representatives from each participating Federal agency to help formulate an appropriate Federal response.

Senator Mark Warner

How did you incorporate the high-priority performance goals into the budget preparation?

The high-priority performance goals represent current priorities of agency leadership—what they hope to get accomplished within the next 18 to 24 months. The goals informed discussions between OMB and agencies—and within OMB—during the formulation of the FY 2011 Budget. The key to this process is that that agencies were asked to define their priorities within existing resources and legislative authority in order to focus the attention of senior leaders and agency staff on program implementation - instead of legislative strategies. Therefore, these goals do not always align with where we are requesting additional funds or new authorities, but are one tool to further improve how programs work.

Senator Mark Warner

When will the quarterly reporting on the goals begin?

Agency Deputy Secretaries have been designated and are working with goal leaders who will establish the specific measures and milestones for each goal over the coming months. Beginning in July, agencies will be asked to report progress on their measures and milestones on a quarterly basis. OMB will initiate quarterly constructive performance reviews that ask agencies to identify promising and proven practices and actions taken to validate and promote them. OMB will also ask agencies to identify problems encountered and actions taken to prevent or mitigate them.

Senator Mark Warner

When will the portal for the high priority performance goals be made publically available?

OMB is standing up a government-wide performance portal that will communicate performance information more candidly, coherently, and concisely. For example, we plan to allow users to look across programs with similar purposes. Currently, we are beginning development of the portal with the agency's high priority performance goals and will aim to make the first data publicly available following the initial quarterly performance reviews in July.

Senator Mark Warner

How are agency leaders being held accountable for these goals? Are there incentives or consequences?

OMB will hold quarterly performance reviews to discuss progress, problems, and plans for the future. Similarly, we expect senior agency leaders to use regular, constructive data-driven reviews to keep their organizations on track to deliver on priority objectives. We do not expect every agency to meet each target set. Indeed, if all targets were met, it would suggest that the targets that agencies chose might not have been ambitious enough. Our goal is for agencies to adopt ambitious targets; work aggressively to achieve them; analyze why targets were met or missed; and identify sensible strategies to improve performance going forward. In instances when agencies are not putting their full effort and attention into achieving a goal, negative consequences can be implemented, including shifts in spending allocations and consideration of management responsibilities. Alternatively, such measures can also be used as positive incentives for agencies that tackle a problem successfully at a lower cost. Using these tools to serve as consequences or incentives will involve careful consideration and consultation within the Administration and Congress.

Senator Mark Warner

Can you tell me how the administration plans to work with Congress to get support from Members to enact these proposals? How can I help?

In this Budget, we invest in programs that work, cut back and reform those that don't, and rebalance the tax code—while putting on the table more deficit reduction than proposed in any President's Budget in more than a decade. I recognize that enacting this into law will not be easy. But, I am encouraged by the fact that, of the discretionary terminations and reductions proposed last year, Congress enacted almost 60 percent—a success rate not achieved under the prior Administration and that many, just a year ago, would have said to be impossible. Together, I believe that we can continue such progress, and I look forward to working with you and other members of Congress to enact the President's Budget into law.

Senator Mark Warner

I was glad to see that you included the SAVE award suggestions in the Terminations, Reductions and Savings volume of the Budget. There were many common-sense efficiency solutions presented that will generate savings at individual agencies. Below is a list of programs presented it in the Budget that could achieve greater savings by broader implementation. Can these ideas be applied government-wide to achieve more savings?

- **Reduction: Strategic Sourcing, Department of Interior**
- **Reduction: Travel and Relocation Reform, Department of the Interior**
- **Other Savings: "Power Off' Computers, Department of Labor**
- **Other Savings: Air Force - Cellular Airtime Optimization, Department of Defense**
- **Other Savings: Common Sense Administrative Savings, Department of Education**
- **Other Savings: Eliminate Paper Paystubs, Department of Treasury**
- **Other Savings: Increased Use of Video Teleconferencing Technology, Department of Energy**
- **Other Savings: Oracle Enterprise License Agreements, Department of Veterans Affairs**
- **Other Savings: Personal Computer Power Savings, Department of Veterans Affairs**
- **Other Savings: Space Consolidation for Rent Savings, Environmental Protection Agency**
- **Other Savings: Streamline Redundant Inspection of Subsidized House, Department of Housing and Urban Development**

Greater savings may be achievable through broader implementation of our proposals to eliminate waste—such as those listed above. As you note, many of these Budget proposals were inspired by suggestions received from Federal workers participating in the SAVE award, which the Administration initiated this year. The SAVE award takes advantage of the knowledge of Federal workers in the field asking them to submit their best ideas for improving government efficiency; based on the success this year, we plan to make this an annual competition to achieve savings. Furthermore, analysts both at OMB and at the agencies continue to evaluate on an ongoing basis how to maximize government efficiency.

Note also that, in some cases, agencies should already be in the process of implementing such savings ideas. On December 21, 2009, OMB issued Memorandum 10-09, Responding to General Government Proposals from the President's SAVE Award, directing heads of departments and agencies to 1) implement a series of immediate, concrete changes to address simple inefficiencies that, as revealed through the SAVE award process, existed across many agencies; and 2) evaluate existing agency and departmental policies and practices to assess compliance with Administration priorities. A copy of Memorandum 10-09 follows.

Attachment

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

THE DIRECTOR

December 21, 2009

M-10-09

MEMORANDUM FOR THE HEADS OF DEPARTMENTS AND AGENCIES

FROM: **Peter R. Orszag**
Director

SUBJECT: **Responding to General Government Proposals from the President's SAVE Award**

The President's first-ever SAVE Award invited employees from across the Federal Government to submit their ideas for making our Government more efficient and effective. The goal of the SAVE Award is to produce ideas that will yield savings while also improving the operation of Government and providing better service for the American people.

Over just three weeks, OMB received more than 38,000 ideas from Federal workers all across the country. The winning proposal, along with select others, will be incorporated into the President's FY 2011 Budget. However, thousands of SAVE Award proposals offered common-sense ideas that are relevant across the Federal government. This memorandum addresses some of these suggestions by directing agencies to respond with a series of immediate and longer-term steps. Agencies are directed to undertake two specific sets of activities, including:

1) Implementing a series of immediate, concrete changes to address simple inefficiencies;
2) Evaluating existing Agency and departmental policies and practices to assess compliance with existing Administration priorities.

Implementing immediate changes

The SAVE Award revealed a number of discrete, inefficient practices that should be fixed immediately. These include:

Making electronic paystubs the default

Many Federal workers expressed concern about the costs associated with paper paystubs, such as printing, shipping, and distributing. Employees currently have the ability to opt in to receive electronic paystubs, but only 64 percent of Federal employees are taking advantage of this option.

OMB reviewed the statistics for each payroll provider and learned that the National Finance Center (NFC) is behind the other payroll providers with respect to the percentage of people receiving electronic paystubs. According to NFC, only 30 percent of its 640,000 customers receive electronic statements. OMB will coordinate with this payroll provider to help boost their electronic statement participation numbers. Defense Finance and Accounting Service (DFAS) reported that 77 percent of the employees served (908,930) are receiving electronic statements and National Business Center (NBC) reported that 83 percent of their clients (199,556) obtain statements electronically. According to GSA, 100 percent of the employees it serves (27,000) receive electronic statements.

OMB is working with each payroll system to assess the necessary steps needed to implement a system in which employees opt out if they wish not to receive their paystubs electronically. By making electronic statements the default option while continuing to allow opt out, OMB hopes to increase the percentage of Federal employees who use this convenient, lost-cost approach.

Better monitoring of transit subsidies

A number of SAVE applicants noted that when Washington, D.C.-based Government employees receive transit subsidies via Smart Trip, they often do not use the amount that they receive, leading to unnecessary expenses for their agencies. In practice, employees have the ability not to claim their Metro benefits during a given month, and the benefits return to the agency in the event that they are not claimed. Unfortunately, this fact is not well publicized.

Agencies offering SmartTrip benefits should begin a communications campaign to encourage employees not to claim monthly benefits if, during a particular period of time, they have a balance that is sufficient for the coming month (for example, if an employee walks to work during the summer).

Evaluating existing agency and departmental policies and practices

In a number of areas, SAVE applicants identified significant inefficiencies that suggest a misalignment between their agencies' current practices and Administration priorities. In these areas, OMB is tasking the agencies to conduct a review of their current practices in order to identify gaps with respect to their achievements in priority areas. These areas include:

Use online technology to improve citizens' access to Government services

One of the finalists for the SAVE Award came from an employee at the Social Security Administration in Alabama, who noted that time and money could be saved by allowing people to schedule appointments online. The Administration is committed to opening up government, to reducing paperwork burdens, to increasing convenience, and to using the Internet to make Government more accessible to citizens. Simple features like online scheduling—a feature that users take for granted when reserving hotel rooms, airplane tickets, or even a table for dinner —can make it easier for citizens to have access to government, free employees up to work on individual cases, and yield savings for taxpayers.

This memorandum directs all agencies to examine their methods for delivering services to citizens—for example, processes for booking appointments, registering for participation in Federal programs, and communicating with program representatives from the agencies. Each agency should identify at least two areas where efficiency and citizens' access could be improved through the use of online technology. Within 60 days, all agencies should report to OMB with their findings and with a plan for implementing their recommended changes.

Improving the energy and water efficiency of Federal facilities

Thousands of SAVE Award entries called for saving energy by taking common-sense actions. These include (a) turning off lights, (b) switching to motion sensors, (c) turning off computers or making sure that they are on standby at night, and (d) minimizing the unnecessary use of air conditioning. Some applicants pointed to specific agency policies that inhibit energy efficiency—for example, agencies' requirements that all their employees leave their computers on every night so that security updates and software upgrades can take place after hours. On water use, countless SAVE entrants want to switch to waterless or water-efficient toilets/urinals, to stop watering lawns during the winter (or in the rain), or to reduce the default temperature of tap water in restrooms.

Applicants' sentiments are aligned with existing Administration priorities, and reflect some of the goals of an Executive Order issued just months ago. When the President signed the Executive Order on Federal Leadership in Environmental, Energy, and Economic Performance, he required Federal agencies to set 2020 greenhouse gas emissions and reductions targets within 90 days, to increase energy efficiency, to reduce fleet petroleum consumption, to conserve water, to reduce waste, and to implement other means to promote sustainable and environmentally-responsible practices. Throughout the FY2011 Budget process, OMB has emphasized that agencies should take these priorities seriously and demonstrate real results. The SAVE Award has shown that this pressure is also coming from the bottom up.

In the time since OMB first launched the SAVE Award, we have seen agencies begin to pay more attention to easy-to-implement solutions that save energy, conserve resources, and are cost effective. This coincides with agency efforts to implement EO 13514 as they begin their development of Strategic Sustainability Performance Plans required by this executive order. For instance, some agencies, including NSF, are requiring workers to print double-sided. However, a great deal of work remains to be done, and there are informal indications that progress towards efficiency goals has slowed down in recent years.

In response to the thousands of SAVE Award entrants who flagged inefficient practices in their agencies, OMB is asking each agency to conduct a review of their policies and practices to confirm that their practices are consistent with Administration priorities. Specifically, agencies and departments should identify internal policies that serve as disincentives to efficiency (for example, requiring all employees to leave computers on every night), as they have already been asked to do as part of their Strategic Sustainability and Performance Plans. The SAVE Award reinforces the importance of this exercise, and OMB will work with the Council on Environmental Quality (CEQ) and others to make sure that agencies are complying with this responsibility.

To increase agencies' accountability in the area of energy and water efficiency, GSA should also implement a "random spot check" program in which teams are sent to assess select buildings that agencies claim are meeting efficiency guidelines and requirements. GSA's findings should be posted on the agency's website.

Making sure that the Government's fleet of vehicles are living up to energy efficiency goals

Several employees suggested that the Government should use more energy-efficient vehicles such as hybrids or smaller vehicles (and even golf carts). Existing statutes and Executive Orders already require that 75 percent of Federal agency vehicle purchases to be alternative fuel vehicles (AFVs), which include hybrids.

Agencies should examine their current vehicle fleets to identify opportunities to transition to appropriate vehicles. As part of their review, agencies should document formal and informal policies concerning the use of SUVs and larger vehicles and to provide a justification for why these kinds of cars are necessary, if they are being used. They should also document the options offered to employees receiving a Government vehicle—preferably in the same format in which that information is conveyed to the employees. Agencies should provide OMB with a report on their current practices within 60 days. An OMB-led review team will assess whether options are being presented in a way that encourages efficient choices.

Reusing Government supplies

Several employees suggested the creation of a government-wide site modeled after "Craig's List." This model exists on a Government-wide basis for Property Act excess, and the concept should be used within individual departments and offices as well.

Presently, agencies identify unneeded personal property through the excess and surplus process, and property available for transfer and use by other Federal agencies is posted on a common, Government-wide site—www.gsaexcess.gov. This site also allows agencies to post requests for assets that they are seeking. We are encouraging agencies to establish a similar, internal process to vet unneeded assets and supplies prior to declaring them to be excess and posting on the GSA website for external exchange. By expanding this model for re-allocating supplies, the Federal Government would be save money and cut down on supplies that go to waste.

I have charged the Office of Federal Procurement Policy to assess the current process and find ways to expand its use within agencies and offices. Upon completion of this assessment, agencies will be tasked accordingly to develop internal policies for re-using supplies.

Senator Michael Enzi

President Obama's Executive Order 13502 encourages federal agencies to "consider" Project Labor Agreements on large federal construction projects. Section 11 of the Executive Order states that it applies only to solicitations for contracts issued on or after the effective date of a final rule necessary to implement the Order mandated by Section 6. The Federal Acquisition Regulation (FAR) Council rule has not yet been published, yet on July 10 of last year your office issued a Memorandum instructing federal agencies to go ahead and start imposing PLAs on federal construction projects without waiting for the FAR Council to issue its required rule. By what authority did you issue your July 10 memorandum?

OMB's July 10, 2009 memorandum provided guidance to departments and agencies on the implications of the repeal of a rule prohibiting agencies from requiring project labor agreements (PLAs). The memorandum, "Implementation of the President's Executive Order on Project Labor Agreements (PLAs)," explained that the Federal Acquisition Regulatory Council (FAR Council) repealed the rule because it implemented an earlier PLA-related executive order that was revoked by President Obama in Executive Order 13502 on February 6, 2009.

The OMB memorandum did not direct agencies to take any particular action with respect to any particular projects. Rather, the memorandum explained that, as a consequence of the FAR Council's repeal of its prior rule, "agencies are no longer prohibited from requiring the use of a PLA when permitted by law and when the agency determines that it is appropriate to do so" and are encouraged "to consider the value of PLAs on a project-by-project basis, and to require the use of PLAs in appropriate circumstances and to the extent permitted by law."

OMB has in the past issued guidance to agencies on the implementation of executive orders related to PLAs. In particular, on October 18, 2002, OMB issued a memorandum to agencies, "OMB Guidance on Project Labor Agreement Executive Order," in which OMB provided agencies with guidance on the implications of a certain judicial decision on their implementation of a prior executive order on PLAs.

Senator Michael Enzi

Less than 16 percent of private construction workers are union members. The remaining 84 percent are non-union, many of whom work for smaller construction companies. The Administration's new PLA policy clearly discriminates against these workers and the small businesses that employ them. What is the Administration's justification for this discrimination? Has the Administration fully considered the adverse impact of its policy on small businesses, non-unionized employers, and the vast majority of employees who work for these employers?

The terms of E.O. 13502 are expressly intended to avoid any discrimination in the use of PLAs. Section 4 of the E.O. requires that any PLA reached under the order allow all contractors and subcontractors to compete for contracts and subcontracts without regard to whether they are otherwise parties to collective bargaining agreements. OMB and the Department of Labor are studying the impact of PLAs, and burden is also being looked at as part of the regulatory implementation in the Federal Acquisition Regulation.

Senator Michael Enzi

The National Safety Council has estimated that, in 2007, Federal Agency Voluntary Protection Program (VPP) participants saved the government more than $59 million by avoiding injuries and private sector VPP participants saved more than $300 million. Additionally, when Workplaces make the significant commitment to safety required by VPP, it allows the Occupational Safety and Health Administration (OSHA) to focus its resources where they are most needed. Thus, the VPP program saves taxpayers in two ways, and creates safer workplaces. Given this, I am very disappointed that OSHA is downsizing the VPP program and is currently considering regulations to limit On-Site Consultations and the Safety and Health Achievement Recognition Program (SHARP). Can you explain why the Administration is turning away from opportunities to save money and free up OSHA inspectors to reach more workplaces that may not be striving for compliance?

The decision to reduce funding for the Voluntary Protection Program (VPP) does not reflect a lack of support from the Administration. The Administration recognizes the safety achievements of VPP members and the money they save from preventing incidents. In a constrained funding environment, however, the agency has decided to shift resources from VPP, which supports mostly large companies that voluntarily meet and exceed OSHA's requirements, to enforcement activities targeting businesses that continue to violate the law and put workers' lives at risk. Working closely with the agency's stakeholders, OSHA will also look for alternative non-federal forms of funding for VPP. Note however that the President's FY 2011 Budget proposes an increase in the State Consultation budget, a program that provides significant value to small businesses.

The Administration has no plans to limit on-site consultations or the Safety and Health Achievement Recognition Program (SHARP). I understand that the agency is considering regulatory revisions to make minor adjustments in how the programs are run. Any such regulations would be subject to standard notice and comment requirements.

Senator Michael Enzi

The ARRA federal construction projects are all subject to Davis Bacon prevailing wage requirements. As you know, well-regarded studies make plain the fact that the labor costs under Davis Bacon are anywhere from 15 to 38 percent higher than the actual fair market labor cost for the exact same work. If the federal government was not paying these artificially inflated costs there would be sufficient funding to hire and employ additional personnel on each project. For example, if the rates are 25 percent over market, five workers, not four could be hired for each of these projects if Davis Bacon did not apply. Since the unemployment rate continues to remain at 10 percent, and since the rate among construction workers is even higher, has the Administration given any consideration to suspending Davis Bacon in light of the fact that we have had 10 percent unemployment rate for an entire quarter and 15.3 million people are unemployed? If it has, what is the rationale for not suspending Davis Bacon to increase federally funded employment opportunities? If suspension of Davis Bacon has not been considered, why not?

In enacting the Recovery Act, Congress required application of the Davis-Bacon Act to construction projects financed with Recovery Act funds. The Administration disagrees with your conclusions about the effects of applying Davis Bacon requirements on hiring and value to workers. Construction jobs have long provided an entry point to a middle-class standard of living, and the Administration wants to ensure that they remain that way. The Davis-Bacon Act protects workers by preventing Federal contractors from using their leverage to lower local construction wage standards, and also makes sure that the jobs that are supported with Federal funds are good, high-quality jobs.

Senator Judd Gregg

Since President Obama took office, NASA's Constellation Program received $400 million in stimulus funds and an additional $450 million in last year's budget. He also established the Augustine Commission to review the future of human space flight. Was it a mistake for President Obama to spend almost an additional $1 billion on this program before the Augustine Commission issued its report? Was this money wasted?

No. The Administration convened an independent expert group, led by former Chair of the National Academy of Engineering Norm Augustine, in May 2009 to review NASA's human space flight program and to provide options for the continuation of U.S. human space flight activities. This group was launched in order to holistically review, with fresh eyes, NASA's human space flight activities. Until the independent review had released its finding and the Administration had thoroughly explored possible paths forward, it would not have made sense to stop work on Constellation. Congress had appropriated funds for Constellation and had the expectation that the program would continue until Congress and the Administration agreed on the next phase.

This review was comprised of an exceptional group of experts from the U.S. government, military, and industry. In October 2009, the group released its final report, which found that the Constellation program was challenged by a broad spectrum of problems and was fundamentally unexecutable. The report also found that a root cause of this troubled state was a decades-long underinvestment in new technology. Following the report's release, the President worked with his advisors, including the NASA Administrator and his Science Advisor, to find a new path forward for NASA. Following a thorough analysis, the final decision was made to terminate Constellation and replace it with a bold new initiative focused initially on technology development and increased commercial participation.

Now that the decision has been announced, we plan to work with Congress to move forward rapidly to end Constellation and begin the new program in FY 2010. We look forward to your support in this matter.

Senator Judd Gregg

Could you please provide the Committee with a table that shows how the Administration arrives at $250 billion in outlay savings over 10 years from a three-year discretionary freeze? It would be instructive have a table that shows the computation beginning with BEA baseline budget authority and outlays for each year from FY 2010 to FY 2020, then removes the spending that is not subject to the freeze to show a subtotal of spending that is subject to the freeze, and finally showing the impact of the freeze.

The attached table walks through a direct comparison of the Administration's FY 2011 discretionary budget policy and the BEA baseline. There are splits included for the security and the non-security categories with the only major conceptual adjustment being made for Pell Grants to reflect the Administration's proposal to reclassify the program as mandatory.

You will note that when compared to the BEA baseline, the 3-year freeze achieves slightly higher savings nearing $259 billion. This is because the Administration's $250 billion figure was based on measuring non-security policy against the baseline projection of current policy (see Summary Table S-2 in the Budget volume). The baseline projection of current policy corrects for an additional quarter of pay that is built into the BEA baseline, which accounts for the discrepancy between the two measurements over the 10-year comparison.

Attachment

FY 2011 DISCRETIONARY POLICY VERSUS BEA DISCRETIONARY BASELINE

(Discretionary amounts in billions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total 2011-2020
BEA Discretionary Baseline:												
Security (includes Overseas Contingency Operations):[1]												
BA	814	836	856	876	897	919	942	966	990	1,016	1,042	9,341
Outlays	844	847	852	865	884	905	923	946	970	995	1,021	9,209
Non-Security:												
BA/OBLIMS	464	474	484	496	508	519	531	544	557	571	585	5,268
Outlays	580	549	509	499	504	513	524	536	549	562	576	5,320
Non-Security - Remove Pell Grants: [2]												
BA/OBLIMS	*-17*	*-18*	*-18*	*-18*	*-19*	*-19*	*-19*	*-20*	*-20*	*-20*	*-21*	*-191*
Outlays	*-27*	*-18*	*-18*	*-18*	*-18*	*-19*	*-19*	*-19*	*-20*	*-20*	*-20*	*-190*
Non-Security (with Pell removed):												
BA/OBLIMS	447	456	466	478	489	500	512	524	537	550	564	5,077
Outlays	553	531	491	481	485	494	505	517	529	542	555	5,130
Total Discretionary:												
BA/OBLIMS	**1,260**	**1,293**	**1,322**	**1,354**	**1,386**	**1,419**	**1,454**	**1,490**	**1,527**	**1,566**	**1,606**	**14,418**
Outlays	**1,397**	**1,378**	**1,342**	**1,346**	**1,370**	**1,399**	**1,428**	**1,463**	**1,499**	**1,537**	**1,576**	**14,339**
Discretionary Policy:												
Security (includes Overseas Contingency Operations):[1,3]												
BA	855	879	798	819	840	864	885	906	929	953	978	8,849
Outlays	855	895	827	811	825	845	862	885	907	931	955	8,743
Non-Security:												
BA/OBLIMS	447	441	446	446	459	472	479	489	502	517	538	4,789
Outlays	553	520	475	456	457	465	475	486	497	511	529	4,871
Total Discretionary:												
BA/OBLIMS	**1,302**	**1,320**	**1,244**	**1,265**	**1,299**	**1,336**	**1,363**	**1,395**	**1,431**	**1,470**	**1,515**	**13,638**
Outlays	**1,408**	**1,415**	**1,301**	**1,267**	**1,283**	**1,310**	**1,337**	**1,371**	**1,405**	**1,442**	**1,484**	**13,614**
BEA Baseline Less Policy:												
Security (includes Overseas Contingency Operations):[1,3]												
BA	+41	+42	-58	-57	-58	-55	-57	-59	-61	-63	-65	-492
Outlays	+11	+48	-25	-54	-59	-60	-61	-61	-63	-65	-66	-466
Non-Security:[4]												
BA/OBLIMS	---	-15	-20	-32	-30	-28	-33	-35	-35	-33	-27	-289
Outlays	+	-11	-16	-25	-28	-30	-30	-31	-32	-31	-26	-259
Total Discretionary:												
BA/OBLIMS	**+41**	**+27**	**-78**	**-89**	**-88**	**-83**	**-90**	**-95**	**-97**	**-97**	**-91**	**-780**
Outlays	**+11**	**+37**	**-41**	**-79**	**-87**	**-90**	**-91**	**-92**	**-94**	**-95**	**-92**	**-725**

[1] Security programs consist of the Departments of Defense, Homeland Security, and Veterans Affairs, International Function 150, and the National Nuclear Security Administration, as well as any amounts classified as being for Overseas Contingency Operations.

[2] In order to make the BEA baseline directly comparable to the 2011 Policy levels, Pell Grants are removed to reflect the Administration's policy to make the program mandatory.

[3] 2010 in the security category includes the Administration's $41 billion in proposed supplemental funding.

[4] The non-security savings actually exceed $250 billion when compared to the BEA baseline. This is because the $250 billion figure was obtained by comparing 2011 non-security policy to the Administration's Current Policy Baseline (see Summary Table S-2 in the *Budget* volume). The Current Policy Baseline is slightly lower for non-security because the Current Policy Baseline corrects for an additional quarter of pay that is built into the BEA baseline.

Senator Patty Murray

While I am pleased overall with your budget request this year, I am concerned the level of investment in our workforce, particularly in your request for job training, still does not meet the desperate need on the street.

The Training and Employment Services account request is 7% below the actual funding level for these programs in 2002, the first Bush Administration budget, when unemployment was less than half the current rate.

- **Can we work to ensure that workforce programs are and will remain a top priority for the Administration as we begin to move to economic recovery and renewed hiring by the private sector?**

The Administration is committed to reforming the workforce system and supporting effective strategies that prepare workers to obtain employment and advance in their careers. The Budget demonstrates a strong commitment to job training and employment programs by setting forth principles for Workforce Investment Act (WIA) reauthorization, and providing $3.9 billion for the Training and Employment Services account, a $97 million (3 percent) increase over 2010. This is an increase of $222 million (6 percent) over 2010 if the Career Pathways Innovation Fund is excluded. (The Career Pathways Innovation Fund was not funded in the Budget because separate pending legislation provides significant support of community colleges and career pathway programs).

Funding for Training and Employment Services includes increases in key program areas, such as innovation funding and green job training. The Budget provides $261 million to the account for innovation funds that will test and support promising practices, driving reform of the workforce system. Also, it more than doubles funding for green job training, providing $85 million for apprenticeships and other training models that will prepare workers of all skill levels for careers in emerging green industries.

The Administration recognizes the importance of job training and employment programs, and looks forward to working with Congress on WIA reauthorization to ensure that these programs are providing high-quality services to both individuals and employers.

Senator Patty Murray

I was also disappointed that there was not dedicated funding for summer jobs included in your budget request (outside of competitive grants in the WIA youth innovation account).

I fought for funding in ARRA for summer jobs and it turned out to be a tremendous success, with the DOL data showing over 300,000 young people got jobs who would not otherwise have been employed.

• Can we work together to ensure in the Jobs package that funding for summer jobs is included once again?

The Administration supports the inclusion of funding for summer and year-round employment opportunities for youth in the pending jobs bill, recognizing that summer jobs programs can provide an opportunity for youth to gain employment experience and job skills. However, past evaluations have found shortcomings in previous summer jobs programs. Therefore, as part of a broader policy to determine what interventions are most effective for at-risk youth, the FY 2011 Budget proposes to fund and evaluate summer and year-round employment opportunities and comprehensive programs combining employment and education through a new $154 million Youth Innovation Fund.

Senator Patty Murray

I want to turn to the budget for the Department of Housing and Urban Development (HUD), which serves so many people that are struggling to find and maintain housing during this difficult economic time.

The President's budget proposes an overall increase to HUD's program levels of around 3 percent over the fiscal year 2010 enacted level. This growth, even while total budgetary resources for HUD have decreased is possible because the budget assumes that the Federal Housing Administration (FHA) will generate substantial receipts based on its increased program activity.

However, these estimates rely, in part, on legislation being enacted that would allow the FHA to increase the annual premiums for all new FHA-insured mortgages, which they are currently prohibited from doing.

- **Is it fair to say that if this legislation was not enacted before the budget is finalized then other HUD programs that serve vulnerable populations would have to be reduced further to account for this lost revenue?**

The President's Budget is a comprehensive and expansive set of proposals, some of which increase expenditures or revenue and others that decrease expenditures or revenue. FHA receipts are not tied to any specific expenditure in the Budget. Legislative action that results in a lower level of FHA receipts than in the Budget does not in itself reduce spending on any program. The receipts are classified as discretionary and therefore reduce the net amount of expenditures that are scored to the Transportation, Housing and Urban Development, and Related Agencies Appropriations Act. By themselves, without the proposed FHA premium authority, and assuming no other changes to FHA programs, FHA receipts would be somewhat lower than those included in the Budget.

Senator Patty Murray

The following statements are from a verbal commitment of follow up:

MURRAY: OK, great. I also wanted to talk to you about the Corps of Engineers budget, because, as you may be aware, in my home state of Washington we have a dam.

It's called the Howard Hanson Dam -- significant seepage problems it -- that is prohibiting the Corps from operating it at a fully- authorized level of flood protection to a lot of our downstream communities -- a huge impact if -- if that dam bursts, or if it's not able to hold the groundwater.

There is currently a study under way to determine the permanent fix for that dam in the Corps' Dam Safety/Seepage Stability Correction Program.

And I understand the Corps is also conducting studies on about 70 other projects as well.

All of those studies are proposed to be funded for $49 million in the F.Y. '11 budget. And I'm concerned that that level of funding won't be sufficient to undertake that many studies.

Do you believe that the $49 million will give the Corps their full capability to follow through on all those studies that are being required?

ORSZAG: We do believe that it would give the Corps adequate capability. But we can, again, in the discussion that we're going to have with you, sit down and walk you through that.

The $49 million included in FY 2011 President's Budget for the Army Corps of Engineers construction program for the evaluation of potential dam safety, seepage/static instability correction problems is the full amount that the Corps can effectively spend on these activities in FY 2011 – in other words, its full capability. This funding would allow the Corps to continue work on its evaluation of the Howard Hanson Dam, as well as all other evaluations identified by the Corps.

Senator Jeff Merkley

The following is based on a verbal commitment to follow up on HUD's budget and the effect of offsetting receipts:

MERKLEY: Thank you for pointing me to those assumptions. I appreciate that. And I hope that the 5.3 percent of the assumption holds because otherwise, we're in a much worse condition. I'm out of time, so a last sentence. And that is: I am wholeheartedly behind taking funds and moving them to support our community banks. That's a proposal that I've been advocating for. But I would recommend that we take that $30 billion out of the $200 billion currently unspent, rather than the funds that are being returned. It seems to be that that would address some of the issues that are being raised right now. But I think we could all -- we ought to all be able to get behind the notion that if our community banks are not recapitalized and they can't lend to small businesses, our small businesses are not going to thrive. Our communities are not going to thrive. It's going to be a very recession. Thank you.

ORSZAG: If the chairman would allow me just 30 seconds just to clarify one thing because I didn't have a chance to fill in the detail. With regard to housing and the Department of Housing and Urban Development's budget, the decline that you see is mostly because there is an offsetting receipt. You can see it in the Federal Housing Administration line in 2011. And that's the primary explanation for the apparent decline in the HUD budget. But we could follow up in more detail...

MERKLEY: That would be perfect. Thank you.

The FY 2011 Budget provides $48.5 billion in program funding for HUD, a 3.3 percent increase from 2010 enacted. This funding level is offset by $6.9 billion in FHA and Ginnie Mae receipts, which results in net budget authority of $41.6 billion, a $2 billion or 4.6 percent decrease from the 2010 enacted level of $43.6 billion -- but, as noted, this decrease does not affect program activities.

THE PRESIDENT'S FISCAL YEAR 2011 BUDGET AND REVENUE PROPOSALS

THURSDAY, FEBRUARY 4, 2010

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

The Committee met, pursuant to notice, at 10 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Cardin, Sanders, Whitehouse, Gregg, Sessions, Bunning, Crapo, and Alexander.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

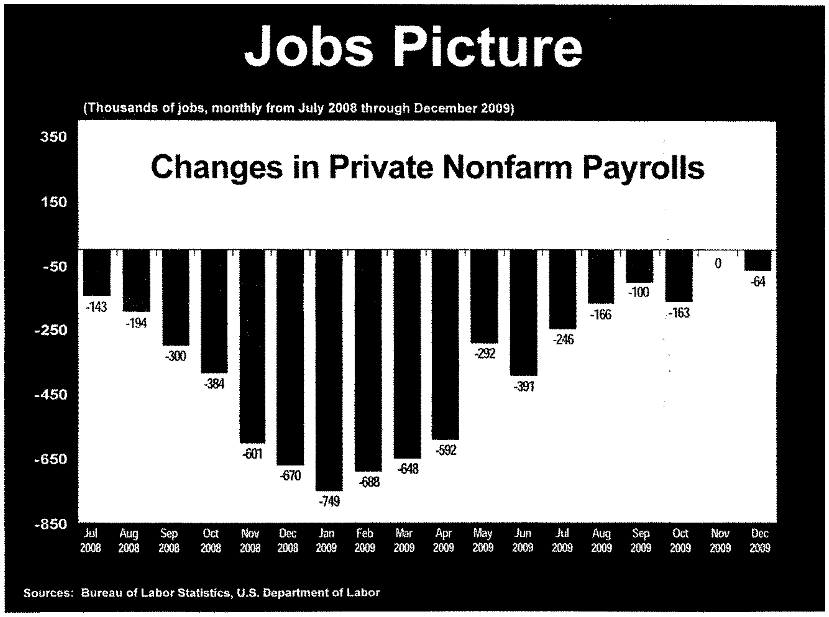
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome Secretary Geithner back to the Budget Committee. We are here today to review the administration's budget and revenue proposals.

When President Obama took office last year, we were in the midst of the worst recession since the Great Depression. The President and the administration, moved quickly to avert an even sharper economic decline, and his policies, I believe, are working.

I also credit the previous administration for the steps that they took at the end of their administration to begin dealing with what I believe could have been a global financial collapse.



The actions taken by the Federal Government over the last year I believe have clearly helped us back from the brink. We have seen steady improvement in the jobs picture. In January of last year, the economy was losing more than 700,000 private sector jobs a month. By the end of the year, the economy was losing 64,000 jobs a month—a dramatic improvement. Now, clearly, that is cold comfort to those who are still struggling to find work, and we need to focus on assisting the private sector create jobs like a laser. I think most of us understand that job creation is primarily a function of the private sector, but we can do things to provide incentives to them to help them in that effort.

I want to take a moment to outline some of the job creation proposals that are in the President's budget. These are temporary recovery measures that he proposes.

President Obama's Job Creation Proposals
Temporary Recovery Measures

- $100 B for new jobs initiatives
  - Tax cut for small businesses to encourage hiring and better wages ($33 B)
  - Investments in infrastructure and clean energy, other tax relief ($67 B)
- Extend Making Work Pay ($61 B)
- Extend bonus depreciation, small business expensing, tax credits for clean energy manufacturing ($6 B)
- Extend UI, COBRA, assistance to states, aid for needy children and families ($87 B)
- $250 payments to retired and disabled Americans ($12 B)
- Total of $266 B; 92% to be spent in 2010 and 2011

No. 1, $100 billion to be devoted to new jobs initiatives, including $33 billion for a new tax cut for small businesses to encourage hiring and better wages. And, by the way, late last year I asked the Congressional Budget Office to evaluate options and alternatives. This option, a tax credit for hiring by business, was one of the two top contenders in terms of the Congressional Budget Office's assessment of what would be most effective. So I am pleased that the President has included it in his package.

Two, $67 billion for investments in infrastructure and clean energy, as well as other tax relief.

He proposes extending Making Work Pay, costing $61 billion.

He proposes extending bonus depreciation, small business expensing, and tax credits for clean manufacturing, clean energy manufacturing, costing $6 billion. By the way, again, CBO, in rating what would be most effective, said for 2010 the jobs credit would be the most effective, biggest bang for the buck. They also gave a very solid, positive rating to small business expensing, Section 179.

The President also proposes extending unemployment insurance, COBRA assistance, assistance to States in aid for needy children and families, costing $87 billion. Most of that, of course, is the unemployment insurance extension. Again, the Congressional Budget Office in their assessment said that would be one of the two most effective measures to be taken in terms of assisting with jobs in the short term.

And he proposes providing $250 payments to retired and disabled Americans costing $12 billion. That is in light of the formula not providing any increase to those who are Social Security beneficiaries.

In total, those measures cost $266 billion over 10 years, with 92 percent to be spent in 2010 and 2011.

The President's budget also includes a number of other measures to assist small businesses, and they include assisting in increasing small business lending by community banks; providing for additional small business loan guarantees; eliminating capital gains taxes on long-term investments for many small businesses; and providing funding to promote small business exports.

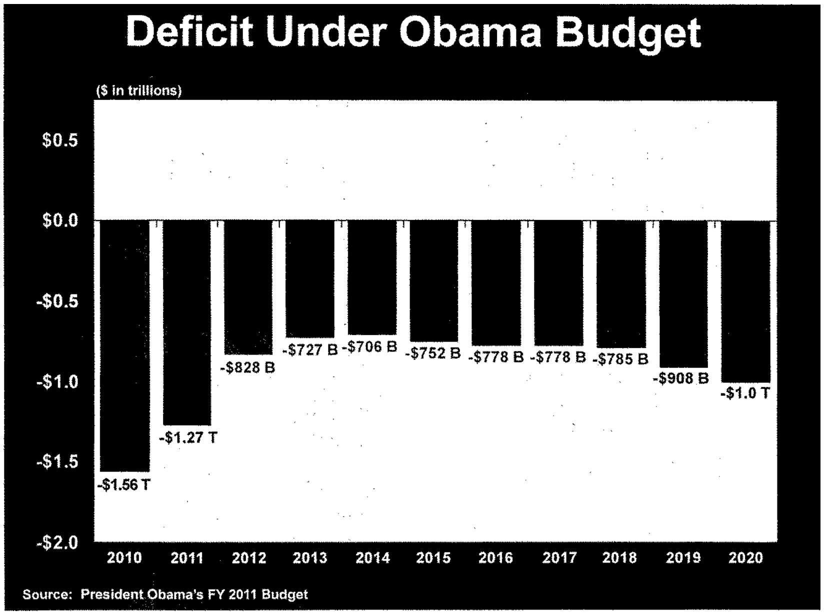
Let me just say in terms of my own reading of things from my constituency, credit to small business is critical. If there is one place that there is a hole in what has been done, it is in getting credit flowing to small businesses. I hear it repeatedly. I have had two of the most successful entrepreneurs in my State who are both close personal friends call me, and they are very well-to-do. They can finance their own deals. But they said, "If there is one thing that is clear, it is that the flow of credit to small business is a very serious problem." And one of them is a banker; one of them is involved not only in banking but a series of other enterprises who has said to me that at his own bank, because of regulators saying to them, "You have got to rebuild your balance sheet," even though their balance sheet was never very impaired because they never got into the risky loan business, they are still finding it difficult to extend credit even to worthy borrowers. So I think this is an issue we do need to focus on.

Revenue Proposals in Obama 2011 Budget

Extend 2001 and 2003 tax cuts for those under $250,000; estate tax at 2009 level; AMT relief	-$3.1 T
Other tax relief for families and businesses	-$293 B
Temporary recovery measures (Making Work Pay, bonus depreciation, other jobs initiatives)	-$83 B
Health reform revenue (placeholder)	$743 B
Limit itemized deductions to 28% rate	$291 B
International tax reforms	$122 B
Financial crisis responsibility fee	$90 B
Other loophole closers and reforms	$309 B
Total Tax Cuts	-$1.9 T

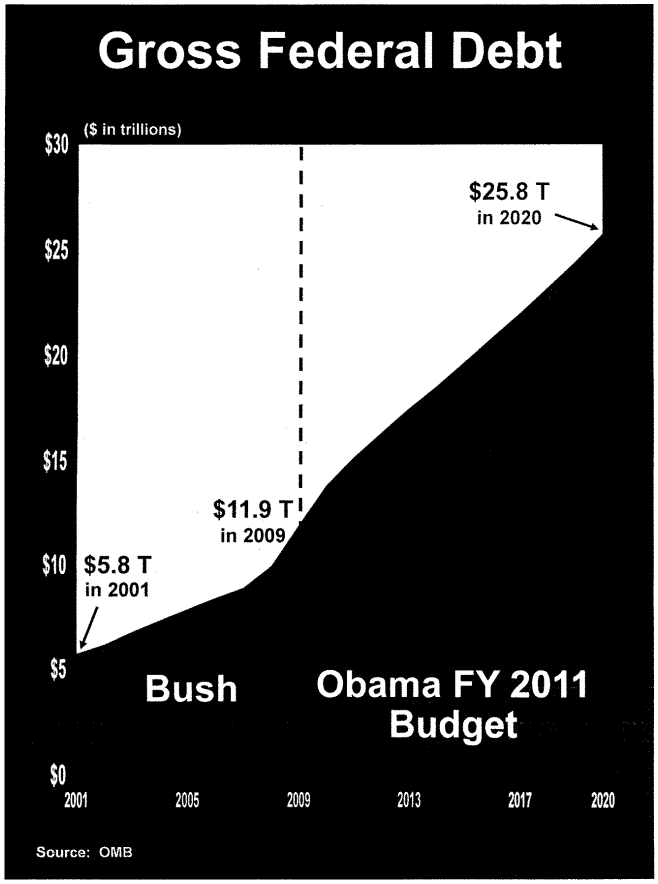
Source: OMB
Note: 2011-2020; totals include the refundable portion of tax proposals.

I also want to highlight that the President's budget includes a net tax cut of $1.9 trillion over 10 years. Here are some of the key revenue provisions: in terms of a tax cut, the budget includes $3.1 trillion to extend the 2001 and 2003 tax cuts for those making under $250,000; continue the estate tax exemptions at the 2009 level; and provide alternative minimum tax relief to prevent a tax increase for those folks who would otherwise face increases this year; $293 billion for other tax relief for families and businesses; and $83 billion for the revenue portion of the temporary recovery measures that I noted, including the new job creation tax credit and extending Make Work Pay and bonus depreciation.

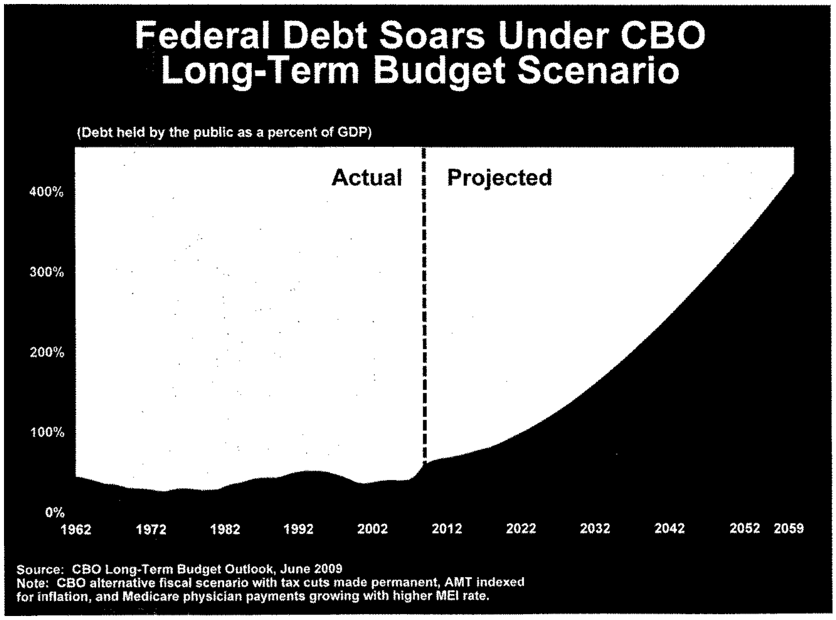


In terms of revenue raisers, it includes $743 billion as a place holder for health care reform revenue provisions, $291 billion from the President's proposal to limit itemized deductions, $122 billion from international tax reforms, $90 billion from a financial crisis responsibility fee, and $309 billion in other loophole closures and reforms. Again, the net is a tax cut of $1.9 trillion.

Let me put up another slide. This chart depicts the projected deficit under the President's budget over 10 years. It shows the deficit coming down from a high of $1.56 trillion, reaching a low of $706 billion in 2014, and then slowly climbing back up to $1 trillion in 2020. It is that second period that I raised the day before yesterday in a hearing with Dr. Orszag and indicated personally that while I strongly support the President's proposals in the short term, I am very concerned about them for the longer term.



The next chart that I want to show depicts gross Federal debt. It shows the debt more than doubled under the previous administration to $11.9 trillion. Under the President's budget, gross debt would continue climbing to $25.8 trillion by 2020 absent our taking additional action.



The long-term debt outlook is even more dire. According to CBO's long-term budget outlook, over the next 50 years with rising health care costs, the retirement of the baby-boom generation, and the permanent extension of all the 2001 and 2003 tax cuts, the Federal debt could climb to more than 400 percent of the gross domestic product.

I believe we need a two-pronged strategy. We need one in the short term to prevent going back into recession. We also need a longer-term pivot to deal with our long-term debt. That is why Senator Gregg and I proposed a statutory commission. I was delighted that we received 53 votes, but it required 60 votes. Fifty-three is not 60. And so now we are left with the alternative of perhaps offering our colleagues another chance at a statutory commission, which I would fully support. The President has said if there is not a statutory commission that he is prepared to create one by Executive order. That is what the Greenspan Commission was that dealt successfully with Social Security in the 1980's. That was an Executive order commission. And the Vice President has provided a letter to me outlining the commitments from the Majority Leader and the Speaker of the House assuring us that there would be a vote on the recommendations of the commission if it had to be established by Executive order.

With that, I want to close by again welcoming Secretary Geithner to this panel, back to this Budget Committee, and we will turn to Senator Gregg for his statement, and then we will go to Secretary Geithner and then open it up for 5-minute rounds. And if we need a second round, we will do that.

Senator GREGG.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and thank you, Secretary Geithner, for being here today.

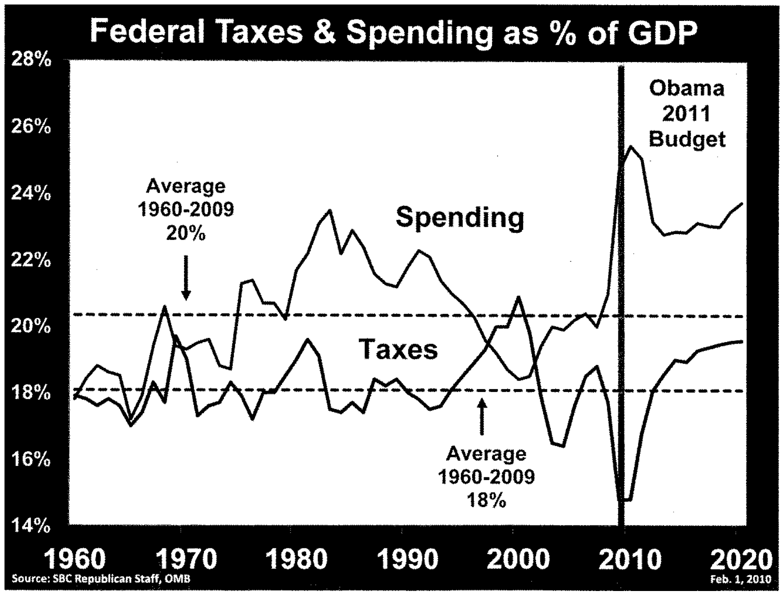
Let me identify myself with the Chairman's remarks relative to the two-pronged approach. I agree 100 percent. The only problem is that the second prong does not exist in this budget.

The budget as it comes to us, as I have said on numerous occasions, and which is obvious, I think, to anybody who takes even a cursory look at it, does nothing about the long-term fiscal insolvency of our Nation; the fact that we are on an unsustainable course; and the fact that $11 trillion of new debt will be put into the system over the 10 years of this budget; and that the deficits never fall to a level that is sustainable and, in fact, expand rather dramatically, and continue to expand even at the end of 10 years, so they are growing.

Ironically, also, the unemployment levels under this budget are—the presumption is that they never, during the President's term, get back to the unemployment level that existed in 2008. They never get back to below 7 percent. They are at the end of 4 years still around 8 percent, and I do not think that is a good unemployment level. And I think a lot of that is a function of the fact that the economy cannot be expected to recover robustly if we are putting on the economy a debt service and a debt burden which basically soaks up the capital of the Nation and uses it for the Government as versus for the productive side of the ledger. I would argue that that is exactly what we are doing with this budget, because we are not putting in place the difficult decisions that need to be done in order to accomplish fiscal responsibility and to pass to our kids a better Nation, a more prosperous Nation.

Since we have the Secretary of the Treasury here, I think we should focus a little bit on the revenue side in this bill. There is $2 trillion of additional revenue in this bill, and just to list a few of them—obviously these are philosophical decisions that the administration has made, which I tend to disagree with, but they raise the marginal rate from 35 to 39.6 percent; they limit tax deductions for itemized deductions to 28 percent; they reinstate the "Pease limitation", a phase-out, which is basically another hit on people who itemize; they raise the capital gains rate; they raise the dividend rate; they assume significant tax increases as a result, or fee increases, however you want to describe them, as a result of health care reform; there are new taxes on financial institutions which, of course, have been in the public domain for a while and discussed; and they change a number of tax events, including LIFO and IRS programs and reductions in tax gap, fossil fuel taxes—all of which add up to $2 trillion of new revenue.

So it is not as if there is not a fairly significant push toward generating revenues. The problem is that at the same time that they are generating revenues—can you put that chart up?



The problem is that at the same time that this bill is generating significant revenues as a result of tax increases and taking revenues well above their historic norm—revenues have historically been about 18.2 percent of GDP since 1940, and under this budget it is presumed that they will get up around 20 percent of GDP. At the same time, the explosion in spending is allowed to continue, and basically the size of the Government grows exponentially, and that is where the problem is, as these lines show—the red line being the rate of growth of the Government, the blue line being the rate of growth of taxes.

Obviously, in the short term, tax revenues have dropped precipitously. Spending has gone up precipitously because of the recession. But it is the out-years, the second step, which the Chairman was talking about, where there is no serious effort to try to get those lines to converge, because if you do not get them to converge, you end up with all this deficit and debt, which is going to drive our Nation into a point of insolvency.

And so I guess I go back to my basic theme, which is that this budget plays small ball—bunts, singles, you know. The Senator from Kentucky could explain to me better what another term might be, but, you know, hit and run—of course, he never allowed anybody to hit a single. But, in any event, small ball is being played here. We are not taking on the big issue, and the gorilla room, which is very significant, is the fact that we are raising the level of debt of this country to an unsustainable level—"unsustainable" being the term that I believe the Secretary has even used. And so we need another approach, and that is why we have supported this commission, and I believe it has to be statutory in order to be effective. So I look forward to hearing from the Secretary.

I also hope the Secretary will address where he sees the banking system today. This is important for us to know, because obviously there is a fair amount of money available to the Secretary—I hope it does not have to be spent—to continue to shore up the banking system. My hope is that instead it can go to reduce the debt, which is what it was supposed to do. And I hope that we are sort of—as a result of the Secretary's efforts and the prior administration's efforts, Secretary Paulson, and the overlapping effort of Chairman Bernanke, I hope that we have stabilized the system to a point where there does not appear to be any significant disruption headed in our way in the financial system. I hope the Secretary will address that issue, how he sees the health of the basic financial system vis-a-vis where we were in 2008 and early 2009.

So I thank the Secretary for being here today.

Chairman CONRAD. Thank you, Senator Gregg.

Again, welcome, Secretary Geithner. Please proceed with your testimony, and then we will go to questions.

STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Chairman Conrad, Ranking Member Gregg, and members of the Committee, it is a pleasure to be back here today. This Committee is the guardians of fiscal responsibility, and in some ways you hold here in your hands this critical challenge of how we balance the critical priorities of supporting growth, fixing what was broken, doing so in a fiscally responsible way, addressing our long- term fiscal problems, and trying to do that in a way that is fair—fair to the American people.

A year ago, as you both said, when the President took office, our Nation was in a deep recession, and we faced a deficit of $1.3 trillion and projected deficits—and this is very important. Before the new Congress took any steps, projected deficits, according to CBO, would more than double the Nation's debt over the succeeding decade. And this recession, of course, has cost tremendous damage, and I think we all know that the road to jobs and to greater economic security and to fiscal sustainability does have to start with economic growth. And today I think it is important to recognize due in large part to the actions of the Congress, the executive branch, and the Federal Reserve, the economy is growing again.

One just brief comment on this morning's productivity numbers. You are seeing extraordinarily high rates of productivity growth in the second half of last year. In many ways, those are a testament to the dynamism and strength of the American business community. It is important for people to understand that. But there was, I think, an encouraging shift if you saw the composition of that. Instead of that coming significantly from reducing payroll and hours and employees, it is now coming in the former of higher output. And I think there is encouragement in that. We should take encouragement from that. But we have got a ways to go still.

So this is progress. It is not enough, and our priority remains, our priority has to remain job creation, investment, and innovation.

Now, we are proposing to extend Recovery Act tax relief for small businesses, and we are proposing, as the Chairman said, a new credit for small business job creation, which combined a $5,000 credit for every new employee hired in 2010 with payroll tax relief for firms that add hours and increase wages.

We are proposing to extend small business tax relief that goes to encourage new capital investments, investments in research and development. We are proposing again to eliminate taxes on capital gains for investors in small businesses.

Just one brief note. That specific proposal would reach, our view is, 2 million small businesses, and we think it is a good, powerful type of step to help encourage investment and innovation.

Now, of course, we understand that Government needs to be smarter, and in the President's budget we have laid out a comprehensive agenda to invest in innovation. The responsibility of Government is to create the conditions for the private sector to grow, to invest, and to create new jobs. This requires financial reform. It requires more support for American innovation. We need to increase exports, and we need to invest in education, and we need health care reform so we can help provide greater economic security for tens of millions of Americans and to help businesses reduce the growth in the health care costs.

Now, alongside these steps, we need to work to continue to improve access to credit for American families and businesses. Over the past year, the broad strategy we embraced to stabilize the financial system has been remarkably effective in helping repair what was broken, bringing a measure of stability to the system, and we have done that largely by encouraging private capital solutions to come in and replace the investments the Government of the United States had to make. And we have achieved those results in terms of stability, lower borrowing costs, better access to credit, at much, much lower cost to the American taxpayer than many had anticipated.

We have already recovered two-thirds of TARP investments in banks which are being used, as Senator Gregg said, to bring down our deficit. The expected cost of stabilizing the financial system has fallen by more than $400 billion. We expect it to fall further, and if we can work with Congress to adopt a fee on the financial system, then we can say to the American people that American taxpayers will not face a penny of loss on the actions the Government had to take under the TARP.

The financial system today is much more stable. As I said, credit conditions are significantly better. You can see that in terms of the price and access to credit for municipal governments, for companies, for homeowners, and for families.

But critical parts of the financial system are still damaged. No surprise. The crisis caused a lot of damage. And I think it is very important that we continue to use the authority the Congress provided us under the TARP to continue to help small banks expand credit to small businesses and to help continue to work to stabilize the housing market.

Now, when you talk to small business owners across the country, as I know you do, they tell a similar story, that their ability to expand and to hire depends on better access to credit. And I think we all know that to get loans for small business to rely on, you have to make sure that small banks, community banks, are in a better position to provide that credit.

Now, on Tuesday, the President announced that we will support new legislation to create a small business lending fund, and we will support legislation that would take existing authority that we have reserved under the TARP and use that authority to help make sure we can provide assistance and support and capital to small community banks that are prepared to work to expand lending to small businesses.

These banks, these small banks, have been at the center of small business lending in the past. They still account or they typically account for more than half of credit to small businesses, and I do not believe it is possible to try to work to address the credit problem small businesses face in this country without helping small business community banks do a better job of helping their customers grow and expand.

Now, we want to complement that with stronger authority for the Small Business Administration, with higher loan limits, lower guarantee fees temporarily. That can be very effective, too. And, again, I think it is important for people to recognize that even as we grow and recover, you need credit to make sure recovery is going to be as strong as possible.

Now, as we repair the damage caused by the crisis and we work to reallocate resources to investments in innovations—and, of course, we operate with scarce resources, we need to commit to work together to reduce our long-term fiscal deficits. Future deficits are too high, and the American people, along with investors around the world, need to have confidence in our ability as a country, as a Government, to work together to bring them down over time. I think failure to do so would weaken recovery. It would mean higher interest rates for families and businesses. It would limit the Government's capacity to deal with the many challenges we face. This is a critical economic imperative for the country.

Now, the President's budget proposes some important steps toward that objective. We do not claim to have solved this problem, but we need to work together to identify ways that are going to put us on a path to fiscal responsibility. We, as a country, need to go back to living within our means again.

The President has proposed a cap on non-security discretionary spending for 3 years. We have proposed to restore the basic disciplines of budgeting that all families live with today that we call pay-as-you-go. We propose ways to make our tax system fairer and begin the process of cutting those long-term deficits. You are both correct to say that the Adminstration has proposed to allow the tax cuts for the most fortunate 2 to 3 percent of Americans expire. But we are also proposing to extend not just the Make Work Pay tax credit for 1 year that goes to 95 percent of working Americans, not just to extend permanently the middle-class tax cuts, but to extend a number of very important provisions for business investment and for small businesses which we think are important not just for the near term but for our long-term economic strength and innovation.

Now, the budget proposes to bring down our deficits as a share of GDP dramatically. We propose ways, specific ways, to bring them down to below 4 percent of GDP, I believe 4 years out. And while I think we all recognize that Government support for the economy is still very important, we cannot let our future deficits and debt continue to grow faster than our economy without making our country weaker in the future.

This is going to be enormously challenging, and that is why we have proposed building on the model, as you said, Mr. Chairman, of both the bipartisan Greenspan Commission established by President Reagan and the proposals both of you have worked so hard to create, defend and explain, and that many of your colleagues support. We proposed a bipartisan commission charged with trying to build consensus on a set of policies that can address not just our deficits over the next 10 years, but the long-term deficits which everybody recognizes are fundamentally unsustainable.

Now, I just want to close with encouragement, with some measure of optimism and confidence. I think if you listen today to how people talk about our economic challenges, you hear a lot of common ground on a set of core things. People recognize that deficits matter. They recognize they are too high. I think people recognize that tax cuts are not free. I think people recognize that we have to pay for programs we propose. And I think everyone recognizes that our priority right now, as you both said very well, is to make sure we are repairing the damage caused by this recession and getting this economy back on its feet, getting people back to work, and restoring their confidence, the confidence of businesses and families in our capacity as a country to work together to solve these long-term problems.

Thank you. I look forward to answering your questions.

[The prepared statement of Secretary Geithner follows:]

Embargoed Until 10:00 a.m. EST, February 4, 2010

Treasury Secretary Timothy F. Geithner
Written Testimony
US Senate Budget Committee
February 4, 2010

Chairman Conrad, Ranking Member Gregg and members of the Committee, thank you for the opportunity to appear before you today to discuss the President's Fiscal Year 2011 Budget.

The U.S. economy is still in the midst of one of the most challenging periods in our nation's history. We have pulled back from the brink of financial collapse and a historic recession. The overall economy grew at an annual rate of 4 percent over the last six months of 2009, but millions of Americans remain out of work and the economic pain of the recession can still be felt throughout our nation. This crisis has caused enormous damage to the basic economic security of tens of millions of Americans.

This is why we have a lot of work to do together to make sure that as overall economic growth recovers, so does job growth. We must restore confidence in the economy's fundamental resilience, and we are taking the steps to ensure sustainable growth going forward that is more widely shared among the American people.

Our immediate priority is to work together to encourage the creation of more and, better-paying jobs. We can only achieve that objective if we are committed to laying a foundation for job creation in the private sector. In the short-term that means ensuring that the true engines of job creation, America's businesses, have the right incentives to expand and hire through new targeted measures in 2010 that will speed job creation.

But laying a new and stronger foundation for the private sector requires more: it requires an equally strong public commitment to invest in the innovation, modern infrastructure, and the education of our future and present workers. These investments will enable our businesses to compete, increase productivity, and most importantly, will help create good, well-paying jobs. In the long-term, this new foundation requires the creation of a strong investment climate by showing our commitment to return the deficit to sustainable levels and establishing the right rules to restore trust in the core functions of our financial system. When recovery is firmly in place and the economy is back on its feet, we need to begin the process of bringing down the deficits that Washington has been accumulating for almost a decade. These deficits are too high and left unchecked they will burden our children and grandchildren, and could drain investment from the private sector, drive up interest rates and threaten the very prosperity we are seeking to produce.

The commitment in this Budget to job creation, innovation, investment in the skills of our people and fiscal sustainability is essential to setting the stage for the kind of broad-based economic growth that will provide middle-class Americans with rising living standards and financial security.

Pursuing these goals requires a careful balance. It means not turning too quickly away from our immediate goals of jobs and recovery, while also not ignoring the long-term health, education and energy challenges that our nation cannot afford to further ignore. And it means laying out a

Embargoed Until 10:00 a.m. EST, February 4, 2010

clear path to fiscal sustainability, and demonstrating our commitment to walk that path by taking the first critical steps along it.

Recovery and Job Creation

As the President said last week, jobs must be our most immediate focus. That means that even before we get to our FY 2011 Budget, we will work with Congress to enact legislation to accelerate the pace of job growth.

First and foremost, we will do this by providing businesses – especially small businesses that have been major job creators in recent years –with tax cuts and other incentives to put more Americans back to work quickly.

The Administration proposes to extend Recovery Act business tax relief, and to create a new, temporary tax credit for job creation. We will extend Recovery Act measures that allow small businesses to deduct the full cost of new investments in qualifying equipment. And we will allow all businesses to take bonus depreciation deductions this year for qualifying capital investments.

Under our new "Small Business Jobs and Wages Tax Cut," all businesses will be eligible for a $5,000 tax credit for every new employee they hire in 2010. An additional bonus amount will be available to firms that increase their payroll by adding hours or raising wages, with the total credit amount capped at $500,000 per firm. Because it will use a 2009 baseline, there are no games or accounting tricks any business could perform to get the job or wage tax cut without actually increasing jobs or wages.

In order to get money out to businesses quickly and thus provide a fast-acting incentive to hire, firms will be able to claim the credit on a quarterly, rather than annual, basis. We expect that over one million small businesses that are growing jobs or wages will receive the credit.

This combination of tax measures will boost the pace and quantity of business investment and, with it the number of new jobs that businesses create.

To cope with the difficulty that small businesses face in getting bank credit, the Administration is proposing legislation that will use $30 billion from TARP to create a new separate program designed to provide capital to small and community banks. Our proposal includes a carefully-designed incentive structure that improves the terms of the capital the more a small bank expands lending to small business. And we will explore additional ideas from Congress on other ways this facility could work to expand lending to credit-worthy small businesses.

We also call for extending through September of the effective Recovery Act measures that supported up to $15.4 billion in Small Business Administration loans through lower fees and higher guarantees during this difficult time. And we will support legislation to increase the loan size of the SBA's two most heavily-used guarantee programs.

Second, the President has proposed measures to spur immediate job growth by creating incentives to invest in our environment and energy security. In addition, the Budget includes an extra $5 billion to expand the number of firms eligible to receive a tax credit for investments in U.S. factories that produce clean energy products. This will boost jobs by helping to build a strong U.S. clean energy industry. And because it is an expansion of an existing program, there

Embargoed Until 10:00 a.m. EST, February 4, 2010

are already worthy businesses ready to receive the benefit so that the additional amount will go to work quickly creating new jobs.

The President is also proposing new incentives for consumers who retrofit their homes to make them more energy-efficient, and we are seeking to expand several Recovery Act initiatives that promote energy efficiency and clean energy and that have been particularly popular and effective at job creation.

Third, the President is proposing to boost infrastructure investment beyond what was included in the Recovery Act so that we can continue modernizing our transportation and communications networks. This increase will support needed public works, provide private sector companies with new work, and spur additional hiring.

As we take all of these steps to get Americans back to work, we need to extend Recovery Act relief for those most hurt by the nation's economic troubles. This will include emergency assistance to seniors, unemployment compensation and COBRA assistance for the unemployed, and relief to revenue-strapped states and localities to help prevent layoffs.

Building a New Foundation

While our first aim must be to restore job growth, the FY 2011 Budget looks beyond the immediate recovery to build a new and stronger foundation for growth in the years ahead. Our aim in doing so is to produce growth that once again raises the living standards of all Americans.

We cannot afford an economic expansion like that of the past decade when, as the President said last week, jobs grew more slowly than during any previous recovery; the incomes of average American households declined while the costs of health care and college reached new highs; and much of our growth was built on the sands of a real estate and financial boom.

In order for Americans to thrive, this nation must rely, as it always has, on a vibrant private sector. Our entrepreneurs, small and large businesses, workers, and nonprofit organizations must be the engines of productivity growth and the primary creators of new, high-quality jobs. Washington's role must be to create optimal conditions for small and large American businesses to grow, innovate and create jobs.

Government can play this important role by helping to ensure that families can save and that businesses have ready access to the credit needed to grow; by helping to expand the body of technical knowledge and the quality of public infrastructure to encourage new businesses and greater productivity; by expanding the market for American goods and services by increasing our exports to the rest of the world; and by helping Americans to better educate themselves in order to best employ the latest knowledge and compete in an increasingly globalized marketplace.

The President's Budget outlines policies to make important progress on all of these objectives.

A strong, healthy financial system is crucial for sustainable growth, job creation, and broad-based prosperity. Such a system helps families save for a house, a child's education and retirement. And it channels those savings into investments that let businesses grow, hire, and raise incomes.

Embargoed Until 10:00 a.m. EST, February 4, 2010

Our financial system is far stronger today than it was a year ago. But it is operating under the same rules that led to its near-collapse and a dangerous recession. These rules must be changed to keep the system from taking unjustifiable risks and so that it can fuel growth.

We need a financial system that is safer; in which financial firms, especially large ones, have more capital to absorb their own losses and cannot take risks that threaten the whole economy. Consumers need to be given the information they require to make the decisions that are right for them and they need to be protected from unfair and fraudulent practices. The government needs to have the authority that it did not have in the recent crisis to break apart and unwind failing firms in ways that limit damage to the system as a whole.

The Administration has proposed reforms that would accomplish these goals, and the House has already passed legislation. We must finish the job of enacting comprehensive reform for the sake of people's financial safety and to ensure growth.

At the very core of the Administration's efforts to build a new foundation for growth are our efforts to encourage American innovation. We already made the largest investment in basic research funding in history last year, and we propose to build on that. Even with our tight fiscal constraints for discretionary spending, our Budget for the next fiscal year will increase civilian research and development (R&D) by 6.4 percent. Our aim is to help create the conditions for greater economic productivity and the emergence of new growth- and job-creating businesses. And with most of these new investments offset by reductions in military R&D, we will pursue this aim without increasing the size of government or government spending.

As the President has said, no area is riper for R&D-driven innovation than energy. Whether you are a consumer watching the cost of filling your gas tank go up or a scientist tracking how climate change is affecting our planet, it is clear that we can no longer afford our heavy reliance on fossil fuels to power our economy.

The transition from fossil fuels to clean energy will challenge both America's technical ingenuity and our political will. But the challenge holds out tremendous possibilities not just for improving our health and the environment, but for creating new, high paying "green" jobs and driving the recovery of America's manufacturing economy.

This Administration is committed to creating clean energy and green jobs. The Recovery Act is already investing $90 billion in clean energy technologies. And our FY 2011 Budget extends that commitment. As I have already mentioned, it expands by $5 billion our Advanced Energy Manufacturing Tax Credit, a 30 percent credit for qualified investments in new, expanded or re-equipped clean energy projects. It substantially expands support for construction of new nuclear power plants by increasing loan guarantee authority for such projects by $36 billion. It funds a $500 million credit subsidy to support $3 billion to $5 billion of loan guarantees for energy efficiency and renewable energy projects. It continues work begun under the Recovery Act to modernize our electrical grid so that it is smarter, stronger, more efficient, and helps foster the growth of wind and solar energy projects.

We will make parallel investments in infrastructure with the intention of taking full advantage of the knowledge generated by the new R&D we are funding. These investments are designed to be launched as quickly as possible in order to create jobs. They will include increasing a $7.2 billion

Embargoed Until 10:00 a.m. EST, February 4, 2010

program to expand access to broadband computer networks, and following through on our five-year, $5 billion commitment highlighted by the President last week in Florida to develop high-speed rail.

We are also proposing to expand and make permanent the very successful Build America Bond program, which was part of the Recovery Act. Build America Bonds have expanded the investor base for municipal bonds and lowered borrowing costs, helping to restore a badly damaged municipal finance market and support job creation through new infrastructure projects. States and localities have already issued over $64 billion in such bonds through the end of December. The President's Budget proposes making Build America Bonds permanent with a subsidy rate that makes extension revenue-neutral. The Budget also proposes expanding the eligible uses of these bonds, allowing them to support financing for nonprofits and a wider range of municipal borrowing.

A critical component for building a new foundation for stable, long-term growth, and a complement to our efforts to increase R&D and innovation, is opening up foreign markets to American goods and services. The President has set a goal of doubling our exports over the next five years and thereby supporting two million American jobs.

Our Budget will substantially increase funding to expand exports, especially those produced by U.S. small businesses. The Budget will provide a 20-percent increase in Commerce Department funding that promotes exports from small businesses, as well as funding for the Import-Export Bank to expand U.S. small business use of the Bank's financial export assistance.

History shows that, besides R&D, the investment that pays the greatest returns in improved productivity and greater prosperity is education. The Budget makes substantial new investments in this area, as well.

The Budget will provide new incentives for the rising generation of students to train as scientists and engineers. And because in order to succeed in a global economy higher education is a necessity and not a luxury, the Administration proposes to increase community college graduation by 5 million students by 2020.

The Budget increases maximum Pell Grants awards to $5,710, and further propose to make Pell Grants an entitlement program, to further the President's commitment that coming from a lower-income family should never be a barrier to any young person with high educational aspirations. In addition, it will extend the American Opportunity Tax Credit, which provides a tax incentive of up to $2,500-a-year toward college costs – or up to a total of $10,000 for a young person getting a four – year degree.

The Budget will support the Administration's efforts to make major reforms and improvements in the nation's elementary and secondary schools to help students graduate so that they are ready for postsecondary education or a career. It will expand the Recovery Act's successful Race to the Top competition for funds to include not only states, but individual school districts, and by investing in a new competitive fund to encourage states to develop innovative techniques for recruiting, retaining and rewarding effective teachers.

Finally, this budget is designed to give middle – class Americans a chance to get back on their feet and contribute to this economy. That commitment has been central to the Administration's

Embargoed Until 10:00 a.m. EST, February 4, 2010

policies from the outset. The middle class was the focus of the Recovery Act. And soon after taking office, the President created a Middle Class Task Force, led by Vice President Biden, aimed at raising the living standards of working families.

In this budget, we build on that commitment. We are proposing to extend the lower- and middle-class tax cuts that are scheduled to expire at the end of 2010. Among its effects, this extension will ensure that 97 percent of small businesses who file individual income tax returns will be spared an increase in their tax rates. The Budget will also extend the Recovery Act's Making Work pay tax credit. And through the initiative of Vice President Biden, we will expand the Child and Dependent Care Tax Credit to help those who are working or going to school and are also responsible for caring for others.

We will further assist tens of millions of middle - class families if we pass health care reform that protects every American from the worst practices of the insurance industry, gives small businesses and uninsured Americans a chance to choose an affordable health care plan in a competitive market, and requires every insurance plan to cover preventative care.

The Administration and Congress have worked hard over the past year on health care and we have no intention of letting the chance for real reform slip away. It is crucial to remember that beyond the difference reform would make to the quality, cost and coverage for tens of millions of Americans, reform would reduce the growth of health care costs. This would be of immense importance to the efficiency of our economy and to our ability to reduce deficits over the long-term.

The Fiscal Imperative

American families are making tough choices in difficult times; Washington must do the same.

Every American knows that the path of our deficits is too high and that if they persist long after this recession ends, they will pose a corrosive threat to our economic future.

That is why we believe that even as we take emergency action to spur demand and job growth, it is not too early to begin the process of imposing policies that can start bringing the deficit down to sustainable levels once recovery and job growth have a firm footing. Failure to show our commitment to bring down medium-term and long-term deficits can weaken a recovery. Failure will mean higher rates for families that want to buy a home or businesses seeking to start or expand. Failure will limit the government's ability to respond in future crises.

Of course, in tackling this problem, we must strike precisely the correct balance with the job- and growth-spurring measures required to assure recovery, and the investment in innovation and education to lay a new foundation for future growth. If we fail to do so, we risk driving the economy back into recession, causing immense additional harm to middle-class families and making it even harder to fix our fiscal problems.

This last point bears repeating. Advocating deep and immediate cuts would damage growth, exacerbating our fiscal challenges.

Embargoed Until 10:00 a.m. EST, February 4, 2010

On the day that President Obama took office, the budget deficit for 2009 stood at $1.3 trillion – 9.2 percent of GDP – and the projected 10-year deficits for the following 10 years were $8 trillion.

These huge deficits are the result of the prior Administration's decision to enact large tax cuts and a prescription drug bill without paying for them. Over the next ten years, those measures alone are projected to add $5.8 trillion to the deficit, including interest expense on the additional associated debt.

The impact of the policies on our nation's debt burden was magnified by the great recession the President inherited and its impact on revenues and automatic increases in spending on safety net programs. Together these automatic changes will increase deficits by about $2.4 trillion over the next ten years. Simply put, over $8 trillion of the projected deficits we faced as we put together this budget were due to the fiscal policies of the last eight years and the effects of the deep recession this President inherited. A much smaller amount – less than one tenth of the effect of the unpaid for policies and the recession – is attributable to the cost of the means by which we supported and pulled the economy out of crisis.

Deficit trends of this level are not sustainable. Beginning to correct them will require cutting deficits enough to stabilize the debt-to-GDP ratio at a manageable level so it is no longer rising. This requires cutting the deficit to 3 percent of GDP. This Administration is committed to achieving the goal of deficits that are roughly 3 percent of GDP by 2015. Doing so would mean that the on-going expenses of government will be completely covered by incoming revenues; the only thing adding to the deficit will be interest costs on the accumulated past deficits.

This is an ambitious goal. The deficit in the current fiscal year is expected to reach 10.6 percent of GDP. To reach our 3 percent fiscal target between now and 2015, we must lower deficits as a share of GDP by more than they have been reduced in any five-year period during the past six decades.

The President's Budget proposes a series of actions that would begin to put us back to a responsible, sustainable fiscal path. Let me highlight those changes:

The Budget will freeze all non-security discretionary funding for three years (2011-2013) at 2010 nominal levels, with funding after the three years increasing only at about the rate of inflation. The freeze will reduce deficits by $250 billion through the end of the decade. Among other things, it will require us to eliminate or consolidate funding for several education programs even as we make significant targeted investments to improve education. It will mean reducing spending on the National Park Service, terminating the Brownfield Economic Development Initiative for poor areas that the President advocated during the election campaign and still supports.

In addition, we need to restore the basic set of disciplines that helped make sure that if Congress proposes new policies or tax cuts, these are paid for with offsetting cuts or changes in policy. In the 1990s, Washington started to live by the budget rule and the basic common sense principle that if the President and Congress wanted to pass an expensive tax cut or entitlement increase – however worthy – they had to find offsetting measure to ensure it did not increase the deficit or debt. This common sense rule – called PAYGO – helped Washington move from large deficits to

Embargoed Until 10:00 a.m. EST, February 4, 2010

surpluses. If Washington had lived up to this principle during the last decade it would have served as a bulwark against the unpaid for tax cuts and entitlement increases that make up the heart of the current deficit and debt. Reinstating PAYGO will help return the government to fiscal sustainability.

The Budget will include proposals to close the "tax gap" by collecting more of the taxes that are owed, but are not paid. This is critically important. Tax evasion not only reduces tax revenue, thereby resulting in an implicit tax increase on those Americans who pay their taxes, it also reduces the faith Americans have in the tax system, starting a vicious cycle that can result in even more evasion. I appreciate this Committee's longstanding interest in, and leadership on, efforts to reduce the tax gap. I look forward to working with the Committee to address this important issue.

The Budget will provide nearly $250 million in new enforcement initiatives to improve compliance, which will build on the foundation established in the FY 2010 budget to hire nearly 2,000 new employees dedicated to addressing international tax evasion by businesses and affluent individuals, improving information reporting, and broadening collection activities.

Since President Obama took office, the United States has aggressively pursued international tax agreements to further cross-border tax information exchange. In the past year alone, the United States has signed agreements improving tax information exchange with Switzerland, Luxembourg, Liechtenstein, Gibraltar, Monaco, and Chile. The United States also is working multilaterally to make sure that countries meet international standards on tax transparency and information exchange. The Administration is committed to preventing the facilitation of offshore tax evasion. Finally, the Internal Revenue Service has vigorously pursued enforcement actions against those hiding money offshore. All these efforts are being undertaken to address a fundamental concern: Again, tax evasion, especially through the use of offshore entities and accounts, undermines confidence in our tax system and results in an implicit tax increase on those who pay the taxes they owe.

Our Budget will include a number of proposals to increase information reporting and withholding. The most significant proposal involves addressing the use of offshore entities and accounts to evade U.S. taxes. This initiative will result in billions more in revenue over the budget window and just as importantly send the message that if you hide income and assets offshore to evade tax, we will find you and you will pay. I applaud the leadership this Committee has shown on the issue.

We are also proposing substantive changes to our tax laws to address rules that yield unfair and economically inefficient results. For example, our proposals to reform our international tax rules, to address those aspects that disadvantage investment in the United States and encourage companies to ship jobs overseas. Of course, we recognize that this is an area where our tax law must strike a balance. We are concerned about the competitiveness of U.S. companies abroad and recognize that the growth of U.S. companies globally can benefit the United States. But we recognize that allowing a company that moves jobs or investments overseas to gain a competitive advantage through our tax code against a competitor that chooses to expand investment and job growth in the United States is unfair and is bad policy. This Budget seeks to strike that balance by limiting our proposal regarding the deferral of expenses only to interest. In addition, we drop a previous proposal to limit the ability of taxpayers to elect the tax status of business entities

Embargoed Until 10:00 a.m. EST, February 4, 2010

under the so-called "check-the-box" rules. We remain concerned about the misuse of those rules to inappropriately avoid U.S. taxes, and thus are proposing tighter rules regarding the use of foreign tax credits, as well as a new provision to backstop our transfer pricing rules that will subject to immediate U.S. tax excessive returns on intangibles transferred to low-tax foreign affiliates. Our goal in these proposals is to limit the role taxes play in business investment decisions by reducing implicit tax incentives to move investment and jobs overseas. We are, of course, open to discussing how best to achieve that goal.

Our proposals to allow some of the Bush Administration's individual tax cuts to expire as scheduled and to limit the value of certain tax benefits are restricted to those with the highest incomes. Moreover, we again propose that the income earned on a so-called "carried interest" be taxed as ordinary income and not at preferential capital gains rates, so that private equity and hedge fund managers pay tax on their compensation under the same rate structure as average Americans.

The new Budget will include the President's Financial Crisis Responsibility fee to be imposed on our largest financial firms. The fee will raise $90 billion over 10 years. And it will be extended beyond that period in the event that the cost to the taxpayers of saving the financial system turns out to be greater than that. This last point is another one that bears repeating; the fee can and will be extended until every penny of taxpayer assistance from TARP has been repaid and the cost of the rescue to taxpayers is zero.

The Administration's Budget will cut the deficit as a share of GDP by half as a share of the economy, from the 9.2 percent of GDP the President inherited in 2009 to 4.2 percent of GDP in 2013. The deficit will fall further in 2014, to 3.9 percent.

But this is not enough.

That is why the Administration supports the creation of a bipartisan Fiscal Commission. The Commission will be charged with identifying policies that could win the necessary political support to complete the job of achieving fiscal sustainability. Specifically, it would be asked to propose how to balance the budget exclusive of interest payments on the debt by 2015.

Both Democratic and Republican administrations have turned to similar bodies when the nation faced complex and contentious fiscal decisions. For example, in 1981, President Reagan established by Executive Order the so-called Greenspan Commission to cope with financing problems of Social Security. We could make progress tackling today's fiscal problems with similar bipartisan action.

While the new Fiscal Commission's first job will be to balance the operating budget of the government—the budget absent interest payments on the debt—by 2015, the panel also would be charged with proposing changes to address the unsustainable rate of growth in entitlement spending and the long-run gap between government revenues and expenditures. The nation will be challenged anew to maintain fiscal balance as the Baby Boom generation retires, especially if we fail to reform health care. This will make the Commission's latter charge as difficult, and important, to meet as its immediate one.

Finally, I want to highlight progress we achieved over the past year in rescuing our financial system and our economy at a lower cost to taxpayers than many anticipated.

Embargoed Until 10:00 a.m. EST, February 4, 2010

Treasury has taken steps to dramatically bring down the cost of the Troubled Asset Relief Program (TARP), which helped stabilize the financial system, and to shift the focus of the program to small business and housing. As a result of careful stewardship and improved financial conditions, the projected cost of TARP has fallen from $341 billion last August to $117 billion in this Budget, and we have removed an additional $250 billion reserve in place in the event that additional financial stabilization efforts were necessary. If Congress joins with the President in enacting the financial fee, American taxpayers will not have to pay one cent for the financial rescue.

Conclusion

While our country is in a stronger position today than it was one year ago, we still face tremendous challenges. In meeting those challenges, the true engine of job growth and prosperity, the private sector, must lead the way. But the government must help create conditions that allow businesses to thrive.

We must work together to spur job growth, to invest in ways that make our economy stronger in the future, and to lay the foundation for long-term growth. And we must work together to ensure that our government goes back to living within its means.

These goals reinforce each other; they are not in conflict. Without growth, we cannot begin the process of restoring fiscal responsibility. Without confidence that we can bring down our long-term deficits, it will be harder to make sure we are getting Americans back to work and improving economic security.

We are a strong and resilient country. We have successfully confronted great economic challenges in the past, and we will do so again. This is a question of will, not ability. The American people want to see us do this together – to work to solve the problems that we all face and to get the economy back on track.

I look forward to working with you in a bipartisan manner on this endeavor.

Thank you.

Chairman CONRAD. Thank you, Secretary Geithner.

I would like to go back and just share with colleagues and those who might be listening experiences I had at the end of the previous administration. I remember vividly being called to a meeting in the Leader's office with leaders of Congress, Republicans and Democrats, with the then-Secretary of the Treasury, and with the Chairman of the Federal Reserve. And in that meeting, we were informed—we were not being consulted; we were being told—that the administration intended to take over AIG the next morning, and they told us they believed, if they did not do that, that a financial collapse would be inevitable and would come soon.

And I remember my own reactions listening to the then-Secretary of the Treasury and the Chairman of the Federal Reserve. Again, they were not there to consult us. They told us they were taking over AIG, and they told us they believed they had the legal authority to do it, and they told us they believed if they did not do it that there would be a financial collapse that would not be limited to the United States. They made very clear they thought there would be a global financial collapse.

That then followed, Senator Gregg will remember well, the discussions on rescue legislation. I remember, too, that long weekend, again, with Secretary Paulson, who told us if we did not come up with a plan by 6 o'clock Sunday evening, the Asian markets would open and they would pancake, and we would then see our own markets crumble the next day.

And however imperfect those solutions were—no question they were imperfect; they were devised under extraordinary time pressures—I believe history will record that they were largely successful. I believe the evidence is really quite clear.

The economy of this country contracted in the first quarter of last year by over 6 percent. We were losing 700,000 jobs a month. That is the reality. In the last quarter, economic growth increased by 5.7 percent. That is a dramatic turnaround. If one reads economic history, it would be hard to find a circumstance in which there was a more dramatic turnaround in the positive direction during this last year. And job loss went from 700,000 a month to 65,000 in the most recent month. Now, we do not have January's numbers yet. Hopefully that will have improved. I do not know. But I believe the record is really quite compelling that the actions that were taken by the previous administration at the end, by the new administration in their beginning days, and by the Federal Reserve were absolutely essential to preventing a collapse. And it has worked. I think the evidence is undeniable.

Is it imperfect? Absolutely. Were there enormous mistakes made that led to this crisis? Absolutely. And I believe fundamentally it was an overly loose monetary policy by the Federal Reserve and overly loose fiscal policy by Congress and the President that created the seed beds for bubbles to form. And when bubbles form, they burst. And when they burst, there is enormous economic wreckage. And on top of it all, we had deregulation that left no one watching derivatives markets that had trillions of dollars flowing around the world unregulated, unchecked, even unrecorded.

Let us not repeat the policies that led to that collapse—an overly loose monetary policy, an overly loose fiscal policy, and deregulation that left us without any kind of oversight of extraordinarily risky measures.

My question is simply this: Looking ahead, this is where I have a bone to pick with this budget, and I certainly support what is being done in the short term, but the longer term, what if the commission, for whatever reason, is not formed? If the Republicans refuse to participate, for example. Some have said they would not. Then what?

Secretary GEITHNER. Mr. Chairman, the idea of the commission, as you both have said so well, is to get people together, removed from politics, to try to take a fresh look at how to dig our way out of this unsustainable hole. And for it to work, it is going to require Democrats and Republicans coming together, and people are going to have to come fresh and open because it is too hard.

So we are going to do as much as we can to try to design it in ways that will command that broad support, and I think it is important to underscore, again, how important it is that people recognize now that we have to start to build that broader consensus. It is not something we can put off indefinitely. I know many of you would like us to be more ambitious in this budget in terms of identifying ways to bring down those long-term deficits. That is a fair point. I think it is important to underscore that we are recognizing in a very clear, direct way that we have to get the deficits down over the medium term to a level where our debt burden as a share of the economy is no longer growing and stabilizes at a rate we can afford and bear. And we are a long way from that point.

Next year is not too soon to begin that process, and in some ways our capacity to be helpful now, to continue to work to help encourage job creation and investment, our ability to do that now depends directly on how much confidence we create that we are going to find the political will as a country to bring those deficits down over the medium term.

Now, of course, we could do that successfully and still face unsustainable long-term fiscal deficits. And as you know, our view is that the only way and the necessary way to begin to deal with those things starts with reducing the rate of growth in health care costs. So that is not something that we can responsiby defer.

Chairman CONRAD. My final question to you: Will Republican leadership be consulted on the make-up of any commission?

Secretary GEITHNER. Yes.

Chairman CONRAD. I think that is absolutely essential. And will there be the assurances that the Vice President has provided in his letter of the Majority Leader and the Speaker bringing the recommendations of the commission to a vote in the Congress?

Secretary GEITHNER. Yes. The basic design of this, as you know and have worked so closely on, is you bring Democrats and Republicans together, ask them to step back from politics, make recommendations that help solve these problems, and the Majority Leader and the Speaker of the House have committed to the President that they will bring those recommendations to a vote.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman. And you have said a lot of things, Mr. Secretary, which I do not have time to discuss them all, so I will just pick a couple of the highlights.

I do want to congratulate the Chairman for his history lesson. It was accurate and correct, in my opinion, but with one caveat, one footnote. It was actually the Chairman of the New York Fed who took over the AIG, and it was the right decision, and it remains, in my opinion, the right decision.

But you said, Mr. Secretary, something that I think you said it in a way that I am not sure people focused on it, but I think it is at the core of the issue, and that is, until the world community and our own markets believe that we are putting in place actions which will fundamentally change the out-year instability of our fiscal situation and the unsustainable path that we are on, we probably will not get robust recovery because people will not be willing to invest and people will not be willing to buy American bonds at a rate that is reasonable. Our costs are going to go up here dramatically, I think, within 4 or 5 years if we do not do something. We may find ourselves—Moody's just yesterday said they may downgrade us. But we may find ourselves in the same situation as Japan is in today, and we will be in trouble. The path we are on is unsustainable and I believe leads to insolvency. And, regrettably, the budget that was sent up—you know, you mentioned the freeze.

I am for the freeze. But it is $10 billion on a $1.6 trillion deficit. It just does not get us there.

You mentioned the tax increases, $2 trillion. I do not happen to support them, but as a practical matter, you still have $11 trillion of deficit on top of that after your tax increases.

And as I said earlier, the taxes are getting well above our historic norm, but spending continues to be unsustainable at these levels. So it is really a Never-Never-Land budget when it comes to the out-year problem that we confront. It is almost as if it does not admit that it exists in many ways.

We can debate later the commission and how you structure it, but I believe the best way to approach it is another vote so that it is statutory.

I guess I want to go, however, to this issue of your new proposals on small business because I do not really understand them. On the one side, you are raising the top marginal rates from 35 to 39.6 percent. Those rates are primarily paid by small businesses. Those are mostly subchapter S corporations. They represent the majority of people who fall into that rate category. So you are raising significantly the tax rate on small business subchapter S. At the same time you are claiming you are going to energize small business activity by a $30 billion capital infusion into banks with assets under $10 billion.

The two do not—the two are going in opposite directions, No. 1, but more importantly—equally important, I cannot understand why any bank in America that is not in serious trouble would ever want another capital infusion from the Federal Government after what they have been through during the experience with TARP. And, therefore, how are you going to get healthy banks to take the money, No. 1? I mean, I can understand where weak banks will take it, but that is not going to cause lending because they are weak. And, No. 2, why do you think a capital infusion into banks under $30 billion with under $10 billion of assets, even if they take it—and I would like you to explain to us why you think they will take it unless you are going to force it on them through regulatory oversight, which I hope you are not—why you think that offsets these very significant increases in taxes on small business that you are proposing, which I think weakens the energy out there to invest and create new jobs and capital because people have to use the money to pay their new tax bill?

Secretary GEITHNER. Those are excellent questions, and let me try to respond.

The proposal we have made to allow the tax cuts on Americans earning more than $250,000 a year to expire will only affect 2 to 3 percent of small businesses across the country. Now, it is 2 to 3 percent. These are independent estimates. They are not our estimates.

Now, you can——

Senator GREGG. But isn't it true, though, that 60 percent of the revenues, approximately, from people paying more than 35 percent—a 356-percent tax rate comes from subchapter S corporations?

Secretary GEITHNER. Well, I guess, again, the way I would say it is——

Senator GREGG. Which is small business.

Secretary GEITHNER. It is only 2 to 3 percent of small businesses. That is the best measures of the overall effect. You need to look at those alongside what we are proposing, which is we are proposing to make permanent tax cuts that will affect 97 to 98 percent of small businesses to give them additional tax relief for business expensing, for accelerated bonus depreciation——

Senator GREGG. I support all those.

Secretary GEITHNER [continuing]. Zero capital gains rate on——

Senator GREGG. Great idea.

Secretary GEITHNER. Those are things we think make a lot of sense, that are good policy, and they are important. But I want to come to this point about credit because it is very important, and so I want to try and respond to your questions about credit.

One of the most effective things we can do to help credit markets is to make sure that small and community banks have the basic resources to expand to meet what will be growing demand for credit as the economy recovers.

One of the most cost-effective ways to do that is to give them a dollar of investment capital with a dividend for the taxpayer. Every dollar we give them should expand lending capacity, their ability to lend, by a factor of 8 to 10. I am not aware of any public policy investment that offers that kind of a return.

Now, you are right. We cannot force them to come and take these investments. In fact, what we saw across the country over the last 10 months or so that is quite damaging is we had 650 small and community banks withdraw their applications from the Treasury to capital for a lot of reasons. I would say the two principal reasons they cite is concern about the perception that they would be stigmatized for doing that—some of their competitors ran ads against the people that took capital—but also because they were very concerned about actual and prospective conditions that might apply that might make it impossible to run their institutions.

So we are not going to be effective in trying to open up those credit pipes unless we can design a program that makes it more likely that they will come and use that capital to expand small business lending.

Now, we have been able to—because we helped recapitalize the financial system with private capital, stabilize the system as a whole with using much less authority than Congress gave us at much, much lower cost. And so what we propose to do is we have reserved some of that authority—and it is a very modest share of our remaining resources—so we can design something together that would meet that basic test.

But you are absolutely right. We have learned something. They need to be willing to come take advantage of that. If we can it right, and I do not think it is that complicated to do. It is a very high return. And I do not believe it is possible, since—small banks are 50 percent of the credit to small businesses,to be responsive to that credit problem without working alongside the SBA to help small banks and small businesses.

And, I am sorry, one more comment, Senator. I think people—it is important to get the balance right. Even though we have put out the financial fire, and even though the actions of my predecessor, the Chairman of the Fed, the Congress in the fall of 2008, and the first 6 months of the year were incredibly effective in putting out that fire, I do not think anybody can look at this system today—and say that the challenge is really over for small community banks, for our housing markets. There are parts of our system that still reflect the basic scars of this crisis, and we want to work with you and figure out how to address that. And the architects of the authority—and I know they are in this room—were very careful and pragmatic in trying to make sure that we had the ability to work through those basic credit pipes of the system. You cannot work around them completely. You can do some things around them, but if you do not work through them, I do not think anything is possible.

Senator GREGG. Well, my time is up, but I just do not see how any board of directors sitting around in a small bank in North Dakota or New Hampshire, unless they are in financial trouble with their capital structure, is going to want to get the Government into their bank after what happened relative to compensation, relative to loan quality, relative to all the chaos that was created as a result of the Government stepping into—I just do not see how this program probably is taken advantage of, but maybe I am wrong.

Secretary GEITHNER. That is probably why we proposed the legislation. And, Mr. Chairman, could I say just one more thing on this?

Chairman CONRAD. Yes.

Secretary GEITHNER. When I hear from small community banks, what they say is something like the following: They are very worried that financial reform is going to come out in a way that is going to put huge new burdens on them. They say, we were not the cause of the problem in subprime lending or the huge predatory abusive practices in consumer credit, and we do not want you to solve those problems on our backs. They say they are facing enormous pressure from their supervisors, and there is always a risk in recessions that people overcorrect after a period where credit was too easy. And they say they cannot raise capital from the private markets, even though the capital markets are much more healthy and open to many large companies and major banks.

So those are things we have got to work on all fronts, and, the tests of how governments deal with financial crises are really three: Do you limit the damage effectively? And, Mr. Chairman, you were right that we have brought it back from the brink of collapse very, very quickly. The question is can you do so at low cost to the taxpayer, and our judgment is we have a very good shot at having solved this in ways that, in financial terms, are a fraction of the S&L crisis, at a much, much lower cost, in a fiscally responsible way. And the third test, which is still before us: Are we going to deal with the moral hazard risk created by our response to the crisis? Are we going to reform the system in ways that will prevent these abuses in the future? And I think it would be important for the banking system as a whole and for businesses to try to bring the financial reform legislation to earth as quickly as possible so people know what the rules of the game are, and I hope we can work with you and your colleagues on how best to do that.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Secretary. I met with you last year when you were seeking Senate confirmation, and I told you that people all across my State were hurting, and small businesses were coming to me and saying they could not meet their payroll and could not get loans, and families who had always had good credit could not get college loans or loans to buy a home or car, and they were pretty angry that their tax dollars were being used to cover the consequences of years of recklessness on Wall Street and failures of a regulatory system. At that time, you talked to me about the need to have transparency and accountability and said that you would focus on Main Street as well as Wall Street.

Well, we are sitting here today, we are here a year later. As Senator Conrad said, we took steps to prevent a major economic collapse. But Americans are still really struggling, and, frankly, I have not seen enough accountability to Main Street.

My constituents tell me all the time that they are not feeling the benefits of the bailout programs that are paid for by TARP, and I really understand that frustration. We provided assistance immediately to Wall Street, but a year later, we do not see it on Main Street. Frankly, I am pretty angry, too, because I see these Wall Street banks that have returned to their bonus-as-usual mentality, and that creates a lot of tension in America.

In my State in the past 6 years, over six community banks have failed, and a lot more are struggling. We just woke up this morning to another headline from Cowlitz County, and a small town, Longview, where Cowlitz Bank is being ordered by FDIC to reduce lending and cut dividends and raise capital. Those are all stemming from bad assets on their books. This is a community with over 13 percent unemployment, and their lending has now dropped by 20 percent, which means those little businesses and those families in that community are really feeling the pinch.

So, you know, I am glad that the President is announcing a plan to jump-start small business lending. I do have some concerns with the approach.

Now, back in the fall of 2008, Treasury began providing billions under the Capital Purchase Program to small and medium-sized banks, and the goal was to expand lending. Now, we know that did not work. Instead of expanding lending, banks that received those capital injections put it in to strengthen or buffer against losses. In fact, I want to quote from the Congressional Oversight Panel that said, "Uncertainty about risks to balance sheets caused banks to protect themselves by building up capital, including devoting TARP assistance to that end. One consequence was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as creditworthy."

Now, I know you understand that reality, and I know that you have stated many times, including in your testimony to the Banking Committee last summer, and you said, "Troubled legacy assets are congesting the U.S. financial system," and that "simply hoping banks work off these assets would prolong the economic crisis and increase the costs to the taxpayer." I assume you are still there and you agree with that.

So you can see now my concern with the administration's approach. You have made some adjustments, and the new small business lending proposal is very similar to a tactic that did not work in the past as it was intended. I think, if we are serious about expanding credit availability to small businesses, that we have got to do it in a more permanent way.

Last year—we talked about this yesterday—you rolled out the Public-Private Investment Program, and some progress was made on the securities side, but we need a renewed focus on getting the legacy loan programs working.

Now, I have introduced legislation and I have made some proposals that I think can help achieve that. I think there are two things that are pretty clear that we need to make: adjustments to the pricing mechanisms to make it economical for banks to sell impaired loans, and adjustments to the requirements for participation, including dividend rates, executive compensation limits, and other factors. Those are improvements that can be made quickly, and, frankly, they do not require legislation.

So I wanted to ask you if you agree with that and hear your comments.

Secretary GEITHNER. I think I agree with everything you said, but I want to make one point before I respond directly to that question.

I believe that the capital investments that were placed in the U.S. banking system were exceptionally effective in improving overall credit conditions, and the best measure of that is what has happened to the cost of credit for all businesses, homeowners, and municipal governments.

Now, as I said—and I completely agree with you—there are still a lot of challenges ahead for the banking system and for small businesses, but the capital programs were exceptionally effective in trying to make sure you did not have a crisis accelerate and to make sure that the recovery was not going to be choked off because of access to credit.

Now, I completely agree with you that there are things we have the authority to modify under the TARP that affect the economic terms that banks get on investments from the Treasury. I think those are necessary, but I do not think they are sufficient.

As Senator Gregg said, there is enormous fear and uncertainty about the broader stigma and conditions that come with the program of the TARP.

Senator MURRAY. Right.

Secretary GEITHNER. I know you have thoughtful legislation in this area designed to try to get directly at the legacy assets that are still in the banks, in the banking system. I would be happy to work with you on that. As you know, we did design—and I think it is a very effective program on the securities side. We have made less progress on the bank side, and partly because we have to work in partnership with the FDIC, and I respect their reservations. They have some understandable concerns about this stuff. But I would be happy to work with you on how best to solve it.

Senator MURRAY. Well, I would really like to work with you on this because of what I see. Just like the Cowlitz Bank that we are reading about today, these banks have troubled assets on their books, and as a result, they are not lending. Then they get in trouble, and then they get closed down, and before you know it, we are not going to have any community banks left. And I am deeply concerned about that.

We helped the Wall Street banks, and there is a real anger at home right now that now we are ignoring what is happening in everybody's neighborhood, and it is affecting their little barbershop and their restaurant and their grocery store and everything else that they count on for employment in those small communities.

Secretary GEITHNER. I completely agree with you about that concern, and we share the basic objectives. And I just want to point out just one clarifying remark. You know, I think a lot of the American people have been left with the impression that this administration came in and put hundreds of billions of additional dollars into our Nation's largest banks. And that is not what we did. In fact, what we did is very quickly make sure that the taxpayers' investments in those banks were repaid, replaced with private capital, so that they were going to be in a stronger position to support recovery.

The only checks this administration, this President has written in terms of investments in our Nation's banking system were not to the large banks but to small community banks and regional banks. It is important to note everything we did to try to make sure that we were pulling the economy away from the abyss and stabilizing people's confidence in their savings in banks across the country, were designed to meet exactly the challenge you said, which is that the only thing that was guiding what we did. We were trying to make sure we were fixing what was broken in our broader system, so that businesses and families across the country would benefit from more credit on fair terms. And, again, the best test of that—and there are enormous challenges ahead—is to just look at what has happened to credit terms and the price of borrowing for a mortgage.

Senator MURRAY. All right, Mr. Secretary. My time is up, but I would like to work with you, because unless we get to the root of this problem, we are not going to see those banks lending.

Secretary GEITHNER. I agree with you.

Senator MURRAY. OK. Thank you.

Chairman CONRAD. Thank you.

Let me just indicate to my colleagues, we have gone really effectively from 5-minute rounds to 8-minute rounds or even something beyond that. So let me just say to our colleagues, I will extend their time as well so they do not have to feel as though they are going over, since all of us have. So, Senator Bunning, I would recognize you for an 8-minute round.

Senator BUNNING. Thank you very much.

Welcome, Secretary Geithner. The Federal Reserve has been out in the press talking about how they are going to make money on their AIG loans. What a joke, making it sound like a good idea for the taxpayers. However, that is not the whole truth because Treasury has committed some $70 billion to the AIG bailout. So the taxpayers are still exposed to AIG and, in fact, are likely to take losses.

What is your current estimate on the taxpayers' losses from AIG?

Secretary GEITHNER. Senator, you are exactly right, and I have made that point as clear as I can. The Government is still exposed to substantial risk of loss in AIG.

Now, the CBO put out an estimate just a few weeks ago. It says that those losses may amount to $9 billion. Our estimates are somewhat higher than that. We do not actually know at this point. And you——

Senator BUNNING. Well, isn't it true—and I do not want to interrupt you, but isn't it true in the budget submission that you made you anticipate $30 billion in losses?

Secretary GEITHNER. Exactly. As I said, our estimates of losses are significantly higher than in the CBO's. They may be right. We are trying to be conservative about it. But I want to just underscore two things. They are a fraction of what those estimates were 6, 9, 12 months ago. They are much lower cost than any of the alternatives we could have considered at that time. And, again, to make sure we can tell the American people they will not pay a penny of the costs of what we had to do in AIG. That requires——

Senator BUNNING. Well, that is if the Congress acts——

Secretary GEITHNER. If the Congress acts, that is right.

Senator BUNNING [continuing]. As you want us to.

Secretary GEITHNER. Well, as the law requires us to, proposed ways to recoup those losses, which we have done. Now, there are different ways to do it——

Senator BUNNING. Mr. Secretary, the law requires you to take all AIG-or not AIG, but TARP money and use it for deficit reduction. All returned money, that is what the law says.

Secretary GEITHNER. That is exactly right. The earnings on this—and they have actually been substantial in most of these programs—go directly to the budget——

Senator BUNNING. What about the cost as far as interest?

Secretary GEITHNER. Repayments, interest, too, also, dividends, interest, warrants. But repayments also, as the law is designed, go to reduce our deficit. And, again, it is very important for people to understand that when I took office, independent estimates of total costs of solving this thing were $400 billion above where they are today. Now, that is good for our long-term fiscal challenges. That means there are resources available today that were not foreseeable at that time to try to deal with our——

Senator BUNNING. You spoke earlier about the cost of money and the cost for the taxpayer, homeowners, borrowers, businesses, schools, municipalities. Would that have something to do with the zero monetary policy of the Federal Reserve?

Secretary GEITHNER. It is very important—and you are exactly right—that what has helped bring stability, improve access to credit, and reduce borrowing costs is the combined effect of three very important instruments: one is what the Fed did and is still doing; the second is what Congress did in passing a Recovery Act and putting a floor under a collapsing economy; and the third is what we did to help make sure there was capital back in the financial system and people were not living with the acute fear that we were going to let things fall apart.

All those things mattered. They were all reinforcing. Again, just one example. I believe even in March of this year, people expected house prices across the country to fall another 30 percent. What happened in fact was you have now had 6 months of initial signs of basic stability in housing prices, and those go directly to how people think about their basic economic and financial security. The value of their pension savings today in an average 401(k) is 35, maybe even more, higher today than it was at the law. You are right that——

Senator BUNNING. Don't speak too soon because it depends on the recovery continuing.

Secretary GEITHNER. It does. Exactly right. You are exactly right about that.

Senator BUNNING. Well, if you look at today's market, you would not be as optimistic maybe as you were yesterday.

Secretary GEITHNER. Oh, I am a very careful person, Senator, and I would always——

Senator BUNNING. It is up 200 points today.

Secretary GEITHNER. I always underscore the fact that we are still living with a lot of damage caused by this recession. And these problems took a long time to buildup; they are going to take a long time to repair and dig our way out of. And it is a responsibility I think we all share to make sure we are doing things that are going to help repair that damage. And we have made a lot of progress, but there are a lot of challenges ahead.

Senator BUNNING. I just want to read from Moody's Investors Services as of this morning. "Unless further measures are taken to reduce the budget deficit further or the economy rebounds more vigorously than expected, the Federal financial picture as presented in the projections for the next decade will at some point put pressure on the triple A government bond rating."

"'Freezing part of discretionary spending for a three-year period beginning in the next fiscal year is a positive step from a rating perspective,' says Moody's Senior Credit Officer Steven Hess. However, the deficits projected in the budget do not stabilize debt levels in relation to GDP, and the portion of government expenditures going to pay interest on the debt shows a steady increase."

So that brings out exactly what our Ranking Member and our Chairman have said. Short term, OK. Long term, really not OK.

Secretary GEITHNER. I agree with that. But let me just underscore one important thing again. We are proposing clear, specific ways—things that are going to be very unpopular—to cut our deficits dramatically as a share of our economy. We bring them below 4 percent of GDP, but as I said, that is not far enough. And that is why we want to have a commission that is bipartisan try to work together to figure out how to deal—to get us that further distance so we do not have a debt burden that is going to make us weaker in the future.

Senator BUNNING. Somebody brought up the Commission that Chairman Greenspan headed up on Social Security. In my opinion, it was a failure in the long run. It was a very successful Commission for the short term. In the long run, Social Security goes negative in 2017, and it pays only 73 percent of our benefits if you project out to 2042.

Just in very little changes in the recommendations of that Commission, extending the retirement age from 67 to 70 would have put that out to 2075, 2080 rather than 2042.

So creating commissions is not always the answer to our problems, especially one that is mandated by the Executive. I agree with both my Chairman and my Ranking Member that if it is going to be done, it has to be done in the Congress of the United States to get everybody cooperating, both Rs and Ds. If we get that, then there will be a coming together on that fiscal problem.

Secretary GEITHNER. Senator, I think you said it right, and I think that 53 votes was not enough. On the other hand, 53 votes signals pretty broad bipartisan support for the basic recognition. You said it very well, which is that you are going to need Democrats and Republicans to come together and propose ways to deal with this. But ultimately Congress has to act. And, you know, commissions do not themselves create consensus. You have got to build consensus across the aisle.

Senator BUNNING. I have gone a minute over, so go right ahead.

Chairman CONRAD. I appreciate the Senator. We went from 5-minute rounds to 8 minutes, and this was 9, and that is really what it is running, so I will allocate 9 minutes to Senator Whitehouse, and I hope he will not go a minute over.

[Laughter.]

Chairman CONRAD. It was completely fair of Senator Bunning to do so because, really, we were at 9 minutes with others. So 9 minutes, Senator Whitehouse, Senator Sanders, Senator Alexander.

Senator WHITEHOUSE. Thank you, Chairman.

Just to followup on the discussion that Senator Bunning was having, I would be an achievable vote on the Conrad-Gregg bill if it were clear to me that the most important part of this, which is health care reform, was going to be handled in a health care-specific way that put reform first and did not bring in a lot of bloody minded fiscal hawks with their knives to just cut away at benefits because they frankly do not understand the technique and the issues of delivery system reform, and if it were clear that there would be a very solid process going into it where people like me could have their voices heard. I could not have made that clearer. I have made that clear in letters to everybody in sight. Those do not seem to be unreasonable requests. We have never been approached on that subject. So I think there are more votes to be had on that.

But if enough Republicans who are actual cosponsors of the legislation, who have put their names behind it, can be directed by their leadership to vote against it when it comes up as soon as it is clear that President Obama supports it, that is a pretty strong sign that there is mischief afoot, and it is very hard to work around that mischief.

Two different points. One is on carried interest. As you well know, there is a loophole that has allowed the wealthiest and best compensated people in America, the big hedge fund managers, to pay income tax rates by pretending that it is capital gains at a rate that is lower than their secretary pays, at a rate that is lower than their driver pays, at a rate that is lower than their gardener pays. And the image to me of some person earning tens, hundreds of millions of dollars a year sitting in their private jet and looking out the window at the father of four who is busy loading their luggage in the rain into that private jet and the guy inside the private jet with the champagne glass is paying a lower income tax rate than the fellow out working hard, showing up every day and loading luggage in the rain, to me that is just something that is very, very wrong with America. And it is in the Obama administration's budget to fix this. I applaud him for that.

What I would like to ask you, Mr. Secretary, is: What will the Treasury's position be on this? Are you just going to run up a flag saying we nominally support this? Or when it comes to the real crunch on this politically, are you going to be there with us? Are you going to be in there fighting in the political scrum that it is going to take to get this change made?

Secretary GEITHNER. Absolutely. Absolutely. And I personally am very supportive of this. In fact, it is just a basic thing of fairness.

Senator WHITEHOUSE. It is sickening, frankly, not to have it straightened out.

Secretary GEITHNER. Why should somebody running a private equity firm or a hedge fund face lower taxes on income than a teacher and firefighter. It is a simple thing. And, you know, I think this is a very compelling thing to do. We had decades where we had an alarming, damaging, corrosive rise in income inequality across this country. Changes to the tax system made that worse.

It is a very important thing to public confidence in our system that we restore a sense of balance and fairness to this. And even though that measure does not produce a lot of revenue, it is good economic policy, and I think it is fairer. And I frankly hope that we can work with our colleagues in London as well to try to make sure they are making comparable changes, too.

So I think it is good policy, and I personally am very supportive of it, and we will fight for it.

Senator WHITEHOUSE. Good. Well, it is very important to me to hear you say that. Like Ronald Reagan, I intend to trust but verify. And I very much hope that you and the administration can be as powerful in the fight as in the starting efforts.

The other point that is very important to me is the continuing problem of foreclosures. I have had several hearings on foreclosures in my Judiciary Subcommittee. The stories are just appalling. When somebody has to go and tell their daughter that she is going to lose her bedroom and that all the stuffed animals have to be packed and that they are going off, it is a terrible family catastrophe when that happens.

When they then have to deal with a servicing company that is not the bank, that cannot answer their questions—Joe Burlingame, a firefighter from Woonsocket, told me at one of the hearings about the absolute nightmare that his family was put through just trying to deal with the bank. Another guy, Joe Verdelotti, who is an electrician in West Warwick, told me about his wife and he having to basically pass the phone when he came home from work and she went off to work because they were stuck on the phone going from voice-mail to voice-mail to push button 2 to push button 3 for so many hours, 6, 7, 8 hours. Over and over again, the personal cost of these foreclosures really comes home to roost on people in ways that are agonizing, in ways that are frustrating, in ways that are painful. And it strikes me that we have a clear and simple way, a market way to find the floor, the actual market floor on the prices of these houses, and to move on and to cut through all of the clutter, all of the delay.

And, by the way, this is not non-HAMP banks. This is people in the so-called HAMP program still getting just crushed by it. And that is to enable somebody when they are frustrated enough to say, "You know what? To hell with it. I am going to go to bankruptcy court, and we are going to get this straightened out once and for all."

I think the instant that that can happen, the entire industry will adapt. You now have a solid, fair, neutral marketplace to decide exactly what that real value is and everybody else has to adapt. Instead, the procedure that you have followed has been to put it on the banks to make the decision about how much money they are going to lose. That is a very hard call to ask a bank employee to make. It is very easy to kick that down the road. And as they kick it down the road, that family continues to be tormented because they are on the other end in a lot of misery.

Will you please support the change in the law that would allow a residential primary mortgage to be reset in bankruptcy the way every other debt can be and not just give it lip service but get in there and fight with us for this? I think in the long run it will actually be better for the banks because of the long agony that they are going through, frankly, it does not help anybody to have this artificial circumstance. There is a price for that house. The bankruptcy court will set it. It is a market and you move on, and that is the discipline that we should be pursuing.

Secretary GEITHNER. Senator, I completely agree with you that housing still seeing enormous devastation, and it is a basic symbol of all what was wrong in this crisis, what is unfair in it, because you saw people that were completely responsible that are the victims of the fact that other people were taken advantage of, lived beyond their means, and you are seeing it directly affect the value of their house, the prospect of keeping their house. It is deeply unfair, fundamentally unfair, and I completely agree that we have an obligation to do as much as we can to make sure that people who can afford to stay in their house do so as well. And it is not something that you can solve with a single instrument, and you know the President has been supportive of carefully designed bankruptcy reform to reinforce this objective.

Now, we are trying very hard——

Senator WHITEHOUSE. The President has been supportive, and he actually supported the legislation when he was a Senator.

Secretary GEITHNER. He did.

Senator WHITEHOUSE. But when we actually tried to bring it up last year, I would describe the support that his administration officials provided that effort as nominal at best.

Secretary GEITHNER. Senator, I just want to say that we are committed to continue to work to do everything we can to be helpful in trying to not just put stability on things, but try to make sure that we are reducing, to the extent we can, the amount of foreclosures out there still ahead of us. And I completely agree with you that we need to get—that banks and servicers need to do a much better job of trying to make sure they are converting these modifications to permanent modifications, and they are very substantial benefits——

Senator WHITEHOUSE. They would not need to do a better job or they would immediately do a better job if the consumer could go to the bankruptcy court and force that process, at least for those that are service mortgages and not held by a bank.

I apologize. I am 20 seconds over. Thank you, Chairman. I appreciate the indulgence.

Chairman CONRAD. Senator Alexander for 9 minutes.

Senator ALEXANDER. And 20 seconds.

[Laughter.]

Senator ALEXANDER. I will give back 20 seconds.

Mr. Secretary, welcome to the Budget Committee, and thank you very much for your service to our country. You mentioned in your testimony how entitlement spending and the contribution that has made to our deficit, and particularly those in the last administration. I remember going to an entitlement summit that the President had last year.

How much of the debt problem, getting it under control in the long term, will have to do with getting control of entitlement spending?

Secretary GEITHNER. The long-term problem, once you look beyond the next 10 years, is really overwhelmingly a combination of two factors. One is the fact that our economy is aging, more people are retired relative to how many people are working. But that is much less important than what has happened to health care costs and what is still projected to happen to health care costs. And that is why I think many people believe that the best path and the only path to fiscal responsibility over the longer term has to go through health care reform that reduces the rate of growth in costs.

Now, in the near term, the next 10 years are not the near term, but the near-term factors are overwhelmingly the consequences of a bunch of policies that were adopted over the last decade and just the huge damage to our revenue base and the interest costs associated with this recession.

Senator ALEXANDER. But, Mr. Secretary, I happen to think entitlement spending is the big gorilla that we need to work on. But if that is true, then why would the administration's budget propose moving a half trillion dollars over the next 10 years into new entitlement spending in the Pell Grant program? We all like college scholarships, but isn't this an example of just saying I see the problem, the boat has a hole in it, and so what I propose to do is just put some more holes in the boat? Wow could we possibly be thinking about adding a half trillion dollars in 10 years to new entitlement spending, no matter how worthy the goal?

Secretary GEITHNER. Senator, the President's view, is that a dollar of help to make higher education more affordable, again, has very high returns to the overall American economy, and that is the judgment we are making. Again, the test we all face is to do things that have a high return for every dollar we are proposing to ask the taxpayers to put up. And I think making higher education more affordable absolutely meets that test and is one of the most effective things we can do.

Senator ALEXANDER. The President mentioned free trade in his State of the Union address as one part of job growth, and he mentioned Colombia. Does that mean we are likely to see the Colombia Free Trade Agreement resubmitted to Congress?

Secretary GEITHNER. Senator, we believe that the three agreements pending can be strengthened and, if enacted with the right set of protections, would be good for expanding exports. But as the President also said in the State of the Union, we want to work with countries around the world on a new multilateral agreement that offers those same basic protections, expands markets, and we want to make sure we are in the game in Asia, too, as other countries move to work on that. But, of course, for these to work, they have to provide strong protections for American workers, and they have to provide a level playing field for American companies.

But one of the best things we can do for future growth is try to make sure that we are part of this, economies that are growing most rapidly, and American companies and workers are able to share in those gains.

Senator ALEXANDER. In looking for ways that Democrats and Republicans can work together, I was especially pleased to see the President's comments about a new generation of nuclear power plants, about his recommendation for $54 billion of loan guarantees for nuclear plants, and his appointment of a commission for dealing with used nuclear fuel. I have been afraid that we are going to have an energy policy that amounted to the energy equivalent of going to war in sailboats by using windmills for this big economy. And I am very encourage by this.

I am wondering if as this policy evolves and matures we will ever get to the point where we can support—as Senator Webb and I do in our legislation on alternative energy and doubling nuclear power—technology-neutral policies rather than this subsidy for wind and this subsidy for solar and this subsidy for geothermal and this subsidy for nuclear, where we have loan guarantees and production tax credits and other appropriate things that led us toward carbon-free electricity, if that is the goal, rather than picking and choosing winners and losers.

Secretary GEITHNER. Senator, I cannot speak to the specifics of that proposal, but I agree with the general principle that our job should be to get the incentives right to encourage people to use energy more efficiently and make sure that we are encouraging cleaner sources of energy use. But we want the technology—we want there to be innovation in technology, and we want to make sure that technologies that offer the best return on those two objectives are the ones that end up dominating the field.

Senator ALEXANDER. What is the plan for getting rid of the Government's investment in General Motors? I had suggested that we just declare a stock dividend and give the stock back to everybody who paid taxes last April 15th. Senator Warner and Senator Corker have a different proposal. It seems to me the sooner the taxpayers get out of the auto business, the better. What is your——

Secretary GEITHNER. I could not agree with you more.

Senator ALEXANDER. So when are we going to do that?

Secretary GEITHNER. We are going to do it as quickly as we can, and I think that there is a lot of merit in what Senators Warner and Corker have described, have proposed, which is to try to make sure that we are managing down those investments as quickly as possible. And, of course, our obligation is to try to make sure we are getting the Government out of that as quickly as possible, but doing so in ways that offer really the best return for the taxpayer. A lot of merit in those suggestions, though, and we are working very closely with them.

Senator ALEXANDER. I still like the idea of the stock dividend. That would get rid of it quickly, and it would make everybody a fan of General Motors who happened to own a few shares of GM stock, and maybe they would go buy a GM car.

Secretary GEITHNER. Senator, just again as a test of our basic theory and approach, if you look at what we have done in the major banks, we have been very successful in making sure private capital came in to take us out, leaving them in a better position than if the Government was in there. And the return to the American taxpayer, in terms of dividends, warrants, on those investments was very high. It does not do anything close to capturing the full cost of the crisis to the economy as a whole, but it shows a basic principle that has guided our approach, and we are going to bring that to everything we have done.

Senator ALEXANDER. My last question is as much an observation as a question. Senator Gregg has suggested that the President might consider encouraging another vote on the Conrad-Gregg commission. I hope you will take that seriously. The fact of the matter is that the President's support came over the weekend before the vote. I understand it was difficult because there are 23 Democratic Senators who were opposed to it, some of them very senior, and many senior Members of the House. It is a big decision to make. And it was sort of a general endorsement.

A President of the United States who is a Democrat, who has 59 or 60 votes in the Senate, who has 17 or 18 Republican votes for something that is important to him, ought to be able to pass it. And perhaps a way to do that is to say we did pretty well there, a Democratic Senator is leaving and a new Republican Senator is replacing him; you are gaining one vote in support there. The Democrat voted no, the Republican said he will vote yes, so you are up to 18 Republicans who have said yes, they will vote for it.

So it might be that with an amendment or two and some consultation that it would pass, and my own judgment is, looking at what happened to President Bush's tax reform commission, for example—which was a pretty good report by some pretty good people, but it just never went anywhere. It just went up on the shelf like a lot of commission reports. I think we are much more likely to get down the road toward deficit reduction with a statutory commission modeled along the lines of the Conrad-Gregg commission than we are with any Presidential commission, no matter how well intended.

Secretary GEITHNER. I agree with much of what you have said, Senator, and, again, we are trying to take the best of Conrad-Gregg, Gregg-Conrad, and the Reagan-Greenspan Commission, which, I think is the only really successful example we have. And in its structure, it is fundamentally different from all the other commissions in between, and I think because of that we think it has a pretty good chance.

Now, before the President made that statement that Saturday, he and the Vice President had been working very hard to try to build consensus on an approach. And, again, I would take some encouragement from the fact that you see people on both sides of the aisle now say again that deficits matter, that our deficits are unsustainable, that our recovery today and our long-term economic health depends on dealing with these kinds of things, and the world is watching us and they want to know whether we are going to have the capacity to build consensus on these things.

Chairman CONRAD. Senator Sanders is recognized for 9 minutes, and with a little slop over on the last one, so we will allow that here as well. Senator Sanders.

Senator SANDERS. Thanks very much, Mr. Chairman, and, Mr. Secretary, thanks for being here.

Mr. Secretary, the name of this Committee is called the Budget Committee, and obviously every member of this Committee is concerned about record-breaking deficits and a $12 trillion national debt. I have to say—and I say this to my friend Senator Gregg, as I suggested through the Chairman last week—that I get a little—I understand that we have got to look forward and not backward. That is clear. We are all in agreement on that. But I do get a little bit tired of being lectured about how serious the deficit crisis is today by, in many instances, the exact same people who caused the deficit crisis. And I want to make this clear so I do not have to repeat it at every meeting that we are in. I—and many of us—did not vote for the Bush tax breaks which cost $600 billion over a 10-year period without any payment for them. I believe Senator Gregg and many others on the other side did vote for those.

I did not vote for the war in Iraq for a number of reasons, not least of which there was no mechanism to pay for that war. I believe my Republican friend Senator Gregg did vote for that war.

I did not, when I was in the House, vote for the insurance company and drug company prescription drug Medicare bill, which could have been paid for by negotiating pharmaceutical prices with the drug industry. Many of my Republican friends voted for that. Senator Gregg, you voted against it. But you voted to waive the budget rule so that it, in fact, did not have to be paid for.

I did not vote for the Wall Street bailout of $700 billion, and, in fact, I brought forth an amendment which said that if you were right, if the Bush administration was right, let us pay for it. Let us do a surtax on the very wealthiest people in this country so that if it was needed, it could be paid for.

I do not support, as Senator Gregg does, the repeal of the estate tax which would provide $1 trillion in tax breaks to the wealthiest three-tenths of 1 percent over a 10-year period.

So all that I say—and Senator Gregg is a good friend of mine. We are neighbors. He is a serious guy. But please do not lecture us when many of us voted exactly in opposition to running up the huge deficit that we have.

My question is: Do you agree?

[Laughter.]

Secretary GEITHNER. I agree that Senator Gregg is a careful, thoughtful person with a great record on fiscal responsibility. And I agree with you—

Senator SANDERS. Ohhh.

Secretary GEITHNER. And I agree with you——

Senator SANDERS. You agree with Senator Gregg and myself. Now, that is a tough one, right?

Secretary GEITHNER. We are all trying to find common ground. And I agree with you that it is important for people to recognize that we are living today with the choices made over a long period of time to not pay for new things that are very expensive.

Senator SANDERS. Well, that is true, but I think you are being too gentle in saying there were people who voted to run up a huge national debt and some people of us did not.

The past is the past. I acknowledge that. We have got to look to the future. But it is not fair to say all of us did this. Some of us did not. All right. Now let me get to areas where you do not agree with me.

I applaud the President for keeping in his budget a proposal to let all of the Bush tax breaks for the wealthiest 2 percent expire at the end of this year. My question is: Why didn't the President propose repealing these tax breaks for the wealthy right now, which I understand would have brought in another $100 billion in that 1-year period?

We have, as you know, Mr. Secretary, the most unequal distribution of income and wealth. I think Senator Whitehouse made some very appropriate references to the outrage that the American people are feeling as the middle class collapses and the people on top get, you know, tens of millions of dollars in bonuses.

What is the problem with beginning to address that problem now?

Secretary GEITHNER. Well, Senator, I just want to say—and I completely agree with you, our tax system today is not fair and the burdens are not shared equally.

Senator SANDERS. So why aren't we moving aggressively to address the——

Secretary GEITHNER. Well, they are scheduled to expire at the end of this year, and we think that is the right time for them to expire.

Senator SANDERS. Why?

Secretary GEITHNER. But it is not——

Senator SANDERS. Why? I mean, in other words, you are right. They are schedule, but you could have——

Secretary GEITHNER. I do not think it was necessary to pull them forward, and as you know, we are trying to balance the basic imperative of trying to make sure that we are all focused on doing everything we can to fix what was damaged in this recession. We are going to keep our priority on that, but we think the country can afford to let those tax cuts expire, and we think it is time to do some modest things to make the system more fair, and that is part of it.

Senator SANDERS. Well, I do not know that I agree with you. I do not——

Secretary GEITHNER. I did not expect you would on this, but I think that is the best way to state the rationale.

Senator SANDERS. OK. I think underlying, everybody here knows that there is a tremendous amount of anger out there, and it is manifested in many ways. I think the Wall Street bailout and the bonuses given to the people who helped cause the worst recession in the modern history of America is certainly an integral part of that appropriate outrage. And I think that the faster the Obama administration says that we are going to address the reality—all right? You say we cannot move faster. We have 19 percent of our children living in poverty. That is the highest rate of childhood poverty in the industrialized world. Right? That is an international disgrace. And yet we have a totally inadequate child care system, totally inadequate education system, as the President understands.

So I do not think it is a good enough response to say, well, you know, we are moving along a timeline. People are increasingly frustrated about income and wealth inequality in America. You are doing some steps that are right. But I would hope that you would be more aggressive on that.

Now, let me ask you a next question. We bailed out our friends on Wall Street whose dishonesty and greed has resulted in some 17 percent of our people being unemployed or underemployed, a total economic disaster. One of the outrages, when we talk about why people are angry, one of the reasons is we bail out these banks—Citigroup, Bank of America, et cetera—and then they charge people 25, 30 percent interest rates on their credit cards.

Will the administration come forward and say that is usury, that is immoral, that is wrong, we should do with the private banking system what credit unions do, have a cap of 15 percent, except under exceptional circumstances go to 18 percent? Can the administration come forward and say, thanks, no more than 15-plus–3 on your interest rates on credit cards?

Secretary GEITHNER. Senator, I support what Congress took last year in putting in place sweeping reforms of consumer credit practices to try to end the abuse and predation that we saw across the system. That was a tragic failure of Government. I am very supportive of those changes. We would be happy to work with the Congress on additional reforms like we are doing in financial reform.

I personally do not support the imposition of a cap on interest rates because I do not think it is the best way to try to make sure we are preventing abuse and predation. But I understand why you support that. I respect your views on it.

Senator SANDERS. Well, it is not hard to understand. Talk to anybody, talk to any of the hundreds of people who have called my office, and you will understand it. Tell me why we should not address a situation where a working person—do you agree that 25- or 30-percent interest rates is usury?

Secretary GEITHNER. What I believe very strongly—and I think this is a deep failure of Government—is that we allowed a level of abuse and predation to happen across the system with appalling, terrible consequences. And I think it is very good that Congress moved last year, even in the depths of the crisis, to start to address that. But that is why we are working so hard to try to make sure that we are putting in place a broader set of reforms——

Senator SANDERS. You are not answering—well, I guess you are answering. You do not agree. I mean, you could do all the kind of talking you want, but people will still be paying 25 or 30 percent——

Secretary GEITHNER. We have to act. We cannot talk about it. I agree with that.

Senator SANDERS. But you do not agree with me. You do not support a cap on interest rates.

Last question. We are running out of time. There is widespread support for more transparency at the Fed. Above and beyond the TARP, we lent out trillions of dollars at zero-interest loans. Secretary of the Fed Bernanke refuses to tell us who received those loans. Do you believe that the American people have a right to know who received trillions of dollars, which financial institutions received trillions of dollars of zero-interest loans?

Secretary GEITHNER. I personally am very supportive and will work to help support broader improvements in transparency by the Federal Reserve System. But I think it is very important we not take steps that would undermine—and you are not proposing this, I do not believe—the independence of the Fed or put us in a position where the Fed's ability to do what was absolutely essential in this crisis——

Senator SANDERS. Do you support letting the American people know who received trillions of dollars of zero-interest loans?

Secretary GEITHNER. Well, again, as I said, there is a very good, constructive set of reform proposals now working its way through the Senate that would bring substantially greater transparency, and I will support those. But the two qualifications I would put on that, just to be direct—and I am disagreeing with you respectfully—is not to threaten the independence of it and not to limit the Fed's capacity to do the essential thing in future crises.

Senator SANDERS. All right. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Cardin, for 9 minutes and some.

Senator CARDIN. I thought it keeps on accumulating, so I thought I would get more. That is why I came in a little late. Secretary Geithner, I was here during your testimony, and let me thank you for your service to our country and thank you for your presence today and your testimony.

Your opening statement is very clear about the need to create more jobs in America, and everything seems to be centered around how we can get job creation in America and get our economy back on track.

You also talked about international trade. The President talked about international trade in the State of the Union address. He wants to double our exports, and I think each one of us would agree with that. I appreciate the comments you made in response to one of my colleague's questions about strengthening international understandings, particularly on a multinational basis. And I strongly support that as it relates to labor and environment, but I would also add as it relates to dumping and other enforcement issues that we should be equally aggressive about.

Let me raise what I think is the largest single issue. China is the largest growing market. Currency manipulation is well known.

If we are going to have a level playing field, why won't the administration be more aggressive on the currency issue so that we truly have economics dealing with the market penetrations, allowing us greater access to the Chinese market?

Secretary GEITHNER. It is a very important issue, and I agree with you about the importance of China moving. And I think it is actually quite likely China will move. I think they recognize this is important to them in their interest as well, and it is an important part of what we are trying to do generally, trying to make sure that the world is growing, not on the basis of an investment-led, export-heavy model again, but growing with stronger consumption, stronger domestic demand, and that requires a level playing field for American exporters generally. We are going to work very hard to encourage those changes. And I share your view about the importance of seeing more progress across the board in this area.

Senator CARDIN. I would make one final observation. You are an economist in that you understand——

Secretary GEITHNER. I wish—I do not think I wish I was, but I am not an economist.

Senator CARDIN. You have a strong background in economics and finance.

Secretary GEITHNER. Fortunately, I am not an economist.

Senator CARDIN. You certainly support allowing currency to reach its true level. I cannot believe that you would feel otherwise. So the only issue is transition. How do we get there? It seems to me that we have just been dragging our feet on this and have not made it the priority it should.

I am certainly sympathetic to allow transition time so there is no major disruption of markets. But if we are not more aggressive on this and we solely depend upon the Chinese to decide when they are going to allow their market to fluctuate, we do a disservice to U.S. manufacturers and producers, and it is going to be extremely difficult to double our exports, as the President wants.

I want to address a second point here, which is health care, which has come up several times during this hearing. Businesses in my community have a tough dilemma. Small business owners are really deciding whether to hire another employee or pay their insurance premiums. Consumers thinking about buying an automobile have to look at the medical bills they have on the counter that have to be paid. And I can tell you about people who are locked in their jobs because they cannot get insurance anyplace else, and they could well have more productive employment, but they cannot change jobs because of our health care system. I could also talk about the burden of health care costs on businesses in America trying to compete internationally, or about how health care expenditures are affecting our budget deficits in large measure.

We need to be clear with the American people about what will happen if we do not get health care costs under control. We have an opportunity in this Congress to get it done. But we cannot continue this current trend—in my State, we are expecting in the next 8 years the cost of a family's health care plan to double from $12,000 to $24,000 a year. That is going to be a huge drain on our economy in creating jobs.

We could all do a better job of articulating the importance of health care reform in getting our economy moving.

Secretary GEITHNER. I could not agree with you more. I thought you said it perfectly. The current system is enormously unfair and puts huge, vivid costs, conspicuous costs, and hidden costs on small businesses, not just on people that do not have health care, but on the businesses we depend on to grow as an economy as a whole. You said it exactly right, and if people said it the way you did, then you might see broader support for this.

But it is good long-term fiscal policy, it is good policy for the American economy and American business, and it is fair and just for people who are denied coverage, do not have access to health care now, and this is something that should be very important.

Again, if you just go back a few months ago, you would see health care costs by businesses cited as their principal concern about their ability to grow and compete.

Senator CARDIN. I want to get to the deficit, because everybody here has talked about the deficit. The deficit is way too large. We have got to get it under control. And Senator Sanders made a strong point about opposing the policies that led us into this deficit. I can cite my opposition to many of the policies that led to these deficits, including the unfunded tax cuts.

But the point is that entitlement reform starts with health care. It is very tough to say we are going to reform Medicare and Medicaid without dealing with the underlying cost of health care. All you are doing is cost shifting in that case. Maybe seniors will pay more for their health care. They are already paying too much. But if we are going to get entitlement reform that is going to help the Federal Government with health care, I do not know how you it can be done without getting health care costs under control.

Secretary GEITHNER. You are exactly right. If you care about fiscal responsibility, if you are worried about our long-term deficits, as everybody has to be, there is no path to address that does not go through health care reform that reduces the rate of growth in costs. That is very hard to do, but there are some very sensible, powerful approaches that have moved through this body that would make a huge contribution to that goal, and you said it exactly right.

Senator CARDIN. I want to talk about small business. You talked about small business. I very much appreciate that. You talked about community banks, and I strongly support what you are doing in trying to help our community banks.

I would make one observation. If you look at the banks that received the funds from the bailout, and you look at the amount of moneys that they have received in assistance and the amount of loans they made to small business in 2008, is less than 1 percent. The total number I have is $238 billion in bailouts, and the number I have for small business loans is $1.26 billion in small business loans in 2008. I know they got the money in 2009, but I am just trying to say they do not have a good history of loaning moneys to small businesses.

Secretary GEITHNER. Actually, they got the money in 2008. We took it back and replaced it with private capital in 2009.

Senator CARDIN. They do not have a good record. We are all going to keep the pressure on the larger banks to make small business loans, but it is going to be a struggle.

Secretary GEITHNER. Right. You are exactly right. Again, about half of small business lending comes from small community banks. The other half comes from larger institutions, and we are working very hard to make sure that we are improving those credit channels that are opening up again. And I believe we are making some progress.

Again, the most important thing for a business is: Is there going to be demand for my products? What all small businesses cite today, their first concern is: Are we going to be growing? Are we going to face growing demand for our products? But credit is part of that, and that is why we should work on this front, and I agree with what you said.

Senator CARDIN. You are focused on it now, and we thank you. It is going to require a continued focus.

Secretary GEITHNER. I completely agree.

Senator CARDIN. It is not going to be solved in the next couple months.

Secretary GEITHNER. I agree. The costs of these things go on for years, and you cannot stop early.

Senator CARDIN. And the last thing I would say—and you pointed this out—helping community banks makes sense. I believe we have got to strengthen the SBA even more. I agree with the reforms that you are asking of SBA. I would give them more resources in addition to this.

But if you do not deal with the regulators and the pressure that the regulators put on the community banks, on the loans that they are making, even though these loans are guaranteed by the Government, it is going to put a lot of pressure on them not to make the loans to the small businesses. So it has to be done in conjunction with an overall strategy that will release money to allow small businesses, which are the economic engine of America, to be able to create the jobs we need.

Secretary GEITHNER. I agree with you. It requires capital, SBA, clarity in the rules of the game, and reform, and we want to make sure there is a balanced approach taken by supervisors across the country so that they are not getting in the way of banks meeting demand of viable businesses to expand.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Cardin. And you actually came in under the overage. So you get a special commendation.

[Laughter.]

Senator CARDIN. I will take it another time.

Chairman CONRAD. Let me go back to the question of credit, if I could, and Senator Gregg has got a few more questions as well.

You know, if we look at what happened to the TED spread, the difference between the Fed can borrow for and what the London Interbank Overnight Rate is, during the height of the crisis that was 9 times normal. That has come back to normal. That is a remarkable change, critically important.

I cited earlier the turnaround in economic growth from a negative 6 percent the first quarter of this year to positive 5.7 percent the last quarter. That is a remarkable turnaround.

The job losses from 700,000 a month at the beginning of last year to 60,000 a month in the last month.

So those who assert none of this is working are to me detached from reality. Clearly, this is moving in the right direction. But we have got two issues.

One is the credit front because small business continues to report to us, and you heard it all around the table here today. I had a case brought to my attention. The guy had a $10 million line of credit. He never missed a payment, never late in a payment, and he has his credit line pulled. He goes to his lender and he says, you know, "Hey, I am making all my payments, always have, will continue, continue to be profitable." And the bank says to him, his primary lender, "This had nothing to do with you. It is a circumstance in which our balance sheet has been impaired by other bad loans, and we have to"—"we have made the judgment, you and others are having their credit lines pulled because we have got to rebuild our balance sheet."

That continues out there, and I think you have heard it loud and clear here today, and obviously you have a plan to respond.

You know, the question in my mind is: With the $30 billion from TARP to help small business, if those small lenders, for whatever reason, are not willing to take that money, what is the back-up plan? What is the alternative? Is there a way—I had a bank in my State that took money and then had ads run against it by their competitors that they had taken these funds.

So if that is an overhang in the market, how do we make certain that this is effective in terms of getting credit out?

Secretary GEITHNER. I think you said it exactly right. I think we have just got to keep working on it, and we need to help make sure that people up here understand that this is good policy, it is good for business, it is fair. And if you scare them to death, they are not going to come. Banks will not come. Strong banks will not come. So it will take work. It just takes some work, but I do not think this is beyond our capacity to solve.

Again, I was in Minneapolis last week, and there was a small bank there that could stand up and say, as many, many banks can say, "I got some capital from the Government. I substantially expanded lending because of that. It was very helpful, very effective." And they can point to their business customers that have loans today, can expand today because of that. We cannot solve these problems if we stigmatize or scare the people we have got to work with to make credit more available.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman.

I suppose I should respond to Senator Sanders, even though he is not here, and I appreciate that the Chairman does not want exchanges, so I did not participate in that. But, you know, in court proceedings, there is something called judicial notice, you know, such as that water runs down hill. I think we can take judicial notice of the fact that a socialist Senator from Vermont and a conservative Senator from New Hampshire are not going to agree, and I am going to accept that.

This issue of recruitment, as you know, under the TARP language this tax on banks, which you are proposing to recoup the cost of the underlying event, was not supposed to occur until 5 years. Now, we picked that date because we had presumed we would have a better sense of exactly what we needed to recoup.

It appears from your numbers that you have testified to here that for the most part you are going to get the bank lending—to the extent you capitalize banks, you are going to get that money back with interest. And you have gotten from the big banks almost all of it back with interest. From your middle-sized banks, you have still got some out there, and you are talking about putting a little more out.

The real place where we have not recouped yet is the automobile companies. Now, I saw where GM said they may pay back at least some portion, maybe their preferred but not their equity positions. So isn't this premature to initiate this recoupment exercise in a context—in fact, AIG is another example. You said it is going to be 30. CBO says it is going to be 9. Chairman Bernanke said it was going to be zero.

Secretary GEITHNER. I agree with what you said, and we do not really know fully the ultimate cost of this thing. It is unclear. And the costs will come overwhelmingly from the combination of what we had to do in AIG, what the previous administration initiated in autos, and what we are doing in the housing side. And you are right. We will not ultimately know the full costs for some years to come.

But there is a basic——

Senator GREGG. Doesn't the law also say the recoupment exercise is supposed to start 5——

Secretary GEITHNER. No, it said I did not have an obligation to propose how to recoup until, I believe, 3 years out. But you may be right about the law thing. Let me just say why I think this is fair and important. A basic principle we are trying to underscore in financial reform is to say that we are going to create a system in the future where taxpayers are not exposed to the risk of loss if the Government has to act to put out a financial fire, and we want to make sure that the industry that benefits from those actions is bearing the costs of solving the crisis.

We have proposed that in financial reform. We want to make sure that you are going to have a system that can put these large institutions through something like bankruptcy, and to make sure as that happens taxpayers are not exposed to any risk of loss.

So we thought it was very important consistent with that principle, building on the model the FDIC uses now, to try to make sure that the large institutions that benefited the most are bearing the costs of the crisis and that we do so in a way that can help address this broad "too big to fail" problem by putting a fee on leverage and on risk. And we think we can begin that process now without putting at risk the broad progress we have achieved in trying to stabilize the system and bring down borrowing costs.

Senator GREGG. Yes, but first off, the law is pretty specific, and I understand you are not familiar with it, but it is Section 134. It says the recoupment exercise, the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfalls in order to ensure that the relief program does not add to the deficit or to national debt. That is supposed to be submitted 5 years from now.

Secretary GEITHNER. Right. I apologize about the 5-year thing, but I think it is important to remind people of that obligation. We are trying to meet that obligation. We are doing this a little sooner than we needed to.

Senator GREGG. Yes, but there may not 5 years from now be anything to recoup. In fact, we may actually have a positive cash-flow. So that is why we put it out 5 years.

Secretary GEITHNER. That would be great, but——

Senator GREGG. So are we going to return this tax if we have a positive cash-flow?

Secretary GEITHNER. Again, we think that there is still significant risk of loss, and we need people to understand that taxpayers are not going to bear a penny of that.

Senator GREGG. Well, I appreciate that, but right now the people that you are asking to pay for it have for the most part paid their money back with interest. If you really are assessing this against significant potential for loss, it should be assessed against the auto industry, right?

Secretary GEITHNER. Well, I do not think there is a fair way to do this. It is important for people to recognize—and I know you do—that the large institutions got enormous benefits from this not captured by the return to the taxpayer in dividends and warrants. And the costs of this crisis go well beyond the financial accounting costs that you see reflected in CBO estimates of losses. And so there is just a basic principle of fairness and fiscal responsibility to underpin what you helped write into law to say taxpayers should not be exposed to loss. We proposed what we think is a fair way to do that.

Senator GREGG. Well, are you setting a precedent now that every time we have a recession of significant proportions that basically there will be a special tax assessed against entities which may have had a major part in playing the—in creating the recession after those entities have already repaid the debts that were used to stabilize the system with interest?

Secretary GEITHNER. I think we are creating a different precedent. Again, this is modeled on what has existed for a long time for banks across the country under the FDIC——

Senator GREGG. Yes, but they have an insurance fund. This is not going into some sort of insurance——

Secretary GEITHNER. No, but even beyond that, the way that law works is if the FDIC has to take action to protect the stability of the system—or it has to recoup those costs in the form of a fee on institutions, so the precedent we are establishing I think is a good precedent, and it is a good precedent for incentives and behavior to make sure that people understand that the big institutions that benefit the most will bear the costs of future crises in some ways proportional to their benefits and their size.

Senator GREGG. Well if that is true, then the automobile companies should be included in your tax.

Secretary GEITHNER. I understand that perspective and we are going to work very hard to make sure that we recoup as much of that loss as possible from what we had to do in the auto industry, again building on the actions that President Bush took in that context.

There are different ways to cut this. You know, you could have done it much, much more broadly. You could have done it narrowly. And we would like to work with the Congress on the best design. We have made what I think is a very acceptable proposal but we know there is going to be different views on that.

Senator GREGG. Thank you. I see Senator Sessions just arrived.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Did I disappoint you?

Chairman CONRAD. Yes.

[Laughter.]

Chairman CONRAD. You ask an honest question. But that is fine. We are always glad to have——

Senator SESSIONS. I was in the Judiciary Committee.

I am sorry, Mr. Secretary, I could not be here. We just have a lot of big issues. I would just ask a few things.

We are on track, according to CBO, and I do not think you would argue with it, to triple the public debt in 10 years. And their score is to show that interest on the debt would go from $187billion in 1 year—I think last year—to $800 billion year in 1 year in 2019. I believe you have been quoted, so many have, as saying that is an unsustainable path. Would you maintain that? Is that your view?

Secretary GEITHNER. I agree completely. I just would make one point of fact, which is that in January 2009, CBO also projected on reasonable assumptions about policy that we were on a path to double and triple the national debt.

Now we are not consigned to that future. It is our responsibility to prevent that from happening. And that requires us to work together to try to make sure we are doing things that will bring those down. And that is within our capacity to present.

But the largest part of that projected increase was baked into our fiscal future because of the choices made over the previous 10 years, 8 years, because of the damage of the recession.

Senator SESSIONS. Well, at some point you cannot just borrow your way out of a recession. If it is such a great idea, why didn't we borrow three times as much?

But let me ask you, a man told me at a town hall meeting in Evergreen, as my daddy says, you cannot borrow your way out of debt.

Secretary GEITHNER. I think that is well said and I agree with that.

Senator SESSIONS. Now the President's budget projects that the debt held by the public is growing, as I understand it. And would you explain to us what it is that the Europeans have on their rule that debt should not exceed 60 percent of GDP? And how do they enforce that? And what is their view about that?

Secretary GEITHNER. You are right about that, and it is a little uncertain how good their enforcement mechanisms are because I think we'd recognize like they do, they'd recognize like we do, which is ultimately it is about political will and we need to find that will together to try to figure out how we prevent that.

But I am glad you cited that because we have said very clearly in this budget, and we said in the last budget, that our economic strength as a country depends on showing a path to get those deficits down to the level where our debt burden is no longer growing and it stabilizes at an effective level.

Now we have proposed policies that take us a long way to that goal, not far enough in part because we inherited a very large structural deficit. But you are right to underscore the fact that the basic test of policy and obligation of government is to make sure we are showing a path that the deficits are low enough so that our debt burden is no longer growing and stabilizes at an acceptable level.

Again, this is something we can do. We have enormous benefit strengths they do not have.

Senator SESSIONS. I just had—I do not want to keep our colleagues a lot longer. But the fact is your budget does not do anything about it. This is the course your budget has put us on. And it seems to me, according to our calculations—well, I guess CBO's numbers—that the debt held by the public will exceed 60 percent of GDP this year and begin approaching 90 percent of GDP by 2020. That is 10 years from now.

Secretary GEITHNER. I think we can avoid that and I think we need to work to avoid that outcome. And I think that is within our capacity to do.

Senator SESSIONS. Well, my view is that we all have spent too much. But I do believe the President has got to seriously talk about it. He made reference to it in the State of the Union. But to me it should have been a core part of his entire address, to alert the American people that changes are going to have to occur and they are not going to be pleasant for everybody who is used to getting so much money.

I have to be critical of it. I think it was not sufficiently realistic—and I think if they are told that we are here, we have got to change this trajectory, and it is going to require us to do these things, and if we do them we can leave our country a healthy place for our children and grandchildren, there would be political support for it. I have not seen that talk yet.

Secretary GEITHNER. I think that is well said and I agree with that, and I know the President does, too. But it is important to recognize also that to get there we need an economy that is growing. We need a sustainable recovery. We need to make sure Americans are more confident they are going to have a job and earnings are going to grow in the future.

That is critical to everything we need to do to restore the damage caused to our long-term fiscal health. So I would just say, as you recognized, and you said it very well, about the importance of dealing with those long-term fiscal perils, there is no path to that without starting with making sure this economy is growing again and we have repaired the damage——

SenatorSESSIONS. I just would challenge one thing. There seems to be an assumption here, and the President has said it—perhaps you have—that we know we have got a debt problem. We will worry about that next year. Right now we have got a recession.

I was with a German official recently and they have not gone into this much debt and they are worried about other European nations such as the Brits, even, as I have heard them explain.

Secretary GEITHNER. Actually, the Germans are actually doing a lot of very substantial government support for their economy now. So in many ways, they are doing what you would expect. Now they are going to do it differently.

But I think you are exactly right. You are not going to make recovery sustainable, people confident in recovery, unless they are confident we are going to be able to move to bring them down. But you cannot solve the wreckage problem and the growth problem today by trying to focus right now on those long-term things.

Again, we have proposed bringing down that deficit from over 10 percent of GDP to below 4 percent of GDP in a relatively short period of time. And the measures we have proposed just for next year would reduce it by 2 percentage points of GDP. And we have been very honest in our budget to say that we get it below four, but that is not far enough.

So I agree with much of what you said. I would just underscore again——

Senator SESSIONS. Well, the Europeans believe it ought to be below three, don't they?

Secretary GEITHNER. Oh no, we say in the budget also for an economy—we have different economies.

Senator SESSIONS. I mean, that is their rule.

Secretary GEITHNER. Yes, for an economy like ours, we are very similar—we are saying to be sustainable over time, the deficits need to be in the range of three. We get them, again, below four.

Senator SESSIONS. It is not very comforting in 10 years when we are—well, we could talk about this more, but I will not belabor it.

Mr. Chairman, thank you and I look forward to working with you as we strive to figure a way to do better.

Chairman CONRAD. I thank the Senator. I thank him for his courtesy, as well.

And I want to thank the Secretary for being here and, once again, at our invitation appearing before the Committee. I think you could hear around the table concerns about—especially concerns about the long term, concerns that I shared again this morning, as did the ranking member, as did members around this table. And certainly about the credit issues, which again when I think the history of this period is written, you will fare very well for what you have done in this first year, responding to a crisis that threatened a global financial collapse.

I will never forget, as long as I live, being with the former Secretary and we were in a conference room over in the Capitol, being asked to come up with a recovery plan. And this was all night, I think it was all night on a Friday night, perhaps it was all night Saturday. I know I was here virtually all night both of those nights.

And I will never forget, as long as I live, the stream of information that was coming in to us through the Secretary, your predecessor, with respect to what was happening to financial institutions around the world, major institutions on the brink of failure in Germany and the German government moving to rescue them. Major institutions in Ireland, in England, in other European countries on the brink and their governments rushing to rescue them with an understanding that we all had to act. And we had to act together to prevent a collapse which could have taken us down a road far more severe than anything we have ever seen before, matching the Great Depression of the 1930's.

I believe we were perilously close to that. I believe the turnaround is really quite remarkable. That the credit spreads have now gone back to normal, that is amazing in 1 year. That we have gone from a negative 6 percent growth to a positive 5.7 percent in 1 year. The job losses have gone from 700,000 a month to 60,000 a month. That is a remarkable improvement.

But it is also true, we have got more to do. In the short term, we have got to strengthen this recovery. In the longer term, we have got to pivot and we have got to deal with this debt threat.

And I am very hopeful that this commission approach will work. After all, Senator Gregg and I worked 2 years to try to convince our colleagues. We are delighted 53 of them, a majority, voted with us on that matter. But 53 is not 60, and it requires 60.

So now perhaps we will have another vote on that. But the President has indicated if a statutory commission is not put in place, he is prepared to put in place a commission by his executive order. And you have indicated that he will consult and you will consult with Republican leaders on how that is formulated.

I appreciate that. I think it is critically important because if the Republicans are unwilling to participate, then we have got to find another way.

And I must say, I was disappointed that seven of our colleagues on that side of the aisle, who were original cosponsors of the Conrad-Gregg proposal, when the roll was called, voted against the proposal that they themselves cosponsored. You know, let us be frank about everybody's responsibility here. Let us be frank about everybody's responsibility here.

And the responsibility to get out of this ditch is not the administration's alone. It is on both sides of this aisle. It is on both sides of this aisle.

Again, I thank the Secretary for his leadership, for dealing with the extraordinary pressures that are on him and on this staff and on this administration and on this Congress and on this country. And we have got to work together to dig out.

Senator Gregg and I, I think, have demonstrated that we are prepared to do that. Mr. Secretary, I think you have demonstrated that you are, as well.

We thank you. The hearing will stand in adjournment.

Secretary GEITHNER. Thank you, Mr. Chairman.

[Whereupon, at 12:09 p.m., the committee was adjourned.]

QUESTIONS FOR THE RECORD

United States Senate

Senate Budget Committee

Hearing on the President's 2011 Budget

Questions for the Record

Treasury Secretary Timothy F. Geithner

February 4, 2010

Questions from Senator Gregg

Bank Tax

The President's budget observes that, "Bank lending continues to contract overall, although the pace of contraction has moderated and some categories of lending are growing again." At the same time, the President has proposed a new, $90 billion tax on certain financial institutions.

1. **Is it the view of the Administration that the financial institutions targeted by this tax are providing satisfactory access to capital, and otherwise facilitating access to credit, such that they can sustain a new tax without an adverse effect on credit markets?**

   The Financial Crisis Responsibility Fee (FCRF) is specifically designed to limit any potential negative effects on lending. First, the FCRF targets institutions that rely on less-stable funding to support riskier forms of lending, so that a bank that funds new loans exclusively with additional stable funding sources like insured deposits and capital would pay no additional fee. Second, the FCRF excludes over 99% of US banks—every institution with less than $50 billion in assets. The excluded smaller banks would be poised to take market share from their larger competitors should firms that pay the FCRF choose to cut back or pass on costs. As the Congressional Budget Office (CBO) noted in their analysis of the FCRF: "Imposing a fee on the largest banks would improve the competitive position of small- and medium-size banks, probably leading to some increase in their share of the loan market."

2. **The President signed into law the Fraud Enforcement and Recovery Act of 2009, which among other things created the Financial Crisis Inquiry Commission. Among its tasks are to "examine the causes of the current financial and economic crisis in the United States." Yet the Administration's proposed tax on financial institutions is asserted to be a "Financial Crisis Responsibility Fee." This new tax is therefore levied on those parties deemed to be responsible for the crisis, and irrespective of their TARP participation, before the FCIC has even rendered an opinion on what caused the crisis to begin with. How do you reconcile that apparent contradiction?**

   The Financial Crisis Responsibility Fee (FCRF) embodies the basic principle that financial institutions, which benefited the most from extraordinary government intervention, not taxpayers, should pay for the costs of financial crises—a principle the President has made clear he supports since day one.

In that light, the FCFR fulfills the President's specific obligations under the Emergency Economic Stabilization Act (EESA) to "submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt."

While the FCIC has yet to complete its final report, there should be little questioning that the largest financial firms targeted by the fee were at the center of the financial crisis and among the biggest beneficiaries of the response—both directly and indirectly.

As such, each of the firms covered by the FCRF would have been eligible for extraordinary assistance during the financial crisis, including the Treasury's capital investments under the TARP, as well as the FDIC's Temporary Liquidity Guarantee Program, the Federal Reserve's Primary Dealer Credit Facility and other Federal Reserve liquidity facilities.

Fannie Mae and Freddie Mac

Press reports prior to the budget's release indicated that the President's Budget would include the Administration's plan for the future of Fannie Mae and Freddie Mac. It appears that the budget does not contain a plan either for Fannie or Freddie to emerge from conservatorship or for those entities to be treated as governmental agencies in the budget. Instead, the budget merely indicates that the Administration is studying the problem, and will "provide updates on considerations for longer term reform of Fannie Mae and Freddie Mac as appropriate." (p. 352, Analytical Perspectives)

1. **When will the Congress receive the Administration's plan for Fannie and Freddie to emerge from conservatorship?**

   As required by the Wall Street Reform and Consumer Protection Act, the Administration plans to submit a proposal for reform of the housing finance system and the GSEs by January 31, 2011.

2. **How will Treasury's December 24, 2009, decision to extend its authority to purchase preferred stock from these two entities through 2012 affect the Administration's plan?**

   The overall goal of the initial Preferred Stock Purchase Agreements (PSPAs) with Fannie Mae and Freddie Mac and the subsequent amendments was to preserve overall stability in financial markets and allow Fannie Mae and Freddie Mac to continue to serve their mission in the secondary mortgage market. By providing added confidence to the holders of debt and mortgage-backed securities issued by Fannie Mae and Freddie Mac, this has enabled the US mortgage market to continue to function. This decision has not altered the careful consideration of alternatives and possible options for reform of the GSEs. As mentioned above, we are committed to submitting a proposal for reform of the housing finance system and the GSEs by January 31, 2011.

3. **Is there now less incentive to truly privatize these firms since the U.S. Government has pledged to make bondholders whole for the next three years?**

   As mentioned above, we strongly agree on the need for reform of the housing finance system and look forward to working with the Congress to enact meaningful reform in a cost effective manner and with due care not to disrupt recovery of the housing markets.. The GSEs, operating in conservatorship, are contributing to stability in housing finance as we carefully consider the significant and necessary structural changes to the mortgage finance system that will help to create a stable and sustainable system over the long-term.

4. **Since the Administration has no plan for Fannie and Freddie to emerge from conservatorship, why hasn't OMB added these entities to the budget as if their operations were conducted by a federal agency?**

   As mentioned above, we are committed to enacting meaningful reform in the housing finance system as soon as practical. The Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac, as it does for the other GSEs. However, this presentation will be continuously reviewed and may be changed in a future Budget if it is determined to be appropriate. Moreover, all of the federal programs that provide direct support to Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are shown on-budget.

   The Administration has carefully considered whether Fannie Mae and Freddie Mac should be consolidated in the Government's financial statements and classified as budgetary entities. Budgetary classification of an entity depends on whether the Government owns and controls the entity in question.

   The GSEs are operating under conservatorship of the FHFA, an independent regulator. The FHFA is actively engaged in its role as conservator of the GSEs, serving as the entities primary prudential regulator and filling an important oversight role. When acting as conservator the FHFA has the powers of the management, boards, and shareholders of the GSEs. However, at inception of the conservatorship, the FHFA made clear the GSEs would continue to be responsible for normal business activities and day-to-day operations.

The relevant Federal financial accounting standards do not require consolidation where the Government's ownership and/or control are temporary. For this reason, the Administration has determined that Fannie Mae and Freddie Mac should not be consolidated and the Government's auditor, the Government Accountability Office has agreed with the Administration's determination.

5. **Would the different budgetary treatment for Fannie and Freddie cause CBO and OMB to provide different scores for legislation that would affect those entities?**

We are committed to the notion that the housing finance system cannot continue to operate as it has in the past. As part of the reform process, the Administration intends to develop a comprehensive proposal for the GSEs and their role in the broader housing finance system through public consultation with a wide variety of constituents, market participants, academic experts, and consumer and community organizations. After reform, the GSEs will not exist in the same form as they did in the past and the future budgetary treatment for Fannie Mae and Freddie Mac will follow from those recommendations.

CBO's current on-budget and the Administration's current non-budgetary treatments of Fannie Mae and Freddie Mac in conservatorship potentially could result in legislative scoring differences. Given that many different options are being considered for GSE reform, defining a specific budgetary treatment at this time for any particular reform structure would be misleading. As noted above, the Administration carefully considered whether Fannie Mae and Freddie Mac should be consolidated in the Government's financial statements and classified as budgetary entities and may change its determination at a future date. The contours of the final legislation reforming Fannie Mae and Freddie Mac will be a key determinant of any such change.

The Administration will present its reform proposal by January as required under the Dodd-Frank Financial Reform legislation. Public input will be a critical as we work to develop and refine the reform proposal.

6. **How would this difference complicate matters under the statutory PAYGO scheme that the Senate passed last week, and that we expect the House to clear this week?**

The precise form of future reforms of the housing finance system that will be enacted by Congress will drive the determination of what parts (if any) of the housing finance system would continue to be responsible for normal business activities and day-to-day operations.

The relevant Federal financial accounting standards do not require consolidation where the Government's ownership and/or control are temporary. For this reason, the Administration has determined that Fannie Mae and Freddie Mac should not be consolidated and the Government's auditor, the Government Accountability Office has agreed with the Administration's determination.

5. **Would the different budgetary treatment for Fannie and Freddie cause CBO and OMB to provide different scores for legislation that would affect those entities?**

We are committed to the notion that the housing finance system cannot continue to operate as it has in the past. As part of the reform process, the Administration intends to develop a comprehensive proposal for the GSEs and their role in the broader housing finance system through public consultation with a wide variety of constituents, market participants, academic experts, and consumer and community organizations. After reform, the GSEs will not exist in the same form as they did in the past and the future budgetary treatment for Fannie Mae and Freddie Mac will follow from those recommendations.

CBO's current on-budget and the Administration's current non-budgetary treatments of Fannie Mae and Freddie Mac in conservatorship potentially could result in legislative scoring differences. Given that many different options are being considered for GSE reform, defining a specific budgetary treatment at this time for any particular reform structure would be misleading. As noted above, the Administration carefully considered whether Fannie Mae and Freddie Mac should be consolidated in the Government's financial statements and classified as budgetary entities and may change its determination at a future date. The contours of the final legislation reforming Fannie Mae and Freddie Mac will be a key determinant of any such change.

The Administration will present its reform proposal by January as required under the Dodd-Frank Financial Reform legislation. Public input will be a critical as we work to develop and refine the reform proposal.

6. **How would this difference complicate matters under the statutory PAYGO scheme that the Senate passed last week, and that we expect the House to clear this week?**

The precise form of future reforms of the housing finance system that will be enacted by Congress will drive the determination of what parts (if any) of the housing finance system should be included on the federal budget as part of the broader housing finance system. It is recognized that any expenditures of the new system must be appropriately offset by other deficit reduction measures so that there is not an overall increase in projected deficits. These reductions will be considered in conjunction with the reform process. The PAYGO impacts of budgetary versus non-budgetary treatment of Fannie Mae and Freddie Mac in their current form will be limited to the specific provisions of any specific legislative proposal, and we expect both CBO and the Administration will keep in close contact with the Congress on their view of scoring issues as the legislative process proceeds.

The FY 2011 Budget captures the full estimated cost of Treasury's financial assistance through the Preferred Stock Purchase Agreements (PSPAs) with the GSEs, treating estimated payments from Treasury to the GSEs as a cost and an increase in the deficit, and treating PSPA dividends as offsetting collections that reduce the deficit.

Questions from Senator Crapo

1. <u>Revenue levels:</u> **In presenting the President's tax plan for his first year in office, his advisors often stated that the net goal of his tax policies would be to maintain revenue to the government in line with the historic average, around 18.2% of GDP. Is this still the goal of the President, meaning that, to bring the budget toward balance, spending, as a portion of GDP, must be brought down to 18.2% of GDP as well?**

   The goal of the Administration is to bring federal finances back to sustainability. We are looking to stabilize the debt to GDP ratio so that growing federal spending does not claim an ever-rising share of the economy.

   The Administration inherited record deficits, and the President's Budget proposes more deficit reduction than any budget proposed by an administration in over a decade. It does this, in part, by restraining spending. For example, the FY 2011 Budget proposes freezing all non-security spending for three years, which saves $250 billion over the next ten years. In fact, the Budget identifies more than 120 government programs that should be terminated or reduced – generating $20 billion in savings in 2011 alone.

   In addition, the Administration proposed and worked to enact statutory pay-as-you-go (PAYGO) legislation. PAYGO requires that Congress only increase spending on entitlements by a dollar or cut taxes by a dollar if it saves a dollar elsewhere. In the 1990s, statutory PAYGO helped move the Government from large deficits to surpluses.

   But, more remains to be done to bring the Budget back to a sustainable path. That's why the President created the bi-partisan National Commission on Fiscal Responsibility and Reform. The Commission is examining the entirety of the federal budget and is charged with bringing balance to the operating budget – outlays less spending on items other than interest – in FY 2015. For that goal to be achieved, operating spending (defined as spending less interest payments) would need to be brought in line with receipts.

2. <u>Fannie/Freddie:</u> **Why did Treasury wait until Christmas Eve, when the Senate had left town, to make the announcement that it was lifting the $400 billion cap on potential losses for Fannie Mae and Freddie Mac, as well as the limits on what the failed companies can borrow?**

   At the time, Treasury still has the authority to inject almost $300 billion into the two companies. According to the Federal Housing Financing Administration, in 2009 Fannie Mae and Freddie Mac issued 73.5% of all new mortgage backed securities in

the U.S. What is the impact on taxpayers of a mortgage market utterly dependent on a federal guarantee?

What will be the consequences on mortgages and homeowners of this effective nationalization of these two companies that dominate the mortgage market?

The changes to the PSPA were designed to provide assurance to market participants by reinforcing the stability of the GSEs in conservatorship and to enable them to continue providing liquidity to the secondary market. The GSEs continue to play a vital role in supporting the housing market during this current crisis. These commitments are another indication that the Treasury stands firmly behind their ability to provide that support.

Treasury, in consultation with FHFA, evaluated a number of forward-looking projections at the time of the change and the $200 billion commitment was likely to be sufficient under a range of conservative assumptions. Nonetheless, to provide additional confidence to the market and to allow the GSEs to continue performing their role in our current housing finance system, we believe it was prudent to fully protect against extreme downside risks in the housing market.

3. <u>Bank Tax:</u> **The President has stated that the biggest banks can afford a modest fee to pay back the taxpayers who rescued them in their time of need. However, before we can determine what the total cost of the Troubled Asset Relief Program (TARP) is to the taxpayer, we must end the authority for TARP to spend more money. Why didn't Treasury let TARP expire on December 31, 2009 and isn't this a signal that the program that was turned into a free-for-all for bailouts will soon be used to ramp up a Federal Government spending spree?**

   When the Obama Administration took office, the financial system was extremely fragile and the economy was contracting sharply. Since January 2009, the financial and economic policies put in place by this Administration in partnership with the Congress have helped to shore up confidence in our financial system. The unnatural restrictions on flow of credit to consumers and businesses which had been seen as a result of the crisis have been loosened, removing one impediment to growth. Moreover, as a result of improved financial conditions and careful stewardship of the stability programs put into place, losses on TARP investments are likely to be significantly lower than originally estimated.

   The Dodd-Frank Wall Street Reform and Consumer Protection Act will continue the process of terminating and winding down many of the government programs put in place in 2008 and 2009, and accelerate the shutting down of TARP by:

- Ending the ability for Treasury to initiate new programs under TARP.
- Ending the ability to use the $700 billion in resources that were initially authorized, capping the program at $475 billion.
- Ending the ability for repayments to be redeployed under any circumstances.

Questions from the late-Senator Byrd

1. **In June 2009, the Administration released a Memorandum of Understanding (MOU) entitled "Implementing the Interagency Action Plan on Appalachian Surface Coal Mining."**

   The MOU noted that "Federal agencies will work...to help diversify and strengthen the Appalachian regional economy and promote the health and welfare of Appalachian communities. This interagency effort will have a special focus on stimulating clean enterprise and green jobs development...."

   - **What new programs is the Treasury Department proposing to advance economic diversification in Appalachia?**

     The Department of the Treasury leads a number of efforts to promote development in Appalachia. For example, the American Recovery and Reinvestment Act of 2009 (ARRA) includes tax incentives for individuals and businesses relating to energy conservation and clean, renewable energy production that have benefited the region. Treasury's Community Development Financial Institutions Fund (CDFI Fund) has a history of supporting development in Appalachia and partnering with Appalachian Regional Commission (ARC). Highlights of the CDFI Fund's assistance to the region include financial and technical assistance awards to Treasury-certified community development financial institutions (CDFIs) and the New Markets Tax Credit, which helps attract private sector capital investment into distressed rural and urban communities. In addition, Treasury recently completed a two-year financial education pilot in partnership with Eastern Kentucky University and the Kentucky Community and Technical College System.

   - **What new resources is the Treasury Department requesting to advance economic diversification in Appalachia?**

     Treasury's CDFI Fund is proposing two new programs in FY 2011 that could help to diversify and strengthen the Appalachian regional economy and promote the health and welfare of Appalachian communities.

     The first proposed program is Bank on USA, an initiative seeking to address the many problems faced by unbanked and underbanked households in America who lack access to the basic financial products and services they need to build more secure financial futures for themselves and their families. Bank on USA will promote financial education, broader access to bank accounts, basic credit products, and other financial services to help families meet their financial needs and build savings and solid credit histories. The program will build on and supplement community-based efforts involving state and local governments, non-profits, and a wide array of financial institutions. While not a regionally-based program, groups seeking to increase access to financial services in Appalachia could apply for competitive awards available through this program.

The second proposed initiative is the Healthy Food Financing Initiative (HFFI), a new multi-year effort that will increase the availability of affordable, healthy foods in underserved urban and rural communities, particularly through the development or equipping of grocery stores and other healthy food retailers. To support this initiative, the Departments of Agriculture, Health and Human Services, and Treasury have partnered to make available over $400 million in financial and technical assistance to community development financial institutions, other nonprofits, public agencies and businesses with sound strategies for addressing the healthy food needs of communities. These organizations will use federal grants, below-market rate loans, loan guarantees and tax credits to attract private sector capital to invest in projects that increase access to fresh produce and other healthy foods. The goal is to substantially reduce the number of food deserts in our nation over the next several years. While not tied to one specific region, these resources could be awarded to CDFIs seeking to eliminate food deserts in Appalachia.

2. **The President's budget includes $250 million for the Community Development Financial Institutions (CDFI) Fund, which will be "coordinated with resources in other agencies to support the Administration's place-based initiatives."**

   - **I would appreciate you providing me a detailed plan on how CDFI funds can be invested in Appalachian counties where large-scale surface mining occurs.**

   Treasury's CDFI Fund is proposing two new programs in FY 2011 that could help to diversify and strengthen the Appalachian regional economy and promote the health and welfare of Appalachian communities. Healthy Food Financing Initiative (HFFI, $25M requested in FY 2011) is intended to increase the availability of affordable, healthy foods in underserved urban and rural communities, particularly through the development or equipping of grocery stores and other healthy food retailers. The goal is to substantially reduce food deserts— areas in the United States with limited access to affordable and nutritious food, particularly such areas composed of predominantly lower income neighborhoods and communities —in our nation over the next several years. While not tied to one specific region, resources could be awarded to CDFIs to eliminate food deserts in Appalachia.

   Bank on USA ($50M requested for FY 2011) will promote access to affordable and appropriate financial services and basic consumer credit products for households without current access. This initiative will provide funding to enhance ongoing local Bank on programs and seed new programs, in addition to financial outreach, education and awareness campaigns. Nearly 30 million households, comprising some 60 million adults do not have adequate access to mainstream financial products and services. Also, while this is not a regional based program, funding could be directed to assist the unbanked in Appalachia.

3. **In a report entitled, "Access to Capital and Credit for Small Businesses in Appalachia, "the Appalachian Regional Commission outlined the inadequate access to equity capital for small-and medium-sized firms in the non-metropolitan counties of Appalachia.**

   - **What is the Treasury Department doing – either alone, or in conjunction with other agencies and organizations – to address this issue?**

     The Department of the Treasury leads a number of efforts to promote development in Appalachia. For example, the American Recovery and Reinvestment Act of 2009 (ARRA) includes tax incentives for individuals and businesses relating to energy conservation and clean, renewable energy production that have benefited the region. Governmental bodies and public power providers in Appalachia were allocated $249 million in total bond authority for Clean Renewable Energy Bonds under ARRA. ARRA also provides for Qualified Energy Conservation Bonds, which can be used by state and local governments for conservation and renewable energy projects. States in the Appalachia Regional Council (ARC) region received a total of $919 million in bond authority through this program. Treasury has also awarded nearly $88 million to date in cash assistance investments in renewable energy in states that make up the Appalachian region under the Cash Assistance for Specified Energy Property in Lieu of Tax Credits program. In this program, federal dollars are leveraged two-to-one by businesses investing in clean energy production.

     Treasury's Community Development Financial Institutions Fund (CDFI Fund) has a history of supporting development in Appalachia and partnering with ARC. Key highlights of the CDFI Fund's assistance to the region include financial and technical assistance awards to CDFIs and the New Markets Tax Credit, which helps attract private sector capital investment into rural and urban distressed communities. In addition, Treasury recently completed a two-year financial education pilot in partnership with Eastern Kentucky University and the Kentucky community and technical college system.

Separately, the President has put forward two new lending initiatives—passed by the House— that will be led by Treasury and are designed to spur private-sector lending to small businesses so that they can expand and create new jobs:

- *Small Business Lending Fund (SBLF):* The SBLF would provide up to $30 billion in capital to small- and medium-sized banks with incentives for participants to increase lending to small businesses.

- *State Small Business Credit Initiative (SSBCI)*: The SSBCI would support up to $20 billion in lending by providing grants to innovative state-based lending initiatives that – despite proven records of success - have been threatened by state budget shortfalls.

Questions from Senator Patty Murray

1. **Economy: While recent 4th quarter GDP estimates are a positive sign that economic recovery is underway, there's undoubtedly a difficult road ahead especially as we look at the labor market. What is the core focus of the Treasury's policies to help foster sustainable economic recovery through the coming year and to bring back jobs and consumer demand?**

   The overarching goal of the Administration's economic plan is to establish the conditions that will allow the economy to move back to full employment. The American Recovery and Reinvestment Act (ARRA), the Financial Stability Plan, and our various housing proposals were all aimed at keeping the private sector from falling deeper into recession.

   Since the ARRA and the Financial Stability Plan were put in place, the economy has improved and job losses have dwindled. Real GDP has grown for four straight quarters through the second quarter of 2010. We have increased private sector jobs by 763,000 since December 2009.

   Still there is more to do. Although labor markets have shown improvement, the unemployment rate remains near 10 percent. That's why the Administration has proposed further action to maintain and strengthen the recovery, including extending tax cuts for the middle class; new tax incentives and a $30 billion lending fund targeted towards small businesses; $50 billion in new investment in roads, railroads and airports; allowing businesses to write off 100 percent of the cost of new equipment bought by the end of 2011; and simplifying, expanding and making permanent the research and experimentation tax credit. Adopting these policies will keep the economy growing and will boost private sector confidence.

   Once the recovery is firmly in place, we need to make sure we are on track to re-establish fiscal sustainability. If spending continues to grow unchecked, federal spending will crowd out private activity. That will cut U.S. economic growth and productivity.

2. **Housing: The housing market is still very fragile and I think we can agree that the fiscal policies put in place have done relatively little to help homeowners and stabilize the market. This is troubling because millions of Americans are still at risk of foreclosure and many more are underwater and must make difficult decisions about what's in their best interest.**

   - **Looking forward, what is the Treasury proposing to address this ongoing crisis?**

- **Is there a way to make a real impact without finding some way to reduce principal amounts owed by borrowers?**

During its first month in office, the Administration took aggressive action. It announced the Homeowner Affordability and Stability Plan, which provided numerous forms of relief, including: broad support for Fannie Mae and Freddie Mac to keep interest rates low and help make mortgages affordable; increased flexibility for Fannie Mae and Freddie Mac in refinancing mortgages to provide homeowners with lower monthly payments; tax credits to support development of affordable housing; and support to state and local housing finance agencies. Since April 2009, record low interest rates have helped more than 7.2 million homeowners to refinance, resulting in more stable home prices and $12.9 billion in total borrower savings.

The Home Affordable Modification Program (HAMP) was an important part of this comprehensive response. It was designed to offer responsible American homeowners reduced monthly mortgage payments that are sustainable over the long-term.

Prior to HAMP, there was no consensus among loan servicers about how to respond to responsible borrowers who were willing to continue making payments but were in need of some mortgage assistance. There were no accepted timeframes for servicer decisions. Servicers were paralyzed by the need to seek approval from investors on an individual, mortgage-by-mortgage basis. And, perhaps most critically, there was no affordability standard for monthly mortgage payments. As a result, the solutions offered by servicers often merely added unpaid interest and fees to the mortgage balance, resulting in higher—not lower—payments for homeowners.[1]

Instead, the HAMP program focuses on affordability, in an effort to ensure that borrowers who hope to remain in their homes will be able to afford the modified mortgage payment structure. Where there was once no consensus among loan servicers about how to respond to borrowers in need of mortgage assistance, HAMP has established a universal affordability standard, a 31 percent debt-to-income ratio. This has dramatically enhanced servicers' ability to reduce mortgage payments to sustainable levels while simultaneously providing investors with a justification for modifications. After HAMP began, the number of modifications that failed to reduce

[1] The quarterly Mortgage Metrics Report released by the Office of the Comptroller of the Currency and the Office of Thrift Supervision show that nearly half of mortgage modifications performed in the most recent quarter ended before commencement of HAMP in March of 2009 resulted in modified mortgage payments that were either the same as or higher than the payment amount before the modification.

monthly payments fell dramatically and comprises just 12.6 percent of all modifications.[2]

The higher quality of these modifications has translated to more sustainable outcomes for homeowners. Homeowners in permanent modifications are experiencing median payment reductions of over $500 per month, or over $30,000 over the first five years, plus up to $5,000 in homeowner incentives for on-time payment performance that reduce the principal balance. Aggregate reductions in monthly mortgage payments for borrowers in active trial and permanent modifications total more than $3.1 billion. Additionally, early indications suggest that the re-default rate for permanent HAMP modifications will be lower than for historical private-sector modifications—a result of the program's focus on properly aligning incentives and achieving greater affordability.

Furthermore, borrowers who do not ultimately qualify for HAMP modifications often receive alternative forms of assistance. Preliminary survey data show that approximately one-half of homeowners not ultimately converting to a permanent modification have received some form of private-sector modification, and the majority has avoided foreclosure through some alternative solution. These numbers help demonstrate that HAMP has changed the servicing industry in a way that is providing broader access to affordable modification options for homeowners both inside and outside of the HAMP program.

Treasury has also taken action to assist borrowers who are significantly underwater on their mortgage. On June 3, 2010, Treasury published Supplemental Directive 10-05: Modification of Loans with Principal Reduction Alternative (PRA), offering mortgage relief to eligible homeowners whose homes are worth significantly less than the remaining amounts owed under their first lien mortgage loans.

With this new guidance, servicers are required to evaluate all non-GSE HAMP-eligible loans with a mark-to-market loan-to-value greater than 115% to determine if a principal reduction is beneficial. If the evaluation shows the net present value (NPV) for a HAMP modification using PRA is positive, servicers are encouraged to offer the principal reduction to the borrower. An updated NPV model reflecting principal reduction will be available to use for this evaluation. Additionally, servicers participating in the Second Lien Program (2MP) will be required to provide a

[2] Office of the Comptroller of the Currency and the Office of Thrift Supervision, "OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data. First Quarter 2010."

principal reduction on the borrower's second mortgage in proportion to any principal reduction offered on the borrower's first mortgage.

Additionally, enhanced Federal Housing Administration (FHA) refinance capabilities that became available this September will offer certain 'underwater' non-FHA borrowers who are current on their existing mortgage and whose lien holders agree to write off at least ten percent of the unpaid principal balance of the first mortgage, the opportunity to qualify for a new FHA-insured mortgage. TARP funds will be made available up to $11 billion in the aggregate to provide additional coverage to lenders for a share of potential losses on these loans and to provide incentives to support the write downs of second liens and encourage participation by servicers.

Lastly, in February 2010, President Obama established the Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets ("HFA Hardest-Hit Fund") to provide targeted aid to families in states hit hardest by the economic and housing market downturn. The HFA Hardest-Hit Fund spans four rounds of funding totaling $7.6 billion for 19 state HFAs, including the District of Columbia.

The Hardest Hit Fund allows state housing finance agencies (HFAs) to develop solutions that are uniquely tailored to each participating state's needs. These efforts benefit enormously from the knowledge and experience of state HFAs, who are deeply familiar with and have demonstrated success in addressing the urgent challenges facing their communities.

Each state HFA determined how to design programs and target resources to meet their distinct needs. Approved states will now begin to set up and roll out their specific Hardest Hit Fund programs in order to provide relief to struggling homeowners as soon as possible, with specific implementation timing depending on the types of programs offered, specific state-level procurement procedures, and other factors. Programs that have been approved for funding include targeted principal reduction, mortgage reinstatement, and short-term support for unemployed homeowners.

Nevertheless, we fully recognize that many responsible homeowners across the country are continuing to grapple with the difficult problems of negative equity, unaffordable mortgage payments, and the possibility of foreclosure.

3. <u>**Status of the Public – Private Investment Program for Legacy Loans:**</u> **Bank failures are damaging and costly. They impact the Deposit Insurance Fund; the FDIC is**

anticipating needing $36 billion for dealing with failing banks this year. There are also many indirect costs. When a community bank fails, an acquiring bank, in many instances unfamiliar with existing customers and the community being served by the target, may cut existing lines of credit. Many community banks have exposure to losses on existing loans and they're building capital and liquidity. This is likely to continue until they feel more security and certainty that sustainable economic recovery and growth is underway. One way to achieve this is to isolate bad loans these banks carry. This is the objective of the Legacy Loans program, is it not? What is the current status of the program? How many investment funds have been established and how many banks are participating? What are the key impediments to participation for banks and investor groups?

The Legacy Loans Public-Private Investment Program was announced as part of the Financial Stability Plan in March of 2009. In June 2009, when announcing the postponement of the pilot sale, FDIC Chairman Bair stated, "Banks have been able to raise capital without having to sell bad assets through the [program], which reflects renewed investor confidence in our banking system. As a consequence, banks and their supervisors will take additional time to assess the magnitude and timing of troubled assets sales as part of our larger efforts to strengthen the banking sector."

4. <u>Fiscal Stimulus and Government Spending vs. Deficits and Debts:</u> **I am very concerned about our deficits and our growing debt. I understand that government spending is prudent during a recession when private spending and investment is down.**

Where do we draw the line between continued spending to speed economic recovery and promote growth and pursuing badly needed adjustments to balance the budget and pay down our debt?

What are the near term and long term risks for American families and our quality of life if we do not take the steps necessary to pay down our debt and return to fiscal responsibility?

We share your concerns about the effects of the budget deficit. There are no hard and fast rules to guide us to make the transition from short-term stimulus to longer-term fiscal sustainability. We are certain, however, that if we do not ensure that the recovery is sustainable, we will see the economy lose jobs and output again.

The spending we have done since early 2009 will actually help the economy and the deficit. By kick-starting the private economy, we estimate that growth, combined with the waning of Recovery Act programs and spending related to the Financial Stability Plan will cut the deficit by more than half by 2013 (from about 10 percent to less than 5 percent of GDP).

The longer-term problems are harder. We are determined to bring these deficits down and we need to do so in a bipartisan way. That's why the President proposed a budget with more deficit reduction than put forward by an administration in over a decade, and that's why the President created the bi-partisan Commission on Fiscal Responsibility and Reform to propose the additional steps necessary to restore fiscal sustainability by the middle of the decade. At the same time we need to orient our spending and tax policies toward improving the way the economy functions in the longer term. We need to continue to renew our infrastructure, develop our alternative energy base, invest in education for our workers, and encourage businesses to invest in research and development. This kind of spending enhances long-term growth.

If we do not bring down our deficits and reorient our spending and tax policies, once the economy begins to recover, government borrowing will compete with private investment. In general this will lead to higher interest rates, lower productivity, and, in the end a lower standard of living.

5. **<u>Future of Fannie Mae and Freddie Mac:</u> I remain very concerned about Fannie Mae and Freddie Mac. On Christmas Eve, the Administration extended to them an unlimited line of credit. They present a huge liability for the federal government and I believe we must take steps to reduce this exposure to taxpayers. But Fannie and Freddie are also playing a very important role in the housing recovery.**

   - **What do you propose we do about Fannie and Freddie? Do you support shifting the role they play in the housing market to the private sector? Does the capacity exist in the market place to absorb this shift?**

Private capital has not yet fully returned to the housing market. Without the continued activity of the GSEs operating in conservatorship, mortgage rates would be higher and homeowners would have a harder time obtaining credit. Care and caution must be exercised to avoid disrupting the flow of credit to average American home borrowers.

The Treasury plans to submit a proposal for reform of the housing finance system and the GSEs by January 31, 2011, as required by the Wall Street Reform and Consumer Protection Act. The transition from the current state of the GSEs operating in conservatorship to new structure for housing finance will require great care. We look forward to working with the Congress to develop a comprehensive reform strategy for the housing finance system and the GSEs in the coming months.

- **How do we unwind these entities and reduce the risk exposure to taxpayers without restricting access to credit for homebuyers?**

  Treasury is committed to carefully analyzing possible impacts of a wide range of reform alternatives. The Administration is committed to an open, transparent process that includes productive public dialogue about how to best address a housing finance system that is in clear need of reform.

6. **Financial Regulatory Reform: Some Members have proposed legislation to reinstate Glass-Steagall. The President has proposed a related proposal which he called the "Volcker Rule."**

   Can you describe for me the differences between reinstating Glass-Steagall and the Volcker Rule?

   With regulations already in place that limit a commercial bank's investment activities and restrictions that limit the ability of holding companies to shift capital between subsidiaries, can you describe for me how specifically, a return to Glass-Steagall will help reduce risks to taxpayers?

   The Administration does not believe that the repeal of Glass-Steagall was a central cause of the crisis. In fact, the most dramatic instability and failures of risk management were seen in institutions and with practices that would have been permitted under Glass-Steagall: including at Fannie Mae and Freddie Mac, Bear Stearns, Lehman Brothers, AIG and Countrywide. Moreover, the Glass-Steagall Act was never fully repealed. Rather, only the restrictions on bank holding companies engaging in securities underwriting and dealing were repealed. The Glass-Steagall Act also established a new class of commercial and investment banking firms ("financial holding companies") and made them subject to additional financial and managerial requirements. The Glass-Steagall restrictions on financial holding companies remain in place.

   The Volcker Rule, which the President signed into law, would restrict FDIC-insured depository financial institutions, and their parent companies or affiliates, from investing in or sponsoring proprietary trading operations or private equity and hedge funds. It would also impose additional capital requirements and quantitative limits on these activities for non-bank financial companies designated for supervision by the Federal Reserve.

There is no substitute for vigilant oversight both at the level of individual firms and for the system as a whole. This Wall Street reform bill signed by the President contains a comprehensive package of reforms to limit the risk of the largest, most interconnected financial firms and to shut loopholes that allowed firms and markets to evade oversight.

This law will:

- Raise capital requirements for banks overall and more so for the types of risky activities that caused problems during the recent crisis.
- Mandate even more robust prudential oversight of the most systemically important financial institutions.
- More strictly enforce the separation between banking and commerce.
- Enhance governance by augmenting the firewalls between banks and their trading affiliates as well as between the trading and lending arms of firms.

Alongside the Administration's Volcker Rule, we believe these reforms will meaningfully strengthen taxpayer protections and increase stability within our financial system.

Questions from Senator Feingold

1. **Mr. Secretary, the President proposes to extend many of the tax cuts enacted in 2001 and 2003, and I want to hear more from you about the trade-offs between further aggravating our long-term deficits, and avoiding policies that undermine our economic recovery. In particular, the President proposes to extend the cuts to the four lowest marginal income tax rates – those which apply to the first $250,000 of a family's income. Just what I've seen over the last couple of years in my own state of Wisconsin tells me that we have to do this, despite the significant increase in the deficit which may result. Millions of Wisconsin families are hurting and hitting them with what is effectively a tax increase right now would be devastating to them. What is your assessment of what it would mean for the economy, and for the prospects of the recovery and in particular for putting people back to work if we did not extend those lower marginal tax rate cuts?**

   The Administration believes that middle class Americans have shouldered too large a burden in recent years. That is why we have proposed to permanently continue the 2001 and 2003 tax cuts for families making less than $250,000, and, in addition to this, the Administration has already proposed and enacted middle class tax cuts that benefits 95 percent of working Americans. Such tax cuts for middle class families are especially important in light of current economic weakness. Unlike higher-income families, middle-income families spend most of their tax relief – which helps grow demand and create new jobs.

   By contrast, the upper-income 2001 and 2003 tax cuts – those tax cuts for families making more than $250,000 – should be allowed to expire. These tax cuts add substantially to the deficit, are unfair, and do little to promote economic growth. Allowing these tax rates for just the top 2 percent of American households to expire will reduce the deficit by more than $700 billion, including reduced interest on the national debt, through 2020.

2. **Mr. Secretary, I've met with both businesses and community banks on this issue of getting adequate credit to businesses, especially smaller firms. Generally, the complaint I hear from businesses is that despite being a good credit risk they are unable to get their local banks to extend them credit. From the banks the complaint I hear is that they'd very much like to extend more credit, but that in the wake of the financial crisis regulators fear being blamed for more bank failures, and are over reacting by being too restrictive, which limits the ability of banks to make the loans they want. To what extent are individual regulators acting too aggressively**

out of fear they will be considered too lax? Are banks being overly conservative as the industry recovers from the financial crisis?

We have also heard this concern and agree that there might be a tendency for some to over-correct. That is why we talked directly with a number of community banks in the development of the President's Small Business Lending Fund proposal, and while a few of the banks have said they do not need additional capital, many also say that their regulators are constraining them from making new loans. This is an indication that while some banks may have sufficient capital to support their existing lending, they would benefit from having more to expand their lending. Regulators are obviously independent, and while in some ways Treasury has limited ability to influence this problem, we will also continue to work with regulators to develop guidelines—like those released last year on commercial real estate and more recently on small business lending—that balance the need for prudent supervision with concerns about being overly restrictive.

CRISIS AND AFTERMATH: THE ECONOMIC OUTLOOK AND RISKS FOR THE FEDERAL BUDGET AND DEBT

TUESDAY, FEBRUARY 9, 2010

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

The Committee met, pursuant to notice, at 10:02 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Cardin, Whitehouse, Merkley, Grassley, Sessions, and Graham.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Welcome. The hearing will come to order.

First of all, I appreciate very much our witnesses being here with conditions as they are, and I appreciate colleagues who are here and who are on their way. I especially want to thank Senator Sessions for being here to represent the Republican side of the aisle. Senator Gregg informed us that he has not been able to get back to Washington at this moment and hopes to be with us soon. But airports, as you know, have been closed, so anybody that was out of town has had a difficult time getting back.

I do not know whether the votes scheduled this afternoon for the Senate are actually going to come off for not. For those who are thinking about tomorrow, we have a hearing scheduled for tomorrow. We are going to make a decision about that very soon because we have witnesses lined up. One thing we are considering is moving tomorrow's hearing to the next day in light of the threat of additional snow this afternoon and through the evening and into tomorrow. If we do get another 10 or 12 inches, it would probably be very difficult for witnesses to get here. I am fortunate. I live about ten blocks away, so I can always get here.

I want to again thank the witnesses very much. This is an important hearing on the economic outlook and risks for the Federal budget and debt. We are joined by an extremely distinguished panel of witnesses:

Dr. Carmen Reinhart, Professor of Economics and Director of the Center for International Economics at the University of Maryland. Welcome. Good to have you here.

Dr. Simon Johnson, the Ronald A. Kurt (1954) Professor of Entrepreneurship at MIT's Sloan School of Management, and Senior Fellow at the Peterson Institute for International Economics. Simon has appeared before this Committee in the past. We have always enjoyed his commentary and his testimony.

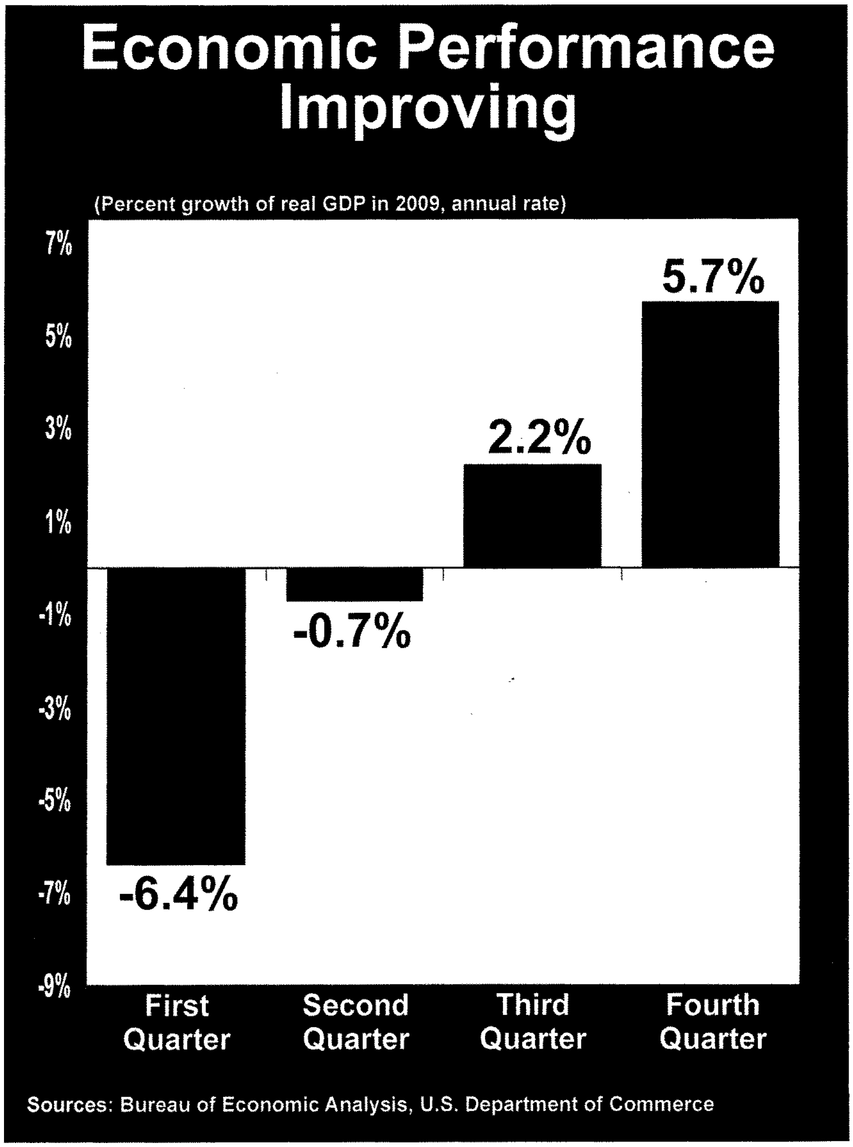
And Dr. Donald Marron, a Visiting Professor at Georgetown's Public Policy Institute and the former Acting Director of the Congressional Budget Office. Always good to have you back before the Committee as well. Dr. Marron is somebody who has served in a very distinguished way at the Congressional Budget Office, and we have always been indebted to him for his service there.

This is Dr. Reinhart's first appearance before the Budget Committee, so we especially want to make her feel at home. We look forward to her testimony, and Dr. Johnson and Dr. Marron are, as I have said, both well known here before the Committee.

As the title of our hearing suggests, we are going to focus today on the Nation's economic outlook and the risks we are facing that could affect the outlook, the Federal budget, and the Nation's debt.

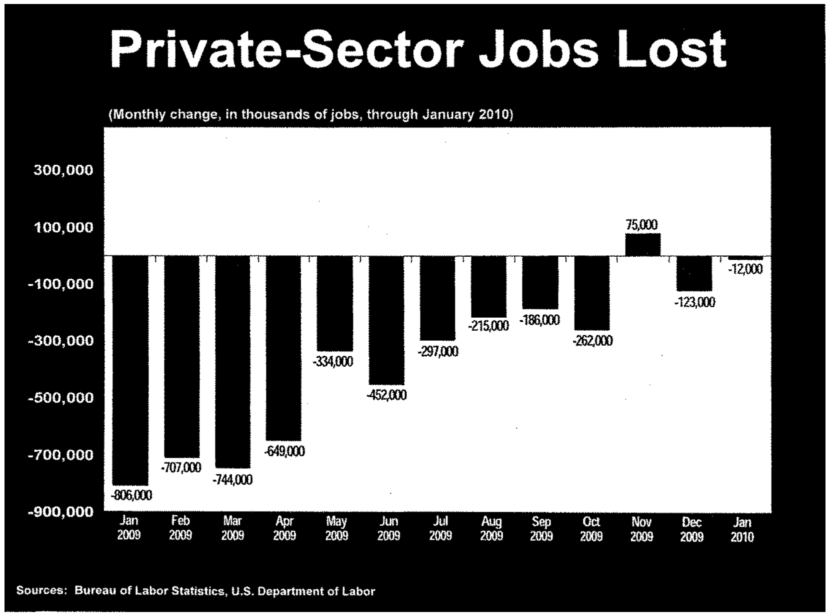
I would like to begin with just a brief review of our economic situation. I think we all know that, when President Obama took office, we were in the midst of the worst recession since the Great Depression. The President moved quickly to followup on the steps that had been taken by the previous administration to avert an even sharper economic decline, and those policies, I think, are clearly working.

The actions taken by the Federal Government over the last year have clearly helped pull us back from the brink. We have seen a dramatic turnaround in economic growth. Economic growth in the first quarter of last year was a negative 6.4 percent. By the last quarter of last year, it had improved to a positive 5.7-percent growth.



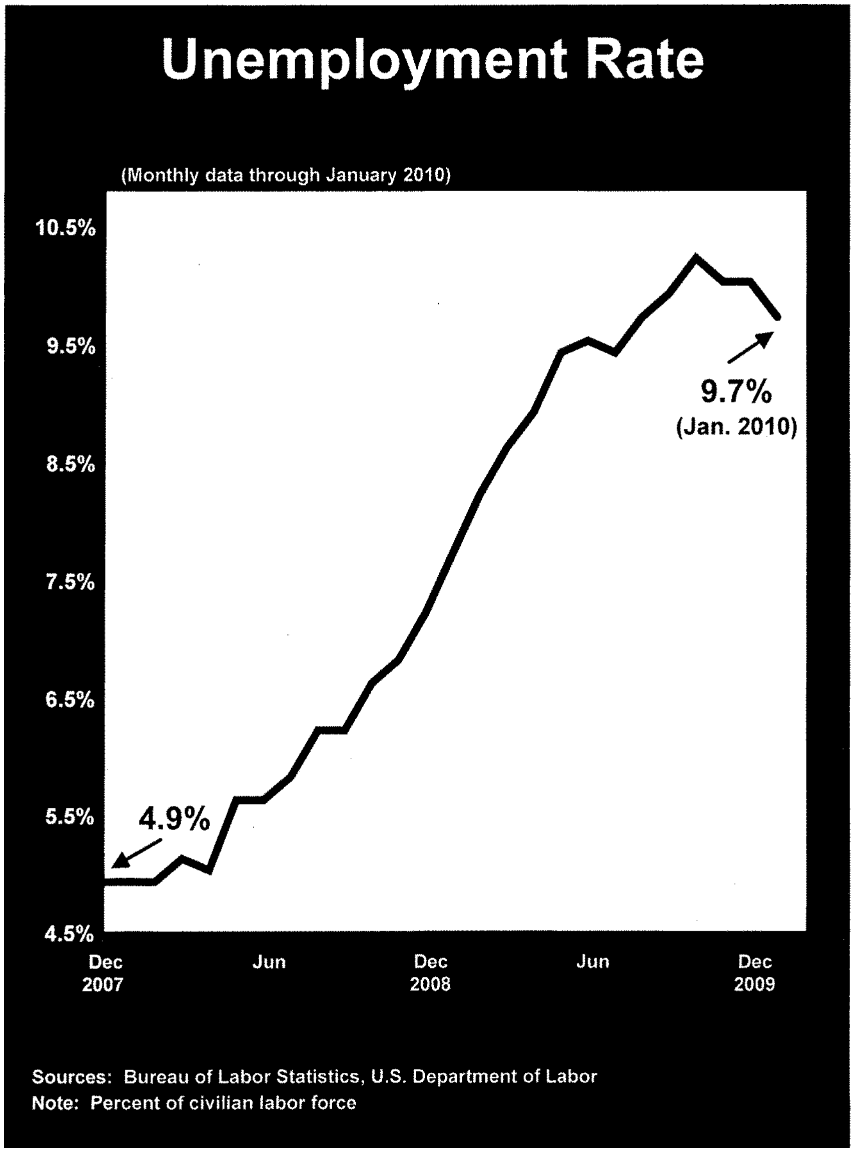
Now, I think it is very important to say none of us anticipates that that level of economic growth will continue. Many of us see a more tepid level going forward.

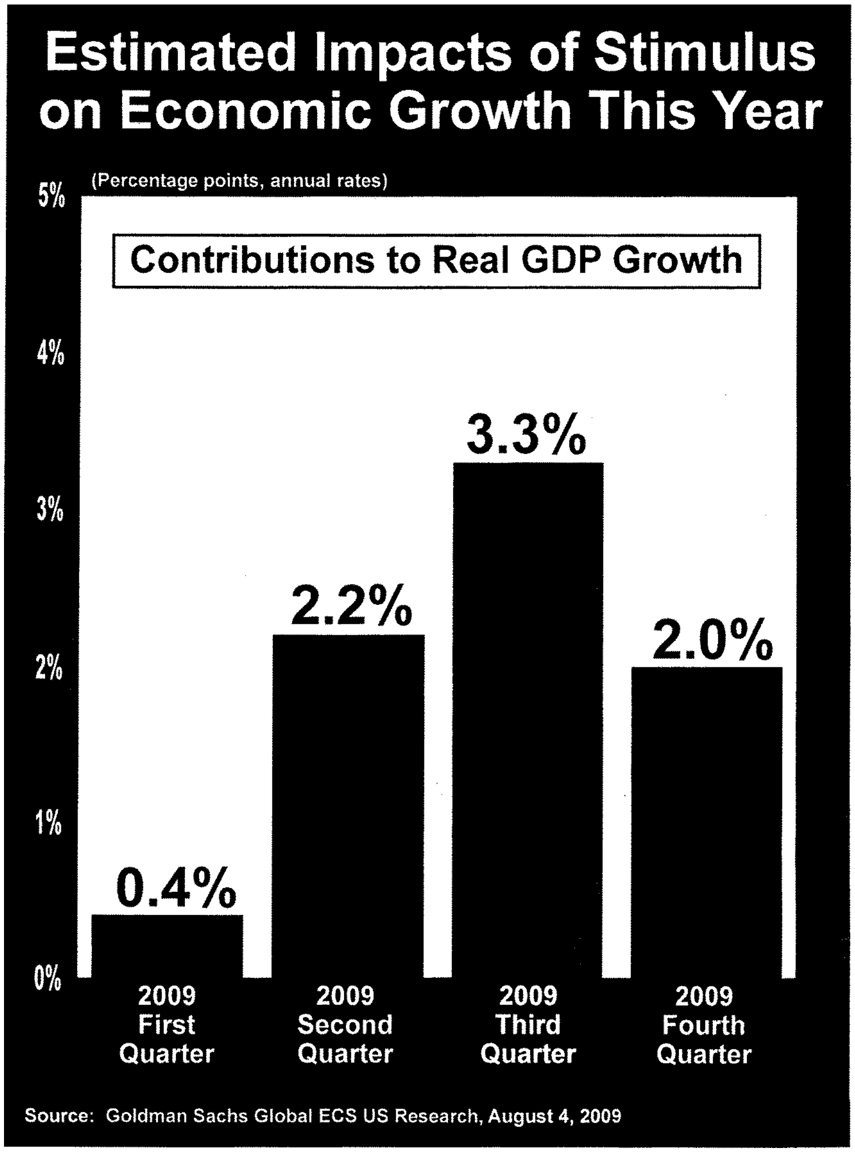
We have also seen a steady improvement in the jobs picture. According to the revised estimates we received last Friday, in January of last year, the economy was losing more than 800,000 private-sector jobs in 1 month. Now, that is up from a previous estimate of about 700,000 jobs lost. So looking back, we can see in January of last year the job loss was running about 800,000 a month. By January of this year, the economy was losing about 12,000 jobs in a month—a dramatic improvement, but still short of where we need to go in terms of dramatically reducing unemployment.



And I must say all of these numbers, to those who are suffering the consequences of a weakened economy, are just numbers on a page. If you are someone who is unemployed or cannot find sufficient work or are underemployed, these numbers are cold comfort to you. It is important to recognize that things are improving. At least the free fall that we were in has been stabilized, and we are starting to move back in the right direction.

According to estimates we received last Friday, the unemployment rate did fall to 9.7 percent, but that is still far too high. Last year's recovery package is still providing stimulus. We know that its impact on economic growth likely peaked during the third quarter of 2009. According to an estimate from Goldman Sachs, the recovery package provided about 3.3 percent of increase in real GDP at its peak during the third quarter. Following the third quarter, the contributions to growth of last year's recovery package began to diminish.

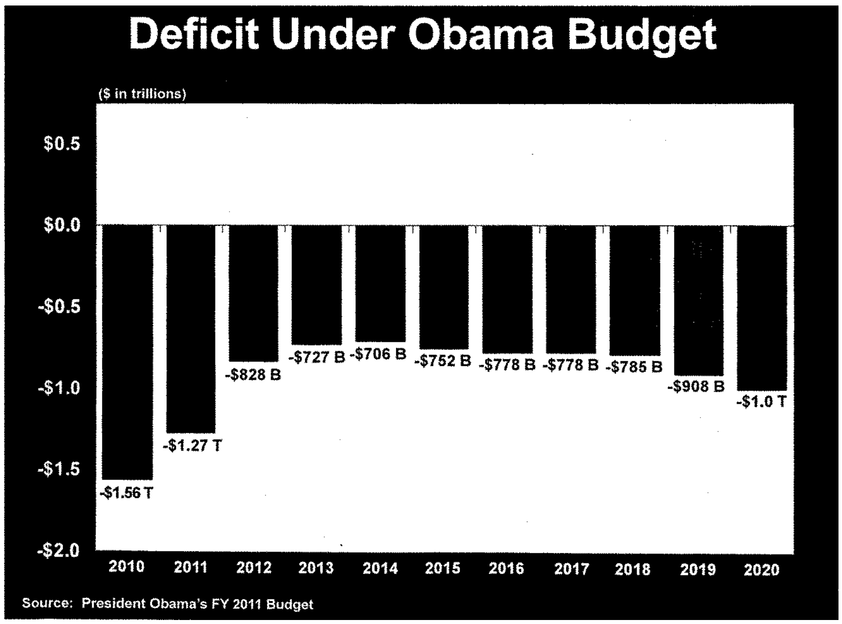

Unemployment Rate
(Monthly data through January 2010)
10.5%
9.5%
8.5%
7.5%
6.5%
5.5%
4.5%
4.9%
9.7%
(Jan. 2010)
Dec 2007
Jun
Dec 2008
Jun
Dec 2009
Sources: Bureau of Labor Statistics, U.S. Department of Labor
Note: Percent of civilian labor force



Given the high unemployment rate, the continuing concerns about the economy, and the fact that the impact of the recovery package has started to wane, I think it is appropriate for us to be considering additional job creation measures at this time. So I would like to hear from our witnesses their views on the benefits of enacting such measures at this time.

The economic downturn and the Federal response to it has contributed significantly to the worsening of our budget outlook. Now, this is the other side of the picture. In the short term, measures that were taken to stabilize the economy and stop a precipitous collapse have been effective. But we know there is a price to be paid, and the price to be paid is increases to our deficits and debt.

This chart depicts the projected deficit under President Obama's proposed budget over the next 10 years. It shows the deficit coming down from a high of $1.56 trillion in 2010 to $706 billion in 2014, and then slowly resuming its climb back to $1 trillion in 2020.



I have said before that I can understand increases in deficits and debt in the short term to deal with an economic weakness and to prevent an economic collapse. But I am increasingly concerned about the out-years because we are already on an unsustainable path, and I am concerned the President's budget does not focus sufficiently on our long-term need to deal with the debt threat.

The Nation's debt outlook is even worse, particularly over the long term. The fact is we are on a completely unsustainable course long term. I personally believe we need a two-pronged strategy going forward—one for the near term, one for the long term. In the near term, I believe we must emphasize policies that encourage job creation in the private sector. But for the long term, we must pivot to controlling our debt. The economic security of our Nation depends on it.

With that, I will turn to Senator Sessions for any opening remarks he might want to make, and then we will go to our witnesses, and then we will have a chance for questions of the panel. Again, Senator Sessions, thank you so much for being here. It speaks very well of a man from Alabama to be here with the weather conditions we are currently experiencing in this city. In North Dakota, this is no big deal, but I am sure in Alabama this would be an all-out emergency.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. It was fun for me to be out a little bit Sunday, to walk around and see the beauty of the snow. It is really a stunning sight. But it does cause difficulties for travel.

Chairman CONRAD. Well, if you like the beauty of this snow, I would like to invite you to North Dakota.

[Laughter.]

Chairman CONRAD. Anytime in January or February of next year. In fact, maybe spend all of January and February.

Senator SESSIONS. Maybe we can invite you south. That would be a better idea.

I thank all of you for coming, and I look forward to your discussion. I frankly do not know how well our actions worked after the collapse in the financial markets. Those who supported it, promoted it, funded it, ran it, all tell us if we had not done it, we would be so much worse than we are today. But forgive me if I am not sold. I just believe that a lot of things had to be done, and I have supported a number of things, but the fundamental actions that we took were troubling to me.

The Fed had to act. We know that. And the Congress has some things that we needed to do. But I am troubled by it all. The TARP, $700 billion, had to pass before the Asian markets opened the next morning, they originally told us. And then when President Bush had left office, he had not spent his $350 billion half of it yet. And one man was allocating $700 billion. So forgive me if I am uneasy about that.

That $700 billion was distributed in ways directly contrary to what Congress was told. We were told it was to buy toxic assets, and within a week they were buying stock in companies, insurance companies, then buying automobile companies. So forgive me if I am not happy and the American people are not happy.

Second, the stimulus package, the $787 billion, it is now 840 because we are spending more under the commitments made than we intended when we passed it. I think it has produced little. In fact, I think it is one of the great tragedies in the history of the country that we have gotten so little out of such an incredibly large expenditure, the largest single expenditure in American history. I do not think it has gone very well. I do not think it has created the jobs they projected it would create, even.

The bill that some of us supported that Senator Thune and Senator McCain offered for half the cost, according to Christina Romer's own analysis, would have created twice as many jobs and half the debt impact on our country.

So we have got some serious problems. One of the things that happens with budgets that, Mr. Marron, as Director CBO at the time you were over there—you might be aware of this; most Americans are not—that the only year that really counts is the year you are in. And the year we are in, for example, has a gimmick if the President's job stimulus package were passed, like the one similar to the House version that he praised in the State of the Union, it has $100 billion more in ten. He is counting $170 billion in the next 10 years, but he is not counting the 100 in this year. It is a violation of last year's budget. But we will have to have a vote sufficient to raise the spending level through emergency designation, I guess, to spend that money this year.

So I guess what I am saying is what I am hearing from the incumbent administration that concerns me is that , it is always next year. Next year. We have got to do all this this year. We are not going to worry about how much debt is being run up this year. We will worry about it next year. And the chart you put up, Mr. Chairman, is, however, the budget that they are citing. So we have got to reduce the budget.

Now, I offered legislation and have 16 or 17 Democrats who support it which says let us take that budget we passed last year and let us follow those numbers, which were basically 1- and 2-percent increases over the next 5 years. But we did not get the 60 votes necessary to pass it. But that would have been a real step, I think, that would help us send a message to the whole world and to our own American people that we are going to contain discretionary spending, at least for a while, and then we absolutely, as, Mr. Chairman, you have led on this, have to discuss how we can reduce our entitlement spendings, and all spending, really. But we have got to act. That is all I am saying.

I look forward to hearing from you. The American people are unhappy with us. They are not happy with us. Unemployment is high. The numbers were not good this last week, another 20,000 increase in unemployment. And I think it takes about an 800,000-increase to begin to reduce the total unemployment numbers. So I am really worried about unemployment. We want to have growth, and hopefully we can.

Mr. Chairman, thank you. I am sorry Senator Gregg is not here. I know he has got a difficulty, but I know you and he have worked on a number of issues that are important, and I hope to be able to work with you, too.

Chairman CONRAD. Thank you, Senator. Again, thank you very much for being here. Now we will turn to the witnesses. Dr. Carmen Reinhart, Professor of Economics and Director of the Center for International Economics at the University of Maryland. Very timely for you to be here given the developments on the international front. Please proceed with your testimony. Then we will go to Dr. Johnson and Dr. Marron. Dr. Reinhart.

STATEMENT OF CARMEN M. REINHART, PH.D. PROFESSOR OF ECONOMICS, AND DIRECTOR, CENTER FOR INTERNATIONAL ECONOMICS UNIVERSITY OF MARYLAND

Ms. REINHART. Thank your, Chairman Conrad and other members of the Committee, for the opportunity to comment on the U.S. economy and the risks for the budget and debt. I am a professor in the Department of Economics at the University of Maryland. I suspect that I was invited here today because, for more than a decade, my research has focused on various types of financial crises, and that includes their fiscal implications and other economic consequences. One of the main lessons emerging from this work is that across countries and over time, severe financial crises follow a similar pattern.

In a paper written over a year ago with my coauthor Ken Rogoff, we examined the depth and duration of the slump that invariably follows financial crises. The recessions following severe post-World War II crises tended to be protracted affairs. Asset market collapses were deep and prolonged. On a peak-to-trough basis, real housing prices declined, on adviser, 35 percent, and this decline stretched out over 6 years. Equity prices collapsed on an average of 55 percent; the recovery from the bottom was quicker. To put it in context, in the present downturn, here in the United States real housing prices have already fallen 36 percent from their February 2006 peak.

Not surprisingly, banking crises are associated with profound declines in output and employment. The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts an average of 4 years. We are following this track: the U.S. unemployment rate bottomed at 4.4 percent in December 2006, about 6 months before the crisis broke; and by its recent peak level in October of 2009, the unemployment rose 5.7 percentage points.

Historically, these conditions produced a marked deterioration in budget deficits. Correspondingly, the real value of Government debt soars after financial crises of this order of magnitude, rising an average of 86 percent in the major post-World War II episodes. The main cause of the debt explosion is not the widely cited costs of bailing out the banking system. Nor is it the fiscal stimulus, as many countries in our sample did not implement such policies. In fact, the critical factor is the collapse in tax revenues that follows in the wake of deep and prolonged economic contraction. Our estimates of the rise in Government debt are likely to be conservative—the 86 percent—as they do not include increases in Government guarantees, which also soar.

Government debt has been soaring in the wake of the recent global maelstrom, especially in the epicenter countries. In related work with Rogoff I completed only a few weeks ago, we calculated the increase in inflation-adjusted public debt that has occurred since 2007. And for five countries with systemic financial crises—which include the United States and the United Kingdom—average debt levels are up by about 75 percent. Even in countries that have not had a major financial crisis, debt rose an average of 20 percent in real terms between 2007 and 2009.

So our main focus is on the longer-term macroeconomic implications of much higher public and external debt. We examine in this work the experience of 44 countries spanning up to two centuries of data on central government debt, inflation, and growth. Our main finding is that across both advanced countries and emerging markets, high debt-to-GDP levels, debt levels, gross debt above 90 percent, are associated with notably lower growth outcomes. Above 90 percent, median growth rates fall by 1 percent; average growth rates fall considerably more. In addition, for emerging markets, there appears to be a tighter threshold for external debt, a lower threshold, so that when external debt reaches 60 percent of GDP, annual growth declines by about 2 percent, and for higher levels of debt, growth is cut in about in half. Our international and historical shows that seldom do countries simply grow their way out of their debt burdens.

There are also thresholds in debt. Why 90 percent? While the exact mechanism is not certain, we presume that at some point, interest rate premia react to unchecked deficits, forcing governments to tighten fiscal policy. Higher taxes have an especially deleterious effect on growth. We suspect that growth also slows as governments turn to financial repression to place debts at sub-market interest rates.

Of course, there are other vulnerabilities associated with debt buildups that depend on the composition of the debt itself. One common mistake as debts soar is for governments to "play the yield curve," shifting to cheaper short-term debt to economize on interest costs. Unfortunately, a government with massive short-term debts to roll over is ill positioned to adjust if rates spike or market confidence fades.

Even aside from high and rising levels of public debt, many advanced countries, particularly in Europe, right now are saddled with extraordinarily high levels of external debt, or debt issued abroad by both the government and private entities. In the case of Europe, the advanced country average exceeds 200 percent of GDP. In private debts, U.S. debts exceed 300 percent, and they are at their highest level since 1916 where the historical statistics of the United States began to record this data. Current high private domestic and external debt burdens would also seem to be an important vulnerability to monitor. Downgrades, ratings downgrades, usually follow debt.

Given these risks of higher government debt, how quickly should governments exit from fiscal stimulus? This is not an easy task, especially given weak employment, here in the United States and elsewhere. In light of the likelihood of continued weak consumption in the U.S. and Europe, rapid withdrawal of stimulus could easily tilt the economy back into recession. To be sure, this is not the time to exit. It is, however, the time to lay out a credible plan for a future exit. The sooner our political leadership reconciles itself to accepting adjustment, the lower the risks of truly paralyzing debt problems down the road, the likes of which we are seeing in Europe right now. Although most governments still enjoy strong access to financial markets at very low interest rates, market discipline can come without warning. Countries that have not laid the groundwork for adjustment will regret it.

This time is not different. Thank you.

[The prepared statement of Ms. Reinhart follows:]

Testimony before the Senate Budget Committee

of

Carmen M. Reinhart

Professor and Director of the Center for International Economics,
University of Maryland

February 9, 2010

Thank you Chairman Conrad, Ranking Member Gregg, and other Members of the Committee, for the opportunity to comment on the U.S. economy and the risks for the federal budget and debt. I am currently a professor in the Department of Economics at the University of Maryland. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises, including their fiscal implications and other economic consequences. One of the main lessons emerging from this work is that across countries and over time, severe financial crises follow a similar pattern.

In a paper written over a year ago with my coauthor Ken Rogoff from Harvard University, we examined the depth and duration of the slump that invariably follows financial crises. The recessions following severe post-World War II financial crises tended to be protracted affairs. Asset market collapses were deep and prolonged. On a peak-to-trough basis, real housing prices declined 35 percent on average, stretched out over six years. Equity price collapses averaged 55 percent, but the recovery from the bottom was quicker. In the present downturn, real housing prices have fallen 36 percent from their February 2006 peak.

Not surprisingly, banking crises are associated with profound declines in output and employment. The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. We are following this track: the U.S. unemployment rate bottomed at 4.4 percent in December 2006; by its recent peak level in October 2009, the unemployment rose 5.7 percentage points.

Historically, these conditions produced a marked deterioration in budget deficits. Correspondingly, the real value of government debt soars, rising an average of 86 percent in the major post–World War II episodes. The main cause of debt explosions is not the widely cited costs of bailing out the banking system. Nor is it fiscal stimulus, as many countries in the sample did not implement such policies. In fact, the critical factor is the collapse in tax revenues in the wake of deep and prolonged economic contraction. Our estimates of the rise in government debt are likely to be conservative, as they do not include increases in government guarantees, which also soar.

Government debt has been soaring in the wake of the recent global financial maelstrom, especially in the epicenter countries. In related work that Rogoff and I completed only a few weeks ago, we calculated the increase in (inflation adjusted) public debt that has occurred since 2007. For five countries with systemic financial crises (Iceland, Ireland, Spain, the United Kingdom, and the United States), average debt levels are up about 75 percent. Even in countries that have not experienced a major financial crisis, debt rose an average of about 20 percent in real terms between 2007 and 2009.

Our main focus is on the longer-term macroeconomic implications of much higher public and external debt. We examine the experience of forty four countries spanning up to two centuries of data on central government debt, inflation, and growth.

Current high private domestic and external debt burdens would also seem to be an important vulnerability to monitor. Downgrades usually follow debt.

Given these risks of higher government debt, how quickly should governments exit from fiscal stimulus? This is not an easy task, especially given weak employment, here in the United States and elsewhere. In light of the likelihood of continued weak consumption in the U.S. and Europe, rapid withdrawal of stimulus could easily tilt the economy back into recession. To be sure, this is not the time to exit. It is, however, the time to lay out a credible plan for a future exit. The sooner our political leadership reconciles itself to accepting adjustment, the lower the risks of truly paralyzing debt problems down the road. Although most governments still enjoy strong access to financial markets at very low interest rates, market discipline can come without warning. Countries that have not laid the groundwork for adjustment will regret it.

This time is not different.

Chairman CONRAD. Thank you for your excellent testimony.

We go to Dr. Johnson next and then Dr. Marron, and then we will open it up to questions. Dr. Johnson.

STATEMENT OF SIMON JOHNSON, PH.D., RONALD A. KURTZ (1954) PROFESSOR OF ENTREPRENEURSHIP, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, SLOAN SCHOOL OF MANAGEMENT, AND SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. JOHNSON. Thank you, Senator.

About a year ago, I testified before this Committee, and I think our discussion together at that point came to the conclusion that we faced a pretty tough year, and I think that that discussion turned out to be exactly right.

My recollection is that we discussed contraction in the global economy for the first time since World War II, roughly around a 1-percent decline on a year-on-year basis. The IMF's latest number for 2009 is a minus 0.8 decline, so I think we were exactly in the right place there.

Now, of course, at this stage we should be discussing a recovery. We have a sharp decline. The post-war experience for the global economy and for this economy is you have a fairly rapid recovery. And the numbers that you showed us for the third and fourth quarters for last year, of course, are encouraging in that direction.

But I am worried, again, about the dynamics that we face during this year. I think there is a great deal of volatility ahead, some of which is domestic for the reasons that Professor Reinhart just talked about; some of which has a global origin that I can expand on in a moment. And I think that while the headline numbers for this year, the year-on-year average growth numbers, will indicate recovery, a modest recovery, if you look at the fourth quarter-on-fourth quarter numbers, so look at the dynamic within 2010, you are going to see something quite different.

In particular, in the second half of this year, I think there is going to be a slowdown. I am not suggesting at this point that we will have a double-dip recession. That would imply an actual decline in output in the second half. But I do think that the pace of growth will slow. I think the pace at which jobs come back will slow. And I think this is a major concern for the budget and for job creation, as you mentioned at the beginning, Senator Conrad.

My overall projection on the fourth quarter-on-fourth quarter basis, which is, I would suggest, the number we might focus on today, is that the global economy will grow around 3 percent. Now, traditionally, that is where the IMF would draw a line on global recession. They have moved the goalpost, given what we have seen in the past 2 years, so that now they will call it global recession at perhaps a 1-percent rate. But 3-percent global is fairly slow, and this rate would be mostly held up by what is happening emerging markets. And I think if we have time we can probe to what extent that is sustainable also beyond 2010.

Now, I think the weaknesses in the U.S. economy are well known to you, and Professor Reinhart already mentioned the main points. Let me just flag for you that the consumer sector is weak. Lower-income households in particular have a substantial debt overhang. Housing prices seem soft in most parts of the world, and asset prices, based on particularly the global picture that I am painting, will remain volatile. So households do not feel their wealth has gone back up matching their recovery in stock prices, for example.

Residential investment is almost certainly not going to lead this recovery. Business investment I think may be stronger. There are issues of credit availability for the small business sector, which I imagine we will talk about later, but in any case, this component of final demand is not big enough to pull the U.S. back to the kinds of growth rates we want.

Now, in addition to all of that, net exports, which has been a brighter part of the picture in the United States over the past 12 months, is likely not to be so strong over the next 12 months for the reasons that I will talk about in a moment.

The fiscal stimulus, as you said, continues, but its impact on growth weakens. I agree with the Goldman Sachs analysis on that. And, of course, we should expect the Federal Reserve to withdraw its support for mortgage-backed securities as we go into the spring. Despite the weakness of the economy, despite the continuing high unemployment, this is what the Fed, I think, is very clearly indicating, both directly and indirectly. So all this adds up on domestic grounds to a difficult second half.

But that is not the worst part of the picture. The worst part of the picture is, I am afraid, that a serious crisis is brewing in Western Europe where there are many people who actually claim this time is different, and I agree—well, I would apply Professor Reinhart's book and conclusions to suggest that it is actually not that different. Greece has a serious sovereign debt problem. These issues are spreading also to Portugal and Spain, without doubt. There may be implications for Ireland and even Italy.

There is a great reluctance on the part of the stronger European countries to help the weaker European countries. We can discuss the details if you would like, but basically, they do not have an institutional mechanism in place. They are not good at creating one quickly. They will not, in my assessment, bring in the International Monetary Fund. And I was, as you know, chief economist at the IMF through August of 2008, and I am very happy to expand on both the procedures and the politics behind that assessment.

But if you put all of this together, you are looking at a substantial shock to government credit, which you will see in credit ratings, you will see in interest rates, you will see in credit default swap spreads. And the big unknown in this picture is what will happen to the financial sector.

Now, we obviously have still too-big-to-fail banks. In fact, I think we can reasonably argue that certainly as we wait for financial reform to come through, this problem has not been addressed. If anything, it has gotten worse. The Europeans have this problem on a much larger scale, by the way. Their big banks are much bigger relative to their economies, and some of these very big banks are in quite small economies that cannot, in my assessment, sustain from a fiscal point of view an additional big financial shock.

So Switzerland, for example, has two massive banks currently with assets and liabilities roughly 6 or 7 times the GDP of Switzerland, looking at the global picture. We can argue about the right metric there. But if the bank fails, it is the size of the bank's global balance sheet relative to your domestic fiscal position.

The situation in the United Kingdom is not much better. There is a massive contingent liability on their balance sheets, as, I would argue, there is on our balance sheet. And I think Senator Sessions was exactly right to stress the TARP experience where you were asked to provide money to buy toxic assets and then it turned out to buy shares in banks and other companies. I do not think that is off the table now in Europe, and I fear that it will come back to haunt us and come back to you as a budget matter in the United States. That contingent liability is very big. I would say it is at least 40 percentage points of GDP based on our recent experience. If you follow Professor Reinhart's book carefully, I think you would even say it is larger than that. We are still carrying that liability; so are the Europeans.

Now, how this will spread through the financial system is very hard to say. My current estimate is that some of it will spread through the credit default swap market, which is, again, unreformed, completely opaque, and actually has not been addressed. The issues of derivatives and off-balance-sheet liabilities have not been addressed since the crisis of 1999 when Long Term Capital Management failed. We are a long way behind this, and this all has fiscal implications.

And, in conclusion, I would like to stress and reinforce what you said, Senator, and what Senator Sessions said and what Professor Reinhart said, about the necessity of a medium-term framework. You do not want, I think, to have fiscal austerity now. That would not be the right measure. If Europe swings into fiscal austerity because of their inability to manage their way through this crisis, that would be bad for growth. The euro will weaken substantially anyway, in my assessment. That is part of what is going to hurt our next exports. They and we need an exit strategy, a medium-term framework that tells you how entitlements are going to be handled over a 5-, 10-, 15-year framework and what the tax base is and what the gap is between those. And, of course, Senator Conrad, when you said that the debt has to be controlled, you are absolutely right. I would just add to that the foreign dimension, because we have not just a large domestic debt, which, of course, Japan sustained for a long time and now it really catches up with them. That is 20 years of struggling with that debt. Most of their debt is held domestically. An increasing amount or a large amount of our debt is held by foreigners, and this has, I think, both economic and geopolitical consequences.

Thank you.

[The prepared statement of Mr. Johnson follows:]

Testimony submitted to the Senate Budget Committee, hearing on "Crisis and Aftermath: The Economic Outlook and Risks for the Federal Budget and Debt," Tuesday, February 9, 2010 (embargoed until 10am).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. Main Points

1) In recent months, the US economy entered a recovery phase following the severe credit crisis-induced recession of 2008-09. While slower than it should have been based on previous experience, growth has surprised on the upside in the past quarter. This will boost headline year-on-year growth above the current consensus for 2010. We estimate the global economy will grow over 4 percent, as measured by the IMF's year-on-year headline number (their latest published forecast is for 3.9 percent), with US growth in the 3-4 percent range – calculated on the same basis.

2) But thinking in terms of these headline numbers masks a much more worrying dynamic. A major sovereign debt crisis is gathering steam in Europe, focused for now on the weaker countries in the eurozone, but with the potential to spillover also to the United Kingdom. These further financial market disruptions will not only slow the European economies – we estimate growth in the euro area will fall to around 0.5 percent Q4 on Q4 (the IMF puts this at 1.1 percent, but the January World Economic Outlook update was prepared before the Greek crisis broke in earnest) – it will also cause the euro to weaken and lower growth around the world.

3) There are some European efforts underway to limit debt crisis to Greece and to prevent the further spread of damage. But these efforts are too little and too late. The IMF also cannot be expected to play any meaningful role in the near term. Portugal, Ireland, Italy, Greece, and Spain – a group known to the markets as PIIGS, will all come under severe pressure from speculative attacks on their credit. These attacks are motivated by fiscal weakness and made possible by the reluctance of relatively strong European countries to help out the PIIGS. (*Section B below has more detail.*)

4) Financial market participants buy and sell insurance for sovereign and bank debt through the credit default swap market. None of the opaqueness of the credit default swap market has been addressed since the crisis of September 2008, so it is hard to know what happens as governments further lose their credit worthiness. Generalized counter-party risk – the fear that an insurer will fail and thus bring down all connected banks – is again on the table, as it was after the collapse of Lehman.

---

[1] This testimony draws on joint work with Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "The Doomsday Cycle" (forthcoming), and James Kwak, including *13 Bankers* (forthcoming, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

5) Another Lehman/AIG-type situation lurks somewhere on the European continent, and again G7 (and G20) leaders are slow to see the risk. This time, given that they already used almost all their scope for fiscal stimulus, it will be considerably more difficult for governments to respond effectively if the crisis comes.

6) In such a situation, we should expect that investors scramble for the safest assets available – "cash", which means short-term US government securities. It is not that the US has anything approaching a credible medium-term fiscal framework, but everyone else is in much worse shape.

7) Net exports have been a relative strength for the US economy over the past 12 months. This is unlikely to be the case during 2010.

8) In addition to this new round of global problems, the US consumer is beset by problems – including a debt overhang for lower income households, a soft housing market, and volatile asset prices. The savings rate is likely to fall from 2009 levels, but remain relatively high. Residential investment is hardly likely to recover in 2010 and business investment is too small to drive a recovery.

9) On a Q4-on-Q4 basis, the US will struggle to grow faster than 2 percent (the IMF forecast is for 2.6 percent). This within year pattern will likely involve a significant slowdown in the second half – although probably not an outright decline in output. The effects of fiscal stimulus will begin to wear off by the middle of the year and without a viable medium-term fiscal framework there is not much room for further stimulus – other than cosmetic "job creation" measures.

10) The Federal Reserve will start to wind down its extraordinary support programs for mortgage-backed securities, starting in the spring (although this may be delayed to some degree by international developments). The precise impact is hard to gauge, but this will not help prevent a slowdown in the second quarter.

11) On top of these issues, there is concern about the levels of capital in our banking system. The "too big to fail" banks are implicitly backed by the US government and for them the stress test of early 2009 played down the amount of capital they would need if the economy headed towards a "double-dip"-type of slowdown; the stress scenario used was far too benign. In addition, small and medium sized banks have a considerable exposure to commercial real estate, which continues to go bad.

12) Undercapitalized banks tend to be fearful and curtail lending to creditworthy potential borrowers. This may increasingly be the situation we face in 2010.

13) Emerging markets are also likely to slow in the second half of the year. Twice recently we have assessed whether these economies can "decouple" from the industrialized world (in early 2008 and at the end of 2008). In both cases, emerging markets – with their export orientation and, for some, dependence on commodity prices – were very much caught up in the dynamics of richer countries' cycle.

14) The IMF projects global growth, 4^{th} quarter-on-4^{th} quarter within 2010 at 3.9 percent, i.e., the same as their year-on-year forecast. We expect it will be closer to 3 percent.

15) Over a longer time-horizon, we will probably experience a global economic boom, based on prospects in emerging markets. With our current global financial structure, this brings with it substantial systemic risks (*see Section C below*).

B. From Greece to the US: The Globalized Financial Transmission Mechanism

1) The problems now spreading from Greece to Spain, Portugal, Ireland and even Italy portend major trouble ahead for the US in the second half of this year – particularly because our banks remain in such weak shape.

2) Greece is a member of the eurozone, the elite club of European nations that share the euro and are supposed to maintain strong enough economic policies. Greece does not control its own currency – this is in the hands of the European Central Bank in Frankfurt. In good times, over the past decade, this helped keep Greek interest rates low and growth relatively strong.

3) But under the economic pressures of the past year, the Greek government budget has slipped into ever greater deficit and investors have increasingly become uncomfortable about the possibility of future default. This impending doom was postponed for a while by the ability of banks – mostly Greek – to use these bonds as collateral for loans from the European Central Bank (so-called "repos").

4) But from the end of this year, the ECB will not accept bonds rated below A by major ratings agencies – and Greek government debt no longer falls into this category. If the ECB will not, indirectly, lend to the Greek government, then interest rates will go up in the future; in anticipation of this, interest rates should rise now.

5) This spells trouble enough for an economy like Greece – or any of the weaker eurozone countries. Paying higher interest rates on government debt also implies a worsening of the budget; these are exactly the sort of debt dynamics that used to get countries like Brazil into big trouble.

6) The right approach would be to promise credible budget tightening over 3-5 years and to obtain sufficient resources – from within the eurozone (the IMF is irrelevant in the case of such a currency union) – to tide the country over in the interim.

7) But the Germans have decided to play hardball with their weaker neighbors – partly because those countries have not lived up to previous commitments. The Germans strongly dislike bailouts – other than for their own banks and auto companies. And the Europeans policy elite loves rules; in this kind of situation, their political process will move at a relatively slow late 20th century pace.

8) In contrast, markets now move in a 21st century global network pace. We are moving towards is a full-scale speculative attack on sovereign credits in the eurozone. Brought on by weak fundamentals – worries about the budget deficit and whether government debt is on explosive path – such attacks take on a life of their own. We should remember – and prepare for – a spread of pressure between countries along the lines of the panic that moved from Thailand to Malaysia and Indonesia, and then then jumped to Korea all in the space of two months during 1997.

9) The equity prices of weaker European banks will come under pressured. Fears about their solvency may also be reflected in higher credit default swap spreads, i.e., a higher cost of insuring against their default.

10) US Treasury and the White House apparently take the view that they must stand aloof, waiting for the Europeans to get their act together. This is a mistake – the need for US leadership has never been greater, particularly as our banks are really not in good enough shape to withstand a major international adverse event (e.g., Greece defaults, Greece leaves the eurozone, Germany leaves the eurozone, etc).

11) We subjected our banks to a stress test in spring 2009 – but the stress scenario was mild and more appropriate as a baseline. Many of our banks – big, medium, and small – simply do not have enough capital to withstand further losses.

12) As the international situation deteriorates – or even if it remains at this level of volatility – undercapitalized banks will be reluctant to lend and credit conditions will tighten around the US.

13) If the European situation spins seriously out of control, as it may well do in coming weeks, the likelihood of a double-dip recession (or significant slowdown in the second half of 2010) increases dramatically.

C. Longer Run Baseline Scenario

1) In terms of thinking about the structure of the global economy there are three main lessons to be learned from the past eighteen months.

2) First, we have built a dangerous financial system in Europe and the U.S., and 2009 made it more dangerous.

    a. The fiscal impact of the financial crisis was to increase by around 30-40 percent points our federal government debt held by the private sector. The extent of our current contingent liability, arising from the failure to deal with "too big to fail" financial institutions, is of the same order of magnitude.

    b. Our financial leaders have learnt that they can bet the bank, and, when the gamble fails, they can keep their jobs and most of their wealth. Not only have the remaining major financial institutions asserted and proved that they are too big to fail, but they have also demonstrated that no one in the executive or legislative branches is currently willing to take on their economic and political power.

    c. The take-away for the survivors at big banks is clear: We do well in the upturn and even better after financial crises, so why fear a new cycle of excessive risk-taking?

3) Second, emerging markets were star performers during this crisis. Most global growth forecasts made at the end of 2008 exaggerated the slowdown in middle-income countries. To be sure, issues remain in places such as China, Brazil, India and Russia, but their economic policies and financial structures proved surprisingly resilient and their growth prospects now look good.

4) Third, the crisis has exposed serious cracks within the euro zone, but also between the euro zone and the U.K. on one side and Eastern Europe on the other. Core European nations will spend a good part of the next decade bailing out the troubled periphery to avoid a collapse. For many years this will press the European Central Bank to keep policies looser than the Germanic center would prefer.

5) Over the past 30 years, successive crises have become more dangerous and harder to sort out. This time not only did we need to bring the **fed funds rate** near to zero for "an extended period" but we also required a massive global fiscal expansion that has put many nations on debt paths that, unless rectified soon, will lead to their economic collapse.

6) For now, it looks like the course for 2010 is economic recovery and the beginning of a major finance-led boom, centered on the emerging world.

7) But this also implies great risks. The heart of the matter is, of course, the U.S. and European banking systems; they are central to the global economy. As emerging markets pick up speed, demand for investment goods and commodities increases – countries producing energy, raw materials, all kinds of industrial inputs, machinery, equipment, and some basic consumer goods will do well.

8) On the plus side, there will be investment opportunities in those same emerging markets, be it commodities in Africa, infrastructure in India, or domestic champions in China.

9) The Chinese exchange rate will remain undervalued. Our reliance on Chinese purchases of US government and agency debt puts us at a significant strategic disadvantage and makes it hard for the administration to push for revaluation. The existing multilateral mechanisms for addressing this issue – through the IMF – are dysfunctional and will not help. There is a growing consensus to move exchange issues within the remit of the World Trade Organization but, without US leadership, this will take many years to come to fruition.

10) Good times will bring surplus savings in many emerging markets. But rather than intermediating their own savings internally through fragmented financial systems, we'll see a large flow of capital out of those countries, as the state entities and private entrepreneurs making money choose to hold their funds somewhere safe – that is, in major international banks that are implicitly backed by U.S. and European taxpayers.

11) These banks will in turn facilitate the flow of capital back into emerging markets – because they have the best perceived investment opportunities – as some combination of loans, private equity, financing provided to multinational firms expanding into these markets, and many other portfolio inflows. Citigroup, for example, is already emphasizing its growth strategy for India and China.

12) We saw something similar, although on a smaller scale, in the 1970s with the so-called recycling of **petrodollars**. In that case, it was current-account surpluses from oil exporters that were parked in U.S. and European banks and then lent to Latin America and some East European countries with current account deficits.

13) That ended badly, mostly because incautious lending practices and – its usual counterpart – excessive exuberance among borrowers created vulnerability to macroeconomic shocks.

14) This time around, the flows will be less through current- account global imbalances, partly because few emerging markets want to run deficits. But large **current-account imbalances** aren't required to generate huge capital flows around the world.

15) This is the scenario that we are now facing. For example, savers in Brazil and Russia will deposit funds in American and European banks, and these will then be lent to borrowers around the world (including in Brazil and Russia).

16) Of course, if this capital flow is well-managed, learning from the lessons of the past 30 years, we have little to fear. But a soft landing seems unlikely because the underlying incentives, for both lenders and borrowers, are structurally flawed.

17) The big banks will initially be careful – although Citigroup is already bragging about the additional risks it is taking on in India and China. But as the boom progresses, the competition between the megabanks will push toward more risk-taking. Part of the reason for this is that their compensation systems remain inherently pro-cyclical and as times get better, they will load up on risk.

18) The leading borrowers in emerging markets will be quasi-sovereigns, either with government ownership or a close crony relationship to the state. When times are good, investors are happy to believe that these borrowers are effectively backed by a deep-pocketed sovereign, even if the formal connection is pretty loose. Then there are the bad times – remember Dubai World at the end of 2009 or the Suharto family businesses in 1997-98.

19) The boom will be pleasant while it lasts. It might go on for a number of years, in much the same way many people enjoyed the 1920s. But we have failed to heed the warnings made plain by the successive crises of the past 30 years and this failure was made clear during 2008-09.

20) The most worrisome part is that we are nearing the end of our fiscal and monetary ability to bail out the system. In 2008-09 we were lucky that major countries had the fiscal space available to engage in stimulus and that monetary policy could use quantitative easing effectively. In the future, there are no guarantees that the size of the available policy response will match the magnitude of the shock to the credit system.

21) Much discussion of the Great Depression focuses on the fact that the policy response was not sufficiently expansionary. This is true, but even if governments had wanted to do more, it is far from clear that they had the tools at their disposal – in particular, the size of government relative to GDP is limited, while the scale of financial sector disruption can become much larger.

22) We are steadily becoming more vulnerable to economic disaster on an epic scale.

Chairman CONRAD. Thank you very much for your excellent testimony.

Dr. Marron, welcome back. It is always good to have you here. Please proceed.

STATEMENT OF DONALD MARRON, PH.D., VISITING PROFESSOR, GEORGETOWN PUBLIC POLICY INSTITUTE

Mr. MARRON. Great. So thank you, Chairman Conrad and the members of the committee, for having me up to talk about the economic outlook and the fiscal situation.

I guess on a personal note, I want to say that I have previously appeared before you in a professional capacity working for the Congress, and now I am appearing as a private citizen, and I must admit I find it incredibly liberating. So I am now free to have my opinion, so watch out for what you have asked for.

[Laughter.]

Mr. MARRON. So as this committee and all its members are very well aware, our nation is on an unsustainable fiscal path. If current policies continue, we will run trillion-dollar deficits in the years ahead, even after the economy recovers, which is quite striking, and the public debt will rise faster than our ability to pay it. Persistent deficits and rising debt will undermine American prosperity, threaten beneficial social programs, and weaken our position in the world.

Those threats deserve immediate attention, but as this committee is also well aware, our economy remains fragile. Payroll employment has fallen by about 8.4 million jobs since the start of the recession and long-term unemployment is at record levels. Recent data, as the Chairman mentioned, have provided some glimmers of hope, strong GDP in the fourth quarter and a decline in the unemployment rate in January, but our economy has a very long way to go. You thus face a very difficult challenge of balancing concern about current economic conditions with a meaningful response to our looming fiscal crisis, and in thinking about that balance, I just want to make five points.

So the first, and this will now repeat what the Chairman said and what my fellow witnesses have said, we should not expect a rapid recovery. It is a good sign that the economy grew strongly in the last quarter of last year, but for a whole host of reasons that we have already heard discussed, I would not anticipate that to continue. We are on a recovery path, but I think the Chairman used the word tepid. I would call it moderate—modest, not one where we should expect rapid.

Second is that uncertainty is actually one factor that has been holding the economy back. Uncertainty discourages investment and hiring and thereby undermines growth, right. If you put the shoes of someone deciding whether to make an investment, whether to hire someone, that is a much easier decision to make if you have some visibility into what the future will hold.

Now, the good news is that economic uncertainty has gone down dramatically, that the economic environment has improved and is more conducive to growth. The bad news, though, is that policy uncertainties are very high. Senator Sessions, you mentioned that some of your constituents are mad with you. I sort of tried to talk to all the business people I know before I came up for this testimony to ask them what was on their minds and what would encourage job creation, and for better or for worse, a lot of them are very upset about just the uncertainty they face. They don't know what is happening with tax policy. They don't know what is happening with health care, in addition to what they don't know that is happening with the economy.

Having worked up here in government for a long time, I understand why some of these uncertainties exist and are necessary, but I think there are opportunities to get rid of unnecessary uncertainties and give people some more clarity about what the future holds. The extreme example of that would be what is happening with the estate tax, which is more of a personal thing, but in some cases a business thing, but obviously there are many other examples on the tax side.

No. 3, persistent deficits and rising debts pose a serious risk to long-term economic growth, and so again, as my fellow witnesses have said, concerns about the near-term economic outlook should not deter Congress from taking steps to strengthen our fiscal positions over the next decade. Again, you know, major steps toward fiscal consolidations shouldn't take effect immediately, right. We are not looking for cuts in 2010 and 2011. But Congress should begin now to plan for deficit reduction and debt stabilization in later years. We need an exit strategy, and that exit strategy should include clear goals and a credible means for achieving them.

President Obama outlined some steps in that direction in his budget, but to be honest, I feel that they fell far short of what is required. Indeed, under his budget, the debt would grow faster than the economy in every single year of the budget window.

To address that concern, the President also proposed the creation of a fiscal commission that would be tasked with stabilizing the debt-to-GDP ratio in 2015 and beyond. I have two concerns about this proposal. First, I don't think the target is aggressive enough. If you took it seriously, as written, it would have the effect of stabilizing debt-to-GDP around 71 or 72 percent of GDP. That is obviously better than exploding and growing, but my own personal preference would be to see it come down to some number like 60 percent of GDP by the end of the budget window. And so I would like to see a commission's target be more aggressive.

And then second, obviously, as you know, there are institutional features of the proposal that are troublesome. My preference would be what you, Chairman Conrad and Senator Gregg, have proposed, of having an actual statutory commission that is backed by the political legitimacy of being passed by the Congress, signed by the President, with all the things that go along with that. And I have concerns and questions about whether a non-statutory commission can get there.

Obviously, what I would be looking for is something that has the power to obviously be paid attention to in Congress, something for which everything would be on the table. I am very troubled when I hear some people say that Social Security ought to be off the table, other people saying that tax revenues ought to be off the table. I think if we are seriously trying to address our fiscal concerns, you ought to let this commission pull on all the levers and they can judge how to balance them.

Fourth, and this is a short one, just bringing the long-term to the present day, a credible plan to reduce future deficits is not just about the future. If we do it well, it will help keep long-term interest rates low today, thus strengthening our current recovery.

And then fifth and finally, in the long term, bringing our deficits under control will require both spending restraint and increased revenues. Spending restraint should receive greater emphasis, I think, both because spending is the primary driver of our long-run budget imbalances, and because higher government spending may slow economic growth. Given the government's existing commitments, however, it is unlikely that spending restraint alone can put our nation on a sustainable fiscal trajectory.

As policymakers consider how to finance a larger government, they should, therefore, give special attention to figuring out ways to make our tax system more efficient. For example, think about ways to tax consumption rather than income. Think about ways to broaden the tax base rather than increase rates. And, to the extent possible, think about ways to tax undesirable things, like pollution, rather than desirable things, like working, saving, and investing.

Thank you.

[The prepared statement of Mr. Marron follows:]

The Economic Outlook and Risks for the Federal Budget and Debt

Testimony before the United States Senate Committee on the Budget

February 9, 2010

Donald B. Marron

Georgetown Public Policy Institute,
Marron Economics LLC,
& dmarron.com

Chairman Conrad, Ranking Member Gregg, and Members of the Committee, thank you for inviting me to appear today to discuss our economic and fiscal challenges.

As this Committee is well aware, our nation is on an unsustainable fiscal path. If current policies continue, we will run trillion-dollar deficits in the years ahead—even after the economy recovers—and the public debt will rise faster than our ability to pay it. Persistent deficits and rising debt will undermine American prosperity, threaten beneficial social programs, and weaken our position in the world.

Those threats deserve immediate attention but, as this Committee is also well aware, our economy remains fragile. Payroll employment has fallen by 8.4 million jobs since the start of the recession, and long-term unemployment is at record levels. Recent data have provided some glimmers of hope: the economy grew at a 5.7% pace in the last three months of 2009 (a figure that many observers expect to be revised up), and the unemployment rate fell to 9.7% in January, down from 10.0% a month earlier. Those improvements are welcome, but our economy has a very long way to go.

Policymakers thus face a difficult challenge of balancing concern about current economic conditions with a meaningful response to our looming fiscal crisis. In thinking about that balance, I would like to make five main points:

1. Most analysts believe that the recession is behind us and that an economic recovery is underway. Where analysts differ is in their assessment of how strong the recovery will be. As always, there is much uncertainty about the outlook, but my best guess is that near-term growth will be moderate, not rapid.

2. Uncertainty discourages investment and hiring and therefore undermines growth. Economic uncertainty has declined over the past year, creating an environment more conducive to growth. Policy uncertainties are enormous, however, and are likely discouraging some employers from hiring and investing. Lawmakers should look for opportunities to reduce unnecessary policy uncertainty.

3. Persistent deficits and rising debts pose a serious risk to long-term economic growth. Concerns about the near-term economic outlook should not deter Congress from

taking steps to strengthen our fiscal position over the next decade. Although major steps toward fiscal consolidation should not take effect in 2010 and 2011, Congress should begin to plan now for deficit reduction and debt stabilization in later years. That plan should include clear goals (e.g., a target trajectory for the debt-to-GDP ratio) and credible means for achieving them.

4. A credible plan to reduce future deficits would help keep long-term interest rates low, thus strengthening the current recovery.

5. In the long-term, bringing our deficits under control will require both spending restraint and increased revenues. Spending restraint should receive greater emphasis both because spending is the primary driver of our long-run budget imbalances and because higher government spending may slow economic growth. Given the government's existing commitments, however, it is unlikely that spending restraint alone can put our nation on a sustainable fiscal trajectory. As policymakers consider how to finance a larger government, they should therefore give special attention to relying on more efficient forms of taxation.

I elaborate each of these points below.

The economic outlook

Most analysts believe that the recession is behind us and that the United States will grow at a moderate pace over the next few years. The *Blue Chip* consensus of private forecasters sees 2.9% real GDP growth in 2010 and 3.1% growth in 2011, for example, while the Administration sees somewhat stronger growth of 3.0% and 4.3%. On the other hand, the Congressional Budget Office projects somewhat slower growth (2.1% and 2.4% in 2010 and 2011, respectively). These forecasts differ in their underlying assumptions—CBO's is based on current law, for example, while the Administration's is based on its policy proposals—but they reflect a general consensus that the economy is once again growing.

Some analysts believe that these forecasts are too pessimistic and that growth will pick up sharply in the next year or two. The primary basis for this view is the observation that sharp downturns have often been followed by sharp recoveries. That is certainly true, but I believe such optimism should be tempered for at least two reasons.

First, as Carmen Reinhart and Kenneth Rogoff have documented in detail, economies tend to rebound slowly from financial crises.[1] It takes time for the financial system to heal and for economies to make necessary structural adjustments (in our case, creating new jobs for workers who previously worked in housing construction and finance). As a result, this recovery is likely to be weaker than those that have followed purely cyclical downturns.

---

1 Carmen M. Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

Second, both households and financial institutions are only partway through the painful process of recognizing losses and deleveraging. According to some recent estimates, 11 million households—accounting for more than 20% of borrowers—are underwater on their mortgages. Unless house prices rebound sharply (highly unlikely) many of those homeowners will default, adding to the stock of foreclosed properties and eating away at the thin capital cushions of many banks. In addition, financial institutions will realize substantial losses as borrowers continue to default on commercial mortgages and leveraged loans. Although the worst of the financial crisis is behind us, there is still much pain to be recognized.

Uncertainty impedes growth

As Nobel Laureate Nils Bohr[2] once said, "Prediction is difficult, particularly if it's about the future." Businesses face that challenge every time they consider whether to invest in new equipment, develop new products, or move into new markets.

In making such decisions, businesses try to predict the uncertain, future returns on those efforts and compare them to their upfront investment costs. With that information in hand, they then have three options: to go ahead with the project, to kill it permanently, or to wait for further information before deciding.

The third option—waiting—is particularly attractive when a business faces significant uncertainty. An investment may be profitable under some future conditions, but unprofitable under others. Even if the firm thinks the investment might be profitable, it may make sense to wait to learn more about future conditions before incurring upfront investment costs. As a result, uncertainty discourages investment.

The same logic applies to hiring as well. Firms face significant fixed costs (e.g., training) when they bring a new employee on board. In other words, hiring a new employee is an investment. And, again, when uncertainty is high, firms have an incentive to delay hiring until they can be more confident that a new employee will generate enough value to cover the costs of hiring.[3]

The degree of uncertainty is thus an important consideration in thinking about the economic outlook. The good news is that economic uncertainty has fallen sharply over the past year. Great Depression 2.0 scenarios appear to be off the table and debate now focuses on the strength or weakness of the nascent recovery.

The bad news is that policy uncertainty remains high, for at least three reasons:

---

[2] Not, as often thought, Yogi Berra.

[3] For a rigorous analysis of how uncertainty discourages investment and hiring, see Nicholas Bloom, "The Impact of Uncertainty Shocks," *Econometrica 77:* 3: 623-685, May 2009.

1. Our obsession with temporary tax provisions. Over the past decade, policymakers have enacted a series of temporary tax reductions, almost all of which are scheduled to expire in the next year or two. These include the individual income tax reductions enacted in 2001 and 2003, the "patch" on the alternative minimum tax, the Making Work Pay tax credit, the first-time homebuyer tax credit, the research and experimentation tax credit, expanded net operating loss carrybacks for firms, partial expensing of equipment investment, tax credits for ethanol-blended motor fuels, various preferences for international income, and on and on. And don't forget the estate tax, which blinked out of existence on January 1, but is scheduled to return in full force next year.[4]

   CBO estimates that the revenue impact of these provisions will amount to 2.7% of GDP in 2012; if all of them expired (as CBO assumes in its baseline) overall tax revenues would thus be boosted by about 17%. Of course, no one believes that all these provisions will expire. But businesses and individuals can't be sure which ones will continue and which not. Some allegedly permanent provisions may actually expire, while some allegedly temporary provisions may get extended.

   That violates almost every principle of good tax policy. And the resulting uncertainty encourages firms to wait-and-see before committing to investments (including new hires) whose economic viability could depend on future taxes.

2. The prominent exercise of government discretion during the financial crisis. The private sector does best when there are clear, well-enforced rules for it to follow. During the depths of the financial crisis, those rules were often superseded (or were perceived as superseded) by policymaker discretion. As a result, firms (primarily but not exclusively in the financial sector) now feel less certain about the rules-of-the-road in such crucial areas as the treatment of creditors in bankruptcy and government-mediated bankruptcy alternatives and the structure of compensation packages.

3. New policy initiatives. Congress has taken up an ambitious agenda over the past year, including proposed legislation to reform health insurance, address climate change, and modernize our system of financial regulation. These efforts would affect every business and family in America, sometimes substantially. But their outcomes remain highly uncertain.

Having worked at both ends of Pennsylvania Avenue through much of this period, I understand the economic and political circumstances that create such policy uncertainties. And I am certainly not suggesting that concerns about temporary uncertainty are a reason

---

4 For a helpful overview of these expiring provisions see Box 4-1 (pp. 82-83) of Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010-2020, January 26, 2010.

for Congress to avoid important issues. (Indeed, if you take my advice, you would add one more item—serious deficit reduction—to your already-crowded agenda.)

Instead, my point is simpler: Policy uncertainty is a drag on the economy, and therefore there is value is eliminating unnecessary uncertainty wherever possible. As the financial crisis recedes, for example, policymakers should strive to reestablish clear rules-of-the-road so that companies can get on with their business without unnecessary doubts about how creditors will be treated or how employees can be compensated.

Similarly, when policymakers have reached agreement on particular policies, there is value in enacting them on a permanent basis. Doing so would eliminate needless, growth-reducing uncertainty and maximize the incentives created by the policy.

Unfortunately, our process often favors temporary policies, with all of their downsides. Consider, for example, the research and experimentation tax credit that the Congress extends every couple of years. This is absurd. If the tax credit is good policy, it should be enacted permanently, thus maximizing the incentive for innovation. If it is bad policy, then it should be killed permanently. Either way, firms that undertake research will face less uncertainty developing their plans, lobbyists can move onto other matters, and legislators can spend their time on more pressing issues.

Addressing our rising debt

Persistent deficits and rising debts pose a number of dangers to American prosperity including reduced economic growth, concerns about inflation, increased reliance on foreign creditors, and reduced flexibility for dealing with future crises.

For all those reasons (and more), it is essential that we place our nation on a sustainable fiscal path. In his recent budget, President Obama takes some steps in that direction, but his specific budget proposals fall far short of that goal. Under the President's budget, deficits would total more than $10 trillion over the next eleven years and would never fall below 3.6% of GDP. The publicly-held debt would more than double, rising from $7.5 trillion at the end of 2009 to $18.6 trillion at the end of 2020, and the debt-to-GDP ratio would rise to more than 77%.

Under the President's budget, the debt will grow faster than the economy in every year of the budget window. In my view, that would pose unnecessary risks to the U.S. economy.

To his credit, the President acknowledges this problem and makes a recommendation for how to deal with it: the creation of a fiscal commission. According to the budget, the fiscal commission would be tasked with:[5]

---

[5] See Table S-1, p. 146, Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011*, February 1, 2010.

"[B]alancing the budget excluding interest payments on the debt by 2015. The result is projected to stabilize the debt-to-GDP ratio at an acceptable level once

would be reasonable. As the Commission notes, the 60% level has often been used by international organizations to determine whether nations have their finances under control. The Growth and Stability Pact of the European Union stipulates, for example, that member nations should keep their public debts below 60% of GDP. Many European nations have breached that threshold during the recession, but will try to regain it once their economies strengthen.

The near-term benefits of credible fiscal policy

As policymakers consider such steps to rein in long-term deficits, they should keep in mind that some of the economic benefits will begin much earlier. World financial markets would certainly welcome signs that the United States recognizes its budgetary challenges and is willing to take hard steps to address them. As result, those markets would reward the United States with lower long-term interest rates. In addition, some recent research suggests that near-term stimulus efforts will be more successful if they are paired with credible commitments to later fiscal restraint.[7]

Addressing spending and revenues

Given the magnitude of the commitments that we have made, it is unlikely that the government will be able to stabilize the debt purely through spending reductions (relative to their baselines). Revenue increases will almost certainly be required as well.

Nevertheless, spending reductions do deserve particular emphasis. Driven by an aging population and rising health-care costs, the government's biggest long-term financial obligations—Medicare, Medicaid, and Social Security—grow faster than the economy each year. As a result, they tend to worsen our future budget challenges. For that reason alone, these spending programs deserve special attention in efforts to get our fiscal house in order.

In addition, experience suggests that spending reductions tend to be more successful than tax increases in achieving sustained budget improvements. In a study of attempts at fiscal consolidation in developed economies from 1970 to 2007, for example, Alberto Alesina and Silvia Ardagna found that fiscal adjustments based on spending reductions were much more likely to result in sustained declines in deficits and debt-to-GDP ratios than were efforts based on tax increases.[8]

Finally, increased government spending will, all else equal, lead to slower economic growth.

---

[7] Giancarlo Corsetti, Andre Meier, and Gernot Muller, "Fiscal Stimulus with Spending Reversals," International Monetary Fund Working Paper, May 2009.

[8] Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," October 2009.

would be reasonable. As the Commission notes, the 60% level has often been used by international organizations to determine whether nations have their finances under control. The Growth and Stability Pact of the European Union stipulates, for example, that member nations should keep their public debts below 60% of GDP. Many European nations have breached that threshold during the recession, but will try to regain it once their economies strengthen.

The near-term benefits of credible fiscal policy

As policymakers consider such steps to rein in long-term deficits, they should keep in mind that some of the economic benefits will begin much earlier. World financial markets would certainly welcome signs that the United States recognizes its budgetary challenges and is willing to take hard steps to address them. As result, those markets would reward the United States with lower long-term interest rates. In addition, some recent research suggests that near-term stimulus efforts will be more successful if they are paired with credible commitments to later fiscal restraint.[7]

Addressing spending and revenues

Given the magnitude of the commitments that we have made, it is unlikely that the government will be able to stabilize the debt purely through spending reductions (relative to their baselines). Revenue increases will almost certainly be required as well.

Nevertheless, spending reductions do deserve particular emphasis. Driven by an aging population and rising health-care costs, the government's biggest long-term financial obligations—Medicare, Medicaid, and Social Security—grow faster than the economy each year. As a result, they tend to worsen our future budget challenges. For that reason alone, these spending programs deserve special attention in efforts to get our fiscal house in order.

In addition, experience suggests that spending reductions tend to be more successful than tax increases in achieving sustained budget improvements. In a study of attempts at fiscal consolidation in developed economies from 1970 to 2007, for example, Alberto Alesina and Silvia Ardagna found that fiscal adjustments based on spending reductions were much more likely to result in sustained declines in deficits and debt-to-GDP ratios than were efforts based on tax increases.[8]

Finally, increased government spending will, all else equal, lead to slower economic growth.

---

[7] Giancarlo Corsetti, Andre Meier, and Gernot Muller, "Fiscal Stimulus with Spending Reversals," International Monetary Fund Working Paper, May 2009.

[8] Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," October 2009.

Chairman CONRAD. Excellent testimony, all three, just terrific, and I appreciate it very much.

So let us go right to it. This committee has a special responsibility to our colleagues with respect to the budget, and it is pretty hard to find a time in our history, at least since this Budget Committee was formed, when budget policy can have such a profound effect on economic issues, economic growth, and all the rest.

So, Dr. Reinhart, if you had this responsibility, what would be the strategy that you would pursue, short-term, long-term, with respect to deficits and debt, with keeping the eye on the effect of the economy? What would you advise this committee to do, both short-term and long-term?

Ms. REINHART. Let me begin by saying that the—in my remarks, I highlighted that I think this is the time to lay out a credible plan for deficit and debt reduction, but it is not the time to start implementing that, and I would like to just elaborate on that remark, especially as it pertains to the experience of other episodes, including here in the United States, in which victory was declared prematurely and stimulus was withdrawn. This was the case in Japan, which has had a decade-long lingering crisis. It was the case in the Great Depression. My work with Vincent Reinhart has documented these episodes—

And that risk is one that should be borne in mind and that is why I stress the credible path, and the credible path, I think, could benefit from looking also at the experience of our neighbor to the north, Canada, in the mid-1990's, which implemented a very significant debt reduction program.

Chairman CONRAD. And what was the result?

Ms. REINHART. The result was very—I would describe it as threefold. One was they achieved their intended goals in bringing their deficits and their debts, the Canadian debt profile. That has been reflected in the risk premium. Canada's risk premium had risen and, in fact, was moving in tandem with emerging markets by the mid-1990's.

Chairman CONRAD. Higher interest rates?

Ms. REINHART. Higher interest rates. Higher interest rates, higher debt servicing costs, more volatility.

Let me add that a second element of their program was also—which I highlighted briefly in my remarks—is paying a lot of attention to how when you have a lot of debt, how debt is managed and reducing their vulnerability to and reliance on short-term debt, and in the Canadian case, on foreign currency debt, which, of course, we don't have.

Chairman CONRAD. Dr. Johnson, same question to you. What would your advice be to this committee, short-term and long-term?

Mr. JOHNSON. Well, Senators, as I think you know, I am not in general a fan of fiscal stimulus. In fact, I testified before this committee and some other Congressional committees more than a year ago saying that it was only the extraordinary circumstances we faced due to the collapse of our credit system, due to the problems brought on by the reckless behavior of our big banks, that led me to suggest that we should at that point have a stimulus around $500 billion. Roughly speaking, I think we ended up in the same ballpark.

I now would hold back again from further stimulus. I think we need to see what happens. I think within the menu that the Congressional Budget Office, for example, has assessed for you addressing employees' payroll taxes, if we come to that, may be an appropriate measure to consider. But I am not yet ready to do that.

So in terms of the short-term, I am not advocating further stimulus at this time. And in terms of the longer-term, I think that the fiscal commission idea is an important one. I think Dr. Marron hit a couple of key points, including nothing being left off the table. And, of course, Medicare is the big item. Now, this is not a call for fiscal austerity immediately. Professor Reinhart explained why that is a bad idea. I fear that may happen in Europe, which will have a negative impact on the global economy that should be avoided, and I am calling for them to not do that in Europe and to find ways to help themselves.

But I do think that a fiscal commission that explains to the holders of our debt where the trajectory is going, and perhaps you would argue—we can argue technically and we could argue politically about what will be the priorities, but everything should be on that table. I think that is absolutely critical. If you had that in place, if you had a credible medium-term framework in the United States now, you would have a lot more room for maneuver on short-term measures. In fact, I might even right now call for reduction in payroll taxes if we had the medium-term framework, but we don't. That is dangerous.

Chairman CONRAD. So you are in some ways linking the two in your mind. That is, it would be a lot more credible to do something with respect to payroll taxes to provide additional lift to the economy if you had some credible process in place to deal with the longer-term debt.

Mr. JOHNSON. Absolutely. Using fiscal stimulus, as you know, is something that we have moved away from, actually, in general, in industrialized countries over the past 20 years because it comes with long and variable lags and it tends not to hit the economy exactly as you hope and when you hope. But there is a case for using it on a temporary basis, particularly if you can persuade the financial markets, which includes the Chinese government.

I mean, let us be frank. If you can persuade everyone that your debt is not on an explosive path and you have the legislative or other institutional mechanisms in place to ensure this is not just a vague promise—the British government today faces a huge problem because their commitments on the fiscal side are, in my assessment, not credible. We don't have that problem yet in the United States, but you need a fiscal commission to really assure that going forward. If you had that commission, it would create a lot more room for short-term maneuvering.

Chairman CONRAD. Dr. Marron, same question to you. If your responsibility was to advise this panel short-term and long-term, what would your advice be?

Mr. MARRON. Sure. So starting with the long-term, as I hinted before, what I personally personally would like to see is a numerical target that lays out what is it that in the latter part of the budget window we want to accomplish, and——

Chairman CONRAD. What do you think it should be?

Mr. MARRON. We can obviously negotiate numbers, but just to make up numbers that are plausible for discussion purposes, say something like you want to cap the growth of debts to GDP at, say, 70 or 72 percent in 2013——

Senator SESSIONS. Mr. Chairman, could I interrupt? I am sorry. I see some of my students from Alabama, St. James School.

Chairman CONRAD. Absolutely.

Senator SESSIONS. That is an excellent school in Montgomery. You see that lady on the front row with her red hat with an "A" on it? That is the No. 1 football team in America, University of Alabama. So St. James is——

Chairman CONRAD. Well, wait a minute. Wait a minute. Wait a minute. In North Dakota, we make that same claim.

[Laughter.]

Senator SESSIONS. You have a good, competitive team. We usually lose to them in the playoffs. But thank you for coming.

Chairman CONRAD. Thank you, and thanks for——

Senator SESSIONS. They had a hard day in the snow, but I think they are probably enjoying it.

Chairman CONRAD. Thanks for acknowledging them.

Senator SESSIONS. Sorry to interrupt you, Mr. Chairman.

Chairman CONRAD. No problem at all. Glad that you did.

Dr. Marron?

Mr. MARRON. Sure. So, say, 70 percent of debt-to-GDP ratio in 2013 is a nominal goal, and then, as I said, to then bring it down through the budget window. I suggested——

Chairman CONRAD. Seventy percent by when?

Mr. MARRON. In, say, 2013, as a cap.

Chairman CONRAD. OK.

Mr. MARRON. And then 60 percent by the end of the budget window. Now, you may be familiar with the Pew-Peterson Commission on Budget Reform recently. They put out a goal of getting to 60 percent by 2018, so I'm being slightly less aggressive than they are.

Chairman CONRAD. Yes.

Mr. MARRON. And again, you know——

Chairman CONRAD. Let me just say, I just this morning looked at a plan that would get us on that path. It is daunting.

Mr. MARRON. It is.

Chairman CONRAD. It is truly daunting. I hope that my colleagues understand how serious the situation is that we confront, because it is dire. The long-term circumstance that we confront is truly dire. Now, certainly, we are not in as bad of shape as Japan, debt-to-GDP. We are not in as serious of shape as parts of Western Europe that confront a debt crisis today. But it is very clear that we could, in very short order confront our own debt crisis, and the consequences to this country would be enormous.

I wish it weren't so. I wish it weren't so. But if you have studied the trend lines—Dr. Marron, you have, Dr. Johnson, you have, Dr. Reinhart, you have—if there is anything that jumps out at you is long-term. I am talking now 10 years and out. We are really facing, if we don't do something about it, consequences that could have enormous adverse impact on this nation's economy.

Do you agree with that statement, Dr. Marron?

Mr. MARRON. Oh, absolutely.

Chairman CONRAD. And what leads you to that conclusion? I just said something that in some circles is very controversial. Why do you think it is true?

Mr. MARRON. Well, and this is something I have relied a lot on the research by Carmen Reinhart and Ken Rogoff, that if you look at history, which is our best place to look, for examples of other countries that have experienced these things, getting on a path where the debt grows faster than the economy persistently, right, ends in tears. And it is something where we remain a very strong economy and a very strong nation that in principle can head this off and that that is a beneficial thing to do. You know, we haven't even covered all of the reasons. Carmen talked about how you have to worry that if interest rates go up, all of a sudden there is a snowballing effect and you find yourself in much worse circumstances than you imagined.

From the United States point of view, our ability to borrow is basically our rainy day fund and we have used it—it has been raining, right, so we have used up a lot of the rainy day fund and that is appropriate. But you need to walk that back down so that if something unforseen happens 8 years from now, you can go to the world capital markets again and say, by the way, I need $2 trillion because something terrible happened. And you lose that flexibility if you don't get on a more sustainable path.

Chairman CONRAD. All right. I have used my time.

Senator Sessions?

Senator SESSIONS. Dr. Marron, I agree with that last statement very strongly. In other words, there is only so much margin that you have before you are in a crisis and we are using that up today as if we are never going to be in another crisis. And I am a little disappointed that you seem to be going along with the idea that we can't begin to ask about spending now. I just do not believe that we can afford to throw another $270 billion of stimulus package when we got so little from the one that we have done. Dr. Johnson, you said you recommended $500 billion. Well, $845 is a good bit over $500 billion, in my view. So we have used this margin up.

I would just criticize the thinking during the Bush administration. It seemed to be, and this word leaked out, that deficits don't matter. That is what those of us who worried about——

Mr. MARRON. Not from me.

Senator SESSIONS. But it did, and one of the—Mr. Greenspan has talked about that, actually. But he didn't realize what was occurring politically and morally in the country. What was happening politically and morally was we were losing our discipline and people were buying into that language. Yes, we could have carried more debt than we were carrying in 2001, 2002, but once you lose your discipline, it just seemed like we just roared forward as if it didn't matter at all, and now we are reaching this level of debt above which we are really endangering our nation if we go above. I just am really worried about it.

And Dr. Marron, you mentioned one thing that is important, and I just need to put it on the table to economists—masters of the universe, I call them affectionately—who think they can just pull the strings to manipulate this massive international economy, and that is a lot of us and a lot of American people do not believe in a growing government, and you mentioned that in your remarks, about that question, and if we get a bigger government, how it ought to be. But I would just say a lot of us oppose that. We don't believe in that. So some modest containment of spending today is maybe not enough to satisfy my concerns.

Dr. Reinhart, you read commentators and the essence of a lot of things you see in financial magazines and newspapers and articles and all is a concern in the real world out there where people are buying and selling and loaning money is that this could lead to a devaluing of the currency and a surge in debt can lead to a difficulty as the Brits have had in selling their debt and could drive up interest rates and deflate the currency. As one man caught me after a speech last week when I was expressing concern about the debt, he said, well, we will just inflate our way out of it. That is what we always do, and don't worry about it.

Would you share with us any thoughts you have about the danger of that kind of thinking? Is that a danger?

Ms. REINHART. I think the danger that I tried to—I think there are two kinds of dangers that I would like to highlight. One is what I mentioned about perceptions of higher risk. That will translate into higher interest rates, which we are taking for granted the very low, near zero interest rates over which we can finance and we should not take that for granted. So we are on the same line.

I think the second risk that I would like to highlight, which I briefly mentioned in my remarks, is the growth. Even absent a gloom and doom scenario, one has to take very seriously that at high levels of debt—and we are close to gross debt being at that 90 percent threshold, we are very close to it—growth declines by about 1 percent. This is a fairly robust result. So lower potential output growth is, in and of itself, even absent a crisis scenario, a source of concern.

Let me add, though, that a weaker dollar would not hurt us. One of the things that has been a drag on this recovery from the crisis is if one looks at the typical recovery from such a crisis, exports in other episodes have led the way. We haven't had that benefit, in part because a good chunk of the rest of the world is also in crisis, and in part because the dollar has not really, relative to other experiences, budged.

So my concerns have to do with the interest rate, the risks, and with the growth. What happens to the dollar? Well, the dollar has been known to go up and to go down. That is less of a—there is less of a lesson there, as far as I can make it.

Senator SESSIONS. Dr. Johnson?

Mr. JOHNSON. Well, Senator, I think the situation in what we are calling the out-years is actually considerably worse than you might think for three reasons. First of all, I think that the debt numbers that we were discussing a moment ago are Federal Government debt, whereas if you look on a comparable basis across countries, the IMF usual procedure is to look at general government debt, which includes other levels of government, and that would increase the debt target, I think, in Dr. Marron's picture and push us closer toward the danger threshold identified by Professor Reinhart.

Second, there is, I think, almost a taboo subject around these issues which is Fannie Mae and Freddie Mac. Now, in the absence—again, let me speak as a former IMF official, what the IMF would say to you if the IMF were in a position to speak freely to the United States—they would say, well, unless you show us a plan for privatizing these entities, which you talk about, but we haven't seen the plan, we have to start thinking about these as liabilities of the U.S. Government. Now, that is a substantial increase. And, of course, they hold assets, right, and I wouldn't exaggerate the losses. But if you are talking about debt owed by the public sector, then Fannie and Freddie would enter into that picture.

And third, what I worry about most of all is——

Senator SESSIONS. So that is not being scored in the numbers that we are looking at today——

Mr. JOHNSON. It is not in the headline numbers. Obviously, the CBO can give you a number on that. That is not an unknown number. But it is not in the headline numbers and it is not, I think, in Dr.——

Senator SESSIONS. But when we talk about the tripling of the debt in the next 10 years based on the chart that the Senator showed earlier, that is not being scored? Is it or isn't it? Does anybody know?

Mr. MARRON. I mean, there is a small—in the official budget that the President put out, there is a small amount of money in there which are the future cash-flows from our support from the two of them. But the several trillion dollars' worth is not in the debt there.

Senator SESSIONS. All right.

Excuse me, Dr. Johnson.

Mr. JOHNSON. If I could finish, in exactly that vein, the "too big to fail" banks are also an implicit contingent liability of the U.S. Government, right, which is not—that is absolutely not scored in any way, because if those banks fail, they will come to you again and say, oh, we need TARP 2, Senator, and we will tell you later what we are going to use it for. That part—and in speaking of it, I understand this is usually considered part of the jurisdiction of the Budget Committee—the Banking Committee, and I did speak to them last Thursday, but I think this is a budget issue, too. A contingent liability of this magnitude—an avoidable one—I mean, these other—reforming Medicare, obviously, is a huge conversation, as you said, Senator. We have to discuss that and the tax base that people are going to generate to support paying for health care for people over 65.

But the contingent liability of the banking system is completely, largely avoidable if you take it on, and if you regard it as a budget matter, I think that is a major step in the right direction.

Senator SESSIONS. Dr. Marron? And before you proceed, I would like to welcome the same group of kids from Montgomery, Alabama. We are glad that this group could join us this morning.

Chairman CONRAD. Welcome.

Senator SESSIONS. As we are talking about things, Mr. Chairman, as you just said earlier, that affect how much debt they will have to pay as they grow up.

Go ahead.

Chairman CONRAD. If I could just interrupt for one moment, on this question of Fannie and Freddie, my understanding that the operations of those institutions are included in the CBO budget numbers now, but not in the OMB numbers. And Senator Gregg and I have made a determination that we would follow CBO. We would put them in our numbers, because we think that has got to be on budget. You can't say this is somewhere off in the wilderness, not accounted for. So we have made a determination that it would be included in the numbers that we have——

Senator SESSIONS. But that has not been in the past, or——

Chairman CONRAD. No. It was not in the past.

Senator SESSIONS. Thank you for that decision.

Mr. MARRON. And so just on the Fannie and Freddie, my understanding is that CBO's numbers—so they have, like, larger numbers in the deficit for the conservatorship, if you will, of Fannie and Freddie. But when you look at their publicly held debt numbers, they haven't suddenly gone up, whatever, $5 trillion yet, if I understand it correctly. So they have taken a step there, but they haven't gone quite as far as Dr. Johnson would suggest.

I wanted to go back to—the very beginning of your question, Senator, was about inflation and about the concern that our fiscal troubles might lead us to pursue inflation as a strategy for dealing with it. That is certainly a legitimate concern given what folks have done around the world in the past. I just want to point out that it won't actually work very well for the United States, the reasons being that, A, on the spending side, we have an enormous number of spending programs, Social Security being the most obvious, that are indexed, and that if inflation goes up, there is a one-for-one increase in our spending, and that is also true in many of the payment rates in Medicare and other programs.

And then, No. 2, increasingly, we have started issuing inflation-indexed debt. So it is probably smaller than it ought to be, but we have Treasury indexed protected securities whose interest rate will rise if inflation takes off.

And then, in addition, we have a decent portion of our debt that is relatively short-term, and so its value could go down for a couple of years because of surprise inflation, but then you have got to go out in the market and the market is going to charge you a premium interest rate and say, you know, you fooled us once, but this time we are going to charge you a much higher rate on your 3-year bonds.

And so for all those reasons, actually, in practical terms, right, inflation is not going to be an effective strategy, right, even though it may be a legitimate concern that some folks have.

Senator SESSIONS. Well, thank you. We do expect, according to CBO's score, interest on the debt last year, the public debt, was $187 billion and they are projecting in the tenth year of this budget an $800 billion annual interest payment. Interest rates, therefore, are hugely significant as to how much that would actually be in the out years. Thank you.

Chairman CONRAD. Thank you, Senator Sessions.

Senator Merkley?

Senator MERKLEY. Thank you very much, Mr. Chair.

Professor Reinhart, you note that Government debt tends to soar in the wake of a financial storm, and also that often that is as a result of a drop of revenue rather than spending on stimulus. Could the deficit that we incurred here in the United States have been even larger if we had not invested in building a financial bridge through the stimulus?

Ms. REINHART. One of the things about this situation, to answer you honestly, is we do not know what the counterfactual. We know that at the time in the fall of 2008, confidence, worldwide confidence, was shattered and that the stimulus package played an enormous role, not just the stimulus package in the United States, the stimulus packages that went into effect in different orders of magnitude, in restoring confidence. So it is very difficult, you pose a very difficult question for me to answer.

I do think that, absent the stimulus—I cannot quantify, I cannot give you a counterfactual. Absent the stimulus, it would have been worse. Our GDP decline relative to declines in other severe financial crises is smaller. Our unemployment increases are pretty much close to the average but are still below the average.

I would have to imagine that, given the magnitude of this crisis, which we have not seen the like since the 1930's, because of its global nature as well, absent those actions, we would not be below the average in growth declines and unemployment increases. We would be doing much worse.

Senator MERKLEY. So for me to restate that, although you cannot prove the counterfactual, it is possible we could have had the same levels of debt, but had no signs of the recovery that have been created partially by the stimulus, or that we might have even had lower levels of employment and had additional current-year deficits, which would be the worst of all cases.

Ms. REINHART. Which is why I tried to highlight the Japanese experience in that regard. Japan, in the mid-1990's, assuming that the crisis was over, withdrew stimulus, saw a double dip, and wound up with the worse of two worlds. It is important to remember Japan's debt, which today stands at about 200 percent, was around 70 percent of GDP before the crisis started, so they wound up with both.

Senator MERKLEY. Thank you.

Professor Johnson and Mr. Marron, would either of you like to comment on that same question?

Mr. JOHNSON. Yes. I would give the stimulus a very positive assessment. I am not a fan of stimulus in general, but I think this was a very unusual set of circumstances, and I think it saved jobs, and I think it prevented damage to potential output that you would have seen otherwise.

The crisis of confidence, when we met a year ago, was extraordinary. As Professor Reinhart said, it was global, it was everywhere. And the fiscal stimulus was an essential part of U.S. leadership in turning the world economy around. If you remember the G–20 summit in April where President Obama took a very positive broad role and brought a lot of countries with him, for example, in recapitalizing the IMF, that also helped to rebuild confidence. That would not have been possible or it would have been very hard and not credible without the U.S. Fiscal stimulus.

I do not think that debt necessarily would have been higher in the short term if we had not done the stimulus. But I think the medium-term prospects would have been much bleaker for this country. And let us face it. The medium-term budget issues which we face, these out-year budget deficits, are mostly—not entirely about Medicare, but mostly about Medicare, and that is a longstanding problem that we have not got around to addressing even though it has obviously in the cards for a while. That is mostly driven by demographics and by the rising cost of health care, itself driven by technological progress.

And I would say also in contrast to other countries, other industrialized countries are almost all in the same place. They just do not recognize it. The European Commission's accounting for future technological progress in health care is much less honest than the CBO's accounting. So we are looking very directly at our future, this bleakness of the future, getting growth back on track. Preventing the destruction of potential output is very important and helpful, so the stimulus was worth doing. And hopefully it will help us tackle those medium-term problems.

Senator MERKLEY. Please be very brief, because I have a bunch of other questions and I am running out of time.

Mr. MARRON. Sorry. I just wanted to say that with the standard models that, say, CBO uses or the administration uses to analyze the stimulus, those have in technical terms multipliers in them that would imply that stimulus does not pay for itself. And so the choice is you do end up with more debt, as Dr. Johnson suggested, but you also get the economic bang in the short run, and that there is a trade-off.

Senator MERKLEY. Thank you. And, Mr. Marron, you had noted that uncertainty is a problem. You mentioned resolving the status of the estate tax. What about the rules of the road in general? And I believe, Professor Johnson, you had noted that we still have not addressed credit default swaps, and, in general, we have not addressed proprietary trading, derivatives, leverage, and many of the risk factors that were inherent and kind of completing the trio here. Professor Reinhart, you noted that following banking crises there are profound declines in output. Certainly all that argues for having rules of the road for our financial community that do not result in high risk taking followed by a collapse. How important is it that we get the rules of the road back in place to address these risk issues within our financial structures? And anyone who would like to jump in on this, I would appreciate it. Yes?

Mr. JOHNSON. Senator, I think it is fundamentally essential because the problems that you just laid out, they are all wrapped up in what happens if there is another financial crisis, what happens if substantial financial players—it could be banks, it could be hedge funds, it could be something else—fail. How does that amplify it for our system? And then if it is a big enough shock, you will be called upon either to do a discretionary fiscal stimulus or to use, of course, the automatic stabilizers that are a good thing. But, again, it would mean our debt is increased.

The problems that you identify are fixable. They are not being fixed. They must be fixed from a responsible budgetary point of view. That is what I would argue.

Senator MERKLEY. And I believe in your testimony, your written testimony, you addressed at length issues in Europe and Greece and Germany and so forth, and the argument that the stress test we put our banks through has not been a highly—was not a high level of stress, if you will, and that if we do not prepare for that, we may have another wave of stress coming that could result in a second financial crisis. Is that a fair summary?

Mr. JOHNSON. Yes. My view is that our financial system is undercapitalized. The stress tests were not tough enough because the stress scenario was not that stressful. And I do not think we are facing at this point—my baseline view is we are not facing more financial collapses, but we are facing banks that do not have big buffers against future losses. They are going to hunker down and be more careful. You will see tighter credit conditions in the second half as a result of throughout the United States, and this is the global side. It is the commercial real estate impact, too; it is the continuing weakness in the consumer sector.

Senator MERKLEY. Thank you. I am not out of time, so I will leave it up to the Chair whether——

Chairman CONRAD. Senator Merkley, let me just say, because others have gone over and because of the attendance we have because of the weather, I think you should feel free to use another 2 or 2–1/2 minutes. Is that OK, Senator Whitehouse? I would do the same for you, obviously.

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

Mr. Marron, would you want to address that same issue?

Mr. MARRON. Certainly. The issue is that we need good rules, and, if possible, it would be good to get the good rules sooner rather than later so that everyone can begin to plan what the new environment looks like. So in my testimony, particularly in my written testimony, I emphasized that there are a lot of policy uncertainties that are hanging over people at the moment that make it difficult for them to plan. Some of them were, frankly, you know, in both the previous administration and the current one, that when we finally fell into this financial crisis, we fell back on a lot of discretionary government actions, a lot of confusion. There was confusion about what the role of TARP was and various other things.

Those may have been necessary in the heat of the moment, but they have created doubt about how we actually run parts of our system. And clarifying that, and then clarifying it in a way where incentives are being created for these firms to behave appropriately, is very important.

Senator MERKLEY. Let me throw out as my final question two issues that we face. One is the challenge in the commercial real estate world that will be coming up—well, it is here now, but it will continue the next year or two. And the second is undercapitalized community banks and their inability to do additional lending.

On the community bank side, I have proposed and the administration has proposed recapitalizing banks in order to enable them to do more lending to small businesses to enable those firms, the small businesses, to recharge the economy.

On the commercial real estate side, though, I have heard very few ideas for how we address the challenge of the fact that folks are rolling over balloon mortgages, but they are trying to do so with a drop in the value of their asset and often decreased cashflows due to tenants who they have lost during this recession.

So should we pursue strengthening our community banks to lend more to small businesses? And what can we do about commercial real estate?

Ms. REINHART. Let me say that the issue of recapitalization, I think helping banks recapitalize should come with a carrot-and-stick approach. One of the concerns that I have about the way that we have gone about addressing the toxic loans is that it is too Japanese, meaning there is too much forbearance. I think the forbearance issue is very pertinent for lending behavior going forward. If you feel you have a lot of bad debt overhang, it will be reflected in your lending practices. That is a lesson that I have taken from the very long Japanese experience.

So I think the idea of helping the banks that lend to small businesses recapitalize, with a proviso toward more aggressive writedowns, is important.

Senator MERKLEY. Thank you.

Commercial real estate, small bank lending?

Mr. JOHNSON. I think that commercial real estate should be left to sort itself out. Honestly, I think it is very hard for the Government to get involved terrorism.

I am sympathetic to this idea of trying to recapitalize the community banks. I think what Professor Reinhart said makes a lot of sense. It will be difficult because the banks will worry about the stigma, and they will worry about what the signal is they are sending if they take more capital. I would be surprised if you can do it, run a program big enough to have a macroeconomic impact, unfortunately.

Senator MERKLEY. Thank you. A final comment?

Mr. MARRON. Oh, I would just say, just building on the uncertainty point, another issue for the community banks will be to what extent there are strings attached with the assistance, both known up front and then possibly, you know, future ones that are difficult to predict. And that also may discourage them.

Senator MERKLEY. Thank you all very much.

Chairman CONRAD. Thank you, Senator Merkley. Excellent questions and very interesting responses.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Chairman, and thank you to the witnesses for being here on this challenging day for travel in Washington.

We are sort of caught between the scissor blades here of, on the one hand, wanting to support the economy so that people are employed and that we can begin to have the nascent recovery we are seeing work for everybody and not just financiers, but have it hit Main Street; and, on the other hand, having this overhang of debt that has sort of dominated our discussion today.

It strikes me that where we have very significantly degraded core infrastructure—in Rhode Island, for instance, we have a bridge through one of our major cities, through Pawtucket. It carries Highway 95, a major national artery, and it is under a weight restriction so that big trucks have to actually take a circuitous route around it. That is going to have to be fixed sooner or later. We cannot have that. It is getting worse, not better. There is a bypass in Providence that the Department of Transportation is refusing to put any more maintenance money into because it is so degraded. It needs to be replaced. But local budgets are so stressed that it is very hard for people to get those jobs done.

Does it make sense to focus under the old-fashioned theories of, you know, if you are going to have to fix it anyway, it is not really adding to your debt, and the proverbial stitch in time saves nine, when you do maintenance more quickly, it tends to reduce the overall or ultimate cost, to focus particularly intently on degraded infrastructure that is going to have to be repaired sooner or later anyway as a way to increase employment without adding to the Nation's overall actually liabilities? Dr. Reinhart?

Ms. REINHART. Let me say that the remarks I am going to make have to be taken with a grain of salt because they are weighed heavily with the experience of one country.

Infrastructure spending was at the forefront of the Japanese stimulus plan. The streets of Tokyo were repaved every other week, and it does add to the debt.

Senator WHITEHOUSE. Well, let me just challenge you right there, because the streets of Tokyo do not have to be repaved every other week.

Ms. REINHART. Right.

Senator WHITEHOUSE. If you are creating make-work, if you are building bridges to nowhere, clearly that is, to me, a different proposition. That is why I focused so much on things that you have to fix anyway. If my roof has a hole in it and the rain comes in, the sooner I fix that, the less my family's long-term cost of that repair. If at the same time my son also needs to make some money for the summer, to send him up to do that now would seem to make a lot of sense. Why doesn't that sort of simple wisdom prevail—or does it—when you are dealing with truly irreplaceable, necessary infrastructure work like bridges that are condemned?

Ms. REINHART. Well, if we are talking about things that need to be replaced is a subset of the more general proposition of infrastructure as a way to go forward in terms of channeling, which is what my remarks were addressing. I think, however, that in the end, anything—be it infrastructure or be it a transfer, it does impact debts. I cannot discriminate across types of—they add debt. But if this is the——

Senator WHITEHOUSE. But don't we have, in effect, a capital liability to fix that bridge, that if we were accounting in a full kind of all-in way, we would recognize some way? I mean, if I were budgeting and it was my house and I had a hole in the roof and I had to put together a family budget, I would put in got to fix that hole in the roof sometime, and whatever it costs, if I am doing a fair family budget, I would put it in, even if it was 5 years or 10 years, if I figured I could not afford it right away and had to put something, you know, to cover it in the meantime.

Ms. REINHART. I understand and I take your point. I would just add that we really should go toward—and looking at any activity as activities that do have debt consequences over the short run.

Senator WHITEHOUSE. Well, since I have used a lot of time on that question, I would like to shift to another one. Since it is just the two of us, if you do not mind, I will take——

Chairman CONRAD. No, I will give you some additional time. I think you were on a very——

Senator WHITEHOUSE. I have two eager hands up, so let us give both gentlemen a chance.

Mr. JOHNSON. Very quick points. First of all, as a way to score the economy, I would look at the CBO's scoring, and I would look at the advantages of payroll taxes over infrastructure spending.

Second, I think your points about having a proper capital budget are essentially right. We should do that. And one way to think about it in the context of the specific instances you are talking about is toll roads and tolls. So as Dr. Marron said, we should be discouraging with our tax system things that are bad, like congestion on major roads. And as somebody who uses, is a willing and happy user of an EZ-Pass scan tag on my car, if you move—and I understand this is not all a Federal Government issue. But if you move people toward a system where people are paying to use roads, paying to use very busy roads, paying to use roads that are more expensive to maintain, that will help address your issue; that will help raise revenue for the specific issues which are much broader than just Rhode Island, obviously infrastructure decaying.

Mr. MARRON. I would just add that—so I agree with you entirely on the theory, which is if you can identify things you would have done anyway and move them up, that is almost—you know, that is incredibly logical stimulus. But there were some if's in there. The first would be, you know, do you have budget discipline that says, wow, if I spend an extra $1 million today I literally will commit myself to spending $1 million less in 2013? You know how highway funding works. That is a hard discipline to institute. But, in principle, you could do that.

The second concern is that in our political system—I do not want to be—this is the mean, flippant version, right? The mean, flippant version would be suppose there are 50 projects like that, but our system requires us to fund 435. So that the theory you have described may be true for a handful of projects, but it is difficult for our system to focus the money just on those.

Senator WHITEHOUSE. The theory is true, but the politics around it make it hard to adhere to the discipline.

Mr. MARRON. Yes.

Senator WHITEHOUSE. OK. Let me jump to health care quickly because, Dr. Johnson, you have said twice that Medicare is the big item, and——

Mr. JOHNSON. Well, it is the Congressional Budget Office that says that.

Senator WHITEHOUSE. I am not disagreeing with you, and I just think it is very important that we look at that. This is an eternal point that I keep insisting on making. Medicare is the big item, to quote you, Dr. Johnson. According to a variety of different sources, the amount of waste, duplication, excess cost, and inefficiency in the health care system runs between $700 billion and $1 trillion a year. We have ways to get at that. But as CBO has testified to us, they require a certain amount of flexibility, experimentation. There is a continuing executive management problem to work your way through that, and it requires providing the executive branch with some new tools. But I happen to believe that very, very significant savings can be achieved that way, and when they are achieved that way, they are achieved in a beneficial way, because it is the extra test that you did not, in fact, need. It is the, you know, hours in the hospital waiting for your paper records to get there and having tests redone in an emergency. It is all of the clutter and all of the clunkiness of our existing health care system.

What I worry very much about is that if we get into a fiscal commission, a statutory commission, and it gets very narrow and it is given a really urgent charge—because this is an urgent problem—if you do not have people who understand the possibilities of taking advantage of those efficiency gains in the health care system—and they are hard to quantify. CBO cannot quantify them effectively. They sort of quantify dribs and drabs around the corners. But they will admit it is not the kind of thing you can quantify because it requires executive administration to make it succeed, and they cannot predict executive administration.

But it really worries me that what we are laying out is an incredibly easy shortcut for fiscal hawks to take hold of this thing and say, "I can document that we will have real savings in the Medicare system if we just throw these people off the system." And the pressure to do that becomes irresistible because we have whipped up this great panic about the debt and we have given people who only understand those tools the controls over this expedited, high-powered system. And I think that would be a terrible, terrible, terrible mistake when you look at a system that is as wasteful and as complicated and as grotesque, where doctors are paid for doing more procedures rather than for outcomes—I mean, every way you look at it, our system is, well, somewhere between $700 billion and $1 trillion a year in waste and excess cost.

How do you go at that in the timeframe—let us say it takes 4 to 5 years to really build out an effective way of dealing with that. How would you relate that into the urgency of dealing with our fiscal debt given the primacy of the Medicare problem in that fiscal debt equation?

Mr. JOHNSON. Well, Senator, I do not disagree with anything you have said. I think we have time. The fiscal situation that we are worried about here, as a number of you have said already, is something that approaches us over the next decade or decade and a half. But we are fortunate, and we should look at the countries in Europe that are now beset by pressing crises, for example, in the United Kingdom. They do not have a decade or a decade and a half. So I would strongly support your proposal that we find ways to control the costs and manage Medicare better.

I would point out——

Senator WHITEHOUSE. Is there any doubt that the efficiency gain could be somewhere between $700 billion to $1 trillion a year if we could get it all out? Obviously, there are problems of gaining it, but——

Mr. JOHNSON. I am not an expert on the details of Medicare, so I would not want to comment on that. I would go——

Senator WHITEHOUSE. Well, it is systemwide. That is not just Medicare.

Mr. JOHNSON. I do not have sufficient expertise, but it would make sense to me that some process of rationalization there would make sense. Also, I am sorry that your colleagues have left, but passing an unfunded prescription medicine component for Medicare under the Bush administration was most unfortunate in this context. And, you know, there are going to be some very tough choices about who gets access to what kind of care.

As I said, the big difference between our projections and the European projections is the expected cost of technological change for treating patients, which has been very much the same across the U.S. and other industrialized countries. We are more honest about looking out in the future and saying we expect for something of the same. The Europeans only take into account their demographic changes.

So there are very tough choices ahead, and I am not on the size of saying throw people off Medicare. I think that would be completely objectionable and unacceptable. But it is a budget issue that we cannot duck forever.

Senator WHITEHOUSE. I have gone well over the time that even the Chairman allowed me, and I thank him for his courtesy.

Chairman CONRAD. Let me just say to the gentleman from Rhode Island, I believe the risk is just the flip of what you see. I believe the risk to Medicare and Social Security recipients is a failure to act in a timely way to deal with the long-term debt trajectory that virtually every expert that has come before this Committee says is unsustainable. That is, as I look ahead—and, you know, I am a beneficiary of Social Security. I lost my parents when I was young. Social Security helped me through college. I have seen it in the lives of my family. I have seen Medicare in the lives of my family. And I have seen it in the lives of my constituents.

My great fear, for the very positive things that those programs do, is that our failure to act to deal with the long-term trajectory is what really threatens them. That is my belief.

Senator WHITEHOUSE. Mr. Chairman, I could not agree with you more, and I think that we have a window of time, as the witnesses have said—we are fortunate. We have a window of time to address this. The wolf is not fully at the door right now. The fiscal knives do not have to come out in the kind of emergency ways that you are suggesting they will have to if we do not get ahead of this. And it is one of the reasons that watching this health care bill be delayed and strung out and attacked and that we have lost an entire year of this administration already before we can really deal with this is so agonizing for me. Because I do think that while we are in this window, we should be focusing relentlessly on that delivery system reform area while we can, because that is the tool that evaporates as the emergency gets closer. The fiscal knives will always be there. You can always throw people off programs. You can always shut programs down. It would be a human tragedy to do so, and we can avoid it if we are responsible about delivery system reform in the time that we now have.

Chairman CONRAD. Well, I agree with the gentleman, that, for some reason, delivery system reform got almost no attention in this debate on health care, and yet every serious expert that came before us told us it is the single most important thing. And, frankly, I think the media have done a grave disservice to the American people for getting distracted—chasing every rabbit of an issue that matters very little to dealing with what has to be done. I largely point the finger of blame on network media that have a minute and a half for a story and never have a chance to explain to people what are the things that really matter to this debate. Instead, they obsess on things that are complete side issues. And I think that has been an enormous disservice to the American people.

I would also blame ourselves for not doing a good job of coming back to what really matters. And it is that delivery system reform that every serious expert that came before us said is the No. 1 opportunity to get costs under control. But it is almost nowhere in the debate, almost nowhere. Instead it is death panels and things that do not even exist that get the attention.

Let me, if I could, go back to the question of where we are. Dr. Reinhart, you testified that once you get to a debt of 90 percent of GDP, your research shows that that has an adverse effect then on economic growth of roughly 1 percent. Is that correct?

Ms. REINHART. That is correct.

Chairman CONRAD. My calculus tells me that me that this year we will hit gross debt to GDP of just over 90 percent. And if we stay on the path we are on, that will continue to rise, with no policy changes—no policy changes—to 97 percent in 2012 and then start coming down only very, very gradually—very gradually, almost imperceptibly.

So that tells me that, according to your research, we already face a consequence of reduced economic growth in the future because of debt levels today. Would that be a correct interpretation of your testimony?

Ms. REINHART. That would be a correct interpretation. I tried to highlight in my remarks and in my written statement that while the plan should not necessarily start today because of weakness in economic activity, a conception of a clear plan to reduce the debt would be or should be forthcoming today. Let me say one thing we can say with a fair amount of certainty. We never know when the wolf will beat down our door. The wolf is very fickle and markets can turn very quickly. And a high debt level makes us very vulnerable to shifts in sentiments that we cannot predict.

Chairman CONRAD. I thank you for that. Let me just say, what I have heard the three of you say—and I will get to you, Dr. Johnson, just momentarily—what I have heard from each one of you very clearly is that you would not take immediate steps to reduce deficits and debt because of the risk that could create to a double-dip. But what I also have heard each of you say is that you do have to put together a credible long-term plan to deal with the debt threat. And, if we do not, that will fundamentally threaten the economic security of the country going forward. Is that a correct restatement of the testimony here? If anybody disagrees with any part of that—Dr. Johnson?

Mr. JOHNSON. If I could just clarify, my position would be, following what I think is the IMF practices, the focus on net government debt, or the general government, which the numbers would be slightly lower than your numbers, but——

Chairman CONRAD. Yes. When I talk gross debt—we probably should just say that for people that might be listening. When I talk about gross debt, I am talking about the debt that is owed to the public plus the debt that is owed to the various trust funds of the United States. I use that figure of gross debt because, in a budget context, that is what matters the most, because all of that debt has to be serviced. It has to be serviced out of current income.

Economists like to look at what is called publicly held debt, which is a lower percentage, in the 60 percent range now of GDP, because they look at the effect of government borrowing on the public sector. Dr. Johnson?

Mr. JOHNSON. Well, 60 percent is the Federal Government number. If we are again on a comparable basis, general government would push it higher, toward 80 percent. The IMF position is that all industrialized countries face a similar situation and require a fiscal adjustment either of taxes or revenue between four and 8 percentage points of GDP over the medium term. That is my position, also, which I think is not at all inconsistent with the spirit of what you are saying.

Chairman CONRAD. Yes, and that is the position—I can't speak for Senator Gregg, but he and I have gone on this effort to have a commission, because we have been convinced you have got to have an overall plan for the longer term, and one that takes account of where we are headed in recognition that Dr. Reinhart's research is accurate, that as you add debt, you fundamentally weaken economic growth.

Let me go to the next point, if I can, and we are going to come back. Senator Cardin has joined us, and I will stop and recognize him next because he has not had a round.

As we look ahead to this medium- and long-term plan, spending has got to be adjusted, and yes, that means Social Security and Medicare have to get on a lower growth trend. It has to be, because that is where most of the spending is. And I also think the revenue side can't be exempt because we now have the lowest revenue—right today, we have the lowest revenue as a share of the Gross Domestic Product in 60 years. We have the highest spending as a share of GDP in 60 years. So we have got the lowest revenue as a share of the economy in 60 years, the highest spending as a share of GDP in 60 years. I don't know of any logical reason that you don't have to deal with both sides of the equation.

But then it goes to the question as to what should the balance be, and I would like each one of you to answer this question. Going forward, in the longer term, should most of the emphasis be on the spending side? Should most of the emphasis be on the revenue side? Or what do you think the appropriate balance should be between spending and revenue, contributions to dealing with this long-term debt? Dr. Reinhart?

Ms. REINHART. I think both the spending and the revenue side have to be addressed. I had mentioned in my earlier remarks that looking at actually what Canada did would be useful, and no stone was left unturned. From decisions that involved unemployment insurance to decisions that involved retirement age, everything—and, of course, on the revenue side, as well. When one is dealing with the gaps that we are dealing with right now, even extracting from the cyclical component that is obviously very big right now, you cannot leave any stone unturned.

Chairman CONRAD. Dr. Johnson?

Mr. JOHNSON. Well, as we have been discussing, unless, as you just said, Senator, unless you bend the curve for Medicare, unless you change that growth rate, that swamps everything, OK. So that is first and foremost.

Chairman CONRAD. That is the 800-pound gorilla.

Mr. JOHNSON. Absolutely, and it is a very unfortunate thing and it is more about—perhaps more about ethics than economics to decide what to do there. That is a very hard social conversation.

On the taxes, though, I think we also have to address it. I mean, honestly, this is a fantastic country. The hope for our nation is based on a very thin and small fragile tax base. If the United States wants to be one of the leading powers in the world, I don't see any alternative but tax reform. And in this context, I would emphasize what Dr. Marron said before, which is we don't—our tax reform kind of grew in a very particular history. We have not redesigned it in a long time and not tried to think about what do we tax to discourage, rather than taxing income, which we actually want people to go out and earn.

And I think we have to address in this context the low private savings rate in the United States. We have built a system in which people don't feel that they should save, and this is clearly a counterpart to our foreign borrowing. One thing is our budget deficit. The other thing, which we haven't talked about today, is that we finance so much of that budget deficit not with private savings, which is what they do in Japan, but by borrowing from China and essentially from the Chinese government. That makes no sense at all in geostrategic terms.

And even if you address—even if we come up with a strong medium-term fiscal framework, you have still got the current account issue. You have still got the low private sector savings. Tax reform, fundamental tax reform to be addressed by your fiscal commission, strikes me as inescapable unless you wish the United States to slip into the ranks of second-rate powers, which, of course, has happened to other countries many times in the past.

Chairman CONRAD. I couldn't agree with you more. I think if this fiscal commission does its work, one part of it should be fundamental tax reform. We have a tax system that is inefficient, and by that I mean a high percentage of what is owed is not being paid. We have incredible leakage through offshore tax havens. If anybody doubts it, go punch in "offshore tax havens," see what you get. Just Google that and see what you get.

We also have a tax system that was never designed for the period we are in. It was designed when America was completely dominant in the world, and we did not have to worry about our competitive position. And we have a tax system that now disincentivizes savings, therefore disincentivizes investment, and if you don't have investment, you can't grow. I mean, it is almost an upside-down system given the circumstance that we are in today.

Dr. Marron?

Mr. MARRON. Thanks. So the first point, which I think the members of this committee will appreciate, is a geeky budget process one in answer to your question of where should the emphasis be, on taxes or on spending, which is we are actually in a situation where it is going to be difficult to have an intelligent conversation about that because of the disparity of views as to what the baseline is, and that there is one view of the baseline that has various tax provisions expired and definitely there is another view of the baseline that has them all notexpiring. As you saw in CBO's recent report, if you add all of them up, the difference is almost 3 percentage points of GDP in 2012.

And so I am not going to have an answer for you, which one is wrong. I am just going to say, politically, that is going to be a hard conversation to have kind of intelligently because people will differ in what they choose.

In terms of substance, the basic story is once the economy is on a recovery path, what happens every year is spending makes our situation worse because it grows faster than the economy and tax revenues make our situation better because they grow faster than the economy. And so it has to be the case that spending is going to get more of the emphasis than the revenue side, just because they are growing faster and that they are the thing that is causing the challenges.

However, if you look ahead and ask yourself, you know, can we go back to a historical 18 percent of GDP tax level and finance the types of things that our government, you know, our society appears to want our government to do, my answer to that is no, right, that the arithmetic doesn't add up, and that finding a way to raise more tax revenues in the future seems inevitable given the trajectory that we are on.

And then I am right back with my colleagues here in just saying that if you are going to do that, scaling up our existing tax system is not an intelligent way to do that, and that as you just described, what you want to do is go revisit it and ask what tax system makes sense for the economy we have today if we have decided that instead of 18 percent we are going to raise 20 percent or whatever of GDP in tax revenues.

Chairman CONRAD. Senator Cardin?

Senator CARDIN. Well, Mr. Chairman, let me thank you for calling this hearing. I think this discussion is critically important to our committee and to our country, so thank you for doing this. I welcome all three of our witnesses, particularly Dr. Reinhart from the University of Maryland. It is nice to have you here. I thank all three of you for your testimony and for focusing on how we can get our economy back on track with the amount of debt that we have incurred. But the bottom line is, what are we doing about the standard of living for the American people?

I know we can't rewrite what happened in the past, Mr. Chairman, but we need to understand and learn from our mistakes. I find it inexcusable that when we had a growing economy, we still allowed the debt to increase. There was no excuse for cutting taxes and increasing spending without paying for it when we had a booming economy.

Dr. Johnson made a point about savings—when our economy was performing the strongest in the world, by far, when we were leading on every good economic indicator during the 1990's and into the 2000's, our savings ratios during that time were among the worst of the industrial nations of the world. Unfortunately, we said, oh, that is OK. We don't have to worry about saving; because Americans are actually saving because the value of their homes is increasing by such a dramatic amount. Then we found out what happened to the values of their homes.

So we really need to learn from the mistakes that we made when our economy was growing: the mismanagement of our debt and the failure to enact policies that encourage savings. Many of us, including the Chairman, tried during that period. I am proud of the work I did in the House with Congressman Portman to focus on policies that would increase our national savings. Congress didn't do as much as we should have.

Now, we are in a recession, when it is difficult to get attention to reducing debt, cutting spending, or increasing taxes. It is even difficult to develop policies for Americans to save because we want Americans to spend during a recession.

So my concern is that as we look at how to deal with the national debt, and the Chairman's commission is by far one of the most credible proposals, I am concerned that the focus may be short-term rather than on long-term, because we are in a recession, so we need to grow. We need to create jobs and we need to spend and we need to make taxes less burdensome in a recession, but that may not be in America's best long-term interest. It certainly is not if it allows the debt to increase, and if we don't deal with issues that the Chairman raised about a tax policy that encourages savings.

My friend, Senator Whitehouse, raised the issue of health care in this context. The good news about the bills that passed both the House and the Senate is that their two principal goals are to reduce the growth rate of health care costs in America, and at the same time to reduce the Federal Government's budget costs.

My concern is that if we look at health care costs solely in light of the Federal Government's budget exposure, and say that we have succeeded if we can reduce entitlement costs to the Federal Government, but we don't look at how much seniors might be asked to pay, how much businesses might be asked to pay, or what individual workers are going to be asked to pay, at the end of the day, we might, in fact, be weakening our economy. We may be strengthening the Federal Government's budget commitment as far as reducing its costs, but we would be reducing our economy, certainly reducing the standard of living for the American people.

So I am concerned as to how we focus today in a recession on reducing our debt. We are all saying the right things. We want to bring the debt down. We want to increase national savings. We certainly want to increase the standard of living for the American people. But if we tunnel vision this health care debate into the Federal budget and don't look at health care costs as growing rate, I think, long-term, we are doing a major disservice to the people of our country.

So how do you put this in context? How do you deal with the current recession? How do you deal with the current crisis that Americans are facing and still allow our economy to grow and to deal realistically with the problems that Americans are facing, whether it's the small business owners trying to maintain health insurance for their employees or the seniors struggling to decide whether they can afford their medicines, or workers finding themselves falling further and further behind when they look at their paychecks.

They are wondering what happened during this prosperous time when America grew and why they should trust us now to get this right when government didn't act responsibly when the economy was growing.

Any advice you have for us? Dr. Johnson?

Mr. JOHNSON. Senator, my view is that if you create the fiscal commission with everything on the table, both the spending side and the tax side, and people regard that as being a credible step forward, which I think they would if it came with the right legislative framework, that gives you the scope in the short term to take measures that will help the standard of living——

Senator CARDIN. If the commission's charge is to deal with the Federal budget deficits, which is its charge, and if we are in a recession when this commission is required to issue its ruling, how does it overcome those two major obstacles to the long-term issues that you raised regarding our tax code, for example?

Mr. JOHNSON. Well, the good thing about being the United States, in our current position in the world, and, in fact, we have the only reserve currency, really, at this point, particularly given the problems we have been discussing in the Euro zone—the Euro is seriously under pressure from a broader point of view where the countries want to hold their reserves—this gives us time. It means, to go back to the Chairman's math, we will be able to run up more debt. The markets will let us do that at lower interest rates than they would otherwise. This buys us time to tackle the medium-term issues around health care spending, around Social Security, and around a sustainable tax base, which I think we are agreeing is about tax reform.

So we have 10 years or 15 years, maybe if you push it we have 20 years to confront those issues. The fiscal commission's mandate, I think, would not be slash the budget deficit now, because that won't help our economy. It will be, get the medium-term budget onto a sustainable basis, take the debt off this explosive path, according to the CBO projections, and if people feel that you are moving in that direction, then the markets will allow us to finance a greater budget deficit. You will be able to spend money on various——

Senator CARDIN. I am not sure we have other options. I am not challenging that. I am not sure there are any better suggestions that have been made than the Chairman's suggestion, quite frankly. So I am not sure there is a better suggestion.

All I can tell you is a lot of us worked on savings issues, and we didn't have a lot of support out there to do things to bolster national savings. We got some things done, relatively minor things when you look at the overall problems we had as a nation, and it wasn't easy getting that done. I just hope that the political will will be there to deal with some of the fundamental issues that have been raised here.

We shouldn't be talking about how much revenue we want to raise, but how we want to raise it. I believe that our tax code really does need major revisions. We need to rely more on consumption-based revenues than income-based revenues and we have to do it in a progressive way. So I will be interested to see whether the type of political support exists for that—Dr. Reinhart?

Ms. REINHART. I would like to address the issue you raised that in good times, our policies have tended to be procyclical. Namely, in good times, the government—there are two things the government can do. One is it can save during good times directly, and then it can create incentives for the private sector to save. During the last boom, we didn't really do either. I think the role of the commission to ensure that during boom periods we don't congratulate ourselves too much—the seeds of the next crisis are sown during the boom. That is when overspending has historically tended to take place.

I do completely agree that—which as I said earlier, no stone left unturned—that the tax code particularly—this is also Simon Johnson's point that we need to address the issue of low savings rates and dependence on borrowing from abroad as part of the medium-term issue.

One very last comment I have to say is I don't know that we do have ten, 15, or 20 years. We just don't know. And so the sooner that we can articulate a plan—you raised the issue of uncertainty. People today, if the debt is perceived to be growing out of bounds, that will create uncertainty not only about future investment, but what people expect as to future benefits. And so a credible plan cannot be articulated too soon.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. I would just say this to my colleagues. I have just gone through an exercise to get the deficit down to 3 percent of GDP by the fifth year of the budget period and to balance by the end of a 10-year budget window. I have just gone through that exercise. I ask all my colleagues to go through that exercise before we get into our budget negotiations. I think you will find it as sobering as I have. I think you will find it as sobering as I have, what it really takes in 10 years to get to balance on a very modest downward trajectory of deficits and debt to GDP. It is very sobering.

Let me go to the question of political will. What is going to be necessary to get this under control, and that means to get back down to 60 percent of GDP on a publicly held basis. That is very, very sobering.

Senator Sessions?

Senator SESSIONS. That was an insightful challenge to us, Mr. Chairman. I think you are correct. I would just share a few thoughts, that the tension is—I think we have too light a treatment to the need to contain wasteful spending now, that is not producing much for the economy. The $800 billion, I mean, was Medicaid, welfare, many things that may need to be strengthened, but the extent of it was so great that we haven't had enough emphasis on job creation which will pull us out of this, I think.

And I would just ask you to think about how will we pay back $800 billion? I mean, the organization proposed at the State of the Union saving $15 billion this year and that might amount to $250 billion over 10 years. That is a lot less than $800 billion. And now we are talking about another $200-plus-billion stimulus package.

So, I mean, these numbers are so large, you are just not going to be able to spend today unlimitedly. We will pay this back, one way or the other. It is going to be a burden. My Democratic colleagues have got to recognize, we just can't ignore the year we are in and the next year as if we are in this severe recession, therefore, all the rules don't apply. The money we borrow is going to be a burden on us. It will be a burden on us.

Dr. Reinhart, I would like to followup with your comments and that of the Chairman about the amount of the debt that we have and the question—maybe all of you discussed it generally—between the internal debt and the public debt. Would you not agree that 30 years ago, 20 years ago, there was a bigger difference than there is today because we did not see quite the dramatic actuarial unsoundness of our entitlement programs. Now that we see those programs are actuarially unsound and we are going to have to call the debt that they loaned to the government for discretionary spending, any addition to the internal debt really is, for anybody analyzing the soundness of the United States financial condition would consider the internal debt too.

Did I make that clear? In the debate over health care, the President asserted, I believe, this plan in 10 years would have a $130 billion surplus, but that was not true, really, and CBO eventually made that quite clear, because it created about a $300 billion surplus in the Medicaid account, but it spent it on a new plan. And they didn't score the internal debt going back to the Medicare Trust Fund. It is a reality. And since Medicare is clearly heading to default and will call that debt pretty soon, it seems to me we have got to understand that this is not—the reality of the internal debt is more significant than it may have been when Lyndon Johnson first started doing this.

Would you comment on that and if you think it is significant?

Ms. REINHART. Well, I certainly think it is significant in a major way. The work that I have done emphasizes gross Federal debt. Ultimately, we feel that it is ultimately the Federal Government, whether the debt is held by other branches of Government or by the public, that we care about. I would say about gross—even using gross Federal debt, that it does not take into account all these important liabilities, hidden debts that are associated with our Social Security system and all other implicit guarantees even outside our Social Security system, such as Simon Johnson mentioned, Fannie Mae and Freddie Mac. But——

Senator SESSIONS. But your gross debt that you figure does include the internal debt that the Treasury owes to Medicare and Social Security?

Ms. REINHART. Partially. Partially.

Senator SESSIONS. But not totally.

Ms. REINHART. Not totally. Partially.

Senator SESSIONS. And for us who are worrying about the health of the American economy, you think we should consider the gross debt more than just the public debt?

Ms. REINHART. I think that when one looks at the debt issue, we are going to be looking at very different measures of debt. I would start out with gross debt, but I would not end with gross debt. I think to take into account medium-term debt sustainability, a lot of these other hidden debts need quantification along the way. It just so happens that gross debt is something that we can measure more readily and more transparently than some of these other explicit or implicit liabilities that we have.

Chairman CONRAD. Senator Sessions, would you allow me just to interject on this point?

Senator SESSIONS. Yes, please.

Chairman CONRAD. Because for those who are listening, I think it is a hugely important point that you are making. The publicly held debt—that is, the money that we have borrowed from the public—is at 60 percent of GDP today. The gross debt is at 90 percent. The difference is the gross debt that you are referring to includes the money that we owe to the trust funds of Social Security and Medicare. I think for people who are watching, this is always confusing. And it is important so that they understand the gross debt. The reason you are focused on it, I am focused on it, is because all the debt has to be repaid. And from a budget standpoint, debt can only be paid out of current income. By definition, the only money we have to pay this debt to Social Security has to come out of current income.

So there is a real budget consequence when those trust funds that have been producing more money than was needed all of a sudden flip and now all of a sudden they are spending more money in Social Security and Medicare than is coming in, trust fund income. And that has happened to both those programs today. Both of them are cash negative today. That is why I want to pivot—I am sorry for interrupting you.

Senator SESSIONS. No, I could not agree more.

Chairman CONRAD. But it is so important that our colleagues understand the implications of this.

Senator SESSIONS. When I came here, I kind of acquiesced into the idea that public debt, well, we will just argue over it as a base, the public debt, and use those numbers. But as I have come to realize, the actuarial unsoundness of Medicare and Social Security, you really cannot do that.

Of course, they do show up, Mr. Chairman, as you know, to be fair. They are showing up on the surge of the public debt's increase as these bonds that the Treasury executes t these trust funds are called. That is one of the reasons, is it not—Mr. Marron, you have been at CBO. That is one of the reasons the public debt is moving as dramatically as it is.

Mr. MARRON. Right. I mean the debt is subject to a limit.

Senator SESSIONS. So it is beginning to move and transfer. We are having less and less internal debt, I assume because it is being converted to public debt, inevitably, as we go forward, because there is not enough money to fund Social Security and Medicare without calling the bonds that are out there.

I just would say that any—maybe you would—my time is about up, so if any of the two of you who have not commented, I wish you would.

Mr. MARRON. OK. Just a couple thoughts. So you notice whenever I speak of the debt I always focus on the publicly held debt, which is kind of the notion of debt that we need to go place with world capital markets to finance ourselves. And it is not because I do not worry about the other ones. It is just that I worry that when you are worried about the other issues, actually the gross debt understates the scope of the problem from those programs, that we have raised money for Social Security and to a much lesser extent for a part of Medicare and labeled them as trust funds for budget accounting, and adding those us we can have a larger measure of debt.

But if you take seriously the commitments that we seem to have made, say, for Medicare, for the other parts of it that are not covered by a trust fund, you know, you have seen these numbers millions of times. People come in with the $40 trillion number and the $60 trillion number, and just these gigantic numbers, which are an attempt to measure what the overall kind of commitment is. I will not call it a debt because, obviously, we can dial it up and down—hopefully down at some point in the future. But I think even the gross debt understates just how severe the trajectory is that we are on.

Senator SESSIONS. Understates it. Do you agree with that, Dr. Johnson?

Mr. JOHNSON. Yes, I think that Dr. Marron said it very well. In addition, the contingent liabilities, which we know are there, and as Professor Reinhart said, that does not fit our standard methodology. But if we have one or two more crises, we will be changing the methodology to recognize that explicitly. And I think it is right. Do not think of the gross debt as the full extent of our problem. Focus on the—I would focus, as you said, on the publicly held debt for what you have to sell and what you have to find what the market will or will not buy, and then you have to look at the projections going forward, including the contingent liabilities and the scenarios around that.

Senator SESSIONS. Briefly, the uncertainty that Dr. Marron and others have mentioned, I believe a lot of that throughout the entire economy, throughout the entire financial world, is the concern over the debt, and would you not agree that it creates a cloud over economic growth and productivity, psychologically as well as otherwise, and that the sooner we get a clear path out of this fix we are in, the better it will be to restart economic growth?

Ms. REINHART. I think one of the scenarios that I alluded to earlier is one in which if there is no plan for containing debt and deficits medium term, I think uncertainty is a factor why we get the results that we get that higher debt levels are associated——

Senator SESSIONS. So you are factoring that in your scores to some degree.

Ms. REINHART. Yes.

Senator SESSIONS. Dr. Johnson.

Mr. JOHNSON. I think we should take events of the past few weeks in Europe, Senator Sessions, as a wake-up call exactly along the lines that you are suggesting. You need a fiscal commission. You need it now. If you do not have it, and the second half of the year is a substantial slowdown, which is what I am expecting, your room for maneuver, your room for sensible short-term programs to support the economy—and you can argue about what the programs are, but the route does not matter. Whichever way you want to go on that, you are not going to have that room because the financial markets are going to becoming increasingly difficult because they are going to push you on the lack of a medium-term credible fiscal framework in the United States. This is what the Europeans have woken up to just now. Tomorrow they have a big meeting in Europe, a summit. This for them is the topic. How do you limit the damage? How do you make the fiscal adjustments credible? They are looking at a lot of austerity in Europe right now. We do not want to go there. Raising taxes, cutting spending—you do not want to do that in the second half of this year. You do not want the financial—if the financial markets force you into it, that is a disaster.

Chairman CONRAD. Do either of the other Senators want a second round? Senator Whitehouse, would you want a second round?

Senator WHITEHOUSE. If it is not too much of an ordeal for our witnesses.

Chairman CONRAD. Well, they are here and they are ready to answer.

Senator WHITEHOUSE. Well, thank you.

Dr. Marron, in your written testimony, you looked at the 11 million households that are underwater on their home mortgages and concluded, A, that they are likely to default and, B, that that will eat away at the thin capital cushions of many banks.

To what extent do you believe that the liability for these mortgages has already been written down by the banks? And would you distinguished between mortgages that have been securitized and mortgages that are actually held by the banks?

Mr. MARRON. I do not have a good answer to your first question. Maybe Dr. Johnson does.

On the second, right, so there are—as you know, some of these mortgages have been securitized and have moved various places, including circuitously back on, in essence, the Federal balance sheet through Fannie and Freddie. And you have got other ones that are out there held by the banks. And, you know, the reality is—and this goes back to kind of the uncertainty point and the "to what extent have we realized the difficulties we are in" point—that financial institutions still differ in the degree to which they have recognized their losses. Some have been more aggressive about it than others, and that that casts, you know, continuing uncertainty over the financial viability of the various firms. And it is ultimately hard to track this through.

Senator WHITEHOUSE. Isn't it advisable to try to move through that uncertainty as quickly as possible?

Mr. MARRON. Yes, I mean, at some level, you know, the end state you want is where everyone honestly appraises what their losses are and then moves on in life. And the difficulty we faced over the last couple of years is it is very hard to get people to go through that process.

Senator WHITEHOUSE. Go ahead.

Mr. JOHNSON. Just to complement that answer, I think the lack of success that the Government programs have had, particularly this PPIP, which is supposed to buy distressed assets from the banks, it just has not got up to scale because the banks do not want to sell. I do not think they have written this down. In fact, they do not want to sell partly because they do not want to take the writedowns. And I think that the strategy that they have had and that has been encouraged by the previous administration and this administration is sit on your losses, wait for the economy to recover, and then you do not have to do the writedown. Eventually the assets will recover.

That works unless you have a double dip or further losses or more strategic default, which I think is, to my mind, what we are looking at here.

Senator WHITEHOUSE. Well, the reason that I was asking that question is that it strikes me we are prolonging the agony by continuing to forbid the residential home owner, if they are in appropriate financial circumstances, to simply go to bankruptcy court and settle their debt the way everybody else does. In fact, I saw a news article earlier today. The Mortgage Bankers Association argued vehemently against allowing regular folks to go to bankruptcy court and get that debt settled the way they can with every other single kind of debt. And I guess it turns out that they may have written down their own mortgage on their building here in Washington, and because it is a commercial mortgage, they can get away with it. So they know it is the right thing to do. They know it moves you quickly to a market-based solution and then everybody can adapt and move on, as opposed to being in this sort of frozen state in which banks are asked now to determine what their losses are going to be mortgage by mortgage, and then the nightmare begins for the person on the other end. We do not have a balance sheet that quantifies the nightmare for the family that has to put up with this. But, clearly, it is a nightmare. We do not have a balance sheet that quantifies the loss in property values around that house as it gets foreclosed and abandoned and stripped. We do not have a quantification of what that means in revenue to municipalities that are struggling.

There is a whole piece of collateral damage that I think gets avoided if we solve that problem in addition to moving quickly to a market base for those, and it is so disingenuous of the Mortgage Bankers Association to be here lobbying against it for regular people when they are doing it with their own darn building themselves.

I would be interested in your thoughts on wouldn't that be the quickest way to find the bottom, as soon as people could cut to a bankruptcy court and have a quick, fair, final determination of it, then everything adapts. There is your finality. Mr. Marron, this was your point, so I will start with you.

Mr. MARRON. So I will take a stab at that. I will confess I have not thought about Chapter 13 and those issues for some time now, so my memory is a little bit hazy. I am an economist. I am going to invoke many hands.

On one hand, I am generally reluctant to do things that are kind of, you know, changing the rules in the middle of the game. I am sympathetic—I may not find it dispositive, but I am sympathetic to the argument that the mortgages were originally initiated under a set of expectations about what the rules of bankruptcy were, and——

Senator WHITEHOUSE. What we have been through in the past year——

Mr. MARRON. No, no. I know. I am just—I am going to be whatever the many-handed right thing is. So I am sympathetic to that.

With the passage of time, kind of the emphasis I place on that goes down as we seem—I do not know what Federal program we are on, six or seven or eight, for trying to address this problem. And no disparagement to the previous administration, the current one, and the Congress. It is a really hard problem, so it is not surprising it has taken this long.

There is an issue—and, again, I do not remember the details, but there is an issue that houses are different than most of the assets that normally go through Chapter 13 bankruptcy procedures, so you would need to think about ways—you know, most of those things are cars or boats or whatever whose asset value is depreciating rapidly, and it is easier to figure out a payment plan and move on. It is more challenging to apply that to housing, and you would need to figure out a way to do it.

You know, I guess I would say over time I have become more sympathetic to the notion that some reform in bankruptcy could be part of the help. You know, the numbers I saw a year ago when I used to think about this more seriously suggested that, you know, even if you did kind of your dream scenario on that front, you know, it is still only a relatively small fraction of the homeowners who are facing these difficulties, but it would be a portion of it.

Senator WHITEHOUSE. Can you think of any other circumstance ever in which there are actual market losses that need to be processed through and a system whereby you did not get to the actual market loss but instead allowed an interested party to be the definer of how much they are going to lose on something was an efficient or effective way of finding the—of letting the market operate?

Mr. MARRON. Oh, so the first part is yes, I can think of folks who are trying that separately, like commercial real estate would be a classic example, right? As mentioned, there are plenty of balloon mortgages on commercial properties that are underwater for which the lenders are doing things like extending terms by a year, trying to put off the day of reckoning, hoping that a rebounding economy will bail them out. And so the problem is certainly not unique to resident real estate.

But then at the end of it, you had the second part of your question, which is and then it works well, and history does not suggest that it works well.

Senator WHITEHOUSE. Clarity is what works well and finding the actual value, correct?

Mr. MARRON. Yes.

Senator WHITEHOUSE. Mr. Johnson? Let me ask both of you to answer, and then I will conclude.

Mr. JOHNSON. I completely agree that taking your mortgage through bankruptcy makes sense. Of course, this measure did come up last year, and it was defeated by the lobbies involved. And that is a problem.

Look, these are not—this is not lifetime servitude. This is a no-recourse loan. The more people who default, the more people who walk away, the lower cost for other people to walk away. And I honestly think that over time this will change. Most of the bankruptcy law in this country has emerged organically over the past 200 year in response to big debt crises and exactly this kind of confrontation and this kind of crisis. This one will change, too. You know, in 5 or 10 years, you will be able to modify first liens in bankruptcy. It will not do us a lot of good right now, though.

Senator WHITEHOUSE. Dr. Reinhart.

Ms. REINHART. Extremely briefly, I think that when we talk about overleveraged households and overleveraged financial institutions, restructuring is a viable way of bringing down, at least partially, that overleveraging. And part of my remarks about forbearance, delaying the inevitable in the case of banks, and your comments, delaying the inevitable on the part of households, are doing just that, delaying the inevitable and making the slowdown much more protracted than it need be.

Senator WHITEHOUSE. Making the slowdown much more protracted than it need be. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator. I would like to just conclude by trying to make sure that we clear up, for those who might be listening, the gross debt, publicly held debt, and then we got into unfunded liabilities, which is a third category, so that we do not leave that confused in the record or confused perhaps in public mind.

The gross debt is all of the debt that is owed by the Federal Government to all of the entities—publicly held as well as to the trust funds, Medicare and Social Security, for example.

The publicly held debt is just that debt that is due to the public. That does not count the debt to the trust funds.

The unfunded liability is still another concept that looks at the differences between the promises that have been made in legislation versus the revenue streams that go with those spending commitments.

Now, that is a more future-oriented look at where we are headed, and the unfunded liability of the United States is in the trillions of dollars. And the biggest part of that is Medicare. The unfunded liability, if my memory serves me correct, in Medicare is 6 or 7 times the unfunded liability in Social Security.

So they are three separate concepts. The reason that we were focusing here, I think—I cannot speak for Senator Sessions, but we were talking about that—is from a budget standpoint, from what we have to deal with, we have to produce the money in this Committee to meet those debt obligations, both the publicly held and the gross debt, because those obligations to the trust funds are backed by the full faith and credit of the United States. They are real obligations. But they can only be funded out of current resources. So when Medicare is cash negative, Social Security is cash negative, that has budget consequences. And we are the Budget Committee.

So I know economists like to look at publicly held debt. Dr. Reinhart is demurring. She is fully prepared to talk about the gross debt. But we have a special obligation to our colleagues to deal with the revenues that are going to be needed to meet these requirements not only of the publicly held debt but also of the gross debt, the obligations to the trust funds. And that has significant budget consequences.

And we have been in this long-term period where the trust funds were producing more money. There was more money coming in than going out. That has been a very happy circumstance. That is all changing now. And I think it is when the changes occur that it is often least recognized. You know, it kind of gets missed by our colleagues.

But this is going to have very, very significant budget consequences, and it is important for our colleagues to know that, and it is important for those who are watching to understand it.

Senator Sessions?

Senator SESSIONS. Just to followup on that, with regard to the way we account for the money in our Government that allows this confusion to continue. It was very dramatically revealed to me and I really did not fully understand it until just before the final vote on the health care bill. President Obama submitted a score from the Medicare that said if you raise Medicare taxes and you cut Medicare benefits, as they propose, it would extend the life of Medicare for 9 years, I believe. I think as it was stated, that is a true fact.

But in the report from the CMS Chief Actuary for Medicare, he had a little parenthetical, basically, and it said, "But, of course, you cannot simultaneously use that money to fund a new program and also extend the life of Medicare."

All right. But the CBO score—Dr. Marron, you used to be at CBO for a period. CBO said that you could, because the CBO score does not score internal debt. And so the President also used the CBO score to say that he could fund his new health care program and extend the life of Medicare by 9 years. And he had a CBO score that agreed with him. And basically what it said—they do not score the internal debt. So you had an increase in revenue out of Medicare, and it was spent on the new health care program, and it did not score as increasing the debt.

Where did the money come from? It was borrowed from Medicare. A debt instrument shows that debt. And when Medicare gets back into its deficit, it will call that debt. And it did increase the debt, as CBO eventually said, by about $226 billion.

So the whole argument that this health care reform was going to save the country $130 billion was wrong. It actually was going to add to the gross debt of the country $200-plus billion, according to CBO, when they finally got the numbers straightened out. And we have got to watch that. Somehow that is a mix-up in the way we score. Both agencies scored according to their accounting conventions, but together they created a misimpression.

Anyway, that is one of my sore sports.

Chairman CONRAD. Senator Whitehouse?

Senator WHITEHOUSE. I am sure that Senator Sessions did not want to create any misimpression himself, but I believe that he said that the President was cutting Medicare benefits, and I think it was clear that he was cutting Medicare spending. But——

Senator SESSIONS. Right. The President did contend that he could cut spending without reducing benefits.

Senator WHITEHOUSE. Particularly in the area of the insurance company that is making 14 percent profits on Medicare and areas like that.

Senator SESSIONS. Well, that is good argument. I would just say that if we can extend the life of Medicare 9 years without cutting any benefits, let us do it today. The problem is you cannot use that saving to fund a new program and also extend the life of Medicare, of which the CBO was absolutely crystal clear.

Chairman CONRAD. Well, you know, it is going to be an interesting year, isn't it?

Let me just say this: I think we do have an extraordinary challenge, and the question for all of us: Are we up to this challenge? There are differences among us on this issue, but I believe the testimony here has been quite clear. in the short term, it would be a mistake to start to reduce the deficit too soon. We have seen what happened in the Depression when that was done. Additionally, Japanese experience cautions us against doing that.

At the same time, it would be a profound mistake not to have a plan to deal with this longer-term debt challenge, because the burgeoning debt fundamentally threatens economic growth, economic security, and the position of our country in the world. And this is not just numbers on a page.

I want to emphasize I think sometimes people listen to us and they hear us talk about this number and that number. Why are these numbers important? The reason they are important is that they ultimately affect people's lives, the ability of people to have a job, to buy a home, to get a college education. All of these things are directly affected by the strength of our economy, and the strength of our economy is fundamentally affected by the decisions the United States makes with respect to its budget obligations and its debt obligations.

The Federal Government represents 20 percent of the economic activity of the country and it has a broader impact with respect to our long-term economic position, because if we take on too much debt, as Dr. Reinhart has testified in a very compelling way here—she has looked at the history for extended periods going back and looked at countries that have faced similar circumstances and then saw what happened. And what she is telling us is very clear. If you take on too much debt, it affects the rate of economic growth in a country adversely. That translates into people's quality of life.

So it is very important for us, I think, to connect the dots for people. This is not just numbers on a page that are just of interest to Government accountants. These things contribute to the economic strength of the country or the depletion of our strength. And that is going to have an effect on every single American and, more broadly, is going to have an effect on the global economy.

So we have a very serious burden here, a serious challenge, and we have got to prove that we are up to it. We have got to prove that we are up to it.

I just want to thank the witnesses today for their assistance to us in that task. Dr. Reinhart, you were terrific, the first time before the Committee. We certainly will invite you back. You were really a great help to the work of the Committee.

Dr. Johnson, it is always good to have you here, a lot of great clarity of thought as well as the ability to articulate these issues in a way that is understandable, even to those of us who are not economists.

And, Dr. Marron, always good to have you back. You are somebody with great credibility before this Committee.

I thank all of you, and I thank my colleagues for being here. The hearing stands in adjournment.

[Whereupon, at 12:31 p.m., the Committee was adjourned.]

QUESTIONS FOR THE RECORD

Senator Sessions Questions for the Record

DATE: **February 9, 2010**
SUBJECT: **Economists Hearing**

---

1. As you know, the European Union requires that its members have a 60% of debt to GDP ratio. Trying to compare the E.U. to the U.S. is difficult, however, because there are different ways to assess U.S. debt. One way is "debt held by the public," which is about 60% of GDP. Another is "general government debt," which includes state and local government debt, and is about 80% of GDP. Finally, there is "gross debt," which includes Social Security and Medicare, and is about 90% of GDP. Which of these measures would be best to compare the current state of the U.S. to the European Union? If none of them are an adequate comparison, then what measurement would you recommend?

2. As you know, most businesses use "accrual" accounting, while the federal government uses "cash flow" accounting. Accrual accounting reflects the net present value of future obligations, while cash flow accounting only looks at the current year's inflows and outflows. Do you believe that the federal government should switch to accrual accounting to better reflect our true debt and deficits?

3. Although there has been much talk of entitlements such as Social Security and Medicare causing our poor fiscal situation, isn't it true that combined these programs have actually been running surpluses for many years, and therefore our current deficits can be attributed to other spending such as discretionary spending?

As you know, 5-year statutory spending caps with low 1-2% annual increases were very helpful in reducing the deficit in the 1990s and achieving years of surpluses. Do you believe that similar caps can be helpful to reduce the deficit today?

4. As you probably know, the President proposes a $90 billion tax on banks (over 10 years). Do you think such a tax would increase lending or decrease lending? Would it increase or decrease interest rates on savings accounts?

5. Although the President proposes $8 billion in capital gains elimination for small businesses in his budget, the budget also proposes $2.2 trillion in tax hikes over the next 10 years, not counting cap and trade, which could cost another $900 billion. What do you think would be the net impact of the budget's tax proposals on economic growth?

A. ANSWERS FROM SIMON JOHNSON TO QUESTIONS FROM SENATOR SESSIONS

1. The best comparative cross-country data we have on government spending, revenue and deficits come from the IMF. They report gross general government debt, which is informative-but not exactly what we (rightly) focus on in the United States (i.e., net federal government debt held by the private sector).

The comparison with Europe is difficult. I would strongly recommend using only net debt measures.

2. Switching to accurual accounting has some appeal, but it would also introduce new complications. The US government has substantial assets on its balance sheet that are not valued at current market prices (e.g., gold holding of the Federal Reserve, various rights of way, and large land holdings.)

Definitely we should recognize more explicitly our future liabilities. But the CBO already does a good job of this in its various alternative baseline projections.

3. The fiscal position of the United States was under control around the year 2000. It moved out of control during the following decade as a result of tax cuts and spending increases (including, but not limited to, foreign wars.) However, the real damage was done by the financial crisis-most of the increase in debt in the CBOs baseline is due to automatic stabilizers, particularly the fall in taxes due to the recession (not the discretionary spending).

For more detail, please see this article and the links to other related research: http://baslinescenario.com/2010/10/14/there-are-no-fiscal-conservatives-in-the-united-states/

Spending caps could play a role going forward. But we also need to look at comprehensive tax reform - our tax system is antiquated and long overdue for an overhaul.

4. A tax on banks of this nature would be unlikely to have much impact in terms of lending, interest rates or anything else.

5. We face a great dilemma in our budget. If we do not address the budget deficit, rising levels of debt will - one way or another - choke off growth. But when and if we either reduce spending or raise taxes (using our existing tax system), this can also impact growth in the short-term.

Responses to Senator Sessions Questions for the Record
Following up on the February 9, 2010 Budget Committee Hearing
Donald B. Marron
February 19, 2010

1. This is an excellent question. In my testimony, I focused on the publicly-held federal debt and suggested that the United States try to get it down to 60% of GDP by the end of the budget window. That 60% figure was partly inspired by the E.U. figure. But, as you note, the E.U. figure combines debt for all levels of government. Thus, for better comparability it would be appropriate to use a measure that combines federal, state, and local debts. (However, I would not recommend that the Congress use such a debt measure is establishing legislative debt targets; Congress directly controls only federal debts and deficits, so its targets should focus on those.)

   The Social Security and Medicare trust funds are important, but I believe that they understate the challenge we face from future entitlement spending. As a result, I tend to not focus on the gross federal debt, even as I do worry about the burden of growing spending on Medicare, Medicaid, and Social Security.

2. As you know, the budget currently uses an accrual approach for some programs, most notably loans, loan guarantees, and TARP. I believe this is the right approach, and that Congress should consider whether the use of accruals should be expanded. One important area to consider would be budgeting for the accrued cost of employee and veteran pension benefits.

   I should emphasize that the annual Financial Statements of the Federal Government do use accrual concepts to present the financial status of the U.S. government. I believe that Congress should give these statements greater attention.

3. Social Security has indeed run surpluses for many years. This year, however, cash outlays from the program are likely to exceed cash inflows. Medicare Part A has a trust fund, but the Parts B and D do not; as a result, the program as a whole has imposed net costs on the federal budget for years.

   Our current deficits reflect a combination of five factors: (1) the structural imbalance between revenues and spending that existed before the economic crisis, (2) the decline in tax revenues caused by the crisis, (3) the increase in spending caused by the crisis (e.g., on Medicaid, unemployment insurance, and food stamps), (4) the financial rescue, and (5) efforts at stimulus. Discretionary spending has certainly played a role, but so have mandatory spending and tax revenues.

   Yes, caps on discretionary spending could definitely be helpful, preferably as part of a larger program for getting our deficits under control.

4. I have not analyzed the proposal in detail, but my initial reaction is that it would reduce lending (because it would increase the cost of some funding sources that are currently used for lending) and that it would increase interest rates on savings accounts (since they would not be subject to the tax and thus would be a more attractive funding source for banks). I do not have any sense, however, of the magnitude of these effects.

5. The expiration of many tax provisions, coupled with the introduction of some new taxes, would raise tax rates significantly from where they are today. The economic impact of those increases will depend on how the additional revenues are used. If the revenues are used to pay for higher spending, they will almost certainly lead to slower economic growth. If the additional revenues are used to reduce future deficits, however, the effect on economic growth is less clear. The economic burden of the taxes would be offset—at least in part and possibly completely—by the benefits of lower government debts (lower interest rates and less risk of a future fiscal crisis).

   The introduction of a cap-and-trade program would almost certainly lead to slower economic growth (see, e.g., studies by CBO on this topic). That burden can be substantially reduced, however, if the resulting revenues are used to reduce deficits or reduce marginal tax rates, rather than given away or spent. That's why I believe that a large fraction of the revenues from any cap-and-trade system should be earmarked for deficit relief.

ANSWERS FROM CARMEN REINHART TO QUESTIONS FROM SENATOR SESSIONS

1.The measure we use in our historical analysis is ***gross central government debt***. It is not because it is the "best" measure of government indebtedness but because it is the measure for which we can get the most reliable data for many countries for a very long sample. Having the fullest data coverage possible is a necessity for studying long term growth, as well as severe financial crises which (thankfully) occur infrequently. Incorporating the pre-World War II era in the analysis importantly enriches our understanding. The federal government has a commitment to service and honor its debts whether **these are held by the public or whether they are held by other levels of government or social security**; this liability is captured in gross debt. That measure for the Unites States is at present about 90 percent. In Reinhart (2010), I report these measures for 22 advanced economies and about 50 emerging markets to facilitate comparisons. It is worth noting, that in the latest Flow of Funds of the Federal Reserve data for the end of the first quarter of 2010 public debt (defined in this publication as the sum of net federal government, state and local, and government enterprises) is about 117 percent of GDP.

2. At a minimum, accrual accounting calculations should receive greater attention from policy makers and public awareness the "bigger picture" should be encouraged.

3. I have not done any calculations breaking down existing deficits into their "sources" in terms of discretionary versus other expenditure. The current surge in deficits and debts importantly also owes to the revenue shortfalls that almost always accompany severe financial crises. This is something that I document extensively in my recent book with Ken Rogoff.[1]

I think at the current conjuncture "no stone should be left unturned", and spending caps are part of a menu of policies that should be considered as part of a deficit reduction initiative.

4.It is not obvious one can make the case that the tax on banks will decrease lending ***per se*** (see below) but I do expect lending to be more moderate in the next decade than it was in the pre-crisis decade, where we had an all-out historic lending boom. I have documented this credit boom-bust cycle extensively in my work. Taxes on banks are historically passed on to depositors and borrowers—which implies lower interest rates to depositors and higher interest rates to borrowers. There is no simple benchmark or formula to pin down how this levy is split between depositors and borrowers.

5. It is my view that tax hikes will be part of any credible "unpleasant but necessary" deficit and debt reduction scheme. Austerity measures are seldom expansionary when they are implemented but historically high levels of debt are associated with lower growth rates.

---

[1] Carmen M. Reinhart and Kenneth S. Rogoff (2009). *This Time is Different: Eight Centuries of Financial Folly*, (Princeton: Princeton University Press)

QUESTIONS FOR THE RECORD FROM SENATOR WHITEHOUSE TO SIMON JOHNSON

Dr. Johnson, at the hearing, you pointed out that CBO and OMB deficit and debt projections do not include a placeholder/estimate for future bailouts of too-big-to-fail firms. Would you recommend that CBO and OMB include such an estimate? In your view, how would this estimate be calculated?

Dr. Johnson, at the hearing, you suggested that CBO and OMB do not properly score the assets and liabilities of Fannie Mae and Freddie Mac in the baseline of the federal budget. How should the assets and liabilities of these entities be scored? If scored according to your recommendations, what would be the approximate net changes in the deficit and debt projections over the ten-year window?

B. ANSWERS FROM SIMON JOHNSON TO QUESTIONS FROM SENATOR WHITEHOUSE

The cost of potential future crises should be estimated in the same way the CBO thinks about other potential events-considering the probability and the likely scale of what could happen. The CBO is perfectly capable of approaching financial risks in this fashion.

The current balance sheets of Fannie Mae and Freddie Mac are too murky for any outsider to take a definite view on the ultimate final cost. Hopefully, the regulators have better information. Buth the principle that should be applied is clear—the budget should reflect the probable costs of “bailing out” these institutions both today and in the future.

SETTING AND MEETING AN APPROPRIATE TARGET FOR FISCAL SUSTAINABILITY

THURSDAY, FEBRUARY 11, 2010

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

The Committee met, pursuant to notice, at 2:03 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Nelson, Cardin, Whitehouse, and Sessions.

Staff present: Mary Ann Naylor, Majority Staff Director; and Winnie Chang, professional staff member.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome everyone here today. I especially want to thank the witnesses for making a special effort given the snow conditions here in the Washington, D.C., metropolitan area. It is difficult to move around. I was up very early this morning shoveling—and I know many others were as well—and getting a little bit of a late start because the trains are not running here either. I was in the weekly caucus, and a surprising number of Senators were there for the conditions. But that made having this hearing challenging. We had really intended to do this yesterday but had to put it off because transportation was not functioning. The witnesses could not get here; members could not get here.

I can say this: that other colleagues will be joining us. There are still caucuses going on, and there are members in those caucuses, and they are discussing important jobs legislation. But they will be joining us as we proceed.

Those of us from North Dakota feel right at home with these conditions, but in fairness, this city I think has done a remarkably good job given how much snow has fallen here. I have certainly found that once you are able to get your car dug out, you can move around. So hats off to the D.C. Government for really, I think, doing a remarkably good job in extremely difficult conditions. This would be even tough back home.

Our hearing today is entitled "Setting and Meeting an Appropriate Target for Fiscal Sustainability." We are joined by a very distinguished panel of witnesses: Dr. Alice Rivlin, Ms. Maya MacGuineas, and Dr. Rudy Penner. I really cannot think of a better group of witnesses for a hearing like this one.

Dr. Rivlin is the Director of the Greater Washington Research at the Brookings Institution. She is also now Co-Chair, along with former Senator Domenici, of the newly established Bipartisan Policy Center's Debt Reduction Task Force. They are doing very important work, and it could not come at a better time. She is the former Vice Chairman of the Federal Reserve, former OMB Director, and she was the first Director of the Congressional Budget Office. What a remarkable series of contributions. So Dr. Rivlin brings an incredible amount of knowledge and experience to the table.

Maya MacGuineas is President of the Committee for a Responsible Federal Budget and Director of the Fiscal Policy Program at the New America Foundation. Ms. MacGuineas appeared before this Committee last November and provided very valuable testimony at that time. We are delighted to have her back.

Dr. Penner is a fellow at The Urban Institute and Co——

Chair of the Committee on the Fiscal Future of the United States. He is also a former Director of the Congressional Budget Office and someone who has very high credibility with this Committee. So we are very pleased to have Dr. Penner with us as well.

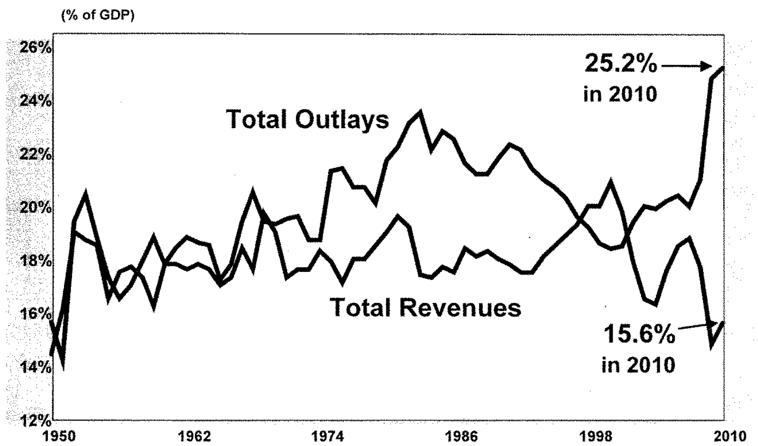
Again, special thanks for your being here. I think this is a critically important hearing because we are about to work on a budget resolution for either the next 5 or 10 years. We have not yet made a determination if this will be a 5-year budget or a 10-year budget, but in addition to that, we also have most certainly a commission that is going to go to work to try to come up with a plan to be voted on by the Congress before the end of this year to get us back on track. And so this hearing, I think, is very much in line with the larger challenge that we confront this year.

We focus today on the question of what is an appropriate target for the long-term fiscal sustainability for our Nation. In an ideal world, our budget would be fairly close to balance most of the time. But given the tremendous long-term fiscal challenges that we confront, we need to determine a level of deficits and debt that is sustainable over the long term.

Our goal must then be to adopt policies that will over time keep our deficits and debt at or below those target levels as much as possible. If we fail to confront our burgeoning deficit and debt, we put our Nation's economy at risk with consequences that could be far worse than anything we have seen in recent times. Each of our witnesses has been involved in efforts to identify such fiscal sustainability targets, so we have an idea panel for considering this subject.

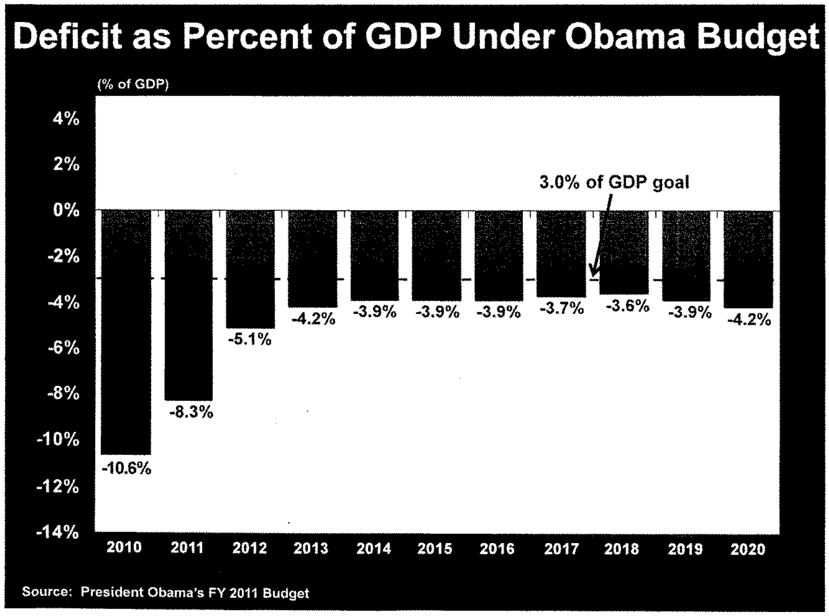
I would like to begin just briefly by outlining the problem we face and some of the fiscal sustainability targets that have been proposed. At its core, our fiscal problem stems from an imbalance between spending and revenue. We can see that spending in 2010 is projected to be over 25 percent of the gross domestic product of the United States—higher than at any point in over 60 years, as measured by the gross domestic product. Meanwhile, revenues are projected to be 15.6 percent of GDP—the lowest they have been in 60 years. Whatever solution we adopt over the long term is going to have to involve both spending and revenue. They both contribute to the problem, and they both have to be part of the solution.

Spending and Revenues



Sources: OMB, CBO

This next chart shows the deficits as a percent of GDP under President Obama's budget over the next 10 years. We can see that, according to the Office of Management and Budget, the deficit is projected to drop from 10.6 percent of GDP in 2010 to 3.6 percent in 2018, and then it begins to creep up again after that. The deficit would never drop to the 3 percent of GDP that the administration has set as a goal last year. And I expect when CBO examines the President's budget, the President's deficit levels will be even higher. So one question we can consider today is whether a 3-percent-of-GDP goal is an appropriate target in the first place.

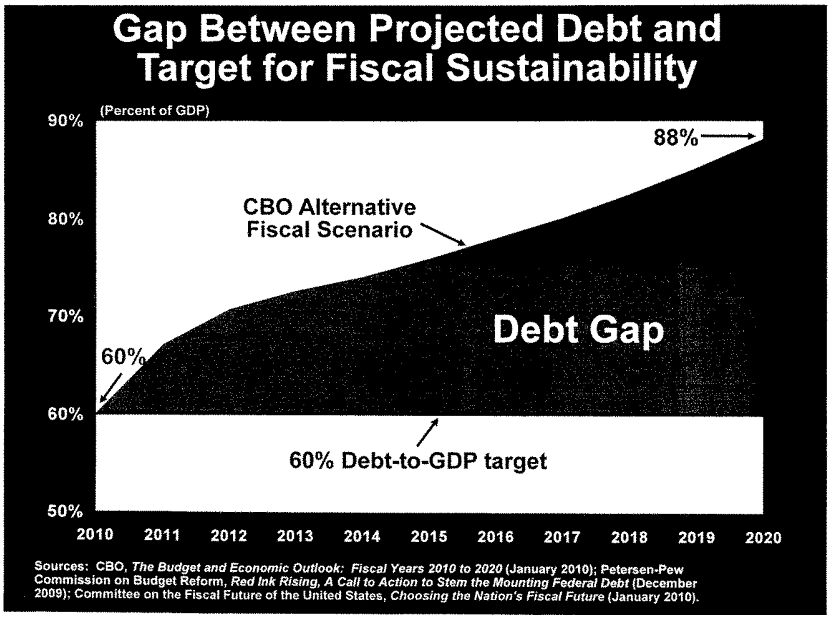


The next chart I would like to put up shows that we have found that many outside budget groups, including the Peterson-Pew Commission on Budget Reform, which Ms.

MacGuineas is working on, and the Committee on the Fiscal Future of the United States, which Dr. Penner co-chairs, have identified a 60-percent debt-to-GDP level as an appropriate target for fiscal sustainability.

To be clear, that is debt held by the public at 60 percent of GDP, not the gross Federal debt, and we are approaching this year—we are going to be measured against the gross Federal debt, a debt of 90 percent of GDP. We have not been that high since after World War II.

The next chart shows the gap over the next 10 years between projected debt under CBO's January baseline, adjusted for alternative policies, and that 60-percent-of-GDP level. Clearly, the debt gap is growing dramatically with debt held by the public reaching 88 percent of GDP by 2020 under this alternative fiscal scenario.



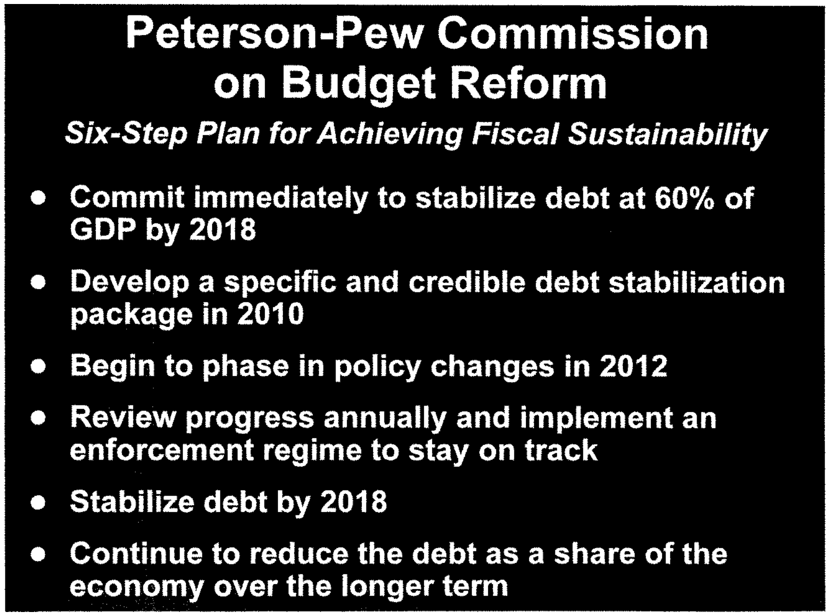
The next chart summarizes some of the fiscal sustainability plans that have been proposed. Peterson-Pew proposes a goal of stabilizing the debt-to-GDP level at 60 percent of GDP by 2018 and reducing it further over the longer term. The Committee on the Fiscal Future of the United States proposes a goal of stabilizing the debt-to-GDP level at 60 percent by 2022 with a deficit of 1.9 percent of GDP in that year. The Center for American Progress proposes a goal of overall budget balance by 2020 and estimates that reaching this goal would stabilize debt as a share of GDP at 65 percent. The Center on Budget and Policy Priorities proposes annual deficits of no larger than 3 percent of GDP, which they estimate would stabilize the debt-to-GDP at about 70 percent.

Summary of Fiscal Sustainability Plans

Organization	Goal	Target Date	Debt-to-GDP	Deficit in Target Year
Petersen-Pew Commission on Budget Reform	Stabilize debt-to-GDP at 60% and reduce over longer term	2018	60%	<1%
Committee on the Fiscal Future of the United States	Stabilize debt-to-GDP at 60%	2022	60%	1.9%
Center for American Progress	Overall Budget Balance	2020	65%	0%
Center on Budget and Policy Priorities	Stabilized debt-to-GDP	2019	70%	3%

Source: Petersen-Pew Commission on Budget Reform, *Red Ink Rising, A Call to Action to Stem the Mounting Federal Debt* (December 2009); Committee on the Fiscal Future of the United States, *Choosing the Nation's Fiscal Future* (January 2010); Center for American Progress, *A Path to Balance* (December 2009); and Center on Budget and Policy Priorities, *The Right Target: Stabilize the Federal Debt* (January 2010).

Now, that is a lot of numbers. That is a lot of things to try to get your mind around. I provide that background to show that there are different goals that people have in mind, that various groups have in mind, as to what is an appropriate level of debt to be shooting for. I am not here to endorse any of those plans today, but I do want to highlight the six-step plan for achieving fiscal sustainability provided by the Peterson-Pew Commission because it provides a specific timeline for action. It recommends the Committee committing immediately to stabilizing the debt at 60 percent of GDP by 2018; developing a specific and credible debt stabilization package in 2010; beginning to phase in policy changes in 2012; reviewing progress annually and implementing an enforcement regime to stay on track; stabilizing debt by 2018; and continuing to reduce the debt as a share of the economy over the longer term.



None of this will be easy, whichever of these goals is adopted. And it is interesting how similar the goals are, many of them focusing on a debt-to-GDP of 60 percent, again, publicly held debt.

Stabilizing the debt at that level will require very difficult decisions. As I said in the last hearing, I have gone through an exercise that I will be sharing with my colleagues of trying to get to 3 percent of GDP by the fifth year of this budget and then to balance before the end of a 10-year period, and I can tell you it is daunting. It is really striking how tough the decisions will have to be to accomplish a goal like that one. It is really striking how tough things are going to have to—the toughness of the decisions to be made.

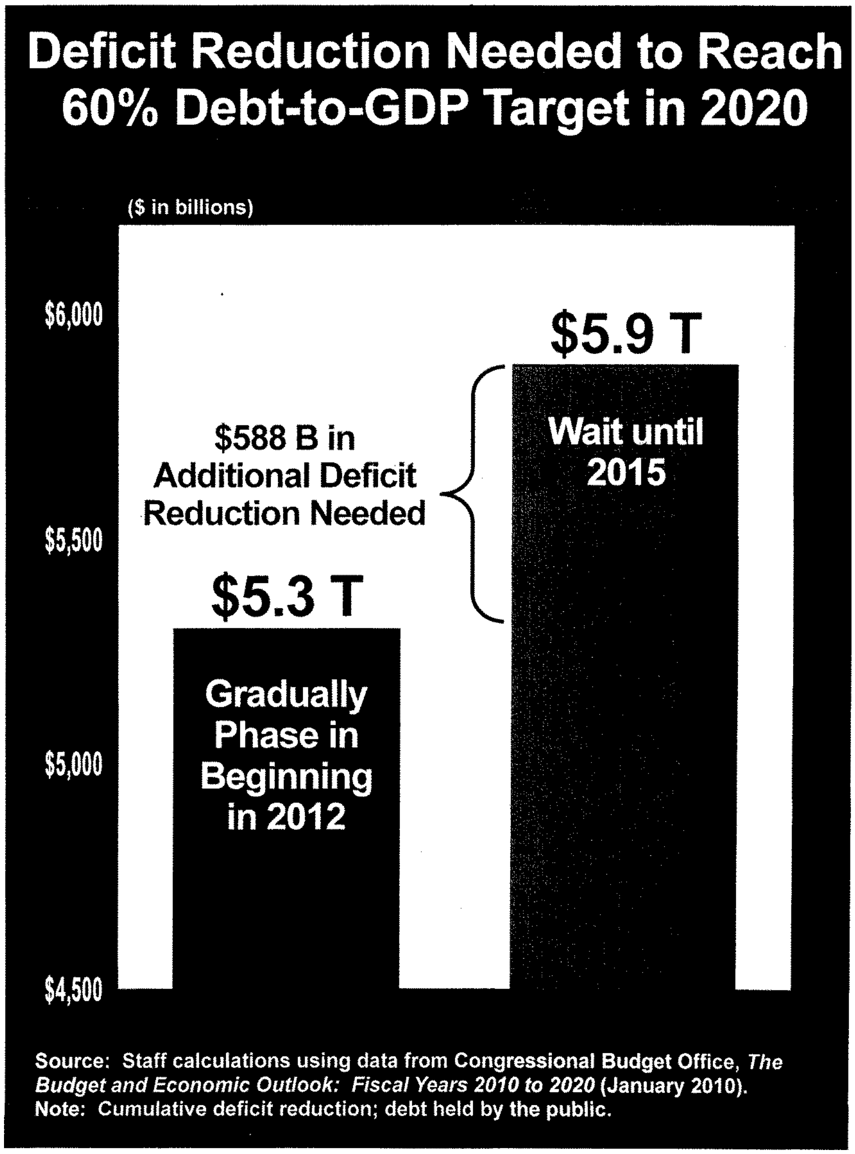
Senator NELSON. Mr. Chairman, may I ask you a question on that point?

Chairman CONRAD. Yes.

Senator NELSON. If I recall, the President's budget projected over at least the next 5 years, if not over 10, 15 years, does not even bring down the deficit to 3 percent of GDP. Is that correct?

Chairman CONRAD. That is correct. So getting to 3 percent by the fifth year, that in and of itself—you know, the President's budget has got some tough things in it. But that does not get down to 3 percent. And then it starts going up in the second 5 years as a share of GDP. And as I said, if one seriously goes through the exercise—which I have asked all of our colleagues to do before we get into the budget. I have asked everybody to do their own exercise, see what decisions have to be made to achieve any of these goals that have been outlined. I tell you, I think it will really sober people how really tough the decisions are going to have to be.

It is clear the longer we wait, the harder these choices become. The chart that I want to show now shows one example of the magnitude of the difference in the level of deficit reduction required if we start gradually phasing in changes beginning in 2012 versus waiting 3 years longer. In this example, waiting 3 more years to begin phasing in changes results in an additional $588 billion in deficit reduction needed.



The final chart is summarizing the point that the bottom line is that we are on an unsustainable course. Our Nation's foremost budget and economic experts have all come before Congress and told us this is the case. Here is what they have said:

Treasury Secretary Geithner said, “Our deficits are unsustainable.”

The CBO Director, Mr. Elmendorf, said, “The Federal budget is on an unsustainable path.”

The OMB Director, Mr. Orszag, said, “The path that we are on is unsustainable.”

The Federal Reserve Chairman, Mr. Bernanke, said, “We cannot allow ourselves to be in a situation where the debt continues to rise, which leads to an unsustainable situation.”

The former Treasury Secretary, Mr. Paulson, said, “It is clearly unsustainable.”

The former head of the GAO, General Walker, Comptroller General Walker, said, “We are on an imprudent and unsustainable long-term fiscal path.”

Budget and Economic Leaders on Unsustainable Budget Outlook

Geithner

"...[O]ur deficits are unsustainable..."

– Treasury Secretary Timothy Geithner
Testimony before Senate Budget Committee
February 4, 2010

Elmendorf

"...[T]he federal budget is on an unsustainable path..."

– CBO Director Douglas Elmendorf
Testimony before Senate Budget Committee
July 16, 2009

Orszag

"...[T]he path that we are on is unsustainable..."

– OMB Director Peter Orszag
Testimony before Senate Budget Committee
March 10, 2009

Bernanke

"...[W]e cannot allow ourselves to be in a situation where the debt continues to rise... which leads to an unsustainable situation."

– Federal Reserve Chairman Ben Bernanke
Testimony before House Budget Committee
June 3, 2009

Paulson

"...[I]t's clearly unsustainable."

– Former Treasury Secretary Henry Paulson
Testimony before House Budget Committee
February 13, 2008

Walker

"We are on an imprudent and unsustainable long-term fiscal path..."

– Former-GAO Comptroller General David Walker
Testimony before Senate Budget Committee
January 11, 2007

Greenspan

"...[T]he federal budget is on an unsustainable path..."

– Former Federal Reserve Chairman Alan Greenspan
Testimony before Senate Budget Committee
April 21, 2005

And the former Chairman of the Federal Reserve, Mr. Greenspan, said, "The Federal budget is on an unsustainable path."

You notice the similarity—unsustainable, unsustainable, unsustainable?

Look, I know that there is a sense of denial among our colleagues about the seriousness of this threat. I see it every day. I have just come from a meeting in which I see it. This is tough, but it has got to be dealt with. If we let this get away from us, we will rue the day. We will rue the day. We will regret forever the consequences for the country.

So, look, we have got to face up to this. Whether it is through the commission that the President proposed or some other method, we have got to deal with the consequences of a failure to act. So we have to act. The sooner, the better. The economic security of our Nation depends on it, and with that, we will hear from our witnesses. I will go to you, Dr. Rivlin. Thank you so much for being here. It would be hard to have a more perfect background than you have had for helping us understand what needs to be done in this circumstance. Please proceed.

STATEMENT OF THE HONORABLE ALICE M. RIVLIN, PH.D., DIRECTOR, GREATER WASHINGTON RESEARCH, THE BROOKINGS INSTITUTION

Ms. RIVLIN. Thank you very much, Mr. Chairman and Mr. Nelson. I am really glad to be here because I greatly admire this Committee for your persistent efforts to focus the attention of the Congress and the Nation on the dangers of projected increases in the public debt and the importance of moving the budget onto a sustainable trajectory. I thought it was a shame that the commission that you and Senator Gregg proposed did not pass. I hope that the President's commission can receive strong congressional bipartisan support. But those of us who care deeply about this issue just cannot give up. So I really appreciate the opportunity to be here today.

As you have pointed out, and so many others, on any reasonable set of economic assumptions, the U.S. budget is on an unsustainable track. There really is not any disagreement about that or about the reasons for it. In the next decade and beyond, Federal spending, driven by the impact of an aging population and rising health care costs on Medicare, Medicaid, and Social Security, will rise substantially faster than the whole economy can grow—faster than the GDP. Revenues, at any set of tax rates, will grow only slightly faster than the GDP, so there will be a widening gap.

These projections are not new. They predate the financial crisis and the current recession. But 2 or 3 years ago, deficits, while inappropriate in a prosperous economy, were of manageable size, in the range of 3 percent of GDP, and the debt was not off the charts. It was around 40 percent of GDP. So the warnings of this Committee and the rest of us about the bigger deficits looming in the future were just not gaining traction.

But the financial crisis of 2007–08 and the deep recession that it precipitated have changed the budget outlook dramatically. The deficit, as you pointed out, peaked at more than 10 percent of GDP, and the debt has soared to an estimated 64 percent of GDP this fiscal year, and climbing. The big deficits will recede as the economy recovers and the temporary spending measures expire. But they will not recede far enough, as you pointed out, and, moreover, the double impact of aging and medical spending—which we once thought of as a long-run problem—is already driving deficits and debt higher and will accelerate by the end of the decade. So solutions must be found, and soon.

As our debt mounts, the risk grows that our creditors, especially the foreign creditors who own about half our debt, will lose confidence in our ability to get our house in order. We have to take action very soon to arrest the debt buildup.

Stabilizing the debt increase seems to be a sensible goal, and stabilizing the debt at 60 percent of GDP, while no magic number, has certainly gained credibility. Two high-level groups that you mentioned, including both Republicans and Democratic budget experts, have recently recommended stabilizing the debt at 60 percent og GDP by a date certain. The crucial question is by when. One could take another number, but 60 percent is good enough.

The Peterson-Pew Commission, of which Maya and I were members, suggested getting to 60 percent by 2018. That is very aggressive. The National Academy Commission, which Rudy co-chaired, suggested a slightly more gradual trajectory, get there by 2022. Even this more gradual trajectory would require substantial changes in current budget policy.

I believe that a credible, politically viable plan to stabilize the debt must have two characteristics:

First, as you pointed out, it must include both reductions in projected spending and revenue increases; and it must have the support of the leadership of both political parties.

The widening gap between projected spending and projected revenues is too large to be closed by either spending cuts or revenues alone. Given the rapid aging of the population, especially in the near term, the high demand for medical care, and other necessary and widely supported functions of Government, I believe it is unrealistic to bring the growth of spending into line with the growth of GDP in the next decade.

In addition, our tax system is extremely inefficient and complex. Part of the gap should be closed by reforming the Federal tax system so that it produces more revenue with less drag on economic growth.

Now, no one needs to tell a Member of the Senate that partisanship has grown more extreme in the last few years. Neither party wants to take the lead in proposing unpopular policies such as cutting the growth of entitlements or increasing revenues, and each is eager to blame the other. But putting the budget on a sustainable track requires unpopular actions, and the only way to accomplish them is for both parties to work together. I have personally never been a big fan of commissions. It would be much better if the Congress could stabilize the debt by using its regular budget process. But a bipartisan commission with fast-track authority it seems to me is the best hope for serious debt reduction right now. I hope there will be an opportunity for the Congress to reconsider its rejection of the Conrad-Gregg proposal or to treat the President's proposal in a similar manner and to give it the force of law.

Meanwhile, as you mentioned, former Senator and former Chairman of this Committee, Pete Domenici, and I have launched a Bipartisan Debt Reduction Task Force that we hope will demonstrate that Republicans and Democrats can work together to produce a sensible, viable debt reduction plan. Under the auspices of the Bipartisan Policy Center, which was founded by Senate Leaders Dole, Daschle, Baker, and Mitchell, we have launched an effort that we profoundly hope will show that crafting a bipartisan deficit reduction plan is not an impossible task. We have recruited an impressive group of citizens, former elected officials, and budget experts—I attach a list—and we will report by the end of the year. We hope to support the efforts of an official commission, whether statutory or created by Executive order, or whatever, and in any case to make our recommendations available to the public and to the Congress for further discussion and debate. We will be happy to assist this Committee in any way that we can.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Rivlin follows:]

"Moving to a Fiscally Sustainable Budget"

Testimony of Alice M. Rivlin

The Brookings Institution and Georgetown

Co-Chair, Bipartisan Policy Center Debt Reduction Task Force

Senate Budget Committee

Wednesday, February 10, 2010

Chairman Conrad, Ranking Member Gregg, and Members of the Committee:

I greatly admire this Committee for your persistent efforts to focus the attention of the Congress and the nation on the dangers of projected increases in the public debt and the importance of moving the budget onto a sustainable trajectory. It is a shame that the bill establishing the Conrad-Gregg Task Force did not pass and that the President's announcement of a Debt Reduction Commission has not received strong bipartisan support. But those of us who care deeply about this issue must not give up! Hence, I appreciate the opportunity to participate in this hearing and hope to reinforce the Committee's commitment to keep pressing for solutions to the most serious threat to America's economic security and leadership capacity.

The dangerous trajectory

On any reasonable set of economic assumptions, the U.S. budget is on an unsustainable track. There is no disagreement among the Office of Management and Budget (OMB), The Congressional Budget Office (CBO), The Government Accountability Office (GAO), and leading private forecasters on where the budget is headed if we do not change course. In the next decade and beyond, federal spending, driven by the impact of an aging population and rising health care costs on Medicare, Medicaid, and Social Security, will rise substantially faster than the whole economy can grow—faster than the GDP. Revenues, at any likely set of tax rates, will grow only slightly faster than the GDP. The gap between spending and revenues will keep widening. The growing deficit will be more and more difficult and expensive to finance. Ultimately, we will not be able to borrow enough to finance the widening gap between spending and revenues.

These projections are not new--they predate the financial crisis and the current recession. But two or three years ago, deficits, while inappropriate in a prosperous economy, were of manageable size. The deficit in FY2008, for example was 3.2 percent of GDP and debt held by the public at the end of that year was 40.2 percent of GDP--not especially high proportions by either historical or world standards. The warnings of this Committee and others about bigger deficits looming in the future were not gaining traction with a complacent public.

But the financial crisis of 2007-8 and the deep recession it precipitated changed the budget outlook dramatically. Revenues fell rapidly as the recession spiraled downward. Spending exploded as emergency measures were taken to keep the financial sector from melting down and to mitigate the effects of the recession. The deficit peaked at more than 10 percent of GDP and the debt soared to an estimated 64 percent of GDP this fiscal year. Deficits will recede as the economy recovers and temporary spending measures expire. However, deficits are not projected to return to previous levels and debt will keep growing rising faster that the GDP even as the economy returns to normal growth. Moreover, the double impact of aging and medical spending—once seen as a "long run" problem—is already driving deficits and debt higher and will accelerate by the end of the decade. Complacency about the fiscal threat is no longer possible. Unfortunately, complacency has been replaced by strident partisan blaming--not yet by a willingness to cooperate on crafting solutions.

But solutions must be found—and soon. As our debt mounts, the risk grows that our creditors, especially the foreign creditors who own half our debt, will lose confidence in our ability to get our house in order and will demand dramatically higher interest rates to lend us more. Rapidly rising rates would derail the economic recovery and balloon the cost of servicing the federal debt. Escalation of the debt has made near term action to reduce deficits more urgent than it would have been at lower debt levels. We no longer have the luxury of waiting for several years until we are sure the economy is growing strongly before taking action to stabilize the debt. We have to take action very soon to arrest the debt build-up before it threatens the confidence of our creditors. Moreover, while there are persuasive economic reasons for curbing the increase in our debt, the moral case is even stronger. It is unconscionable for today's Americans to live persistently beyond our means and pass our bills on to future taxpayers.

Stabilizing the debt increase—at what level and when?

Rapid near-term deficit reduction would derail the recovery and risk sending the economy into a second downturn. But adopting a firm debt reduction goal and a credible plan for achieving it over a defined period would likely increase the chances of sustained recovery. A goal-oriented plan would reassure our creditors that we understand the problem and are taking action. It would reduce the risk of rising interest rates.

Two high level groups, including both Republican and Democratic budget experts, have recently recommended stabilizing the debt at 60 percent of GDP by a date certain. There is nothing magic about 60 percent, but the goal has been approved by both the European Union and the International Monetary Fund and is not so stringent as to be unachievable. A crucial question is 60 percent of GDP by when? The Peterson-Pew Commission on Budget Reform, of which I was a member, recommended stabilizing the debt at 60 percent of GDP by 2018, with actions starting in 2012 (*Red Ink Rising; A Call to Action to Stem the Mounting Federal Debt,* December 2009). Given the depth of the recession that goal is quite ambitious. The Committee on the Fiscal Future of the United States also recommended the 60 percent goal, but proposed getting there more gradually over the ten-year period, 2012-2022 (National Research Council and National Academy of Public Administration, *Choosing the Nation's Fiscal Future, 2010*). Even this more gradual trajectory would require substantial changes in current budget policy. Stabilizing the debt to GDP ratio, and eventually bringing it down, however, would not actually require a balanced budget in a growing economy. It would only require that deficits not add to the debt faster than the growth of GDP.

Pre-requisites of a credible plan

I believe that a credible, politically viable plan to stabilize the debt must have two characteristics:

- It must include both reductions in projected spending and revenue increases; and
- It must have support of the leadership of both political parties.

The widening gap between projected spending and projected revenues is too large to be closed by either spending cuts or revenue increases alone. The rapid projected growth in spending is driven by commitments to an aging population, especially for medical care, that are pushing up federal spending faster than GDP can grow. Reducing that spending growth to rates more in line with GDP growth is imperative and can be achieved only by greatly improving the efficiency of our health care delivery system, paring back lower priority entitlement benefits and holding the line on discretionary spending. But given the rapid aging of the population, especially in the near-term, the high demand for medical care, and other necessary and widely supported functions of government, it is unrealistic to bring the growth of spending into line with GDP growth in the next decade.

In addition, our tax system is extremely inefficient and complex. Part of the gap should be closed by reforming the federal tax system so that it produces more revenue with less drag on economic growth.

Partisanship has grown more extreme in the last few years and is at an especially high pitch in this election year. Neither party wants to take the lead in proposing unpopular policies such as cutting the growth of entitlements or increasing revenues, and each is eager to blame the other. But putting the budget on a sustainable track requires these unpopular actions, and the only way to accomplish them is for both parties to work together. I have never been a fan of commissions—it would be much better if Congress could stabilize the debt by using its regular budget process—but a bipartisan commission with fast track authority is the best hope for serious debt reduction right now. I hope there will be an opportunity for the Congress to reconsider its rejection of the Conrad Gregg proposal or something like it or to embrace the President's alternative and give it the force of law.

Meanwhile, former Senator Pete Domenici and I have recently launched a Bipartisan Debt Reduction Task Force that we hope will demonstrate that Republicans and Democrats can work together to produce a sensible, viable debt reduction plan. Under the auspices of the Bipartisan Policy Center, founded by former Senator Leaders Dole, Daschle, Baker and Mitchell, we have launched an effort that we profoundly hope will show that crafting a bipartisan debt reduction plan is not an impossible task. We have recruited an impressive group of citizens, former elected officials, and budget experts to help us (list attached) and will report by the end of the year. We hope to support the efforts of an official Commission, whether statutory or created by executive order, and in any case to make our recommendations available to the public to foster discussion and debate. We will be happy to assist this Committee in any way we can.

Thank you.

BIPARTISAN POLICY CENTER

DEBT REDUCTION TASK FORCE
(Membership as of February 4, 2010)

- **Co-Chair Senator Pete Domenici**: Senior Fellow, Bipartisan Policy Center
  United States Senator from New Mexico (1973-2009)
  Former Chairman, Senate Budget Committee

- **Co-Chair Dr. Alice Rivlin**: Senior Fellow, Brookings Institution
  Director, Office of Management and Budget (Clinton Administration)
  Founding Director, Congressional Budget Office
  Former Vice Chair, Federal Reserve

- **The Reverend A.R. Bernard, Sr.**
  President, Council of Churches of the City of New York
  New York City Economic Development Corporation Board

- **Robert L. Bixby**
  Executive Director, The Concord Coalition

- **James Blanchard**
  Partner, DLA Piper
  Former U.S. Ambassador to Canada, former Governor of the State of Michigan and former U.S. Representative from Michigan

- **Sheila Burke**
  Faculty, John F. Kennedy School of Government, Harvard University and Georgetown University
  Former Chief of Staff to Senate Majority Leader Bob Dole

- **Dr. Leonard E. Burman**
  Daniel Patrick Moynihan Professor of Public Affairs, Maxwell School of Syracuse University
  Former Treasury Deputy Assistant Secretary for Tax Analysis
  Former Director of the Tax Policy Center of the Urban Institute and Brookings Institution
  Former Senior Analyst at the Congressional Budget Office

- **Robert N. Campbell III**
  Vice Chairman, Deloitte LLP (state, local, education, public health and nonprofit clients)

- **Henry Cisneros**
  Former Secretary of Housing and Urban Development (Clinton Administration)
  Former Mayor of San Antonio
  Current Executive Chairman of CityView

- **Carlos M. Gutierrez**
  Scholar, University of Miami Institute for Cuban and Cuban American Studies
  Former Secretary of Commerce and former President and CEO of Kellogg USA

- **G. William Hoagland**
  Vice President of Public Policy, CIGNA
  Former Staff Director, Senate Budget Committee
  Former Director of Budget and Appropriations, Office of Senate Majority Leader Bill Frist

BPC Debt Reduction Task Force Membership
Page Two

- **Frank Keating**
  President and CEO, American Council of Life Insurers
  Former Governor of Oklahoma

- **Karen Kerrigan**
  President and CEO, Small Business and Entrepreneurship Council
  Founder of Women Entrepreneurs Inc.

- **Maya MacGuineas**
  President, Committee for a Responsible Federal Budget

- **Donald Marron**
  Visiting Professor, Georgetown Public Policy Institute
  Former Member, Council of Economic Advisors
  Former Acting Director, Congressional Budget Office

- **Edward McElroy, Jr.**
  CEO of Union Labor Life Insurance Company
  Former President, American Federation of Teachers
  Former Vice President, AFL-CIO

- **Joe Minarik**
  Senior VP and Director of Research, Committee for Economic Development
  Former Associate Director for Economic Policy, Office of Management and Budget
  Former Chief Economist House Budget Committee

- **Marc H. Morial**
  President and CEO, National Urban League
  Former Mayor of New Orleans

- **William D. Novelli**
  Professor, McDonough School of Business at Georgetown University
  Former CEO, AARP

- **Anthony A. (Tony) Williams**
  Executive Director of the Government Practice at the Corporate Executive Board
  Director of State and Municipal Practice at Arent Fox PLLC
  Former Mayor of the District of Columbia and President of the National League of Cities

Contact:
Charles S. Konigsberg,
Director, Economic Policy Project and Debt Reduction Task Force
Bipartisan Policy Center
1225 I Street, N.W., Suite 1000 Washington DC 20005
202.379.1636
ckonigsberg@bipartisanpolicy.org

Chairman CONRAD. Thank you very much for that testimony, and thank you very much for the effort, because the clock is ticking, this is the time.

One of the things I want to emphasize is Senator Gregg and I, who joined together after 2 years of working together on a proposal, were delighted to get 53 votes in the Senate. That is a majority. But all of us know it takes a super majority to pass. And we would have passed if everyone who had been an original cosponsor had stuck with us. But we had a number who did not. We had a number of other who had committed to supporting it who did not. And so that leaves us with a circumstance that either we go back and offer a statutory commission again, with the hope that some others will be persuaded to join us; or the President goes forward with his Executive order commission, which has now been buttressed by very specific pledges by the Speaker of the House and by the Majority Leader, that the recommendations of that commission will be brought to a vote in the Senate and in the House. And that is a very, very important difference from the way other commissions have operated.

Ms. MacGuineas, welcome. It is good to have you here. Please proceed with your testimony, and then we will go to Dr. Penner.

STATEMENT OF MAYA MACGUINEAS, PRESIDENT, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET, AND DIRECTOR, FISCAL POLICY PROGRAM, NEW AMERICA FOUNDATION

Ms. MACGUINEAS. Thank you. Thank you so much, Senator Conrad. It is really a privilege to be here again, and I think it is such an important topic because this is kind of moving toward helping people understand the specifics of what it is going to take to put the budget back on a sustainable path.

What I would like to touch upon today is the need to pick a fiscal goal, how to think about the right goal, how to think about the right policies to achieve that goal, the types of policies that will be needed, and the consequences of failing to act.

First, the need for a fiscal goal. Clearly, the Federal budget is on an unsustainable path, and while nobody can predict at exactly what point excessive debt would lead us to a fiscal crisis, we can all agree that we would rather not find out, so we need to get out ahead of this first.

There are a number of compelling reasons to have a specific goal, and the first is to reassure credit markets that the U.S. is serious about controlling its debt and dependency on borrowing. While history and international experiences show us that cutting government spending or raising taxes too early when coming out of a recession can be destabilizing, we have also seen that announcing and committing to a credible plan can have positive economic effects and that an announcement effect can actually buy you some time.

The second reason to commit to a fiscal goal is that it allows policymakers to say no. Even when there are new priorities that are compelling and have lots of good points that you want them in the budget, we can no longer afford to deficit finance additional policies, and I even believe that by picking a fiscal goal, it elevates the issue of coming up with a plan even before other policies that are paid for. So it really elevates that to a top-level priority.

Third, having an agreed-upon goal allows comparisons of the tradeoffs between different approaches. So, for instance, health care reform only slows the growth of health care slightly. Much greater sacrifices will have to be found in other parts of the budget. If a plan doesn't raise taxes, entitlements and discretionary spending would have to take a tremendous hit. If the plan protects all beneficiaries over a certain age, then people who are younger will have to sacrifice more, and so on. So right now, it is much too easy for anybody to demagogue, and you can say, well, your plan would cut Social Security by X amount, or that would be the largest tax increase ever, and it is not fair to compare those against the option right now, which is staying on an unsustainable course. So this is really a way to level the playing field of options.

I would also like to take this opportunity to thank you and Senator Gregg for the really important work you did on putting forward the plan for the commission, and I am sorry that some of your colleagues changed their minds and didn't support it, but I hope we will be able to turn that into some productive mechanism to move forward.

So in terms of picking the right goal, there is no single right goal. As you mentioned, the Peterson-Pew Commission has recommended stabilizing the debt at 60 percent of GDP by the year 2018, and over the long term, we think it is critical that we continue to bring the debt down closer to historical levels at below 40 percent because of the fiscal flexibility that you need to have by not having excessively high debt levels. That is one of the things that helped us respond to this economic downturn.

So we base the 60 percent target on international, economic, and political factors. Global markets are more likely, we believe, to embrace a goal that has international credibility, as the 60 percent number does. We also believe that it is the most ambitious and economically sensible target that can be achieved in the timeframe. Given the significant risks of high U.S. debt, a less aggressive target might be insufficient to reassure markets. We also worry that if a timeframe is too long, policymakers might not stick to the plan and they would change course in the middle of it.

The goal really requires two pieces, bringing the debt down to a reasonable level of 60 percent or whatever target is picked, and then stabilizing it so it doesn't come back up in the longer term. We don't get into this in the report, but I think it is quite likely that you will need to have different kinds of policies to achieve those. So the medium-term target is going to need policies that can be implemented more quickly and they may well come on the discretionary and revenue side of the budget, while the longer-term goal, so that the spending side of the budget doesn't turn back up again, is going to have to really get at the drivers of growth, the policies that are a result of aging and health care problems, Social Security, Medicare, and Medicaid.

When I had the opportunity to talk about the commission here, the bottom line, I felt, was that the most important thing is that the structure of the commission have widespread buy-in, and I think the exact same principle applies to a fiscal goal. But the most important thing here is that there is widespread buy-in to it so that we can have that be the first step and then move into the specifics of how you achieve it.

So whatever fiscal goal we do end up picking, the starting point really, really matters. It will be greatly affected by whether policymakers let policies that are slated to expire do so, or whether they renew them but pay for them, or whether they are made permanent in a way that is deficit financed.

If we assume the fiscal goal of stabilizing the debt at 60 percent in 2018, it would require roughly—and you showed this in your posters, in your charts—it would require roughly $1.5 trillion over 9 years that we don't assume you would start immediately under current law to get there. And it would take $5 trillion under current policy. That just shows you the huge additional debt that is layered on by extending a lot of policies without attempting to offset any of those costs.

We include in our report a budget blueprint that is purely illustrative. It is not a plan that our commission endorsed, but it shows all the policies. We lay out the policies under both scenarios that it would take to get to that 60 percent target, and it is here and it is included in my written remarks.

I also wanted to put forth a couple principles that I thought were helpful in coming up with the specific policies. The first is that changes should be conducive to economic growth, or at least minimize the degree to which it hinders growth, whenever possible.

The second is that spending growth is the crux of the long-term budgetary problem, but that both spending and revenues will probably have to be part of any budgetary solution.

Third, reform should, indeed, focus on the drivers of programmatic growth, particularly for the long-term stabilization portion of a goal.

And finally, the sluggish economy should not be used as an excuse to delay coming up with a plan, even though we need to be sensitive about implementing a plan too quickly.

So the Committee for a Responsible Federal Budget doesn't endorse specific policy changes, so I will go ahead and speak only on my own behalf when I put forward a couple examples of what I think we should be talking about. And I do think it is so important to talk about specifics, because the kinds of things that are in the political discussion right now are much smaller than the types of policies it is actually going to require, and I think policymakers and the public have to come to an understanding of exactly what it is going to take.

So some of the most promising policies that I would recommend are, first, raising the retirement age. As life expectancy increases, we just can't afford to support people in retirement for as long as we have currently under these programs. Increasing the retirement age also has positive labor market effects.

Second, restructuring some of our entitlement programs so that we slow the growth of benefits for people who need them the least. Given that entitlement programs will have to change, you can either reduce benefits across the board or you can reduce them more for people who need them less, and I certainly think we should do that in terms of Social Security. We should look at ways to slow the growth of benefits at the upper end. And in terms of Medicare, it makes an awful lot of sense to ask people who can afford to contribute more to the cost of their benefits to do so.

Third, we are going to have to do more on health care. No matter what happens with the health care bills that are being considered, as we have seen, they haven't done enough to control costs to really take a lot of pressure off the rest of the budget. So I think it is very important that we look at the pieces of the Medicare reforms that would be most likely to slow the growth of health care costs, including the Medicare Commission, including the tax treatment of employer-provided health care.

And we need to have a rational discussion in this country about who should pay how much for health care. We are constantly kind of shifting it around so you pay for your health care, you pay for your health care, and people don't think that the costs come down to them. We need to have a more sensible discussion about it and bring people closer to the costs so that we can help control them in the longer term.

I think reintroducing discretionary spending caps makes an awful lot of sense. In the past decade, discretionary spending grew faster than the economy, even excluding defense spending. That is the case. And so I think to ensure that politicians make tough decisions in this area of the budget, we can have strong, enforceable spending caps. They have always been the traditional counterpart to PAYGO and I think both of them should be in place as we go forward. Nobody thinks that they replace an actual budget deal, but they can certainly help us stay on track.

Broadening the tax base, I think is a critical piece of this. Right now, the tax base is replete with credits, exemptions, deductions, exclusions. All told, tax expenditures lead to $1 trillion less in revenues collected by the Federal Government than would otherwise take place, and they are what account for the great complexity of the tax code. So I think we can do a lot of reforms on the tax base to simplify, make more efficient, make more progressive our tax base.

Finally, even after all spending cuts have been put in place, it is very likely that there will still be a budgetary gap, and I think we are going to have to talk about what kind of broad tax reform should be on the table. I think it is likely that that discussion is going to look at a number of different revenue options, from increasing rates, to a transaction tax, which we have just started to hear a little rumbling about and you see more of that discussion going on in Europe right now, to a VAT, to an energy tax. My preference would be to look at an energy tax or a cap-and-trade which doesn't return all of the revenues back to families or to businesses. But I think it is important to think about if you can't get there on spending, you have to fill it in with revenues. What is the most efficient way that you can do that? We know that the higher taxes are, the more they can hurt the economy, so we want to be very thoughtful about that.

Finally, two process recommendations. The first is that I think a budget deal should be enforced with a debt trigger. The type of trigger that we recommended in our commission report was one that is broad-based and applies equally to revenue and spending. Triggers have not been particularly effective in the past, and one of the reasons is that so many parts of the budget are exempt from that trigger. We wanted to have a trigger that was uncomfortable enough that nobody wanted to pull it, but possible that if it had to be pulled, it could actually be put in place. So we did a lot of thinking about how to construct that trigger.

Second, we have the expiration of the 2001–2003 tax cuts coming up. I think that can serve as a very useful lever right here, where we have members of both parties who want to extend at least the bulk of the tax cuts. I think delaying doing that until we have a budget deal in place makes a good deal of sense. If we continue to give away all the sweeteners in the budget, it makes it so much harder to take the tough medicine.

So just finally, the risk of inaction is becoming more and more apparent every day. We see what is going on around the world. We hear what Moody's and other credit agencies are warning to us. And we know that excessive debt can harm the economy in terms of interest rates, in terms of jobs, in terms of standard of living.

The most prudent course of action would be to commit to a credible plan as quickly as possible and to phase in gradually as the economy is recovering enough so that it can accommodate that. If we don't get our fiscal house in order, we know that, ultimately, we will face some sort of fiscal crisis, either a steady deterioration of our standard of living or an abrupt crisis brought on by some external action. Clearly, nobody wants to see that happen, and so I once again thank the committee for holding this hearing and starting to talk about the specifics as we move forward.

[The prepared statement of Ms. MacGuineas follows:]

Hearing before the Senate Budget Committee on

Setting and Meeting an Appropriate Target for Fiscal Sustainability

February 11, 2010

Statement of Maya MacGuineas

Committee for a Responsible Federal Budget

Chairman Conrad, Ranking Member Gregg, and Members of the Committee, good morning – it is an honor to appear before this Committee. Thank you for holding this important hearing on the specifics of achieving fiscal sustainability – it comes at a critical time.

I am the President of the bipartisan Committee for a Responsible Federal Budget. Our Co-Chairs are Congressmen Bill Frenzel (R-MN), Tim Penny (I-MN), and Charlie Stenholm (D-TX). The Board is made up of past Directors of the Office of Management and Budget, the Congressional Budget Office, and the Government Accountability Office, as well as Chairmen of the Federal Reserve Board and the Budget Committees, and other budget experts. Additionally, I am the Director of the Fiscal Policy Program at the New America Foundation, a non-partisan think tank. I am also a member of the Peterson-Pew Commission on Budget Reform, which, in December, released *Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt*, which proposes a six-step framework to address the growing federal debt.

The main points I would like to emphasize today are:

- The need to pick a fiscal goal
- How to think about the right goal
- How to think about the right policies to achieve that goal
- The types of policies it will take to close our fiscal gap
- The consequences of failing to act

The need for a fiscal goal

Clearly, the federal budget is on an unsustainable path. Assuming current law, the debt held by the public will grow from \$7.5 trillion (53 percent of GDP) in 2009 to \$15 trillion (67 percent of GDP) by 2020. Continuing a number of policies that are slated to expire, including the 2001 and 2003 tax cuts, patching the Alternative Minimum Tax, and reforming the sustainable growth rate for Medicare, without offsetting the costs, would make this bad situation dramatically worse, with the debt growing to well over 100 percent of GDP—or $22 trillion in 2020. Things only get worse after the ten-year window.

We must change course. Nobody can predict at exactly what point excessive debt would lead to a fiscal crisis, but we can all agree it would be best not to find out. The policies needed to bring down the deficits and debt to sustainable levels—cutting spending and raising taxes—are not the types of budgetary change politicians relish making. The current political environment makes this already unenviable task even harder.

There are a number of compelling reasons to pick a fiscal goal. The first is to reassure credit markets that the United States is serious about controlling its debt and its dependency on borrowing. Currently, creditors are quite willing to lend to the United States and interest rates are historically low, allowing us to borrow at relatively low cost. This is undoubtedly the result, at least in part, of the 'flight to quality' that regularly occurs during uncertain times. But how long will our debt be viewed as 'quality'?

Our current budget plan relies on trillions and trillions of dollars of borrowing over the next decade. Even if we make significant improvements to the budget's path, we likely will still have to borrow staggering amounts in the coming years. We must find a way to reassure credit markets.so we can continue to borrow at manageable interest rates. Significant upward pressure on interest rates—either gradual and steady, or sudden—could prove destabilizing to our economic recovery at just the wrong time.

While history and international experience shows that cutting government spending or raising taxes too early during an economic recovery can push the economy back into recession, it also shows that committing to a sensible framework for medium-term debt reduction can improve creditors' expectations of a country's fiscal management and strengthen a recovery. The "announcement effect" from a credible commitment can have positive economic effects by signaling that the United States is serious about reducing its debt, which in turn can lead to relatively lower interest rates and boosts to growth and employment. In other words: the mere announcement of a plan to achieve a goal—if viewed as credible—can make achieving a fiscal goal easier, even before any policy changes have been made.

The Committee for a Responsible Federal Budget strongly supports this model, and we even started a club, the "Announcement Effect Club," modeled on Greg Mankiw's Pigou Club, which recognizes economists, budget experts, and lawmakers who also support it.

There rarely are free lunches in budget policy, but the ability to bring about economic improvements prior to action is at least a small one, or free amuse-bouche.

The second reason to commit to a fiscal goal is to help lawmakers to say no. There are plenty of compelling spending increases and spending cuts that could, and ideally would, be made. Two of my personal preferences are for lowering corporate income tax rates (in an era of mobile capital and global competition, it is counter-productive to have such high marginal corporate tax rates), and increasing government spending on well-targeted investments in education, R&D, and infrastructure. But as compelling as these and other priorities may be, there is absolutely no room in the budget to deficit finance them. It should not even be a matter for discussion (other than, perhaps, for stimulus measures, but even stimulus policies should come with offsets so that they are repaid over a longer time period to allow for stimulative effects.)

Establishing a fiscal goal allows policymakers to say "No" to the notion that we can deficit finance any new initiatives, no matter how worthy. It helps to operationalize the principle that anything worth doing is worth paying for. And it goes further, requiring policymakers to prioritize developing a sustainable budget plan in front of other new budgetary endeavors, including even new priorities that are paid for. One of the risks to saying yes to major new initiatives that are paid for is that they consume budget offsets that might otherwise be used for deficit reduction, making the development of a budget plan even more difficult.

Finally, having a unified goal allows for comparison of the tradeoffs between different approaches. If, for instance, health care reform only slows the growth of health care spending slightly, much larger sacrifices will have to be made in other areas of the budget to achieve the goal. If a plan doesn't raise taxes, entitlements and discretionary spending will take a much larger hit. A plan that protects all benefits for people above a certain age, say 55, will result in younger participants enduring much larger reductions. A budget that includes all sorts of "sweeteners" to make it politically easier to pass, also will have to have more offsets to achieve the goal. And so on.

Right now it is much too easy to demagogue any approach: "You would cut Social Security benefits by 50 percent!" Or: "That would be the largest tax increase ever!" But it isn't fair to compare a policy change to the lack of one—because the latter is not sustainable. A single fiscal goal is the critical first step to creating a level playing field for comparing budget reform options.

Picking the right goal

While there is no single "right" fiscal goal, the Peterson Pew Commission on Budget Reforms proposes stabilizing the debt held by the public at 60 percent of GDP by 2018. Specifically, we recommend six steps:

Step 1: Commit immediately to stabilize the debt at 60 percent of GDP by 2018
Step 2: Develop a specific and credible debt stabilization package in 2010
Step 3: Begin to phase in policy changes in 2012
Step 4: Review progress annually and implement an enforcement regime to stay on track
Step 5: Stabilize the debt by 2018
Step 6: Continue to reduce the debt as a share of the economy over the longer term

We based the 60 percent target on a number of factors, including what we viewed as politically achievable, the right balance between economic recovery and fiscal considerations, and the standards used by other industrial nations.

From a financial perspective, the United States must persuade credit markets that it is serious about debt reduction. Global markets are more likely to embrace a plan if the goal has international credibility and the 60 percent debt threshold has become an international standard. In the EU, under the requirements of the Maastricht Treaty and the Growth and Stability Act, EU countries must satisfy a benchmark target of 60 percent of GDP for debt and 3 percent for annual deficits. Likewise, the IMF has singled out the 60 percent debt target as a reasonable benchmark.

We believe a 60 percent target is the most ambitious and economically sensible target that can reasonably be achieved in this timeframe—given the significant risks of high U.S. debt, a less aggressive target might be insufficient to reassure the markets. Over the longer-term, we think it is critical that the debt decline to pre-crisis levels—under 40 percent of GDP, but more time will be needed to get there. Lowering the debt too quickly could hurt our economy, and if too many other nations cut their debt at the same time, the global economy as well.

This goal really requires two pieces: bringing the debt down to a reasonable level of 60 percent of GDP in the medium term and then stabilizing that the debt so it doesn't grow faster – and eventually grows slower – than the economy. It is quite likely that the medium and longer-term objectives will require different policy approaches, with the first prioritizing policies that can be phased in more quickly—probably cuts and freezes in discretionary spending and revenue increases; whereas the longer term changes will have to focus on the real drivers of the longer-term deficit problems—aging and healthcare, and will require structural changes to Social Security, Medicare and Medicaid.

More important than any specific fiscal goal is that the goal be an economically and politically reasonable target with widespread buy-in. This will allow policymakers to proceed to determining how best to achieve that goal and assessing the tradeoffs involved.

Getting specific

Picking the fiscal goal, of course, is the easier part. Getting there is much more difficult.

The starting point matters

Whatever fiscal goal we end up picking, the starting point matters. Achieving a fiscal goal will be greatly affected by whether policymakers let policies that are slated to expire do so, or whether they are renewed but are paid for, or whether they are made permanent and deficit-financed.

If we assume the fiscal goal of stabilizing the debt at 60 percent of GDP by 2018, under current law (where policies expire) it would require roughly $1.5 trillion in savings over the next nine years. (The specific savings required would depend on how quickly policies were phased in, which affects the level of interest savings generated.) We assume no policy changes for two years and very minimal changes for the next few years, and a gradual glide path to very small deficits (less than 1 percent of GDP) by 2018. Thereafter, you can stabilize the debt while still running small deficits as long as the economy is growing faster than the debt.

We included a *Budget Blueprint* as an appendix to our *Red Ink Risking* commission report that shows what this would require. This is not a specific plan endorsed by our commissioners, but rather it illustrates the level and type of policy changes required. (Appendix 1.) The blueprint includes:

- Savings from defense/lower war costs ($50 bil)
- Cuts to/elimination of outdated programs ($5 bil)
- Agriculture cuts ($5 bil)
- Changes to Social Security: raise retirement age, reduce benefits for higher earners, other benefit calculation changes ($20 bil)
- Changes to health care ($15 bil)

- Reforms to contracting payments ($15 bil)
- Other mandatory savings ($15 bil)
- Tax base broadening ($35 bil)
- Change to the superlative CPI for indexing of certain programs and tax policies ($30 bil)

Note: All savings are average 1-year savings

If these policies were enacted, it would save roughly $1.3 trillion over seven years and would generate an additional roughly $200 billion in interest savings. Under this scenario, in 2018, the debt would stand at $12 trillion (60 percent of GDP) instead of $13.5 trillion.

If instead we assume those expiring policies are extended and deficit financed, the task becomes *significantly* harder, requiring a total of $5 trillion in savings over the same time period instead of $1.5 trillion.

Our second illustrative path includes additional options, including:

- Discretionary spending caps pegged to inflation (our baseline assumes it grows with GDP, which is more in line with what it has done historically) ($130 bil)
- Reducing the 2001/03 tax cuts (reduce rate cuts by half) ($35 bil)
- Introducing a new energy tax ($100 bil)
- Larger savings in some of the above categories

Both examples illustrate that substantial changes will be required. Virtually no area of the budget will be unaffected—and if any area is exempted, it will mean larger changes elsewhere.

The policies I have touched upon here are much larger than the specifics policymakers tend to discuss publicly—if they discuss deficit reduction policies at all. Unfortunately, the political environment currently is not conducive to an honest discussion about the magnitude of changes necessary to achieve any reasonable fiscal goal. Whenever policymakers dare to be specific about cuts to programs or tax increases, they are too often met with criticism and attacks. We need to find a way to have a more honest and constructive dialogue about our fiscal future.

I would like to take the opportunity to thank both Chairman Conrad and Ranking Member Gregg for their important work in promoting a bipartisan commission to help in this process. I am very sorry the Senate did not accept this idea last month, and I hope we will find a way to transform it into the next productive mechanism for moving this process forward.

Principles for change

Given how large the necessary changes will need to be, we suggest some principles for determining what those changes should be:

Change should be conducive to economic growth, or at least minimize the degree to which it hinders it, wherever possible. The Committee for a Responsible Federal Budget has spent a lot of time exploring fiscal turnarounds, both domestically and abroad. Nearly all of them have one component in common – strong economic growth. On the one hand, strong economic growth helps bring in more revenues, and it means less spending will be required on unemployment and other so-called “automatic stabilizers.” At the same time, it means a larger GDP – so we are actually increasing the denominator as we shrink the numerator in the debt-to-GDP equation. Don’t get me wrong, our problems are too severe to mitigate through a strong and growing economy, but this surely can help. To this end, it is important to understand that not all policy changes are equal. Pro-growth policies—such as fundamental tax reform, improving labor force incentives, and protecting productive investment spending—should be given special consideration when crafting a fiscal plan. On the revenue side in particular, assuming taxes go up, it becomes increasingly important to have as an efficient a tax system that depresses growth as little as possible—something our current tax system doesn’t come close to resembling.

Spending growth is the crux of the long-term budget problem, but both spending and revenues will probably have to be part of any budgetary solution. Anyone who has tried to develop a plan to achieve a reasonable fiscal goal either solely through spending reductions or tax increases knows just how close to impossible it is. Realistically it is hard to envision a workable plan that doesn’t involve both spending cuts and tax increases, and it is even more difficult to imagine a political "grand bargain" where both are not involved.

Focus on the drivers of program growth. Though everything will have to be on the table, any package should be weighted toward reforms of the most problematic areas of the budget. Reforms in programs that are growing faster than the economy, such as health and retirement programs, are the most likely to produce large and compounding savings, which not only help stabilize the debt in the medium term but keep it from growing again over the longer term.

The sluggish economy should not be an excuse to delay crafting a plan. Developing and implementing a plan can and should occur at two different points, with policymakers developing a plan as quickly as possible, while phasing it in more gradually only as the economy is strong enough to accommodate those changes.

Specific ideas

The Committee for a Responsible Federal Budget does not endorse specific policy changes. Our board members—two of whom I am sitting next to at this hearing—do, but as an organization we do not. So I will speak on my own behalf, not the entire board's, when I mention what I think are the most promising policies.

1 Raising the retirement age. Over the past 50 years or so, life expectancy has increased significantly, yet the average retirement age has fallen from 65 to 62. Raising the retirement age for Social Security would not only reduce the program's obligations, but likely would encourage people to work longer. And a larger work force means more taxable income and stronger overall economic growth. An increase in the age for Medicare (possibly combined with an option to buy into the program at earlier ages) would also be sensible.

2. More means-testing in entitlements. Given that entitlement spending will have to be reduced, we can proceed by reducing all benefits, or by reducing them more for those who depend on the programs less. I favor the second option and think we should consider slowing the growth of Social Security benefits for the well-off and asking them to pay a greater share for their Medicare benefits.

3. Do more on health care. Whether the bills being considered as part of health care reform pass or not, more will have to be done to control costs. We should proceed with changes to slow the growth of overall healthcare costs—such as changing the tax treatment of employer-provided health insurance, as well as changes specific to Medicare, Medicaid, and other government health care programs. We have to have a sensible discussion about how much the government should pay for when it comes to health care costs and how to introduce more price sensitivity into the public and private insurance arrangements.

4. Reintroduce discretionary spending caps. Over the past decade or so, discretionary spending has grown far faster than the economy, even excluding defense spending. To ensure that politicians make tough decisions in this area of the budget, we must have strong enforceable spending caps in place. In the past, they have proved to be the sensible companion to PAYGO.

5. Broaden the tax base. The tax base is replete with credits, exemptions, deductions, and exclusions. All told, the government loses around a trillion dollars *a year*, due to these tax expenditures. While politicians love these tax breaks since they allow them to achieve spending priorities – for education, housing, favored industries – all while appearing to give tax cuts, they are really spending programs dressed up as tax cuts. We should dramatically reform this part of the tax code, in a way that would simplify the code, make it more efficient, and raise government revenues.

6. Even after spending has been reduced and the tax code reformed, there is likely to be a gap between spending and revenues. If so, we will need to consider new revenues. Given some of the options likely to be discussed – higher income tax rates, a transaction tax, and VAT, my preference would probably be for an energy tax which could have positive effects on energy policy, the environment, and the budget. Certainly a cap and trade regime that did not return all revenues to families and businesses would be more sensible than one that does, from a budgetary perspective.

Finally, I will also suggest two process recommendations.

First, a budget deal should be enforced with a new debt trigger. The Peterson Pew Commission recommends a trigger which would take effect if an annual debt target were missed. Any breach of the target would be offset through automatic spending reductions and tax increases applied to both sides of the budget equally. Past automatic policy changes failed in part because so many programs were exempt from the trigger and it was so easy to bypass the restrictions. A debt trigger should be punitive enough to cause lawmakers to act but realistic enough that it can be enacted as a last resort if policymakers fail to act or select policies fall short of the goal.

Second, we currently have a hammer built into the budget: the expiration of the 2001 and 2003 tax cuts, the bulk of which both political parties support extending. Lawmakers could consider agreeing not to extend these tax cuts until a reasonable fiscal target has been put into place and a plan to achieve it has been agreed upon. Given the support for extending the tax cuts, this would help motivate lawmakers of both parties to create a comprehensive budget reform plan.

The risks of inaction

The risks of inaction are becoming more apparent every day: We see what is happening to overleveraged nations around the globe. We regularly are reminded by credit rating agencies that the United States is risking its own triple-A credit rating by failing to act, and by foreign leaders, that they are concerned about our fiscal well-being.

Excessive debt can hurt a country, its citizens, and its economy in many ways. It can harm the economy by pushing up interest rates—particularly dangerous as we emerge from a severe recession. It can slow the growth of wages and keep living standards from increasing by as much as they otherwise would have, leaving the country's citizens worse off. The massive amount of debt issued by countries around the world risks crowding out private investment. We already are already seeing the cost of capital increase for corporate borrowers—the opposite of what we want to see in terms of job creation. And excessive debt deprives the country of the fiscal flexibility to respond to future crises and new national priorities as they arise.

If we do not get our fiscal house in order, we ultimately risk a fiscal crisis. It could come sooner rather than later. It could come from a shock elsewhere or at home. History shows that tipping points are difficult to predict, but that vulnerabilities are usually well-known. With the federal debt about to expand dramatically, the risks of doing nothing are unacceptably high for the American taxpayer.

Thus, this is exactly the right time to focus on dealing with the medium and long-term budget challenges facing the country. Over the past year, the top priority was – as it should have been – dealing with the very serious economic and financial crises facing the country. But continuing to add to the debt without a plan to bring it back down to a sustainable level jeopardizes the recovery and puts the future growth path of this country at grave risk.

The most prudent course of action would be to announce a credible course of action for addressing the nation's budgetary challenges *immediately*, while phasing in the actual policy measures to get there more *gradually*. Simultaneously, we must be preparing the country for the large changes that will be required to accomplish any reasonable fiscal goal. Perpetuating the notion that we can achieve a sustainable fiscal future while taking major areas of the budget off the table and focusing only on minor incremental changes, stand in the way of making progress in time to get in front of the problem.

Thank you again for inviting me here today. I look forward to any questions.

Budget Blueprint: Paths to 60%

Current Law: Debt in 2018 (% GDP)	7-year savings, 2012 – 2018 $13.5 TRILLION (67%)
Defense# (lower war costs)	$350 billion
Outdated Programs (eliminate or cut certain discretionary programs)	$25 billion
Agriculture (reduce direct payments to farmers)	$25 billion
Social Security* (raise retirement age, reduce benefits for high earners; enact other changes)	$150 billion
Health Care* (enact deficit-reducing health reform which slows health care cost growth)	$100 billion
Contracting Reform (gradually reduce number of contractors; reform payments)	$100 billion
Other Mandatory Savings (reduce federal benefits, increase user fees; cut certain programs)	$100 billion
Tax Base Broadening (consolidate and cap breaks for housing, health, education & saving)	$250 billion
Superlative CPI* (index government benefits and tax code to alternative measure of inflation)	$200 billion
Deficit Reduction	$1,300 billion
Interest Savings	$200 billion
Debt (% GDP)	$12 TRILLION (60%)

Today's Policies: Debt in 2018 (% GDP)	7-year savings, 2012 – 2018 $17 TRILLION (85%)
Defense (reduce certain weapons systems)	$100 billion
Outdated Programs (eliminate or cut certain discretionary programs)	$100 billion
Discretionary Caps (cap normal discretionary spending growth at inflation)	$900 billion
Agriculture (phase out payments to farmers and other agricultural subsidies)	$100 billion
Social Security* (raise retirement age, reduce benefits for middle-high earners; enact other changes)	$300 billion
Health Care* (enact deficit reducing health reform and cap growth of government health spending)	$400 billion
Contracting Reform (reduce number of contractors and reform payments)	$150 billion
Other Mandatory Savings (reduce federal benefits, increase user fees; cut certain programs)	$200 billion
Tax Base Broadening (consolidate and cap breaks for housing, health, education & saving)	$400 billion
Reduce 2001/2003 Tax Cuts (gradually reduce rate cuts by half)	$250 billion
State & Local Tax Deduction (phase-out deduction to finance AMT patches)	$600 billion
Energy Tax (institute tax on carbon emissions or equivalent cap-and-trade system)	$700 billion
Superlative CPI* (index government benefits and tax code to alternative measure of inflation)	$200 billion
Deficit Reduction	$4,400 billion
Interest Savings	$600 billion
Debt (% GDP)	$12 TRILLION (60%)

Current law assumes greater war costs than does the Commission's baseline

* Certain policies such as changes to Social Security, health care, and indexing will contribute more to the goal of keeping the debt stable as a share of GDP after 2018.

Note: The budget blueprint is an illustration of the types and magnitudes of policies that would be necessary to achieve debt stabilization goal under different scenarios. Both targets and savings estimates are rounded for illustrative purposes. Numbers vary tremendously depending on policy specifics, timing phase-ins, and interactions. In general, reaching our target from a "current law" baseline requires smaller changes, since that baseline assumes policies – such as the allowed expiration of the 2001 and 2003 tax cuts — which would result in lower levels of debt. The Peterson-Pew Commission on Budget Reform does not endorse either of these plans, but rather provides them in order to demonstrate the magnitude of choices which would be necessary to reach our recommended goal.

Sources

The source for most of the options contained in the Budget Blueprint is the Congressional Budget Office's (CBO) Budget Options reports released in December 2008 and August 2009. We specify where an insufficient amount of savings exists from these options.

Scenario 1: Assumes Current Law

Defense: According to CBO's August *Budget and Economic Outlook: An Update*, gradually reducing the number of troops in Iraq and Afghanistan from 210,000 to 75,000 would save nearly $600 billion by 2018. We assume a drawdown would be possible as the Iraq war phases down, although it may not be as large as described above due to new commitments to Afghanistan.

Outdated Programs: CBO's *Budget Options* includes well over $150 billion in options to reduce discretionary spending over 10 years. For example, eliminating the Department of Energy's research on energy-efficiency and renewable energy technologies would save $10 billion over the next decade, eliminating the Department of Transportation's New Starts Transit programs would save almost $15 billion over ten years, and eliminating federal funding for national community service programs could save nearly $8 billion over ten years.

Agriculture: According to OMB, the Administration's proposal to phase out direct payments to high-income farms would save $10 billion over 10 years and their proposal to reform the crop insurance program would save another $5 billion over ten years. Since OMB estimates farm commodity payments, alone, to total nearly $65 billion over the next decade, we assume additional savings can be achieved through reducing these payments.

Social Security: CBO estimates Social Security savings of $111 billion over 10 years for progressive price indexing, or slowing the growth of benefits in a progressive manner, and $92 billion in savings over 10 years from raising the retirement age. Additional savings could come from other smaller changes such as reducing the spousal benefit.

Health Care: CBO's health care *Budget Options* includes over $2 trillion in potential health care savings. Additional savings have been scored from many of the recent health care reform bills. We assume many of these policies would be adopted as part of a health reform bill, but others could be used for debt reduction. Examples for potential health care savings include cutting subsidies to Medicare Advantage, (more than $150 billion over 10 years), raising the age of eligibility for Medicare to 67 (more than $90 billion over 10 years) and reducing Medicare's payment rates across the board in high-spending areas (more than $50 billion in savings over 10 years). To put these numbers in perspective, the government is expected to spend over $6.5 trillion on Medicare and Medicaid alone from 2012 – 2018.

Contracting Reform: In July the White House announced it would begin to implement reforms to the federal contracting system that would save $40 billion a year. We assume these savings would accrue slowly over time as reforms take effect.

Other Mandatory Savings: CBO's regular *Budget Options* includes well over $200 billion in possible savings over 10 years through a variety of mandatory spending cuts, imposition of fees, and changes to certain federal employee benefits. Over $150 billion in additional 10-year savings can be found between the recommendations in the President's Budget and options related to federal employee health benefits in CBO's health care *Budget Options*. For example, replacing private student loan subsidies with direct federal loans could save more than $40 billion over 10 years, and reducing veterans' disability benefits to account for Social Security payments could save $20 billion. For perspective, total mandatory spending, excluding Social Security, Medicare, and Medicaid, is projected to be around $3.5 trillion from 2012 through 2018.

Tax Base Broadening: Revenues lost to tax expenditures represent upwards of $1 trillion a year, according to some estimates; and a number of options exist for reducing the various tax credits, deductions, and exclusions. Limiting the mortgage interest deduction for expensive homes, for example, would raise over $40 billion over 10 years; and converting it to a 15 percent credit would raise almost $390 billion over that same period. Another option might be to change the tax treatment for life insurance for as much as $265 billion in ten-year revenue, or limit the deduction for charitable giving, resulting in as much as $220 billion in revenue over ten years.

Superlative CPI: CBO estimates that using a different measure of CPI for the Social Security COLA would save nearly $110 billion over 10 years, and using it for the tax code would generate just under $90 billion. Additional savings would also accrue due to other federal programs tied to inflation.

Scenario 2: Assumes Commission's Fiscal Baseline

Defense: The Commission's fiscal baseline already assumes a troop drawdown for Iraq and Afghanistan, and that any new costs associated with the wars in Iraq and Afghanistan would be paid for. CBO's *Budget Options* includes over $170 billion in savings options over a 10 year period in addition to this drawdown. Some of the biggest savings could come from cancelling programs such as the Joint Strike Fighter ($37 billion) and Future Combat Systems ($22 billion). To put these proposed cuts in perspective, the government is projected to spend roughly $4.5 trillion on defense between 2012 and 2018.

Outdated Programs: See Outdated Programs above. Additional savings would be necessary, and could come from, for example, eliminating federal grants for wastewater and drinking water, which would save $11 billion over 10 years or increasing fees for aviation security to save almost $20 billion over ten years.

Discretionary Caps: The Commission baseline assumes discretionary growth at the rate of GDP. According to CBO's August *Budget and Economic Outlook: An Update*, assuming discretionary spending growth at the rate of inflation, by itself, would save roughly $1.7 trillion over 10 years, including over $1.3 trillion between 2012 and 2018. To put the savings in perspective, total discretionary spending would be about $10.5 trillion between 2012 and 2018 under the Commission's fiscal baseline.

Agriculture: This option would eliminate most agricultural subsidies. In 2008, CBO estimated that commodities payments, crop insurance, and related programs would cost around $95 billion between 2012 and 2018; the 2008 farm bill changed these spending levels only modestly. In addition to largely eliminating these programs, savings could come from phasing out subsidies to ethanol and other biofuels, ending the market access program, and phasing out certain subsidies administered through the tax code such as the supplemental revenue assistance program, among other options.

Social Security: See Social Security above. Additional savings could be achieved through more aggressive forms of indexing reform, extending the years of work used to calculate benefits, as well as modifying the tax treatment of Social Security benefits.

Health Care: See Health Care above. Additional savings could come from more expansive and aggressive changes to the government health care savings, including a revenue positive reform of the sustainable growth rate for Medicare physician payments and a cap on the growth of overall government health care spending.

Contracting Reform: See Contracting Reform above. Here we assume a faster phase in of the reforms.

Other Mandatory Savings: See Other Mandatory Savings above. Additional spending cuts would be necessary. For example, adoption of a voucher program for federal employee health care could save $40 billion over 10 years, and financing the food safety and inspection service solely through fees would raise almost $10 billion.

Tax Base Broadening: Simply limiting the tax benefit of itemized deductions to 15 percent brings in $1.3 trillion over 10 years according to CBO.

Reduce 2001 and 2003 Tax Cuts: The Commission's fiscal baseline assumes most of the 2001 and 2003 tax cuts would be extended — other than those for families making over $250,000 annually. But, significant savings would be realized if fewer of these cuts were extended. For instance, we estimate from CBO's *Budget Options* that allowing the remaining brackets to revert to halfway between their current and scheduled levels would save nearly $300 billion between 2012 and 2018.

State and Local Tax Deduction: CBO estimates in its *Budget Options* that eliminating this deduction would save more than $860 billion over 10 years. We estimate that approximately $680 billion of this would accrue between 2012 and 2018.

Energy Tax: In its *Budget Options*, CBO estimates that putting a price on "upstream emissions of greenhouse gases" would generate more than $880 billion in the 8 years between 2012 and 2019. We assume this would occur through either a carbon tax or a fully-auctions cap-and-trade system.

Superlative CPI: See Superlative CPI above.

Chairman CONRAD. Thank you. Thank you for really excellent testimony.

Dr. Penner, welcome. It is always good to have you here. We appreciate very much all of the effort that you have extended helping us understand the alternatives going forward. Please proceed.

STATEMENT OF RUDOLPH PENNER, PH.D., INSTITUTE FELLOW, URBAN INSTITUTE CO-CHAIR, COMMITTEE ON THE FISCAL FUTURE OF THE UNITED STATES

Mr. PENNER. Well, thank you, Mr. Chairman. I would like to thank the committee for the opportunity to testify on this report, "Choosing the Nation's Fiscal Future". It was organized by the National Research Council and the National Academy of Public Administration and I co-chaired the report with John Palmer of Syracuse University. I share Alice's admiration for the work of this committee and it is a particular privilege to be here.

Like a number of other reports, this one makes the argument that today's budget policies are, indeed, unsustainable. As you noted, you have heard that argument many times before, so I won't go into it here. The arguments are in my prepared testimony.

As recommended in the report, "Red Ink Rising", our committee believes that Congress should set a target for the debt-GDP ratio and not exceed it. We believe further that a prudent target would be to hold the debt to 60 percent of the GDP. If the Nation experiences good fortune while holding the debt to this level, it would be wise to lower the target further.

Now, as Maya has said, the choice of 60 percent as a target is a matter of judgment. The committee had to balance the risks of choosing a higher target against the political difficulty involved in getting to something lower.

A higher debt-GDP ratio means running higher deficits. To make the arithmetic easy, for example, if the GDP grows at 5 percent per year, then arithmetically, a 60 percent target implies holding the deficit to 3 percent of the GDP, whereas if we went to 80 percent, the deficit consistent with that would be 4 percent of the GDP.

As the target for the deficit and debt-GDP ratio is raised, government would draw on a higher proportion of the available supply of domestic and foreign saving, and interest rates would rise. To the extent that the deficit was financed out of domestic savings, there would be less available to finance U.S. private investment and that would mean lower productivity growth than otherwise, and therefore lower wage growth and lower standards of living.

To the extent that foreign saving are used to finance deficits, Americans would have to devote a growing proportion of their incomes to paying interest and dividends to foreigners, and again, American living standards would suffer.

And a higher debt-to-GDP ratio also raises the risk of a total meltdown in the market for our bonds. Problems would arise if recession, wars, or some other emergency pushes the ratio above the target and potential buyers of our bonds begin to doubt our ability to put fiscal policies back on a sustainable path.

If people want to see what could happen next, they should look to Ireland and Greece. In the face of a debt crisis, Ireland has been forced to raise taxes quickly and slash spending. Civil service pay has been cut more than 7 percent and social programs have been decimated. Tax increases and spending cuts have amounted to over 5 percent of GDP, a huge negative stimulus that exceeds the value of our recent positive stimulus program.

Greece may yet be bailed out by the EU, but I suspect that any lender is going to impose harsh conditions on their fiscal policies, and it raises a question, who would bail us out? The IMF? What would the American people think about having our policies dictated by a lender?

All this suggests that it might be much better to choose a target for the debt-GDP ratio considerably lower than 60 percent. However, as you suggested, Mr. Chairman, when you look at the policies necessary to get even to that level, they are extremely difficult politically.

I believe that the most important contribution of our committee was to outline a rich menu of policy options that would get us from here to there. We group the options into four packages. At one extreme, the committee asked what spending cuts would be necessary to stabilize the debt-GDP ratio at 60 percent if the total tax burden were maintained at its historic level between 18 and 19 percent of the GDP. That package is called the low spending option.

At the other extreme, the committee estimated what tax increases would be necessary to finance currently promised Social Security, Medicare, and Medicaid benefits while other programs grew as determined by current law. There did eventually have to be some slowdown in health costs because they can't be allowed to consume the whole of the GDP. But such a slowdown could be put off for a long time.

Two middle paths were also delineated. They differed primarily in the degree to which benefits were maintained for the elderly population. In the path that was relatively generous to the elderly, spending on infrastructure, research, and other types of spending had to be constrained, while the other middle path, non-elderly spending could be treated more generously.

The four packages were put together for illustrative purposes only. The numerous policy options contained in those packages could be put together in an infinite variety of combinations.

The package that avoided any significant increase in the tax burden required that the rate of growth of Social Security benefits be held to the level that could be financed with the current payroll tax structure. That required accelerating by 5 years the speed with which the full retirement age reaches 67 and indexing it to longevity after that. It involved reducing the indexing of initial benefits for the top 70 percent of earners and also switching to an experimental price index which has been developed by the BLS and which most people expect to grow more slowly in the long run than the current index.

In assessing such a package, it is important to differentiate an absolute reduction in the purchasing power of benefits compared to today's level from a reduction in the rate of growth of benefits. Although the package seems severe, it would more than maintain the purchasing power of today's level of benefits for all but the most affluent. It would, however, reduce replacement rates considerably below the levels promised by current law.

The rate of growth of health spending in the low-spending option had to be held back to that caused only by the aging of the population. That is to say, all other causes of excess health cost growth had to be wiped out. We divide health options into two categories, those that can be readily scored by the CBO and those that are so uncertain that CBO does not provide estimates.

It would probably involve using every option mentioned in the chapter to some degree to achieve the health target for the low-spending path. To the degree that options with uncertain effect actually worked, the scorable options could be implemented less painfully.

Another more radical approach to achieving the health cost target would be to put Medicare and Medicaid on fixed budgets. Fixed budgets are used in the universal coverage systems of Canada and the United Kingdom. In Canada, every hospital must work on a budget and physicians are limited as to their gross income. The rationing methods that go with the fixed budgets are anything but transparent.

A different approach to a fixed budget would be to use a voucher system to provide Medicare. The voucher would be used by the elderly and disabled to buy insurance and the value of the voucher would vary inversely with income. Medicaid could be put on a fixed budget by shifting to a block grant.

The low-spending option also implies severely constraining all other spending, as well. The low-spending defense path would allow the Pentagon to maintain the current personnel policies but would allow very little investment in new weapons systems. Although it would allow small foreign interventions, nothing as large as the current effort in Iraq or Afghanistan would be possible. All other non-defense spending would have to be lowered considerably below today's share of the GDP.

In the package that attempts to maintain current law benefits, that is the high-spending option, two different financing mechanisms are proposed. In one, we just proportionately raise all tax rates in the current system until you hit 50 percent for the top rate. That happens by 2020. We don't want to go above that because of the inefficiencies and inequities that would cause, so we introduce a Value Added Tax at that point, at first at less than 1 percentage point, but ultimately reaching 7.7 percent by 2040.

In the other approach, which I think is much preferable, the income tax is radically reformed. Almost all tax expenditures would be eliminated. The employer-provided health exclusion would be capped. There would be only two rates, one at 10 percent and the other at 25. The top would start at $44,950. They would rise temporarily, but the elimination of all the tax expenditures, especially those related to health, generates so much revenue in the long run that the rates could actually be lowered over time.

Besides large increases in income tax revenue, the high-spending scenario would require a doubling of the Medicare HI tax, and considerable increases in the Social Security payroll tax. The payroll tax cap would be gradually raised until it covers 90 percent of earnings. The payroll tax rate would have to go from 12.4 percent ultimately to 14.7 percent by 2080. And there would have to be a second tier surtax that didn't earn you any benefits, which would start at 2 percent and ultimately rise to 5.5 percent.

So this high-spending option would raise the overall Federal tax burden by 50 percent compared to the 17.7 percent of 2008 and it would continue to rise after that. If you add a reasonable estimate of State and local taxes, the U.S. tax burden, which is now considerably below the OECD, would go significantly above the average by mid-century.

Now, speaking for myself and not the committee, I think when you see the extraordinary spending cuts that would be required to keep the tax burden constant and the extraordinary tax increases that would be required to keep all of our promises to the elderly and others, I can't help but agree with you, Mr. Chairman, that some mixture of those two things would be required. But I certainly am not speaking for the committee on that point.

We did, therefore, have these two middle options, which as I said before differ in their degree of generosity to the elderly. I can discuss those in detail later if you like.

The testimony concludes by looking at a lot of process changes that our committee considered. We don't think process changes can cure the problem all by themselves, but we think they might be helpful in helping the Congress deal with this extraordinarily difficult task.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Penner follows:]

CHOOSING THE NATION'S FISCAL FUTURE

Statement of

Rudolph G. Penner

Institute Fellow

The Urban Institute

Before the

Senate Budget Committee

U. S. Congress

February 11, 2010

The views expressed are those of the author and do not necessarily the views of the trustees, executives, or staff of the Urban Institute.

Mr. Chairman, Senator Gregg and other members of the Committee, I would like to thank you for this opportunity to testify on *Choosing the Nation's Fiscal Future,* the report of a committee organized by the National Research Council and the National Academy of Public Administration and funded by the John D. and Catherine T. MacArthur Foundation. I co-chaired the committee along with John Palmer of Syracuse University.

Like a number of other reports this one describes the unsustainability of today's budget policies. The arithmetic of the budget problem is simple. Three programs – Social Security, Medicare, and Medicaid – constitute more than 40 percent of spending other than interest in a normal year and all are growing faster than the economy and tax revenues. At the same time Congress has kept the overall tax burden remarkably constant between 18 and 19 percent of the GDP for most of the past 50 years. The combination of three large rapidly growing programs and a constant tax burden inevitably implies a growing deficit if spending for other government spending programs is held to a constant share of GDP. As the deficit increases, the national debt grows faster and faster, and interest on the debt becomes a budget problem in itself. In the baseline projection used for our study, the debt passes 100 percent of the GDP in the late 2020s and 200 percent shortly after 2040 under the very conservative assumption that interest rates and the rate of economic growth remain constant in the face of rapidly growing deficits. It is, however, highly unlikely that world capital markets will tolerate this sort of fiscal profligacy for a long period of time. The market for our debt would collapse long before 2040.

There are many indications of these long-run problems in the 2011 budget just issued by the administration. Spending for Social Security, Medicare, Medicaid and interest already equal almost 70 percent of revenues in 2011. Although the absolute level of the deficit declines from 2010 to 2014, it rises thereafter and begins to grow as a share of GDP after 2018. The debt in the hands of the public rises from 53.0 to 77.2 percent of GDP between 2009 and 2020. The interest bill more than quadruples over the same time period.

Our committee believes that Congress should set a target for the debt-GDP ratio and not exceed it. Given an explicit target the American people could judge how well the Congress and administration are doing in their pursuit of fiscal responsibility. We believe further that a prudent target would hold the debt to 60 percent of GDP. That ratio should be achieved by 2022 and we should begin implementing the necessary policies by 2012. If the nation experiences good fortune while holding the debt to this level, it would be wise to lower the target further.

Admittedly, the choice of 60 percent as a target is a matter of judgment. The committee had to balance the risks of choosing a higher target against the political difficulty involved in getting to something lower. A higher debt-GDP target means running higher deficits. For example, if the GDP grows at 5 percent per year, a 60 percent target implies holding the deficit to 3 percent of GDP whereas an 80 percent target would imply a deficit of 4 percent.

As the target for the deficit and debt-GDP ratio is raised, government draws on a higher proportion of the available supply of domestic and foreign savings and interest rates rise. To the extent that the deficit is financed out of domestic saving there would be less available to finance U. S. private investment and that would mean lower productivity growth than otherwise. Consequently, wage growth and standards of living would also be lower. To the extent that foreign saving is used to finance deficits, Americans would have to devote a growing proportion of their incomes to paying interest and dividends to foreigners and again American living standards would suffer.

A higher debt-GDP ratio also raises the risk of a total meltdown in the bond market. Problems would arise if a recession, wars, or some other emergency pushes the ratio above the target and potential buyers of our bonds begin to doubt our ability to put fiscal policies back on a sustainable path. If people want to see what could happen next, they should look to Ireland and Greece. In the face of a debt crisis, Ireland has been forced to raise taxes quickly and slash spending. Civil service pay has been cut more than 7 percent and social programs have been decimated. Tax increases and spending cuts have amounted to over 5 percent of GDP -- a huge negative stimulus that exceeds the value of our recent positive stimulus program. Greece has not yet decided on very specific actions, but interest rates on its debt have soared relative to German rates and rating agencies have significant lowered their bond rating. Some hope that the EU or IMF will yet bail Greece out, but I suspect that any lender will impose harsh conditions on their fiscal policies. Who would bail us out? The IMF? What would the American people think about having our fiscal policies dictated by a lender?

All this suggests that it might be much better to choose a target for the debt-GDP ratio considerably lower than 60 percent. However, when the committee looked at the sort of policy changes necessary to keep the ratio as low as 60 percent, it concluded that it would be politically implausible to choose a much lower target.

I believe that the most important contribution of our committee was to outline a rich menu of policy options that would get us from here to there. We grouped the options into four packages. At one extreme, the committee asked what spending cuts would be necessary to stabilize the debt-GDP target at 60 percent if the total tax burden was maintained at its historic level between 18 and 19 percent of GDP. That package is called the low spending option. At the other extreme, the committee estimated what tax increases would be necessary to finance currently promised Social Security, Medicare, and Medicaid benefits while other programs grew as determined by current law. There did eventually have to be some slow down in health costs in this package or ultimately the health programs would consume the whole of the GDP. But such a slowdown could be put off for a long time.

Two middle paths were also delineated. They differed primarily in the degree to which benefits were maintained for the elderly population. In the path that was relatively generous to the elderly, spending on infrastructure, research and other types of spending had to be constrained while in the other middle path non-elderly spending could be treated more generously.

The four packages were put forward for illustrative purposes only. The numerous policy options contained in those packages could be put together in an infinite number of combinations.

In the package that avoided any significant increase in the tax burden, the rate of growth of Social Security benefits was held to the level that could be financed with the current payroll tax structure.[1] At the same time the actuarial deficit facing the Social Security system was also cured. That required accelerating by 5 years the speed with which the full retirement age reaches 67 and indexing it to longevity thereafter, reducing the indexing of initial benefits for the top 70 percent of earners, and switching to an experimental price index, which has been developed by the Bureau of Labor Statistics and which is expected to grow more slowly in the long run than the current index. In assessing such a package, it is important to differentiate an absolute reduction in the purchasing power of benefits compared to today's level from a reduction in the rate of growth of benefits. Although the package seems severe, it would more than maintain the purchasing power of today's level of benefits for all but the most affluent. It would, however, reduce replacement rates considerably below the levels promised by current law.

The rate of growth of health spending in the low spending option had to be held to that caused only by the aging of the population. That is to say, all other causes of excess health care cost growth had to be wiped out.

Two types of cost reducing options are described in our health chapter. One set includes options whose effects on health costs can be estimated by CBO with some degree of confidence. These are options such as increasing Part B and D premiums, increasing the eligibility age for Medicare, and reducing provider reimbursements. The other set involves options whose effects are so difficult to assess that CBO does not provide estimates. These include such initiatives such as using information technology more extensively to track patients

[1] The committee thanks staff members of the Social Security Administration's Office of the Chief Actuary for providing cost estimates on various proposals contained in the report's illustrative scenarios and for reviewing text for completeness and accuracy.

and coordinating the treatment of chronic diseases. It would probably involve using every option mentioned in the chapter to some degree to achieve the health spending target of the low spending path. To the degree that the options with an uncertain effect actually worked, the scoreable options could be implemented less painfully.

Another more radical approach to achieving the health cost target would be to put Medicare and Medicaid on fixed budgets. Fixed budgets are used in the universal coverage systems of Canada and the United Kingdom. In Canada every hospital must work on a fixed budget and physicians are limited as to their gross income. Strong political pressures make it almost impossible to keep the growth of the fixed budgets down to the level of GDP growth, but nevertheless the fixed budgets impose some restraint compared to our open-ended budgets for Medicare and Medicaid. The rationing methods that go with the fixed budgets in Canada and the U. K. are anything but transparent.

A different approach to a fixed budget would be to use a voucher system to provide Medicare. The voucher would be used by the elderly and disabled to buy insurance and the value of the voucher would vary inversely with income. It might or might not vary with geographic location and age and it could be combined with changes in insurance regulation to do such things as outlaw the use of pre-existing conditions. Medicaid could be put on a fixed federal budget by shifting to a block grant.

Our analysis clearly shows that there would have to be radical changes in health policy to achieve the target of the low spending path. The pain involved in achieving the target would clearly depend on how much the efficiency of the current system could be improved. Although our health chapter describes a large number of options that purport to do this, we do not claim to have examined every option ever mentioned.

The low spending option also implies severely constraining all other spending as well. The low spending defense path would allow the Pentagon to maintain current personnel policies, but would allow very little investment in new weapons systems. Although it would allow small foreign interventions, nothing as large as the current effort in Iraq and Afghanistan would be possible. All other nondefense spending would have to be lowered considerably below today's share of the GDP.

In the package that attempts to maintain current law benefits, that is to say, the high spending option, two different financing mechanisms are proposed. In one, the existing income tax system is the primary source of additional revenues and all rates are raised proportionately until the top rate hits 50 percent.[2] That happens by 2020. We did not think it prudent to have the top rate go above 50 percent because of the inefficiencies and inequities inherent in the current system.

After the top rate reaches 50 percent, a value added tax of slightly less than one percent is imposed. The value added tax rate must be raised gradually and it reaches 7.7 percent by 2040. In the other approach, the income tax is radically reformed. Almost all tax expenditures would be eliminated; the employer-provided health exclusion would be capped. There would be two rates. The first, at 10 percent, would start at $22, 475. The top rate of 25 percent would start at $44,950. The rates would rise to 11.1 and 27.7 percent in 2020, but could be lowered

[2] The Urban Institute–Brookings Tax Policy Center provided the estimates necessary to construct the revenue scenarios underlying the committee's four policy packages.

thereafter because the elimination of most tax expenditures and in particular the capping of the health insurance exclusion yields growing revenue over time. The initial structure of the simplified tax for 2012 was chosen to emulate the distribution of the tax burden under the current system. It would become gradually less progressive over time, but the Congress could easily fix that if it wished by small changes in the rate structure and standard deduction.

Besides requiring large increases in income tax revenues, the high spending scenario would necessitate a doubling of the Medicare HI tax and considerable increases in the Social Security payroll tax. The payroll tax cap would be gradually raised until it covers 90 percent of earnings; the payroll tax rate would be raised from the current 12.4 percent to 12.7 percent in 2012 and then in steps to 14.7 percent by 2080; and there would have to be a second tier tax that would not earn extra benefits. It would start at 2 percent in 2012 and gradually rise to 5.5 percent in 2060.

By 2040 the tax increases required by the high spending option would raise the overall Federal tax burden by 50 percent compared to the 17.7 percent of 2008 and it would continue to rise after that. I know of no state and local budget projections that go out as far as Federal budget projections, but it is safe to say that if state and local tax burdens are added for comparability, the U. S. total tax burden, which is now considerably below the OECD average, would be higher than today's OECD average by mid-century.

The intermediate package that has the lower spending path would solve two-thirds of Social Security's long-run financial problems by cutting benefit growth and one-third by raising payroll tax rates. Solving Social Security's long-run financial problem also helps lower the unified budget deficit along the way. In this intermediate package, Medicare and Medicaid spending is allowed to grow to 7.2 percent of GDP by 2030 compared to 6.5 percent in the low spending package. Spending, other than that for interest, Social Security, Medicare and Medicaid totals 8.9 percent of GDP compared to 6.8 percent in the low spending path and 10.8 percent in 2008. The increase is devoted to defense and domestic spending on things like research and infrastructure.

The intermediate path with the higher spending devotes a large portion of the spending increase to Social Security, Medicare, and Medicaid. All other non-interest spending is lower than in the first intermediate path.

If revenues for the two intermediate paths are raised using the current income tax structure, the top rate never has to exceed 50 percent. Consequently, there is no need for a value added tax. Of course, a value added tax could be used with any of the four packages to lower the income tax rates necessary for fiscal sustainability.

Although no one believes that changes in the budget process can ensure that the Congress makes the difficult choices necessary to attain fiscal sustainability, our committee felt that there were some reforms that could help the Congress deal with the problem. The main deficiency in the current process is that it is too shortsighted. Most of the effort is concentrated on formulating the budget for the next fiscal year. If the Congress set a long-term goal for the debt-GDP ratio, it would be forced to pay more attention to the long-run impact of policy decisions and it would provide a benchmark for judging whether policies were moving toward sustainability.

Although CBO and OMB make long-run budget projections, those of CBO are produced separately from the *Budget and Economic Outlook,* which plays an important role in today's process. OMB's long-run projections are provided deep in *Analytic Perspectives* and few readers get that far. We believe that long-run projections should be fully integrated into the main budget documents. Other documents may also be helpful. Australia produces a report every three years examining the effect of budget policies on different generations. Apparently it provokes much public discussion that draws attention to the effect of policies in the long run. In addition, it may be useful to require the president to report every year on the long-run fiscal health of the nation.

The committee discussed how long-run budget targets might be enforced. Automatic triggers present one option. An automatic sequester of spending was used to enforce Gramm-Rudman-Hollings, but it was not well designed. A trigger cannot impose too much political pain or else Congress will change it. But it should be demanding enough to encourage the adoption of more rational policies.

In conclusion, I would like to thank other members of our committee for the hard work they put into producing our report and also thank the very able staff led by Stevens Redburn who made it all possible. A diverse set of ideologies was represented on the committee, but the group was very congenial and all debates were rational. Few committees are that pleasant.

Chairman CONRAD. Dr. Penner, thank you for that excellent testimony, and even more for the outstanding work to lay out specific options. I tell you, I think if our colleagues go through the exercise you have just gone through, the exercise I have just gone through with my staff, it will be so sobering to them that I think it will help advance the need to act soon, to begin the process.

We know that in the midst of an economic downturn, in terms of good economic policy, you don't cut spending or raise taxes. Those both have a tendency to further jeopardize recovery. But very soon here, as recovery takes hold, we have to pivot and focus like a laser on this debt threat. All of you have made that abundantly clear.

Senator Sessions has joined us. I know that he was in another committee. I am delighted that he is here. I want to recognize Senator Sessions for any opening statement that he would want to make——

Senator SESSIONS. Thank you.

Chairman CONRAD [continuing]. And then we will open it up to questions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. I will be brief. First, thank you for the series of hearings you have been holding, Mr. Chairman, because we are hearing from some of the best people in the world, in America, on perhaps the biggest threat we have to our country at this time. I look forward to working with you and believe we are going to have to take some steps.

On the question, you note that we shouldn't cut spending or raise taxes in a time of economic downturn. I think the real question we have is how much can we increase spending. $800 billion that was passed—over my objection. Every penny of that will add to our debt, and I truly believe we did not get the kind of job creation and economic stimulus that was projected for it, and I think many people predicted that. I believe Nobel Prize winner Mr. Becker wrote that he saw that you should hope to get over $1 stimulus for $1 invested. He thought we would be well below that. That is why he opposed it. And apparently, reality has indicated that is so.

I just would say to you wise thinkers sitting there—and I don't speak for other members of my party. This is such a big issue and it is very personal. I am not for a permanent increase in the size of the U.S. Government. I believe we have a culture, a history, a heritage of limited government and we have accelerated our debt situation through a number of bad decisions, in my view, and now the answer is, well, we just have to have a tax increase and this will raise up somewhat the percentage of GDP the government extracts every year and I don't like that.

So you might say, well, Sessions, we are willing to cut a little bit, but you have got to raise taxes a little bit. Well, I am not too sure about that. I mean, that is not what my people are saying. They think government wastes too much money, spends too much money, and it needs to take a shave and not grow.

So I guess I am being honest with you, Mr. Chairman. We have got a big problem here because this isn't an easy thing for me to say I am going to vote for tax increases this deep, in my view, of what I was sent here to do on behalf of my constituents. And that is not going—I think a lot of other people feel the same.

So what we will do, I don't know, but we are going to have to deal with the reality that you are laying out for us and I will do my best to think about it.

Ms. MacGuineas, thank you for the support—and Ms. Rivlin—of the bipartisan bill we offered to contain spending at the 2-percent or so level that the budget calls for. I think 17 Democrats voted for that, close to the 60-vote majority needed to pass it, and maybe we can somehow get that across the hump.

Finally, the containing spending is always about next year. We have just got one more year to keep thing going. And that is concerning to me. I think we have got to look at this year's budget and make sure that not a dime is spent that isn't critically important that it be spent. Thank you.

Chairman CONRAD. Thank you, Senator Sessions. Let me just say to my friend, you know, what we have is a circumstance in which those who are on the more liberal side of the spectrum do not want to change the trajectory on Social Security and Medicare by a nickel, and we have got those on the more conservative of the spectrum who do not want to raise taxes by a nickel. And we are in a circumstance, I believe, that is going to require both. I personally believe we are going to have to do more on the spending side long term than on the revenue side, because if you look at the long-term trajectory, the reality is I think more is going to have to be done on the spending side than on the revenue side. But I believe if we really set the kind of goal that we need for the country in terms of level of debt, that if we just did it on the spending side of the equation, as Dr. Penner said, the cuts would have to be so deep, so draconian, that it would not be sustainable.

And, on the other hand, I know that there are passionate feelings about revenue, not raising revenue. I think the first place we look on the revenue side is a more efficient revenue system, because my calculation—and I know the Internal Revenue Service will not agree with this, but I believe we are only collecting 76 percent of what is owed under the current system. If we actually collected the money we are supposed to collect under the current system, we would not need any tax increase, we would not need additional revenue. We would have additional revenue, and we would in large measure eliminate the gap. We would still have very serious problems on the spending side of the equation because of the baby-boom generation, and the undeniable fact is we are going to double the number of people eligible for Medicare and Social Security.

And I have had people who are on the more liberal side of the equation attack me and say I am for cutting Medicare and Social Security and that is what my whole goal is. I would just say to them, if they are seriously concerned about Medicare and Social Security beneficiaries, then they better get serious about how we deal with the utterly unsustainable course that we are on, because the fact is both of them are cash negative today. Medicare, according to the trustees, is going to go insolvent in 8 years. Social Security is not far behind. Both of them are now putting pressure on the general fund because we owe out of the general fund to the trust funds of Medicare and Social Security the money that we borrowed from them, and we have borrowed in the hundreds of billions of dollars. And that has got an immediate budget effect, which was the part of the conversation you and I were having the other day, that those who just focus on the publicly held debt—and I think it is important to repeat, because there is a lot of reference here to various debt stabilization levels, and the 60 percent of debt-to-GDP, gross domestic product, is based on the publicly held debt. That is the debt that we owe the public. It does not count the money that we owe the trust funds.

When you look at all of the debt, the gross debt, which you and I were advocating we have to do—certainly from a budget perspective we do—because the reality is the debt that is the gross debt of the United States includes what we owe to the public; it also includes what we owe to the trust funds of Social Security and Medicare.

When you look at it on a gross debt basis, we are already this year going to have a debt that is going to be 90 percent of the gross domestic product of the United States. Ninety percent. We have not been that high since after World War II.

As a share of the publicly held debt, our debt is going to be over 60 percent of GDP, and what most of the witnesses here are advocating is a debt stabilization goal of 60 percent of GDP, which I think is a worthy goal.

Senator SESSIONS. Which is using the public debt.

Chairman CONRAD. Yes, of the publicly held debt.

But, again, I think it is very important for members of this Committee to know from a budgetary standpoint that gross debt has to be very much on our minds, because we have got to come up with the money to pay back those trust funds, and that can only come out of current income.

Now, let me go to the witnesses, and let me ask you this question. You have done the scenarios, and I applaud you for going through and actually coming up with alternative scenarios. And, boy, it is sobering, is it not, Dr. Penner?

Mr. PENNER. It certainly is, Senator.

Chairman CONRAD. And you are well known as beining conservative financially. You are somebody that has been very clear with respect to the long-term trajectory. When you go through the effort to come up with a plan that stabilizes the debt at 60 percent of GDP, there are just a whole lot of very unhappy choices. Isn't that the case?

Mr. PENNER. Yes, sir. I think any reasonable path involves significant changes to what you might call the sacred cows of Social Security and Medicare and, as I said, I think some increase in the tax burden. I do think that the best way to go about it, as you implied, is through a radical tax reform, because the way economists see it, the inefficiency of the tax system increases with marginal tax rates. And if we can get rid of a lot of tax expenditures, we can lower those rates actually below today's level and still raise additional revenues.

Chairman CONRAD. But let us be very clear. When we are talking about that, we are talking about things like the interest deduction on mortgages. We are talking about the fact that today health care benefits are untaxed. You get, as we all do, benefits—or more of us do, benefits from our employers. Those are not taxed. That is $2.5 trillion, by the way of tax benefits for health care over the next 10 years—$2.5 trillion. That is real money.

Mr. PENNER. And it grows over time.

Chairman CONRAD. And it grows geometrically over time.

So let me ask you, Dr. Penner, with respect to that—and I will go to the other witnesses as well. We are going to have to deal with Social Security and Medicare. Medicare is the 800-pound gorilla. It cannot be allowed to continue to grow at its current rate without swamping the whole system. And to those who say they care about Medicare beneficiaries—and I believe all of us do—and to those who say they care about Social Security beneficiaries—and I believe all of us do—and to those who say they care about the tax burden on our taxpayers—and I believe all of us do—isn't it true, Dr. Penner, that we are headed on a course that threatens all of those interests?

Mr. PENNER. Yes, it is, sir, but I think we should not exaggerate the pain involved in this too much, because as I noted, even in our most severe cuts to Social Security, most of the population ended up with higher real benefits than they get today. Now, that was not true with the most affluent because of our progressive indexing system. But in either of our middle-ground scenarios, the real value of benefits does continue to go up over time.

Chairman CONRAD. But isn't Social Security the easiest one here to deal with?

Mr. PENNER. That is true. With regard to Medicare, that is much more difficult, both conceptually and politically—conceptually because we do not know how well a lot of the frequently suggested options would work, politically for very obvious reasons.

But, again, after you do what you can to get rid of the inefficiencies in the system, the major driver here is technological change, which makes health care more expensive every year. And so what we are talking about is improving quality of health care over time, and we should not lose sight of that. It would be easy to finance the quality of health care we have today, but it is what is promised for the future that is so difficult.

Chairman CONRAD. Let me just go right to the 800-pound gorilla, because it is Medicare. Dr. Rivlin, what would you recommend to this Committee and to the Congress that we do to deal with Medicare and its threatened insolvency?

Ms. RIVLIN. That is the hardest question, but I think there are a lot of partial answers. We do not know really how effective some of the things that have been suggested in terms of making the health care system more efficient can be, but they ought to be tried. We should put in place a strong Medicare commission that picks the best ways of changing the reimbursement rates so that they favor better, more efficient health service delivery, and cannot be overridden by the Congress—which has been happening time after time, as you well know—and other kinds of ways of reducing the rate of growth of Medicare spending. We are lucky in a sense. We have a very inefficient health system. That may sound counterintuitive, but compared to some other countries, we have very large opportunities to make this system more efficient in the near term. And in the end, we are going to have to worry about rationing. But I do not think we are going to get there for a couple of decades. We have the opportunity to be more efficient.

Chairman CONRAD. Let me ask you this question, and I will ask all the witnesses this question. Senator Gregg and I wrote the Congressional Budget Office, and we said, "What would be the most effective things that we could do to contain exploding costs in health care?" Their answer to us was clear and compelling.

No. 1, they said, "You have got to begin to tax Cadillac plans. You have got to reduce the tax exemption for health care."

No. 2, they said, "You have got to reform the delivery system. Instead of paying for procedures, you have got to begin to pay for quality outcomes."

They said those are the two most important things you can do. Do you agree with that?

Ms. RIVLIN. I agree with that, and I think an enormous opportunity was lost actually by the Obama administration in not embracing Senator McCain's notion that the tax exclusion of employer-paid health insurance from income should be gradually phased out. That is, I think, a better approach, actually, than taxing the Cadillac plans, although they——

Chairman CONRAD. Well, in fairness, that is really what CBO did recommend. I morphed it a little there to taxing Cadillac plans. They really said phaseout——

Ms. RIVLIN. Well, they get to the same objective.

Chairman CONRAD. Yes, they do. In an economic sense, they do.

Ms. RIVLIN. Yes, and I think you could do it either way. But it is really important that we not have the tax system favoring excessively generous health plans which encourage people to use too much health care and encourage the providers to deliver it in an inefficient manner. And the other piece is all of the things that go with making the health care delivery system more efficient, not all of which we know yet. We need to experiment with that and figure out how to do it better, because it can be done better.

Chairman CONRAD. We know it can be done better because here in this country we have got systems that are relatively low cost that have the best outcomes: Mayo Clinic, Cleveland Clinic, Geisinger. They are operating at much lower costs and getting the highest quality outcomes.

Ms. RIVLIN. Right. And we know something about how they do it.

Chairman CONRAD. Yes, we do.

Ms. RIVLIN. It is a question of spreading it to other systems.

Chairman CONRAD. Maya, what would you say? With respect to Medicare, because I want to go right at the 800-pound gorilla, what do you think would be leading alternatives for us to consider to deal with the exploding costs?

Ms. MACGUINEAS. Yes, well, I tend to always regularly bow to the reports of CBO, which I think are phenomenal, and so it is always nice to sit between two former CBO Directors. I think that report that you and Senator Gregg requested was really, really important, and it focused exactly on the right things.

Clearly, our tax preference for health care is one of the things that is driving up the cost. It is putting us into insurance systems—we are demanding more health insurance and less in wages, which is not a rational policy normally, but that is what the tax incentive is to do when it is pushing up costs.

So it is unfortunate that we have not been able to go at that head on. I am of the camp that you pull that back as much as possible. I basically say the things in the report, the things that make sense. I think paying for outcomes rather than procedures makes sense. I think the comparative effectiveness studies which were put in place, looking at what works, are very important. But you have to understand there is a second step of that. It is not just that you study it and then put the report on the shelf. You then have to use what we find to limit what health care would be compensated for by Medicare, Medicaid, or other insurance.

And I think one of the things, like Alice said, rationing does not have to happen immediately. But we cannot make it a bad word. Rationing happens in a system like this. You cannot have everything paid for in an unlimited way. And we need to be able to have a discussion about what should be covered and by whom. And, unfortunately, health care is one of the most explosive discussions that is out there, and so while I do not think we need to go to any extremes right now because there are so many inefficiencies that could be wrung out, it needs to be acceptable to talk about the tradeoffs in health care just like in other areas of our economy.

Chairman CONRAD. All right. Senator Sessions.

Senator SESSIONS. Thank you. We had an excellent hearing Tuesday, and Dr. Reinhart from the University of Maryland testified, and Mr. Johnson and Mr. Marron. But one of the things we discussed and we should get on the same page about is: What do we mean when we say debt-to-GDP ratio? What is the best number?

The European Union uses a 60 percent debt-to-GDP. In a meeting we had with some German leaders a week before last, one person noted they count local government debt, too, in that. Is that right, Dr. Penner?

Mr. PENNER. It is indeed.

Senator SESSIONS. I did not know that. And, second, I assume their 60 percent would include the internal debt, the non-public debt, too. I do not know if they have such a situation. Ours is driven by the unique accounting procedures we use, I think the CBO letter said.

So I guess what I am saying to you is when we discuss this with the American people, what is the best number that we should start using? I have used the public debt simply because nobody disputed that that was a bottom-line debt figure. But what I have learned in the latest flap over health care legislation and my belief that the President understated the cost of the plan, it is because CBO does not score the internal debt. But since we now know that Medicare and Social Security are on an insolvency trajectory that is very real—not like it was 20 years ago when this reality was not so close—don't we now need to re-evaluate that and perhaps begin to discuss the issue by utilizing the gross debt rather than the public debt? Dr. Rivlin?

Ms. RIVLIN. I think you are stuck with using both numbers, because they have different significance and both are important. If you talk about the public debt, that really is what we owe to the public, including other countries, and roughly half of it is owed to other countries. They hold our debt. And it is important to——

Mr. SESSIONS. When you say other countries, is that individuals or nation states?

Ms. RIVLIN. It is mostly nation states. It is—but——

Mr. SESSIONS. I am sorry I interrupted you.

Ms. RIVLIN. Yes. It is governments and central banks in other countries. China and Japan are the largest ones, but not the only ones. And it is important to keep that in mind. That portion of the public debt makes us very vulnerable to the policies of those countries, and it is one of the reasons for worrying about the public debt.

There are, I think, different reasons for worrying about the total debt because we are now at the point at which we are going to have to start redeeming that debt, and that means that we will be buying back those bonds—we, the taxpayers—in order to make sure that the Social Security and Medicare payments are made.

So that total debt is important, too, and I think you cannot oversimplify the thing by saying there is only one important number. There are two important concepts and two important numbers here.

Senator SESSIONS. Dr. Penner, it seems to me that what we are doing is, since we are not raising revenue or cutting expenses, we are converting the internal debt to public debt, inevitably, inexorably, because both of our trust funds are not in surplus or soon will not be in surplus. Is that the danger of the internal debt?

Mr. PENNER. That is exactly right, sir, and I wanted to point out that when we, in this report, do our baseline, that baseline implies that the debt in the trust funds is going to gradually be sold so that trust fund debt becomes debt held by the public. And, actually, it is not all that many years before the distinction between the gross and net debt essentially disappears because the two biggest funds, Social Security and Medicare, are emptied over time.

Senator SESSIONS. But to keep us from being too overawed by it, Mr. Chairman, CBO is scoring that, I believe, are they not? In other words, CBO is scoring in their surging of the public debt the transfer of internal debt to public debt. If we focused on public debt, we do have some sort of a projection of the direction we are going. But when we increase, as the health care bill would have done, the internal debt, I do not think we can any longer suggest that that is not a cost, an increase in the debt of the country.

Following up on debt, I believe it was Stephen Moore who has made the point, I do not know if this has been fully proven economically, but if we had a 1-percent greater growth rate than our projections now have for the American economy, Social Security would not go into default. Whatever, we know that growth makes a big difference, particularly, I think, in Social Security, and so does economic growth in the economy. And, of course, when you raise taxes, it diminishes growth and debt diminishes growth. Dr. Reinhart testified that the level of debt we are in will take us to a reduction in economic growth by 1 percent of GDP, which is a stunning figure, if that is accurate. And I think all the panelists agreed that it was accurate. Actually, the three of them did not dispute that and acknowledged that.

So it seems to me we are caught between this “damned if you do and damned if you don’t” to a degree. I am inclined to think that we have got to contain spending now, not let this money get out the door, like the stimulus package, when you get so little for it and make sure that every dollar gains us something in terms of growth and increases the debt as little as possible.

But what is your thinking about the comment about growth and the size of debt, Dr. Rivlin?

Ms. RIVLIN. Growth is a very good thing. We are all for growth, I think, and the more the economy grows, the easier it will be to solve this problem.

One of the illustrations of that is what happened in the several decades after World War II where we had a very large debt, over 100 percent of the GDP, and the economy was growing rapidly. Over that period the debt-to-GDP ratio came down primarily because the economy grew so fast, not primarily because the debtcame down .

But, I just wanted to say one thing about Social Security, and that is, yes, growth is good for bringing the revenues into the Social Security trust fund. But our benefits are indexed to wages, and growth pushes up wages. So unless we change the way the formulas are calculated, growth does not help us all that much on Social Security.

Senator SESSIONS. Do you think the index should be more fairly inflation rather than wages?

Ms. RIVLIN. I think it is not exactly a question of fairness, but if we are going to bring down the rate of growth of Social Security benefits in the distant future—not for people who are retired now—then I think we could index the benefits, the initial benefits, to prices for people above the middle or above the 60th percentile or something. One way to do that would be to phase in an indexing which would be less generous for people at the top than people at the bottom, and that would help a lot.

Senator SESSIONS. Thank you. I would say that I just read a Fortune magazine that had four of the top investing people. One was Mr. Gross at PIMCO and Jeremy Siegel and two others. Three of the four said the new normal is low growth, and they attributed the low growth for the next decade to debt. Mr. Siegel took a more optimistic view thinking productivity, technological advancements could be the breakthrough that could help us not do this. But that was pretty grim. These are people who are telling their customers how to invest their money, and they were not optimistic about the future.

Chairman CONRAD. Let me just say on the point that you made, here is my rough recollection—because I was going over this with some intensity last year, and my rough recollection was if we have 1 percent more growth than the actuaries are estimating—because they are estimating very low growth for the next 50 years in the United States. They are——

Senator SESSIONS. Two percent is it?

Chairman CONRAD. Yes, it is 2.2 percent, something like that. And if you had 1 percent more economic growth, my recollection is that takes care of about 75 percent of the problem.

Here is the dirty little secret. From a budgetary standpoint, it does not take care of the problem at all, or very little of it, because we still have this circumstance where we have borrowed from the general fund, we have borrowed money from the Social Security trust fund. Now that money is going to have to be paid back. The only way it can be paid back is out of current receipts.

This is a concept that most of our colleagues have not gotten their mind around. This is going to have a significant effect on the rest of the budget, because we have been in this very happy circumstance where the general fund has been able to, in effect, borrow from the Social Security trust fund $150, $180 billion a year. Now that is ending. That source of money is ending because Social Security right now is cash negative. It is going to be permanently cash negative in 2016.

So now where is that money going to come from? Now where is that money going to come from when the situation is reversed and the general fund has to start paying off these bonds that represent the borrowing that has occurred? And somehow we have got to help our colleagues understand we are headed for a very different budget circumstance.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Chairman. Thank you for holding this hearing, and I thank all the witnesses, who I think gave very valuable testimony. I want to extend my particular appreciation to Dr. Rivlin for being here and for her many, many years of service in the budget and economic environment.

But my questions, I would like to particularly focus on Dr. Penner. I want to thank you for being here. I thank you very much for presenting from your Choosing the Nation's Fiscal Future Report. It is the first time that I have seen a budget document address in anything other than a very cursory way the value that can be achieved from reform in the health care delivery system.

You put it in the context on pages 85 to 86, and then later on, 95 to 102, of the Medicare system, but if we are, in fact, engaged in achieving those—what did Dr. Rivlin say—very large opportunities to make the system more efficient in the near term, if we are engaged in capturing those, it is my understanding that because they are systemwide reforms in many cases, if a hospital increases quality, reduces hospital-acquired infections conceivably to zero, is no longer paying—we are no longer paying $70,000 per hospital-acquired infection, then it is not just the Medicare system that saves, it is everybody who is paying for health care that saves.

I would like to ask you, if we are good at that, and I take the number as being somewhere between $700 billion a year in excess cost and waste, which is the White House Council of Economic Advisors number, and $1 trillion a year in excess cost and waste, which is the Lewin Group and Treasury Secretary O'Neill number, that if we can get a significant chunk of that—and I know it will take time, and I know, to use your, I think, very accurate phrase, it will be an ongoing learning process—I think Dr. Gawande wrote a very good, similar description of that recently—isn't it true that many of the benefits of that will fall outside of the Medicare and Medicaid system and will help with the overall burden of health care costs that the economy has to bear helping, in fact, private companies that are buying in the private market in parallel with the assistance to Medicare and Medicaid?

Mr. PENNER. I think that is absolutely right. You can categorize Medicare options into two categories. One contains the sort of options that you are talking about. If we could get rid of infections in hospitals or reduce the readmission rate, that would help the whole system, including private insurance.

There are, however, other kinds of options, like increasing the eligibility age for Medicare, that are essentially means of shifting costs out of the government budget and onto the private sector.

Senator WHITEHOUSE. That, to me, is one of the real values of focus on delivery system reform, because it is really a win-win. It is not a zero-sum game in which you are shifting costs off of government and onto the private sector, and because people resist that and build new devices to prevent it, you are actually probably adding to net health care costs in some of those circumstances as the insurance mechanism develops to try to continue to game the system and create additional costs for people in the system gaming behavior.

But it is important to me that you said it. I think it is sort of discouraging, in a sense, that it is only two pages and five pages out of the whole volume when I consider how valuable it is. But I have to say, this is the high-water mark to me in the budget discussion, and I know that Senator Conrad and Senator Gregg are extremely keen on getting this statutory commission going, and I have to say that my single greatest reservation about it is that I worry that it will be populated with a lot of people who are fiscal, economic brilliant people but who don't really have the specialized sense of how delivery system reform can and must take place, who don't understand, as you do, the executive management function of developing it.

It will be an ongoing learning process. It requires multiple building blocks to achieve. And that it will be overlooked. In the same way that CBO, as you point out, couldn't really score it effectively because of the nature of the process, that when we look at this going forward, people will say, well, you know, if we can just chuck some people off of Medicare, boy, we can count those savings right away and we can put them right in the bank. It is harder work to do the other thing, and therefore, there will be a bias in favor of what I would call the fiscal hawk.

You said the two alternatives. I describe them as sort of the bloody Civil War surgeon's bucket of tools, you know, of saws and knives and things like that, and then a more modern doctor's tool kit with modern technologies and non-invasive procedures and pharmaceuticals and things like that. And we can do it the modern way, but there seems to be a huge firewall between the people who understand delivery system reform and the people who are looking at the fiscal problem. They are completely different silos. I see almost no overlap. How do we break down and penetrate those silos and get the more expert discussion of the delivery system reform happening in the fiscal budget context?

Mr. PENNER. Well, I think while I agree that the system is terribly inefficient and that if we could improve the efficiency, we could save enormous amounts of money, I wouldn't want to say it is easy, either. I mean, I think the very fact that we don't understand the cost savings that go with a lot of these proposals suggests how hard it is. We have got to do our best to learn more. As Alice said, maybe that can be done to some degree through various demonstration experiments and so forth.

Senator WHITEHOUSE. Let me ask her to chime in in my minute remaining so I get a chance to hear from her on this. Dr. Rivlin?

Ms. RIVLIN. Well, I agree with you, but I am a little less discouraged. I think there are quite a lot of people that are thinking very seriously about systemic reform and about budget problems at the same time. One of them is my Brookings colleague Mark McClellan, whom I believe you know. He and others, Dr. Fisher and the people who have worked on the Dartmouth Project, are definitely in this camp. They are people who deeply care about delivery system reform but who care about the economics, as well.

Senator WHITEHOUSE. I just want to try to populate the fiscal prudence camp——

Ms. RIVLIN. Good.

Senator WHITEHOUSE [continuing]. With more of those people who understand that and to make sure that that is the way that we proceed first on this.

Ms. RIVLIN. Yes.

Senator WHITEHOUSE. As the Chairman said very, very correctly yesterday—I think it is a critically important point that he made—you can go after Medicare with fiscal knives anytime you like. You can overnight chuck people off it. You can overnight cut benefits. You can overnight use the bloody Civil War tool box.

Ms. RIVLIN. You might not get reelected.

Senator WHITEHOUSE. In a crisis, who knows what people will do. But what is different about the delivery system reform piece is that it will take time to develop it. The building blocks have to be applied, to use Dr. Penner's testimony. The ongoing learning process has to take place, again using his words. And so every minute, every hour, every day that goes by that we are not very deliberately engaged in that is time lost against whatever that day of reckoning or moment of reckoning might be, as I think it was Ms. MacGuineas said. It could be an abrupt crisis that provokes this and we don't want to waste the time between now and then.

So I would urge all of us to be as proactive as possible in urging that, and that includes the Obama administration, which I hope is not waiting around for the health care bill, which has a lot of important building blocks in it, to pass.

I have gone beyond my time. I apologize, Chairman.

Chairman CONRAD. No, that is fine. I would just say this to you and for those who might be listening. One of the greatest frustrations I have had in being a participant and in some ways a witness to the health care debate is big chunks of the news media paid almost no attention to the things that the people who are most knowledgeable about health care have told us were the most important things.

CBO told us phasing out the favorable tax treatment for health care, employer-based health care, is one of the most important things that needs to be done. They also said one of the most important things that needs to be done is this reform of the delivery system. Did you see any of the national media spend 30 seconds on that issue, on reforming the delivery system, to stop paying for every procedure, instead to pay for quality outcomes? Did you see one story that talked about that? I didn't. Instead, they chased every rabbit, everything that is a side show, a side issue, most of which doesn't matter a hoot, according to the experts, in solving the problem.

And I will tell you, I don't know what is happening as a culture, but when we have the national news media obsessing on Michael Jackson and obsessing on side issues and giving no basis of information to people to make judgments on things that really matter to our economic future, we have got a very big problem. My plea to the national media is, look, I know it is a ratings game on TV. I get it. But you have got some obligations. You are using the public airwaves here. You have got some obligation to talk about things that are serious, that really matter to our future.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. I again thank you for having this hearing and thank you all for being here.

The question really is how we can have a fiscally sustainable budget, so let me stay on health care for one more moment because, Dr. Rivlin, I might not agree with you on the politics of this. Cutting Medicaid may not be a terribly unpopular thing. I don't know. We are certainly having a hard time extending FMAP help to our States now where it is going to have a major impact on Medicaid budgets, I know in Maryland and——

Ms. RIVLIN. I thought we were talking about Medicare.

Senator CARDIN. Well, my point is this. If we are looking at a sustainable budget, one could say the Federal Government could cut back on its commitments to pay for part of health care, whether it is Medicare or Medicaid or other health care programs, and that certainly would, at least in the short term, reduce our Federal budget deficit. But that would be the wrong thing for us to do from the point of view of our economy, and it would be the wrong thing for us to do as to what is right for the Federal Government to do.

On the economy, if we make it more expensive for businesses to pay for health care, they are going to have to compete internationally, and the President is talking about doubling our exports, it just makes it more difficult. But small businesses are already having a tough time paying their health care premiums, and if we don't do something to make it easier, but instead make it harder, it is going to cost jobs. And I can tell you, there are a lot of people in Maryland today who are withholding purchases—withholding going to a restaurant or buying a car—because of their concerns about paying health care bills, because, frankly, Medicare doesn't cover enough and private insurance is not covering enough and a lot of people either have no coverage or they have major gaps in coverage.

So as we talk about entitlement reform and how are we going to deal with the projected huge deficits at the national level, I am very concerned about that. I hope that we will listen to what Senator Whitehouse and Senator Conrad are saying: that if we don't figure out a way to bring down health care costs in America, but instead just try to look at the Federal budget and say, we are successful and we can reduce our exposure, then I think we have missed the opportunity to remedy a real problem that we have with our economy, at the same time dealing with a sustainable and fiscally responsible Federal budget.

I feel the same way that the Chairman feels about how coverage has been on this, and I hope the President is successful in bringing together Democrats and Republicans. I hope that what will clearly be nonnegotiable is that health care reform has got to bring down the growth rate of health care costs. It must be done in a way that is fiscally responsible for the Federal budget. And it must to provide affordable coverage for every American. That is what we should agree on. To me, that is how you are going to have a fiscally sustainable Federal budget. If you don't do that, the problems will even be greater in the future.

I think that when you look at some of the proposals that are being suggested around here, I am concerned that we could get from, whether it is this commission or some other group using, as Senator Whitehouse said, Civil War tools to solve a problem when we should use modern technology.

Ms. RIVLIN. I don't disagree with that. I thought I was agreeing with Senator Whitehouse that the most important thing to do is to reform the delivery system and to make the health care system more efficient and effective for everybody.

Senator CARDIN. I think we are all saying the same thing, but——

Ms. RIVLIN. I think we are all saying the same thing.

Senator CARDIN. I think we are, but the Chairman started the hearing talking about the Federal debt, and we all talk about the Federal debt. It is way too big, and we know we can't have a sustainable, fiscally responsible Federal budget unless we deal with the debt. I always like to remind people, let us go back and take a look at what happened when we had a growing economy.

And you know, Mr. Chairman, you and I supported the statutory pay-as-you-go, PAYGO. We should have had that when we had a balanced budget so we couldn't have passed Medicare Part D without paying for it, increasing Federal spending, or we couldn't have tax cuts that weren't paid for, so that we at least had some fiscal responsibility. Sometimes it is easier when you have a budget surplus to spend recklessly. And now we are paying a heavy price as a result of it.

And as we found out at the last hearing, you also have another major problem, and that is lack of savings in America. During our growth time, we didn't save. Instead, we said, well, we are building up equity in our homes. Well, we saw what happened to the equity in the homes.

So my question to the panel is, here we are, still in the aftermath of the worst recession in my lifetime, and we know that the Federal Government has a critical role to play during a recession in creating jobs, part of which is fueled by Federal spending. We also know that we need consumer confidence for people to spend. And yet we want to look at reducing Federal spending and increasing personal savings. How do you reconcile those differences as we look at this year's budget and the following year's budget? Any of you.

Ms. RIVLIN. Let me start quickly. I think you have to do two things at once. You have to do what is necessary to get us out of the recession and you have to start by enacting very soon measures that will bring down spending—bring down the rate of growth of spending. We are not going to bring down spending. We are going to bring down the rate of growth of spending over time. I think that has to include the entitlement programs. And I also think you have got to recognize that bringing the debt to a—stabilizing the debt is not going to be possible right away on just the spending side. You are going to have to have some more revenues, too.

Senator CARDIN. Yes?

Mr. PENNER. I basically agree with that. I don't think the conflict between the short- and the long-run is as severe as a lot of people make out. I think you could today talk about passing reforms that perhaps would slow down the growth of Social Security benefits or increase the payroll tax. You could today pass things that would be implemented, say, starting in 2012 as our report suggests. And I think that might even help with the short-run economic situation, because there is a lot of concern out there about our debt and what it will imply in the future with regard to tax changes and spending changes. And if you could reduce that uncertainty, I think it would help a considerable amount.

Senator CARDIN. Thank you.

Ms. MacGuineas?

Ms. MACGUINEAS. To your health care and your stimulus comments, I mean, I think both you and Senator Whitehouse made very important points that we heard sort of in the beginning of the health care debate, that the No. 1 thing that we could do to get the fiscal situation under control is to slow the growth of health care costs. And unfortunately for me watching this, somebody who has had to learn more about health care than I ever wanted to—I want to be just a fiscal person, not with a bloody saw, but somebody who doesn't have to understand the technical pieces of health care, but you can't be a budget expert without learning about health care.

I think one of the things that we saw which was somewhat discouraging was a little bit of the watering down of the pieces of the health care bills that would slow the growth. And what I would hope that we would see as we go back and revisit this is everybody who understands the importance of combining health care reform and budgetary reform really goes back and reemphasizes those pieces that we saw in the CBO report would help us the most slow the growth. The more that we get out of health care savings over time, the less we have to go to all the other pieces of the budget, and I think that is really important.

I want to speak just a moment for a point Senator Sessions was making, which I think is about sort of mistrust of what the two parties are doing and standing in the way of this. But one of the things that you voiced a concern about is sort of Republicans looking at Democrats through stimulus and health care and feeling that they are trying to push an expansion of government that then means when we deal with a budget compromise, it puts taxes back on the table. And I think there is a different half of that, which was during the Bush era, when we decided to cut taxes before reforming entitlements, I think the other party could sort of see that as the same way. We chose to cut taxes before we dealt with the budget situation and that changes the negotiation.

The result, of course—I mean, we know this—is a horrible high level of mistrust which makes coming up with the kind of compromise so, so difficult. And I come back to something that, Senator Conrad, you keep bringing up. Oftentimes, we try to convene members of both parties to talk through these things and think about what productive people can work on, and at this point, it is very hard, because when you get to the kind of specifics we have talked about in this hearing, things can get dicey.

But I think there are three things that are really helpful for members to do together, and one is pick a fiscal goal. And again, it is not so important exactly what it is, but that there is a widespread commitment to a fiscal goal that levels the playing field.

A second one is not to insult different ideas for helping, whether it is on health care reform or budgetary reform. Encourage people to come up with all the ideas they have so that we can then have a discussion about the tradeoffs between those reforms instead of saying, you know, no, we should not raise taxes. No, we should not cut Social Security. We need to encourage those.

But the third thing that I think is so important is this exercise that you have been doing in your office. Every member needs to sit down and see how they would achieve the fiscal goal that they think is something that would reassure credit markets, because when you get into the nitty-grittys of the policies, you realize everything has to be at play here. This is not earmark reform. This is not just waste, fraud, and abuse. This is really big structural changes that we have to think about.

Just quickly in terms of stimulus, I am somebody who didn't think the stimulus package was perfect, but thought it was very, very necessary and I was incredibly concerned about where the economy was headed, and I thought focusing on economy recovery was absolutely right. I don't know if the right thing is another stimulus or jobs package right now. I know it should be economically motivated, not politically motivated, meaning we shouldn't put a lot of unrelated things in the package and it should be something that is well targeted.

It should be temporary. One of the things that has concerned our organization is watching how the White House has put some stimulus measures and a stimulus package into its baseline in a way to make them permanent without offsetting the costs. That shouldn't happen. These are temporary policies.

And I do think now we have such a high level of debt, it may be worth thinking about offsetting the cost of stimulus measures over a long time period. So if there is something we need to do this year and/or next year and it is the right thing to do, you do it, but you also should include an offset so it is repaid over time, because the debt doesn't really care why—what the dollar is borrowed for. Sure, you want it to grow the economy, but in the end, we are bumping up against our debt limit, so we need to figure out a way to bring down the debt once we get the economy strong again, as well.

Senator CARDIN. Well, I thank you for that response to not only my question but the other members'. That is good advice. A lot of what you are saying is what our Chairman has been urging us to do, including the exercise to try to balance the budget. I thought that would be a fun thing to do during the Presidents' Day holiday, so I will take my Chairman up on that.

[Laughter.]

Ms. MACGUINEAS. It is fun.

Chairman CONRAD. I would just say, even if one doesn't get to balance, in some ways it is less important than finding a way to get the debt stabilized, which is the testimony of this group after a lot of work that they have done. Perhaps a more appropriate goal than reaching balance is stabilization of the debt and then working it down over a longer term, because, frankly, we are at a debt level, I believe, that is going to be too high. Even that exercise is very daunting.

I just say to my colleagues and their staffs who are here and listening, please have your member or you, as a staff, go show your member, what does it take. And it is not just dealing with earmarks, and it is not nibbling around the edges here and there in domestic spending. No, no, no. It is going to take bold strokes to deal with this challenge. It is going to take big ideas and it is going to take political courage, because it is every hot-button issue that is out there. It is Social Security. It is Medicare. It is revenue, all of them.

We have got an obligation. I mean, history is going to judge us. History is going to judge us, whether or not we were up to this challenge and whether or not we were true patriots. Were we really concerned about the country, or are we just concerned about our own political hides? You know, history will judge. History will judge. Do we come through at a time our nation really needs us? I believe we can, and I hope that we will. But it is not going to happen nibbling around the edges. And it is not going to happen unless we find a way to come together, because political control switches.

You know, I have been here 23 years. I am a Democrat. Sometimes we have been in control. A lot of times, we haven't. And it goes back and forth and it is going to go back and forth again. That is why, in my own personal belief, we have got to find a way to do this together, because when the political winds change next, if we don't have a plan that all of us basically think has got merit, it will be abandoned.

If you look at the trend lines, it really is sobering. This is no joking around now. I mean, we are headed in a way that could take this nation to second-class status. That is how serious this is.

So I just urge my colleagues, let us really make our best, best effort to work together and try to come up with solutions. And I know we can do it. I know we can. It is going to take all of us to give. I mean, I have got all kinds of things.

Let me just say, I come from a farm State, one of the most heavily dependent States on agriculture programs of any State. I am ready to take on farm support and to reduce even what was in the bill that I just helped pass. That is how serious I am about doing what has to be done. So, look, it is time for all of us to get out every sacred cow and face up to this debt threat.

Final thoughts, Senator Sessions?

Senator SESSIONS. Well, thank you for this. We have got to confront the problem. You are doing so. I know you share with the administration realities that we are facing in unvarnished ways and I can only hope that that will help us deal with it.

But you know, the President never was a mayor. He never was a Governor. He never ran a company. And he was only in the Senate a few years. It took me a number of years to begin to understand some of the complexities of our debt. So when they submit a budget that calls for a $170 billion jobs stimulus over the next several years, OK. But what is not stated is $100 billion that they are going to be offering this year, all additional debt, and it is really $270 billion, and all $100 billion of that would be emergency spending adding to our total debt.

What I am saying is, I am thinking that our President is going to have to lead on this issue. He can't tell us that the health care bill was going to save money. He can't tell us his bill is $170 billion when it is $270 billion. We have got to get straight about it.

Mr. Chairman, I wanted to ask one question, and I think this came to me clear in reading these financial people, their comments, and I think you said it, Dr. Penner. When we surge our debt from $5 trillion, $7 trillion it was a year or so ago to $17 trillion in 10 years, tripling it, that money, that is the public debt. So that is borrowed from either our individual Americans or other countries and that is money that would otherwise be available to be loaned into the commercial economy, creating jobs, and it crowds out and drives up borrowing costs for the private sector. I guess that is one of the factors that Dr. Reinhart was mentioning and why it slows our growth down. But would you elucidate on your comment on that? That will be my last question.

Mr. PENNER. Well, I think you have summarized my point very well. The money we borrow comes out of something. There isn't a free lunch here. And whether we use domestic saving to borrow or use foreign saving to finance our deficit, it will ultimately reduce our standards of living. I don't think you can get around that. Whether the line is between having or not having a large deterimental impact as bright as a 90 percent debt ratio, I find that a little hard to swallow in their work. But certainly, the higher the deficit, the more it impacts negatively on our potential to grow.

Senator SESSIONS. The other two?

Ms. MACGUINEAS. Sure. I think that is a good point. I have to say that I was actually trapped in my car on Tuesday trying to get into the line to get to the grocery store to find that there was no food and the only thing that kept me from having road rage was that I got to listen to the hearing on C–SPAN, and it was really an excellent hearing. It was really interesting.

And when I first turned it on, Senator Conrad, you were talking about the difference between the public and the total debt, and I think they are so important, because the reason the public debt matters is when you are looking at financial markets and taking this capital out of the economy, and that is the point you are making, Senator Sessions, that right now, when you are thinking about job growth, this debt dependency is a real threat to it because you are taking away the capital that could go to job creation. And so we need to weigh those tradeoffs.

And I also think it is right to point out that especially this Budget Committee needs to be aware of the total debt, because that is the one that affects what we are committing to in the future, and we are allocating our resources in the future, losing the control that we have over the budget. Now, usually you say you want to leave flexibility for the next generation. We care about our kids. I just spent 4 days locked in a house with my kids. I am not sure how much I care anymore. I am really, really glad to have gotten out of the house.

[Laughter.]

Ms. MACGUINEAS. But I know when I go back, I will look at them and I will feel the same sentimentality, that it is important that we do this for the next generation.

But the debt right now is threatening our economic recovery in the short term as well as the long term, and I think that is a really critical and important point, and why when we think about stimulus job creation, it is not in a vacuum. The dependency on the borrowing that is allowing us to do that, we have already lost our fiscal flexibility, so it is hurting us to have stimulus programs. I think it is a great point.

Ms. RIVLIN. I substantially agree with all of that, but we are in a very deep recession, the result of financial mismanagement. We are not in a situation which we can return to budget balance quickly, nor should we. Raising taxes or cutting spending to create a balance very quickly would be disastrous and I think we should remember that.

Senator SESSIONS. I agree. Maybe we can refrain from making it more bad than it is.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions, and I want to thank the witnesses. I deeply appreciate your coming out, given these conditions especially. I very much appreciate the effort and the energy that you have put into your testimony here today and the committee has certainly benefited by your expertise and by your thoughtful consideration of these issues.

With that, we will stand in adjournment.

[Whereupon, at 4:02 p.m., the committee was adjourned.]

DEFENSE BUDGET AND WAR COSTS: AN INDEPENDENT LOOK

TUESDAY, FEBRUARY 23, 2010

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

The Committee met, pursuant to notice, at 10:02 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Merkley, Gregg, and Sessions.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. I want to welcome everyone here this morning. I especially want to welcome our witnesses.

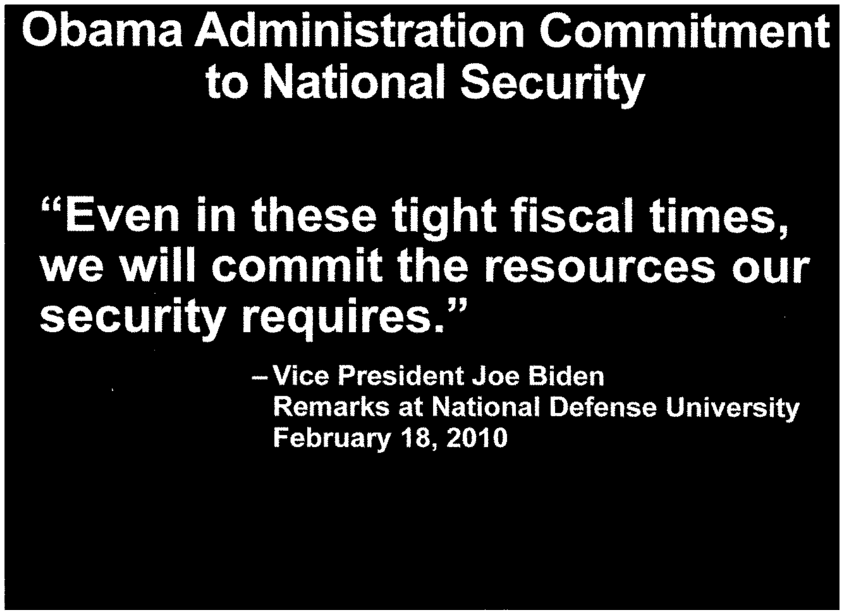
Our hearing today will focus on the defense budget and war costs. We are joined by a very distinguished panel of outside defense experts.

Dr. Cindy Williams is the principal research scientist at MIT's Security Studies Program. She is a former Assistant Director for National Security at the Congressional Budget Office.

Dr. Gordon Adams is a professor of U.S. foreign policy at American University. He is a former Principal Assistant Director for National Security at the Office of Management and Budget.

And General Paul Van Riper is a retired lieutenant general of the U.S. Marine Corps. He is currently serving on the Independent Review Panel of the Defense Department's Quadrennial Defense Review.

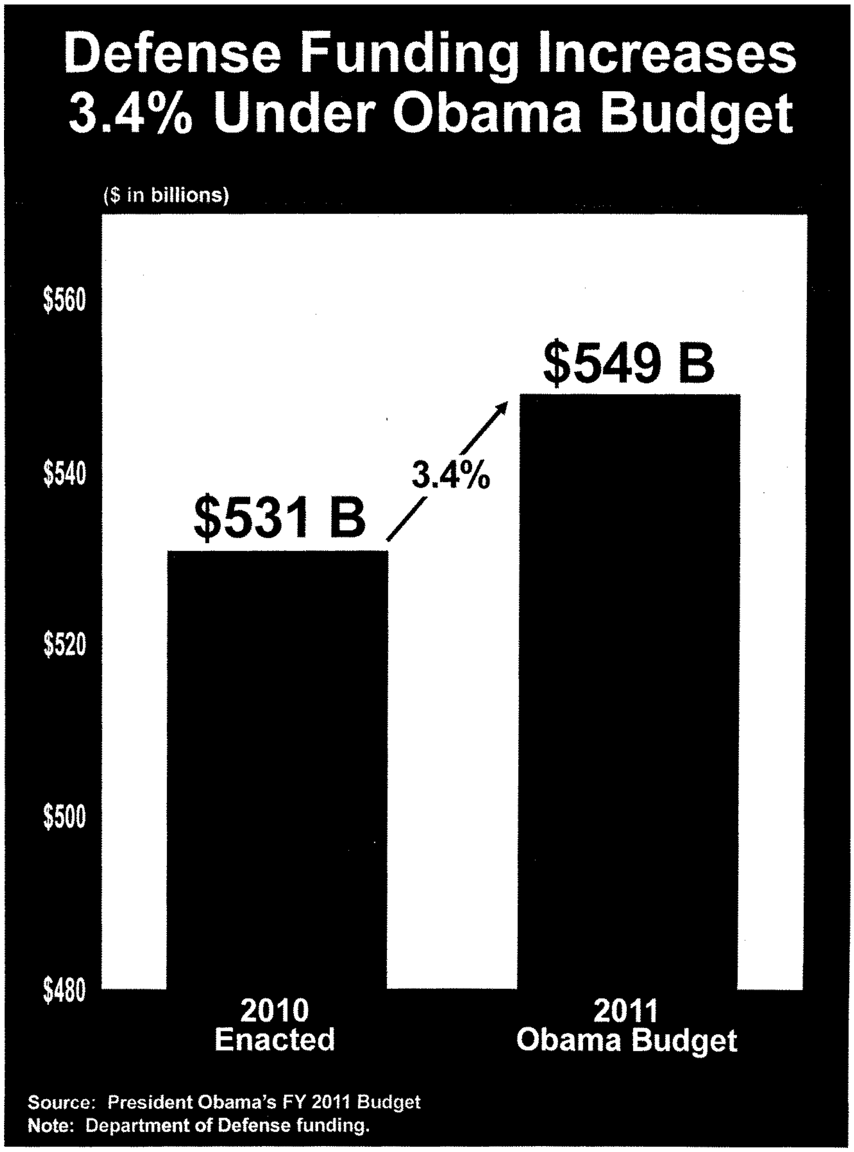
Welcome to all of you. We could not have a more distinguished group of witnesses here this morning. We are delighted you are here.



I thought I would begin with just a brief overview of the defense budget and the war costs that we face.

First, I think all of us acknowledge on this Committee that national security must always be our top priority. We need to do whatever it takes to protect this Nation and to give our men and women in uniform the resources that they need. The Obama administration has made that point, and made it repeatedly.

This is what Vice President Biden said in a speech to the National Defense University just last week: "Even in these tight fiscal times, we will commit the resources our security requires."



And the President's budget backs up those words. It provides $549 billion for the Department of Defense in 2011, representing about a 3-percent increase over 2010. But given the Nation's deficits and debt, it is more important than ever that we get the most out of each defense dollar. A dollar wasted on an unnecessary or inefficient defense program is still a dollar wasted, and we need to ensure the funds we set aside for defense are actually going to efforts that will make us safer.

Obama Administration Efforts to Refocus Defense Budget

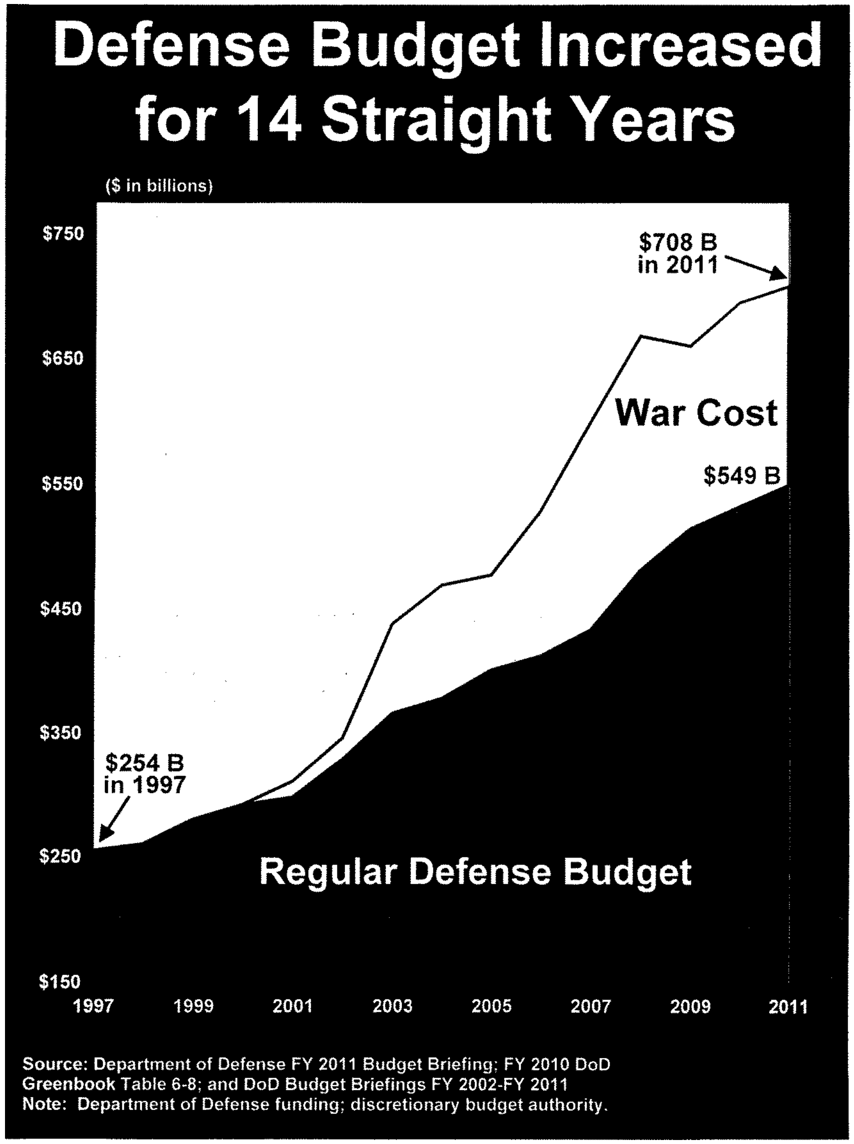
Examples of last year's changes:

- Ended F-22 production
- Reconfigured Army's Future Combat Systems
- Halted Army Brigade Combat Team expansion at 45
- Ended Navy DDG-1000 Destroyer production
- Ended Presidential helicopter
- Shifted to regional missile defense

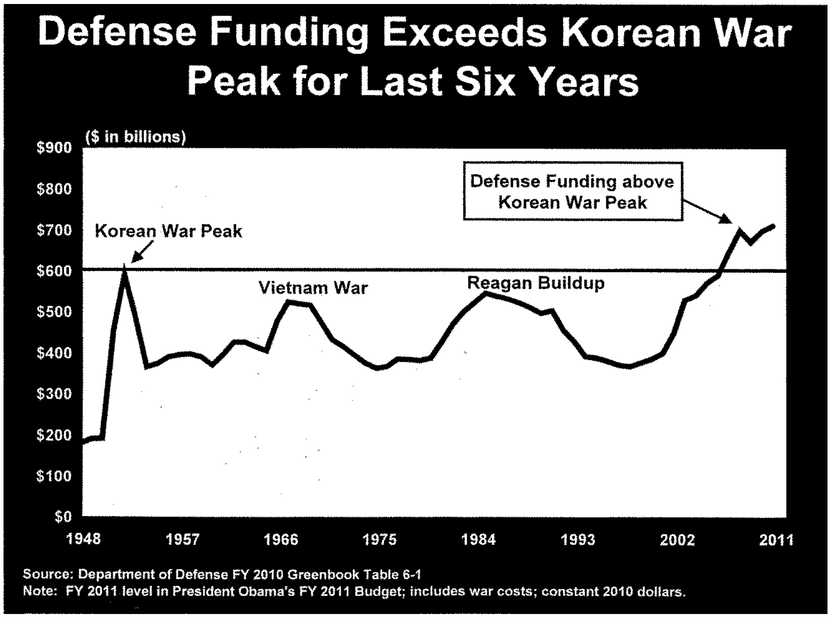
Examples of this year's proposed changes:

- End C-17 military transport production
- End Navy CG(X) Cruiser
- Terminate flawed human resources system
- Terminate flawed command and control system

The administration has taken a number of steps last year and again this year to refocus defense dollars in a way to make them more effectively spent. Here are some of the changes made last year, that the administration made with the support of Congress: F–22 production was ended; the Army's Future Combat Systems was reconfigured; they halted the Army brigade combat team expansion at 45; they ended the Navy DDG 1000 destroyer production; ended production of a new Presidential helicopter; and shifted to regional missile defense. And this year, the administration proposes ending C–17 military transport production, ending the Navy CG(X) cruiser program; terminated a flawed human resources control system; and terminated a flawed command and control system.



Even with these efforts, the defense budget is taking up a tremendous and growing part of our national budget. In the President's latest request, the defense budget will have increased for 14 years in a row. The regular defense budget will have almost doubled over that time period, rising from $254 billion in 1997 to $549 billion in 2011. And when you add war costs on top of that, we will be spending over $708 billion in 2011. That is a tripling, roughly a tripling, from 1997.



But to put this in historical perspective, we can see that our defense funding, including war costs, is far higher than during the Reagan defense buildup and the Vietnam War, and it has exceeded the Korean War peak for the last 6 years.

Defense Secretary Gates on Time Frame for War in Afghanistan

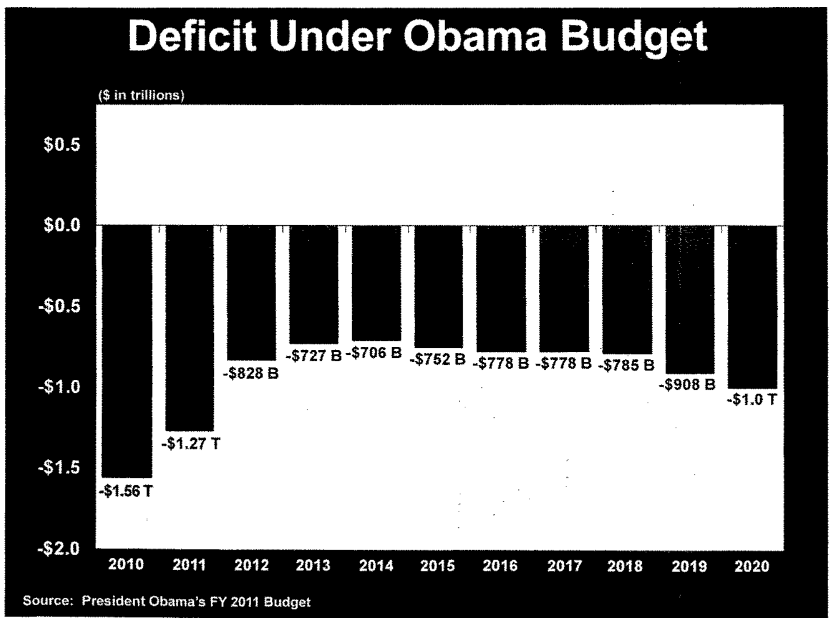
"...July 2011 is the beginning of a process of drawing down in Afghanistan. That process will be based on the conditions on the ground.... [The President] has not put deadlines in terms of when our troops will all be out.

"But clearly he sees ... July 2011 as ... an inflection point where we begin to draw down those forces, in Afghanistan, and with a view to transferring this responsibility to the Afghans, over a period of probably two or three years."

– Defense Secretary Robert Gates
Testimony before Senate Foreign Relations Committee
December 3, 2009

I think it is important to recognize what Secretary Gates has said in testimony before the Senate Foreign Relations Committee. He said, and I quote, "July 2011 is the beginning of a process of drawing down in Afghanistan. That process will be based on conditions on the ground. The President has not put deadline in terms of when our troops will be out, but clearly he sees July 2011 as an inflection point where we begin to drawn down those forces in Afghanistan, and with a view to transferring this responsibility to the Afghans over a period of probably 2 to 3 years."

So under the timeline, we would presumably have a military presence in Afghanistan until at least the middle of 2013 or 2014.



We also need to remember the context within which we consider these defense requests. Our Nation is deep in debt. This chart depicts the projected deficits under the President's budget over the next 10 years. It shows the budget deficit coming down from a high of $1.56 trillion in 2010 to $706 billion in 2014, but then starting to go back up. It is that pattern that is of great concern to this Committee.

In the near term, I think we all understand what we confront. But what is of very deep concern to this Committee, certainly this member, is the long-term outlook of the President's budget. That is unsustainable, and it is going to have to be addressed. I am delighted that he is going forward with a commission to make recommendations and that those recommendations will come to this Congress for a vote before the end of the year. I think that is critically important.

But we also understand we have a responsibility now to look at all spending that is proposed, to scrub it, to review it, and that is part of this process.

We are joined by my colleague, the Ranking Member, Senator Gregg, and we will have his statement now, and then we will go to the panel for their testimony. Welcome.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and I thank the panel for being here today to give us their thoughts on the defense procurement issues and specifically the defense budget, and I appreciate your holding this hearing.

Obviously, defense is the first responsibility of a national government. Having a strong defense capability and making sure that the people who serve us in the military are fully supported is absolutely a priority for us as a Congress. But that does not mean that we should not look at the way these dollars are being spent and make sure that we are getting the most for the dollars that we are spending in all functions of Government, including defense. And, thus, I would be interested in this panel's thoughts in this area, but especially as it relates to, as I see it, defense spending being divided into three areas.

First, obviously, is fighting the war. What does it cost us to fight this war? What will it cost us to fight this war? What is a fair assessment of that cost? Whatever it takes, we are going to have to spend. That is just a fact of life because of the fact that we have troops, soldiers in the field, and they deserve our full support.

Second, of course, is the issue of purchasing weapons systems to support our troops and the question of which weapons systems we should be supporting, whether we should be changing our focus—the entire military structure is changing its focus—and whether our focus is too much in a historical mode with strategic systems.

And third is the cost of personnel, and specifically the cost of personnel post-service, and what are the real costs and what percentage of the defense budget is basically being locked down and put in place in a manner that basically cannot be adjusted as a result of those costs being put in place, and other things we should be looking at to try to bring those costs under control, especially in the area of health care in the Defense Department and in the area, obviously, of retirement benefits.

So those are the three areas I am interested in hearing from the panel, and I appreciate the Chairman having brought them before the Committee today, and I look forward to their testimony.

Chairman CONRAD. Thank you, Senator Gregg, and we will proceed with Dr. Williams. Again, Dr. Williams, the principal research scientist at MIT's Security Studies Program, former Assistant Director for National Security at the Congressional Budget Office, and, of course, we rely on the CBO very much for estimates that we rely on.

Dr. Williams, welcome. Please proceed.

STATEMENT OF CINDY WILLIAMS, PH.D., PRINCIPAL RESEARCH SCIENTIST, SECURITY STUDIES PROGRAM, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Ms. WILLIAMS. Thank you, Mr. Chairman, Senator Gregg. I appreciate the opportunity to appear before you today to discuss the

Nation's defense budget. I have provided a written statement, and I am hoping that it will be entered into the record.

The United States is privileged to have a military vastly more powerful than any other in the world, and our future national security demands that we provide it with adequate resources. But the Nation's resources are not unlimited, as you pointed out, and as in other areas of the Federal budget, the choices you make for the next decade will influence the choices available to the Nation in the future.

Mr. Chairman, you already highlighted the rapid rise in defense spending since 1997. The administration's budget for fiscal year 2011 calls for additional real increases for the next 5 years.

It seems to have become conventional wisdom that the defense budget must continue to rise in real terms just to keep the armed forces intact. Those who see increases as inevitable often argue that the same factors that have pushed portions of the budget upwards in the past must be unavoidable in the future. That is not the case. Rather, what seem like unavoidable increases often reflect specific policy choices that do not have to be repeated. In some cases, they actually augur an opportunity to spend less, not more, in the future.

I would like to focus here on two examples: operation and maintenance, and the equipment purchases attributed to the wars in Iraq and Afghanistan.

First, operation and maintenance. A glance at the raw trends does indeed leave the impression that the DOD's operation and maintenance budgets have nowhere to go but up. The Congressional Research Service estimates that O&M funding per active-duty troop climbed an average of 2.5 percent a year since 1955, as shown in Figure 4 of my written statement. But there are reasons for past increases, and generally they do not portend unavoidable budget growth in the future.

These reasons include the expansion of infrastructure on military bases during the 1950's and 1960's as the U.S. turned to a large peacetime military. They include the added operational costs of the Vietnam War. They include the shift in 1973 to the all-volunteer force. The creation of the all-volunteer force prompted the Department to improve support of all kinds and showed up in the O&M budget. It also led to a major expansion of the population of military retirees. Their health care costs show up in the O&M budget.

Another important factor was the transfer of work from uniformed personnel, whose pay is charged to the military personnel account, to contractors, whose costs are generally in O&M. During the 1990's, O&M budgets were also pushed billions of dollars higher by new missions like drug interdiction, cooperative threat reduction, and environmental cleanup.

During the past decade, the biggest O&M cost driver was health care. We are all aware of the rising costs for health care across the United States, but the defense situation is made worse because of deliberate choices during the past decade to expand the benefits and hold to a fee structure that makes military health care much cheaper for retirees than other options available to them and, therefore, draws large numbers of military retirees into the military medical plan when they have other choices. Other factors during the past decade include the expansion of installation security and force protection measures and other changes made in response to 9/11.

Factors like the adoption of the all-volunteer force, the shift of work to contractors, added missions like drug interdiction, and expanded missions like force protection are likely here to stay. Reducing their costs in absolute terms will require choices and tradeoffs, but there is no reason to expect that their costs will rise uncontrollably in the future just because they added to budgets as they were introduced. One thing is certain, though. Assuming that O&M costs face an unavoidable rise simply because they went up in the past is the surest way to make it so. It is also an invitation to waste.

Now let me turn to the costs of equipment reset due to the wars. It seems, again, to have become conventional wisdom that huge amounts of military equipment have been destroyed, damaged, or just plain run into the ground by operations in Iraq and Afghanistan. To compensate, so the argument goes, the Army and Marine Corps will need major new investments in equipment during the coming decade. In fact, the evidence points in the opposite direction: the services are actually better off in terms of equipment as a result of the wars than they would otherwise have been.

Since 2002, the Department has budgeted more than $230 billion for procurement ostensibly related to the wars. A sizable share of that money went not to replace equipment lost in battle but to outfit the forces with entirely new equipment. Some examples include the Army's restructured brigades, modern equipment for the Guard, and the MRAPs. Moreover, the fraction of deployed equipment that has been destroyed in combat is actually quite small. There is also little reason to believe that the equipment is being ground down at a particularly rapid rate by being used heavily in the wars. In short, rather than signaling the urgency of a fresh round of procurements to fix things that broke in the wars, the wartime procurement should put the services in a better position to face the future.

Let me summarize by saying that rising defense budgets are not a new law of physics. Assuming that they are will inevitably lead to waste that the Nation cannot afford.

Mr. Chairman, Senator Gregg, that concludes my remarks.

[The prepared statement of Ms. Williams follows:]

Statement of
Cindy Williams

Principal Research Scientist
Security Studies Program
Massachusetts Institute of Technology

Visiting Fellow
Dickey Center for International Understanding
Dartmouth College

The U.S. Defense Budget

Before the
Committee on the Budget
United States Senate

February 23, 2010

Mr. Chairman, Senator Gregg, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the nation's defense budget. The United States is privileged to have a military second to none, and our future national security demands that we provide it with adequate resources.

Excluding the costs of the wars in Iraq and Afghanistan, budget authority (BA) for national defense rose by about 50 percent (after adjusting for inflation) between the post-cold war low of FY 1998 and FY 2010.[1] This represents an average annual rise in real terms of about 3.5 percent. If the costs of the wars are included in the FY 2010 figure, the inflation-adjusted rise since the post-cold war low point is greater than 90 percent—an average real rise of about 5.5 percent a year for twelve years.

The budget the administration submitted to Congress earlier this month calls for continued increases, though at a more modest level. The proposed budget would raise non-war national defense spending by another 1.8 percent in real terms between FY 2010 and FY 2011, and an average of 1 percent annually from FY 2010 to FY 2015.

It seems to have become conventional wisdom that the defense budget must continue to rise annually in real terms, just to keep the armed forces sized, equipped, and trained about as they are today. Those who see increases as inevitable generally argue that the same factors that have pushed portions of the budget upwards in the past must be unavoidable in the future.

That is not the case. Rather, what seem like unavoidable increases often reflect specific decisions and pressures that do not have to be repeated.

This statement looks at past growth in three areas of DoD's budget: operation and maintenance, military health care, and equipment purchases attributed to the wars in Iraq and Afghanistan. In each area, it finds that past growth does not portend unavoidable growth in the future.

The statement begins with a brief overview of the administration's FY 2011 plan for national defense and a look at the composition of the Department of Defense budget. It continues with a look at the causes of rising budgets in the areas listed above, and ends with a brief conclusion.

Overview of the Administration's Budget for National Defense

For FY 2011, the administration requested $549 billion in non-war discretionary BA for the Department of Defense (DoD), compared with $531 billion appropriated for FY 2010. Mandatory budget authority of $4 billion, much of it to fund concurrent receipt payments for military retirees who also receive disability payments from the Department of Veterans Affairs, pushes the department's non-war budget to $553 billion. The administration requested an additional $159 billion in budget authority to fund the wars

[1] The calculation uses the DoD deflator. The rise based on the GDP deflator is about 60 percent.

in Iraq and Afghanistan for FY 2011. The $27 billion in discretionary BA requested for the nuclear weapons activities of the Department of Energy and defense activities in other departments brings the administration's total plan for budget function 050, national defense, to $739 billion, as shown in Table 1.

Table 1. National Defense Budget Budget Authority in Billions of Current Dollars		
	FY 2010	FY 2011
051 Department of Defense		
Non-war		
Discretionary	531	549
Mandatory	4	4
Total non-war	534	553
Overseas Contingency Operations	163[a]	159
Total Department of Defense	697	712
053 Department of Energy	18	19
054 Defense-Related Activities	7	8
050 National Defense	**722**	**739**

Source: Author's table based on DoD and OMB budget tables for FY 2011.
Figures may not add to totals due to rounding.
[a]Includes $33 billion in February 2010 request for emergency supplemental appropriation

National defense is of course not the only tool in the nation's security toolkit; homeland security and non-military international activities are also important. In addition to the 050 request, the administration's plan calls for $53 billion in homeland security funding outside of DoD and $65 billion for International Affairs (budget function 150). This brings the president's FY 2011 budget for the major elements of security and foreign affairs to $857 billion in BA.[2]

As envisioned in the president's budget, total national defense spending in 2011 would account for 19.4 percent of federal outlays and 53 percent of discretionary outlays. National defense outlays in the president's plan come to 4.9 percent of the projected gross domestic product (GDP).

For the non-war, or base budget, the DoD's FY 2011 request for discretionary funds represents an increase in nominal terms of 3.5 percent over FY 2010 and a rise in real terms of 1.8 percent. The administration's request calls for a real rise of about 1 percent a year in DoD's discretionary base budget between FY 2010 and FY 2015 (see Table 2).

[2] Budgets and resource allocation processes for defense, homeland security, and international affairs are discussed in *Buying National Security: How America Plans and Pays for Its Global Role and Safety at Home* (Routledge 2010) by Gordon Adams and Cindy Williams.

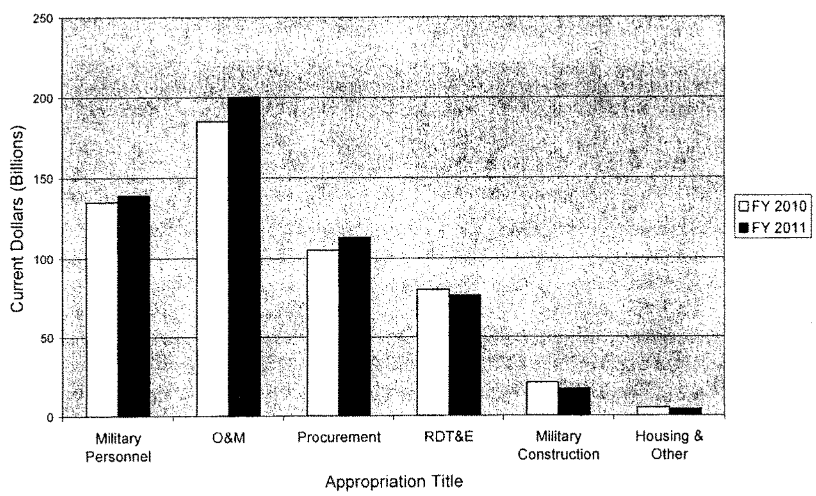
Cindy Williams
23 February 2010

Table 2. DoD Discretionary Base Budget Billions of Current Dollars					
FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
531	549	566	582	598	616

Composition of the Administration's Budget for DoD

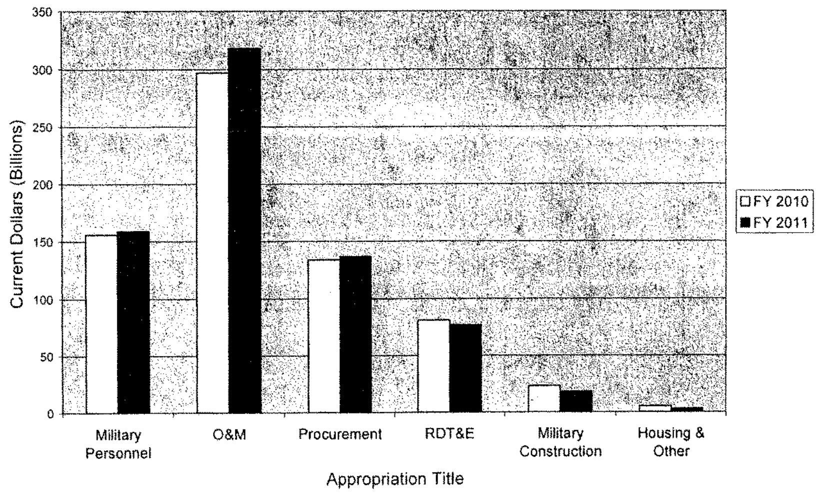
Compared with the FY 2010 budget, the FY 2011 request for DoD is more heavily weighted toward military personnel, operation and maintenance (O&M), and procurement. It is less heavily weighted toward research, development, test and evaluation (RDT&E) and construction (see Figures 1 and 2). Much of the reduction in construction spending is related to the planned completion of base closure and realignment activities undertaken under the 2005 BRAC round.

Figure 1. DoD Base Budgets FY 2010 and FY 2011



Cindy Williams
23 February 2010

Figure 2. DoD Total Budgets FY 2010 and FY 2011

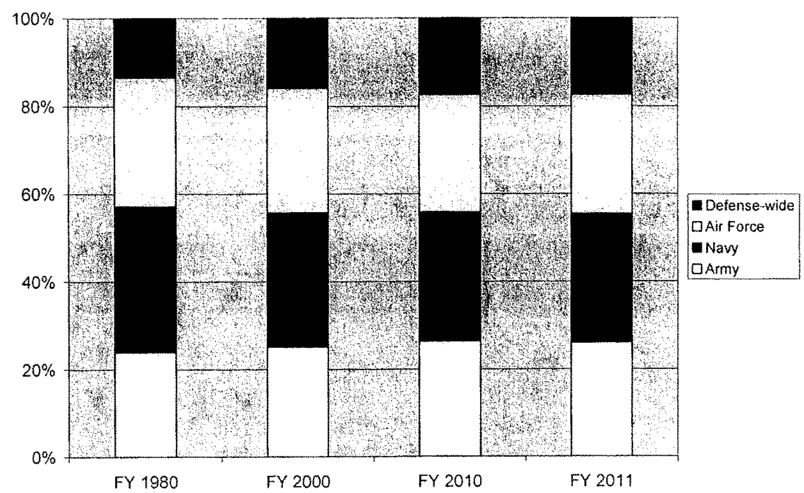


The DoD plans to devote 26 percent of its base budget to the Army, 29 percent to the Department of the Navy, 27 percent to the Air Force, and 17 percent to defense-wide activities that are not attributed to any of the services. Compared with 2010, the plan makes virtually no change in the composition of the DoD budget by service. In fact, as Figure 3 shows, the components' relative shares of the FY 2011 base budget are about the same as they were at the height of the cold war and before 9/11.

In the following three sections, I discuss factors that have pushed defense budgets up in recent years in three areas: operation and maintenance in the base budget, military health care in the base budget, and the procurement spending attributed to the wars in recent years.

Cindy Williams
23 February 2010

Figure 3. Component Shares of DoD Base Budget



Factors in the Past Growth of O&M Budgets

Operation and maintenance budgets fund a wide variety of activities, including the upkeep of equipment and real estate; supplies and spare parts; transportation; fuel; and individual training and education as well as the training and operation of combat and support units. It funds the pay of most DoD civilian employees and a large network of support contractors, as well as much of the cost of health care for service members, retirees and their families. The O&M category is associated with both mission readiness and infrastructure.

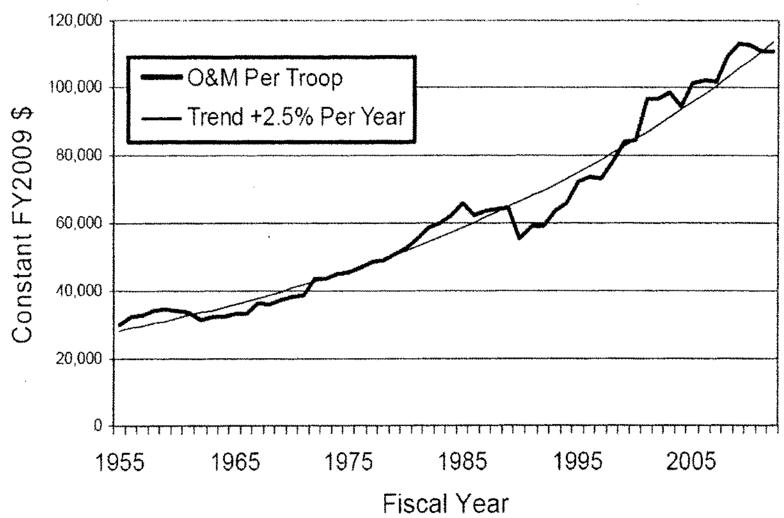
A look at the raw trends suggests that DoD's operation and maintenance budgets have no place to go but up. The Congressional Research Service estimates that O&M funding per active duty troop climbed an average of 2.5 percent a year since 1955 (see Figure 4).[3] There are reasons for past increases, however, and generally they do not portend unavoidable budget growth in the future.

1955 to 1965
For example, the period from 1955 to 1965 saw the expansion of family-friendly infrastructure on military bases as the United States adjusted to the presence of a large

[3] The figure includes the costs of the Vietnam War, but excludes costs for more recent military operations, beginning with the Gulf War in 1991. The figure is drawn from "The Sustainability of Current Defense Plans," written statement of Stephen Daggett, Congressional Research Service, before the Committee on the Budget, U.S. House of Representatives (February 4, 2009), p. 8.

peacetime military. The number of family housing units on military bases in the United States and overseas nearly doubled during that period, from 200,000 to about 400,000.[4] The period also saw the creation of family-oriented health clinics and elementary schools run by the DoD.[5] Once built, that infrastructure added to support costs. Those costs persist today, though the ongoing shift to privatized housing on military bases is expected to bring at least the housing support costs down in the coming years.

Figure 4: Operation and Maintenance Funding per Active Duty Troop, FY1955-FY2013



Source: CRS based on Department of Defense budget data.

1966 to Early 1970s

From 1966 until the early 1970s, much of the rise in O&M spending can be explained by the Vietnam War, whose operating costs per troop are included in Figure 4. War spending in general is heavy on operations and support, and O&M spending per person generally accelerates in wartime.[6]

---

[4] "Military Family Housing in the United States" (Washington, DC: CBO, 1993), Figure 8, p. 33.

[5] Deborah Clay-Mendez, "Cash and In-Kind Compensation Policies for a Volunteer Force," in Curtis Gilroy and Cindy Williams, *Service to Country: Personnel Policy and the Transformation of Western Militaries* (Cambridge, MA: The MIT Press, 2006), p. 270.

[6] A similar rise in O&M spending per person is evident in today's wars. Between FY 2001 and FY 2008, total obligational authority for O&M per active-duty troop grew from $105,000 to $179,000 (FY 2010

Early 1970s to 1980

As the Vietnam War ended, one might have expected O&M funding per troop to return to the 1965 level. That did not happen, in part because of the post-Vietnam downsizing of the military. As we saw later during the post-cold war downsizing, it is not easy to trim infrastructure as rapidly as forces are reduced. Another important factor was the shift from a conscript military to the all-volunteer force (AVF) in 1973. During the 1970s and into the early 1980s, DoD made substantial improvements in support to accommodate the all-volunteer force. O&M costs related to recruiting offices and training facilities rose. Family services like on-base child care were expanded. Housing for single personnel improved. The upkeep of office space and training facilities took on new importance as the services looked for ways to offset some of the negative features of military life.[7] By 1980, funding for base operating support and real property maintenance claimed 21 percent of the O&M budget.[8]

1980 to 1985

During the military buildup of the late Carter and early Reagan years, O&M budgets grew rapidly, though not as quickly as procurement funding. Between 1980 and 1985, increases in funding for base operating support and real property maintenance accounted for a sizeable portion of the rise in O&M spending per troop.[9] During the same period, a definitional change that shifted the cost of certain spare parts out of the procurement budget and into O&M accounted for another significant portion of that rise.[10] Military medical costs rose significantly during the period, but in 1985 still accounted for less than five percent of the O&M budget.[11]

Funding for depot maintenance and other logistics also grew rapidly during the Carter-Reagan buildup, particularly for the Navy.[12] The reasons for that growth are not entirely clear. The number of ships in the force grew during the period as the Navy worked toward its goal of 600 vessels. Ship steaming hours did not climb during the period,

---

dollars). (The rise is not apparent in Figure 4, which excludes the incremental costs of the wars in Iraq and Afghanistan.)

[7] The AVF also led to changes in the composition of the force that pushed O&M costs higher. Between 1974 and 1977, the fraction of enlisted personnel who were married rose from 43 percent to 50 percent, thus increasing the demand for family-oriented services. See Office of the Under Secretary of Defense for Personnel and Readiness, "Population Representation in the Military Services," FY 2004, Figure 3.4. The shift also led to an increase in the fraction of enlisted personnel who serve long enough to qualify for retirement benefits, including the health care benefits whose costs have grown dramatically. The number of military retirees rose from 700,000 in 1969 to 1.7 million in 2003. Both of those fractions have held steady in recent years, however.

[8] Author's calculation based on Neil M. Singer, "Overview of Operation and Maintenance Accounts" (Washington, DC: CBO, March 1985), Table 1.

[9] Author's calculations based on Lane Pierrot, "Operation and Support Costs for the Department of Defense" (Washington, DC: CBO, July 1988), Table 1, p. 5.

[10] Author's calculations based on Lane Pierrot, "Operation and Support Costs for the Department of Defense" (Washington, DC: CBO, July 1988), Table 1, p. 5.

[11] For comparison, O&M funding for military health care now constitutes about 20 percent of the base budget for O&M.

[12] Author's calculation based on Neil M. Singer, "Overview of Operation and Maintenance Accounts" (Washington, DC: CBO, March 1985), Table 1.

however, nor did Navy readiness grow appreciably.[13] One analyst posits that O&M spending for ships rose because the sea service retained a substantial number older vessels in its quest to build the planned 600-ship Navy.[14] That explanation does not seem entirely satisfactory, however, particularly because Navy ships continued to age during the following five-year period, and Navy depot maintenance spending fell.

Another theory is that the large increases in overall military budgets during the period simply reflect the fact that budgets generally were on the rise. O&M spending does seem to rise and fall in loose concert with total defense budgets—an indication that some of the seemingly avoidable rise in O&M spending is a consequence of budget largesse as much as a cause of it.

The consequences of the growing peacetime establishment on bases and the introduction of the AVF persist in today's O&M budgets. Their absolute costs may not be easy to reverse, but there is no reason to believe that the bursts of budget growth that they fueled will have to be repeated in the future.

1989 to 1999

Between 1985 and 1989, non-war O&M funding per active-duty troop fell, only to rise sharply again through the decade of the 1990s. Several factors put upward pressure on per capita O&M during this period. One was the failure to reduce infrastructure in concert with the downsizing of the operating forces. Between 1989 and 1996, mission-related spending for the services' forces fell by 31 percent, consistent with the drop in the number of troops. Budgets for the services' administrative activities fell by just 19 percent, and their training and recruiting activities shed just 24 percent.

One consequence of the downsizing was a shift of some infrastructure-related work previously done by uniformed service members to the private sector. Studies show that the shift generally saved the department money, at least in the early years. The shift to contractors meant that funding for such work transferred from the military personnel account to O&M, however, thus putting additional upward pressure on O&M.

Another factor was increased emphasis on mobilization forces, whose budgets rose significantly during the drawdown of the 1990s. Other areas whose per capita O&M costs rose during the period were intelligence, communications, and special operations.

This period also saw the introduction of several new missions to DoD, including environmental programs, drug interdiction, cooperative threat reduction, and treaty verification.[15] Those missions added billions of dollars to O&M budgets even as sharp

---

[13] Amy Belasco, "Paying for Military Readiness and Upkeep: Trends in Operation and Maintenance Spending" (Washington, DC: CBO, September 1997), p. 31.
[14] Gregory T. Kiley, "The Effects of Aging on the Costs of Operating and Maintaining Military Equipment" (Washington, DC:CBO, August 2001), p. 11.
[15] Amy Belasco, "Paying for Military Readiness and Upkeep: Trends in Operation and Maintenance Spending" (Washington, DC: CBO, September 1997), p. 31. O&M budgets for those four missions come to about $7.3 billion in the FY 2010 budget.

reductions took place in other areas, and they persist today. It stands to reason that if additional new missions fall to the department, O&M budgets will grow to accommodate them. That is no reason to suppose that rising O&M costs are unavoidable, however.

1999 to Today

Since 1999, base defense budgets have climbed every year. O&M budgets rose with them, though at a significantly slower pace.[16]

The fastest growing element of O&M budgets during the recent period is health care. O&M health care costs per active duty troop shot up by a factor of two and one-half between 1999 and 2010. That rise accounts for more than one-half of the increased bill for O&M in the base budget. To some extent, DoD's rising medical costs reflect the rate of growth in health care costs in the underlying U.S. economy. In DoD's case, however, the rise was exacerbated by a broadening of benefits and a shift of health care costs from the civilian sector to the department, as the next section discusses.

Outside of health care, some of the added O&M expense is due to the changes the department made in response to 9/11 and the costs of the wars in Afghanistan and Iraq.[17] For example, a portion of the money added to base O&M budgets went into the expansion of terrorism-related activities, including installation security and force protection. Budgets for communications and intelligence also rose. In addition, to avoid expanding the military or civilian workforce, the department gave much of its added work to contractors, whose costs generally show up in O&M budgets. Rising fuel prices also contributed to higher O&M budgets during the past decade.

The repair of war-torn equipment is not a factor in rising base budgets for O&M; the costs of repairing equipment damaged or stressed in the wars in Iraq and Afghanistan have been borne in the war budgets.[18] It is not clear what role aging equipment has played in the recent O&M rise. Much of the services' major equipment has not yet exceeded its expected service life, though that picture will change quickly for some systems under current replacement plans.

Most of the increase in base budget O&M during the recent period was caused by the growth in health care costs or the expansion of terrorism-related activities. As discussed in the next section, DoD health care costs are rising faster than they otherwise would because of deliberate policy choices; putting the brakes on them would require political will, but they are not unstoppable. Now that they have been instituted, there is no reason to believe that the costs of installation security, force protection, and other antiterrorism measures will grow faster than inflation in the coming years.

---

[16] Annual O&M growth during the period was about 2.1 percent above inflation during the period, compared with 3.2 percent annual growth above inflation in the overall base budget.
[17] Trying to understand the rise is in O&M budgets since those wars began is complicated by the choices the department made in assigning activities to base budgets versus supplemental appropriations.
[18] In fact, beginning in 2007, even equipment damaged during training at home was repaired using war funding.

Looking to the future, this leaves the cost of maintaining complex new equipment as well as aging equipment as the main important factors to watch. History shows that these costs are likely to rise. Because equipment upkeep costs generally constitute a relatively small share of O&M base budgets, however, expected growth in this area does not have to portend the inevitable multi-percentage point rise in O&M that too many observers take as a given.

One thing is certain: assuming that O&M costs face an unavoidable rise simply because they rose in the past is the surest way to make it so. Several past efforts to bring O&M costs under control have been successful. Assuming based on past trends that it cannot be done is an invitation to waste. The better strategy is to put O&M on a diet and challenge the services to bring the costs of operation and upkeep under control.

Growth in Budgets for Military Health Care

The DoD's health care costs rose from about $20 billion in 1998 to $47 billion in 2010 (FY 2010 dollars)—an annual growth rate of 7.4 percent above inflation. Absent changes in policy, CBO projects they will at least double between now and 2028.[19]

With health care costs in the civilian sector rising as rapidly as they are, it is easy to assume that the rise in defense health care costs simply reflects the underlying cost pressure that all Americans face. Unfortunately, the picture for DoD is substantially worse, for two main reasons: the expansion of health care benefits since 2000 and an increase in the number of beneficiaries who choose to use the department's program rather than the civilian options available to them.

Tricare for Life

The department provides health care coverage and services for service members and their families. It also provides health care for military retirees and their beneficiaries and survivors. More than half of those eligible for DoD benefits are retirees or their family members.

Retirees and their family members who are eligible for Medicare (generally those who have reached the age of 65) are expected to use Medicare as their first choice for health coverage. In 2000, coverage for that population was greatly expanded through the Tricare for Life program. Tricare for Life works like a premium-free wrap-around policy, paying virtually all medical expenses that are not covered by Medicare. In DoD's budget, Tricare for Life is funded on an accrual basis that recognizes the expected future costs of the program that will be borne as today's service members and their families retire from the military and reach Medicare age. Those costs added about $11 billion to the department's health care bill between 2000 and today.

[19] "Long-Term Implications of the Fiscal Year 2010 Defense Budget" (Washington, DC: CBO, January 2010), p. 14.

Another policy option might be to reverse the incentives for working-age military retirees, by paying them make other health care arrangements. Absent a fee increase or another policy change that shifts the incentive structure, DoD's costs for purchased care and pharmaceuticals—a major driver in the department's rising health care budget—will more than double between now and 2028.[22]

Equipment Reset Due to the Wars in Iraq and Afghanistan

It seems to have become conventional wisdom that the Army and Marine Corps will require a major new investment in equipment during the coming decade, because so much equipment was damaged, destroyed, or "run into the ground" by operating in excess of its expected service life during the wars in Iraq and Afghanistan. In fact, the evidence points in the opposite direction: the services are better off in terms of equipment as a result of the wars than they would otherwise have been.

Including the administration's emergency supplemental request for FY 2010, procurement funding attributed to the wars since 2001 comes to more than $230 billion of the trillion dollars attributed to the wars. Procurement designated as war funding accounted for more than 20 percent of the department's total procurement funding during the period. Funding for procurement in the war budgets grew sharply between 2004 and 2008, peaking at about $65 billion in FY 2008—more than one-third of the department's total budget for the wars that year.

It would be easy to suppose that most of the procurement money in war budgets paid to replace equipment that was irreparably damaged in battle. Instead, a sizeable share of that money went to outfit the forces with entirely new equipment. In some cases, the services used it for upgrades and purchases of new equipment to fill shortfalls that existed well before the wars began.[23] The purchase of additional trucks for the Army and the procurement of modern equipment for the Army National Guard fall into that category. In another example, the Army purchased equipment to outfit newly formed units as it undertook the modularity restructuring it had planned to undertake regardless of the war.

Some of the money was used for upgrades and systems thought to be better suited to use in the wars as they unfolded—for example, up-armored HMMWVs and Mine-Resistant Ambush-Protected vehicles (MRAPs). Since 2007, some of that money has also gone to purchase new equipment to replace items lost in training within the United States. Rather than signaling the urgency of a fresh round of procurements to fix things that broke in the wars, these expenditures should put the services in a better position to face the future.

In actuality, the fraction of deployed equipment that has been destroyed in combat is quite small. There is also little reason to believe that equipment is being ground down at a

[22] "Long-Term Implications of the Fiscal Year 2010 Defense Budget" (Washington, DC: CBO, January 2010), p. 15.
[23] Frances M. Lussier, "Replacing and Repairing Equipment Used in Iraq and Afghanistan: The Army's Reset Program" (Washington, DC: CBO, September 2007), p. ix.

rapid rate by being used heavily in the wars. For example, CBO found in 2007 that most of the Army's equipment in Iraq was operating well below sustainable rates.[24]

Moreover, toward the end of the previous administration, the department front-loaded its requests for funding to reset and reconstitute equipment lost or damaged during the wars.[25] That practice appears to have ended. Nevertheless, the substantial investment in reset and reconstitution in recent years may actually put the department's equipment in better shape as the wars end than before they began. As a result, future equipment costs should arguably be lower, rather than higher, as a result of the wars.

Concluding Remarks

Defense budgets shot up dramatically during the past decade. The administration's budget request signals continued increases for the coming five years, though at a more modest pace. The proposed budget would raise non-war national defense spending by another 1.8 percent in real terms between FY 2010 and FY 2011, and an average of 1 percent annually from FY 2010 to FY 2015.

It has become conventional wisdom that the defense budget must continue to rise annually in real terms, just to keep the armed forces sized, equipped, and trained about as they are today. Those who see increases as inevitable generally argue that the same factors that have pushed portions of the budget upwards in the past must be unavoidable in the future.

A look at several areas of spending growth suggests that future increases are not in fact inevitable. Rather, what seem like unavoidable increases often reflect specific decisions and pressures that do not have to be repeated, or investments that should last into the future. Rising defense budgets should not be thought of as a new law of physics.

Mr. Chairman, that concludes my remarks.

---

[24] Frances M. Lussier, "Replacing and Repairing Equipment Used in Iraq and Afghanistan: The Army's Reset Program" (Washington, DC: CBO, September 2007), p. ix.
[25] Amy Belasco, "The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11" (Washington, DC: CRS, September 18, 2009), p. 27.

Cindy Williams
23 February 2010

Chairman CONRAD. Thank you very much.

And now we will go to Dr. Adams. Dr. Adams is a professor of foreign policy at American University and a former Assistant Director for National Security at the Office of Management and Budget. Welcome, Dr. Adams.

STATEMENT OF GORDON ADAMS, PH.D., PROFESSOR OF INTERNATIONAL RELATIONS, SCHOOL OF INTERNATIONAL SERVICE, AMERICAN UNIVERSITY

Mr. ADAMS. Thank you very much, Senator. Mr. Chairman, Senator Gregg, it is a pleasure to see both of you this morning, and I thank you for the opportunity to appear and talk about the defense budget request and the issues that you have raised from the dais.

You are discussing today one of the most sensitive and difficult spending issues you face: how to fund appropriate defense needs while ensuring essential budgetary discipline to our national defense budget at a time of continuing overseas combat operations. The administration has sent you a budget request that is historically high and has asked that it be exempt from the discretionary spending freeze it proposed for the remainder of non-defense discretionary spending.

I will argue instead, and do in my statement—which I would appreciate being entered in the record—that the defense budget should be included in any budgetary freeze or overall discretionary budget caps or reductions the Committee is considering.

I make four points in my testimony. First, although Secretary of Defense Robert Gates, who has done some remarkably good things at the Defense Department, has described this request and the accompanying QDR as "bracing dose of realism," which makes significant tradeoffs, it actually, in my judgment, reflects very little discipline in defense planning and budgeting.

Second, the QDR, which was just released with the budget, continues mission expansion for the military, broadening defense requirements in a way that makes budget discipline even more difficult.

Third, the reluctance to impose planning discipline and make choices now will lead to pressures for continuing high defense budgets, a point that my colleague Cindy Williams has already underlined, with serious implications for deficits in the out-years.

And, finally, you do have options to set limits on the mission and budgetary expansion. Let me briefly say a few things about each of those points.

First, with respect to the lack of budget discipline, the budget you have received follows in the tradition of being based on the appropriation DOD received last year, plus more funding growth, and I would associate myself with Dr. Williams' comments about there is nothing inexorable about this kind of law. Defense has, in fact, been unconstrained relatively for the past 10 years, and it is now, as your own chart points out, higher than the 1952 Korean War budget peak, higher than the peak defense budgets of 1985, higher than the Vietnam budget peak for defense.

By increasing defense resources to this level, the budget avoids priority setting, choice making, and tradeoffs. It would increase resources for near-term challenges, as described by the Secretary, but it does not rebalancing by reducing funding for longer-term priorities. Instead, it funds both. The procurement, operations and maintenance, and military personnel increases are not offset elsewhere in the budget. There are virtually no significant procurement programs eliminated this year. The two that are flagged—the C–17 and the F–35 engine—provide no savings, as they were already not in the long-term defense plan.

While overseas contingency operations would decline slightly, there is every prospect of a future supplemental, and the budget plug of $50 billion for the out-years is continued as the tradition in this budget as well. There is no visible effort to restrain O&M costs. Military personnel costs grow as well, with end strength continuing to increase, even if temporary, which sets a long-term track for budget expansion throughout. And the administration deserves credit for seeking more clarity and discipline in OCO budgeting—overseas contingencies—but there are a number of programs, as Dr. Williams suggests, that need to be examined closely in the OCO request as to whether they are, in fact, directly related to war costs. I particularly underline in my testimony the $2.8 billion in funding for long-term reconstitution, which is something, arguably, that has gone on in the $230 billion or so that Dr. Williams mentioned.

The second point on the link with the Quadrennial Defense Review, I suspect the dilemma you are going to face is being exacerbated by the new Quadrennial Defense Review. It has had an influence, I think, on the budget request, but I would suspect that the impact was not so much to restrain the budget as to encourage its continued growth.

Secretary Gates has said that this shifts away from two major regional contingencies near simultaneously as a planning algorithm, but, in fact, it does not. As Secretary Gates himself has said, "What I wanted to convey was a much more complex environment in which you have to do not just two major conflicts, which does not rule them out, but a broad range of things as well, or in the future one of those conflicts and a number of other contingencies."

The many missions and objectives offered in the QDR are not given any relative priority. Rather, the discussion of the risk in the document seems to support the idea that defense planning and budgeting needs to lower every risk at the same time.

The QDR also fully endorses the mission expansion begun under the prior administration, pushing the military into missions and capabilities that have future implications for the expansion of the U.S. military role, the size and composition of our armed forces, future defense budgets, as well as the roles and capabilities of our foreign policy institutions.

The third point, future pressures on the defense budget. Dr. Williams has mentioned pressures that are particularly coming on the procurement side. Let me add to that that mission expansion is going to cause upward pressure. Operations and maintenance spending unrestrained will exercise upward pressure, especially as the civilian work force expands. Health care costs, as she pointed out, are rising even more rapidly than those for Medicare. The mission expansion will lead to demands for force expansion, which is the underlying driver of most of the defense budget. And the administration will encounter continuing war costs and will have to adapt that $50 billion plug to a more realistic estimate.

Finally, the QDR itself and the budget point out that the Department has no way to scrub its underlying budget requirements in part because its budgeting and accounting systems are not up to the task, which means it is one of the sources of building the budget on top of last year's number. They are not really looking at what last year's number can save.

Fourthly, options for the Congress. Do you have options? You know, defense budgets, as you will remember, Senator, were not exempt from past efforts at deficit reduction. They were including in Gramm-Rudman-Hollings. It helped seal the deal, in fact. They were included in the Budget Enforcement Act of 1990. Both first President Bush and President Clinton made sure that defense was included, planning was included under the caps that existed between 1990 and 2002. So there is no ipso facto reason for saying that defense ought to be exempt.

In my statement—I will not detail them here, but I offer several areas where you might want to look, the Congress as a whole might want to look to include defense in an overall discretionary freeze, including the budget resolution as a freeze level itself, military personnel freeze, reducing the rate of growth in operations and maintenance spending, limiting base budget procurement growth, further reductions in R&D, and the careful scrub of the of the procurement part of the OCO budget I mentioned before.

You face, as you yourself have pointed out, Mr. Chairman, very broad budgetary and economic challenges, and I think it is important for you to consider how you might include defense in dealing with this challenge, I believe at no sacrifice to our national security. A freeze at this point, combined with clear out-year caps in discretionary spending, could, in fact, provide the incentives for more disciplined planning and budgeting at DOD.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Adams follows:]

Testimony of
Dr. Gordon Adams

Professor of International Relations
School of International Service
American University

Distinguished Fellow
Henry L. Stimson Center

The FY 2011 U.S. Defense Budget and the Quadrennial Defense Review

Before the
Committee on the Budget
United States Senate

February 23, 2010

> "The budget and the reviews are also shaped by a bracing dose of realism – realism with regard to risk, realism with regard to resources. We have, in a sober and clear-eyed way, assessed risks, set priorities, made tradeoffs and identified requirements based on plausible, real-world threats, scenarios, and potential adversaries." (Secretary of Defense Robert Gates, Press Briefing on FY 2011 Defense Budget, 1 February 2010)

Mr. Chairman, Ranking Member, Members of the Committee, thank you for the opportunity to appear today and discuss the defense budget request submitted by the administration for FY 2011. The Committee has a challenging job this year, finding ways to fund what is necessary, restrain spending on the unnecessary, and set overall spending limits in a challenging atmosphere of slow recovery, significant unemployment, and historically unprecedented deficits.

You are discussing today one of the most sensitive and difficult spending issues you face: how to fund appropriate defense needs, while ensuring essential budgetary discipline to our national defense budget, at a time of continuing overseas combat operations. The administration has sent the Congress a budget that is historically high and has asked that it (along with international affairs and homeland security budgets) be exempt from the discretionary spending freeze it proposed for the remainder of non-defense discretionary spending.

Let me summarize my view on this request for an exemption from the freeze: the defense budget should not be exempt from a freeze. Instead, the Department of Defense should be included in any budgetary freeze or overall discretionary budget caps or reductions the committee is considering.[1]

I will summarize my testimony in support of this view in the following way:

- Although Secretary of Defense Robert Gates has described this year's Department of Defense budget request and the accompanying Quadrennial Defense Review (QDR) as providing a "bracing dose of realism," making significant tradeoffs, it reflects very little discipline in defense planning and budgeting. Instead, the administration built its request on top of the existing defense budget, making hardly any tradeoffs in any area of spending, including procurement.

- The 2010 QDR does not "rebalance" the defense program or the budget, by setting priorities, making program tradeoffs or calibrating risks in a disciplined way. Instead, it continues the mission expansion for the military begun during the previous administration, and, in doing so, broadens defense requirements in a way that makes such discipline even more difficult.

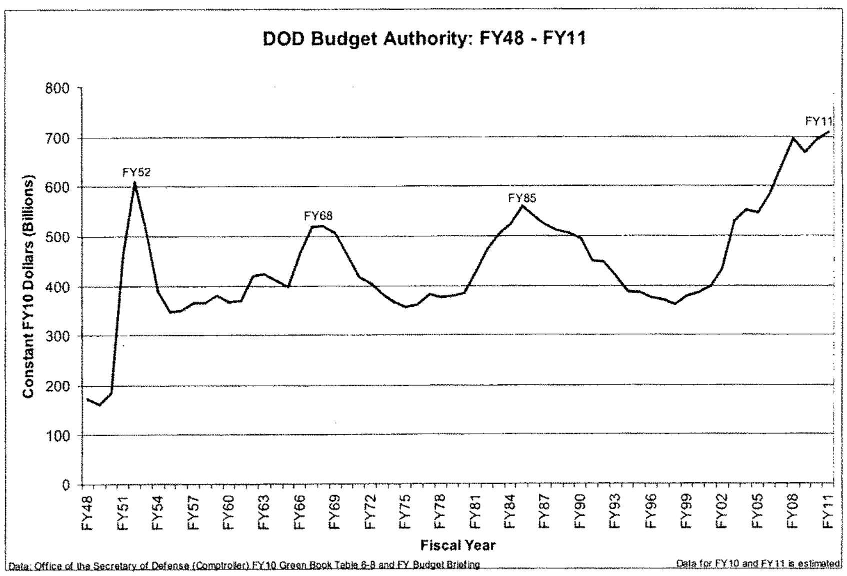
---

[1] Note that throughout the testimony I address only subfunction 051, Department of Defense, of the budget request, not all "national defense" (050).

- The reluctance to impose planning discipline and make choices now will lead to pressures for continuing high defense budgets, with serious implications for budget deficits in the out-years.

- It is important for the Congress to act this year to begin to set limits on this mission and budgetary expansion, or the task will become increasingly difficult. An unconstrained defense budget is likely to make draconian choices in all other areas of discretionary spending necessary. I suggest some approaches the Congress might consider in considering this year's budget request.

Lack of Budget Discipline
There is no magic number for the size of the defense budget; typically most annual budget requests are based on what a federal department received last year, plus more funding for program growth, initiatives, and rising costs. The FY 2011 DOD budget follows this pattern.



Over the past ten years, the pressures of war spending have relaxed discipline overall for the defense budget. As a result the $708 billion requested for total Department of Defense resources reaches unprecedented levels. The DOD base budget request of $548.9 billion adds 3.4% to the FY 2010 base budget level, or 1.8% real growth.[2] The total resources requested are, in constant dollars, 16% higher than the 1952 Korean War budget peak,

---

[2] The full $708 billion request is 2.2% real growth over the FY 2010 number, if one includes the full FY 2010 OCO supplemental request of $33 billion in the FY 2010 number.

26% higher than the peak defense budgets of 1985, and 36% higher than the 1968 peak year for Vietnam War-era defense budgets.

By increasing requested defense resources to this level, the budget avoids priority-setting, choice-making, and tradeoffs. It would increase resources for near-term challenges, as described by the Secretary, but it does not execute this "rebalancing" by reducing funding for longer-term priorities. Instead, it increases funding for both near-term and long-term programs and activities.

- The request includes additional funding for rotary wing aircraft, unmanned aerial vehicles (UAVs), and special operations forces, tied to ongoing operations and near-term "threats," but these additions are not offset by longer-term reductions. It seeks significant growth in the base budget for procurement (+7.7%) and operations and maintenance (+8.5%) and military personnel (2.6%). This growth is only partially offset by cuts in the smaller requests for research and development (-5.0%), military construction (-19.5%), and family housing (-19.3%). These reductions do not reflect a decision to "rebalance" the budget away from these other accounts. The proposed R&D reductions reflects maturing programs that are moving into procurement, while the military construction reductions reflect the end of the BRAC process and family housing reductions reflect progress in the privatization of military family housing.

- The procurement budget request reflects little priority-setting. Secretary Gates made several hardware program cuts in the FY 2010 budget, for which the Department deserves full credit. However, the savings were not major. The F-22 was slated to finish production, so there was no funding for the program in out-year budget projections in any case. The C-17 program was also slated to end, though Congress restored it. The FCS vehicle cancellation was not a program termination, but a "restructuring," as was the DDG-1000 decision. There are fewer major program decisions in this year's request. Two – the C-17 and the F-35 alternate engine - are likely to be restored by the Congress, and neither saves resources, since DOD did not include them in the future-years plan. The Navy's command ship replacement program is not cancelled, but deferred. Only the CG(X) cruiser is a clear program termination, with small savings and consideration of alternative approaches still under way in the Navy. (Overall, Navy shipbuilding funds grow nearly 14% above the FY 2010 level in the FY 2011 budget request.)

- Overseas Contingency Operations funding would decline slightly (from 162.6 billion in FY 2010 to $159.3 billion in FY 2011, if the FY 2010 budget request of $33 billion is appropriated), but there is every prospect of a future supplemental for FY 2011, especially to fund withdrawal from Iraq and, possibly from Afghanistan, as well.

- The FY 2011 base budget request for Operations and Maintenance would rise significantly – 8.5% in current dollars (or 7.9% per troop). O&M budgets have risen rapidly over the past eight years, due to overseas operations in Iraq and Afghanistan. In the base budget, however, DOD has for decades under-budgeted for Operations and Maintenance, projecting a flat funding requirement into the future years, though O&M costs have risen inexorably at an average annual rate of around 2.5% per troop. But there is no evidence in the FY 2011 budget request of an effort to restrain O&M costs, aside from the usual statements about bringing effective management to the business operations of the Department. Moreover, if DOD is moving to expand the size of its civil service work force, O&M costs are likely to continue to grow in the future.

- Funding for Military Personnel grows, as well. This includes funding for a "temporary" increase in Army end-strength of 22,000, on top of the more than 90,000 already added to the ground forces over the past three years. End-strength growth is a core driver of future defense budgets.

- Less visible, but equally important, the FY 2010 OCO supplemental and FY 2011 budget requests may still be funding costs that should be traded off in the base budget. The administration deserves credit for seeking to provide more clarity and greater discipline on OCO budgeting, but there are a number of programs in the OCO requests which Congress will want to examine closely, to ensure they are directly tied to the war. In particular, the budget seeks $2.8 billion in funding for "long-term reconstitution," a new category whose definition is unclear. In particular, the FY 2011 OCO seeks $204.9 million for an F-35, whose relevance to current operations in Iraq and Afghanistan is unclear.

In sum, the budget request does not appear to be a "dose of realism." It brings overall 051 funding to an historically high level, and raises DOD's budget to 56% of overall discretionary spending.

The QDR-Budget Linkage: Why Defense Budget Discipline Is Difficult
The 2010 Quadrennial Defense Review was released at the same time as the FY 2011 defense budget. Having participated in two such reviews, I should note that they have generally not played a role in disciplining defense budget requests. This QDR is different. It was conducted in parallel with the FY 2011 budget process and it is my impression that it had a significant influence on the budget request. I would suggest that that impact was not so much to restrain the budget, as to encourage its growth.

Secretary Gates announced his intention of "rebalancing" the strategic objectives and missions of the US military through the QDR, to include a strong focus on the successful pursuit of current military operations and the development of capabilities that could cope with near-term threats and challenges. The QDR makes it clear that this goal was part of the guidance that flowed from the QDR into the budget process, leading to increases in funding for rotary wing aircraft, unmanned aerial vehicles, and Special Forces, among other items. However, the QDR did not "rebalance" the military's objectives and missions. Instead, it appears to have continued to expand those missions, building on the experience of the past decade, with serious implications for the FY 2011 budget and-year defense funding.

Some have suggested that the QDR shifts the center of gravity in defense planning away from long-term threats and challenges and a force planning algorithm of "two Major Regional Contingencies, near simultaneously (2 MRCs)." That does not appear to be the case. The defense strategy, and the force planning construct that follows from it seem to accept those missions and more, providing a basis for force expansion, and budget growth for years to come.

A careful reading of the QDR and the Secretary's statements supports this conclusion. Excerpts from the QDR and the Secretary's briefing of February 1, 2010 illustrate the point. Far from rejecting the notion that 2 MRCs should be included in DOD missions and planning, the Department seeks to build on those requirements and expand missions broadly, including activities that historically have been civilian responsibilities in the US government.

Secretary Gates made the goal of broadening U.S. military missions clear in his press briefing on release of the QDR and the FY 2011 budget February 1, 2010:

> ...I felt for some time, the two-major-theater or operations construct was out of date [;]...we are already in two major operations..." "[W]hat I wanted to convey was a much more complex environment, in which you may have to do not just two major conflicts, but a broad range of other things, as well, or, perhaps in the future, one of those conflicts and then a number of other contingencies. So I just felt that construct was too confining and did not represent the real world that our country and our military forces are going to face in the future.

The QDR is equally explicit:

> In short, U.S. forces today and in the years to come can be plausibly challenged by a range of threats that extend far beyond the familiar 'major regional conflicts' that have dominated U.S. planning since the end of the Cold War....[I]t is no longer appropriate to speak of 'major regional conflicts as the sole or even the primary template for sizing, shaping, and evaluating U.S. forces. Rather, U.S. forces must be prepared to conduct a wide variety of missions under a range of different circumstances....

The QDR and the Budget describe this broad and demanding set of missions in two types of statements, one described as "Objectives," and the other as "Missions." While these two lists are somewhat confusing and overlap in several ways, together they make it clear that the range of missions, and therefore of budget requirements, is very broad. The "Objectives" include: "prevail in today's wars," "prevent and deter conflict," "prepare for a wide range of contingencies," and "preserve and enhance the All-Volunteer force."[3] The "missions" include: "defend the United States and support civil authorities at home," "succeed in counterinsurgency, stability, and counterterrorism operations," "build partnership capacity," "deter and defeat aggression in anti-access environments," "prevent proliferation and counter weapons of mass destruction," and "operate efficiently in cyberspace."[4]

While the QDR asserts somewhat indirectly that some of these objectives and missions may be more important than others, there is no concrete indication of which these are, what program choices have followed such an assessment, or how the FY 2011 budget request reflects such a prioritization.[5]

All defense planning reflects a calculation of risk. Some risks are greater than others, and the military may not be the best tool for some contingencies. Inevitably, there are never enough resources to contend with all risks and all defense planning needs to assess the acceptable level of risk. In the QDR, however, there is not such an assessment. Rather, the discussion of risk in the document seems implicitly to support the idea that defense planning and budgeting need to lower every risk, without priorities or tradeoffs.[6]

Mission expansion is particularly noticeable with respect to the QDR's focus on counter-insurgency (COIN), counter-terrorism, and stability operations. I have commented on this trend, which began in the previous administration, in other testimony.[7] There is a growing tendency for the Defense Department to expand into missions and activities where the military-civilian interface is increasingly gray, both inside the U.S. government and in field operations.

The increasing DOD focus on COIN and stability missions is pronounced in this QDR and in the budget request. The QDR gives high visibility and standing to the mission of "Building the Security Capacity of Partner States."[8] Based on experience in Iraq and Afghanistan, the Department and the services are rapidly expanding these activities, with significant implications for force structure, civilian operations, and, consequently budgets. According to the QDR, this includes expanding current efforts to assist other

[3] Note that, in reality, the all-volunteer force is a capability designed to achieve the other three objectives, not a separate objective. Note also that the third objective – contingencies – overlaps with the first two objectives – prevailing in today's wars and deterring future ones.
[4] There is also some overlap in these missions with the objectives described above, particularly the COIN, CT, stability mission, and the mission to deter and defeat aggression.
[5] The relevant texts are: "Not all challenges pose the same degree of threat to national interests, rely on U.S. military capabilities, equally, or have the same chance of occurring." (QDR p.42) "A tailored defense posture…also recognizes that augmenting our overseas presence is not always the most effective method to achieve our strategic objectives." (p.63)
[6] Quadrennial Defense Review, pp.89-95.
[7] Dr. Gordon Adams, "Rebalancing and Integrating the National Security Toolkit," Testimony before the Senate Committee on Foreign Relations Hearing on "Implementing Smart Power: An Agenda for National Security Reform" 24 April 2008, and Dr. Gordon Adams, "The Role of Civilian and Military Agencies in the Advancement of America's Diplomatic and Development Objectives," Testimony before the House Subcommittee on State and Foreign Operations, 05 March 2009.
[8] See Quadrennial Defense Review 2010, pp.26-31 and 73-75.

countries in strengthening their security sectors, training and advising security forces, and working with civilian agencies on security assistance and police training.

A number of DOD capabilities have already been created or are proposed for this mission, at growing cost. These programs include the on-going training and equipping efforts in Afghanistan and Iraq ($13.6 billion in the FY 2011 OCO request), the Commanders Emergency Response Program (CERP) in those two countries ($1.3 billion), a global train and equip program for security forces ($500 million), an expanded Civilian Expeditionary Work force (CEW) to deploy with military forces in such contingencies, and two training programs to support defense ministries in partner countries.[9] The QDR makes it clear that DOD intends to continue to carry out such programs, expand the training and exercising of the US military to carry out such activities, and push for a broad interagency agenda of security assistance initiatives.[10]

There are important implications of this trend for the authorities and responsibilities of our civilian foreign policy institutions. Many of these activities are not core to the capabilities of the military, but they have been and should be core to our civilian institutions, which we have underfunded for these tasks. Expanding these missions at DOD runs the risk of further undermining civilian capabilities in this area.

More broadly, there are likely to be consequences of this mission expansion for US national security interests, as the US military becomes increasingly involved in the security, governance, and economic institutions of other countries. As the QDR itself notes in its risk evaluation: "[T]here are political risks:...[P]olitical risk derives from the perceived legitimacy of our actions and the resulting impact on the ability and will or allies and partners to support shared goals."[11]

The QDR does not make clear where, besides Iraq and Afghanistan, this broad range of authorities and programs should be carried out. To the degree such programs are part of strengthening the counter-terror capabilities of other countries, they may make sense, but these are not likely to be force-intensive operations. It is not clear from the QDR where the US is likely to encounter insurgencies that require the deployment of significant US military forces in counter-insurgency or stability operations. The expectation that such missions are in the future for the US military may be a case of basing planning on the last two operations, which were regime-changing exercises in pursuit of US policy interests. It is far from clear than many more such missions are in our future. This is an area that Congress should examine carefully, as the missions have major implications for the expansion of the US military role, the size and composition of our armed forces, future defense budgets, and the role, capabilities, and funding of our civilian foreign policy institutions.

---

[9] These are the Defense Institution Reform Initiative (DIRI), and the Ministry of Defense Advisor (MODA) programs. Quadrennial Defense Review 2010, p.30.
[10] See, for example, the proposal for three joint DOD/State Department funds, at a potential total cost of $2 billion, for security assistance, post-conflict reconstruction, and conflict prevention, made by Secretary Gates to Secretary of State Hillary Clinton December 15, 2010, published in the *Washington Post*, December 23, 2009.
[11] Quadrennial Defense Review, p.95.

Future Pressures on Defense Budgets

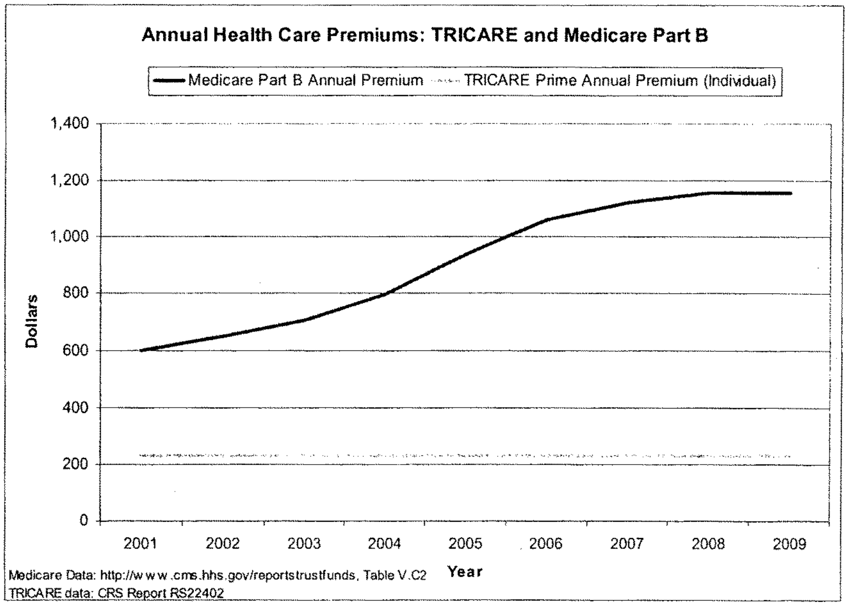
The defense budget does not make major tradeoff decisions and the QDR suggests significant mission expansion. The result will be growing internal pressures to continue to increase defense resources. It will become more difficult and challenging to restrain future defense budget growth if Congress does not impose some discipline today. What are these pressures?

First, COIN, counter-terrorism and stability operations, including the security assistance activities I described, create such pressure. Add to that the "anti-access" challenge described in the QDR, which responds to the reality that other nations may be building capabilities that make it harder for the US to operate overseas. The budget supports a next wave of programs for littoral operations, long-range strike, and missile defense, among others, that are intended to cope with this interplay between our global role, and the responses and ambitions of other countries.

Second there are several internal budget pressures that grow out of the absence of discipline in the budget process:

- Without attention, Operations and Maintenance spending will continue to rise above the rate of inflation. Adding 20,000 to the civilian acquisition work force, as proposed in the FY 2011 budget, will increase this pressure, even if it benefits DOD contract management capabilities.

- DOD health care costs are rising rapidly. The DOD Unified Medical Budget is experiencing cost growth above the rate of inflation, even above the cost growth experienced by Medicare. Secretary Gates noted in his February 1st press conference that DOD's costs have grown from $19 billion to $50.7 billion, or 166% in the period between FY01 and FY10. This increase outpaces Medicare costs by 53% over the same period. Several times in the last decade, DOD has proposed increasing fees for TRICARE beneficiaries to compensate for some of this growing cost, but this proposal has not survived congressional scrutiny. Consequently, and despite DOD's quicker rise in costs, TRICARE Prime premiums have remained constant from FY01 – FY10 even as Medicare Part B premiums have nearly doubled. Even more than the economy as a whole, health care costs are creating fiscal stress for DOD.



- Mission expansion is creating pressure for force expansion. DOD has already added 92,000 to the ground forces and Congress is being asked to fund an additional 22,000 temporary ground forces in this budget. As forces grow, so does the entire budget, for only research and development is spared from this pressure for more overall resources.

- Costs for the wars in Iraq and Afghanistan will add to out-year pressure. Instead of estimating the out-year budgetary consequences of these wars, the administration has simply moved the $50 billion place-holder to the right. We have a future policy for the two conflicts; it should be possible to estimate the future costs. The budget seeks $159.3 billion for the war effort, scarcely different from the average costs of these wars in recent years. This number is unlikely to fall to $50 billion in FY 2012, which means the budget understates the projected deficit by some amount.

Third, DOD's estimates for out-year defense spending are seriously undermined by the limited transparency the Department has on its budgets and spending.

- Secretary Gates stated in his press briefing that roughly half of the procurement budget "goes for conventional modernization, unrelated to the current wars," while current war programs consumed 7-10 percent, and "dual-capable capabilities" about 40%. While it is worthy to try to parse the procurement budget in this way, one wonders how the Secretary can be sure of the data, since, as the FY 2011budget *Overview* notes:

> "The Department remains hindered by budget and accounting systems that were not designed to accumulate 'total costs' in any manner other than along appropriations lines. It is a labor-intensive effort to update the Department's budget among its 6,500 program elements in order to present a budget display by strategic goal and objective....This precludes the Department from being able to provide a budget display of resources by DOD's strategic goal and objective in the President's budget."[12]

Equally important, as the FY 2011 budget notes, DOD is "one of a very few cabinet level agencies without a 'clean' financial audit opinion." It is difficult to know exactly how much DOD is spending, and whether it is spending wisely and appropriately, when it has not yet unified or standardized its many financial systems and cannot pass a standard audit consistent with the requirement set out in the Federal Financial Manager Act of 1996. Unfortunately, this problem has been pointed out for more than ten years by the Government Accountability Office and, despite repeated statements of the desire to conform by successive Secretaries of Defense, the Department still cannot do so.

Defense budgets remain high and continue to grow not only because of policy and mission-driven decisions and plans, but also because the Department lacks the ability to carry out a fundamental review of its programs and spending, array its resources by mission, audit its performance, and use that information to provide feedback for future budget planning.

Options for the Congress

This committee, the Congress, and the White House face daunting fiscal and economic challenges: sharp declines in federal revenues driven by the continuing recession and high unemployment, combined with rapidly rising mandatory expenditures, particularly in health care, leading to historically unprecedented peacetime deficits and rapid growth in the nation's debt.

These challenges pose a sufficiently severe threat to our security that no part of federal spending, including defense, should be exempt from budget discipline. Defense budgets were not exempt from this effort during the Cold War. They were included in the original Gramm-Rudman-Hollings act, making it possible to create a congressional consensus to support deficit reduction. They were not exempt from the Budget Enforcement Act provisions of the Omnibus Budget Reconciliation Act of 1990. Both the Bush and Clinton administrations made major reductions in the defense top line at the end of the Cold War, which provided the incentive for significant priority-setting and management discipline in the Defense Department. A disciplined defense budget contributed to falling

[12] DOD Overview, p. 7-17. The Performance measurements part of the Overview Budget (p.7-36) notes that DOD can validate as "audit ready" less than 10% of its Treasury funding balances and less than 15% of its Statement of Budgetary Resources.

deficits in the 1990s, under caps on discretionary spending. Today's challenges are even more severe.

It is my view that the DOD budget (excluding clearly war-related spending) should be included in an overall freeze for FY 2011. Applying such a freeze to discretionary budget authority (BA), the Congress would need to find $9.7 billion in defense BA savings below the FY 2011 defense budget request. Applied to defense outlays, a freeze would require reducing DOD outlays by $18.2 billion, which could require reducing BA by $29.8 billion, or 5.2% below the requested level for the base budget.[13]

What options might the Congress consider to reach these targets?

- **Overall freeze:** The first, and in some ways, most important limit Congress could set is to include a BA or an Outlay freeze in this Committee's budget resolution. Priority-setting and tradeoffs at DOD are incentivized by knowing resources will be more limited. The administration chose not to impose such discipline, leaving the responsibility to the Congress. The Department should be asked how it might adjust to such a freeze.

- **Military Personnel:** The FY 2011 OCO budget requests $2.6 billion in funds to support the "temporary" increase in Army and Marine Corps end strength. This request could be offset in the base Army budget through force management, deferring an equivalent level of recruitment for the Army base force budget, saving $2.6 billion in BA and $2.5 billion in Outlays. The strategic and mission basis for continuing to expand the ground force is not persuasive. Forces deployed in Iraq are currently declining; forces in Afghanistan are due to begin to fall in FY 2011. There is no scenario in the predictable future which would require a major deployment of US military forces for counter-insurgency or stabilization missions. Future COIN and CT missions, such as the Horn of Africa or Yemen, are unlikely to require major deployments of US ground forces. Future force planning should examine the opportunities to limit force growth or even reduce numbers to reflect this declining requirement for ground forces. DOD should also examine the prospects for rebalancing the ground forces between support billets and combat billets, to increase the number available for combat missions.

- **Operations and Maintenance:** Providing growth for base budget O&M at 3%, still above the rate of inflation, rather than the 8.5% rate in the budget request could provide more than $10 billion in BA reductions and roughly $7 billion in outlay reductions from the request level.

[13] Defense outlays are projected to surpass the BA request in FY 2011 because of high prior year appropriations. An $18.2 billion target for outlay reductions from the FY 2011 defense spending projection could require $29.8 billion in BA savings, based on using the average 051 outlay rate of 64%. The necessary BA reduction could vary widely, depending on the outlay rate of the accounts in which BA reductions were made.

- **Procurement.** Limiting growth in procurement funding to the rate of inflation could provide savings of $6 billion in BA and $1.6 billion in Outlays. There are additional systems in the procurement pipeline which should be scrutinized to achieve such a reduction, either because they are tied to lower-priority missions or are troubled. These in include the Virginia class submarine program, the F-35 fighter, and the Expeditionary Fighting Vehicle. A more thorough scrub of the procurement budget request could yield even more savings.

- **Research and Development.** Reducing Research and Development budgets by another $6 billion from the DOD request, would yield $6 billion in BA and $3.3 billion in Outlays. Particular attention could be paid to the follow-on Army program to design a vehicle to replace the FCS vehicle program terminated last year – the Brigade Combat Team Modernization program. The new budget request contains $3.2 billion for this follow-on program, virtually the same level of funding as was provided the terminated program in prior years. The level of funding for national missile defense – nearly $10 billion in FY 2011 R&D – could also be examined; the program has yet to prove it can perform successfully.

- **OCO Funding.** While I have suggested that war-related budgets be spared from a freeze, the OCO supplemental requests for FY 2010 and FY 2011 should not be spared scrutiny to ensure they contain only spending related directly to war requirements. Over the past three years, the services have already received sizeable appropriations on the front end of reconstitution, through budget requests that were not so tightly defined. In particular, the $21.3 billion "reconstitution" budget request for FY 2011 merits close scrutiny, especially the $2.8 billion requested for "long-term reconstitution." Long-term acquisition planning and funding should be done in the context of the base budget, not a supplemental or war-related title. Congress should take a hard look, for example, at the $200 million request for an F-35 fighter included in the FY 2011 OCO budget.

Conclusion

The options I have suggested here affect only the margin of an unprecedentedly high budget request for the Department of Defense. The weakness of this budget request is that it reveals very little effort to provide the "dose of realism" the Secretary promised. The base budget does not make choices or set priorities consistent with such discipline, nor does it reflect priority-setting driven by the new QDR. The Congress faces broad budgetary and economic challenges and should consider how it might include defense in dealing this challenge, at no sacrifice to our national security. Moreover, given the historic growth in defense spending over the past decade, a freeze at this point, combined with clear out-year caps on discretionary spending, could provide the incentives for more disciplined planning and budgeting at DOD.

Chairman CONRAD. Thank you very much, Dr. Adams, for your testimony.

Now, we will go to General Van Riper. General Van Riper is a retired Lieutenant General of the Marine Corps, currently serving on the Independent Review Panel of the Defense Department's Quadrennial Defense Review. Welcome. Thank you very much for your service. Thank you for being here today.

STATEMENT OF PAUL K. VAN RIPER, LIEUTENANT GENERAL, UNITED STATES MARINE CORPS (RETIRED)

General VAN RIPER. Mr. Chairman, thank you for providing an opportunity to speak to you today. As you noted, I am a member of the Independent Panel to Assess the Department of Defense Quadrennial Defense Review. Because deliberations of the panel are ongoing with a final report not due to Congress until July 2010, my remarks today will center on material contained in the seven chapters of the Fiscal Year 2011 Defense Budget Overview, not the one chapter that summarizes the QDR.

The defense budget request specifies what the Department's senior leaders believe is needed for our national security. In other words, this budget identifies the means that the American Armed Forces will require, and in many cases use, in the coming years to protect our nation and its interest.

More important than the identification of the means, however, is an explanation of why the Nation requires these means and how the Armed Forces will make use of them. Our national strategies, security, defense, and military, are to explain the why behind the means. That is, they are to give good reason for the purposes that underpin the strategies, goals, and objectives and describe how they relate to the resources the Department of Defense is requesting. The Joint Force and service concepts should explain how the force will use these means operationally.

If we fail to get the strategies and the concepts right, we are unlikely to get the means right, either. A clear and compelling logic of ends, ways, and means must run through all of these strategic, budget, and operational documents. In the final reckoning, the quality of our thought will prove more significant than the quantity of our means.

My written statement is based on an analysis of the defense budget overview using this ends, ways, means construct.

In the 14 years after Congress enacted the legislation that required the President to transmit to Congress each year a report on national security of the United States, the administration submitted a national security strategy fairly regularly, but often not at the time specified. However, the last administration submitted only three national security strategies in 8 years and the current administration has yet to offer one. A national security strategy informs the budget. In its absence, we must seek other sources of strategic thought.

To judge the thought behind the fiscal year 2011 defense budget request, I turned to President Obama's speeches that address his administration's strategic approaches. In addition, I read Secretary of Defense Gates' 2008 National Defense Strategy and his article, "A Balanced Strategy in Foreign Affairs." To determine if the defense budget request leads to a force that can implement Admiral Mullen's vision of how the Joint Force circa 2016–2028 will operate, I looked to his Capstone Concept for Joint Operations.

Let me place my conclusions up front. In general, I find a common theme and consistency among all these speeches and documents linking goals and objectives to the specific capabilities and capacities enumerated in the defense budget request. Furthermore, I am confident that achievement of those capabilities and capacities will, for the most part, support current and future operational ideas. This is not to say that room does not exist for improvement of selected aspects of the budget request. In my written statement, I identify several shortcomings.

One of the most positive aspects of the defense budget request is a long overdue recognition of the real reasons for military innovation and change. Recent predecessors to this defense budget request made too many groundless assertions, positing that transformation would render obsolete current technology and methods of warfare. These unsupported claims revealed their authors' fundamental misunderstanding of why and how militaries alter or improve the means and methods they intend to employ in combat.

For a decade and a half, U.S. military endured demands from senior defense leaders, supported by pundits on the sideline, that undertake transformation for transformation's sake alone. The effect was to draw most of the service's and joint community's intellectual energies into fool's work at the expense of thinking critically about how our forces might operate to meet emerging security problems. In my view, the Department of Defense wasted hundreds of millions of dollars in the name of transformation. For the most part, all we have for the money spent is a handful of vacuous concepts and disingenuous reports on flawed experiments.

Recent leadership changes within the Department of Defense and U.S. Joint Forces Command have been a breath of fresh air, as this has allowed subordinates to think about and plan for war as it exists in reality, not as the uninformed wish it to be.

I also find the defense budget request agreeable that it largely avoids focusing on many of the meaningless adjectives recently used to modify the nouns "war" and "warfare," examples being fourth generation warfare, asymmetric war, netcentric warfare, et cetera.

Promptly, the defense budget request starts to rebalance our forces, capabilities, and capacities between the only two forms of warfare that exist, regular and irregular. I find strong evidence in the defense budget request that it supports both acquisition and refurbishing of needed weapons and equipment. Unfortunately, I cannot find the same support for the professional education and training essential to reacquiring and building the knowledge and skills required to fight regular nation state enemies. The Joint Forces and the services too often look to training and education accounts as bill payers when funds and personnel are short in other areas.

In closing, I urge this committee and the entire Congress to evaluate carefully the national security strategy when the White House submits its report in the near future, ensuring that it, in fact, does relate to and support the Department of Defense fiscal year 2011 budget request. Additionally, I entreat you to monitor closely the new national defense strategy that should flow from the Quadrennial Defense Review and the subsequent national military strategy that ought to draw from the defense strategy and defense review.

Once more, I thank the committee for the opportunity to share my thoughts and concerns.

[The prepared statement of General Van Riper follows:]

STATEMENT OF

PAUL K. VAN RIPER

LIEUTENANT GENERAL

UNITED STATES MARINE CORPS (RETIRED)

BEFORE THE

UNITED STATES SENATE COMMITTEE ON THE BUDGET

CONCERNING THE UNITED STATED STATES

DEPARTMENT OF DEFENSE FISCAL 2011 BUDGET REQUEST

23 FEBRUARY 2010

Introduction

Mr. Chairman and members of the committee, thank you for providing me an opportunity to speak to you today. As an American citizen, I appreciate the committee undertaking this independent look at the Department of Defense Fiscal Year 2011 Budget Request and associated war costs. Our countrymen deserve this type of close scrutiny of the Executive Branch's view of national security. Moreover, such scrutiny serves to widen and deepen public discussion about our national security.

I am honored that the Secretary of Defense recently appointed me to serve as a member of the Independent Panel to Assess the Department of Defense Quadrennial Defense Review. As you know, this outside assessment is required by law. The Department of Defense Fiscal Year 2011 Budget Overview book incorporates a discussion of the Quadrennial Defense Review in chapter 2. Because deliberations of the Panel are ongoing with a final report not due to Congress until July 2010, I will limit my testimony to material contained in the other seven chapters of that book.

From Strategy to Budget to Operational Concepts

The Department of Defense Fiscal Year 2011 Budget Request spells out in great detail what the Department's senior leaders believe is needed for our national security. In other words, this Budget identifies the *means* that the American Armed Forces will require and in many cases use in the coming years to protect our nation and its interests. More important than identification of the means, though, is an explanation of *why* the nation requires these means and *how* the Armed Forces will make use of them.

Our national strategies—security, defense, and military—are published to explain the "why" behind the "means." That is, they are to give good reason for the purposes that underpin the strategies, goals and objectives and describe how they relate to the resources the Department of Defense is requesting. These strategies should also explain in increasing detail how American Armed Forces will use these means strategically. Finally, joint force and service concepts should explain how our forces will use these means operationally.

In Clausewitzian terms our strategies describe the *ends* we desire as well as the strategic *ways* we will seek to achieve those ends. Our operating concepts describe the military *ways* or methods available to support our strategies. I believe it important to continually remind ourselves that if we fail to get the strategies and the concepts right we are unlikely to get the means right either. A clear and compelling logic of ends, ways, and means must run through all of these strategic, budget, and operational documents. In the final reckoning, the quality of our thought will prove more significant than the quantity of our means. My remarks that follow are based on an analysis of the Defense Fiscal Year 2011 Budget Request using this ends, ways, means construct.

As I am certain the committee knows, in accordance with Title 50, chapter 15, section 404a of the United States Code, the President is to "transmit to Congress each year a comprehensive report on the national security of the United States . . . on the date on which the President submits to Congress the budget for the next fiscal year" and "not later than 150 days after the date on which a new President takes office." In the first 14 years after Congress enacted the legislation containing this requirement, administrations submitted a national security strategy fairly regularly though often not at the time specified. However, the last administration submitted only three national security strategies in eight years and the current administration has yet to offer one.

A national security strategy informs the Defense Budget. In its absence we must seek other sources of strategic thought. To judge the thought behind the Department of Defense Fiscal Year 2011 Budget Request I turned to President Obama's speeches that address his administration's strategic approaches, in particular those he delivered at Camp Lejeune in February 2009, in Cairo in June 2009, and at West Point and in Oslo in December 2009. In addition, I read Secretary of Defense Robert Gates' *National Defense Strategy* of June 2008 and his article, "A Balanced Strategy" in the January/February 2009 issue of *Foreign Affairs*. To determine if the Defense Budget Request leads to a force that can implement the Chairman of the Joint Chiefs of Staff, Admiral Mullen's "vision for how the joint force circa 2016-2028 will operate in response to a wide variety of security challenges" I looked to his *Capstone Concept for Joint Operations*. In addition, I reviewed current joint doctrine and operating concepts to judge if the near term impact of the Defense Fiscal Year 2011 Budget Request will support the operational ideas they contain.

Evaluating the Strategy to Budget to Operational Concepts Construct

Placing my conclusions up front, in general I find a common theme and consistency among all these speeches and documents linking goals and objectives to the specific capabilities and capacities enumerated in the Department of Defense Fiscal Year 2011 Budget Request. Furthermore, I am confident that achievement of those capabilities and capacities will, for the most part, support current and future operational ideas. This is not to say that room does not exist for improvement of selected aspects of the Budget Request. Later I will identify several. My greatest concern, however, is that current and anticipated economic conditions may not allow the Nation to sustain the effort it continues, and in some cases begins, in this proposed budget.

Statements of the President and the Secretary of Defense contained in the key documents mentioned above provide examples of the close relationship between these leaders' strategic "guidance" and the Defense Budget Request. To illustrate, President Obama in his West Point Speech said; "Our overarching goal remains the same: to disrupt, dismantle, and defeat al Qaeda in Afghanistan and Pakistan, and to prevent its capacity to threaten America and our allies in the future." Secretary Gates wrote in his *Foreign Affairs* piece, ". . . to fail—or to be seen to fail—in either Iraq or Afghanistan would be a disastrous blow to U.S. credibility, both among friends and allies and among potential adversaries." The Defense Fiscal Year 2011 Budget Request declares one of its objectives to be to "prevail in today's wars" and then describes actions "to increase the capabilities available to our deployed forces—especially those forces in combat in Iraq and Afghanistan." In addition, it lists as one of four key priorities, "enhance capabilities for current conflicts" and details those capabilities among which are the acquisition of additional rotary wing aircraft, greater intelligence, surveillance and reconnaissance support, and an increase of personnel for special operations forces. (See section 4 of the Defense Budget Request.) I find it relatively easy to follow the logic trail in this example as well as many others.

A second example of the relationship between goals, budget, and execution is seen in Secretary of Defense Gate's words in his *Foreign Affairs* article that point to the need to protect the United States' power projection capabilities. Such capabilities are detailed in section 4 of the Defense Budget Request—examples being shipbuilding, a next generation bomber, and a new missile defense approach—all of which relate to forcible-entry capabilities identified in the *Capstone Concept for Joint Operations*.

Another instance of the connection between the previously cited documents is the statement of President Obama in his Camp Lejeune speech that; "I want you to know this, military families are a top priority for Michelle and me, and they will be a top priority for my administration" and the Defense Fiscal Year 2011 Budget Request for nearly three billion dollars of additional funds for Military Family and Health Care Programs. (See figure 3-5 of the Defense Budget Request.)

Two of the most positive aspects of the Defense Fiscal Year 2011 Budget Request are that its text is very readable and that there is a long overdue recognition of the real reasons for military innovation and change. Recent predecessors to this Defense Budget Request made too many groundless assertions that there was an imperative to undertake fundamental change in the weapons, equipment, organization, or doctrine of the U.S. military. These assertions posited that "transformation" would "render obsolete current technology and methods of warfare." These unsupported claims—also made all too commonly in the larger defense community—revealed their authors' fundamental misunderstanding of why and how militaries alter or improve the means and methods they intend to employ in combat. Simply, these claims ignored first-rate research that pointed out that successful innovation in the past depended on "the presence of specific military problems the solution of which offered significant advantages to furthering the achievement of national strategy."[i]

For a decade and a half the U.S. military endured demands from senior defense leaders supported by pundits on the sidelines that it undertake transformation for transformation's sake alone. The effect was to draw most of the services' and joint community's intellectual energies into fool's work at the expense of thinking critically about how our forces might operate to meet emerging security problems. In my view, the Department of Defense wasted hundreds of millions of dollars in the name of transformation. For the most part, all we have for the money spent is a handful of vacuous concepts and disingenuous reports on flawed experiments.

Recent leadership changes within the Defense Department and the U.S. Joint Forces Command have been a breath of fresh air as it has allowed subordinates to think about and plan for war as it exists in reality, not as the uninformed wish it to be!

I also find the Defense Fiscal Year 2011 Budget Request worthy in that it largely avoids focusing on many of the meaningless adjectives recently used to modify the nouns war and warfare; 4th generation war, asymmetric war, net-centric warfare, and so forth. We have squandered too much energy and too many resources in efforts to explain or define such terms when they are essentially meaningless. As noted strategists Colin Gray writes, "Warfare is warfare, period."[ii] Though, as Clausewitz observed, "War is more than a true chameleon that slightly adapts its characteristics to the given case."[iii] Thus, we can say warfare has two forms; "regular" where generally similar forces maneuver and fire to gain a position of advantage in relation to the other and "irregular," that is, wars of insurgency.

Properly, the Defense Fiscal Year 2011 Budget Request starts to rebalance our forces' capabilities and capacities between these two forms of war. The generation I represent learned hard lessons during the Vietnam War about how to operate against an insurgent enemy. Pained by the outcome of that war and overly focused on advancements the Soviet military made in the 1960s and early 1970s we neglected to capture these lessons and to codify them in new doctrine. Moreover, we failed to include the study of insurgency in the curricula of our professional military schools. Our sons and daughters have paid a high price for our disregard of this important form of war; once again they and our Nation have had to re-learn how to counter insurgencies through bitter experience. We cannot repeat this tragedy! The proposed defense budget provides strong evidence that defense leaders are well aware of this issue.

Much of the U.S. military's equipment and many of its weapons systems needed to confront a so-called regular enemy are degraded and in some cases are nearing obsolescence. In addition, the U.S. military's six or seven-year concentration on countering insurgencies has allowed too many of the tactical and technical skills that enabled early success in Operation Iraqi Freedom to atrophy. The Army has majors in the combat arms who have never maneuvered as part of a brigade, the Marine Corps has gunnery sergeants who have never been aboard an amphibious ship, and the Air Force and Navy have pilots whose experience flying in a high-threat environment is very limited. In regard to the former, that is, rebuilding the U.S. military's capability to engage and win in "regular" warfare, I find strong evidence in the Defense Budget Request for both acquisition and refurbishing of the needed weapons and equipment. Unfortunately, I cannot find the same support for the professional education and training needed to reacquire and build both the knowledge and skills needed to fight nation-state enemies.

The joint forces and the services too often look to training and education accounts as bill payers when funds and personnel are short in other areas. Personnel directorates deny officers and staff noncommissioned officers schooling in order to support other functions and to fill wartime billets. Leaders direct professional schools to prepare students for their next assignments rather than the rest of their careers. Such actions hinder our future leaders.

Final Thoughts

In closing, I urge this Committee and the entire Congress to evaluate carefully the National Security Strategy when the White House submits its report in the near future, ensuring that it in fact does relate to and support the Department of Defense Fiscal Year 2011 Budget Request. In addition, I entreat you to monitor closely the new National Defense Strategy that should flow from the Quadrennial Defense Review and the subsequent National Military Strategy that ought to draw from the Defense Strategy and Defense Review. I also ask that you look carefully at the structure of the services' operational units. There is a tendency to mask shortcomings in new organizations; one example being the Army's brigade combat teams that have only two maneuver battalions instead of the three battalions that brigades have traditionally had in the past. Two battalions not only have less combat power, especially in infantry, but they also limit the forms of maneuver available to a commander. In addition, look to the numbers of aircraft currently assigned to squadrons compared to the numbers in the past. Authorities usually justify lesser numbers by pointing to increased capabilities of newer systems, a shortsighted metric in some cases. Check closely the number of personnel actually in units compared to these units' tables of organization or designed structures. Often we see a predisposition to create more units instead of ensuring existing ones are at full strength. This practice forces commanders to create a work-around when personnel are not available to operate in accordance with existing doctrine, tactics, and techniques.

I also ask you to examine closely the concepts and doctrine the joint force and services promulgate in the coming years to ensure that our Armed Forces have a body of knowledge that is informed by history, grounded in the realities of war, and that captures the hard earned lessons gleaned from more than eight years of war. Finally, I request you pay close attention to the manner in which the services select and assign officers to command and staff colleges and war colleges as well as the content of the curricula followed in these schools. The Nation cannot afford to allow near-term requirements to undermine the development of long-term capabilities.

Once more, I thank the Committee for the opportunity to share my thoughts and concerns.

---

[i] Williamson Murray and Allan Millet, eds. *Military Innovation in the Interwar Period*, "Innovation: Past and Future" (Cambridge: University of Cambridge Press, 1996), p. 311.

[ii] Colin S. Gray, *Another Bloody century: Future Warfare* (London: Weidenfeld & Nicolson, 2005), p. 370.

[iii] Carl von Clausewitz, *On War*, Michael Howard and Peter Paret, eds. and trans. (Princeton, New Jersey: Princeton University Press, 1976), p. 89.

Chairman CONRAD. Thank you, General Van Riper.

I first want to go to you, because you have really raised strong words about these concepts of transformation that were bandied about so widely for a number of years. I must say, I agree with much of your assessment. After having consulted with top military leadership, uniformed leadership, both those still on active service and those retired—those retired, obviously, were in a much better position to speak their minds openly and candidly, as you have just done—and I heard very consistently from them an assessment very close to what you have just provided.

That is, that in the discussion of transformation, it sort of became almost a movement and it was very hard to penetrate what it actually meant. It was something that had a lot of support and was used to justify actions that the Defense Department, frankly, at times, I thought were curious, especially from a budgetary standpoint. You said you think hundreds of millions of dollars were wasted. Frankly, I think you could multiply that. I think billions of dollars were wasted chasing a concept that didn't have much meat on the bones.

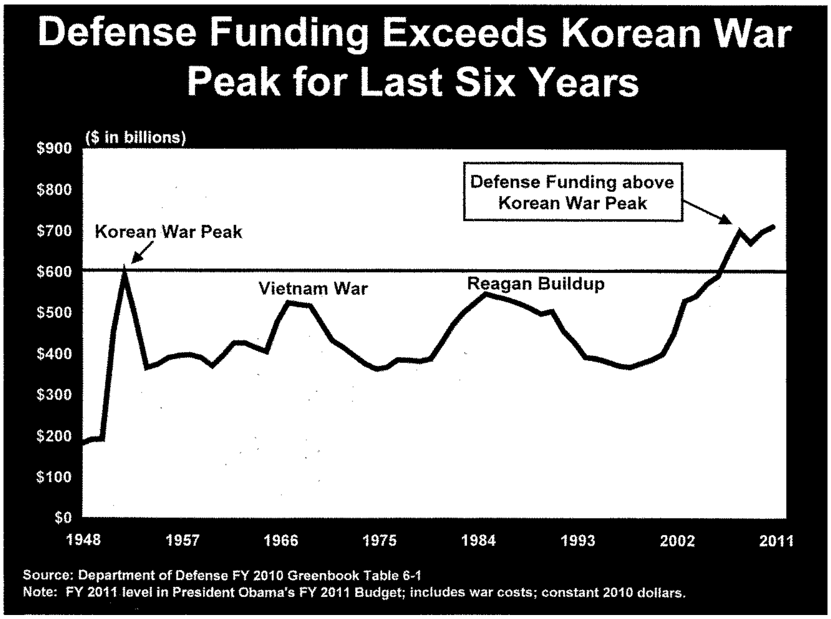
I would just be interested in your further assessment of how did we get going down that track and how did it gain so much, I won't say credibility, but so much energy being focused on it? What is your assessment? How did we get into that?

General VAN RIPER. Mr. Chairman, if there is to be change, transformation, some of the other words used, revolutions in military affairs, technical military revolutions, there needs to be a problem that we are going to solve. And this was the failure from immediately after Desert Storm up until some key changes in the leadership in the Department and some of the larger commands. And that is, there was never a problem identified. There was simply the assertion that we had to change. And my question in the forums that I would be in is, why? What for? It never was answered. There was a focus on technology as if technology was going to solve our problems. There was no quality of thought.

In terms of an organizational look at it, it is surprising, because the generation that I came from, the post-Vietnam generation, went through an intellectual renaissance led by Admiral Stansfield Turner, General Don Starr, and General Al Gray in the 1970's and mastered conceptually the art of war, usually codified in air-land battle, but in a larger joint context. We demonstrated that mastery in Desert Storm and again in the takedown of Baghdad and then walked away from it for really a myth.

Chairman CONRAD. It was really a very curious period, a very curious period, and there seemed to be during that time a lack of respect for many in the uniformed military. I observed that repeatedly. Civilians at the Defense Department and those who were—I don't remember quite the words that you used—pundits, I think you used the word, people were brought in to advise the Defense Department who had no defense background. Well, maybe they had written books, some of them fictional books, about military involvement in the past, but it was a very odd thing to witness and I appreciate your making the point here today.

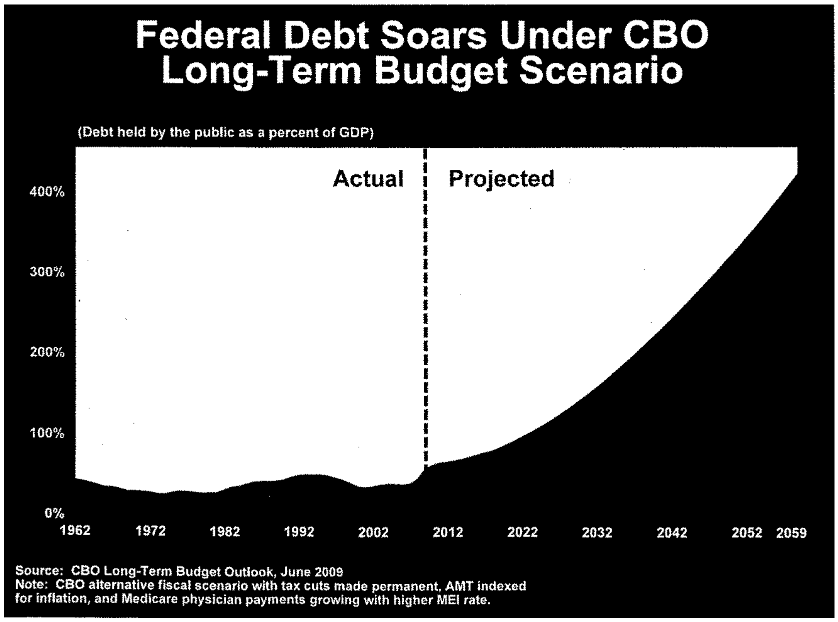
Let me go to a point I want to talk to you all about because this is the Budget Committee. We have got a special obligation to our colleagues on taking what the President has proposed and reworking it into a budget resolution to consider all of the tradeoffs that we confront.



This is what we see in terms of defense spending in today's dollars related to previous buildups, the buildup during the Reagan years, the buildup during Vietnam, the buildup during the Korean War Peak, and we see we have surpassed that now and continue to go up. I don't think that is dispositive with respect to what we do with respect to defense spending now. It has got to be dictated to by the terms of what we confront and what we are dealing with.

There is another aspect to this, and that is our long-term debt. Our long-term debt—I don't know if we have that chart available—that is the deficit. I think I took that out. It may be in the outer office here, maybe if somebody could get that for me.

We are on a course that is absolutely unsustainable as a nation with respect to our overall debt burden. Very soon, we will have a debt that will be a gross debt that will be 100 percent of our gross domestic product. Here is the chart I was referencing, and we are right at the dotted line. That is what has happened so far in terms of growth of debt.



But look what is about to happen. And this is driven by a number of factors. It is driven by health care spending that is going up much more rapidly than underlying inflation. It is driven by demographic changes. The Baby Boomers are going to double the number of people eligible for Social Security and Medicare. It is driven by defense costs and war costs. It is driven by tax policy if we extend all of the tax policies that have been cast in the Bush administration and the Obama administration. I find there is a lot of confusion about what has happened to tax policy in the Obama administration. The fact is, taxes have gone down under the Obama administration. Every tax matter that has been proposed and passed has been a cut in taxes.

So we now confront a circumstance in which our revenue is at the lowest level as a share of GDP that it has been in 60 years. Our revenue is about 15 percent of GDP. Spending is at its highest level as a share of GDP in 60 years. It is at about 26 percent of GDP. So we have a gap between spending and revenue of 11 percent of GDP. That is really stunning. To have a stable debt, economists tell us you need a deficit of about 3 percent of GDP. So we are almost four times that.

The reality that we confront on this committee is that we are on an utterly unsustainable course in every aspect of our spending, in every aspect of our revenue, because the gap between the two is utterly unsustainable, and it will lead, according to most witnesses that have come before this committee—in fact, every single one—every single one of whatever stripe, whether they were representing the Republican side of the aisle, the Democratic side of the aisle, or independents—every single one have told us, you are on an utterly unsustainable track.

And the consequences of being on an unsustainable track with respect to deficits and debt is that at some point, those who are lending this money, and increasingly those are foreign entities—last year, 68 percent of the new debt financing came from abroad. China is now the biggest funder of the United States—China. Japan is No. 2. That, too, has consequences.

I say all of this because I feel increasingly like I am in some netherworld on this committee, that the whole enterprise of the budget of the United States is utterly disconnected from reality. We have now had the Chinese warn us publicly and privately that they are increasingly reluctant to finance this debt. We have had Moody's tell us they are considering downgrading the quality of U.S. debt.

And so on this committee, we confront a circumstance that, really, everything has to be on the table. Everything has to be up for consideration. That is clearly the charge that is being given to this debt commission the President has formed and is naming now.

I saw them quizzed this week and they were asked, is this off the table? Is this off the table? And they said, nothing is off the table. Nothing is off the table. I take from that that defense cannot be off the table, either.

I would just ask each of you, in turn, if you were advising this committee on where we could achieve savings in defense over time, what would be your top recommendations? Dr. Williams?

Ms. WILLIAMS. My top recommendation is to stop the strategy that the Defense Department has currently embraced and that the Obama administration has embraced and that the Bush administration also embraced. It is hugely expensive. It encourages our allies to free ride. It encourages our other friends to behave badly toward their populations and their neighbors. It fuels the recruitment into the camp of our enemies.

And so it strikes me that the only way that we can really turn defense into a sustainable operation that is going to fit within the kinds of budget cuts that other sectors are going to have to have is to cut back substantially on what we expect our military can do for us. Cut back substantially. If we did that, we could have enormous savings in the size of the force. We could reduce the size of the Air Force. We could trim the size of the Army. We could really get some savings.

Short of that, we can live for the next 5 years under a budget that looks sort of like the administration's plan, which I actually agree with General Van Riper is fairly well matched—the administration's plan is fairly well matched to its strategy. So you can decide that you are going to have a mild freeze on defense by trimming here and there, and I will suggest some ways that you could do that. But if you really want to get some traction on this problem and turn defense into a sustainable operation for the long-term future, it has got to be with a different strategy.

So, some things that you could do. First, the services need to stop choosing the most expensive of every single item, and I think the Navy's cancellation of the DDG–1000 and the return to the Arleigh Burke, its purchase of more smaller ships, those things are a good start. But what about the F-35 Joint Strike Fighter? It is hugely more expensive than the F–18. It is hugely more expensive than the Air Force's F–16. We cannot keep making choices that way in the world of equipment.

We can certainly do a better job on bringing the costs of military health care closer to the costs that people pay in the civilian world by changing a couple of things. The first is that we must find a way to start bringing the cost sharing of the health care program for military retirees closer to what people pay in the private sector. If we don't do that, we are going to continue to have people migrate into the military system who otherwise would have used their second employer's insurance or their spouse's insurance, simply because it is so much more economical for them to be in TRICARE. The administration did not propose that this year. The Bush administration did propose it for the final 3 years of its budgets. The option was rejected by Congress. It strikes me that it is time for Congress to act on that, even though the administration didn't ask for it.

Another option for reducing health care costs is to decide today to retain fewer personnel to retirement. In other words, don't keep as many people in the military all the way until they retire. Even if you had to pay something to encourage some of them to leave, we would be better off in terms of the defense budget over the longer term by doing that.

Chairman CONRAD. All right.

Dr. Adams?

Mr. ADAMS. Yes. Thanks for the question, Senator. I think it is a very important question. As I said in my testimony, I think you struggle with the enormous burden that you have of trying to get the budget under control and trying to get the deficit and the debt under control and to deal with extraordinarily explosive elements of budget expansion in the mandatory and the revenue side. That is a major challenge. There is no question that at 55 percent of discretionary spending, defense is also something that needs, in my judgment, to be included in how you think about debt.

And then I think what Congress needs to do, and this is obviously a broader test than just your committee, is to think both about the external and the internal sources of growth in the defense budget and how those can be gotten under control.

The external issue is an issue of strategy. It is an issue of mission. And I think the major problem that you face in the QDR and the problem that you are going to face in the source, the policy source of budget expansion is the enormous expansion of mission in the Department of Defense. What we are asking the troops to do has grown enormously. It started with things like counternarcotics and comprehensive threat reduction, but now it is enormously expansive in areas of counterinsurgency tactics and operations, counterterrorism operations, stability operations, and even more broad than that in the Department of Defense, strategic information operations. We have now got a military system that is acquiring task after task after task and it has enormous built-in budgetary pressures.

I think that makes it very difficult for the Congress to confront the external source of growth because there is so much rhetoric that surrounds it. General Van Riper talked about the rhetoric around transformation. Well, there is a tremendous amount of rhetoric today around the threat, as well, and that threat expands from wars of choice—Afghanistan and Iraq, with the objective of regime change—into a rapid and expanding view that where every failed fragile state, insurgency, or terrorist operation is underway, it is the responsibility of the United States somehow to deal with it.

And as I said in my testimony, we have not chosen between the classic state-on-state military missions that General Van Riper is talking about and this enormous expansion of missions that Secretary Gates has referred to in the QDR and in the budget presentation. Unless we can tackle that problem of what we think the appropriate role of the United States military is in the broader universe, it is going to be very hard to make the case for budget reductions. That amplifies the case for saying we need to grow defense now.

It is not much of what you will discuss in the committee, but it is much of what Congress will discuss in looking at this budget on the defense side. What are the missions? Are these appropriate missions? Are the lessons of Iraq and Afghanistan and broad expansion of COIN and CT and stability operations around the globe or are they not? Do we need to rethink that and think about what the appropriately sized role of the U.S. military is, and, I suggest in my testimony, how we bolster our civilian capabilities to engage internationally in areas particularly where governance and failed states are causing us strategic issues?

The only thing that I would exempt from that judgment in the budget today from the outside point of view is the war costs right now for the operations in place, and as I have suggested to you, even there, I think it is important for the Congress to take a very close look at the procurement investment. The reinvestment portion of this year's OCO budget title is over $20 billion. That is an awful lot of money on a history of appropriations of $20 to $30 billion a year particularly to the Army, for what is called reconstitution and reinvestment. So from a Congressional point of view, a tough brush scrub of what the wars require in the way of equipment replacement is a critical starting point.

And then there are all the internal sources, some of which I have mentioned in my testimony. Interestingly, I think my own experience, having been around for a previous iteration of how you deal with budget deficit reduction and include defense, I would argue—and others will disagree with this—that one of the most successful defense build- downs that we have had in this country in our history since the Second World War was the period from 1989 to 1995 that we did not break a force. At the same time, we brought the defense budget down.

The consequence, as I observed it from my position at OMB, was that the military and the Department engaged in one of the most sensible priority setting and management operations I have ever seen them engage in. In other words, there is nothing like external budget discipline to say you have got to focus on what your real tasks are.

So one of the missions of this committee, I think, is to say we are going to include defense in this budget discipline. Now give us your best thinking of how you are going to accommodate that freeze. How do you get to it, not as a Washington Monument exercise, oh my God, the sky is falling, but as what would you really do? How would you prioritize? Part of that is going to be mission. Part of it is going to be things like military personnel. Do you need to grow the force when the force will be coming down, as we know, in Iraq and Afghanistan? Is it important, then, to add to the size of the force or are there ways we can gain force savings?

Operations and maintenance, as I said in my statement, contains no external discipline in the Department of Defense. Eight-and-a-half percent growth in budget resources from 2010 to 2011 says somebody is not managing the O&M store. That is one of those areas where there are enormous opportunities to savings, but you have got to bear down. So when you talk with defense witnesses, pushing them on operations and maintenance savings, I think, is important.

Procurement—as I said, I don't think the 2011 budget makes many very serious procurement system choices. Mostly, it endorses increases in procurement, some of them highly desirable, like UAVs, some of them questionable. You know, Virginia-class submarine, questions need to be asked about it. Whether the F–35 ought to proceed as quickly as it is, the question needs to be asked about. The Department has not yet focused on the Marine Corps Expeditionary Fighting Vehicle, which is in trouble, but it can't somehow bring itself to cut it loose.

Questions need to be asked about the research and development budget. For example, much is made of the cancelation last year of the Future Combat Systems Vehicle program at the Department of Defense. The replacement program in the budget request this year is $3 billion worth of R&D. In other words, there has been no budgetary resource saving to speak of in the area of vehicles for the Future Combat Systems program. It is a relabeling. It is a redrafting. It is the same budgetary amount. Is that a necessary program?

And finally, I suggested in the area of overseas contingency operations, it is really important to scrub the procurement end of that budget request to see if there aren't programs that really belong in the base budget and ought to be traded off against other programs currently in the base budget, and as I say, overall budget discipline is going to push the Department to set those priorities and make those kinds of choices.

Chairman CONRAD. Thank you.

Senator Gregg and I have made the point repeatedly, not during just this administration, but the previous administration, the kind of base budget creep that we see happening. It has enormous implications for the long term.

You know, my colleagues get tired of us saying it, but it is true. We are on an utterly unsustainable course and no part of the budget will be exempt if, God forbid, we face a crisis because those who are lending us the money decide they are not showing up at the Treasury auction window weeks or months from now. Then all of us will be in the soup and we will be in the soup big time.

Mr. ADAMS. Can I underline the point that you have made just briefly, Senator, on the base budget, because I think that is a critical point that I develop in my testimony. The Department itself will tell you that it cannot array its budget data by mission, that they have no way of doing that. That said, the Secretary has said that of the procurement requests, 50 percent of the programs being bought are for long-range missions, 7 percent are closely axed on the war, and 40 percent—the remaining 40 or 43 percent are dual-use. Frankly, if you can't array your budget data by mission, I don't know how he knows that to be true. There is really no way the Department can measure it.

And when you look at how they are spending money, as the GAO has probably repeatedly testified for you, they have said they don't have the budgeting, financial accounting, and business systems that enable them to say, here is where we are wasting money in the base budget. They simply can't answer the question. The consequence is then we pile next year's budget on top of last year's budget.

Chairman CONRAD. You made another point that I have found—the truth is the accounting systems that we have at the Department of Defense are so inadequate to analyzing what is actually going on there that it really is impossible to say. That gives this Committee an extremely difficult challenge because—how I started is what I believe. We have got to—our first obligation is to defend this Nation, and we have got to provide the resources to do that. And we cannot be penny wise and pound foolish with respect to providing those resources.

At the same time, in the aggregate we are on a collision course with reality, and the reality is we cannot afford as a Nation all of the things that we are doing. It is inescapable. It is inescapable. We have doubled the national debt over the last 9 years. We are getting ready to double it again over the next 8 years. And we are headed for territory never seen before in terms of a debt as a share of the size of our economy. That is just a reality. We are going to have a debt that will be unmatched since right after World War II. And we are headed for a circumstance, according to the Congressional Budget Office and the Office of Management and Budget and the General Accounting Office, that we are going to have a debt three times the size of the debt that we had after World War II as the previous record. And nobody believes that that is sustainable. Not a single witness, whether it is the previous Secretary of the Treasury, the current Secretary of the Treasury, the head of the General Accounting Office, the head of the Congressional Budget Office, the head of the Office of Management and Budget, that has not said to us the course we are on is utterly unsustainable.

So I have said to my friends—and I have very close friends in the uniformed military—you know, we are going to have to face up to this in every part of the budget.

General Van Riper, what would be your recommendations to this Committee?

General VAN RIPER. Mr. Chairman, I would like to answer first as a retired general officer with some 41 years of enlisted and commissioned service who has remained engaged in the defense community for the last 13 years, and then I would like to answer as a private citizen.

I would urge first, what I have in my statement, that we need to focus on the budget, but let us look at what drives the budget, and that is, the strategies. Do not change the budget without changing the strategies, or you get a strategies-resource mismatch. So we need to trace that through, and when the White House provides you its National Security Strategy, if we are going to do something to the budget, then it ought to work back into that national security strategy.

On the other end, whatever is in that budget ought to support the operational concepts that the Chairman has published, or that concept ought to be changed. So there is, as I say, an ends-ways-means linkage here we ought to be very careful of.

Specifically, though, in terms of the military, there would be a number of things. One is do not allow systems to go into acquisition with immature technologies. What began as the DD(X) became the DD–21, and then the DD–1000 that was just limited at three ships, began, as I understood it, with 18 immature technologies. It is just not the way to do procurement.

Chairman CONRAD. You are saying "immature"?

General VAN RIPER. Immature.

Chairman CONRAD. Immature technologies.

General VAN RIPER. Immature, yes.

We need to hold both the services and industry to account for problems. The amphibious ship the LPD–17, built by Northrop Grumman Ship Systems, the first one was a pure disaster in terms of its capabilities. It was either the second or third, the Navy accepted the ship, and then for 2 years put it into dry dock to finish it. No one seemed to be held accountable for these sorts of things.

We found out with the Future Combat Systems that the lead system integrator does not work. These are Government skills that we need to keep. We cannot simply turn them over to industry and expect good results.

I would suggest we take a look at lengthening our service career. We now look at 20 being norm, 30 for the senior officers and senior staff noncommissioned officers. Let us look to a 30-year career being normal. Twenty was when we did not understand our health issues, we drank too much, we smoked, we did not exercise. I am 72. I still run. I think I could still be a fairly decent general officer. I retired 13 years ago. So let us look at a 30- year being normal, our generals and admirals going to 40. And what that would do is, I think, have a very narrow top and a wide base, but cut down on the post-retirement cost.

I believe you have to see the consequences of what is going on, so I would advocate co-pay both for active and retired of all of these benefits that we have so you see some impact on it.

As a private citizen, I worked very hard—I started from humble circumstances. My family up in Pittsburgh worked hard—both as a Marine and since retirement. But my wife and I are blessed that we probably, in terms of income, are in the top 3 percent of the citizens. You need to tax us. You need to tax all of us more.

You need to pass health care reform because you will not fix military health care until you fix health care reform in general. And we need to have regulation of the financial industry.

Chairman CONRAD. OK. Thank you for all of that. Very clear.

Let me just say one of the things that is very striking in these budgets is the health care accounts, and the health care accounts in every sector of our society are running amuck. It is true in Medicare. It is true in Medicaid. It is true in the private sector. It is true in the military. And I myself believe in co-pays. I had a very wise man who was a doctor in my State, who had practiced in India, had practiced in Europe, and had practiced in America. And he said the one thing—he came to one of my town hall meetings in North Dakota. He said the one thing he observed is that where you do not have co-pays, you have overutilization. It has been clear to me in my career. And he talked about a circumstance they had in a lesser developed country where they had prescription medicine that was given away free. And he said, "Every day we would come, and there would be a long line around the building and people getting free medications." And they imposed a very modest, even in that society a very modest co-pay, problem solved. And he had observed this in England. He practiced there. He practiced in the United States. He practiced in India.

So, you know, as soon as you mention it, it is controversial. People say, well, you are creating a disincentive for people to join the military. Look, this to me is going to have to be throughout society. People are going to have to be part of the solution, and we cannot allow this to continue to spiral out of control.

I see Senator Merkley has arrived and would recognize him for a statement and questions.

OPENING STATEMENT OF SENATOR MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chair. I was at the Environment Committee on the budget hearing that Lisa Jackson was presenting. I wanted to make sure I got by in part to give a warm welcome to Cindy Williams, whom I worked with going on three decades ago at the Department of Defense. It is good to see you. So I apologize that I missed your presentations, and I will be catching up on them in the course of the day.

But I did want to note—and just see if you all have any comments—I just came back from Afghanistan, Pakistan, and India to try to get a better sense of some of the challenges we face there and how our defense budget might respond to that. And I must say I found it to be a very daunting proposition.

I was particularly struck when we had folks presenting the challenge that corruption presents in Afghanistan, and to give you a sense of this, the discussion of positions being sold, from Governorships on down; then within the police, very similarly police chiefs selling the positions—buying the position and then selling the positions under them; and then in the military, similar practices.

I met with a bunch of tribal leaders, and the tribal leaders said: Here is the problem. The central government does a series of appointments that come down to our local level, and we know who the fair and capable people are, but they never get the appointments. The greedy and the corrupt people get the appointments, so the central government's appointees become an affliction. And they told story after story of this affliction.

So it is a major dilemma for our strategy in Afghanistan, is if we are building a strong central government but the strong central government has this systematic corruption through it that results in the incompetent or the greedy abusing their powers at the local level, that is a big problem.

Now, we are attempting everything possible—and I must say, I was so impressed by the American forces and the American planning. I think General McChrystal has put together as good a plan as could possibly be made. One person briefing us pointed out that the challenge we face is that you can start with folks who have taken jobs, for example, as police because it is a chance to make money. And after we get through training them, then they are better trained, but they are still—they are "better trained thugs," was the exact words that were used. And I think it recognizes that there are cultural designs in the system that cannot be changed overnight. And, clearly, we are basing our strategy on a strong central government. We are basing our strategy upon training of the armed forces and training of the police. And it is a fearsome, challenging task.

I would just appreciate any insights that you all might have as it relates to our budget and our expenditures.

Ms. WILLIAMS. I would like to say something about that. I am sorry that you were not here earlier because now everybody else has to hear why I think our strategy, our current strategy in dealing with the rest of the world is problematic.

One reason is it encourages our allies to free-ride or to easy-ride. But another is that it encourages those who we think we are helping to behave badly, because they are getting money and they are getting protection for which they are not accountable to their people. And I think that, and not just the culture, is the problem in Iraq and Afghanistan, that we are creating friends who cannot help but act badly toward their people. They cannot help but be corrupt, because we are giving them oodles of money and oodles of protection without them having to ask for it from their people.

So to me it is way more than culture, and a change of strategy would be a good thing. A complete change of strategic course for our national security strategy and our military strategy would be a good thing for the long-term future because it would save us money, but it would also keep us from getting into problems like these.

Mr. ADAMS. Senator, I have——

Senator MERKLEY. Before we go on, can I just ask you to take that a little further? What does that look like then when you refer to that change in strategy? What does that look like?

Ms. WILLIAMS. We are obviously entrenched in the two wars where we are and have to—at least for the time being. I think we heard earlier that maybe we will be out of Afghanistan by 2013. It looks like we will be out of Iraq next year. But over the longer term, it strikes me that we should not be in the business of nation building. We should not be in the business of regime change. We should not be in the business of imagining that security in every single country of the world is a national security matter to the United States.

Instead, we should look to the immediate problems that we have. We should stop thinking that we can stop terrorism against the United States by invading other countries and running them. We should stop imagining that we are going to be the administrators of countries that are divided or countries that are losing their way from the point of view of their governments.

Senator MERKLEY. Thank you. I really appreciate your comments.

Mr. ADAMS. Senator, could I add to what Dr. Williams had to say here? Because it brings it down to budgetary terms here. I think there are something like $13 billion in the current OCO budget request for security force assistance in Iraq and Afghanistan alone. Thirteen billion dollars for us to invest in a process which I think, in my judgment, you very accurately described; that is to say, it is not at all clear that that investment is going to pay off because of the nature of the societies, the way in which those forces are organized, the way in which jobs are acquired, who gets promoted, who gets the position. And the press reports on the Marjah struggle today seem to indicate a kind of a reluctance, particularly in Afghanistan, to put those security forces forward in the combat situation that they are involved.

What that suggested to me is not that the Afghanis are somehow inept and that we are somehow the most capable force in the world. It suggests to me that the process of building states is extraordinarily hard. It takes a long period of time. And as any good counterinsurgency expert will tell you—and the COIN manual that was put out by the Army makes it very clear—most of that task, if it works at all is a civilian task. The ballpark figure everybody in uniform seems to think is right is about 80 percent. About 80 percent of this mission is a civilian mission.

We have given that mission in two countries—which, I hasten to add, we invaded, which makes the conditions of state building even more difficult and challenging—to the United States military, absent any other capability to engage in the U.S. Government.

The question I think we need to ask ourselves—and this jumps right on Cindy Williams' point—is: Who has this mission? And can we, in fact, accomplish this mission?

I was in a Red Team panel for a proposal on a civilian intervention force that the Special Inspector General for Iraq Reconstruction has just announced, a couple of months ago, and I made the point in the group of 40 or 50 people—uniformed people, civilian people, people who have been in this mission for years—you know, this may be something that we are not very good at. And I was surprised at the number of heads that nodded around the room, saying, "Yeah, you know, we ought to think about whether we are building a major capability to do this which is something that we are not very good at, is very hard, takes a long time, an awful lot of money, and may not produce results."

It is not like there is not a problem here, because there are a lot of countries around the world with failed, fragile, weak post-conflict governance which is problematic for their security, for regional security, and ultimately for our security.

So the real question on strategy is: How does the United States lead in an international community in trying to cope with the structures and problems of governance in weak states? It is a bit challenge, but it is not one we can do alone. It is not one I think the military is particularly skilled at doing, and we ought not be asking them to do it. And it is one we are going to need more partners, collaborators, private sector, NGO, international organization, allied countries, and ourselves to say how do we tackle what is clearly a global security challenge, which is weak and fragile and failing in post-conflict states, where most of the job is a civilian investment, not a military investment.

Senator MERKLEY. One thing I was very struck by is a number of very capable, very competent military trainers saying, "We have come for a year and we have learned a great deal in the course of that. We have established a whole bunch of key relationships, and we are really starting to understand and be able to mentor in a meaningful manner. But next month we leave, and a new team comes in."

I thought, wow, that is another difficulty I had not given thought to, the rotation of our trainers and mentors through the system. The world is very different in different places, and it does take time, and we do not start out even speaking the language, if you will, and so forth. And about the time that you might start to build the relationships and have a sense of trust, you are rotating out. And when you say we are not very good at it, I think that is one of the challenges that we have.

Mr. ADAMS. I fully agree.

General VAN RIPER. Senator, in regards to your specific question about tribes, I think we will be well served if we build from both ends for the foreseeable future. At some time we are going to have difficulty, and I think the moves for tribal engagement, which I am sure you saw out there, are the way to go. You cannot build straight from the top down.

In terms of 1-year tours and then leaving, this was our difficulty in Vietnam. It was not a 7-year war. It was seven 1-year wars as we rotated our service people in and out.

The Department of Defense now has a program that is called the "Old Hands for Afghanistan and Pakistan," where some relatively large number will be expected to serve there, come back to a billet in the United States that is related to the war, and then go back immediately. So their rotations will be back and forth so this expertise will be built up that perhaps it would be worthwhile to be briefed on.

In terms of the so-called whole of government, I think we are moving in the right direction, but the reality is there are some parts of our Government that do not have and may not ever be able to gain the sort of mind-set that the Department of Defense has. The Commerce Department, the Agriculture Department are not thinking about these sorts of operations that the military is engaged in. They are worried about farming and about agriculture.

I believe within the Department of Defense, at least for the leading edge of these sorts of other sorts of skills, it is going to have to be in the Department of Defense with both the plan and the hope that you can turn over to the civilian side as quickly as possible. But certainly insurgencies, the 80–20 percent is probably pretty accurate.

Senator MERKLEY. Thank you all very much, and thank you, Mr. Chair.

Chairman CONRAD. Thank you, Senator Merkley.

I would just say I had the opportunity in life to go to high school in Libya, graduated from an American Air Force base there, Wheelus Air Force Base in Tripoli, Libya, in North Africa. And I remember coming back and thinking to myself that if we believe we understand these cultures that are so different from ours, that we understand them so well that we can go in and meaningfully rearrange them, we are in a dream world. And that thought has followed me to this current position, and I remember some of the briefings we have had in 407, secure briefings where I have heard described what we are going to do in places with cultures very different from ours. And I have thought, boy, it sounds pretty arrogant to me that we are going to go in there and fundamentally change the way they operate.

I do not think so. I personally think it is a bridge too far. I think we are way overestimating our ability to meaningfully alter the way those societies operate. And my own view has been I would like us to set a good example. Let us do a good job here running our own affairs, which currently we are not doing, in my judgment, and let us set a good example. On defense, I think you have got to deal with the terrorist threat as it comes, and the notion that we are going to go and rebuild nations, put me down as a skeptic. I think the chance that we can go and rebuild nations in a fundamental way is way beyond our capability. We just do not have the people with the language skills.

If you think about that, what an amazing thought it is that we are going to go in where we have got very few people that even speak the language, and we are going to change the way they operate? Wow. Really? Is that really going to happen? I do not think so.

Senator Merkley?

Senator MERKLEY. Mr. Chair, one of the things I was pondering on my way back from Afghanistan and Pakistan was what might initially sound like a completely disconnected experience, which was working in inner-city Portland, Oregon, in an area that had been very poor and very gang affected. And I was working for Habitat for Humanity, and we were attempting to make significant changes in that community, and to do so through homeownership and various other groups working at nutrition, working on education, and so forth. And those efforts made an impact, but it was not easy. And yet we spoke the language. We had far more—we had surrounding areas that were affluent and successful that provided a path, if you will, of influence, an example of how it could be done differently. But bringing a lot of resources to bear right within our own community proved challenging.

And I think that if you take an entire nation that is poverty stricken, now it is not just a pocket of poverty, an entire nation that may have a different work ethic or education ethic, the fact that we do not even speak the language, and you put all those pieces together, you now have something that is many orders of magnitude more challenging than tackling poverty in pockets here in America. And I think that from a very different angle gave me a healthy dose of caution about the challenge we are undertaking.

Chairman CONRAD. You know, in my own reading of history, great powers bleed themselves in foreign adventures. Washington warned us about this in our own country, and there is a lot of wisdom in that, at least to me. I know that is maybe controversial with some of our colleagues who have visions of America transforming the rest of the world in very short order. I just do not think it is realistic. And when I look at just our budget circumstance, which is daunting, as every member of this Committee knows, the thought that we have got the will and the wallet to go around the world transforming cultures very different from ours when we do not even know the language kind of leaves me deeply skeptical.

Senator MERKLEY. If I could throw in one more comment, it is about the law of unintended consequences. We are fighting the Taliban in Afghanistan, and the Taliban really had two—and the mujahedeen, and there were kind of these two sources. We were supporting the mujahedeen to take on the Soviets. Pakistan proceeded to take the students who were refugees in their country, train them and arm them and send them back into Afghanistan. And so those were the two driving forces that created the Taliban movement that we see now.

I do not think in our wildest dreams at that point did we anticipate that this would become an enemy that would nurture terrorist attacks on the United States that would be a huge national security problem for us.

One of the cautions that was mentioned when I was in Afghanistan, and another issue that I probably should have thought about but did not until it was raised, is if you create a very strong central military, how confident are you that that central military is not going to at some point say, "To heck with the civilian process or the parliament or the appointments, we are taking over"? And that is just one example of how the path ahead might end up very different than the model that we might have in our minds as we undertake this nation building.

Chairman CONRAD. Well, those are all good thoughts.

Let me just again thank our panel. I would ask them if they had any concluding thoughts that they would want to share with the Committee. Dr. Williams, anything that you would want to make sure is on our minds as we address the budget challenge for this year?

Ms. WILLIAMS. I would like to pile on to the point that Dr. Adams made that nothing helps people make better choices than the imposed discipline of a tight top line, and this is the Committee that could start working toward that, helping the Defense Department make better choices just by giving it a much, much tighter top line.

Chairman CONRAD. Dr. Adams.

Mr. ADAMS. Well, I certainly agree with that. I think that for this Committee you have such a challenge, and I think doing that kind of budget discipline in defense is vital to do this year, and it is going to be difficult in the policy and political environment we are dealing in, because it will be said that this is not supporting troops when they are deployed in the field, and that always makes it enormously difficult to do. So you will be standing kind of in front of a rhetorical truck if you engage in that kind of discipline, but I strongly encourage you to do it.

The other thing is when you are dealing with issues that are the kind that Senator Merkley has raised, I think it is going to be important for you to drill down to the budgetary circumstances of them; for example, the $13 billion or so that we are doing in security force training; for example, the Pakistani counterinsurgency fund, over $1 billion; the CERP program at $1.3 billion; half a billion dollar in global train-and-equip programs. There are $15 to $20 billion worth of spending that we are investing this way in this budget that is another place to look and raise questions and say: Is this really successful? Does it work? Where are the performance indicators? Can we change these countries, and ought we be a little bit less generous in how we go about funding them?

Chairman CONRAD. OK. And, General Van Riper, what would you——

General VAN RIPER. Mr. Chairman, you mentioned the importance of history. History teaches no lessons, but it certainly provides a context. We cannot understand the future without that context.

And to Senator Merkley's question, I think we would do well to look at two countries we have been involved in in the past. One is the Philippines, where a very long period, not great success, at least for many years. But then the Republic of Korea, South Korea, where we had similar circumstances, and we build a functioning government, obviously doing quite well economically over the years. So we might learn from those. Not so much Europe because you had functioning democracies and we re-established them.

In terms of as we look to the future, and particularly Afghanistan and Iraq and our problem, I have always been troubled by the fact that if this is a global war and it is an existential threat, what is our strategy for that war? In looking to the last two examples of global wars, World War II and the cold war, we had a strategy. And you could stand back and look at that and understand where Afghanistan fit in if Iraq should have fit in, and the campaign plans for them.

I for one felt that Iraq was not the right war at that time, but if we decided to do it, we needed a campaign plan. All we had was an operations plan for the takedown of Baghdad and, consequently, were not prepared for it.

But without that national strategy that is akin to what we saw in World War II for this global war against Islamist insurgents and the campaign plan to support it, I am not sure how this body or any other body can judge where we are and what we are doing.

Chairman CONRAD. You know, you make a point that I think is very, very important. I have gone to dozens of briefings, and I am really left with the thought that we do not have what I would consider a comprehensive strategy to deal with what is clearly a threat. It is sort of an ad hoc strategy. You described Iraq as a plan to take down Baghdad and there was not really the follow-on, and I think that is true.

It also strikes me, as we look at what happened, 9/11, the Taliban were providing sanctuary for those who organized the attack on us. We had to respond to that. We had to go and try to take down that growing insurgency. But that is not just an element that is in Afghanistan. That is an organization that is now spread around the world. I do not know what their latest estimate is, how many countries have an al Qaeda presence, but it is in the dozens. And the strategy of going to a nation state to try to deal with an insurgency that is operating sub rosa in dozens of countries around the world, I am not sure we have really put together a plan or a strategy to deal with that threat that is still there.

As I said, I graduated from a military base in North Africa, and I could see then the kind of cultural chasm that exists. It is a very different way of looking at the world that many of those people have than the way we look at the world. They are mad about things that happened 800 years ago, and they are really angry about it.

You know, who in the United States spends any time thinking about something that happened 800 years ago? We are very future oriented, looking ahead. And it is a very fundamental difference, and I am not sure that we really have got a plan to deal with that.

Senator Sessions has joined us.

Senator SESSIONS. Thank you. I saw Ron Paul on the television this morning. He said we are spending a trillion dollars to defend an empire. Obviously, he thought it was too much. And I guess if you get the State Department budget and the defense budget, it is pretty close to a trillion dollars in total for everything that we do. But I don't think we can avoid that responsibility that we have to defend the country, and sometimes defending the country is better to be done abroad and early rather than late when it is close and even more expensive. General, I guess that is what you spent a lot of your life trying to do and trying to help us do.

Dr. Adams, you mentioned the CERP money is $1.3 billion. Ten minutes ago, I had General Casey at the Army's posture briefing on that very budget. The way it worked in Iraq was in areas, particularly in the Sunni areas, we were able to deal with the local leaders and that CERP money allowed them to deliver on promises made and transformed really—that is what transformed Iraq.

As explained to me by one of the Marine generals, they met with a tribal leader. He was tired of al-Qaeda and he asked, "What can do I for you, General?" and the general said, "I need your young men." He said, "I will have 500 Monday," and 550 showed up and they helped arm them and somehow they found some money to help them be police officers. Within weeks or a few months, they had run al- Qaeda out of the area, and that is really how that happened in a lot of ways.

So I guess, to me, that is maybe money from your perspective as a bookkeeper unaccountable. It is going out in ways that are not totally micromanaged. But at the same time, that was money that I really believe helped. And I think that they have got too many restrictions in Afghanistan, which was the reason of my question on that. And most of the money is going through the State Department, and more of it is supposed to be used for bridges and roads and drainage ditches, whatever, that they do. But essentially, you have to have, would you not agree, General, that security is a critical thing.

General VAN RIPER. Certainly.

Senator SESSIONS. So if you can get the local community on board and can help them with a small amount of money create a security force that actually defends their village, valley, then that maybe saves a lot of money, perhaps.

So it is a difficult thing. These are life and death issues out there. Our soldiers are on the line. It is life and death for them, and it is not easy. Whatever tactic tends to work today, they figure a way to get around it.

Despite the defense procurement spending, it is a job creating, stimulative program, and we do have a lot of defense needs in our country. I was very disappointed that the President's stimulus bill, the $862 billion, or the new one, the $270 billion stimulus package that is being talked about, does not have virtually any defense spending. Wouldn't it be prudent and smart on some of the systems that we definitely need for the future of this country to have created jobs in the short run and have advanced some of our defense systems through the stimulus funding? If you all briefly would like to comment on that, I would appreciate that.

Ms. WILLIAMS. I will just mention that of the $800 billion in stimulus money last year, more than $7 billion of it did go to defense, and certainly defense spending——

Senator SESSIONS. That would be less than 1 percent, wouldn't it?

Ms. WILLIAMS [continuing]. Defense spending is just as stimulative as other spending. So I am not opposed to putting money into defense when it is going into a stimulus package. My concern is that defense has been so rich in recent years that there is just enormous temptation to waste money. Stimulus money, who cares if it is wasted? That is the point. Get it spent. But other money, I would be very concerned, and because of that, I am concerned about raising defense's top line in any way.

Senator SESSIONS. I would certainly agree that every dollar, every penny needs to be spent wisely. That results in some very tough choices—and the Secretary of Defense is making them. Some I agree with, some I don't. But as to the amount we are spending as a percent of GDP, in the early 1980's, we were at 6 percent of GDP and now I understand it is about 3.6 percent. Admiral Mullen, the Chairman of the Joint Chiefs, has indicated that he thinks a baseline of about 4 percent of GDP would be appropriate for our country.

Do any of you see any value in discussing how much the Nation should spend on defense by matching it to the economy, the size of the economy, the GDP?

Mr. ADAMS. It is an approach to defense spending, frankly, Senator, that I think doesn't do much for defense spending or for the economy, either one. It is a very small percentage, as you say. Therefore, its overall stimulative effect is relatively small.

But more than that, and partly dealing with the earlier question that you raised, my judgment is that defense budgets ought to be built, as General Van Riper has been saying this morning, with respect to defense strategy, not with respect to its economic impact. The concern that I would have with respect to a share of GDP is what happens when the GDP share goes in the opposite direction? If the GDP were to go down, would we then stick with 4 percent of GDP of a declining number? I wouldn't. I would be looking at defense needs in terms of our strategy and our international position regardless of what the share of GDP is.

Senator SESSIONS. I think that is a good point and I would value that. I guess what I would say, though, for those who contend that we are spending much larger amounts than we have ever spent before on defense, when you look at the size of the economy, I think there is an argument to be made that it is considerably below even in the 1980's, after Vietnam but still during the cold war. Would you agree?

Mr. ADAMS. I think your data is unquestionable. That is absolutely the case. However, again, I think our choices about defense are choices about our security, not about the share of GDP. If we faced a serious major existential threat a la World War II-style, for example, it wouldn't bother me to spend significantly higher proportions of our GDP. But what ought to drive it is the nature of the international situation that we face, not a specified share of GDP. I think that could be a manacle as well as a promise.

Senator SESSIONS. I tend to agree with that, but I also tend to believe, by historical standards, we are not above what we have been spending on defense.

General Van Riper, do you want to comment on that?

General VAN RIPER. Senator, my wife and I are blessed with a son who is a Lieutenant Colonel of the Marines now and has had three tours in Iraq, so I come from that perspective. As I look, and these are data points of one as I move about various bases and engage in the defense community, I think they are in good shape. I am seeing things built, programs that are underway, equipment being bought that I never saw in my 41 years of active service.

So as a judgmental, I was quite happy with where the stimulus went, the fact that it did not go to the Defense Department, and I am relatively happy with the budget request as we see it now.

Senator SESSIONS. Well, do you want to cancel all our new aircraft and new naval systems? We have certainly surged our MRAPs. That was an immediate response. We put the money out. That was a lot of money that went forward and rushed those vehicles that would withstand IEDs. We have done that for our soldiers on the ground.

But, General, we are adding 22,000 more troops, according to the President's request and the Secretary of Defense's, and we are authorizing more than that, I think, in the defense bill, but we are going to actually put on the payroll another 22,000. We are in a war situation and they have to be paid and all of those things. It seems to me what I am seeing is a real retrenchment in procurement for the weapons systems, many of which we are using today that were funded quite a number of years ago and brought online. Do you see any danger that research and development, procurement of new systems, could be threatened if we keep our increase at about the cost of living while we are increasing soldiers and still in a conflict?

General VAN RIPER. There are certain areas of the budget, research and development being one, that I wasn't as comfortable with. But in terms of the major systems which the Secretary identified, the rate at which he requests procuring them and the amounts, I felt comfortable with.

Senator SESSIONS. Well, I have looked hard at a number of those issues and I am aware that he faces difficult choices, and I in no way criticize him for having to make some of the tough decisions he must make, but I am seeing a trend that if we don't watch it, we will end up, just by the natural increase in military personnel, expenses, their health care, their retirement, salaries, family benefits, and all of those things, with the cost of each soldier going up and the number of them going up. Then we may not be fulfilling our obligation to the next generation, as I think President Reagan deserved credit for, of investing in some things that now we have used but that he never used when he was President. So that is a challenge, I think, in how we wrestle with this budget. But I hope we can keep it down. I agree with that. We don't have the money. We just don't.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, and thank you for coming and thank you for your observations.

Just on the GDP, the numbers I have show that for fiscal year 2009, we are at 4.5 percent of GDP for defense. For 2010, 4.7. For 2011, 4.7. That is actually higher than during the Gulf War, much lower than World War II. Dr. Adams made the point, if we faced a similar threat—World War II, we were at 34 percent of GDP for defense, and I don't think anybody quibbled about a dime.

Senator SESSIONS. Well——

Chairman CONRAD. We had to save the world against fascism——

Senator SESSIONS. Well, I thought that number was including the supplementals, but it must not have been. I think the number, 3.6 is baseline defense budget, more like we were in the 1980's. But it is—I am not saying we don't cut costs. I am just saying that we are not at a historically extraordinary high level with a war going on.

Chairman CONRAD. No. When measured that way—you know, I put up before the gentleman came a chart showing in dollar terms that we are the highest we have been in today's dollars. As measured against the economy, that is a different measure, and even on that measure, we are certainly at a healthy level.

I think, really, Dr. Adams made probably the right assessment. We have got to build a defense budget. I started this by saying, our obligation—our first obligation is to defend this country. So we have got to spend what it takes to defend this country.

We have got a larger issue that you referenced just at the close. Our problem was our total budget circumstance is on an utterly unsustainable course and we are going to have to deal with it and we are going to have to deal with it soon.

Again, I want to thank this panel. I appreciate very much your testimony before the committee. It is of great assistance to this committee. We are going to be having another defense hearing with the Department of Defense, I think next week. We certainly welcome all members to participate actively in that.

With that, the committee will stand in adjournment.

[Whereupon, at 11:46 a.m., the committee was adjourned.]

QUESTIONS FOR THE RECORD
RESPONSES TO QUESTIONS ASKED BY SENATOR WHITEHOUSE

To: Senate Budget Committee

From: Dr. Gordon Adams

Date: 18 March 2010

Re: Responses to Questions for the Record following SBC's 23 February Hearing

With ongoing wars in Afghanistan and Iraq, the President continues to request historically-high defense spending during an economically painful time for many Americans. I fully support providing funding to ensure that our troops are well equipped, and recognize that our recently-augmented presence in Afghanistan may further increase costs. However, I'm concerned that billions of dollars a year in defense spending has been lost through waste, fraud, and abuse. As noted in Allison Stranger's book, One Nation Under Contract, "the Pentagon has acknowledged that $8.2 billion of taxpayer money flowed through contracts into Iraq, some in stacks or pallets of cash, without appropriate record keeping or oversight." Furthermore, the Government Accountability Office has placed federal contracting management on its High-Risk list, calling for immediate attention to this issue. Contracting inefficiencies divert resources from our troops, jeopardize the readiness of our armed forces, and bloat the defense budget. How can the Congress help the Department of Defense reign in the costs associated with inefficient contracting practices?

The Department of Defense indicated in its FY2010 budget request that it "will begin reducing its reliance on support service contractors from the current 39 percent of the workforce performing administrative and advisory services to the pre-2001 level of 26 percent."[1] It likewise determined that, "by 2015, the acquisition workforce will grow by about 20,000 people." The Quadrennial Defense Review, released on 01 February 2010, confirmed that both of these efforts are ongoing (pg. 55, 77). One of the best ways that Congress can help the Department of Defense reign in contractor costs is to exercise focused and robust oversight throughout the five year duration of this transition.

One important question throughout this process will be the per-person savings as the contractor workforce decreases and the civil service increases. The House Appropriations Committee's summary of the FY2010 defense appropriation bill noted that "the Department [of Defense] estimates that every position that is converted from contract to federal civilian saves on average

[1] "Overview of the DOD Fiscal 2010 Budget Proposal": www.defense.gov/news/2010%20Budget%20Proposal.pdf, pg. 5.

$44,000 per year."[2] That figure may change, however, as the transition moves forward. Congressional attention to this issue could be of significant value.

If implemented as planned, this transition will reduce the number of defense contractors significantly. A substantial number nevertheless will remain – 26 percent of the administration and advisory cadre, along will a steady presence of personnel from training, equipping, logistical, private security, and analytical fields. Oversight of this workforce is inhibited by the Defense Department's general inability to meet the standards of an independent financial audit, which is documented by the Department itself.[3] This shortcoming presently is on GAO's high risk list and has been so for years. Oversight of this issue is very important, and the time may have come for legislative action to ensure that those funded to manage these activities follow through on their responsibilities.

The FY2011 defense budget makes a critical and long-overdue investment in hiring 20,000 in-house acquisition workforce personnel. According to the Quadrennial Defense Review, over the last 10 years, the Department of Defense's contractual obligations nearly tripled, while the acquisition workforce was reduced by over 10 percent. To what extent do you think the Department of Defense's budget has been strained by waste, fraud, and abuse resulting from a lack of proper oversight in recent years? Will the level of new acquisition resources requested by the President be sufficient to curb wasteful practices? How long do you think it would take for significant cost savings to be realized?

The Department of Defense's budget has been strained heavily by wasteful spending in recent years. The extent of this problem cannot be quantified because of the Department's inability to meet the standards of an independent financial audit, as alluded to above. Yet that inability itself offers comprehensive and powerful evidence of the presence of waste. According to Office of Management and Budget estimates, funding next year for the Department of Defense will represent more than half of America's discretionary spending.[4] 'Losing' that money in the recesses of Pentagon accounting is grossly unacceptable. Remedying this shortcoming would illuminate areas of significant cost savings immediately.

Adding 20,000 in-house acquisition personnel undoubtedly will improve contracting oversight. The extent of that improvement, however, depends on the quality brought to the job by these new

---

[2] Summary: FY2010 Defense Appropriations": http://appropriations.house.gov/pdf/FY2010_Defense_Appropriations_Bill_Summary.pdf, pg. 2.

[3] "Overview of the DOD Fiscal 2010 Budget Proposal": http://comptroller.defense.gov/defbudget/fy2011/FY2011_Budget_Request_Overview_Book.pdf, p. 7-17.

[4] OMB Historical Table 5.5: http://www.whitehouse.gov/omb/budget/fy2011/assets/hist05z5.xls.

civil servants. Additionally, the impact of each additional hire will decline as the workforce grows, and it is possible to foresee a circumstance in which there are too many acquisition personnel relative to the contracting requirement. Additional hires under this circumstance would hurt oversight by causing personnel to interfere with one another. In short, quality matters equally to quantity.

Acquisition personnel, like any other type of professional, require meaningful education, training, and experience in order to maximize their performance. The time required for the government to achieve significant cost savings will be proportional to the time required to educate, train, and develop these personnel systematically. Cost savings can be accelerated by recruiting already-experienced personnel but, given the volume of personnel needed, the government will have to apply considerable resources to in-house development. Consequently, significant cost savings likely will be extended over a period of years.

Too many factors presently are in flux to project whether this expansion of the acquisition workforce is sufficient to curb wasteful practices. Given recent trends, an increase in acquisition personnel and a decrease in contracting bode well for a reduction in waste. Investing to ensure a high-quality workforce – one that is educated, trained, and developed – would offer further promise.

161 Waterton
Williamsburg, Virginia 23188
2 March 2010

The Honorable Sheldon Whitehouse
U. S. Senate Committee on the Budget
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Whitehouse:

In response to your request to answer two specific questions for the record following the United States Senate Committee on the Budget hearing of 23 February 2010 concerning the United States Department of Defense Fiscal Year 2011 Budget Request, I provide the following:

Question One. In addition to ongoing oversight activities, I believe Congress can help the Defense Department to "reign in costs associated with inefficient contracting practices" by examining in depth as well as detail each of the Department's major commands and agencies. There are undoubtedly many programs and activities in these organizations that in normal times, let alone during a period of great economic difficulties, are not worthy of taxpayers' dollars. I have stumbled across several over the past few years and wondered how the Department could justify their continued existence. As an example, I offer the Joint Capabilities and Integration Development System (JCIDS) and its associated Joint Operations Concepts Development Process (JOPSC-DP). From 2005 to 2008 I attended many briefings on vacuous military concepts prepared by highly paid contractors whose writing often wouldn't have passed a high school English teacher's scrutiny. After tortuous and lengthy reviews these concepts were then subjected to assessments by a series of boards. I remain convinced that a reasonably informed group of professional military officers could have produced the results of this process far quicker for a fraction of the cost. The Congressional Budget Office seems to me best suited to examine the Department of Defense's major commands and agencies, though it might need additional resources temporarily. Obviously, it would take a number of years to study all these defense organizations, but perhaps after a few were examined the others would take heed and begin to tighten up their own programs.

Question Two. Although I do not have the expertise to answer that part of the question relating to sufficiency of the 20,000 additional acquisition workforce personnel or how long it will take to achieve significant costs savings, I do believe this investment is well worth while. By in large, the promised benefits the Defense Department was to achieve through such initiatives as lead system integrators and other efforts that turned over key elements of weapons and equipment development to industry were not met. Among the most striking examples are the Army's Future Combat System and the Navy's LPD-17 amphibious ship.

Respectfully,

Paul K. Van Riper

Paul K. Van Riper
Lieutenant General
United States Marine Corps (Retired)

Responses to Questions for the Record
"Defense Budget and War Costs: An Independent Look"
Committee on the Budget
United States Senate

Cindy Williams
Principal Research Scientist
Security Studies Program
Massachusetts Institute of Technology

Visiting Fellow
Dickey Center for International Understanding
Dartmouth College

Question 1: With ongoing wars in Afghanistan and Iraq, the President continues to request historically-high defense spending during an economically painful time for many Americans. I fully support providing funding to ensure that our troops are well equipped, and recognize that our recently-augmented presence in Afghanistan may further increase costs. However, I'm concerned that billions of dollars a year in defense spending has been lost through waste, fraud, and abuse. As noted in Allison Stranger's book, *One Nation Under Contract*, "the Pentagon has acknowledged that $8.2 billion of taxpayer money flowed through contracts into Iraq, some in stacks or pallets of cash, without appropriate record-keeping or oversight." Furthermore, the Government Accountability Office has placed federal contracting management on its High-Risk List, calling for immediate attention to the issue. Contracting inefficiencies divert resources from our troops, jeopardize the readiness of our armed forces, and bloat the defense budget. How can Congress help the Department of Defense reign in the costs associated with inefficient contracting practices?

Response: The money spent on contracts represents a large share of the defense budget, and lowering the costs associated with inefficient contracting practices is important. My response considers contracts in Iraq and Afghanistan first, followed by non-war contracts.

At the beginning of stability operations in Iraq, the White House and the Department of Defense made a deliberate decision to favor speed and agility over management control and oversight in contracting and in aid to local entities. Some observers argue that the decision was appropriate, because putting money to work quickly was essential. Problems related to financial oversight and control in Iraq continue to this day, however, as recent reports by the Special Inspector General for Iraq Reconstruction (SIGIR) indicate.

Several steps might help the DoD to improve the efficiency and accountability of its contracting practices for stabilization and reconstruction operations. The first is to develop a full understanding of the contracting problems in recent years in Iraq and Afghanistan. Congress could request that the Department of Defense submit a report on lessons learned through those problems. Other steps that the department can undertake include:

1. Create data-gathering and reporting mechanisms for stability and reconstruction spending that provide transparent and timely information on contract spending and outcomes;
2. Establish a single office in the field with responsibility for financial oversight of in-country stabilization and reconstruction operations;
3. Clarify the contracting rules that should apply in stabilization and reconstruction operations; and
4. Improve mechanisms for clarifying project requirements and estimating the long-term costs of projects undertaken in theater.

Congress can help the Department of Defense by mandating such steps.

Iraq and Afghanistan are by no means the only areas where the Department of Defense has problems in contracting management. As the GAO's High-Risk series points out, contracting problems are of concern across DoD. Two contributors to these problems are the persistent lack of consequences for cost overruns and the vague and overly ambitious definition of requirements at the front end of the acquisition process. Congress can help DoD to put an end to consequence-free cost overruns by requiring and supporting the termination of programs faced with Nunn-McCurdy breaches.

The problem of overly ambitious requirements is harder to deal with. Perhaps the best way to help the department instill greater realism into its requirements is to put it on a diet. The discipline of a tight budget—and the expectation of smaller budgets in the future—will help leaders at every level set priorities for what is actually required.

Question 2: The FY 2011 defense budget makes a critical and long overdue investment in hiring 20,000 in-house acquisition workforce personnel. According to the Quadrennial Defense Review, over the last ten years, the Department of Defense's contractual obligations nearly tripled, while the acquisition workforce was reduced by over 10 percent. To what extent do you think the Department of Defense's budget has been strained by waste, fraud, and abuse resulting from a lack of proper oversight in recent years? Will the level of new acquisition resources requested by the President be sufficient to curb wasteful practices? How long do you think it would take for significant cost savings to be realized?

Response: Proper oversight can clearly make a difference in levels of waste, fraud, and abuse. It is not clear how many new government employees will be needed to ensure a proper level of oversight of all the department's acquisitions. Unfortunately, history shows that developing an estimate of savings realized from the expansion of the acquisition workforce—even after the fact—will be most difficult.

THE PRESIDENT'S FISCAL YEAR 2011 BUDGET FOR THE DEPARTMENT OF TRANSPORTATION

WEDNESDAY, FEBRUARY 24, 2010

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

The Committee met, pursuant to notice, at 9 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Wyden, Feingold, Nelson, and Whitehouse.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome everyone to the Senate Budget Committee this morning. Our hearing today will examine the President's Transportation budget request. Our witness is the Secretary of Transportation Ray LaHood. I especially want to welcome you to the Senate Budget Committee.

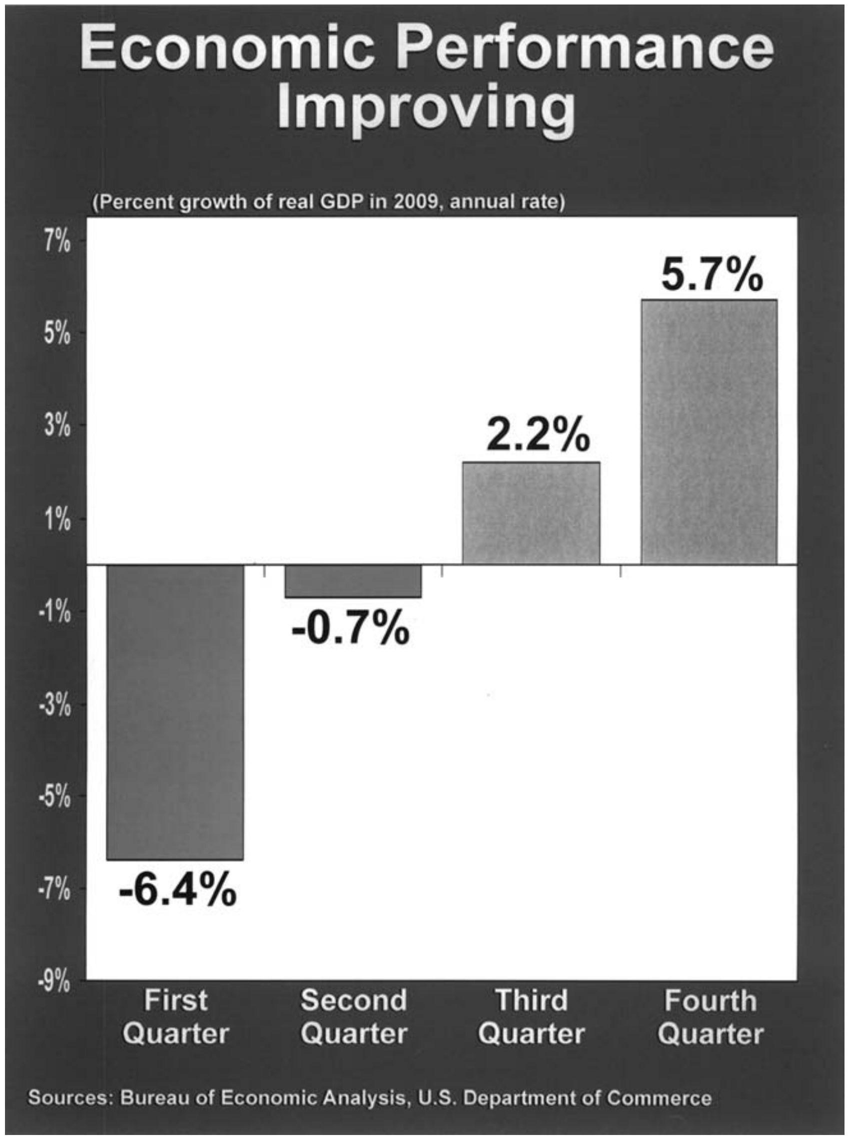
Secretary LAHOOD. Thank you.

Chairman CONRAD. This is Secretary LaHood's first appearance before the Senate Budget Committee, and we are delighted that he could be here. I would like to begin by providing an overview of transportation funding and the challenges we face in this area. And I also apologize to the Secretary because our attendance is affected. Members know that we typically do hearings beginning at 10. Because of your schedule and because of Senate votes that have been now scheduled in the middle of the hearing, which is unusual but unavoidable given the circumstances we are facing, members had previous obligations and other committee work. So that clearly is affecting our attendance. Our Ranking Member is delayed as well by other responsibilities, but we will press ahead because this is an important hearing for the Budget Committee.

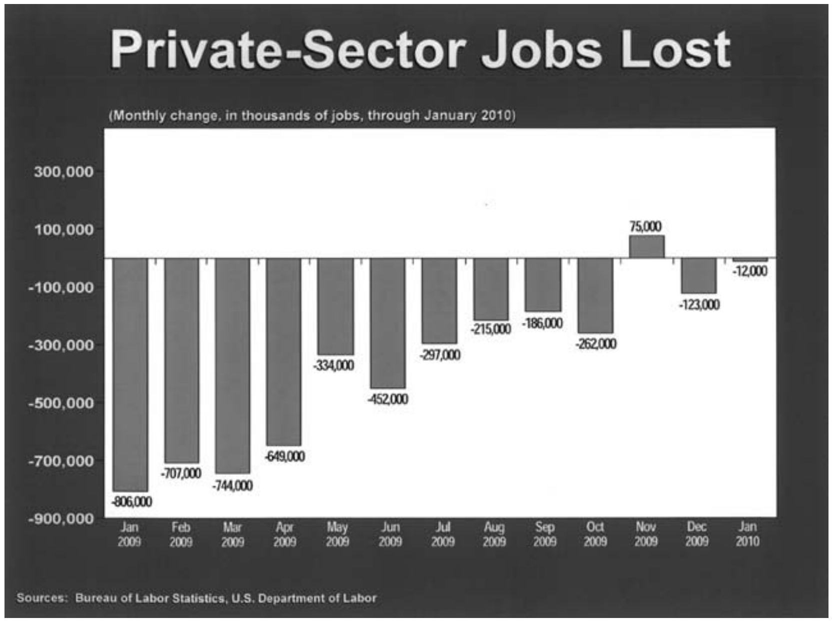
It is clear that transportation funding has played a role in helping to revive our struggling economy. When President Obama took office last year, we were in the midst of a deep recession, the worst since the Great Depression. The actions taken by the Federal Government over the last year. I believe, have helped pull our economy back from the brink. I think it is undeniable that the series of actions taken by the Congress, the President, and by the Federal Reserve have averted what could have been a global financial collapse. I was in the room; I saw the reports coming in that were truly dire.

One of the actions that was taken was the Recovery Act, which included additional transportation investments. Those investments were certainly not the only factor contributing to our turnaround, but they appear to have made an important contribution. And those transportation investments will have the added benefit of improving our nation's long-term economic efficiency and competitive position.

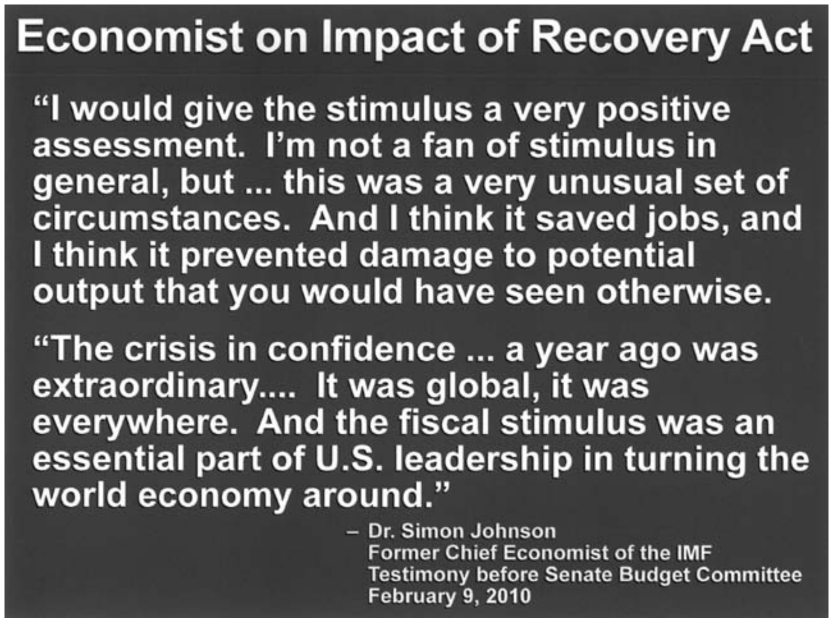
We have seen a remarkable turnaround during this last year in economic growth. Economic growth in the first quarter of last year was a negative 6.4 percent. By the last quarter, it has improved to a positive 5.7 percent.



We have also seen a steady improvement in the jobs picture. In January of last year, we now know the economy was losing more than 800,000 private sector jobs a month. I have previously used the number 700,000. We now know that, in fact, we were losing 800,000. By this January, the economy was losing about 12,000 jobs a month. That is a dramatic improvement. And I know it is cold comfort to those who do not have work or cannot find the work that they would like. But, nonetheless, we have to deal with the reality that we have seen a dramatic improvement in the jobs picture, and we are hoping to see positive job growth in the months ahead.



Most economists agree the Recovery Act had a positive impact. This is what Dr. Simon Johnson, the former Chief Economist of the International Monetary Fund, said in testimony before the Budget Committee, this committee, earlier this month. He said, and I quote: “I would give the stimulus a very positive assessment. I am not a fan of stimulus in general, but...this was a very unusual set of circumstances. And I think it saved jobs, and I think it prevented damage to potential output that you would have seen otherwise. The crisis in confidence...a year ago was extraordinary...it was global, it was everywhere. And the fiscal stimulus was an essential part of U.S. leadership in turning the world economy around.”

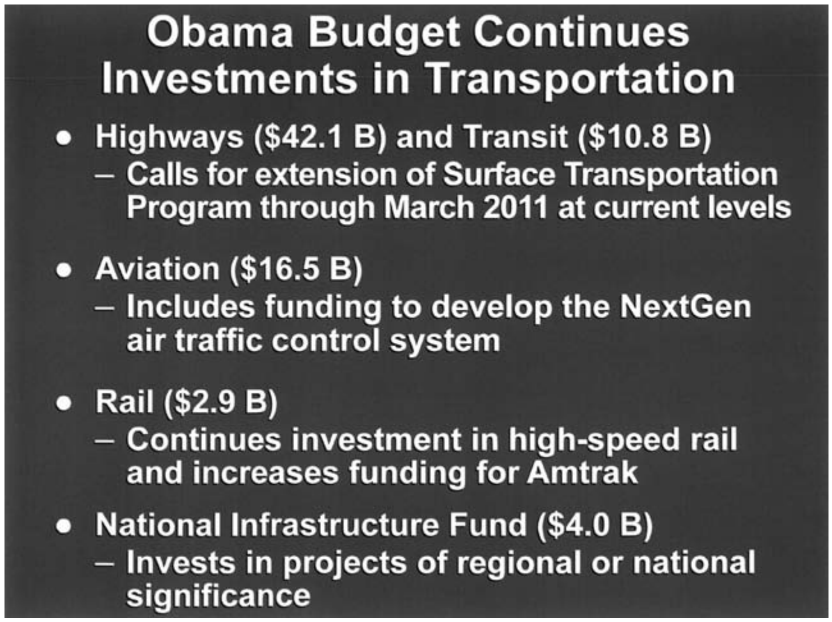


I believe Dr. Johnson has that right.

This chart highlights the key transportation investments in the Recovery Act. In total, it provided $48 billion to rebuild and modernize the Nation’s transportation system, including: $27.5 billion to build and repair highways; $8.4 billion to expand transit systems; $8 billion to develop high-speed intercity passenger rail; $1.5 billion for investments in surface transportation projects; $1.3 billion to expand airport capacity and improve safety; and $1.3 billion to modernize Amtrak’s equipment and upgrade tracks.

Let me just say in the debates over the Recovery Act, I was an advocate for $200 billion in that category. I believed we should have put $200 billion in the infrastructure accounts. I did not win that debate. I still believe, looking back, that while we all acknowledge there is a delay in infrastructure projects and getting them moving, the job creation that would have flowed from that size of a package, as well as the need to deal with the backlog that we confront across the country in terms of highway repair, bridge repair, airport improvement, that those are investments that would have wise to be made now. You cannot get a better time to bid contracts than right now.

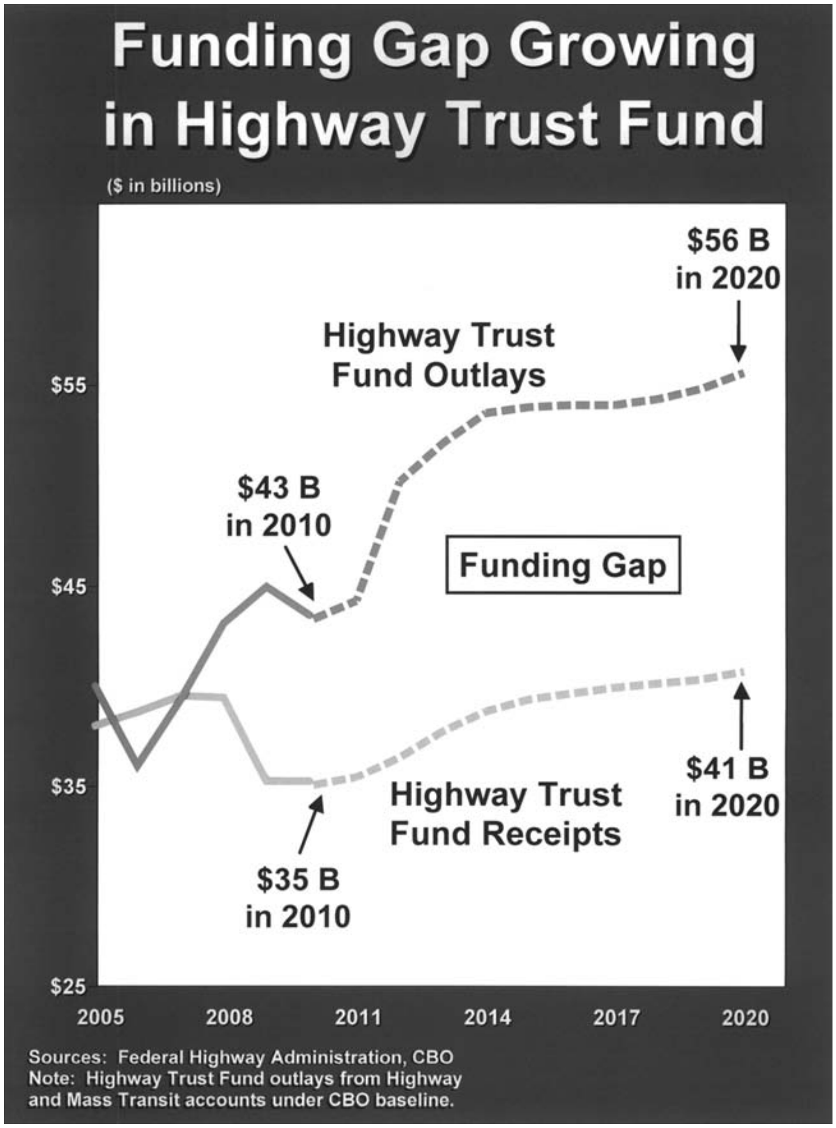
And the President's budget request, I am happy to say, for 2011 continues to make investments in transportation. The budget includes $42 billion for highways and $10.8 billion for transit and the extension of the Surface Transportation Program, or highway bill, through March of 2011 at current levels.



The budget includes $16.5 billion for aviation, including funding to develop the Next-Generation Air Taffic Control System, which we simply must do. If we are going to remain competitive, we have got to go to the Next-Generation Air Traffic Control system.

The budget also includes $2.9 billion for rail, continuing the investment in high-speed rail and increased funding for Amtrak, both very much needed. And the budget includes $4 billion for the National Infrastructure Fund to allow for investing in projects of regional or national significance.

But we have serious highway and transit funding problems going forward. This chart shows that Highway Trust Fund receipts are projected to be lower than Highway Trust Fund outlays in the years ahead, and this funding gap is growing. The jobs bill now under consideration includes a General Fund transfer to fill this gap for 2010 and 2011. This is not my preferred alternative. I do not think—and we heard yesterday from the Ranking Member very clearly on this matter, and I agree with him, on the long term. It is not satisfactory for us not to address this long-term funding gap.

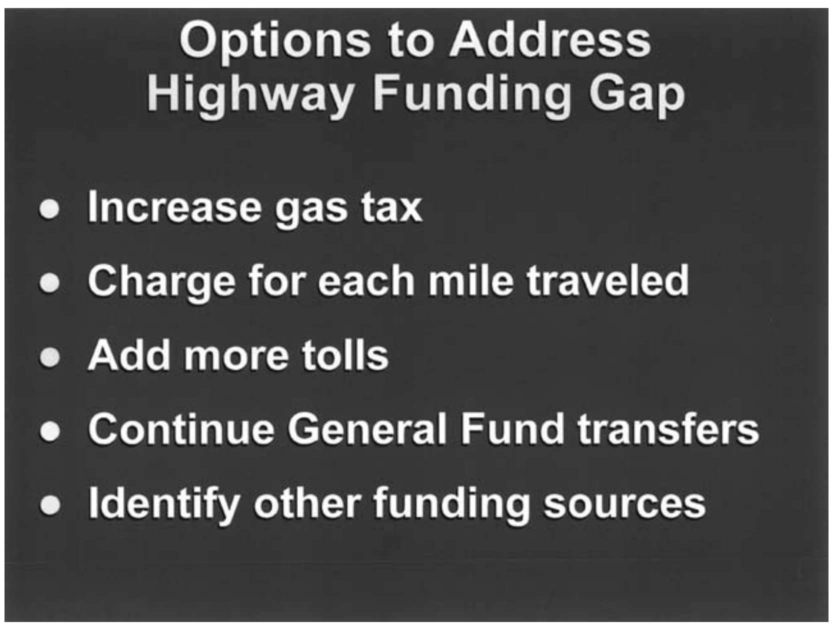


On the other hand, in the short-term what is the alternative? I think we have to be very serious, what is the alternative? Are we really going to raise taxes in the midst of a continuing weak economy, one that is improving but is still not fully recovered? Are we going to really raise taxes in that circumstance? Are we going to reduce the ability to go forward in this highway construction season when we have got the opportunity to have bids at very favorable rates; to create jobs and to improve the competitive position of the United States?

For those who say, well, "we ought to just shut it down, we ought to have dramatic cuts", I profoundly disagree. I think that would be wrong on every count. I think that would be wrong in terms of the taxpayer interest. I think it would be wrong in terms of job generation. I think it would be wrong in terms of economic growth. I think it would be wrong in terms of improving the competitive position of the United States.

But over the longer term, we have to find another way. Given our nation's dire financial outlook, we cannot afford to continue funding our highways and transits out of the General Fund. That cannot be the answer. That is why it is critical that we get a long-term highway reauthorization plan from the Administration. We need to know how the Administration would bridge this funding gap. We would like to hear from Secretary LaHood when Congress can expect to receive the Administration's long-term highway reauthorization plan.

This next chart shows some of the options that have been proposed to address the highway funding gap, and these include: increasing the gas tax, charging for each mile traveled, adding more tolls, continuing General Fund transfers—which I strongly oppose, and identifying other funding sources.



Now, let's be frank, none of these are popular options. But we have to find a way to close this funding gap. We are going to have to start making tough choices.

With that, I want to go to Secretary LaHood for his opening statement, again, to welcome you. We are delighted that you are in that position; we have high regard for you. I followed your career when you were in the House of Representatives. You were known as somebody who reached across partisan divides, was eminently fair in the way you conducted yourself, and really I think in many ways are a role model for how Members of Congress, both the Senate and the House, ought to operate.

With that, we very much appreciate your being here today. Please proceed, and then we will go to questions from members.

STATEMENT OF THE HONORABLE RAYMOND H. LAHOOD, SECRETARY, U.S. DEPARTMENT OF TRANSPORTATION (ACCOMPANIED BY CHRIS BERTRAM, CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF TRANSPORTATION)

Secretary LAHOOD. Thank you, Mr. Chairman. Thank you so much for that lovely, very generous compliment. Everybody has a copy of my opening statement, and I know that you are under some time constraints because of the vote. I would be happy to just forgo this and go to questions, or I will do it however you want to do it.

Chairman CONRAD. I think it would be most useful to the Committee if you would summarize, hit the high spots, what you want the Committee to be thinking of as we prepare the budget resolution.

Let me just say I met with members of this Committee late yesterday and told them that we are on a fast track here to produce a resolution, given other business in the Senate, and so if you would not mind summarizing the high spots, and then we will go to questions.

Secretary LAHOOD. The President's request for next year totaled $79 billion, a $2 billion increase over Fiscal Year 2010. These resources will support the President's and DOT's top transportation priorities for safety on the road, in the air, making communities livable and sustainable, and infrastructure.

Safety is our highest priority. I testified yesterday before the Energy and Commerce Committee in the House, along with the CEO of Toyota, and we talked a lot about safety. All last year, I spent a good deal of time traveling the country. When there was an air crash in Buffalo where 49 people were killed, the Colgan Air—we immediately held 12 safety summits around the country to try to and identify issues with small airplanes, with commuter planes. We came up with recommendations even before the NTSB acted. We held a day-and-a-half distracted driving conference where we have identified the epidemic in America with people using cell phones and texting while and driving. The President was good enough to include in our budget request some grants that we will be making, once you all approve our budget, to really make this a high priority.

So I want you all to know that safety is our No. 1 priority. The President included in our budget 66 additional personnel for NHTSA. This is our safety organization. This is the organization that has the responsibility for working with car companies and others to make sure that cars are safe.

We have, as you indicated, Mr. Chairman, $1 billion for NextGen. We have to get the next-generation technology which improve the air around airports, will relieve congestion, and will provide the safety that is necessary around airports. We are committed to doing that.

We are seeking $1 billion to continue the 5-year $5 billion pledge Congress made in this year's budget on high-speed rail. We allocated $8 billion. Those announcements have been made, and now we have a request for an additional $1 billion. There is actually $2.5 billion in our current budget, for which we are grateful.

We will also work with Congress on a transit safety bill as a result of the WMATA crash. We feel the law prohibits us from getting involved in safety when it comes to transit, which is ludicrous. There is a bill pending in Congress that we want to work with you all on that will give us the opportunity to improve safety. There is a request for $30 million to implement that legislation.

Chairman CONRAD. Mr. Secretary, could I just stop you? When you say WMATA, for those who are listening, that relates to the Metro——

Secretary LAHOOD. That relates to America's metro system, which is right here in Washington, D.C., that delivered 2 million people on Inauguration Day all over this city. That crash has alerted us to the fact that we need to really play a role in safety. We have been prohibited by law from doing that, and the new law will give us that—not just with WMATA, but any transit system across the country.

Chairman CONRAD. WMATA stands for the Washington Metro Area Transit Authority?

Secretary LAHOOD. Yes, sir. In the budget, the President is requesting $150 million to help WMATA fix their safety problems.

Chairman CONRAD. And, you know, all of us have constituents coming here every week.

Secretary LAHOOD. Correct.

Chairman CONRAD. I have dozens of people come from North Dakota every single week to meet with members of the delegation, to meet with agencies, and this has become a very significant concern. We have one serious question after another about what is happening with Metro, and it affects people coming here from all around the country every day. So I do not know why Transportation was precluded from being involved in safety considerations for Washington Metro, but it is absolutely imperative that these safety issues be addressed.

Secretary LAHOOD. Well, there is a bill pending in the Senate, and I would encourage all of you to have your staff take a look at it, and if you can, cosponsor it. It is a very good bill, and it really addresses these safety issues for transit programs.

Chairman CONRAD. All right.

Secretary LAHOOD. We have also requested over $500 million for our livable communities. We are working with HUD and EPA to really come together around the idea that people would like to have more transit, more light rail, more street cars, more walking and more biking paths. It is the first time that people can remember when agencies have really come together and are sharing resources. So we are grateful for that kind of collaboration.

So, with that, Mr. Chairman, you have highlighted our budget on some of your charts, and I have tried to highlight it here. I think in order to save some time, I am willing to begin to answer questions.

[The prepared statement of Secretary LaHood follows:]

STATEMENT OF
THE HONORABLE RAY LAHOOD
SECRETARY OF TRANSPORTATION

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

February 24, 2010

Introduction

Chairman Conrad, Ranking Member Gregg and Members of the Committee, thank you for the opportunity to appear before you today to discuss the Administration's fiscal year (FY) 2011 budget request for the U.S. Department of Transportation and discuss some of our successes implementing the American Recovery and Reinvestment Act of 2009 (Recovery Act). As President Obama made clear in his State of the Union address, his number one priority in 2010 is accelerating the pace of job creation. Transportation is an important part of his plan to put Americans back to work. The President's budget proposes $100 billion for a jobs package that includes critical investments in transportation and infrastructure in addition to clean energy investments and tax cuts for small businesses. The President has called for new investments in a wide range of infrastructure, such as highways, transit, rail, aviation, and water, designed to get out the door as quickly as possible. The President has specifically emphasized additional funding for multimodal transportation infrastructure programs such as the Recovery Act's TIGER program, which has proven successful in encouraging merit-based infrastructure investment that leverages federal dollars. In the first round of recently announced TIGER grants, the Department received more than $60 billion in applications for $1.5 billion in awarded funding, including several billion for innovative projects that would be difficult to fund under existing programs and authorities.

The Administration's FY 2011 budget request for the U.S. Department of Transportation reflects the importance of strengthening our nation's transportation system. In my first year as Transportation Secretary, I have travelled throughout the country and I know first-hand how important a safe and reliable transportation system is to all Americans. The President's request totals $79 billion, a nearly $2 billion increase over FY 2010 levels. These resources will support the President's top transportation priorities: improving transportation safety, investing for the future, and promoting livable communities.

Highway Safety

Safety is and will continue to be our top priority, and reducing highway fatalities is one of the Department's High Priority Performance Goals. The budget contains a number of new initiatives to increase road, transit, and aviation safety. One of the most serious issues facing drivers today is distracted driving. We must end the dangerous practice of unsafe cell phone use or texting while driving. Too many lives have been lost already due to distracted driving. Working together, I believe that we can stop this dangerous practice -- and save lives. The President's Budget requests $50 million for the National Highway Traffic Safety Administration (NHTSA) for a new incentive grant program to promote State laws to curtail unsafe cell phone use and eliminate texting while driving. Today, our children don't think twice when they "buckle up" – and our goal is that tomorrow, our future generations won't think twice about putting down their cell phone so that they can drive safely. This new program will work alongside NHTSA's other highway safety programs in making our highways safer for everyone. The President is also asking for funds to support 66 additional personnel for NHTSA to be assigned to highway and vehicle safety issues, and $7 million for the Federal Motor Carrier Safety Administration for 118 new truck safety personnel.

NextGen

The future of aviation is in our hands. The President's FY 2011 plan includes over $1 billion – an increase of $275 million over the fiscal year 2010 levels – for "NextGen" -- the program to modernize the air traffic control system. Currently, the Federal Aviation Administration is undertaking a long-term effort to improve the efficiency, safety, and capacity of the aviation system. But while we are talking about the future of aviation, I'm pleased to report that it's happening now. The funds requested under the fiscal year 2011 budget request will support the transformation from a national ground-based radar surveillance system to a more accurate, satellite-based surveillance system. This system is already being used in the Gulf of Mexico, which is improving the safety and accuracy of air traffic services in the Gulf. We will be building on the successes of our research and development, to improve capacity to the flying public. We will be developing more efficient routes through the airspaces, and improving aviation weather information. As always, as we launch these critical new applications, we will continue to keep our strong focus on safety. Under my budget request, our vision of a modernized air traffic control system is becoming a reality.

High Speed Rail

The budget also continues President Obama's vision to better connect communities with a new, high-speed rail network. The budget includes an additional $1 billion for High Speed Rail. This request builds on the historic $8 billion down payment provided through the Recovery Act, and continues the five year, $5 billion pledge made in the fiscal year 2010 budget. The $2.5 billion provided to the Department for high speed rail grants last year along with our recent announcements of the first awards of the High Speed Rail Program will put us one step closer to making High Speed Rail a reality.

This is an exciting time for the nation. Looking ahead, high-speed rail will one day provide the traveling public with a practical alternative to flying or driving, particularly in highly congested areas. With trains efficiently connecting city and business centers, travelers will enjoy a new level of convenience not available in many parts of the country today.

Rail Transit Safety

The President's request also includes resources to address rail transit safety. While rail transit is safe, we must take substantive steps now to make it even safer for the future. We are all well aware that rail transit has the potential for catastrophic accidents resulting in multiple injuries, considerable property damage, and heightened public concern. Following the recent tragic accidents in Washington DC, Boston, and San Francisco, it is clear that we need to strengthen the safety oversight of transit rail operations. Our budget requests $30 million to establish a new transit safety oversight program within the Federal Transit Administration, which has never before been granted safety oversight authority. This program will implement a comprehensive safety oversight strategy, as proposed in the Administration's transit safety bill, to establish common safety standards nationwide and to ensure the safety of our nation's transit riders.

Investing in Transportation Infrastructure

As we continue to focus on improving transportation safety, we must also rethink the way we invest in our future transportation infrastructure. That is why the President's plan includes $4 billion to establish the new National Infrastructure Innovation and Finance Fund (Infrastructure Fund). This is the first year of a 5-year plan to capitalize the fund with $25 billion. This Fund will invest in projects of regional or national significance, and marks an important departure from the Federal Government's traditional way of spending on infrastructure through mode-specific grants.

Instead, the Infrastructure Fund will directly provide resources for projects through grants or loans, or a blend of both, enabling us to effectively leverage non-federal resources, including private capital. The projects funded under the Infrastructure Fund will be based on demonstrable merit and analytical measures of performance. Only the most worthwhile projects from around the nation will be selected. Projects eligible for funding from the Infrastructure Fund consist of multi-modal projects that include highway, transit, rail, aviation, ports and maritime components. This marks a bold new way of thinking about investments in our transportation infrastructure and will become a key component of the Administration's future surface transportation proposal.

The reauthorization of the Nation's surface transportation programs is complex and has critical long-range implications for the future. While the President and the Congress continue to work on a long-term strategy for surface transportation, the President's plan continues the current levels of spending: $42.1 billion is proposed for highways and bridges and $10.8 billion for transit. Within this funding, $1.8 billion is included for "New Starts" and "Small Starts", and $150 million to enable the Washington Metropolitan Area Transit Authority to focus on badly needed safety-related infrastructure improvements. Reauthorization is a challenging issue facing our nation and I look forward to working with the Congress to design a new Federal surface transportation program that leads to higher performing investments, increases transportation options, and promotes a sustainable environment.

Livability

The President's plan also provides a record investment to make our communities more livable. Our budget request allocates over $500 million toward investments that support the President's multi-agency Partnership for Sustainable Communities. We have joined with the Department of Housing and Urban Development and the Environmental Protection Agency to stimulate comprehensive regional and community planning efforts that integrate transportation, housing, energy and other critical investments. Together, we will help state and local governments make smarter investments in their transportation infrastructure, to better leverage that investment and advance sustainable development.

Recovery Act

February 17th marked the one-year anniversary of the Recovery Act and I am pleased to report that much has been accomplished to improve transportation infrastructure throughout the Nation. Overall, the Recovery Act provided $48.1 billion for transportation programs to be used for improvements to our Nation's highways and bridges, transit systems, airports, railways, and shipyards. To date we have obligated $35 billion on more than 12,500 projects nationwide. Nearly 20% of these funds have already been expended as projects get underway and move towards completion – creating jobs throughout the transportation sector.

In addition, Section 1512 of the legislation calls upon Recovery Act fund recipients to report on the number of jobs created on individual projects. We have now completed two rounds of recipient jobs reporting. Based on the numbers reported during each round, we are averaging about 41,000 direct full time equivalent jobs reported for transportation programs nationwide based on the recent October – December 2009 reporting period. I want to emphasize that the jobs estimates included in this report are only those directly associated with the individual transportation projects and do not include the many other jobs created as due to increased demand on supply chains and other supporting services. When these indirect jobs are also taken into account, it is clear that the Recovery Act resources have made a significant impact on jobs and we expect these numbers to hold steady as some of the larger transportation projects continue to come on-line.

Conclusion

Thank you for the opportunity to appear before you to present the President's FY 2011 budget proposal for the Department of Transportation and discuss some of the successes of the Recovery Act. This plan supports our Nation's key transportation priorities, and makes investments that will benefit all for years to come. I look forward to working with the Congress to ensure the success of our newest initiatives.

I will be happy to respond to your questions.

Chairman CONRAD. All right. We appreciate that very much and let us wade right——

Secretary LAHOOD. Can I just also indicate, Chris Bertram is our Budget Director at DOT. He is a very familiar face around here. We are grateful that he was willing to leave his position here in the Senate and come to work for us, and he has done a great job.

Chairman CONRAD. And very respected here, so we are delighted that he is here. Let me just begin, and we will go 7-minute rounds this morning, if that is all right with colleagues. We are going to be interrupted with a vote or two votes, I am told by Leadership, so we do have to be mindful of that. Let me go right to it, if I can.

First, with respect to stimulus, as I understand it, in the recovery package, of the $48 billion that was provided in the Recovery Act, 75 percent of that you have already obligated. Is that correct?

Secretary LAHOOD. Yes. We followed every guideline that you all set in the bill. We have met every deadline. There are a couple of deadlines coming up in early March on transit and highways, and we will meet those. We have gotten the money out the door in the States, and the transit systemsand airports have been very helpful in making sure—that this money has been spent correctly and on time.

Chairman CONRAD. And that this money, even though this was part of a recovery package outside the normal process, that these funds are being spent in a way that we can assure taxpayers these funds are being spent carefully and wisely. Is that the case?

Secretary LAHOOD. Absolutely. I know of no boondoggles, no earmarks, no sweetheart deals. All done by the book. The IG is looking at some of these, and ultimately there will be reports on this. I do not think anybody will ever be embarrassed by the way this money has been spent.

I was pleased to read today that the Congressional Budget Office has now said that over 2 million jobs were created as a result of the stimulus. Now, unfortunately, it was buried in USA Today. If the story had been reversed, I know it would have been on the front page. But, look, this is a nonpartisan group. Over 2 million jobs created. We should all be very proud of that.

Chairman CONRAD. Well, let me just say, I personally believe, it was that a perfect package? No. I mean, no work by 435 Members of the House and 100 Members of the Senate and a brand-new Administration is ever going to be perfect. But to me, it is very clear that the recovery package played a role in what is really a remarkable turnaround, both on the jobs front and in terms of economic growth.

Let me go to the question further. Of the $48 billion, as I understand, $35 billion has been obligated, $9 billion has actually been spent. Of those obligated funds, do you have a handle on how quickly those funds will actually be spent in the States? I assume much of that will now be spent in this coming year.

Secretary LAHOOD. It will be spent this year, and the way it works is we have to receive the proposals from the States.

Chairman CONRAD. Right.

Secretary LAHOOD. We check all the boxes to make sure. We obligate the money, and then they go out and get contractors to do the work. That will take place this year with the remainder of the money. The jobs bill that you all pass will be a great follow-on to our ability to continue to make progress on projects that States were not able to get funded or projects that were not quite ready. It will be a great transition.

Chairman CONRAD. Well, I think that is the case.

Let me go to a second issue, and that is the funding gap that I referenced. This chart shows what the receipts are of the Highway Trust Fund. Mr. Secretary, you are well familiar with this. And on the other hand, the red line, the dotted line, shows the forecast for the Highway Trust Fund outlays. And we have a gap there, a significant gap, in 2020 of $15 billion and in 2010 of $8 billion. And it is a gap that is growing. That is the point.

What is your strategy for dealing with that gap? When will the Adminstration come forward with a long-term reauthorization plan?

Secretary LaHood. Let me say that we are grateful to the Congress for passing a bill that will extend the current program through December 31st, and I hope the House will adopt that because that really goes to what we talked about last year, which was an 18-month extension. That gives us time to work with all of you in the Congress on the way forward.

Now, the President has said he does not want to raise gas taxes. In a very bad economy, that is not the thing that we should be doing to people who are out of work and can ill afford to buy a gallon of gasoline. We have talked about the infrastructure fund for which the President has included $4 billion in our budget request. An infrastructure fund, commonly referred to as an "infrastructure bank," if you like that term, creates a fund that can fund significant projects around the country, big projects that will have national significance. That is one way.

We know that in some parts of the country—probably not in your part of the world—tolling is a way to pay for additional capacity, and we need to look at that. You can raise a lot of money through the use of tolls. We have talked about the idea of public-private partnerships. Where roads are going to be built, there can be some private dollars utilized to help with part of that infrastructure. That is going on in certain parts of the country.

We know the Highway Trust Fund is insufficient. People are driving less. They are driving more fuel-efficient cars. Your chart shows it. We have a huge gap. There is no question about it. So we are going to work with Congress, try to find the way forward here on how to pay for all the things we want to do.

If you look at Chairman Oberstar's bill, it costs $450 billion, and it is a pretty good bill. It meets a lot of infrastructure needs in the country, but there is not $450 billion at this point to pay for it.

Chairman Conrad. Yes. Well, if I would have included on my chart the House proposal, we would see that, where I have $56 billion, it would be $82 billion.

Secretary LaHood. That is correct.

Chairman Conrad. So, look, the question that I have, the specific question is, when can we expect a plan from the Administration on a long-term reauthorization?

Secretary LaHood. I think soon after you all pass this extension. We are working on it now. We are working with OMB and the White House. I think we will have some very good principles for all of you to look at very soon after the extension.

Chairman Conrad. All right. That is very important. It is important to this Committee. More broadly, it is important to both the House and the Senate in terms of long-term plans, which we now have a commission working on.

Secretary LaHood. Yes.

Chairman Conrad. And it is going to be critically important to the deliberations of that commission as well.

Senator Whitehouse.

Senator Whitehouse. Thank you, Chairman Conrad, and welcome, Mr. Secretary.

Secretary LAHOOD. Thank you.

Senator WHITEHOUSE. I wanted to ask three questions. The first is about TIGER grants and that program, and before I ask you the question, let me thank you. Rhode Island could not be more delighted to have obtained $22 million for the Quonset project, which will help provide vital infrastructure and support for a growing clean energy industry and the potential for that to be a real hub for offshore energy.

Secretary LAHOOD. Well, thank you for your support, Senator. You and I met and we talked about some issues, and we appreciate your support.

Senator WHITEHOUSE. Well, it is very mutual. My question is this: You were able to fund $1.5 billion in TIGER grants.

Secretary LAHOOD. Yes.

Senator WHITEHOUSE. When you put them out to bid, you got $60 billion worth of applications.

Secretary LAHOOD. Yes.

Senator WHITEHOUSE. That leaves, assuming all the $1.5 billion goes out, about $58.5 billion of projects that States and municipalities and others brought forward and that we have not been able to fund.

In very broad strokes, how would you evaluate those $58.5 billion? How many of them, if the funding were available, are really worthy of going forward with now as opposed to just, you know, sort of a fluff project thrown in on a Hail Mary? I mean, how many of them—and what sort of a number should we be considering to take advantage of all that ready-to-go, shovel-ready work?

Secretary LAHOOD. I would say the majority of those. Unfortunately for us, these were very hard decisions. I would say the majority of the applications were very worthwhile projects, that if we had had $60 billion, the majority of those would have been funded. They were good projects. They really were. I know there is a lot of disappointment around this building and the building across the way. I have met with some about that, and we will try to be helpful.

We do have $600 million in our 2010 budget for TIGER, and we will be putting up guidance on the web. We know that some of these projects will come back to us, and we encourage that. $600 million is real money, but it is not nearly enough to meet all the needs.

Senator WHITEHOUSE. Yes. I have a more general point that I would like to ask your opinion on. We face twin problems: a dire need for jobs, particularly in my home State of Rhode Island but across the country, and a fiscal problem that is looming toward us. Those are in opposition. The spending and borrowing now to support the jobs adds to the fiscal problem later.

It strikes me that there is something of a sweet spot in the middle of that where we are dealing with infrastructure that is sooner or later going to have to be repaired anyway. We have a Providence viaduct that is so decrepit that they have stopped committing—I think both State and Federal have stopped committing maintenance funds to it because it really needs a rebuild. We have a bridge that is requiring people to drive all the way around an outer highway loop to avoid going over the Pawtucket River because of weight restrictions that prevents large trucks from going over. It is highway 95. It is pretty central.

Those things are going to be repaired sooner or later, and under the old Yankee principle that a stitch in time saves nine, we all know that very often maintenance projects are cheaper done early rather than when they are left to further erode and degrade.

Is that a philosophy that we should be following, that where we can identify transportation projects that are clearly going to need to be accomplished at some point, why not speed them up now? And is there not a good argument for those projects that they really do not contribute to the long-term fiscal liabilities of the Nation?

Secretary LAHOOD. Absolutely. There are many of those around the country, and we know for the last decade we have ignored our infrastructure needs. We have not put the resources into them, and that is why we have bridges falling down around the country. We have roads crumbling around the country. What you all did was very helpful in giving $48 billion to infrastructure. That money has been well spent, and a lot of people have gone to work in good-paying jobs around the country. But we still have many unmet needs.

Senator WHITEHOUSE. You have given me a great lead-in to my third question, which was about how we look at better capital budgeting, if you will, of our infrastructure needs. I really applaud what the President has done with the infrastructure fund. I think Chairman Dodd did a lot of work on that earlier. I think it is a great idea, very important, and it is a step in the direction, it is a mechanism for a form of capital budgeting.

But our budget does not really reflect in any way that I can find the infrastructure deficit that we have as a country of failed and failing roads, water, bridges, basic infrastructure. And, moreover, when we go to build a piece of infrastructure that is going to last 20, 40, 60 years, we expense it in the year that we spend it. The private sector would never do that. If you were a corporation and you did not disclose those kinds of capital liabilities, you would have lawsuits all over you. And if you had a major project that you were going to amortize over 20 or 40 years, you would not be forced to expense it in the same year.

Are there ways that you, within your existing authorities, can explore ways of trying to better budget in a way that matches private sector budgeting so that you are accounting for real infrastructure liabilities and able to expense over the life of a project?

Secretary LAHOOD. Well, what we did, in anticipation of you all passing another jobs bill, is develop a list, which I will be happy to provide to the Committee, of the most immediate and long-term infrastructure needs around the country. It is a long list and it is billions of dollars. That is our guidepost as we work with Congress on a new authorization bill. Here are the unmet needs and here is the wish list for States and others in transportation, and——

Senator WHITEHOUSE. My time has expired, so if I could ask you to take that last question for the record. If you would like to——

Secretary LAHOOD. OK.

Senator WHITEHOUSE [continuing]. Answer in greater detail, I would appreciate it, and I thank the Chairman.

The Federal budget process has established rules and procedures for accounting for infrastructure costs over the useful life of a project, generally recognizing the project's total costs at the beginning of a project. The Department of Transportation does not typically own the assets that we provide grant funding toward. The infrastructure constructed by the funding that DOT distributes to States for highway and tranist construction finances projects that are typically owned by the State or local transit authorities. The closet comparison that the Department has to match private sector budgeting is credt program budgeting under the Credit Reform Act of 1990, as amended (FCRA). The FCRA changed the budgetary measurement of cost for direct loans and loan guarantees from the amount of cash flowing into or out of the Treasury to the estimated long-term cost to the Government. Only the unreimbursed costs of making or guaranteeing new loans are included in the budget.

Chairman CONRAD. I thank the Senator. I thank him very much for sticking to the time, and I ask other Senators to try to stick closely to the time, as well, given the fact we have a vote scheduled at 9:55.

Senator Feingold?

Senator FEINGOLD. Thank you, Mr. Chairman, and I want to join with you in your words about Secretary LaHood. It does get my cheesehead a little irritated when I hear him talking about tolls, though, because I would like to have all the money I have paid out over the years coming down to Illinois through the tolls, but that is just a Wisconsin-Illinois thing and I am just giving you a hard time. But it is good to see you.

Secretary LAHOOD. Thank you.

Senator FEINGOLD. Let me start by talking a little bit about high-speed passenger rail. I was pleased that the Adminstration included a significant investment of $8 billion in passenger rail as a part of the American Recovery and Reinvestment Act and continues to followup that initial investment with a proposal for another $1 billion in the Fiscal Year 2011 budget.

Of course, I was particularly proud to support Wisconsin's successful $822 million application to the program that will extend passenger rail service from Milwaukee to Madison and link our State's two largest cities. Beyond the thousands of jobs that will be created directly, there should be numerous additional benefits from reduced congestion to reduced gasoline use and more desirable and livable communities.

Even before the first dollar has been spent, there is already speculation on what the next passenger rail project will be to link Western Wisconsin and the Twin Cities to Milwaukee and Madison, or even eventually heading north to Green Bay.

But before we get too far ahead of ourselves, I think it is important to take a little time to focus on the current project and how it can best fulfill its promise to create jobs, and that is, in my view, by ensuring that local small businesses can compete for contracts associated with this project. I have been hearing some concern about the potential for contracts to be so large or complicated that only huge national companies would be able to compete for the funding, so I would like to know, are there ways for the contracts for the large construction projects using this money to be structured, perhaps by breaking them up into smaller pieces, so that small businesses can participate? And if so, has the Department or

State Departments of Transportation been actively encouraging ways to put out contracts for bid that will get the broadest and greatest applications?

Secretary LAHOOD. Well, first of all, let me thank you for your support, Senator, on this initiative, and I also want to compliment your Governor. He has been right there, right from the beginning. I have had so many meetings with Governor Doyle on this, and he has been a real leader. Wisconsin is in the place it is in because of his leadership and also because of your leadership and I appreciate that.

We have grant agreements that we now have to negotiate with the States for the money that has been allocated, for example, to Wisconsin. I take your point on this. We want to make sure that those that want to get in the high-speed rail manufacturing business have an opportunity to do that. We will be working with Governor Doyle and his team at the Wisconsin Department of Transportation to be sure that small businesses have an opportunity. That can be done through these grant agreements that we will be negotiating.

Senator FEINGOLD. I am pleased to hear that and I would like to be informed of any details of this as it goes forward——

Secretary LAHOOD. You will be.

Senator FEINGOLD [continuing]. Because it is of vital interest to us and our State.

I am also pleased to see some of the proposed spending cuts in the budget, including a proposal to terminate the Rail Line Relocation Program. I also included this proposal in my Control Spending Now Act that I introduced last fall, which would cut—the overall bill would cut about half-a-trillion dollars over the next 10 years.

But if we are going to start getting our deficits under control, we have got to find some places where more cuts could be made. For example, President Bush in his Fiscal Year 2009 budget proposed to rescind $626 million in highway earmarks that were over a decade old and still had less than 10 percent of the funding utilized. I have expanded on this concept for another provision of the bill that I have introduced, so that all earmarks across all Federal agencies would be rescinded if 90 percent of the funding remained unobligated after a decade.

You can get back to me with the details, but can you tell me whether the $626 million in old highway earmarks still remains unspent and whether there are similar unwanted or low-priority projects in other transportation accounts? And just more generally, would you be supportive of my proposal?

Secretary LAHOOD. The answer is yes, we are supportive of your proposal, and we have identified significant—millions of dollars worth of earmarks. For the record, I will get you the specific number, but we support your idea, Senator.

The amendment offered by Senator Feingold would rescing Department of Transportation earmarks if less than 10 percent of the appropiated funding has been obligated within 10 years (unless the Secretary determines that an additional obligation of the earmark is likely to occur in the upcoming year). The total estimated amount of highway projects that would be rescinded per the Geingold Amendment is $563.5 million. Of this amount, approximatel $469 million are balances from projects authorized by TEA-21.

Senator FEINGOLD. Very good. And then similarly, during reauthorization, would you oppose the special no-year contract authority and obligation limitation that means that these earmarks never expire?

Secretary LAHOOD. Yes, sir.

Senator FEINGOLD. Thank you, Mr. Secretary. Continuing on the issue of earmarks, I am concerned that the funding for capital purchases of buses and bus facilities under the Section 5039 program is typically completely earmarked. While Wisconsin's transit agencies and State Department of Transportation work together to distribute funds from a Statewide bus capital earmark based on need, smaller transit systems across the country are losing out. These systems, of course, as you know, provide vital services to communities and they are too important to let Congressional seniority and committee assignments determine which projects receive funds.

During reauthorization of the highway bill, would you support creating a formula or competitive program to replace the current system, and if so, I would encourage you to talk to Wisconsin about how that is done.

Secretary LAHOOD. We will do that, and we will certainly look at your proposal. We set a good record with Tiger, thanks to the bill that you all passed for the $48 billion. There were no earmarks for our portion of the Economic Recovery. We did it on a competitive basis. We know we can do it. It is the best way to do things. It is the fairest way to do things, and we hope that working with all of you under authorization, we can find that path forward.

Senator FEINGOLD. Thank you for all your very responsive answers. Good to see you.

Chairman CONRAD. Boy, Senator Feingold is batting a thousand, as I count.

[Laughter.]

Chairman CONRAD. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman, and thank you for holding this hearing. It is good to see Secretary LaHood here. We love him when he comes to Oregon. He has been a great advocate for some of our state-of-the-art efforts in transportation.

Let me, if I might, Mr. Secretary, start with Build America Bonds. As you know, Build America Bonds are selling like hotcakes. Jurisdictions large and small have essentially said this is the way to turn around the deep freeze that we have been getting in the municipal finance market. We got the program started in the middle of last year. We estimated that you might see $4 or $5 billion worth of Build America Bonds issued. At the end of the year, it was $64 billion. It is projected to be about $130 to $150 billion this year, and I am very pleased that the Adminstration, and I know of very few instances like this, after a relatively short period of time has actually said this program ought to be made permanent. So I am very pleased with that and your help on this effort.

What I want to do is go over with you, just so we have it on the record, the issue with respect to Build America Bonds and job creation. Now, as we have seen with your general figures, the Department of Transportation estimates that each $1 billion of direct spending in the transportation area creates more than 30,000 jobs. So my question is, why would it be any different with bond funding? In other words, when you get $1 billion spent on bond funding, wouldn't that be also a tremendous shot in the arm in terms of job creation for our country?

Secretary LAHOOD. Well, Chris Bertram tells me that he thinks that you are right, you are spot-on on this, that it wouldn't be any different.

Senator WYDEN. I appreciate that, because what I like so much about what the Adminstration is trying to do on this transportation issue is to put more tools in the tool box. You know, I never ran around—and I am very appreciative of Senator Thune and Senator Collins, it has been a bipartisan effort—and say, oh my goodness, I just want everybody to use only Build America Bonds. What I wanted to do was to make sure, as I say, jurisdictions small and large would have more tools in their tool box, and I think we have been able to do that.

I am very grateful that the Adminstration is really using its bully pulpit. You all have been showing up at announcements and jurisdictions from New York City to all kinds of small jurisdictions in America, and I thank you for that.

Let me ask you one other point with respect to this new proposal from the Adminstration to make it permanent. Are there any other issues that you would like us to have on the record associated with making it permanent? What I like about that is it sends a message, again, of certainty and predictability, that there is strong support for that. Are there any other thoughts you would like us to know——

Secretary LAHOOD. On Build America Bonds?

Senator WYDEN. Yes.

Secretary LAHOOD. Well, not other than to say thank you for your leadership. This is a very innovative, creative way to improve infrastructure. It is as we said to the Chairman earlier, we have got to find creative, innovative ways to do all the things we want to do. There is none better than this, and you will continue to have our support. We will work with all of you on the way forward with authorization and make sure that whatever we can do to make this permanent, we will do it.

Senator WYDEN. Well, I am very appreciative. I have one other topic that I want to ask you about, and I probably ought to quit while I am ahead, and I thank you for your support on the effort.

The other issue I just wanted to touch on is an area that relates to environmental policy but has real implications for transportation, as well, and that is the lack of recycling at airports. As you know, an enormous amount of trash and things travelers have and things generated by airports is not recycled, and it has been known for years that the airports don't recycle most of their waste. There is evidence they could save something like $100,000 a year by doing so. Of course, if airports recycled as much as we are trying to get people to do at home, you would have a significant reduction in carbon emissions, as well.

I have been working with a broad coalition on this issue. I am going to be introducing legislation to create incentives to promote this. I have been working with the Association of Airport Executives, the Airport Council International, the flight attendants, and others. I just wanted to bring this up at the hearing and would just ask if you would be willing to commit this morning to just working with us on this issue and having your staff available so that as we go forward, we could make sure we had the expertise?

Secretary LAHOOD. Absolutely. We would be happy to come up and meet with your staff and find out how we can be helpful. I think it is a great idea.

Senator WYDEN. I am not surprised at that answer, either. I remember when we were serving together in the House of Representatives, all of us felt that you were one of the people who always was a problem solver, always wanted to try to find common ground, and wasn't long on a lot of flowery rhetoric but wanted to get results.

Secretary LAHOOD. We want to be helpful.

Senator can I just mention one other thing——

Senator WYDEN. Of course.

Secretary LAHOOD [continuing]. That I know is near and dear to your heart, and also to your colleagues from your home State. Streetcars are taking off all over America. What you all have done in Portland to really ignite the enthusiasm—you, Mr. Blumenauer, Mr. DeFazio, and others, but primarily the three of you—you should be thrilled. A lot of communities around America are getting into the streetcar business and many of them are going to be made right there in your home State. So I want to compliment you, Mr. Blumenauer and Mr. DeFazio, for the struggles that you have gone through over the years and for really hanging in there, because streetcars are coming back to America.

Senator WYDEN. I tell you, I think this country is falling in love with streetcars. If you talk to our folks at home, they are getting calls all over the country, all over the world. People have picked up on the fact that this is a chance to move people around in an efficient way. It is a chance to save energy. It is a winner from every perspective. So I thank you very much for that shout out for streetcars that are made in my hometown. You mentioned my House colleagues. We may have to form a Streetcar Caucus just to try to respond to all the inquiries of interest. It couldn't happen if we didn't have the support of the Adminstration and we thank you for it.

Secretary LAHOOD. Thank you.

Chairman CONRAD. Thank you, Senator Wyden, and Senator Wyden, thank you for your focused leadership on Build America Bonds. It has made a big difference. It is going to be part of this package, this jobs package.

You know, it is really hard to find something, I think, that works better than these Build America Bonds, conceptually, financially. People have skin in the game, so the money is spent responsibly. Senator Wyden, I think, deserves a shout out here, as well, from all of us for pressing this over a long period of time, and it is working and it is working beyond anybody's wildest imagination of how well it might work. We have actually tested it in the real world. This is one of those things that has actually worked and worked beyond what advocates claimed for it. So kudos to you.

I also want to recognize Brodi Fontenot, who is with the Secretary today. Brodi was the budget analyst for the Senate Budget Committee for transportation and veterans. Now he is a Deputy Assistant Secretary of Transportation for Management and Budget and we welcome him back to the Committee. He is somebody that has a great deal of credibility with the Committee. Brodi, if you would stand and be recognized, we are glad to have you back.

Secretary LAHOOD. Thank you for doing that, Senator. That is very nice.

Chairman CONRAD. Well, Brodi, as you know, is top notch. We are delighted when people leave here and move up because of their own good work, and we are delighted that you recognized it.

Secretary LAHOOD. You have trained him well.

Chairman CONRAD. He is tight with a buck.

[Laughter.]

Chairman CONRAD. If I can go to a question that I think is important that we get on the record before we end, and we are going to be better than our word to you, given the votes that are going to occur shortly, we won't ask you to wait while we go and vote and come back. We will just shut down the hearing.

Let me ask you this because I think it is important for us to know. What is your assessment of how big the backlog is with respect to high-priority transportation projects around the country? Have you put a number on what the backlog might be?

Secretary LAHOOD. Between $80 and $100 billion, and I will be happy to share the list with the Committee that we put together in anticipation of you all passing another jobs bill.

Chairman CONRAD. Between $80 and $100 billion. I tell you, I wish so much when we did the Recovery Package, those of us who believed it ought to be larger to accommodate this backlog, I wish we had been more successful in persuading our colleagues to have a bigger package, because you are talking about $80 to $100 billion, not just of requests that are out there, I assume, but the projects that have real merit.

Secretary LAHOOD. Absolutely. As I said to Senator Whitehouse for a decade, we have really ignored infrastructure. We just haven't put the resources into it. There are a lot of lousy bridges and roads that need to be constructed—these are good projects, they really are.

Chairman CONRAD. Yes, they are good projects, and not only do they create jobs, and jobs that are here in America-——

Secretary LAHOOD. Exactly.

Chairman CONRAD. I mean, you are building a road in the United States. Those are jobs that are going to be right here in this country.

Secretary LAHOOD. Right, and the spin-off in terms of the materials that are needed and all the things that go into building a road or a bridge are all American jobs.

Chairman CONRAD. And it helps improve the competitive position of the United States. I would say anybody who goes to any major city and at four o'clock in the afternoon goes to try to get home—you can see it here in Washington, D.C. You get out on that Beltway, it is a total crapshoot. I often think when I am driving, what is the economic cost to our economy of all the goods that are moving, all the businesses that depend on the ability to move freight being ground to a halt? What is the economic cost of that? What does that do to our competitive position?

Obviously, that involves not only roads and bridges, it involves our airports: it involves our rail systems. And what is happening with the Metro system here?

In my home State, we are a major energy producer for America. Most people don't think of North Dakota that way. They think of us as an agricultural State, which we are proud to be, in many areas the No. 1 agricultural State in America. But we are also a major energy State. We produce the electricity for nine States in North Dakota at our mine-mouth coal plants. We are now the fourth largest oil producer in the United States. I don't think many people would think of North Dakota as a major oil producer, but we are. We have the greatest wind energy potential of any State in the nation.

And these highways that are in the energy corridor with the major finds in the Bakken formation and now a new formation underneath the Bakken that also has tremendous reserves, we have got a two-lane road that is servicing that major energy corridor. I was just on that road a couple of months ago. It is unbelievable. It is like being on the beltway at four o'clock, big truck after big truck after big truck—hill, truck, curve. As my Grandfather used to say when we went through Wisconsin, hill, truck, curve.

[Laughter.]

Chairman CONRAD. That is what is happening in North Dakota in this major energy corridor, Highway 85. There is going to have to be serious money spent there so that the energy needs of the country can be met efficiently.

Let me go to one other matter before we go, and I know votes are ready to start momentarily on the Senate floor, and that goes back to the question of Tiger grants. You had $60 billion, as I understand, more than $60 billion of requests, is that correct?

Secretary LAHOOD. That is correct.

Chairman CONRAD. And you had $1.5 billion to meet the requests.

Secretary LAHOOD. That is correct.

Chairman CONRAD. Your analysis of that $60 billion was that most of those were projects of merit, is that correct?

Secretary LAHOOD. That is correct.

Chairman CONRAD. I am sure there were some that were not.

Secretary LAHOOD. That is correct.

Chairman CONRAD [continuing]. And that is the way the world works.

Secretary LAHOOD. The majority were meritorious.

Chairman CONRAD. The majority were meritorious.

Secretary LAHOOD. Yes.

Chairman CONRAD. That is a big—is that included in your $80 to $100 billion of backlog?

Secretary LAHOOD. I would have to check, but probably a few. Some of them were road and bridge projects that I am sure were in the $80 to $100 billion.

Chairman CONRAD. It would be very helpful for the Committee if you could look at those and look at the $80 to $100 billion of backlog and get us a number that takes out any duplication so that we have as good a sense as we can of what the total is.

Secretary LAHOOD. We will do it.

Chairman CONRAD. All right.

Secretary LAHOOD. Yes, sir.

Chairman CONRAD. I thank you very much for your testimony.

Secretary LAHOOD. Thank you.

Chairman CONRAD. I thank you for your service.

Secretary LAHOOD. Thank you.

Chairman CONRAD. I know these jobs are demanding, and you will note I didn't even ask you why North Dakota didn't get any Tiger grant money.

Secretary LAHOOD. Thank you.

[Laughter.]

Secretary LAHOOD. I will be happy to come up and brief you, though, Senator. I know——

Chairman CONRAD. Look, I——

Secretary LAHOOD. Look, you have been a strong supporter of infrastructure and transportation and I know you get it. Why don't we just make arrangements to come and brief you on—because there is $600 million available in the next round and we ought to look at that.

Chairman CONRAD. Well, we would like to talk, and look, we respect the circumstance that you face. You have got $1.5 billion and you have got $60 billion of requests, so——

Secretary LAHOOD. We will come up and brief you on it.

Chairman CONRAD. Let me also indicate that for the knowledge of colleagues, the staffs who are here, colleagues who might be listening, leadership has asked us to be ready in about the third week of March for a budget resolution. Now, we don't know if that timing will hold as we go forward, but that puts us on a very fast track because the Senate schedule this year is a little different than it has been in the past in terms of when the break comes. So that really puts all of us on alert, if you will, that for us to get our work done in a timely way, or at least be ready to go when leadership may ask us to go to the floor, we have got to get ready.

And so I am asking colleagues, if there are things that they want to make certain are in the resolution, if there are things that are of special concern to them, please get that in. I have asked on our side to get all of those things to the Committee by the end of the work day on Friday. I would say to my colleagues on the Republican side, if there are matters of significant concern to your members, if you would get that to us by the end of the work day on Friday, we will then be in as good a position as we can to go forward on the time that has been given to us.

Again, Mr. Secretary, thank you so much for your testimony here today, and again, thank you for your service.

Secretary LAHOOD. Thank you.

Chairman CONRAD. The committee will adjourn.

[Whereupon, at 9:56 a.m., the Committee was adjourned.]

QUESTIONS FOR THE RECORD

Senate Budget Committee

February 24, 2010 Hearing

Department of Transportation Fiscal Year 2011 Budget Submission

Follow-Up Questions for

Ray LaHood, Secretary

Department of Transportation

Senator Judd Gregg

QUESTION 1: Why did the Administration transmit a budget with a negative balance in the highway account, a negative balance in the mass transit account, and a negative balance in the Highway Trust Fund, but without a proposal to address these deficits?

ANSWER:

The purpose of the budget presentation is to accurately depict the condition of the HTF and recognize that, under current law, maintaining baseline spending will require support from the General Fund.

QUESTION 2: Last June, you submitted written testimony to the House Appropriations Committee that the Administration "[believed) very strongly that any Trust Fund fix must be paid for." Then in July, during the question and answer period of a hearing with the House Budget Committee, you said; "[We) have put forth a proposal to the leadership to extend the current highway bill for 18 months, which we believe would cost $20 billion. And we have told Congress that we would find the money and pay for it. So we are not for the idea of just taking money from the general fund and lopping it over into the Highway Trust Fund. We think we should pay for it. " Why did you not send a proposal to Congress for the $7 billion in offsets that you promised to find to pay for the transfer that was enacted last summer? Does the Administration still believe that General Fund transfers into the Highway Trust Fund should be paid for? If so, what are you doing to identify and propose an *offset* for the transfer you say is needed for the next year and a half? Why should we believe you this time when you did not follow through on your previous commitment?

ANSWER:

The Department is pleased that Congress has since passed an extension of surface transportation programs through December 2010 and repealed the provision prohibiting the crediting of interest to the Highway Trust Fund. The receipts from the interest provision will assist in ensuring the trust fund's solvency into next year and the extension will give Congress and the Administration more time to reach consensus on new, long-term legislation and a way to fund it.

<u>QUESTION 3</u>: *Question.* The FY 2011 Budget does not include a reauthorization proposal for surface transportation. Instead, you've testified, as recently February 3, 2010, before the House Appropriations Committee, that the Administration is working on some principles.

a. Given the permanent and chronic insolvency of the Highway Trust Fund, shouldn't one of those principles be to align highway spending with the revenue in the HTF?

b. Please provide a list of the Administration's principles for reauthorization.

<u>ANSWER</u>:

The Obama Administration believes that the surface transportation reauthorization bill must be transformative and is working toward that goal. We have initiated a series of listening sessions to get input from stakeholders and this continues. We have established five key priorities to guide our work--safety, livable communities, state of good repair, environmental sustainability, and economic competitiveness—and are working on the more detailed principles on how to advance the priorities.

<u>QUESTION 4</u>: Does the Administration believe that the highway program should be strictly a user-financed program? And will the Administration reauthorization proposal reflect this belief?

<u>ANSWER</u>:

Although the Administration has not yet developed a comprehensive funding strategy for the reauthorization of surface transportation programs, the Administration is committed to a sustainable financing solution and it is clear that user-financed resources will continue to play a central role. However, there are some instances where other funding sources can be appropriate. For example, the FY 2011 Budget proposes a National Infrastructure Innovation and Finance Fund (I-Fund) paid for with discretionary budget authority from the general fund. The I-Fund will forge a new path forward in infrastructure investing that applies a consistent and rigorous analysis to seek out high value projects nationwide that clearly forward strategic priorities. Many I-Fund investments will leverage scarce Federal resources by delivering support in the form of Federal credit. Federal loans and loan guarantees are typically repaid by means of revenue streams supported either through user fees or local taxes raised in the vicinity of the funded project thus reducing the ultimate burden on the Federal tax payer. The I-Fund would support investment in the full range of transportation modes—aviation, rail, highway, public transportation, ports, and maritime components through a variety of innovative financing structures.

Senator Debbie Stabenow

QUESTION 1: As you know, in Michigan we currently have a 14.6% unemployment rate, the highest in the country. We desperately need infrastructure jobs in the state. I appreciate the past efforts of the DOT and the recent grants we received under the High Speed Rail program and the TIGER grant program. These funds will be critical in our state's recovery.

The President's budget demonstrates a continuing commitment to jobs and infrastructure programs as a means to create and save jobs across the country.

What can Michigan do to show a commitment to transportation, transit, and high speed rail as we try to remain competitive for future funding opportunities at the DOT?

ANSWER:

In terms of high-speed and intercity passenger rail funding from the Federal Railroad Administration (FRA), it is important that States begin to undertake the detailed service development planning, environmental studies, engineering preparation, and stakeholder negotiations that are needed for implementing high-speed rail services.

Going forward, FRA will be working closely with interested States to help develop and refine their high-speed and intercity passenger rail proposals. FRA staff will collaborate with their counterparts in State transportation and rail offices to provide feedback and technical assistance throughout the project development lifecycle.

Additionally, States must be prepared to invest in their projects. Although the Recovery Act did not require a non-Federal match for high-speed and intercity passenger rail projects, the FY 2010 Consolidated Appropriations Act requires a minimum 20 percent non-Federal contribution. The costs inherent in developing a national network of high-speed rail corridors far exceed the Federal funding available today or in the near future.

QUESTION 2: We all have experienced delayed and cancelled flights, and the frustration that comes with them. In fact, delays cost the US economy $11 billion per year. The need to modernize our air traffic control system and reduce delays has never been greater. I am pleased to see that the budget includes additional funding for NextGen. Could you give us a sense of where the FAA is in the process of modernizing and how these additional funds will help jumpstart the effort?

ANSWER:

The FAA is on track to deliver our current NextGen commitments over the coming years. Recognizing NextGen is a portfolio of investments, it can be expected there will be incremental progress as the FAA implements NextGen solutions and capabilities throughout the near and mid-term. This new infrastructure and associated capabilities will provide a foundation for expanded capabilities and benefits that will be introduced over the long term. The FAA continues to conduct research with agency partners, such as NASA, to realize additional capabilities beyond the mid-term.

It is expected that a significant portion of the core objectives of NextGen (enhanced safety, increased system capacity and improved quality of service) will be met as planned through the implementation of relatively well-understood, advanced concepts, technologies, procedures, and policies. We estimate that by 2018, NextGen will reduce total flight delays by roughly 21 percent while providing $22 billion in cumulative benefits to the traveling public, operators and the FAA. In addition, 1.4 billion gallons of fuel will be saved, cutting carbon dioxide emissions by nearly 14 million tons.

The funding for FY 2011 will help the FAA accelerate some key NextGen activities. Most areas of NextGen acceleration support the FAA's response to the RTCA Task Force recommendations. These include:

- Capability to share data about location of traffic on the airport surface;
- Adopting improved standards and procedures and deploying automated tools to increase availability of converging and intersecting runways during poor weather conditions.
- Development of advanced satellite-enabled navigation procedures at major metro areas to maximize use of the limited airspace.
- Elements of the first segment of the digital data communications capability, which will provide the ability to deliver reroutes, routine clearances and revised departure clearances without the use of voice communications.

QUESTION 3: Do you agree that passing FAA reauthorization will help spur modernization and create jobs across the country?
ANSWER:
Yes. Reauthorization will enhance our ability to implement the NextGen plan to modernize our air traffic management and airspace infrastructure. Achieving the next level of capacity expansion, efficiency improvements, safety enhancements, and environmental performance from NextGen is essential for the U.S. aviation system. Lack of a multi-year authorization and the resulting funding and programming uncertainties hinders NextGen implementation and its resulting benefits.

QUESTION 4: I am encouraged that DOT is planning to hire truck safety personnel within Federal Motor Carrier Safety Administration. In fact, one of the key areas that I am interested in is heavy vehicle safety - together with my colleague Senator Voinovich, I introduced legislation that would provide a tax credit to facilitate the deployment of advanced safety systems for commercial vehicles (trucks) and motor coaches. By providing the fleets with tax incentives, designed to make such crash avoidance systems more affordable, this legislation would help to increase the voluntary use of advanced vehicle safety technologies in the domestic market and reduce injuries and fatalities on our nation's roads. This is also a jobs bill as it would help get more of these systems out into the market and boost value-added manufacturing.

Has the Department of Transportation considered the use of select "incentives" such as tax credits to help accelerate the deployment of advanced safety technologies on commercial motor vehicles and motor coaches in the United States and therefore reduce the human and economic costs associated with crashes? This type of an innovative approach seems even more critical these days in light of these tough economic times we are all facing. How is the Department seeking to encourage the voluntary adoption of advanced safety technology?

ANSWER:

During the last several years, the Federal Motor Carrier Safety Administration (FMCSA) has partnered with the trucking industry to test and evaluate several advanced safety technologies for commercial motor vehicles. To date, the deployment of these technologies has been growing, primarily among larger motor carriers. However, major obstacles to their widespread deployment by the entire commercial motor vehicle industry include concerns about the systems' costs and returns on investment, as well as the need for more objective quantitative information regarding their safety impacts, reliability and validity.

To that end, FMCSA has implemented strategies to overcome these obstacles through several projects assessing current use, as well as continuing to provide up-to-date information on the latest developments, functionality, costs, and benefits of these systems to the commercial motor vehicle industry. As part of this effort, the agency has completed analyses of the economic benefits, expected costs, and industry returns on investment for the following systems that were identified as having the greatest impact on reducing crashes:

- Stability control systems, which reduce crashes caused by excessive speed in curves, evasive maneuvers, and loss of vehicle control.
- Forward collision warning systems, which alert drivers when their vehicle approaches a slower moving vehicle or a stationary object.
- Lane departure warning systems, which warn drivers if they unintentionally deviate from their lane.

These analyses showed that on an annual basis, roll stability control systems were estimated to have the potential to reduce 1,000 to 2,000 rollovers and returned up to $9.36 per dollar invested; lane departure warning systems were estimated to have the potential to reduce 4,000 to 8,000 collisions and return up to $6.55 per dollar invested; and forward collision warning systems were estimated to have the potential to reduce 9,000 to 18,000 rear end crashes and return up to $7.22 per dollar invested. All three systems had payback periods of three years or less.

The agency has learned through focus groups and surveys that general industry awareness of these technologies is low, especially among smaller carriers. To that end, the agency is currently conducting research on how to best meet the informational needs of the industry and is coordinating with the National Highway Traffic Safety Administration on developing outlets to provide this information such as websites and brochures.

In the future, FMCSA plans to perform expanded testing and evaluations of next generation onboard safety systems that focus on integrating the features of current systems. Collision mitigation systems are one type of promising next generation system that integrates collision warning and adaptive cruise control with active braking. A major advantage of collision mitigation systems is that they are fully integrated with anti-lock braking and stability control systems to reduce the frequency and severity of more crashes.

Senator Ron Wyden

QUESTION 1: The DOT budget includes over $500 million for a livable communities program that would go to states and local governments to integrate land use planning and transportation. A lot of this kind of work has already been done in Oregon, with great economic benefit. Can you layout your plan for using the money under this proposal? Specifically, would you issue awards to cities and states that can immediately use this funding to implement transportation projects that reduce energy use and increase transportation options? Will the past successes of jurisdictions be considered a positive aspect when award grants? Or would this be a program to provide remedial support to those cities and states that are not up to speed on this kind of good work?

ANSWER:

DOT requested $527 million for livable community efforts for FY 2011. This funding will be divided into 3 programs: a Livable Communities Program within the Office of the Secretary (OST); transit funding to support livable communities in FTA; and a capacity-building grant program in FHWA. The purpose of these programs is to provide transportation planners the tools, resources, and capacity they need to ultimately develop a transportation system that provides transportation choices and complements land use, housing and water investments.

$20 million of the FY 2011 budget request is to establish a new Livable Communities program including a new Office of Livability within OST. This Office will provide leadership for DOT's livability efforts, coordinate livability programs across the Department's modal administrations, provide grants and technical assistance targeted at improving States, regions, and localities' ability to plan and execute transportation investments in support livability and sustainability goals, and assess the effectiveness of various programs in supporting livability. Additionally, the Office of Livable Communities will serve as the focal point for interagency efforts such as the Partnership for Sustainable Communities. This will include spearheading efforts such as developing metrics and performance measures for livability.

DOT's request of $307 million will refocus existing FTA programs to expand transit access for low-income families and increase the planning and project development capabilities of local communities. This program would provide effective transportation alternatives that increase access to jobs, health and social services and other activities. Aligning current programs such as the Job Access and Reverse Commute formula grants, Alternatives Analysis grants; and formula grants for State and metropolitan planning, would allow DOT to fund efforts with HUD and EPA to develop strategies that link quality public transportation with investments in smart development.

$200 million of the FY 2011 budget request will fund a competitive livability program within FHWA. The focus of this discretionary grant program is to increase capacity at all levels of government to integrate transportation, housing, economic development and water infrastructure planning and investments while enhancing natural resource conservation in urban and rural communities. The funds could be used to improve modeling and data collection, provide training, and support organizational changes to better carry out integrated planning. This assistance would be available to states, MPOs, local governments and tribal partners. This program would seek to invest in communities at various stages of capacity – from a sophisticated community that is trying to develop dynamic modeling to an area just starting out and may need to focus on updating data and staff training. This program will be designed to meet communities where they are, take them to the next level and learn from their efforts.

QUESTION 2: When does DOT plan on issuing the remaining FY2010 budget money for passenger rail? Can we anticipate that this money will be spent in the same way that the money in the stimulus package was spent? Is DOT open to funding new high speed rail projects that weren't included in the stimulus?

ANSWER:

The Federal Railroad Administration (FRA) intends to hold two separate solicitations for the High-Speed Intercity Passenger Rail (HSIPR) Program funding appropriated for FY 2010. FRA issued an application solicitation on April 1st for planning projects and remaining FY 2009 appropriations funding ($65 million). In June 2010, FRA plans to conduct a second solicitation for rail construction projects, both large-scale corridor development programs and smaller, discrete projects.

The HSIPR Program selections announced by President Obama on January 28th contained a mixture of project types: corridor programs (containing packages of projects) that develop segments or phases of high-speed and intercity passenger rail corridors; individual construction projects; projects that complete preliminary engineering and environmental studies; and project feasibility and planning studies. The FY 2010 Consolidated Appropriations Act stipulates that at least 85 percent of the $2.5 billion appropriated for the HSIPR Program be dedicated to corridor programs. The legislation also allocates $50 million of the total funding for planning activities.

Funding will be available on a competitive basis for all eligible projects and applicants, regardless of whether a project was submitted or selected to receive Recovery Act funding. FRA will continue to employ a merit-based application evaluation process to select projects for FY 2010 funding.

QUESTION 3: As you know, the TIGER grant program was hugely popular. I think part of the reason for this is that it allowed projects to compete based on performance and outcomes of the projects. Can you comment on the importance of using outcome-based criteria in funding transportation projects? Can I expect that DOT will continue to move towards this result-based model when making these funding decisions?

ANSWER:

The ability to dedicate a small portion of federal transportation resources to fund projects of national significance through a merit-based competition, based on performance and outcomes of the projects, is an important part of our overall approach to address our most critical transportation needs.

Every project selected through the TIGER discretionary grant and the National Infrastructure Investment (TIGER II) grant process, will require specific performance measurements, so we can track actual outcomes against the estimates provided in the submitted applications.

This will provide a wealth of knowledge that will eventually inform the Department's other surface transportation programs, as we work to better identify the highest-priority needs, and how to address them, through the Reauthorization process.

QUESTION 4: One of my major priorities is getting the Amtrak Pioneer Line restored. In order to get to that point, Amtrak needs to take a serious look at where they want to go and whether they truly want to be a national rail system, or if it just wants to serve the Eastern Corridor. Running a truly national system is going to require more rail cars and more rail infrastructure in general. Amtrak currently has plans to phase in new rail cars over a thirty year period. I'm not sure we can wait until 2040 to get a nationwide system up and running again.

With that in mind, do you share my commitment to immediately improving and expanding long-distance passenger rail? As a member of the Amtrak board, can you commit to increasing the purchase of long-distance rail cars in a fashion that will bring real benefits to the many small and rural communities that lie outside of the 11 designated high speed rail corridors sooner than 30 years from now?

ANSWER:

The Federal Railroad Administration (FRA) supports the development of a national rail network that benefits and serves both densely populated urban centers and communities that serve as regional centers in the Nation's rural areas. The development of such services is dependent upon State and Amtrak plans for intercity passenger rail, which are driven by a multitude of financial and policy considerations unique to each potential service.

As required by Section 224 of the Passenger Rail Investment and Improvement Act of 2008 (PRIIA), Amtrak issued The Pioneer Route Study Report on October 16, 2009. This report examined the feasibility of reinstating Amtrak's Pioneer route, and can be found at: http://www.amtrak.com/servlet/ContentServer?c=Page&pagename=am%2FLayout&cid= 1241245669222. The report concluded "the addition of the Pioneer and other long distance routes to the Amtrak national network could produce numerous public benefits, albeit at a significant cost."

Ultimately, Federal, State, and other stakeholders need to consider whether the significant capital and on-going operating subsidies necessary to reinstate the Pioneer route are an efficient use of taxpayer funds, relative to other potential rail investments.

QUESTION 5: Would you consider supporting a provision allowing transit agencies increased discretion on the use of transit assistance for operating costs particularly during these extraordinary times of economic crisis? If so, what level would you support - understanding that 10% is inadequate at this time?

ANSWER:

Secretary LaHood has stated that DOT will work with members of the House and Senate on the issue of allowing transit agencies more flexibility to use a portion of their federal funds to cover operating costs during these tough economic times.

QUESTION 6: Mr. Secretary, I want to commend you for the emphasis your budget has placed on sustainability and advancing the President's livable communities initiative. Through the Partnership for Sustainable communities, DoT plans to allocate $527 million to its Livable Communities Program that support greater transportation choices and integrate housing and land use in transportation planning decisions. Could you elaborate on the specific transportation programs funded through the Livable Communities Program?

ANSWER:

DOT requested $527 million for livable community efforts for FY 2011. This funding will be divided into 3 programs: a Livable Communities Program within the Office of the Secretary (OST); transit funding to support livable communities in FTA; and a capacity-building grant program in FHWA. The purpose of these programs is to provide transportation planners the tools, resources, and capacity they need to ultimately develop a transportation system that provides transportation choices and complements land use, housing and water investments.

$20 million of the FY 2011 budget request is to establish a new Livable Communities program including a new Office of Livability within OST. This Office will provide leadership for DOT's livability efforts, coordinate livability programs across the Department's modal administrations, provide grants and technical assistance for improving local public outreach, and assess the effectiveness of various programs in supporting livability. Additionally, the Office of Livable Communities will serve as the focal point for interagency efforts such as the Partnership for Sustainable Communities. This will include spearheading efforts such as developing metrics and performance measures for livability.

DOT's request of $307 million will refocus existing FTA programs to expand transit access for low-income families and increase the planning and project development capabilities of local communities. This program would provide effective transportation alternatives that increase access to jobs, health and social services and other activities. Aligning current programs such as the Job Access and Reverse Commute formula grants, Alternatives Analysis grants; and formula grants for State and metropolitan planning, would allow DOT to fund efforts with HUD and EPA to develop strategies that link quality public transportation with investments in smart development.

$200 million of the FY 2011 budget request will fund a competitive livability program within FHWA. The focus of this discretionary grant program is to increase capacity at all levels of government to integrate transportation, housing, economic development and water infrastructure planning and investments while enhancing natural resource conservation in urban and rural communities. The funds could be used to improve modeling and data collection, provide training, and support organizational changes to better carry out integrated planning. This assistance would be available to states, local governments, MPOs and tribal partners.

Senator Bill Nelson

QUESTION 1: We are very grateful in Florida to have been awarded one of the largest high speed rail grants for the first phase of our statewide system, which will go between Tampa and Orlando. As with many of the grant winners, Florida was awarded half of what it requested-so it will be able to get well underway with construction, but still has to find the rest of the money as well.

Since I know you want to see this project be successful just as much as we do, considering you are investing a great deal in it, how do you plan on awarding future high speed rail grants? Will you focus on the projects you have already chosen, or will it be a new competition every time?

ANSWER:

The Federal Railroad Administration (FRA) intends to hold two separate solicitations for the High-Speed Intercity Passenger Rail (HSIPR) Program funding appropriated for FY 2010. FRA issued an application solicitation on April 1st for planning projects and remaining FY 2009 appropriations funding ($65 million). In June 2010, FRA plans to issue a second solicitation for rail construction projects, both large-scale corridor development programs and smaller, discrete projects.

Funding will be available on a competitive basis for all eligible projects and applicants, regardless of whether a project was submitted or selected to receive Recovery Act funding. FRA will continue to employ a merit-based application evaluation process to select projects for FY 2010 funding. However, unlike the funding appropriated under the Recovery Act, applicants will be required to invest in their projects in order to be eligible to receive funds. Funding under the FY 2010 Consolidated Appropriations Act requires at least a 20 percent non-Federal share of the project financing.

Senator Benjamin Cardin

QUESTION 1: The service that the Washington Metropolitan Area Transit Authority (WMATA) provides to the area's thousands of federal employees makes the system vital to the function of the federal government. This month's blizzards demonstrated both:

1) how integral the Metro system is to the function of the federal government, so much so that OPM's decision to shut down the federal government was largely based

on Metro's inability to operate during the snow storms on above ground rail lines; and,

2) Metro's clear need for better resources, as the system is often hobbled by weather-related conditions that comparable transit systems manage to operate regular service through.

I applaud your request for $150 million and am hopeful that the federal government's investment in the system will form a base of consistent funding that WMATA needs. Would you give the committee a sense of the Administration's perspective on the service and function that Metro provides to the federal government?

ANSWER:

WMATA is critical to the mobility of the Washington area, just as the Metropolitan Transit Authority is to New York City and BART is to San Francisco. According to the Metropolitan Washington Counsel of Governments, WMATA's most recent data revealed 47% of all peak period riders are federal employees. Additionally, the Washington Post recently reported that about 20 percent of commuters in this area use some form of transit, and the Office of Personnel Management has estimated that about 120,000 employees from 80 federal agencies (out of 289,000 civilian federal workers in the region) receive transit benefits. WMATA is the primary system used by these commuters.

QUESTION 2: This week, the NTSB is holding hearings in conjunction with its ongoing investigation into the tragic accident that occurred on the Red Line on June 22nd of last year. Since then, Metro has experienced a number of accidents that have resulted in the on-duty deaths of its own employees, and many more service disruptions and delays. Metro's value to the region and the federal government is intrinsically linked to how well it functions in getting people to and from work safely.

How does DoT envision its funding request for Metro helping alleviate many of the maintenance, repair, and operational needs of the system that has led to the decline in Metro's safety?

ANSWER:

The Secretary LaHood will use his authority to approve grants under this program to ensure that available funds first address WMATA's most critical safety needs. Maintenance and repair needs are also addressed through formula grants funded from both the Urbanized Area and the Fixed Guideway Modernization programs. These grants are in addition to the $150 million.

QUESTION 3: Transit funding for existing systems and- helping expand transportation opportunities in new and growing communities are critical to efforts to increase the number of livable communities. The New Starts program makes multi-modal transportation systems possible. Your budget plans to put $1.8 billion towards the New Starts and Small Starts program. What is the split between the programs?

ANSWER:

Of the $1.822 billion requested, $1.56 billion is for 18 New Starts projects and $200 million is for 9 Small Starts projects. The remaining $62 million is reserved for yet-to-be identified projects and for oversight.

QUESTION 4: Last month you announced a policy shift about how the New Starts Program would be implemented to emphasize livability. What are the metric that you plan to use to carryout this plan and how will it affect the programs' budgets?

ANSWER:

As announced by Secretary LaHood on January 13, 2010, FTA will soon publish in the Federal Register for comment a rulemaking to better capture in its evaluation and rating process the wide range of benefits New Starts projects can provide, including a revised cost effectiveness measure. This Advanced Notice of Proposed Rulemaking (ANPRN) will invite feedback on what benefits should be included in the evaluation process and issues related to baseline alternatives, travel demand modeling, and New Starts and Small Starts streamlining. The New Starts and Small Starts projects funded in the FY 2011 budget were selected using the current project rating criteria. The earliest any revised rating criteria could be utilized would be for the FY 2013 budget.

QUESTION 5: Amtrak provides a unique service to the country that is often overlooked. While Amtrak ridership, particularly in the Northeast, remains high, the aging system continues to face operational challenges.

While I believe the $1.6 billion budget request that you are proposing is sound, I'd like to hear how these funds are to be directed and what type of priority is being given to Amtrak's maintenance and repairs needs.

ANSWER:

The President's budget specifies that the $1.6 billion be allocated as follows: $563 million in operating support and $1,052 million in support for capital investment and debt service. The capital and debt service funds are provided through a grant agreement between the FRA and Amtrak. That agreement is contingent on FRA's review of the projects proposed by Amtrak management (after its own corporate review and prioritization process) to be funded under the agreement.

QUESTION 6: The Maryland Transit Authority's operation of MARC service in partnership with Amtrak, between the Baltimore metropolitan area, including BWI Airport, and to the West to towns like Cumberland and Hagerstown, provides additional weekday transit service to federal employees who live outside the Washington DC Metropolitan Area. How does your budget support commuter rail systems like MARC?

ANSWER:

Commuter rail systems are eligible for grant assistance from FTA, predominantly provided through the formula-based Fixed Guideway Modernization Program and the Urbanized Area Formula Grants program.

The FY 2011 Budget requests $4.61 billion for the Urbanized Area Formula Grant Program. The program distributes funds to urbanized areas (UZAs) around the nation for capital investment in bus and rail systems including commuter rail.

The Fixed Guide way Modernization Program provides capital investment in existing fixed guideway systems, including commuter rail. For FY 2011, the Budget proposes merging the Fixed Guideway Modernization Program and the Bus and Bus Facilities Program into a new $2.853 billion Bus and Rail State of Good Repair Program. Commuter rail systems would continue to be eligible for assistance under this program, which is aimed at improving the condition and performance of existing assets.

For these formula programs, regional officials decide how to allocate FTA funds within their UZAs to local transit agencies. Because transit funding policies differ across UZAs, direct Federal support for commuter rail agencies varies from place to place.

QUESTION 7: Construction of High Speed rail across the country is as innovative and transformative as the President Eisenhower's vision for the interstate highway system, and it is truly America's next great infrastructure project. While I'm pleased with the $69 million Recovery Act grant Maryland received to advance High Speed Rail along the Northeast Corridor, it seems as though expectations for funding this project were much higher than were realized. DoT's budget allocates $1 billion for high speed rail.

How are jurisdictions evaluated for this funding and would the FRA consider revising its eligibility and application guidance so that jurisdictions better understand the needs of their application?

ANSWER:

The Federal Railroad Administration (FRA) received nearly $57 billion in high-speed and intercity passenger rail requests – far exceeding the initial $8 billion available under the Recovery Act. The vast majority of these requests were for projects that had potential for playing an important role in the Nation's future transportation network. However, due to the funding available and project concerns stemming from the relative lack of corridor and project planning at the State level, the Department was generally unable to fully fund applicant requests. To increase the likelihood of success in future application solicitations, it is important that States begin to undertake the detailed service development planning, environmental studies, engineering preparation, and stakeholder negotiations that are needed for implementing high-speed rail services.

The initial corridors and projects selected to receive funding represent strategic investments that will build new high-speed rail corridors, upgrade existing services, and lay the groundwork for future high-speed rail services. In order to reach these selection decisions, FRA employed a thorough, merit-based application review process based upon requirements contained in the Passenger Rail Investment and Improvement Act of 2008 (PRIIA) and the Recovery Act, as outlined in the High-Speed Intercity Passenger Rail

(HSIPR) Program Interim Guidance (available at: http://www.fra.dot.gov/downloads/RR Dev/fr_hsipr_guidance.pdf).

Applications were evaluated against selection criteria organized into three main categories:

- Public Return on Investment— assessing a project's transportation, economic recovery, and other public benefits (such as environmental quality and energy efficiency);
- Project Success Factors—assessing a project's management and implementation approach, as well as the sustainability of project benefits;
- Timeliness of Project Completion

While these three higher-level selection criteria will likely remain unchanged for FY 2010, the details and thresholds of the evaluation factors within these broader categories may be altered to reflect applicant and grantee feedback, as well as any programmatic input from Congress and the Administration. Likewise, applicant and project eligibility are mandated by Sections 301, 302, and 501 of PRIIA, and cannot be altered without legislative action.

Going forward, FRA will be working closely with interested States to help develop and refine their high-speed and intercity passenger rail proposals. FRA intends for this collaborative approach to improve transparency and the States' understanding of where their projects fall within the pipeline of potential Federal funding.

In addition to the HSIPR program, Amtrak received a Recovery Act grant of $1.3 billion. Of this amount, approximately half is being spent on NEC infrastructure needs.

QUESTION 8: America's rural and underserved communities have some of the hardest hit places by the current economic recession. In places like Appalachia, the economic challenges of these communities are compounded by poor and inadequate infrastructure. The Appalachian Development Highway System is a project aimed at solving the region's transportation challenges to attract economic opportunity to the region. DoT's budget makes no request for the ADHS citing that it is to be funded through the Federal aid highway program - which needs to be reauthorized.

I am concerned about the message DoT is sending about the importance of completing this project which is incredibly important to a region that needs the jobs this project brings to Appalachia.

Will DoT support funding to complete the ADHS?

ANSWER:

The Department of Transportation (DoT) and the Federal Highway Administration (FHWA) will continue to work closely with all States during the planning, programming, design and construction of ADHS projects selected for funding. We look forward to working collaboratively with Congress as well as State and local stakeholders to address the many complex challenges facing the nation's surface transportation programs.

DEPARTMENT OF DEFENSE FISCAL YEAR 2011 BUDGET REQUEST

THURSDAY, MARCH 4, 2010

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

The committee met, pursuant to notice, at 2 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Wyden, Nelson, Warner, and Grassley.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

Let me just say that we have just been alerted by leadership that there will be five votes commencing at 2:30. That poses very difficult circumstances for this hearing to be conducted in the usual form. So what I am proposing is that we waive opening statements on our side, that we go immediately to the opening statements of our witnesses and ask them to be as succinct as they can, and then we go directly to questions. If that is acceptable on both sides, that will be the way we proceed.

I want to welcome our witnesses today. I deeply appreciate the Deputy Secretary of Defense, William Lynn, and the Under Secretary and Comptroller of the Department of Defense, Robert Hale. As Deputy Secretary, Bill Lynn serves as the Chief Operating Officer of the Department, and as Under Secretary and Comptroller, Bob Hale serves as the Chief Financial Officer of the Department. This is the first appearance for both before the Senate Budget Committee and we want to welcome them and look forward to your testimony.

Please proceed.

STATEMENT OF WILLIAM J. LYNN, III, DEPUTY SECRETARY OF DEFENSE, U.S. DEPARTMENT OF DEFENSE; ACCOMPANIED BY ROBERT F. HALE, UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF DEFENSE

Mr. LYNN. Thank you very much, Mr. Chairman. You have a written statement, I think, in front of you. I would ask you to put that in the record. I will summarize briefly the main points of that and then we will go, as you suggested, to your questions.

The top-line request from the Department for fiscal year 2007 is $708 billion. That consists of $549 billion to fund the base Defense program and then another $159 billion to support overseas contingency operations. There is also a $33 billion request for a fiscal year 2010 supplemental to pay for the additional 30,000 troops deployed to Afghanistan.

The base budget represents about a 3.4 percent increase in nominal terms and a 1.8 percent increase after adjusting for inflation. Measured in terms of share of the economy or Gross Domestic Product, the Defense budget would be steady at about 4.7 percent this year.

The priorities reflected in the Defense budget reflect those of the Quadrennial Defense Review, which was just completed. There are three major priorities that I would summarize for you. Rebalancing Secretary Gates is trying to rebalance America's defense posture, emphasizing the capabilities needed to prevail in the current conflicts while still taking appropriate steps to modernize against future threats.

The second priority is reform. The reform agenda that Secretary Gates laid out in last year's budget, the fiscal year 2010 budget that we are now executing, laid out a reform agenda. An important part of that was to cancel or curtail programs that were either underperforming, were in niche areas with exotic technologies, or we had sufficient quantities of. Those included last year, importantly, the F–22.

This year, we have continued that approach of appropriate fiscal discipline and program discipline and we are proposing seven major systems be curtailed. The list of those are in my statement. I would highlight two, the C–17 and the Joint Strike Fighter. The C–17 is a fine airplane, but we already have 40 more than the Defense Department originally requested and we are above the number that has been laid out in the recently submitted Mobility Requirement Study, so we would curtail that program. And the Joint Strike Fighter Alternative Engine, we do not think the up-front costs, which are substantial, are justified by the prospective savings, so we would propose not to go forward with that program.

The third priority is resourcing. The President has made, I think, an important strategic decision, which is to give national security agencies, including the Department of Defense, real growth in this budget while holding domestic agencies flat. I think that represents a balancing of the important national security needs against fiscal austerity and he has tried to draw that balance appropriately.

Modest real growth in the defense budget itself is necessary for several reasons. Some of our costs, such as benefits, especially health care, are growing faster than inflation, and ultimately, the overall cost of sustaining the force grows faster than inflation. So in order to maintain the force levels we have, we need at least some level of moderate real growth given that making force cuts when we are in two major operations is really not an option, at least in the near term.

Mr. Chairman, in closing, we believe that the fiscal year 2011 budget represents the minimum funding needed to provide for the defense of the United States and its people. It gives us the tools to prevail in the wars we are in while making investments for the future. We would strongly urge Congress to support the full Defense request in its upcoming budget resolution and its subsequent funding allocations.

With that, Mr. Chairman, I would turn it to your questions.

[The prepared statement of Mr. Lynn follows:]

Statement

of

William J. Lynn, III
Deputy Secretary of Defense

before the

U.S. Senate

Budget Committee

March 4, 2010

For Official Use Only
Until Released by the Senate Budget Committee

Mr. Chairman, members of the committee, thank you for the opportunity to discuss the President's fiscal year 2011 budget request for the Department of Defense.

On behalf of our Servicemen and women—as well as DoD civilian employees—I would like to thank the committee for your support of the Department's vital missions. Our troops have shown incomparable bravery and compassion in their service in Afghanistan, Iraq, Haiti, and in many other countries around the world.

The budget request for fiscal year 2011 is, in the judgment of Secretary Gates and DoD's senior leadership, what is needed to sustain and rebalance our forces to address the national security threats we face today and anticipate in the future.

This budget continues the reform agenda established by President Obama and Secretary Gates in the FY10 budget. Building on the FY10 initiatives, the 2010 Quadrennial Defense Review (QDR) assessed the threats the U.S. faces in the coming years, established strategic priorities, and identified key areas for investment.

President's FY 2011 Budget Request

The President's topline budget for FY 2011 requests $708 billion for DoD. This amount includes $549 billion in discretionary budget authority to fund base defense programs, an increase of more than $18 billion over the $531 billion base budget enacted in FY 2010. The increase amounts to 3.4 percent, or 1.8 percent real growth after adjusting for inflation. The FY 2011 request includes an additional $159 billion to support overseas contingency operations, primarily in Afghanistan and Iraq.

It should be noted that, even with modest real growth, DoD outlays as a share of Gross Domestic Product (GDP) will remain flat at 4.7 percent in FY 2010 and FY 2011. Considering only the base budget, DoD consumes about 3.5 percent of GDP.

Growth in the DoD Budget Topline

As the President stated in his budget message to Congress, "Our future is dependent on maintaining American leadership abroad and ensuring our security at home." The President's budget request for DoD accordingly reflects the administration's commitment to modest, steady, and sustainable growth in defense spending.

In making his budget decisions, President Obama carefully balanced our national security needs with our economic needs, including the deficit. Even as the President imposes a spending freeze on domestic agencies, he has made a strategic choice to continue funding modest growth in the military and in other national security agencies. Real growth is projected at 1.8 percent this year and approximately 1.0 percent when averaged over FY 2010-15.

Modest real growth in the DoD base budget is necessary for several reasons. DoD has some costs that increase with inflation, such as pay and benefits. Other costs are growing faster than inflation. In particular, military health care expenses are likely to increase by as much as five-to-six percent per year over the next five years, reflecting the rise in overall U.S. health care costs and increasing use of the TRICARE program.

Because the total cost of sustaining the force is growing faster than inflation, DoD needs real growth simply to maintain present force levels. Sustaining our current size and capabilities is essential to prosecute current wars, meet U.S. commitments worldwide, and conduct unanticipated operations, including relief efforts for natural disasters. We cannot afford to make cuts in the size of our force or our operations while we are at war.

DOD must also enhance capabilities for which we have an identified need and prepare for new threats we may face in the future. Building the capacity of partner nations to support U.S. counter-terrorism operations has emerged as a crucial national security priority. The budget therefore includes higher funding under the Section 1206 Train and Equip authority. The budget also increases support to defend our computer networks against cyber attacks, enhance our space capabilities, and deploy advanced missile defense systems.

We urge Congress to support our full defense request in its upcoming budget resolution and in subsequent funding allocations by House and Senate Appropriations Committees. The bottom line is this: We need modest real budget growth to sustain and equip a military at war while also preparing for the future.

Themes and Programs in FY 2011 Budget Request

The base budget for FY 2011 request reflects three overarching institutional priorities.

First, it reaffirms and strengthens the nation's commitment to care for the all-volunteer force, which Secretary Gates has called our greatest strategic asset.

Specifically, the FY 2011 budget includes $138.5 billion for military pay and allowances, including a 1.4 percent pay raise; $2.2 billion for enduring programs to support wounded, ill, and injured Service Members; $50.7 billion for the Unified Medical Budget and the Military Health System that serves 9.5 million beneficiaries; $8.1 billion for military family support programs; and $18.7 billion to fund critical military construction and family housing requirements.

Second, the proposed base budget continues the rebalancing of America's defense posture by emphasizing capabilities needed to prevail in current conflicts, while still enhancing capabilities that may be needed in the future.

For the wars we are in, especially the conflict in Afghanistan, the budget provides for more rotary-wing aircraft; the addition of 1,500 new helicopter pilots per year by

2012; increased Intelligence, Surveillance, and Reconnaissance (ISR) support; enhanced Electronic Warfare platforms; and increased funding for Special Operations Forces.

The FY 2011 base budget also allocates $189 billion to conventional and strategic modernization, including:

- $10.7 billion for continued development of the F-35 Joint Strike Fighter and procurement of 42 aircraft;
- $864 million to support development of a new aerial refueling tanker;
- $25.1 billion for procurement of new ships, equipment, and research and development;
- $3.2 billion support the restructuring of the Army's Future Combat Systems;
- $9.9 billion for missile defense;
- Funds to strengthen U.S. capabilities in space and to stand up a new U.S. Cyber Command.

These advanced weapons and capabilities are essential to keep us ahead of our adversaries. We need weapons systems that give U.S. forces an overwhelming advantage in combat, which will both save lives and shorten conflicts

Third, the President's budget will continue the Department's commitment to reform the way DoD does business, especially in the area of acquisition.

To ensure that every defense dollar is spent wisely, the FY 2011 base budget will bolster the capability and size of our acquisition workforce. The eventual creation of 20,000 new positions in the federal acquisition workforce will enhance our ability to oversee programs and generate independent cost estimates, in compliance with Congressional legislation. We ask the Congress to support our in-sourcing initiative to hire new civilian workers in place of contractors, a move that will ultimately reduce costs and operational risks. Our goal is to serve as good stewards of taxpayer dollars as we provide the warfighter with world-class capability.

An important component of acquisition reform is having the discipline to curtail or end unneeded and troubled programs. In last year's budget, Secretary Gates recommended canceling or curtailing programs that, if taken to completion, would have cost the taxpayer $330 billion dollars. This year he has proposed cutting seven major systems, including:

- The Next Generation Cruiser CG(X)
- The Navy Intelligence Aircraft EP(X)
- The Third Generation Infrared Surveillance system (3GIRS)
- The Net Enabled Command and Control System
- The Defense Integrated Military Human Resources System (DIMHRS)
- The C-17
- An alternate engine for the Joint Strike Fighter.

The C-17 and the JSF alternate engine, as Secretary Gates has already discussed, are two systems in particular that we are opposed to funding further. Three department studies completed over the past five years each confirm the adequacy of our current strategic airlift capacity. The C-17 is an excellent plane. But we already have 194 C-17s and will have procured 223 when the currently authorized procurements are completed. This is in addition to 111 C-5s.

The second JSF engine is similarly a capability that careful review has found to be more costly than the benefits it would provide. We took a fresh look at this issue, considering the $2.9 billion of additional funding it would take to develop a second engine to take it to competition, the downstream complications of separate maintenance regimes, potential savings achieved through competition, and the development status of the original engine. Our bottom line is that pursuing a second engine would not serve the interests of the taxpayers, our military, our partner nations, or the integrity of the JSF program.

FY 2011 Costs for Overseas Contingency Operations

Besides the base budget, the FY 2011 budget request contains funds to support overseas contingency operations. As Secretary Gates has said repeatedly, DoD's highest priority is to provide troops in the field with everything they need to be successful.

We are asking for $159.3 billion to fund military operations in Afghanistan and Iraq in FY 2011. Included are funds for:

- Operations ($89.4 billion),
- Force Protection ($12 billion),
- IED Defeat ($3.3 billion),
- Afghan and Iraqi Security Forces ($13.6 billion),
- Coalition Support ($2.0 billion),
- Commander's Emergency Response Program ($1.3 billion), and
- Reconstitution or resetting of equipment ($21.3 billion).

The budget supports a responsible drawdown of U.S. forces in Iraq and transfer to Iraqi responsibility and control. The budget also supports the growth of forces in Afghanistan, including a supplemental request of $33.0 billion in FY 2010 to pay for the additional 30,000 troops that President Obama has ordered to be deployed.

Longer Term Prospects

As we conduct a responsible drawdown in Iraq and eventually leave Afghanistan, the Department's war-related costs will decline. Because we cannot accurately forecast wartime costs more than about one year in advance, DoD's long-term budget contains a placeholder of $50 billion per year for wartime spending from FY 2012 through FY 2015.

Long-term trends in the base budget depend largely on threats to U.S. security and the forces and equipment that must be maintained to counter those threats. If we must maintain current force levels, we can expect the base defense budget to require some continued real growth.

We will continue to search for ways to minimize this growth and to achieve efficiencies in all areas of the defense budget. Health care is one area in particular where the introduction of efficiencies may yield cost savings. If present trends continue, we can expect health care to consume 10 percent of DoD's budget by 2015. We have proposed some health care efficiencies in this budget. Our goal is to work with Congress to continue providing high-quality health care while slowing cost growth.

Closing

Mr. Chairman, in closing I want to thank you and the Committee for the opportunity to testify about the Department's topline budget. Your support of our troops and their families is deeply appreciated. We are confident that the choices and priorities contained in the FY 2011 budget request will provide for the defense of the United States and its people. We are committed to ensuring that our Armed Forces have the tools to prevail in the wars we are presently engaged in, while also making the investments necessary for the future.

Mr. Chairman, that concludes my opening statement. I welcome the Committee's questions.

Chairman CONRAD. Thank you. Thank you for being so succinct.

Of course, we have had a chance on this committee to already have a hearing on Defense and we have had a tremendous amount of material from your Department as well as our own independent analysis available to members of the committee. So I want people who are listening to understand there has been an enormous amount of work done trying to scrub these budgets to determine whether or not the taxpayers' money is being used wisely or not.

Let me get right to it, if I can. First of all, we thank you for your service. We very much appreciate people of your quality and character being willing to serve in public life, and I say that to both you, Mr. Lynn, and to you, Mr. Hale. You both come before us with stellar reputations and we certainly want to recognize that.

With that said, we have an extraordinarily serious problem facing the country. We understand our first obligation is to provide the resources to defend this nation, and we take that obligation seriously. This committee will provide the resources necessary to defend this country. So let there be no doubt about that.

But we also have an obligation to try to determine whether or not taxpayer dollars are being spent as efficiently and effectively as they can be. One of the great concerns that we have on this committee is whether or not procurement dollars are being well spent, whether or not O&M dollars are being well spent, and this committee, as we have expressed repeatedly, wants to see funding in Defense, whether it is for ongoing Defense operations or war operations, be transparent and be budgeted for.

So the first question I have goes to the request for $33 billion of supplemental 2010 funding. Every time we see a supplemental coming our way that wasn't previously budgeted for, that raises red flags, especially with a committee that has the jurisdiction that we do. I hope you understand and can respect that. So could you tell us, why is there a need for $33 billion of a supplemental over and beyond what was previously budgeted for for 2010?

Mr. LYNN. Yes, Mr. Chairman. We share your policy preference to have all the operating costs for the conflicts budgeted up front. Frankly, we attempted to do that when we submitted the fiscal year 2010 budget. The reason for the $33 billion supplemental is that the policy changed over the course of the year, and in particular, the President, after a detailed review of the policy in Afghanistan, decided to supplement the number of troops and add over 30,000 troops to the fight in Afghanistan. That required the additional funding. The funding that we had laid out did not anticipate that level—that increase in the troops as well as the forward operating bases, the logistics costs, the transportation costs, the training costs of bringing those troops in. And so there was a requirement for the supplemental.

Frankly, we are submitting the fiscal year 2011 operating budget in advance this year for the conflicts. We are hoping that that budget will not require a supplemental.

Chairman CONRAD. OK. Let me get right to it, if I can, because we are on 5-minute rounds and then we will go to Senator Grassley, and if we need additional rounds, we will certainly do that because we are going to have until about 2:45.

Senator Grassley, do you think we should go a little longer than 5-minute rounds? Should we go seven?

Senator GRASSLEY. I will be able to ask my questions, so I don't care whether it is seven or five.

Chairman CONRAD. OK. All right. We will start with five, and then if you need more time, we will do it.

Thirty-three billion—is it the testimony before this committee that that entire $33 billion is because of the 30,000 ramp-up of troops for Afghanistan?

Mr. LYNN. No. I think the bulk of it is, and that was, I think, the reason we went to a supplemental. But there are, I think, fuel costs, some of which would apply to Afghanistan, some of which would be broader, and I think there is some Iraqi training money, and I turn to Bob——

Mr. HALE. Iraq security forces money for $1 billion is not related to it. All the others are at least partially related. Mr. Lynn mentioned the funding for Iraq security forces. We also have some money in there for Army mobilization costs to mobilize the troops. So I would say $30 billion is related directly. Another couple are partially related. And the $1 billion of Iraq security forces is not related directly to Afghanistan.

Chairman CONRAD. All right. Let me say this to you, or ask you this. How confident are you that the $159 billion, as I heard your testimony, that is for the wars, that is separate and apart from the $549 billion for ongoing operations, how confident are you that the $159 billion that you are budgeting for 2011 will be adequate and sufficient and will preclude the necessity of a supplemental at this time next year?

Mr. LYNN. I would say we are moderately confident. I think we have budgeted relatively conservatively and we think we have a pretty good understanding of the situations in both Iraq and Afghanistan. So if that holds, if those situations hold as we had projected, we think that the numbers will be accurate. If the situation on the ground changes in either Iraq or Afghanistan, that will probably make a liar of me.

Chairman CONRAD. All right. Let me first say that you have done a much better job than we have seen being done in the past with respect to budgeting on the front end. It does concern us to have a supplemental floating through here for over $30 billion, and we hear your explanation.

Let me go to several other areas of cost increase that are of special interest to the committee. Operation and maintenance costs are up, are up as I read this request by more than 8.5 percent. That gives us concern in terms of what that means in future years. Can you give us any insight into that O&M increase of 8.5 percent and what it means for future budgets?

Mr. LYNN. I would say two things and then ask the Comptroller for a bit more detail. The first is we have tried to do more accurate budgeting in two ways. We have tried to include more of the operating costs in the base budget versus the budgets for the conflict. That shift has caused—this was money that in prior years would have been in the supplementals. We have now, because we think it is going to continue with or without the conflict, so we have tried to put it in the base budget so that the OCO or what you were calling the supplementals isn't subsidizing the base budget the way I think it was in the past.

The other, and this goes more to the out years, less to your first years, we have tried to account for the fact that there is—historically, over the last 50 years, almost without fail, there has been two to 3 percent real growth in the operating budgets. This is due to information technology costs, health care costs, a whole variety of cost increases. And so if you project lower than that, you tend to have to come back in the budget year and fix it, and that tends to come out of the investment account and disrupts your planning. So we have tried to project as accurately as we could the out-year operating costs and that has yet led to some increases.

Bob, I don't know whether you want to add anything.

Mr. HALE. Let me focus on three categories for why the increase between 2010 and 2011. It is about 8 percent. It is about $16 billion. It is substantial.

One is what Mr. Lynn mentioned, about $1.4 billion in there for, we call it, OCO to base in wartime into the enduring budget.

Chairman CONRAD. Let me say, I personally applaud you for doing that. I think Senator Gregg has been very clear about our concerns about this not being done in the past.

Mr. HALE. And you will see that in subsequent budgets as we are planning to move more.

The second piece is essentially fiscal year 2010 is understated for a couple of reasons. One is the fuel costs. We thought fuel would be considerably lower than it is turning out to be. So about $2 billion there that we are asking for in fiscal year 2010. That lowers the base in 2010 and we have fixed it in 2011.

And Congress cut about $1 billion out of the O&M budget in fiscal year 2010. We feel we need that back.

The third part, and it is about half of the growth, is a wide variety of operational changes. We have higher training costs associated, for example, with training more helicopter pilots so we can make full use of our forces. We have higher military intelligence costs associated with building the capability that we need in wartime and otherwise. There is some higher maintenance, depot maintenance costs, particularly in the Navy as they have encountered higher costs to repair ships.

O&M is the most diverse account in the budget, Mr. Chairman, and so there are dozens of reasons, and I don't known them all and I won't try to give them all, but if you would like more detail, we can get it to your staff or in the record.

Chairman CONRAD. I think that would be useful to the committee.

I will recognize Senator Grassley now for 7 minutes.

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

Secretary Lynn, in preparation for the debate over your nomination to be Deputy Secretary, we exchanged a number of letters on Department of Defense financial management issues. This correspondence pertained to what I consider misguided financial management policies that were pursued during your tenure as DOD Chief Financial Officer from November 1997 to January 2001. Many of my questions pertain to two payment policies known as pay-and-chase and straight pay. Neither of these policies complied with the law. They also addressed an arbitrary allocation scheme used by the Defense Financing and Accounting Service at Columbus Center for making progress payments on big contacts. This scheme is also called bucket billing. It has been declared illegal by both the Inspector General and by the Government Accountability Office.

In responding to my questions, you made a personal commitment to me to address and correct these problems. As I understand it, all three of these problems persist today. Pay-and-chase and straight pay have been morphed into the Direct Bill program and Power Track, which allowed huge sums of money to be paid out with essentially no supporting documentation other than pay vouchers. Many of the large Department of Defense contractors are approved for direct billing. These programs put the Department of Defense check-writing machine on autopilot.

The Department of Defense IG audits clearly indicate that these payment programs are what they call high-risk zones, ripe for fraud. I also understand that the bucket billing operation at Columbus is still operating at full steam. Your predecessor, Mr. John Hamre, assured me that he would fix that problem after he was confirmed as Deputy Secretary, but he didn't keep his word.

So, two questions. What are you doing to prevent fraud in the Direct Bill and Power Track programs, and second, what have you done to close down the bucket billing operation?

Mr. LYNN. Senator Grassley, I mean, I think the policies that you are referring to, the pay-and-chase and straight pay, I think we can both—those are policies that are no longer being pursued by the

Department. They are actually stopped either during or before my tenure before.

Where I think the overall policy that you are referring to, the overall rubric goes under the phrase "pre- validation." In other words, what you would like to see, and I think should see, is that we pre-validate that there is an obligation before we pay an invoice. I think that is the direction that you want the system to go.

We have been making steady progress on that. It is not at 100 percent at this point. It is at 99.5 percent. We do need to bring it to 100 percent. We are taking steps to do that. Maybe the most important overall step that we are taking is in the enterprise planning area, where we have set up a—you set up a system that is completely integrated. So the invoice, the receipt, and the obligation are all in a single integrated information, management information system so that the checking, the ability to check, is done inside one loop. That addresses that.

I am in the process through the DBMC, the Defense Business Management Steering Committee, to implement that and we are working on that as a long-term solution to the issues that you have suggested.

Senator GRASSLEY. Well, I would hope that at least not because Chuck Grassley says so, but because the IG at DOD says so, that these are very still high-risk areas, that you keep that in the back of your mind, because I think my judgment is you have a ways to go. I am not going to challenge you that you are making progress, but I don't think you are there yet, and I guess you said you weren't there yet. But this is something that needs continual ongoing attention on your part because this is where we waste so much of the taxpayers' money.

Question No. 2: In your letter of February 3, 2009, you gave me this assurance. Quote, "If confirmed as Secretary of Defense"—I should say, "Deputy Secretary of Defense, I will do my utmost to strengthen the Department's financial management and internal controls designed to prevent fraud." Just about every DOD IG audit—and when I say that, I have a staff person that goes over these audits, so I hope you know I give this attention—but just about every DOD IG audit finds that internal controls are weak or nonexistent and that it is, quote-unquote, "impossible" to audit contracts because supporting documentation is missing and there are no audit trails to follow.

These are red flags. They are indicators of fraud. You assured me that you would strengthen internal controls, but they remain weak or nonexistent, and that leaves DOD resources vulnerable to theft and fraud. Since becoming Deputy Secretary of Defense, what exactly have you done to strengthen internal controls?

Mr. LYNN. Senator, I have been working with Mr. Hale here to my left on the Financial Management Improvement Plan. Strengthening internal controls is part of that. Bringing the DOD audit standards up to snuff is part of that. The focus is that we have tried to focus our resources initially on the thing that is most important to the Department, which is keeping track of the resources that Congress provides the Department. So that means our initial focus is on the statement of budgetary resources, and so we have targeted our improvement plan in that direction.

I don't know, Bob, if you want to add.

Mr. HALE. I think the enterprise resource planning systems that Mr. Lynn mentioned before, which are being deployed right now in the Navy, the Army is beginning to deploy them, the Air Force is a little behind, and our two small agencies and we are moving ahead to the Defense agencies, will strengthen internal controls. These are systems that impose the controls. You can't make obligations without going through all of the steps required by the financial regulations. So as we get them in place, they will strengthen our internal controls.

I would put this in context, Senator Grassley. I think we have got 50,000 men and women around the world in Defense financial management who are making Defense financial management work in support of the national security mission. We do have the ability, and I think the IG would agree with this, and their review is several years old, to track the money that you appropriate and ensure that it is distributed to the accounts that Congress says should receive them in law, so-called funds distribution—appropriations received is the term that auditors use—and we are in the process as part of this Financial Improvement and Audit Readiness Plan of verifying that again, because I think it is particularly important, or should be, to the Congress to know that we are distributing these funds. If you put $100 billion in weapons to track combat vehicles, it will be in that account and it will be distributed, and with any restrictions you impose, and that is auditable or at least can be validated.

So I think we are getting the mission done. We need to do better, and there are two broad pieces, as Mr. Lynn has said, the Financial Improvement Audit Readiness effort and these enterprise resource planning systems.

Senator GRASSLEY. I hope I am here next year to continue this discussion. Thank you.

Chairman CONRAD. And can I just rivet the point, because Senator Grassley, who has been a long-time consistent voice on these issues is right. I think all of us know the financial systems and internal controls at DOD need improvement. You have acknowledged that. You have indicated you have begun a process to make improvements. We will be looking at what the IGs report in the future with respect to those improvements, and it is critically important.

I mean, we can't have a circumstance in which dollars, precious dollars that are being allocated for the nation's defense are wasted. And the only way we can determine whether or not that occurs is if we have auditable records, if we have a financial system that will allow us to check and ascertain whether or not the dollars have been used for the purposes intended and whether those dollars have been expended in a way that is efficient.

With that, I will recognize Senator Warner for—

Senator WARNER. Thank you, Mr. Chairman. And, Secretary Lynn and Under Secretary Hale, thank you very, very much for your service and for being here.

Let me say at the outset that I am going to raise an issue where my friend and colleague Senator Nelson and I have a difference, I think a legitimate difference, in opinion, but it is one that I want to try to bring my background in business and as a Governor where we actually had to balance our budgets on a regular basis and make ends meet. I have raises a series of questions for you gentlemen, perhaps Secretary Lynn first off, where I need a much fuller understanding to get to the point of accepting the decision that the QDR made.

The issue I am raising, of course, is the porting of our carrier fleet on the east cost, currently homeported at Norfolk, Virginia, and the question that has been raised by the QDR that has said the need to create a new homeporting facility in Mayport, Florida. And I understand Senator Nelson has pointed out repeatedly and accurately the long history that Mayport has played serving the non-nuclear components of our carrier fleet, and it is a wonderful community and wonderful facility.

The QDR said there was a need, and I believe the quote was, "to mitigate risk of terrorist attack, accident, or natural disaster" to create this requirement to have some back-up or secondary facility. There was no analysis done that I have seen in any of the documents on whether the locations were given equal balance since clearly, in terms of natural disasters, in terms of hurricanes, there is a grave, actually higher incidence of possibility in Florida than in Virginia, and there were enormous amounts of recent expenditures made to upgrade the security facilities in Norfolk.

So for my first question, I want to go through all of these, I would like to get an analysis done of was there an estimate—was one of those priorities higher than the other? Natural disaster? Terrorist attack? Accident? What was the ranking of those risks in terms of prioritization in of making this assessment, No. 1.

No. 2, Under Secretary Flournoy, when she met with the members of the Virginia delegation, said that the Department went through this analysis and thought about the kind of back-up that was needed to protect the security needs of our country. And let me make clear that I absolutely believe that the security needs of our country trump every other item, and I say that at the outset. But Under Secretary Flournoy said that the Department reached the conclusion in effect, two choices. And what was key in at least her description was that they were two valid choices, each that met the defense needs of our country. One choice was homeporting a carrier at Mayport permanently. The second choice was to continue the dredging efforts that I know Senator Nelson has supported and upgrading the pier and having that facility simply as a back-up in the event of disaster, attack, or accident in Norfolk.

So the term was that this was, in effect, an insurance policy by making the substantially greater investments in Mayport. We have got a variety of numbers, but I believe the most recent number we have received from the Department is that insurance policy is at a cost of $671 million.

My second question is: When we have got two valid choices both meeting by the Department's acknowledgment the security needs of our country—so this is not a question any longer of security; it is a question of how much additional insurance we may need or additional back-up to have, but not a security question, at a $671 million cost, where will that fall in terms of a prioritization when you have already got a $36 billion backlog in shore infrastructure needs that the Navy has documented? Will that trump that $36 billion in infrastructure backlog needs? Does it go at the front of the line, the back of the line, or the middle of the line? And I think this is really important for us as we weigh this financial decision that we are going to be asked to make. That is, I think, my third question.

My fourth question is the one where I hope that I and others will continue to try to make the strong case. We think you have grossly underestimated the costs of this so-called insurance policy. I think we will show in coming weeks and months that these costs will be well in excess of $1 billion, especially when you build in the infrastructure needs for the basing of the crew and their support staff, look at the needs for creating the appropriate—when you have got a nuclear carrier there homeported—evacuation needs for the road structure, do the additional buildup that the Navy has committed and already successfully implemented in Norfolk to buildup against the possibility of terrorist attacks.

And my last question, and the one that ultimately is the most important question that I personally need to get an answer for is: Even if you could ever get to the argument that this is a worthy investment, you are going to convince me that you are going to bump these other criteria, bump this other $36 billion backlog to move it somewhere on that list, at what price does this insurance become—since we have agreed there are two valid choices that meet security needs, homeporting or simply upgrading the facilities in Mayport as a back-up facility, if this ends being a $1 billion—if we can legitimately show this is a $900 million price tag, a $1 billion price tag, $1.2 billion price tag, is there any dollar amount that this insurance policy does not become a valid choice and an appropriate choice for the Defense Department to make if we start again with the premise that the Department has already acknowledged that either option, homeporting or simply upgrading the facility as a back-up facility, both meet the security needs of the country?

Mr. LYNN. OK, let me try and tackle those questions. Let me step back, though. When we came into office, there was a Navy recommendation to go forward with the homeporting at Mayport, to do the full facility. We thought that was a—it was a strategic decision. It is under the rubric "strategic dispersal of carriers." We thought that was an important decision, and we thought it ought to be made within the Quadrennial Defense Review. So we essentially stepped back——

Senator WARNER. Excuse me a second. I know my time is almost expired, and Senator Nelson is going to want equal rebuttal time here, but——

Mr. LYNN. Well, we will stay as long as you need.

Senator WARNER. Just one comment. Secretary John Warner, who held this position for a long time prior to me, who has got exponentially greater knowledge of the Navy and the DOD than I will ever have, former Secretary of the Navy, said that that decision that appeared in the waning days of the prior administration without any kind of preliminary work, kind of appeared whole cloth, and I appreciate you and Secretary Gates and others saying this needed to be in the QDR, but to somehow say that that prior decision point popped up at the end of the last administration, he claimed that it smelled of politics. I do not know, but I appreciate the fact that it got put into the QDR, and now that we can make this analysis on both the defense needs and the very legitimate extensive needs of the Navy's capital requirements.

Mr. LYNN. I think we are agreed that is the right context. It was not popular at the time to do that, but that is what we did. And that goes to your two decisions. We did make a subsidiary decision, though, in that, and it was clear—however you came out on building the facility in Mayport or not, it was absolutely clear that we needed to dredge the harbor and to make at least an emergency port available in Mayport. And we went forward with that in the immediate timeframe, and we took a longer term to look at the much larger expense, frankly, of doing Mayport.

So when you are saying there were two choices, I mean, it was sort of a stepped-up—there was one clear choice, which was do the—and immediate choice, which was to do the dredging and the emergency availability of Mayport for a carrier. And then there was a second longer-term decision, which was to evaluate should we put the funding in to put the nuclear facility.

After doing——

Senator WARNER. Can I again just clarify one point here? Because this is really very, very important—how this plays out. My understanding has been that the Department has said that for the security needs of the Nation—both of these choices, permanent homeporting or an emergency back-up, both of those choices met the security needs of the Nation. And then there was a question of whether you—

Mr. LYNN. Well, that is not actually the way I would phrase it. I would say that the threshold decision, which was the more modest financial commitment to have the emergency, was a decision we could take immediately. The more expensive decision and the longer term of whether to put a nuclear facility in was a decision that we wanted to put into the Quadrennial Review. It was really a strategic decision, a decision of strategic dispersal. On that decision, we came to the conclusion that although it did—I think it will cost what you say, the $671 million. That was an increase from a prior estimate. We do think it will cost that. But despite that cost, we should pay that cost in order to continue the policy that has been longstanding of having two carrier ports on each coast. That is what we have on the west coast right now. It is what we have had on the east coast, but we were able to do it without a nuclear facility because it was a conventional carrier.

So the decision that came up when the conventional carrier, the John Kennedy, retired, you had to make a decision, OK, do we invest in a nuclear facility at Mayport to keep the strategic dispersal or do we not? After looking at it in the QDR, we came to the conclusion that, yes, that is worth the investment.

Now, you asked where does this rank kind of in other investments, and we pushed the Navy on that because there are other bills in the Navy, and the Navy does not—you know, no service has everything they want. That is just the way life is. So we asked them: Is this really something that is within—that you are willing to displace other requirements for? We sent them back. They came back and said yes. And the rationale—you were trying say priority.

The rationale went a little bit different. You asked for a ranking of, you know, I guess, hurricanes versus terrorist assaults. It was the accumulation of all of them that caused us to think that there is a risk. We did not rank them, but we think there is a risk there. And I think the term "insurance" is not a bad one, that we wanted to buy some insurance. One way of looking at the premium is the investment in the carrier force is well over $100 billion. So this is a 1-percent or so insurance premium that you are going to pay.

You also asked the question kind of what would be too much. Of course, you know, going to the extreme, if it cost us $100 billion, we would not do that. Now, you want to where in between $671 million and $100 billion, and I cannot give you a precise number except to say that is the equation. How much insurance do you want to use to protect this large investment? We concluded that $671 million was a reasonable insurance premium to pay for that investment, and that was essentially what we did in the year intervening between when we came in and when we issued the QDR.

Senator WARNER. My time has expired.

Mr. LYNN. I am staying as long as you need.

Chairman CONRAD. Senator Nelson.

Senator NELSON. If the Senator wouldn't mind staying, I had deferred to the Senator instead of taking the time first because I was not going to bring this up. We have been through this process laboriously now for the 10 years that I have been Senator, and painfully, over the course of the last year of the Secretary's tenure, he has accurately characterized that he made the decision as he did with regard to dredging, the long lead items, the dredging and the pier at Mayport, and then the issue was deferred to the United States Navy, and the Defense Department, of course, signing off, and this went all the way to Secretary Gates with regard to the homeporting issue.

Mr. Secretary, is it true that up until the retirement of the John F. Kennedy that there were always two homeports of the Atlantic fleet carriers on the east coast?

Mr. LYNN. Yes, sir.

Senator NELSON. Is it true that up until the late 1980's, Mayport was the homeport for two aircraft carriers?

Mr. LYNN. I believe so.

Senator NELSON. Is it true that not two but three homeports are located on the Pacific Coast?

Mr. LYNN. Yes, two in close proximity, but that is correct.

Senator NELSON. And is it true that the lessons of Pearl Harbor and the dismissal of Admiral Kimmel and the stripping of his two stars from his four stars and forced retirement as a result of the lessons of Pearl Harbor is still a lesson that is taught in the United States Navy?

Mr. LYNN. I am sure the Navy well remembers Pearl Harbor and tries to learn its lessons. I would not put that as the principal reason here, though. I think we were looking more prospectively at the risks that we thought might face us as we go forward, and as I think Senator Warner correctly characterizes, this is an insurance premium that we want to pay. And it was more in that framework that we looked at it.

Senator NELSON. Thank you.

Now, with regard to that insurance premium and your commentary, are you aware when this issue was raised, first by the other Florida Senator—and I did not raise it first—in front of the Armed Services Committee, responded to by Senator Webb of Virginia, and then furthermore raised by me to the CNO, Admiral Roughead, and the Secretary of the Navy just recently in a hearing in front of the Senate Armed Services Committee, that Admiral Roughead testified to the fact that the cost of making Mayport nuclear capable was approximately $500 million instead of the amount that you have stated?

Mr. LYNN. 500 instead of 671?

Senator NELSON. Instead of the 671.

Mr. LYNN. I guess I would have to look into that. I may be counting the costs of the dredging, and I do not know what you are——

Senator NELSON. OK. And, specifically, I asked that question about the cost of the dredging and the amounts of work being done to one of the piers, which is roughly about $70 million, which is already in this current funding bill of which you all, the Navy and DOD, had requested.

So I asked Admiral Roughead, does that mean, then, since $70 million is being done right now in the dredging down to 55 feet, a mile and a half out into the Atlantic, in order to get to the mouth of Mayport, is that cost then a cost that is part of the $500 million, therefore, the balance that is due is somewhat between $430 million and——

Mr. HALE. Senator Nelson, I think the $500 million, which I believe includes the $70 million, is military construction. There are some other costs. There would be PCS costs. There would be some infrastructure costs. So I believe the $670 million is a better total figure. And I will go back and get that for the record.

Senator NELSON. All right. Well, let us get clarification because I am just repeating what Admiral Roughead testified to.

Mr. HALE. I think he may have been referring only to the milcon costs, but we will double-check.

Mr. LYNN. We will get the record of that hearing, and we will get back to both Senators with our understanding.

Senator NELSON. OK.

Senator NELSON. You know, at some point we have to have a decision and move on, and I understand Senator Warner—he is a great, distinguished Senator. He is my personal friend. And I do not like the fact that we have to keep bringing this up, and I certainly am not going to look forward to a fight in the Budget Committee, the Senate Armed Services Committee, and the Appropriations Committee on a decision that the Navy and Secretary Gates have made that is essential to the national defense and national security of the country.

I would just point out this in closing: In February of 2005, the CNO, Admiral Vernon Clark, said that the Navy should have two carrier-capable ports on each coast, and this is testimony in front of the Senate Armed Services Committee. In March of 2006, the Deputy Secretary of Defense and the former Secretary of the Navy Gordon England stated that a nuclear carrier should be in Florida to achieve dispersion. In March of 2006, the Vice Chairman of the Joint Chiefs of Staff, Admiral Giambastiani shared that we should disperse our carriers on the east coast. And I will never forget his riveting testimony that he saw, one holiday, five carriers all tied up next to each other of which we have shown pictures of that several times as clearly an indication that that is not in the interest of national security.

In July of 2007, the Chairman of the Joint Chiefs, Admiral Mullen, stated, “I am on the record more than once for this, very supportive of strategic dispersal of our carriers.”

In December of 2008, Secretary Gates wrote, “Having a single CVN homeport has not been considered acceptable on the west coast and should not be considered acceptable on the east coast.”

And in January of 2009, the Navy issued the record of decision to establish a naval station at Mayport as a CVN homeport.

And then, in the QDR that you have indicated, in 2010, it is complete, and the Defense Department has validated the Navy’s position, stating, “To mitigate the risk of a terrorist attack, accident, or natural disaster, the U.S. Navy will homeport an East Coast carrier in Mayport, Florida.”

So, Mr. Chairman, I just want the record—I know our colleague from Oregon has come, and we have a vote. I am not going to take the additional time that my colleague took. I wanted that read into the record. I wish, since the Defense Department has made their decision, that we could let it be. But if it needs to keep being brought up, I am compelled to bring up the long, lengthy, and detailed record that has been established.

Thank you.

Chairman CONRAD. I thank the Senator, and we will go to Senator Wyden for 7 minutes.

Let me just indicate to colleagues the vote has begun. There is about 11–1/2 minutes left on the vote. I will recognize Senator Wyden for 7 minutes.

Senator WYDEN. Thank you very much, Mr. Chairman, and I will try to be shorter than that.

Secretary Lynn, I think you are aware of the problems being encountered by the Shepherds Flat Wind Energy Project in our home State. The project would be an enormous boost to eastern Oregon, providing thousands of jobs and a huge source of clean energy in our State. Unfortunately, the project is threatened by a conflict with Defense Department radar systems in the area.

My concern is—and, obviously, I care greatly about my constituents who are finding this is a very immediate problem. But, generally, I continue to be concerned—I serve on the Energy Committee as well—about the Department’s apparent inability to adequately address its concerns with wind turbine replacement in an efficient fashion.

As we see more of these wind farm projects established, we are seeing almost a trend where the services raise objections at the 11th hour. This costs local companies millions, and obviously, what we want is we want a system that promotes sensible renewable energy development and addresses our very obvious national security needs.

So my question, Secretary Lynn, is: What steps has the Department taken to effectively and efficiently address these issues with respect to renewable energy projects in a fashion that is consistent with national security? Secretary Lynn.

Mr. LYNN. Senator, I am afraid I am not familiar with the Shepherds Flat issue, so I am going to have to take that for the record and come back to you.

Senator WYDEN. All right.

Senator WYDEN. Has the Department established an office or designated a point person who can deal with this? Because, obviously, my constituents care greatly about this, but we are not going to be the only one. We are looking at this being a centerpiece of the President's economic development strategy. It is obviously important to help us break our dependence on foreign oil. Is there somebody who has been designated, or an office, to ensure that we coordinate this effort in a fashion that is efficient?

Mr. LYNN. Well, actually, you did, sir. The Congress created a confirmed position for operational energy matters. We have submitted a nomination for this position. She is before the Senate, and she would be underneath the Under Secretary for Acquisition Technology and Logistics, and the responsibilities of that office would be, I think, exactly along the lines that you are talking about.

Senator WYDEN. And who is doing it until that gets put in place? I think that would really be the question. And I think your point is a valid one, and I think we want to know who do you go to until that is up and running.

Mr. LYNN. We have starting to stand that office up in anticipation of getting the individual to lead it, but there is also an Office of Installations and Environment within the Under Secretary of Acquisition, and they are in a supporting role until we are fully staffed in the operational energy——

Senator WYDEN. If you could get me, Secretary Lynn, a name and a phone number, that is what I think my constituents want to know: Who are we going to go to now in order to try to address this? Because this is our biggest effort. It is going to cost a lot of money, and this is an 11th-hour objection. In other words, everybody has been working very constructively together, and obviously you are not aware of it today, so I have got to go back and try to address that. We just want to have a name and a phone number and somebody who has got some authority until this new position is up and running.

Mr. LYNN. Let me investigate a little bit the issue, and we will get you a name and a phone number.

Senator WYDEN. One last question, if I might. My State does not have active-duty bases, but we have a tremendous level of participation in the National Guard and Reserves. We have developed a host of programs, yellow- ribbon programs and others, to try to help the troops make the transition. But, unfortunately, there still really is not the kind of transition structure back to civilian life that the Guard and Reserve folks say they need. It seems like it is almost you go from carrying your rifle overseas to carrying your child here, and if you are a Guard member and you are not from an area with a lot of active bases, there is really nowhere to turn. Our Reserve forces get 15 days of pay and benefits before they are essentially hit with the prospect of reduced income and tension in the family and concerns with respect to a transition from serving in the military to being home.

I have introduced a piece of legislation called the Soft Landing bill that is intended to relieve the stress on the warriors who have come back by giving them active-duty benefits for another 45 days in effect so that there could be additional time to make a transition.

What would be your general reaction to something like this, extending the transition time for Guard and Reserve folks when they come back from combat?

Mr. LYNN. Well, I have two contradictory reactions, Senator. First, the issue you identify is a valid one. The transition for Reserve units coming back from the conflicts can often be more difficult because they come back and then disperse, and so they often do not have the same support structure and the same resources that our active-duty units might be able to draw on. So I think there is certainly an issue there.

What you propose in terms of the 45 days of benefits, I do not know what the cost is, but I think it could be relatively substantial. I think we have put 500,000 troops through the conflicts from the Guard and Reserve to this point. So I do not expect our top line to be increased to accommodate that, so the question I would have is what other programs would we have to sacrifice to get this program, which I there is a valid need here, but is this the most cost-effective way to address it would be the question I have.

Senator WYDEN. Well, we will want to have that discussion with you. I think your point is a fair one as well. I think there have been a number of weapons systems that Secretary Gates, for example, has been on something of a crusade to try to say no longer meets the rigorous tests of being cost-effective when you have got to make tough, tough choices. I just want to know what you think of the concept. You have indicated that conceptually we have got a valid point. We will continue to have the budget debate with you. I have introduced the legislation. Thank you for this discussion.

Thank you for the time, Mr. Chairman. I know you have other items, and getting that phone number and name for the matter involving wind will be very helpful, Mr. Secretary. We will continue the discussion with respect to Soft Landing.

Mr. LYNN. Thank you.

Senator WYDEN. Thank you.

Chairman CONRAD. I want to indicate that there are about 4–1/2 minutes left in the vote, so then there are going to be four votes. I see no reason to ask you to stay for four votes. That would be an hour and a half. You have got a lot of other things to do at a time when we have two major conflicts and all the rest that is going on in the world. So I want to thank you for your testimony here today. I want to thank you for your service to the Nation. The Committee appreciates your answers here today, and we may, because of the unusual nature of this truncated hearing, need to submit other questions in writing from colleagues who were not able to be here because of votes on the floor, and I hope that you will respond to those in a timely way. Can we count on your to do that?

Mr. LYNN. Absolutely.

Chairman CONRAD. All right. Thank you very much, and the Committee will stand adjourned.

Mr. LYNN. Thank you, Mr. Chairman.

[Whereupon, at 2:57 p.m., the Committee was adjourned.]

QUESTIONS FOR THE RECORD

CHARRTS No.: SBC-01-001
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Gregg
Witness: HON Lynn
Question: #1

Insourcing

Question: Your testimony states that DOD intends to begin insourcing up to 20,000 jobs into the federal acquisition workforce, that is, converting positions hitherto held by contractors to federal civilian jobs. Ironically, during the almost two decades since the cold war ended, DOD has consistently made efforts to outsource what had once been federal acquisition jobs to the private sector. This was a bipartisan policy pursued both by the Clinton and the Bush administrations. Now DOD is moving in the diametrically opposite direction.* Is the rationale for this policy change primarily to improve oversight of contractor performance, or to save money on the positions themselves?

Answer: The strategy and planned acquisition workforce growth of approximately 20,000 is a key element of DOD's acquisition reform effort to enhance DOD's ability to improve acquisition outcomes, oversee programs, and ensure taxpayer dollars are spent wisely. This includes building sufficient internal capacity to perform and maintain effective control over key acquisition functions.

CHARRTS No.: SBC-01-002
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Gregg
Witness: HON Lynn
Question: #2

Insourcing

Question: Your testimony states that DOD intends to begin insourcing up to 20,000 jobs into the federal acquisition workforce, that is, converting positions hitherto held by contractors to federal civilian jobs. Ironically, during the almost two decades since the cold war ended, DOD has consistently made efforts to outsource what had once been federal acquisition jobs to the private sector. This was a bipartisan policy pursued both by the Clinton and the Bush administrations. Now DOD is moving in the diametrically opposite direction* Have you done estimates on how much money converting 20,000 positions is supposed to save?

Answer: The decision to in-source contracted acquisition support services is not being driven by cost savings. It is intended to rebalance the workforce, rebuild the Department's organic capabilities, and reduce risks by enhancing DOD's ability to improve acquisition outcomes, oversee programs, and ensure taxpayer dollars are spent wisely.

CHARRTS No.: SBC-01-003
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Gregg
Witness: HON Lynn
Question: #3

Insourcing

Question: Your testimony states that DOD intends to begin insourcing up to 20,000 jobs into the federal acquisition workforce, that is, converting positions hitherto held by contractors to federal civilian jobs. Ironically, during the almost two decades since the cold war ended, DOD has consistently made efforts to outsource what had once been federal acquisition jobs to the private sector. This was a bipartisan policy pursued both by the Clinton and the Bush administrations. Now DOD is moving in the diametrically opposite direction.* Previous rationales, whether in Vice President Gore's National Performance Review, or in government management initiatives in the Bush administration, asserted that outsourcing would save money. Were they wrong? Why did outsourcing not succeed in your vie

Answer: Contractors remain a vital source of expertise to the Department and are an integral part of our Total Force. Maintaining contractors to perform certain non-inherently governmental functions continues to be an important cost savings tool for the Department. It is clear that the pendulum swung too far in the direction of outsourcing inherently governmental functions, including entrusting aspects of contractor oversight to contractors. The Department's in-sourcing initiative seeks to rebalance our workforce with the proper mix of contractors and civilians; to rebuild organic capabilities; to reduce operational risk by ensuring that inherently governmental functions that support the readiness/management needs of the Department be performed by government employees.

CHARRTS No.: SBC-01-004
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Gregg
Witness: HON Lynn
Question: #4

Defense Budget Metrics

Question: When he became Chairman of the Joint Chiefs of Staff, Admiral Mullen, said that DOD needed a budget equal to 4 percent of GDP, excluding war supplementals. But that raises the question as to whether share of GDP is an appropriate metric for basing long-range defense planning. It is also a departure from traditional budget planning in DOD, which assumed that present and future threats drove the amount of money needed.* What is the appropriate metric for the defense budget, in your view - should it be some set percentage of GDP or should it be built around real and potential threats?

Answer: The most appropriate metric for long-range defense planning is the U.S. armed forces' ability to achieve the objectives of the defense strategy. This includes prevailing in ongoing conflicts, preventing and deterring threats to the U.S., preparing effectively for the broad range of future challenges, and preserving and enhancing our all-volunteer force.

Required force enhancements should be identified by examining ongoing conflicts, as well as the performance of the current and planned force through combinations of scenarios spanning the range of plausible future challenges, as the Department does in the Quadrennial Defense Review process. In order to determine the mix of military capabilities best suited to supporting the nation's defense strategy, the Secretary, advised by other senior civilian and military leaders within the Department, reviews, modifies, and endorses a set of scenarios that the QDR uses to help evaluate current and potential future forces. The annual defense budget should provide sufficient resources to execute successfully the full range of missions called for in our defense strategy.

Given this threat environment, the United States needs a broad portfolio of military capabilities with maximum versatility across the widest possible spectrum of conflict. The 2010 QDR guidance drove the development and review of the Fiscal Year (FY) 2011 budget proposal and the Department's Future Years Defense Plan (FYDP) FY 2011-2015. The FY 2011 budget proposal represents an increase informed by our defense strategy, and the FYDP puts us on track to resource the priorities enumerated in that strategy properly.

CHARRTS No.: SBC-01-005
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Sessions
Witness: HON Lynn
Question: #5

Question: For nearly a decade we have seen one fiasco after a with the Air Force's aerial tanker competition. The original tanker lease scheme collapsed and people went to prison, and the 2008 competition was invalidated by a GAO protest. This week Aviation Week is saying there is a possibility that one of the two contractors may not even bid on the latest Request for Proposal. That would be a blow to the program and a stain on the DoD acquisition process that could result in a sole-source selection. How confident are you that there will be cost-saving competition on this $35-billion program? You have been quoted as saying that the tanker source-selection process is a "flagship" for acquisition programs. Please explain your rationale for this statement. If only one offeror submits a bid, what actions will you take to ensure the American taxpayers are not unduly charged as a result of this process turning into a sole-source selection?

Answer: The KC-X source selection is indeed a "flagship" for the Department's acquisition reform priorities in terms of clearly stated and stable Warfighter requirements, transparent source selection strategy, and contract structure designed to provide best value to the taxpayer, including, in this case, a fixed-price structure. If there is only one offeror capable of, or willing, to meet the Warfighter's requirements, then we will pursue a fair and reasonable contract with the bidder. On February 3, 2010, the Secretary of Defense stated, "We would like to have a competition ... and we hope that both companies will agree to participate. But we will move forward. We have to have new tankers." In the event only one proposal is received, the USAF will conduct the same evaluation as to whether the proposal meets all Warfighter requirements. Next, the program office would exercise a clause in the Request for Proposal to obtain certified cost and pricing data, which will be audited by Defense Contract Auditing Agency. In addition, the USAF will use any other relevant information available during the negotiation. Finally, the USAF retains the option to not award the contract if a satisfactory agreement cannot be reached in the best interest of both the Warfighter and the taxpayer.

CHARRTS No.: SBC-01-006
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Sessions
Witness: HON Lynn
Question: #6

Question: Baseline defense spending as a percent of GDP has declined from 6% in the early 1980s, to about 3.6% today, despite the United States still having global responsibilities. When AdmiralMullen, the current Chairman of the Joint Chiefs of Staff, was confirmed he said that the United States needed to set baseline defense spending to at least 4% of GDP. Do you believe that weshould set a particular GDP target for baseline defense spending, and if so what should it be?

Answer: The most appropriate metric for long-range defense planning is the U.S. armed forces' ability to achieve the objectives of the defense strategy. This includes prevailing in ongoing conflicts, preventing and deterring threats to the U.S., preparing effectively for the broad range of future challenges, and preserving and enhancing our all-volunteer force.

Required force enhancements should be identified by examining ongoing conflicts, as well as the performance of the current and planned force through combinations of scenarios spanning the range of plausible future challenges, as the Department does in the Quadrennial Defense Review process. In order to determine the mix of military capabilities best suited to supporting the nation's defense strategy, the Secretary, advised by other senior civilian and military leaders within the Department, reviews, modifies, and endorses a set of scenarios that the QDR uses to help evaluate current and potential future forces. The annual defense budget should provide sufficient resources to execute successfully the full range of missions called for in our defense strategy.

Given this threat environment, the United States needs a broad portfolio of military capabilities with maximum versatility across the widest possible spectrum of conflict. The 2010 QDR guidance drove the development and review of the Fiscal Year (FY) 2011 budget proposal and the Department's Future Years Defense Plan (FYDP) FY 2011-2015. The FY 2011 budget proposal represents an increase informed by our defense strategy, and the FYDP puts us on track to resource the priorities enumerated in that strategy properly.

CHARRTS No.: SBC-01-007
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Sessions
Witness: HON Lynn
Question: #7

Question: Despite defense procurement spending being at least as "stimulative" as most government spending, neither last year's $862 billion stimulus bill nor the President's proposed $270 billion stimulus package for this year included any defense procurement spending. Do you believe that including defense procurement items in stimulus bills could kill two birds with one stone-that is provide urgently needed hardware for our military while simultaneously stimulating the economy?

Answer: The FY 2010 enacted Defense budget included $131.2 billion for procurement for both base and Overseas Contingency Operations (OCO) needs and the FY 2010 supplemental budget requests an additional $4.8 billion for procurement. The FY 2011 budget request includes $112.9 billion in the base budget and another $24.6 billion for procurement in the OCO budget. This healthy level of funding provides adequate funding to meet defense requirements and supports the economic benefits targeted by the stimulus bills.

CHARRTS No.: SBC-01-008
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Wyden
Witness: HON Lynn
Question: #8

Question: Under the President's budget, total national defense spending in 2011 would account for 19.4 percent of federal outlays and 53 percent of discretionary outlays. It has become conventional wisdom that the defense budget must continue to rise annually in real terms, just to keep the armed forces sized, equipped, and trained about as they are today. But rising defense budgets should not be thought of as a new law of physics. We can change trends with some critical thought and better application.- To be blunt, why should DoD be exempt from a discretionary spending freeze?

Answer: The nation is engaged in two wars in Iraq and Afghanistan. The FY 2011 base budget request provides the minimum necessary resources to recruit, train, equip, and sustain the force necessary to support the nation's national security needs. The FY 2011 Overseas Contingency Operations budget request provides the necessary resources to support the troops in the field to ensure they can successfully accomplish their mission. To accomplish the nation's national security goals, the modest level of growth reflected in the administration's budget request is necessary.

CHARRTS No.: SBC-01-009
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Wyden
Witness: HON Lynn
Question: #9

Question: Under the President's budget, total national defense spending in 2011 would account for 19.4 percent of federal outlays and 53 percent of discretionary outlays. It has become conventional wisdom that the defense budget must continue to rise annually in real terms, just to keep the armed forces sized, equipped, and trained about as they are today. But rising defense budgets should not be thought of as a new law of physics. We can change trends with some critical thought and better application.- As a follow up, how would DoD respond if procurement budgets were capped at inflationrates?

Answer: Putting artificial caps on any single portion of the defense budget will increase the risk that important defense needs will not be met. The annual defense budget must be balanced based on identified requirements. The Department must be allowed to make appropriate budget tradeoffs between operating costs and investment costs, to include procurement, based on the assessment of both short-term and long-term risks. The Department is faced over the next few years with a real situation of aging equipment across a wide range of mission areas (air, space, ground and sea). In addition, the Department must reset equipment inventories negatively affected by the worn out, damaged and destroyed equipment resulting from the intensive pace of operations in Iraq and Afghanistan. While the budget emphasizes the needs of today, the Department cannot lose sight of modernization requirements, such as a fifth generation tactical aircraft, which will ensure our future warfighters have the best technology available to successfully accomplish their missions.

CHARRTS No.: SBC-01-010
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Wyden
Witness: HON Lynn
Question: #10

Question: Under the President's budget, total national defense spending in 2011 would account for 19.4 percent of federal outlays and 53 percent of discretionary outlays. It has become conventional wisdom that the defense budget must continue to rise annually in real terms, just to keep the armed forces sized, equipped, and trained about as they are today. But rising defense budgets should not be thought of as a new law of physics. We can change trends with some critical thought and better application.- Why are we duplicating training, maintenance, and operations of particular mission capability between service components versus streamlining process and building capability partnerships between the services?

Answer: We have learned from painful experience that the wars we fight are seldom the wars that we plan. As a result, the United States needs a broad portfolio of military capabilities with maximum versatility across the widest possible spectrum of conflict. This strategic reality shaped the QDR's analysis and subsequent conclusions which directly informed the program decisions contained in the FY11 President's Budget and Future Years Defense Plan. Changes directed under the QDR can be broadly characterized by the following trends:

U.S. ground forces will remain capable of full-spectrum operations, with continued focus on capabilities to conduct effective and sustained counterinsurgency, stability, and counterterrorist operations alone and in concert with partners.

U.S. naval forces likewise will continue to be capable of robust forward presence and power projection operations, even as they add capabilities and capacity for working with a wide range of partner navies. The rapid growth in sea- and land-based ballistic missile defense capabilities will help meet the needs of combatant commanders and allies in several regions.

U.S. air forces will become more survivable as large numbers of fifth-generation fighters join the force. Land-based and carrier-based aircraft will need greater average range, flexibility and multi-mission versatility in order to deter and defeat adversaries that are fielding more potent anti-access capabilities. We will also enhance our air forces' contributions to security force assistance operations by fielding within our broader inventory aircraft that are well-suited to training and advising partner air forces.

The United States will continue to increase the capacity of its special operations forces and will enhance their capabilities through the growth of organic enablers and key support assets in the general purpose forces.

The capabilities, flexibility, and robustness of U.S. forces across the board will be improved by fielding more and better enabling systems, including ISR, electronic attack, communications networks, more resilient base infrastructure, and enhanced cyber defenses.

CHARRTS No.: SBC-01-011
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Stabenow
Witness: HON Lynn
Question: #11

Question: In the last 10 years, the U.S. has lost over 5-and-a-half million manufacturing jobs, due to misguided trade policy and a lack of focus on importance of manufacturing to our middle class.The Quadrennial Defense Review (QDR), states that the Pentagon has had a "hands-off' attitude toward the U.S. defense industrial base, a key industry for my state of Michigan. The manufacturing base of the U.S. not only provides our troops with the newest technology, butmuch of that technology is commercialized creating long-term and stable jobs for the middle class. H~ow does the President's Budget correct the hands-off approach of the Pentagon toward manufacturing, and create an environment where our manufacturing industries can thrive in the global marketplace?

Answer: The President's Budget strongly supports manufacturing by providing $107.4 billion in the base budget for Department of Defense procurement, an increase of 5.6% from the previous year. Last year, the Department reported that 98.2% (by value) of contracts for defense items were awarded to domestic manufacturers. In addition to providing a robust source of funding, the Department is taking discreet actions to ensure the industrial base on which it depends is robust and capable. For instance, the Department is conducting assessments on the effects of program terminations on the defense industrial base, and it is taking a very "hands on" approach to sustain specific industrial sectors, such as the solid rocket motor industry, that require direct attention. The Department is committed to being more forward leaning in its ongoing assessments of the industrial base – including closer Department cooperation with the Services to foster an integrated approach to the overall industrial base, with a particular emphasis on the lower tiers; and placing transparency and dialogue with industry at the forefront of its agenda.

CHARRTS No.: SBC-01-012
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Whitehouse
Witness: HON Lynn
Question: #12

Question: According to the Quadrennial Defense Review, over last ten years, DoD's contractual obligations nearly tripled, while the acquisition workforce was reduced by over ten percent. I applaud the President's commitment to adding 20,000 new federal acquisition personnel which will permit DoD and other agencies to do more direct purchasing and to more closely audit contractors for waste and abuse. Is it enough to better manage or should we try to reverse or limit the explosion in outsourcing of the past decade?

Answer: The strategy and planned acquisition workforce growth of approximately 20,000 is a key element of DOD's acquisition reform effort to enhance DOD's ability to improve acquisition outcomes, oversee programs, and ensure taxpayer dollars are spent wisely. The growth is a significant step towards rebalancing and improving the Department's internal capability in the areas of program management, systems engineering, contracting, pricing, cost estimating, and other important acquisition functions. Implementation is underway and Components will make appropriate adjustments. Half of the acquisition workforce growth is associated with in-sourcing contracted services supporting acquisition. While contracted services will continue to be a major element of DOD's Total Force capability, DOD will meet its needs in accordance with 10 U.S.C 2463, "Guidelines and procedures for use of civilian employees to perform Department of Defense functions" and with OMB policy.

CHARRTS No.: SBC-01-013
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Whitehouse
Witness: HON Lynn
Question: #13

Question: The Brookings Institution's Peter Singer estimates that a third of the U.S. Army's operating budget is spent on private military contractors, and the ratio of private contractors to U.S. soldiers on the ground has grown by at least a factor of 10 since the Persian Gulf War. It stands to reason that contractors may be needed to provide specialized services during wartime. However, the growth in DoD contracting over the past ten years is unprecedented. What accounts for the high level of contracting in Iraq and Afghanistan? Are DoD's needs during the current conflicts somehow different in character from the needs during previous wars?

Answer: The U.S. Government military and civilian forces have been downsized significantly over the last 25 years as a result of several U.S. Government policy decisions, including: (1) the shift to an all-volunteer force; (2) an effort to capture a "peace dividend" following the collapse of the Soviet Union; and (3) many service and support functions being outsourced to contractors as a result of Office of Management and Budget (OMB) Circular A-76 and performance-based logistics concepts.

In addition, the increasing technical complexity of DoD weapons systems and equipment requires a level of specialized technical expertise, but of limited scope, that the DoD does not believe can be cost effectively serviced and supported by a military force capability.

The structure of our military forces has adapted to this environment, thereby increasing our dependence on contractor personnel to provide support services both at our home bases and with our deployed forces.

The current Overseas Contingency Operation (OCO) deployments of DoD military forces are the first major contingency operations to reflect the full impact of the shift to reliance on contractor personnel for critical support functions, especially in the areas of logistics, where contractors provide more than 80 percent of the force support. The scale and duration of OCO have required a significant increase in support by contractors and deployment of contractor personnel in forward areas, especially when executive force caps, troop rotation timing and continuity, dwell time policy, and military quality of life issues are considered. Future deployments of DoD military forces are anticipated to require similar levels of support.

CHARRTS No.: SBC-01-014
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Whitehouse
Witness: HON Lynn
Question: #14

Question: You describe in your testimony the escalating costs of the TRICARE program. Please describe the Department's efforts to work with its health plans and provider networks to decrease costs through delivery system reforms, for example through bundled payments to providers and hospitals, pay for performance, payment penalties for readmissions, or other strategies?

Answer: TRICARE has implemented the following provisions to control health care costs for our program:

Outpatient Prospective Payment System (OPPS): TRICARE implemented OPPS on May 1, 2009, to bring reimbursement rates for hospital outpatient services into alignment with Medicare rates. Under this congressional mandate, hospital outpatient services will be reimbursed to the extent practicable in accordance with the same reimbursement rules as apply to payments to providers of services of the same type under Title XVIII of the Social Security Act (42 USC 1395 et seq.). Based upon claims data from the beginning months of TRICARE's OPPS implementation, it is estimated the net cost reductions are about $42.2 million per month ($506.4 million per year). It is also estimated in the first year of implementation of OPPS, Extra and Standard beneficiaries will save about $40 million in reduced cost sharing. This is equivalent to over $100,000 per day. These savings are due to reduced allowable amounts and therefore reduced cost sharing by TRICARE Extra and Standard beneficiaries.

Present on Admission (POA) Indicators: TRICARE has adopted Medicare's Hospital Acquired Conditions (HAC) policy with POA indicators. Conditions are acquired during the hospital stay may result in reimbursement at a lower-level TRICARE diagnosis-related group (DRG) rate. The DRG rate is considered payment in full and the hospital cannot bill the beneficiary for any charges associated with the HAC not present on admission. Effective October 1, 2009, TRICARE may reduce reimbursement when one of the following HACs is not present on admission:

- Serious preventable events (objects left in surgery, air embolism, blood incompatibility);
- Catheter-Associated Urinary Tract Infection;
- Pressure Ulcers Stages III & IV;
- Vascular Catheter-Associated Infection;
- Surgical Site Infection;
- Falls and Trauma;
- Manifestations of Poor Glycemic Control; or
- Deep Vein Thrombosis and Pulmonary Embolism.

<u>Section 707 of the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 2007</u>: In January 2008, the Department clarified the relationship between TRICARE and employer-sponsored group health coverage as required by Section 707 of the NDAA for FY 2007. The law prohibits employers from offering incentives to TRICARE-eligible employees to not enroll or terminate enrollment in an employer-offered group health plan that is or would be primary to TRICARE. We estimate this has saved the Department over $63 million in FY 2009.

Other cost control initiatives put into place include:

- Efforts to discourage inappropriate use of emergency rooms by beneficiaries for urgent care.
- Encouraging the use of the TRICARE Mail Order Pharmacy, the least expensive option to obtain medications outside a military treatment facility.
- Consolidation of two pharmacy contracts into one and six overseas contracts into one, which reduces administrative costs to the program while gaining cost efficiencies through consolidation and competitive pricing.
- Elimination of co-pays for preventive services for Standard beneficiaries to increase individual health status and decrease overall healthcare costs.
- Established a smoking quit line to assist beneficiaries in obtaining healthier lifestyles and reducing the cost of care for unhealthy behaviors.
- Established pay-for-prevention demonstrations to assist beneficiaries in improving their health.

CHARRTS No.: SBC-01-015
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Cornyn
Witness: HON Lynn
Question: #15

Question: On February 8, 2010, a high-ranking Chinese military officer, PLA Major General Luo Yuan, stated in an interview with state-controlled media that China could attack the U.S. "by oblique means and stealthy feints," in retaliation for U.S. arms sales to Taiwan. He went on to say, "Our retaliation should not be restricted to merely military matters, and we should adopt a strategic package of counter-punches covering politics, military affairs, diplomacy and economics to treat both the symptoms and root cause of this disease..., For example, we could sanction them using economic means, such as dumping some U.S. government bonds." China's outward-investment practices are far from transparent, making it difficult to determine exactly how much U.S. debt China actually holds. In light of the apparent intentions of some in the Chinese government in using China's U.S. debt holdings as a potential weapon against the U.S. and a tool to influence U.S. national security policy, such as the sale of arms to Taiwan, would it be wise to take steps to increase the transparency in China's holdings of U.S. debt?

Answer: That question lies outside DoD's cognizance and purview, and I would therefore refer that question to the Department of the Treasury.

CHARRTS No.: SBC-01-016
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Feingold
Witness: HON Lynn
Question: #16

Question: Deputy Secretary Lynn, GAO has recommended that the Defense Department conduct an analysis of alternative aircraft to the V.22 Osprey given the high cost of the aircraft and limitations on its ability to operate safely in high risk environments. GAO noted that replacing some or all of the planned V-22s with a mix of fixed and rotary wing aircraft may better serve our national security interests and be more affordable. Please submit to the Committee an analysis of alternatives as recommended by GAO.

Answer: The Department did not agree with the GAO recommendation. In our formal comments, we stated that, "DoD supports validating required MV-22 quantities and the proper mixture of aircraft, but not by means of a new V-22 alternatives analysis. Planning for all elements of Marine Corps aviation (including required quantities, location and employment of medium lift assets) and total force affordability are reviewed and updated annually in the Marine Aviation Plan. Previous Aviation Plan updates have adjusted required quantities for KC-130Js and AV-8Bs. More recently, the FY09 Aviation Plan addressed the needs created by sustained irregular combat and adjusted CH-53K, AH-1Z and UH-1Y quantities. The Marine Aviation Plan is formulated in a constrained budget environment which ensures that both war fighting needs and affordability are weighed in the derivation of the optimum aviation force structure. Additionally, the Department of the Navy budget is scrutinized yearly by the Office of the Secretary of Defense during Fall programs reviews.

Performance attributes such as parts reliability, aircraft availability and operating costs are monitored and factored into Aviation Plan updates. As more is learned about the MV-22B's achieved performance and how best to employ its inherently transformational capabilities within the Marine Air Ground Task Force, future adjustments to planned quantities of MV-22 may be appropriate."

In a recent status report to the GAO, we submitted the following reply:

"The V-22 program continues to work aggressively to improve V-22 readiness and reduce operating costs. The Government-industry team has a coordinated strategy to address these issues which is spiral in nature and will provide incremental improvements over time. The team is executing this strategy, having improved many aspects of maintainability, improved component reliability, and overall affordability. With the commitment of $24.5M transferred to V-22 readiness accounts in January 2010, we are now accelerating the incorporation of these improvements onto fleet aircraft. Numerous activities are underway, including the following:

- Instituted a Critical Item Logistics Review process to identify top aircraft degraders to determine the specific causes and trends and to prioritize readiness improvement opportunities.

- Established an In-Service Team to systematically prioritize readiness, affordability plans and reliability corrections into fielded and production aircraft. Primary functions include:
    - Identification of cost reduction opportunities, concentrating on material and non-material cost drivers.
    - Realizing savings by selectively revising maintenance concepts. Maintenance Concept Reviews have re-characterized more than 300 high cost consumables as repairable, contributing to reduced operating costs.
    - Prioritized non-recurring engineering efforts have been initiated for component reliability improvement.
    - Component level cost modeling to account for all initiatives.
- In concert with industry partners, the Program Office has aligned organizational structure, strategy and established a readiness "war room" for the centralized coordination of readiness activity.
- Bell and Boeing have established 2010 readiness goals and are incentivizing executive compensation to V-22 readiness.
- In addition to regular oversight of the program through the acquisition chain of command via PEO (A) and ASN(RDA), the Deputy Commandant for Aviation convenes quarterly V-22 Executive Supportability Summits with Bell and Boeing senior leadership participation.
- An Aviation Rapid Action Team has been dispatched to improve repair turn-around times by increasing repair capability at the intermediate maintenance level. These actions will reduce the number of components in the repair pipeline and put more spares back in stock for the Fleet's use.
- Naval Inventory Control Point is breaking out component procurement and repairs with the OEM in efforts to reduce costs associated with prime contractor pass through and profit as part of the normal activity at this point in the life cycle of a program.
- The program is pursuing a Performance Based Logistics supply support contract award in FY 2011 to reduce Total Ownership Cost.

The President's Budget Request for FY 2011 included funding for readiness and affordability improvements. The Program Office, HQMC, and Navy are seeking funding for other readiness degraders as part of developing Program Objective Memorandum 2012. Navy and OSD acquisition offices will review the Program Manager's comprehensive strategy to address aircraft readiness and the Marine Corps funding allocation in the coming months."

CHARRTS No.: SBC-01-017
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Feingold
Witness: HON Hale
Question: #17

Question: Under Secretary Hale, according to GAO and DOD reports, the Department and the Services waste hundreds of millions of dollars annually by purchasing spare parts that are not needed and by failing to recover overpayments to contractors.a. Please outline the steps the Department is taking to reduce wasteful spending on unnecessary spare parts and to increase its rate of recovering overpayments to contractors.b. Please provide a breakdown for both FY08 and FY09 of how much money was spent on unnecessary spare parts or on overpayments that were not recovered.c. Please set a goal for reducing wasteful spending on spare parts and overpayments to contractors and provide the Committee with the projected savings in FY10 and FY11 based on this goal.

Answer: **Response on Unnecessary Spare Parts:** The Department is developing a comprehensive plan for improving inventory management of secondary inventory for the Military Departments and the Defense Logistics Agency. The plan will provide an analysis of key improvement efforts underway and will identify the major changes needed in the Department's policies and processes to transform the way the Department forecasts and holds inventory, balancing risk with cost. The plan will also establish a set of goals and targets to reduce the acquisition and storage of secondary inventory that is excess to the Department's requirements in accordance with the FY2010 NDAA, Section 328. The plan is due to the Congress in July 2010.

Response on Recovering Overpayments to Contractors: It is the policy of DoD that collection of debts owed to the government shall be promptly and aggressively collected, with follow-up action(s) taken as necessary, to recover outstanding debts. The Department follows the Federal Acquisition Regulations (FAR) Subpart 32.6 "Contract Debts" in issuing demand debt letters to contractors/vendors upon identification of an overpayment, in applying interest, penalties, and administrative charges, and in collecting the debts, including offsetting the debt against any other payments otherwise due the contractor. Further, in accordance with the provisions of the Debt Collection Improvement Act of 1996, the Department will transfer any debt that is delinquent more than 180 days to the Department of Treasury for collection.

The Department prevents, identifies, and collects improper payments to contractors through various mechanisms such as recovery and contract auditing. More importantly, the Department focuses on preventing improper payments from occurring in the first place by deploying software tools to review payments before they are made and improving existing internal controls and payment policies and procedures.

- The Department developed and deployed substantive changes to DoD Financial Management Regulations (FMR) that updated and clarified contract payment policies and documentation requirements. One example is a matrix tool to assist certifying officials in identifying the critical data elements necessary to properly certify a payment made in support of a military contingency operation.

- The Department also updated its debt collection policies by developing one FMR chapter to address the implementation of the Improper Payments Information Act and another to institute the Recovery Audit Act; both chapters specifically address improper payments. These changes build on the requirements in the Office of Management and Budget (OMB) Circular No. A-123, Appendix C for the prevention and reporting of improper payments.

In August 2008, DoD began rolling out the Business Activity Monitoring (BAM) software tool to identify and prevent improper payments in DoD's four largest commercial payment systems, which account for 89 percent of all Defense commercial payments. As BAM has matured and reviewers gained additional analytical expertise, more and more improper payments have been prevented. These types of preventative (vs. detective) activities consistently prove to be the most cost-effective. DoD's recovery rate increased from 78 percent in FY 2008 to 87 percent in FY 2009.

- For FY 2008, the Department identified $53.3 million in contract payment errors and recovered $41.7 million, or 78 percent, during the same fiscal year. Collection activity continues.

- DoD disbursed an estimated $351.9 billion in contract payments in FY 2009, of which $47.1 million (less than 2/100ths of 1 percent) was identified as improper payments. More than $41.1 million, or 87 percent, was recovered during the same period, and collection activity continues for the balance.

The Department is currently working with the OMB to set recovery goals as part of the requirements contained in the President's Executive Order 13520, "Reducing Improper Payments" issued in November 2009.

CHARRTS No.: SBC-01-018
Senate Budget Committee
Hearing Date: March 04, 2010
Subject: Hearing on Department of Defense Fiscal Year 2011 Budget Request
Member: Senator Feingold
Witness: HON Lynn
Question: #18

Question: Deputy Secretary Lynn, please provide a list of major defense acquisition programs for which the Department plans to make a production decision prior to or without ensuring that all of the critical technologies of the program have been demonstrated in a realistic environment.

Answer: There are no Major Defense Acquisition Programs for which the Department plans to make a production decision prior to ensuring that all of the critical technologies have been demonstrated in a realistic environment.

○